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How Interest Rates Affect Your Costs

It's not rocket-science. The more you have to pay in interest, the more your mortgage will cost you over it's life. But most people don't realize just how much difference even a small difference in interest rate can make, particularly if you've amortized your mortgage for 20 years or more.

Let's look at the interest you'll pay on a $200,000 mortgage amortized for 20, 25, 30 and 40 years, at a variety of interest rates to see what the difference looks like:

Amortization	5%	5.5%	6%	7%
20 years	$115,500	$128,500	$141,800	$169,200
25 years	150,000	166,200	183,900	220,200
30 years	184,300	206,000	228,300	274,200
40 years	259,700	291,100	323,300	389,600

If you borrow at 5% and amortize for 25 years, your $200,000 mortgage will cost $150,000 (or ¾ of your original purchase price). If your rate is just half a point more, your cost jumps by $16,000. At a point more - 6% -- your cost jumps to almost $34,000 more. And at 2 points more, your cost jumps more than $70,000, more than doubling the cost of your home. So just a two-point difference in cost means more than $70,000 in additional interest costs.

At this point I want to say something about "equity." This word bugs me, not because the word is bad, but because people are dumb and don't understand how it works. Equity is the difference between what you pay for your home and what your home is currently worth. Most people take that to mean "what you paid when you bought your home." But that's not true. It's what you paid when you bought your home, PLUS your financing costs to date.

If you take the dumb approach to calculating equity, then you're deluding yourself into thinking your home is making yourself richer than it is. If you buy a home for $200,000, average 6% on your mortgage and amortize it over 20 years, at the end your home must be worth more than $341,000 for you to BREAK EVEN. That means you must have an average return of 8.5% a year on your home just to break even. And that's without property taxes or upkeep calculated into your "costs."

Hey, let's say you amortized for 40 years. How much would your house have to be worth for you to break even? Well, that'd be $523,000. Yup. Over half a million bucks and you'd just be breaking even. Ouch.

As you can see, how long you amortize your mortgage for has a big impact on your overall interest costs. A $200,000 mortgage at 5% will cost you $115,500 if amortized for 20 years, but will cost $13,000 more at a half-point higher. Amortize that mortgage for 40 years, and that half-point difference in interest rate will end up costing you over $31,000 more in interest.

Want to do some of these calculations for yourself. Here's a good calculator (link: http://www.lendingmax.ca/calculator.php) to use. If you just want to see what various mortgages will cost, make sure you put the same number of months in for both term and amortization.

So what affects the interest rate you end up paying on your mortgage. Market conditions, of course. There are times when rates are higher or lower, rising or falling. Here's a good article on interest rates for your reading pleasure. But there are other factors that affect the rate you'll pay ranging from whether you choose:

- an open or closed mortgage
- a fixed-rate or variable-rate mortgage
- a short or long term for your mortgage
- a regular or accelerated payment option.

And, of course, how worthy you are as a borrower, as shown in your credit history or by your credit score, will also affect the rate you end up paying.

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