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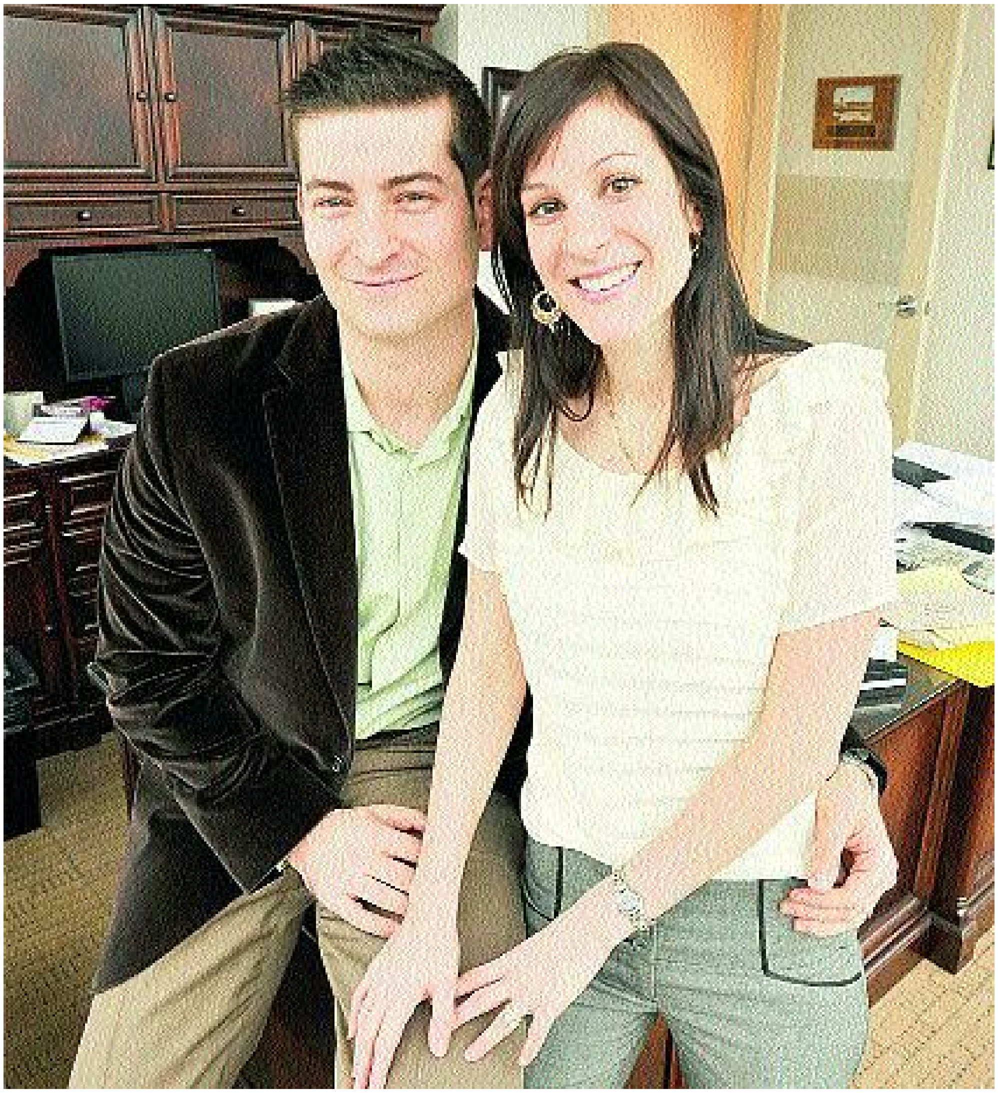
Fixed-rate mortgage better for first-timers

Arrangement takes the uncertainty out of repayment

By Michael Sasges, Vancouver SunJanuary 17, 2009



Mike and Lisa Averbach are partners in business and life. Among their observations about people looking for a mortgage is that, all too often, they bring a poor credit history to the search.

Photograph by: Ian Smith, Vancouver Sun, Vancouver Sun

The Canadian-mortgage drama needs a Greek chorus, those Athenians the ancient playwrights used to comment and explain and emend the drama, here the meaning of borrowed money priced at a 50-year low.

The first observation this chorus might make:

Three out of four first-time homebuyers in Canada probably don't know how good the news is.

A mortgage insurer, the multi-national Genworth organization, is the source of that conclusion.

It reports that in a recent test of Canadian first-time homebuyer knowledge of mortgages and homebuying terms and concepts only 25 per cent of the participants correctly answered more than seven out of 10 questions; fewer than one per cent answered all 10 questions correctly.

"Results indicated that first-time homebuyers have a lack of understanding of common mortgage terminology such as credit rating; mortgage term; variable or fixed interest rates; amortization; default insurance; and the debt service ratio," a Genworth news release comments.

To which Vancouver mortgage-broker Mike Averbach of Averbach Mortgages might have said, I could have told you that.

Averbach is a natural candidate for membership in the Canadian mortgage-drama Greek chorus. Money may be cheap right now, he cautions, but borrowed under a mortgage with a variable rate, it could become very expensive very quickly, turning drama into tragedy.

