Mortgaging your future

Mortgages with long amortizations can be very costly

BY MONICA TOWNSON

When newlyweds and new homebuyers Mark Cohen and Daniela Ferri went shopping for a mortgage recently, they chose a mortgage with the traditional 25-year amortization period. Although long-term mortgages — think: 40 years — offer low monthly payments, Cohen, 29, and Ferri, 28, were more concerned about the total amount of interest they'll pay over the life of their mortgage than keeping payments low now.

"We were advised to make payments as fast as we can," says Cohen, a public relations and marketing consultant, "because that makes the most sense long-term, financially."

With two incomes to put toward the mortgage payments — Ferri is a communications consultant — the couple have also talked about using extra cash to pay down the principal. It's a strategy that makes sense: if the couple pay off their mortgage as quickly as possible, they will knock hundreds of thousands of dollars off the cost of buying their home. It's short-term pain for long-term gain.

"This is our primary asset," Cohen adds. "We're less concerned about investing in stocks and bonds. This is our home."

Taking on a mortgage with a 40-year amortization period — often with no down payment — and low monthly payments has been a quick and easy way for first-time homebuyers to enter the housing market. But this can be a dangerous strategy; in fact, this past summer, the federal government — anxious to "reduce the risk of a U.S. real estate bubble developing in Canada," — announced measures to crack down on 40-year amortizations with no down payments.

As of Oct. 15, 2008, the maximum amortization period for government-backed mortgages will be 35 years and a minimum down payment of 5% of the purchase price of the home will be required. Several financial services institutions, including CIBC and Bank of Montreal, have announced they will no longer issue 40-year mortgages.

However, amortizations of 30 to 35 years are still available, and some experts suggest that they will become the choice of many prospective homebuyers.

But, as Cohen and Ferri have figured out, those borrowers who go this route

A QUESTION OF INSURANCE

When you borrow big money on a home mortgage, the issue of mortgage insurance will be front and centre.

If your down payment is less than 20% — formerly 25% — of the price of the home you are buying, you will be required to have mortgage insurance. This is designed to protect the mortgage lender in case you default on your mortgage. Only Canada Mortgage and Housing Corp. and Genworth Mortgage Insurance Corp. provide this insurance, and the cost — based on a percentage of the amount borrowed for your mortgage — is tacked on to your total mortgage amount. Your mortgage lender will arrange this insurance.

Coming up with the biggest down payment you can will help you avoid the additional cost of this insurance, which can add quite a bit to the cost of your mortgage. And as the payment is spread over time, it will add to your total interest costs, too.

But do you need other kinds of mortgage insurance? For example, your financial services institution will probably offer life insurance that will pay off your mortgage completely if you die while amounts are still outstanding. (See story on page 72.) Most homebuyers will want to have life insurance so that a surviving spouse will not be forced to sell the home if one of the partners dies unexpectedly.

The lender may also offer disability and job-loss insurance that would cover mortgage payments if you become disabled or lose your job. (See story on page 66.) Conditions vary and restrictions may apply to this type of policy; there may also be limits to the amount covered. But should you buy insurance from the mortgage lender? It may be convenient, but financial advisors say it's not necessarily the best option.

"Never buy life insurance from the financial institution," says financial advisor Cynthia Kett, a principal with Toronto-based Stewart & Kett Financial Advisors Inc. Apart from the fact that rates banks charge for such insurance may be higher, she points out that the amount covered goes down as your mortgage is paid off, but the premiums stay the same.

"I'd rather see someone buy their own term life insurance," Kett says. That way, the amount of coverage is maintained even as you pay down your mortgage.

Purchasing individual disability insurance, however, can also be expensive. To get a lower rate, Kett suggests joining a group — for instance, a professional association or an organization such as the Canadian Automobile Association.

Toronto-based financial advisor Aileen Pollock, owner of Pollock Financial, suggests individual coverage may be even cheaper for someone who is in good health. The cost of group coverage, says Pollock, is based on the assumed health of all members of the group. As well, she notes, buying insurance coverage from the financial services institution holding your mortgage may present difficulties if you want to change financial services institutions at some point and your health has declined. You may then be unable to get coverage or you may have to pay more for it.

face huge interest costs.

For example, say you had opted for a 40-year amortization when they were widely available. On a $250,000 mortgage at a 6.5% interest rate, you would pay about $200 a month less by opting for a 40-year mortgage instead of one with a 25-year amortization, says Phil Soper, president and CEO of Royal LePage Real Estate Services in Toronto. But if you took the entire 40 years to pay it off, you would pay $445,000 in interest, vs $252,000 in interest if the mortgage were amortized over 25 years.

Nor is it safe to assume house prices in Canada will keep on going up, so that at some point in the future you could switch to a shorter-term amortization and pay down the mortgage faster.

When Cohen and Ferri were shopping for their mortgage, they turned to a friend who is a mortgage broker to get the best deal. Their condo cost $314,000 and they had a $40,000 down payment. Because their down payment was less than 20% of the condo's price, they had to have mortgage insurance, which cost about $6,000. "It's tacked on to the mortgage, so you don't really feel it," Cohen says.

And the couple chose a fixed-rate mortgage with a five-year term. At the time they bought, a variable-rate mortgage would have cost more than 6%, while the bank offered them a fixed rate at 4.93%. "We realized it was a good deal," Cohen says. "I'm more comfortable with minimizing the risk and knowing what my rate will be month to month."

