Canada’s mortgage market benefits from easing financial stains
Should we review our conclusions on available mortgage options?

In March 2009, we published a study to help homebuyers choose a mortgage. After mentioning that almost all of the past studies on this subject showed that choosing variable rate mortgages over a long period was better than opting for fixed rate mortgages, we showed that the latest financial crisis had led to major changes in Canada’s mortgage market. The question therefore deserved another look. The financial crisis and increase in financing costs for financial institutions had prompted the latter to charge an additional 1% over the prime rate on their variable rate mortgages. Under the circumstances and given our economic and financial scenarios, we had concluded that the five-year fixed rate mortgage looked more attractive to a large portion of borrowers.

However, we were well aware that the situation could still change quickly. The last point made in our conclusion read as follows: “The evolving situation in the financial markets could make us review this issue again if more changes hit Canada’s mortgage sector.” Over the past few months, the financial crisis ended and the situation quickly reverted to close to normal. The financing premiums of Canada’s financial institutions dropped sharply, allowing the latter to significantly reduce the additional premium on variable rate mortgages. As a result, we decided to update our March 2009 study to see if we should modify our conclusions.

RECENT CHANGES IN CANADA’S MORTGAGE MARKET
In the past nine months, the situation on international financial markets has changed quite a bit. At the start of March 2009, the financial system was still on the verge of collapsing, menacing to drag many major foreign banks into bankruptcy. The unprecedented efforts made by governments and central banks to restore investor confidence seemed to have failed and the stock markets continued to tumble amid strenuous financial tensions.

The situation made an about-face in the weeks that followed. The details of the U.S. plan to stabilize the financial system provided the spark that finally managed to convince investors that the worst would be avoided. The results were immediate. Stock markets staged a spectacular comeback that is ongoing—the S&P 500 is up more than 60% since reaching its trough. Commodity prices also recovered sharply and all indicators of financial strains retreated close to levels associated with a normal situation (graph 1).

Graph 1 – Canada’s financial conditions have improved remarkably these past few months

* Compared to the average.
Sources: Bank of Canada and Desjardins Economic Studies

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The easing of financial tensions had a positive impact on Canada’s mortgage market. The financing premiums charged to corporations, including financial institutions, fell sharply, which led to a widespread drop in financing costs in an environment where federal bond rates remained very low (graph 2). This drop was passed on to borrowers as the posted rate for a five-year mortgage quickly fell to an unheard-of 5.25%. The drop in financing premiums also helped limit the increase in fixed mortgage rates since last summer despite the onset of increasing bond rates. The five-year mortgage rate has thus seasewed in the past few months, settling at 5.59% by the time we published our study—a level that is still extremely low, historically. For its part, the variable rate benefited from the Bank of Canada’s (BoC) last cut to its key interest rate to drop to 3.25% in April. In addition, the situation’s ongoing improvement convinced the financial institutions to significantly reduce the premium on variable rate mortgages and to once again start granting prime rate variable mortgages if borrowers committed to five year terms. Despite the fact that the BoC’s key rate remained unchanged, the reduced variable rate thus fell from 3.25% to 2.25% this fall (graph 3).

NEW INTEREST COST SIMULATIONS FOR FIXED AND VARIABLE RATE MORTGAGES

In order to weigh the different options available to mortgage borrowers, we will apply the same method as that used in our March 2009 study, i.e. a comparison of interest payments based on different interest rate scenarios. Our calculations, regardless of the type of mortgage involved, are based on a $150,000 mortgage loan with monthly installments of $1,000 over a five-year term. The best mortgage, strictly from a financial standpoint, is simply the one with the lowest interest costs and the highest principal reduction at the end of the term.

For the fixed rate mortgage, the calculation does not require any forecast. At the current posted rate of 5.59%, the total interest cost over five years for our fictitious mortgage would be $38,684. The mortgage balance would therefore be reduced by $21,316 ($60,000 - $38,684). In real life, however, borrowers are usually able to negotiate significant discounts on the posted rate. The scope of the discounts depends on several factors, including the borrower’s financial position and the amount of the loan. With a discount of slightly more than 1%, the total interest cost on a fixed five-year mortgage would be $29,559.

The calculation is a bit more complex for variable rate mortgages. Let’s suppose that a mortgage is taken out at the currently posted reduced variable rate, namely the prime rate. If we assume a stable relationship between the prime rate and the BoC’s key interest rate, the variable mortgage rate would therefore be the target overnight rate, plus 2%. In light of this hypothesis, interest on mortgages can therefore be calculated based on movements in the BoC key rate over the next five years.

If the key rate were to stay at 0.25% for five years, the variable mortgage rate would remain constant at 2.25%. This scenario, which is highly unrealistic, would only generate $14,330 in interest. However, we have to recognize that the key rate will not be able to stay this low forever. We had to experience the worst financial crisis in more than 50 years to convince the BoC to cut its key rate close to the zero mark. Now that the recession appears to be over and the situation on financial markets is getting back to normal, the key rate will begin sooner or later to climb to more normal levels. As such, this scenario will not be retained in our comparisons.