"Unless circumstances require you to take a floating product such as a line of credit or an open variable, we recommend a solid fixed-rate mortgage for the security and peace of mind of knowing what your payment is going to be for the next few years," Averbach said in an interview.

Peter Veselinovich of Investors Group is another believer in the fixed-rate mortgage for the first-time buyer.

"Think of the difference between a short-term, or variable-interest rate, and a longer interest rate as the insurance premium that you are paying for certainty," the Investors Group vice-president said in an interview.

"Today, this premium is very low. Longer term fixed rate mortgages may be the best choice for many first-time buyers or other borrowers who want certainty around their mortgage payment and the pace at which the mortgage is repaid.

" . . . If changing interest rates keep you awake at night, selecting a fixed-rate mortgage, preferably with a longer term, is the answer."

Veselinovich, as you might expect of an executive responsible for an investment syndicate's mortgage investments, has some ideas on the ideal contents of a mortgage.

- Prepayment "privileges" "Ensure that the pre-payment arrangement meets your requirements if you were to have extra cash for an additional monthly payment or a lump-sum payment.

"Typically, this amount is about 15 per cent annually. Many lenders will allow a special, one-time prepayment that is larger . . . . Always inquire about these privileges, and ensure that any special consideration is documented . . . ."

- Portability "The ability to 'port' your mortgage to another property if you move may allow you to retain an attractive interest rate, while blending it with a new rate in the event you need additional funds.

"If there is a chance that you may move to a different city or province, ensure that your lender can operate in the new region, otherwise, you will not be able to port the loan, and would likely be subject to penalties to pay out your existing mortgage."

- Flexibility "The ability to convert your mortgage to other products or terms is important. As an example, if you select a variable-rate mortgage and interest rates subsequently increase, you may want to switch to a fixed-rate mortgage. The ability to do so, and the cost around the switch, may vary among lenders."

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Q: Variable rate mortgages have traditionally generated lower expenses for a borrower over a mortgage term. Your news release says don't expect that history to repeat. Why?

A: Not that long ago variable, or floating, mortgages were available at a discount off the prime bank rate of 9/10ths of a percentage point. Now, they are being offered at a minimum of prime plus 6/10ths of a percentage point, and some are even as high as prime plus 1 1/2 points.

To put that in perspective, a homeowner who received a variable-rate mortgage from one of our preferred lenders in 2007 would be re-paying the mortgage at a rate of 2.6 per cent. Compare that with a client who decided to go with a current variable-rate mortgage-offer: he or she would be paying 4.1 per cent at a minimum. On a $300,000 mortgage, that's a difference of $236 a month on a traditional 25-year amortization.

Unless circumstances require you to take a floating product like a line of credit or an open variable, we recommend a solid fixed-rate mortgage for the security and peace of mind of knowing what your payment is going to be for the next few years. We're certainly not saying that one shouldn't accept a variable-rate mortgage and in fact, over the long run, a variable rate mortgage is still a viable option but a good plan and close monitoring of both fixed and prime rates will be more important.

Where variable mortgage borrowers once had a nice cushion should prime increase, they will feel the pain in the payment much faster with today's floating options.

All variable-rate mortgages allow you to lock in at any point but what that rate will be when that time comes is anyone's guess. Making sure your variable-rate mortgage commitment has a guarantee of the best available fixed rate at time of conversion is vital.

Q: What do you know about mortgages that you think new-to-market house-hunters, or the typical first-time homebuyer, ought to know?

A: It's important that new house-hunters realize that with a small amount of planning and preparation, the mortgage process can be easy and free of stress. The financing portion of the home-buying process should be the first step and not the last, a chronology too many mortgage professionals see too often.

I can't emphasize enough how important it is for house-hunters to book an appointment with a mortgage professional so we can go through a full analysis of credit and income. This will give them an accurate feel for the amount of house they can afford and will address any possible issues before they begin their search.

Q: Why does Averbach Mortgages, in its literature, distinguish between the pre-qualified homebuyer and the pre-approved buyer?

A: It's imperative that first-time homebuyers are pre-qualified, not just pre-approved when they are at that point of taking a plunge into the market and making an offer on a home.

The first question a realtor usually asks a client is, "are you pre-approved?" What they should be asking is, "are you pre-qualified?"

A pre-qualified buyer has backed up an application for a mortgage with a demonstrated proof of income, a salary letter and a recent pay stub, for example, and has demonstrated the availability of a down payment by a three-month history of contributions, for example, or a gift letter from an immediate family member.

Typically too many people produce their documentation only after they have made an offer on a home, with subjects. There's nothing more surprising or embarrassing than being declined for a loan because the information on the application doesn't match the documentation. We always insist that income and downpayment be proven before making an offer.

Recently, some lenders have shown a preference for the insurer they use. If the lender insists on sending the deal to CMHC it becomes impossible to buy a house with a rental suite in it if you are relying on the rental income unless the suite is "legal." CMHC does not allow income to be used that is generated from an illegal suite.

