Fixed rate, variable rate or both: How to choose the right type of mortgage rate for you

Whether you are acquiring, renewing or refinancing your mortgage, one of the biggest decisions you face as a homeowner is choosing between a fixed or variable rate mortgage.

Choosing between a fixed or variable rate mortgage is not a simple decision, which is why many people are looking for advice to help them decide which mortgage interest type is best for them based on their personal circumstances.

You can choose to go with a stable, fixed rate mortgage. Or, you may feel more comfortable with the risks and potential rewards of a variable rate mortgage. For the "best of both worlds," you might decide on a mortgage that combines both interest types. It really depends on your tolerance for risk, as well as your current goals and the life stage you are in.

Here is some information about each option to help you make the right choice.

The case for fixed rate

Fixed rate mortgages are chosen because of the high level of stability they provide. A fixed rate mortgage offers the security of locking in your interest rate for the term of your mortgage. This means you'll know exactly how much principal and interest you will be paying on each regular mortgage payment throughout the term you select.

The main advantage of selecting a mortgage with a fixed interest rate is that you can depend on an interest rate that stays the same during the term of the mortgage. The down side is that you can't take advantage of a lower interest rate — and the ability to have more of your payment go towards the principal and less to interest — if interest rates drop during the term of your mortgage.

The case for variable rates

Many Canadians shy away from the option of a variable rate mortgage because of the potential risk of rate increases. However, while there is always a risk of interest rate fluctuations, this concern may be less of a factor than you may think, and there are other reasons to consider a variable rate mortgage.

Many Canadian economic experts believe that a mortgage rate that varies with fluctuations in the bank's prime rate will offer the greatest advantage when it comes to long-term savings on interest costs. Examining Canadian mortgage rate data from 1950 – 2007, Dr. Moshe Milevsky, Associate Professor of Finance at York University, found:

- Choosing a variable rate mortgage would have saved Canadians $20,000 in interest payments over 15 years (based on a $100,000 mortgage); and
- Canadians would have been better off with a variable rate mortgage compared to a five-year fixed rate 89% of the time[1].

With a variable rate mortgage

- Regular mortgage payments are set for the term, even though interest rates may fluctuate during that time.
- When rates go down, an increased amount of your payment goes to pay the principal. With more going into your principal, the less interest you pay, and the faster the mortgage is paid off.
- When rates go up, you'll see an increase in the portion of payment that goes into paying the interest. With less going into the principal, the amortization period is extended.
- Typically, variable rates include some of the lowest rates available.
- Variable rates offer you the freedom to convert any time to a fixed rate mortgage with a term that's at least as long as the one remaining on the mortgage.

The case for both fixed and variable rates in one mortgage

Not sure about putting all your eggs in one basket? Now you don't have to. If you have sufficient equity in your home, the RBC Homeline Plan® might be for you. It gives you the flexibility to choose both fixed and variable rate options, all in one plan.

You can split your mortgage between fixed and variable rates with different terms and maturities in order to benefit from potential interest savings and the security of a predictable rate. Whether rates remain stable or fluctuate, this strategy reduces the risk of making a bad decision and could save you thousands of dollars in interest costs over the life of your mortgage.

Variable rate versus fixed rate versus both: Which should you take?

Your RBC® mobile mortgage specialist can advise you on the current rates offered by RBC Royal Bank® and help you decide which mortgage option best fits your situation and risk tolerance. To help you start thinking about what's right for you, here are some general guidelines to consider:

A fixed rate mortgage is best for you if...

