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The Mortgage Process 101

Choosing the right mortgage term and options is very important.

With the ongoing uncertainty of where interest rates are headed, homebuyers are struggling more than ever with decisions about their mortgage options.

Pre-Approval

1. With a pre-approved mortgage, you'll know how much home you can afford and how much your payments will be. You lock in your pre-approved interest rate for a set period of time to protect you in case rates rise while you are shopping for a home. If rates go down, you get the lower pre-approved rate.
2. When you find the home you want, you will be ready to make an offer. The seller and Realtor will take it seriously, knowing you've got solid financial backing.
3. You are under no obligation to buy.
4. Your mortgage professional will tell you about the various mortgage options and offer advice about which options best suit your needs.
5. For the pre-approval process, you will need to provide details and documents for items such as employment, income, assets, downpayment, and liabilities and give permission for a credit bureau report.

How Much Mortgage Do You Need?

That primarily depends on two things: Your income and your downpayment.

Income

Lenders qualify you using two standard ratios.

- **Gross Debt Service Ratio (GDS)**

Generally, no more than 32% of your gross annual income should go to "mortgage expenses" such as principal, interest, property taxes, and heating costs (plus maintenance fees for condo mortgages).

- **Total Debt Service Ratio (TDS)**

TDS evaluates the gross annual income needed for all debt payments including mortgage, credit cards, personal loans, car loans, etc. TDS payments should not exceed 40% of your gross annual income. The combined incomes for you and your spouse are usually considered when determining this ratio.

The Downpayment

The downpayment is that portion of the purchase price that you furnish yourself. For a CMHC-insured mortgage, there is a minimum downpayment of 5%.

Be sure to reserve some funds to cover your home inspection, closing costs, moving, and other potential expenses.

If your downpayment is **20% or more** of the home's purchase price, you can apply for a conventional mortgage. Conventional mortgages have the lowest carrying costs because they don't have to be insured against default, a requirement in the Canadian banking system if you have less than 20% down.

The downpayment represents your financial stake or equity in your new home. The balance of the money is borrowed from a financial institution in the form of a mortgage.

It is to your advantage to save and put down as much money as you can because interest costs for a smaller mortgage are lower.

Be sure to reserve some funds to cover your home inspection, closing costs, moving, and other potential expenses.

Mortgage Payments

Each of the following options can help you build your home equity faster.

Accelerated Bi-Weekly Payments

Save interest by increasing your mortgage-payment frequency. With an accelerated weekly or bi-weekly payment option, you are essentially making the equivalent of one additional monthly payment each year, which will help pay off your mortgage faster.

Scenarios 1, 2, and 3 compare monthly, accelerated bi-weekly, and accelerated weekly payments.

Interest Saving Example	Scenario 1 Monthly payments	Scenario 2 Accelerated bi-weekly	Scenario 3 Accelerated weekly
Payment	$1,664.32	$832.16	$416.08
Term Interest Cost	$66,256.53	$65,036.82	$64,991.45
Amortization Interest Cost	$249,152.06	$208,476.05	$208,197.95
Proposed Amortization	30.0 years	25.8 years	25.8 years

The above chart from the Royal Bank assumes the following.

a. *There is a constant interest rate throughout the amortization period.*

b. *Interest is compounded semi-annually for fixed interest rates and each payment period for variable interest rates.*

c. *The payment schedule you selected is maintained with no additional payments or skipped payments, unless selected by you.*

*Source: RBC mortgage calculator at www.rbcroyalbank.com**

Double-Up Your Payments

When you double-up a payment, your extra payment goes directly toward reducing the principal balance of your mortgage. A common option is that you can pay ***up to*** the equivalent of your regular monthly mortgage payment, whether it's weekly, biweekly, or monthly.

Make Extra Principal Prepayments

Applying prepayments directly to your mortgage principal allows you to prepay a certain amount (usually 10%) of the original amount of your mortgage once in every 12-month period. When your mortgage is up for renewal, you can make a principal prepayment for any amount you wish. A principal prepayment of even $1000 a year can make a sizeable difference in the time it takes to pay off your mortgage.

Increase Your Payment Amount

Some mortgages allow you to increase the amount of the principal and interest portion of your mortgage payment by as much as 10% once a year. The increased amount goes directly toward your principal.

Use Your RRSP Contributions

Under the federal government's Home Buyer's Plan, first-time homebuyers are eligible to use up to $25,000 in RRSP savings per person ($50,000 for couples) for a downpayment on a home. The withdrawal is not taxable as long as you repay it within a 15-year period. To qualify, the RRSP funds must have been in your RRSP for at least 90 days.

Use a Shorter Amortization Period

A shorter amortization period means higher regular payments but you will pay significantly less interest over the life of your mortgage because interest is being calculated on a lower principal balance.

New Mortgage Guidelines Could Affect You

The new B-20 mortgage guideline introduced by the federal government are impacting the way financial institutions lend money. The guideline have reset mortgage-lending rules to more conservative standards.

