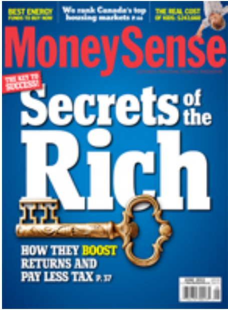
Insulate against interest rate shock

Rather than just shop for a great rate, I looked for a mortgage broker that understood or long-term goals. The result: a plan that would help us save more than $100,000 and protect us from the interest rate shock.

By Romana-King-Blog | Online only, 10/06/11



Despite everything I know, when I bought my new house I really felt the belt-and-suspenders part of my personality kick in.

Yes, a variable rate mortgage makes sense in this current environment, but rates will go up. And my conservative right-brain logic was demanding an answer: How do we insulate ourselves from rising rates?

My mortgage broker, Nawar Naji, had the perfect solution: hedge.

Nawar, a former engineer turned independent mortgage broker and real estate investor, explained that by opting for a five-year closed variable (with all the bells and whistles) we could then insulate ourselves from rising interest rates with additional monthly or annual payments.

I'm not unfamiliar with this strategy—I wrote about this strategy when I offered would-be homebuyers a method for selecting between a variable or a fixed-rate mortgage.

The idea is pay the fixed rate, while opting for the variable rate mortgage, with the increased payments insulating you from the shock of future interest rate hikes.

For example, if I were to walk into a bank and set up a fixed-rate mortgage (under a "set it and forget it strategy," as Nawar calls it) I would end up paying $1,584 per month. At the end of the five-year term I would've paid just over $33,000 against the principal of the loan. At that point, however, I would have to renew my mortgage. Assuming rates rose by 0.75% each year for those five years, my renewal rate would be 5.75%, or an increase of $329 per month.

"What the inflation hedge does is spread that interest rate shock over the five years of your mortgage term, which helps absorb the payment shock," explains Nawar.

This means dividing the potential interest rate shock (in this case $329) by the length of your mortgage term (in this case five years) to determine how much you should add to your payments each year ($329/5 = $65.80).

Now, if I were to stick with a fixed rate mortgage, this would mean paying $1,584 each month in the first year; $1,649 each month in the second year; $1,715 each month in the third year; $1,781 in the fourth year and $1,847 in the final and fifth year.

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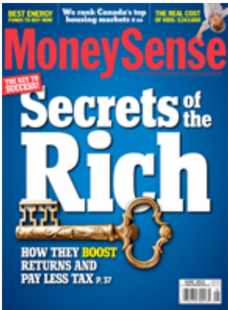

By the end of the five years I would have paid just over $41,000 against the principal (or added more than $8,000 to my equity share in the home).

Sounds good, right?

It gets better.

According to Nawar: homeowners can save even more by locking in a variable rate mortgage, but paying the fixed rate and using the hedge strategy.

For instance, in the first year I could pay the $1,296 variable rate but to increase the equity in my home I'll pay the fixed rate of $1,584. Then each year, I tack on the additional $65 to the monthly payments. By the end of five years I would've paid more than $45,000 against the principal and be five years ahead on the amortization schedule, which would save me approximately $95,000 in payments, according to Nawar. In the end, Nawar's strategy will save me almost $110,000. Not bad for a little planning.

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