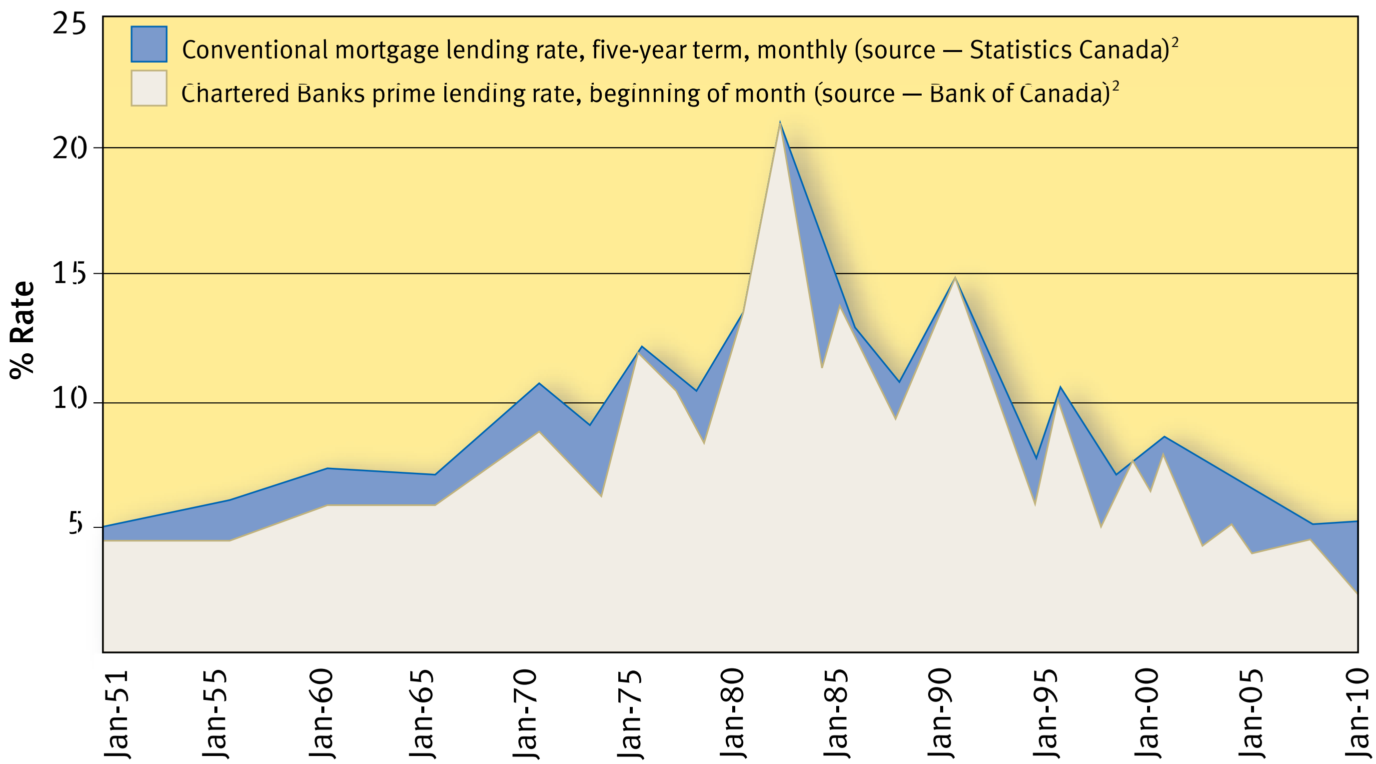
- You enjoy the security of a rate that is guaranteed not to change for the term of the mortgage and are willing to pay a slightly higher interest rate for that security
- You prefer the peace of mind of predictable mortgage payments and amortization that are guaranteed not to change during the term of your mortgage

A variable rate mortgage is best for you if...

- You are comfortable with rate fluctuations to gain possible long term interest savings
- You have the flexibility to accept possible increases in your amortization should the interest rate increase
- Regular mortgage payments are set for the term, even though interest rates may fluctuate during that time

An RBC Homeline Plan is for you if...

- You are concerned about future interest rates and want to enjoy the security of a fixed rate, while wanting the potential long term savings of a variable rate mortgage
- You have sufficient equity in your home that default insurance is not required
- You want the best of both worlds



Fixed rate observations

By taking a look at the chart, you can see that except for a brief period of volatility between 1980 and 1984, the five-year rate stayed between 5% and 7% between 1951 and 2010. The chart shows how a fixed rate mortgage can have both a positive and negative impact over the long term. When rates moved up, those with a fixed rate were protected against fluctuations while when rates moved down those with fixed rates did not receive the benefit of lower interest rates. With a fixed rate mortgage, amortization remains constant despite rate fluctuations.

Variable rate observations

The primary concern clients have with variable rate mortgages is the risk of interest rate fluctuations in an environment of increasing rates. As you can see, since the early 1980's, there has been a declining trend in prime rates[†] overall, which has favoured clients who chose variable terms. However, the opposite was true through the 1970's and early 1980's when prime rates increased. Interest rates have been exceptionally low through 2009 and early 2010 and it is widely anticipated that they will start to increase in the second half of 2010. This may favour locking in a fixed rate today over choosing a variable rate.

Choosing both a fixed and variable rate

If you are unsure about your level of risk tolerance for rate fluctuations, choosing both allows you to take advantage of the lower interest rate of a variable rate mortgage and the security of a fixed rate mortgage.

Selecting the mortgage rate that works for you

The reality is no one can be certain what the future holds. Rather than trying to guess where rates are headed, it's best to consider your own situation. The life stage you are in, your current goals, your objectives and your tolerance to risk all come into play.

The important thing to remember is you are not alone in making a decision. RBC mobile mortgage specialists are trained to work with you to provide you with the mortgage advice you need to make the right decision based on your needs and your lifestyle.

For more information on finding the best mortgage rate fit based on your personal objectives and tolerance to risk, please call your mortgage specialist today or 1-800-769-2511.

All residential mortgages and lending products are offered by Royal Bank of Canada.

† Prime rates announced by the major Canadian banks.

1 Dr. Moshe Milevsky, Associate Professor of Finance, Schulich School of Business, York University, "*Mortgage Financing 2007: What Now?*" 2007.

2 Source for Conventional mortgage lending rate and Chartered banks prime lending rate is Bank of Canada.

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