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Variable rate mortgages good for homebuyers

IT HAS ALWAYS been harder to get a mortgage in Canada than in the U.S. and that's probably a good thing. The subprime mortgage meltdown south of the border had many causes — real estate values that collapsed when most people thought they would continue to rise, consumers taking on mortgages that offered super-low introductory rates for the first 12 to 24 months followed by increases of five points or more.

But perhaps the biggest single cause is related to flexible lending guidelines. Lenders were qualifying borrowers who had very little in the way of income, job security or assets to back up the mortgage.

"It was a mindset that was very much focused on the transaction, rather than making sure that borrowers could qualify for what they were getting into," says Rob Regan-Pollock, a senior mortgage broker with Invis. "Lenders were qualifying people at the lower rates, believing they could sell in a few years and make a profit."

Lenders in Canada follow underwriting guidelines set down by CMHC, Genworth and AIG that securitize mortgages for lenders. The delinquency rate in Canada is a quarter of one per cent, versus up to 30 per cent among subprime borrowers south of the border.

"Lenders in Canada don't want to lend for the sake of lending, and put people in a position where the loan is not going to perform," Regan-Pollock adds. "Because there are huge costs associated with non-performing loans."

The subprime crisis in the U.S. has led to a global mortgage malaise, as mortgages have lost much of their appeal as an investment. One of the effects felt in Canada is that lenders are becoming more competitive in the effort to maintain market share.

As an example, homebuyers looking for a fixed-rate mortgage may qualify for quick closing discounts if the financing is completed within a shorter time frame like 30 or 45 days. Other discounts on fixed-rate mortgages are available to borrowers with good credit histories.

Another option is the so-called front-loaded variable mortgage. With this option, borrowers receive a larger discount off the prime rate up front for the first six months, followed by a higher rate below prime for the balance of the term.

Regan-Pollock says this strategy appeals to people who would like to wait a few months before deciding if they want to lock in to a fixed-rate mortgage down the road.

"When you look at the cost of borrowing, front-loaded variable mortgages offer a better deal for the first three years of the mortgage term versus traditional discounted variable-rate mortgages," he notes.

The lower initial variable rate gives the borrower the opportunity to attack their principal very early in the mortgage, which can be a good debt management approach, he advises.

"This takes the biggest bite out of the total amount of interest paid throughout the life of the loan, and will allow them to pay off the mortgage faster."

For example, a borrower could pay an extra \$3,188.09 against the principal of a \$250,000 mortgage in the first six months if they opted for a front-loaded variable mortgage, compared to what they could pay with a fixed mortgage.

This assumes a variable mortgage with an introductory rate of 3.00 per cent (prime minus 1.75 per cent) for the first six months with no changes in prime, versus a fixed mortgage at a now-competitive 5.59 per cent, with both mortgages having a 25-year amortization.

Many of these variable-rate mortgages have liberal conversion privileges that allow borrowers to switch to another mortgage type and lock in to a fixed-rate mortgage when they're ready. Despite lower rates on variable mortgages, many first-time homebuyers are opting for a fixed-rate mortgage, Regan-Pollock says.

"Discounted fixed rates are fairly low these days and if borrowers lock in, say for five years, they have the assurance that they can ride out any ups and downs in the market during that time."