Navigating rising rates

Ensure your household budget measures up in the face of rising interest rates.

For years, interest rates in Canada have been at record lows allowing for affordable borrowing through mortgages, car loans and lines of credit. Many Canadians took advantage of the "sale" on debt to spend more, but recent interest rate hikes were a wake-up call for those carrying large debt loads. Here's what they mean – and how to prepare for potential future rate increases.

In 2017, after seven years of historically low interest rates, the Bank of Canada raised its key interest rates twice – from 0.50 per cent to 0.75 per cent in July, and then again to 1.00 per cent in September. These increases were followed by another hike to 1.25 per cent in January 2018.[1] Banks and financial institutions followed, and most prime lending rates rose incrementally from 2.70 per cent to 3.45 per cent.[2] Although interest rates are still relatively low, this sparked a flurry of discussion among financial experts. What will happen if rates rise a full percentage point? How about two? Are Canadians prepared for continued increases?

Research conducted by Manulife Bank suggests that many Canadians aren't in a position to absorb a significant interest rate increase. Seven in 10 Canadian homeowners say they could not manage a 10 per cent rise in their mortgage payments. And nearly one in four haven't had enough money to pay bills at least once in the past 12 months.[3]

Yet, Canadians have good intentions when it comes to debt – 64 per cent say that being debt-free is a top financial priority. And almost half of Canadians with debt succeeded in reducing their debt in the past year – though just 31 per cent met their debt reduction goals.[4]

Some smart strategies can help make your household finances more resilient, so you're ready to adapt to potentially rising interest rates. First, it's important to understand how higher rates may affect you.

The impact of higher rates on debt

The recent rate increases were predicted to add about $50 to $150 more per month for a household with a $480,000 variable rate mortgage.[5] The impact may, of course, be significantly higher or lower depending on the amount and structure of the debt. Canadians who have stretched to take on larger mortgages or increased their lines of credit may find that their household budgets have been greatly impacted by the interest rate increases.

Note: interest rate information accessed March 2018. Rates are accurate as of press time.

[1] http://www.bankofcanada.ca/core-functions/monetary-policy/key-interest-rate/
[2] http://www.cbc.ca/news/business/bank-of-canada-rate-decision-1.4490918
[3] http://www.manulife.com/Master-Article-Detail?content_id=a0Q5000000MeTiIEAF&sAnalyticsPageInfoSiteSectionPath=News&lpos=0
[4] http://www.manulifebank.ca/debtresearch
[5] http://www.thestar.com/business/economy/2017/09/06/rising-interest-rates-a-warning-to-consumers-that-low-rates-arent-permanent.html

Here's a more detailed look at the impact of a key interest rate increase on common types of debt.

Mortgages

Mortgages may have a variable rate or a fixed rate. Payments on a variable rate mortgage will rise almost immediately, as lenders react to changes in the key interest rate. Payments on a fixed rate mortgage won't change until renewal. It's important to note that if the fixed rate was set five or more years ago, it may actually be higher than current fixed rates. In that case, renewal could be an opportunity to reduce payments.

Lines of credit

Most lines of credit, including home equity lines of credit, have a variable rate. Often, the lender only requires borrowers to pay the interest that is due each month – but these interest payments won't make a dent in the principal. If the variable interest rate rises, payments will rise, too.

Student loans

Student loans that have a variable rate will rise with increases in the key interest rate, making it more of a challenge to pay off. A student loan with a fixed rate won't rise; however, the risk is for those who are about to start making payments, generally required six months after finishing school, and who may have to lock in at a higher fixed rate.

Car loans

Car loans generally have fixed payments, but may come with either a variable or a fixed rate. For a variable rate car loan, payments will stay the same as the key interest rate rises, but the amortization period (the length of time before the loan is paid off) will stretch further into the future.

Credit cards

Most credit cards charge a fixed rate of interest, which won't change with the key interest rate. However, this may still be the most expensive loan for many Canadians. Those who carry a balance on their credit cards should consider paying off this type of debt first.

Run the numbers for your household

Earlier, we looked at the potential costs of recent interest rate increases. Now, let's look at the impact of a three per cent interest rate increase on a household with $278,748 in mortgage debt, a $6,000 personal loan, a $10,000 car loan and a $6,500 credit card balance:[6]

- A variable rate $278,748 mortgage rising to 6.1 from 3.1 per cent would cost $457 more each month
- A variable rate $6,000 personal loan rising to 7.75 from 4.75 per cent would cost $9 more each month
- A fixed rate $10,000 car loan and fixed rate $6,500 credit card balance, while not affected by a rate increase, would require the same payments from a depleted household budget

In this scenario, the additional monthly cost would be $466, or $5,592 per year. Even if interest rates rise just one per cent, the additional monthly cost would be $148, or $1,776 per year. Without a plan of action, many Canadians would find it difficult to manage an extra expense of that size.

Make your household finances more resilient

Overall, less debt means less vulnerability to interest rate increases. Consider strategies that can help you reduce what you owe by paying it down as fast as possible. One way is by consolidating higher-interest debts at a lower interest rate. Another is reducing expenses and putting that money towards debt repayment – trim or eliminate discretionary costs, or defer big expenses such as a home renovation.

Extra money from reducing expenses could also be directed towards building an emergency fund that will be there to help manage additional annual costs associated with rising rates.

Seeing in black and white what debt is costing you today, and what it could cost you if rates rise in the future, is great motivation to eliminate it. Talk to your advisor about creating a customized plan to reduce your household's debt. Moving towards debt freedom will put you in a stronger financial position whether interest rates rise or not. ■

[6] http://www.canada.ca/en/financial-consumer-agency/services/interest-rates-rise.html?wbdisable=true

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