



Debt check-up: Are you at risk if interest rates rise?

Interest rates are at all-time lows in Canada, but they are likely to rise at some point. When they do, you can expect that your debt payments will increase if:

- you have a mortgage, a line of credit or other loans with variable interest rates, or
- you are nearing the end of the term on a fixed interest-rate mortgage or loan and will need to renew it.

Have you risk-proofed your budget to ensure you can manage future increases in your debt payments? If you are already close to the maximum payments you can afford, it's time to think about how you can prepare to manage your debt if interest rates and your payments increase.

Example: Impact of interest rate increases

Sofia and Lucas bought their first home for \$320,000 in 2010.¹ They had a \$32,000 down payment (10 percent), so they needed mortgage default insurance, which brought their mortgage loan to \$293,760. They chose a variable interest-rate mortgage for a five-year term, with a 25-year amortization period. They also have other debts, as shown below.

**Example:
Impact of
interest rate
increases
(continued)**

They have been making all their payments, but they have trouble putting aside money for savings. They are starting to worry about what would happen if interest rates on their mortgage and some of their other debts increase. They decide to check how interest rate increases of 0.5%, 1%, 2% and 3% would affect them.

Mortgage:

After two years, the outstanding balance on Sofia and Lucas' mortgage is now \$277,658, with 23 years remaining on the amortization period. The **variable** interest rate is currently set at 3.1%.² Their current monthly mortgage payment is \$1,405.

Car loan:

The current balance is \$10,000, with three years remaining on the term. The interest rate is **fixed** at 5.5%², and monthly payments are \$302.

Personal loan:

Lucas has a personal loan of \$6,000 to be paid off in two years, with a **variable** interest rate currently set at 4.75%² and a monthly payment of \$262.

Credit card debt:

The couple is carrying \$6,500 in credit card debt, with an interest rate of 19.9%.² They aim to pay it off within two years by making monthly payments of \$328. (This assumes that they do not add any new charges to the credit card during that time, and that the interest rate stays the same.)

Description	Balance	Current interest rate	Amort-ization or repayment period	Current monthly payment	Monthly payment if interest rate increases:			
					+ 0.5%	+ 1%	+ 2%	+ 3%
Mortgage costs								
Mortgage	\$277,658	3.1%	23 years	\$1,405	\$1,477	\$1,550	\$1,702	\$1,861
Dettes à taux d'intérêt variable								
Personal loan, variable rate	\$6,000	4.75%	2 years	\$262	\$264	\$265	\$268	\$270
Other debt payments: fixed interest rate or unlikely to be affected by 0.5%–3% increase								
Car loan	\$10,000	5.5%	3 years	\$302	\$302	\$302	\$302	\$302
Credit card	\$6,500	19.9%	Target repayment in 2 years	\$328	\$328	\$328	\$328	\$328
Total monthly debt payments				\$2,297	\$2,371	\$2,445	\$2,600	\$2,761
Increase in monthly costs				----	\$74	\$148	\$303	\$464

Sofia and Lucas were surprised to see that if interest rates increase by 1%, they will have to find almost \$150 in their monthly budget to cover the higher costs. If rates rise by 3%, their monthly payments will be over \$450 higher.

Sofia and Lucas decide that they are outside their financial comfort zone. They consider options to have more money available to repay debts and save for their goals.

Tips

- If you have debts with high interest rates, such as credit cards, consider consolidating your debts in a loan with a lower rate, BUT
 - keep your payments the same, and
 - avoid taking on any more debt.

This will help you reduce your debt levels faster, since more of your payment will go toward the principal.

- Paying off your debt with the highest interest rate first will reduce the amount you are paying in interest and help you reduce your debts more quickly.
- If you are considering borrowing more, take a close look at how it would impact your payments, your budget and your ability to save for other goals. Stay within your comfort zone.
- You are in the danger zone if:
 - you are already having trouble making your debt payments, or
 - you are close to your limit and would have trouble making higher payments if interest rates increase.

To reduce your risk, review your budget with a goal of reducing your spending, so that you have more money available to repay debts.

- Remember that getting the biggest mortgage or line of credit that you are offered may push your financial limits. Leaving some room to deal with the unexpected will reduce the stress on your finances—and your nerves.
- To increase your debt repayments, consider ways you could increase your household income.
- It's also a good idea to ensure you have an emergency fund of at least three months' living expenses to deal with unexpected situations.

Worksheet

- Use the table below to calculate your current monthly mortgage costs and debt payments.
- Talk to your lenders to find out how much your payments would increase if interest rates rise by 0.5%, 1%, 2% and 3%.
- Look at how the higher payments would impact your monthly budget and your ability to save for your goals.
- If you are outside your comfort zone, look at how you can reduce expenses or earn more money to pay off your debt faster.

Description	Balance	Current interest rate	Amortization or repayment period	Current monthly payment
Mortgage and housing costs				
Mortgage				
Condo fees (include 50% of total cost)			N/A	
Debts with variable interest rates				
Home equity line of credit				
Personal loan, variable interest rate				
Other debt payments: fixed interest rate or unlikely to be affected by 1%–3% increase				
Personal loan, fixed interest rate				
Credit card				
Car loan				
Total monthly debt payments				
Monthly household income				

Keep your debts in check—Your financial health depends on it!

Other FCAC information of interest

Tip sheets

- How to Beat that Debt
- Managing Debt: Getting Help from a Credit Counselling Agency
- Making a Budget and Sticking to It
- Buying and Maintaining a Home: Planning Your Housing Budget
- Understanding Variable Interest Rate Mortgages
- Be Smart with Your Credit Card: Tips to Help You Use Your Credit Card Wisely

Publications

- Paying Off Your Mortgage Faster
- Credit Cards: Understanding Your Rights and Your Responsibilities
- Understanding Your Credit Report and Credit Score

Interactive tools and other Web resources

- Budget Calculator
- Credit Card Selector Tool
- Mortgage Calculator Tool
- Dealing with Debt (life event)

References:

¹ The average price of homes sold in Canada in 2010 was \$339,045, based on Canadian Real Estate Association data. A lower figure of \$320,000 is used in this example.

² Interest rates used in this example are representative of interest rates for these financial products as of May 2012.


About Financial Consumer Agency of Canada (FCAC)

With educational materials and interactive tools, the Financial Consumer Agency of Canada (FCAC) provides objective information about financial products and services to help Canadians increase their financial knowledge and confidence in managing their personal finances. FCAC informs consumers about their rights and responsibilities when dealing with banks and federally regulated trust, loan and insurance companies. FCAC also makes sure that federally regulated financial institutions, payment card network operators and external complaints bodies comply with legislation and industry commitments intended to protect consumers.

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