In scenario A, we will use our forecast for Canada’s key rate found in most of our financial publications. Overall, changes in the Canadian economy have been fairly in line with our historical average.
expectations in the past few months as the recession started to give way to a modest recovery. Our scenario for the key rate has not fluctuated very much since March 2009. The BoC should keep its key rate unchanged for several more months. It reiterated its conditional commitment to keeping the rate at 0.25% until mid-2010 and, in our opinion, tightening should only begin at the end of the year. Rates should subsequently climb gradually, stabilizing at 4.25% at the end of 2012. Based on this scenario, the interest applicable to a variable mortgage would reach $30,380, $820 more than that payable on a five-year fixed rate mortgage.

It must be said, however, that interest rate forecasting over a five-year horizon has its share of uncertainty. As a result, we repeated our calculations based on two alternative scenarios. In scenario B, the economic recovery would be more pronounced or the BoC would be more concerned about inflation; Canada’s key interest rate would start to climb as of June 2010, reaching 5% by mid-2012. In this case, the interest payable on a variable rate mortgage would reach $36,087. Our alternative scenario C is based on a lacklustre recovery that would keep inflation pressures at very weak levels. The key rate would only start its ascent as of spring 2011 and stop at only 3.75%. In this scenario, interest would amount to $26,219, a savings of almost $3,300 vs. a five-year fixed rate mortgage. These three variable mortgage rate scenarios are illustrated in graph 4.

AN OPTION THAT’S ENJOYING RENEWED POPULARITY: THE “5-IN-1” MORTGAGE
Another change that took place this year, at least at Desjardins, is the strong return of another mortgage product: the “5-in-1.” With this product, the interest on the mortgage is based on the one-year fixed rate in effect at the beginning of each 12-month period, over a term of five years. This product usually offers clients a substantial rate cut for the first year– we suppose 1.5%–and a more modest discount for the four following years (e.g. 0.5%). This product is a compromise between a five-year fixed rate mortgage and a genuine variable rate mortgage based on the prime rate.

To calculate the cost of the “5-in-1” mortgage, we have to use scenarios for the one-year mortgage rates over the next five years. For the basic scenario, we can use our most recent forecast of retail rates. After a very low rate of 2.00% for the first year, the “5-in-1” rate would climb gradually to reach 5.95% in the last year. Interest rates would therefore reach $28,800 over five years. We also carried out simulations to calculate the cost of the “5-in-1” product based on our alternative scenarios B and C (graph 5).

CONCLUSION: FIXED RATE MORTGAGES DON’T STAND OUT AS MUCH
The results of our simulations are shown in graph 6 (on next page). In scenario A, our basic scenario, the costs of the three mortgage options are similar. The fixed rate option is the winner in scenario B where interest rates move up more quickly. However, if rates stay low for longer than forecast, as illustrated in scenario C, the fixed rate mortgage ends up being the most expensive since the interest payable for this type of mortgage exceeds that of the “5-in-1” option by about $4,500 and that of the variable rate option by about $3,300.

When comparing results with those from our March 2009 study, we can see that the fixed rate option does not stand out as much. This is directly due to the cancellation of the premium on the variable rate vs. the prime rate. The “5-in-1” mortgage also shows that it also a very interesting option, which could explain its renewed popularity. While the variable rate mortgage never looks like the best option in all three cases studied, we can easily imagine a situation where a new round of shocks could hit Canada’s economy, forcing the BoC to keep its key rate at floor levels for much longer than provided for in scenario C. In this case, those who opted for variable rates would come out ahead.
1. Despite the lower premiums on variable rate mortgages, this option doesn’t seem to be the best in today’s environment where interest rates are expected to climb. Over a very long period, for example 25 years, this option could end up doing well, however, as was the case in the decades leading up to the financial crisis of 2007.

2. Strictly from a financial standpoint, it is difficult to choose between the fixed rate mortgage and the “5 in 1”. The choice between these two options should be based on borrowers’ profile and their expectations about interest rates.

3. In the three scenarios, the difference in interest costs was not considerable, so all three mortgage products studied seem to represent three reasonable options. Some hybrid products, that split the mortgage into one fixed rate portion and one variable rate portion, also deserved to be considered.

4. Borrowers who opt for a variable rate mortgage or the “5-in-1” product must understand that the interest rate on their loan will only increase in the years to come and that these increases could be significant.

5. For borrowers who have a certain aversion to risk, the five-year fixed rate mortgage offers some peace of mind. This feature is even more appealing in an environment where movements in the financial markets are imbued with uncertainty. While this kind of built-in insurance against rate hikes was at times very expensive in the past, the cost of this insurance today is close to zero, since our simulations do not indicate that a fixed mortgage will be more expensive than other options in the next five years.

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