The rule changes are broad based.

1. For borrowers without a 20% downpayment, mortgage amortization is reduced to 25 years from 30 years. Low-ratio home buyers with 20% or more down can still ask for a 30-year amortization.
2. As for the other rule changes, most borrowers are not affected or there is a minimal impact.
   If you already have a mortgage, be careful before altering its terms because some lending policies are being grandfathered. Work with an experienced, knowledgeable, and reputable mortgage professional before making any changes to your mortgage.

When you double-up a payment, your extra payment goes directly toward reducing the principal…

Short-Term Strategy Can Mean Long-Term Stability

Mortgage ***portability*** and ***assumption*** features are often overlooked and become much more important to you in an environment of increasing interest rates.

Let's assume . . .

You are about to buy a home.

- Interest rates could be higher 2 years from now.
- You *might* sell in 2 or 3 years and purchase a different property.
- You have limited cash flow and want to pay off your mortgage as quickly as possible.

You see a low 2- or 3-year rate offer advertised and think *Wow, that is a low rate. My payments and interest will be reduced if I choose that one.* It fits with your strategy of timing the end of the mortgage term with the potential sale of your property.

Now let's look at how a longer-term mortgage could make more sense for you.

Assume . . .

- You decide to opt for a 5 or 7 year interest-rate term.
- You still plan to sell in 2 or 3 years.

If your mortgage comes with a **portability option**, you can transfer the terms and conditions of your current 5 or 7 year mortgage to a new home purchase when you sell in 2 or 3 years.

Alternatively, if you need more money to pay for a new home, your mortgage can be increased and the existing low rate blended with the current posted rate to obtain a weighted annual interest rate.

Depending on current rates and your final blended rate with the add-on amount, your modified monthly payments could be more economical than with a brand new mortgage. In other words, today's low interest rates coupled with the longer mortgage term can become your "asset" and an attractive choice that can save you money when your existing mortgage rate is lower than current rates.

The mortgage **assumption** option can be an asset and a good tactic, particularly if you have a low interest, longer-term mortgage in a buyer's market and especially when mortgage rates are rising. Your existing low-rate mortgage can be an attractive feature for prospective buyers—you can allow a buyer to take over your mortgage or ***assume*** it.

If rates are on the rise, your low-rate mortgage gives your buyer built-in monthly savings until the end of **your** mortgage term. The assumption option can help your Realtor sell your home.

Please note: A buyer can assume your mortgage only if he or she meets the usual mortgage qualification requirements ***and*** *if you decide not to take it with you to your new home.*

Many variables must be considered when choosing the type of mortgage and term options best for you, especially in the face of changing mortgage rates. Consult a mortgage specialist for expert advice.

Fixed or Variable?

You can choose to go with a stable, less-flexible fixed-rate mortgage or you may feel more comfortable with the risks and potential rewards of a variable-rate mortgage.

The Case for Fixed Rate

A fixed-rate mortgage offers a high level of stability because it provides a locked-in rate during the entire term. You know exactly how much principal and interest you will be paying on each regular mortgage payment. The down side is you can't take advantage of a lower interest rate—and you don't have the ability to put extra payments toward the principal. Fixed is for you if you enjoy the security of a rate guaranteed not to change for the term of the mortgage and you are willing to pay a slightly higher interest rate for that security.

The Case for Variable Rate

Typically, variable rates include some of the lowest rates available but many Canadians shy away from the option because of the risk of rate increases. Many Canadian economic experts believe, however, that a mortgage rate that varies with fluctuations in the bank prime rate will offer the greatest advantage when it comes to long-term savings on interest costs.

The type of mortgage you choose really depends on your tolerance for risk, your current goals, and your stage of life.

Here are some variable-rate payment details.

- Regular mortgage payments are set for the term, even though interest rates may fluctuate during that time.
- When rates go down, an increased amount of your payment goes toward paying the principal. With more going into your principal, the less interest you pay, and the faster the mortgage is paid off.
- When rates go up, you'll see an increase in the portion of your payment that goes toward paying the interest. With less going into the principal, the amortization period is extended.
- You can always lock-in to a fixed rate mortgage.

Choose a variable rate if you are comfortable with rate fluctuations to gain possible long-term interest savings and you have the flexibility to accept possible increases in your amortization, should the interest rate increase.

Fixed and Variable Rates in One Mortgage

Many lenders offer mortgages that can "hold" a combination of both fixed and variable terms. To benefit from potential interest savings and the security of a predictable rate, you can split your mortgage between fixed and variable rates with different terms and maturities. Whether rates remain stable or fluctuate, that strategy reduces the risk of making a bad decision and could save you thousands of dollars in interest costs over the life of your mortgage. Note: Most lenders require a somewhat larger downpayment for that product.

The type of mortgage you choose really depends on your tolerance for risk, your current goals, and your stage of life.

There's more to mortgages than just great rates. Make sure you are getting a mortgage that gives you peace of mind with flexible options that allow you to pay down your mortgage fast. ▲

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