Even before the government cracked down on 40-year mortgages, many financial planners were advising against them, especially interest-only mortgages, as some borrowers were taking. In an uncertain economic climate, says Cynthia Kett, a principal with Stewart & Kett Financial Advisors Inc. in Toronto, they are dangerous. "It encourages people to spend beyond their means," she says. "If the houses are too expensive, they shouldn't be buying them."

As well, Kett warns, people need to think ahead about their retirement plans. Most want to have their homes paid off before they retire — they do not want to be making mortgage payments out of their pension income, as they could be if their mortgages go for 40 years.

Financial advisor Aileen Pollock of Toronto-based Pollock Financial says a long-term mortgage gives people a false sense of accomplishment. "They have a home and they can afford the payments," she says. "But over the years, they're really going to pay though the nose. It's a deterrent to one's financial objectives."

That said, some experts say there are instances in which longer-amortization mortgages may be appropriate. Bernice Dunsby, senior manager, home equity client acquisition, with Royal Bank of Canada in Toronto, says such amortizations might fit the bill for a young professional couple in the early stages of their careers. "If they know their cash flow will increase over time," she says, "a longer mortgage will allow them to get into a home sooner."

With lower payments, they can buy the home of their dreams, she points out. And they might not stick with a longer amortization, taking advantage of prepayment options to pay down their mortgage faster as their cash flow increases.

However, Dunsby cautions, "Even though lower mortgage payments might look appealing now, in the long run, it will cost them more."

As for choosing the type of mortgage, Dunsby notes rates on open mortgages (which you can pay off in whole or in part anytime without penalty) are generally higher than for closed mortgages (a penalty is charged if the loan is paid off or renegotiated prior to the end of term). This added prepayment flexibility can make an open mortgage as much as three percentage points more than a closed mortgage. So, says Kett, if there's no way you can pay much off the principal during the term of the mortgage, go with a closed mortgage.

Then you have a choice of a fixed-rate or variable-rate mortgage. With the latter, if interest rates go down, more of the payment is applied to reduce the principal; if rates go up, more of the payment is applied to payment of interest. Many people prefer a fixed rate because they know what their regular mortgage payments will be. You can also opt to have part of your mortgage at a fixed rate and the rest at a variable rate.

Kett believes homebuyers should go for a conventional mortgage and save the full 20% for a down payment, so that they can avoid having to buy mortgage insurance. "And if they have to spend less to accumulate that down payment," she says, "that's what it's like to own a house."

As for interest rates, Kett suggests using a mortgage broker — as Cohen and Ferri did — who will survey lenders to get you the best rate. And don't forget, she adds, you can always negotiate a lower rate with a lender.

Other financial advisors say the best protection in uncertain times is to find the most flexible terms for your mortgage. Pollock believes that one of the most flexible options is an all-in-one account — such as Manulife Bank's Manulife One account. Not only do these accounts allow you to use your savings to pay off your mortgage as quickly as possible, she says, but you can get back the money you have paid down if times are bad. •

HOW TO GET FAST RELIEF

If you're looking to pay off your mortgage as soon as possible, there are plenty of options from which to choose. Applying lump-sum payments to the mortgage principal or speeding up your monthly payments — switching to semi-monthly, biweekly or even weekly — will mean the mortgage is paid off sooner, which could save you thousands of dollars in interest costs over the life of the mortgage.

Most financial services institutions have calculators on their Web sites into which you can plug information and figure out how to become mortgage-free faster. Royal Bank of Canada's Mortgage Centre Web site, for example, at *www.rbcroyalbank.com/RBC:SFQlJI71JscARPDMo2U/products/mortgages/index.html* has a mortgage calculator that lets you compare the options.

Let's suppose you have a mortgage of $175,000 amortized over 25 years with a fixed interest rate of 6.09% and a five-year term. Customers can often negotiate with the lender for a more favourable rate than the posted rate, says Bernice Dunsby, senior manager, home equity client acquisition, with Royal Bank in Toronto. The 6.09% rate in this example is a special rate; the posted rate for this particular mortgage would be 7.15%.

Your monthly payment on this 6.09% mortgage would be $1,129.05. Over the 25-year period, it would cost you $163,708.48 in interest — almost as much as the amount of your mortgage. (The calculation assumes interest rates stay the same throughout the 25-year period). However, Dunsby notes, if you switched to accelerated weekly payments (the amount of a monthly payment divided by four), you'd pay $282.27 every week and have the mortgage paid off in less than 21 years — and you'd save more than $32,000 in interest over the 25-year amortization period.

As well, most lenders allow you to make lump-sum payments to reduce the principal amount owing on a mortgage. Such payments also shorten the amortization period and save on interest costs. If you have a closed mortgage, you may prepay up to 10% of the original principal amount once in every 12-month period. The prepayment is applied directly to the principal of your mortgage. Of course, you can pay as much as you like off the mortgage when it comes up for renewal at the end of your term.

An open mortgage lets you pay down the principal or repay the mortgage completely at any time without penalty. The rate of interest will be higher than that charged on a closed mortgage on which there are penalties if you want to pay it off or renegotiate before the end of the term. If you choose an open mortgage at Royal Bank, says Dunsby, you may make a principal repayment of $500 or more as often as you like.

>FOR MORE STORIES ON:
- **disability insurance,** see page 66
- **life insurance,** see page 72