Thus, if you are trying to buy or refinance a home and you need the rental income to qualify for the loan you may be out of luck. If the bank you want a mortgage from insists on sending the deal to CMHC for insurance, ensure the suite is legal and has been registered with municipal authorities or the loan will be declined.

Of course you can avoid all of this if you put 20 per cent down and thus do not require mortgage-default insurance.

Q: What do you know about the ability, and inclination, of financial institutions to underwrite first-time buyers these days?

A: Although it might seem easier to get into the market now because real estate prices have dropped dramatically, lenders are tightening up their qualifying screws.

They are making it harder and harder to get a mortgage as their appetite for less-than-perfect borrowers is decreasing for fear of default. CMHC has increased its minimum scores for high-ratio loans so it is more important than ever to manage your credit wisely.

We are continuously educating our clients on how to better their credit to qualify for a good mortgage. Many clients don't realize how easy it is to damage their credit and conversely how quickly it can be repaired if the right steps are taken. If you do have a problem, now is the time to deal with it! If you fix the issue today you will be back in business before you know it.

People who have high credit scores will have access to more products, a larger number of lenders, and the possibility of better rates. A good credit score has never been more important than it is in today's lending environment.

Q: What's your opinion of mortgage rates, today and in the immediate future?

A: Rates are as low as they've been in a few years, but they should be even lower.

Lenders haven't just tightened up on their lending qualifications. With bond yields being where they are, the spreads on fixed-rate mortgages are fatter than ever.

Five-year fixed-rate money should be available at the high end of three per cent, but with the profitability reports down, banks are left with little choice but to increase the spreads.

To be fair to the big banks, their costs of raising funds have also increased and appeasing the shareholders is a top priority. This is especially evident in the variable, or floating, mortgages.

Q: What do you want Vancouver Sun readers to know about the current mortgage environment?

A: There are very few situations -- if any -- where you have the opportunity to work with an expert during the entire financing process . . . for free! In this type of lending environment, it is more important than ever to have an experienced mortgage professional advocate for you and provide you with the essential information and advice you require as well as ensure that you get the product best suited to your specific needs. This is the biggest purchase you will make in your life. So get the help of an independent expert.

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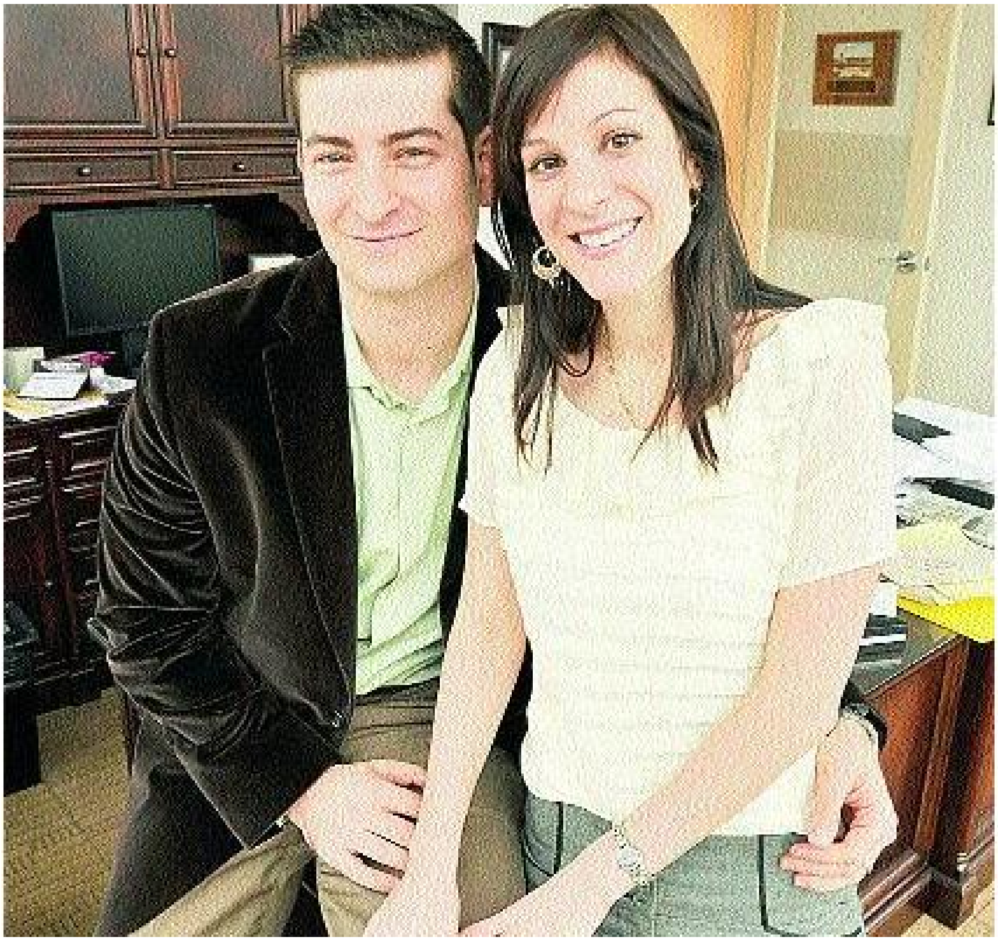

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