

## **Mortgage Education**

We have had a lot of questions coming through our office lately about mortgages. Questions like, should I refinance my mortgage to get a better rate, should I buy a home, should I sell my home, where is the best mortgage rate? So we asked a mortgage expert to provide some core information on how mortgages work, what lenders look at and when is the best time to make changes to a mortgage.

Rick Dumas, a mortgage planner with Mortgage Architects, has provided us with some information. Rick's background has also included being a realtor and a financial planner.

### **Mortgage topics:**

1. What is a credit score and how does it impact my ability to borrow?
2. What are some of the basic types of mortgages and how can I pay off my mortgage faster (you may be surprised!)?
3. When is a good time to refinance (or move lenders) and what are some ways to make my mortgage tax deductible?

### **Mortgage Rates & Credit Scores**

When most people are making a large purchase, such as buying a home, they want personalized service so they know that their unique situation is being looked at. Unfortunately, the hard truth is that – to most lenders – you actually are a number. It's an important number: your credit score.

Your credit score – the higher the better – is your passport to financial opportunities. Known as a FICO score – with a possible range of 300 to 900 – your number tells lenders what kind of risk you are likely to be as a borrower. With a credit score above 800, for example, the lenders are going to be very happy to see you at their door. And you'll have a chance to save big on any borrowing you do. Why? A high credit score says you're reliable and responsible with your debt: you should get fast approval at the best possible rates.

But maybe you were late paying your credit cards a few years ago. Bad news: any history of late payments or a record of debt being sent to a collection agency – and your credit score is going to take a serious hit. It doesn't matter how much the debt was for. If your score tips below 600, you may pay a premium on your borrowing rate.

Maybe you didn't even know that someone – somewhere – was keeping track of how you handled your credit. But if you've ever had a credit card, borrowed money, or leased a car, the credit agencies probably know who you are.

The good news is that you can manage your credit score to make the most of your financial opportunities. Here are a few simple tips to best manage your credit.

**1. What is on your credit file:** First of all, knowledge is power. It's easy to find out your credit score, and to see your full report: everything that a lender would see. You can order your credit report free through the mail, or you can order it online and – for a small fee – you can download it immediately. Contact Equifax or Trans Union:

Equifax: 1-800-465-7166 [www.equifax.ca](http://www.equifax.ca)

Trans Union: 1-866-525-0262 [www.transunion.ca](http://www.transunion.ca)

As soon as you get your report, check closely for any errors in your file. If something is wrong, report it immediately, so that your file can be corrected.

You should know that your credit score captures your perceived lending risk at a moment in time so your score can change from month to month. The companies that hold your credit accounts and loans report transactions to credit bureaus regularly. That's a great opportunity for you, because it means you can improve your score with the right credit behaviors.

2. **Pay your bills on time** – making at least the minimum payment. Using your credit card regularly and paying it off promptly is better than not using it at all or carrying a big balance.
3. **Have a margin of safety** - Your score will be higher if you have a gap between your credit limit, and what you currently owe. Try not to let your balance run higher than one-third of your limit.
4. **Time is on your side** - The longer your history, the better. Don't cancel your oldest credit card – even if you no longer use it. That good history can help you. Get advice before you cancel unused cards. And don't regularly take out new credit accounts.
5. **Don't make too many applications for credit** – every time you go to a different lending institution they run a credit check. And that includes those credit card applications that come in the mail. Lenders will know where you have gone to apply for loans. With a mortgage broker they do one credit check and can go to over 50 lenders so you don't have to.
6. **Talk to a mortgage planner** - an experienced mortgage planner can review your situation and help you determine how best to improve your credit. Many of the over 50 lenders have different lending criteria and a qualified mortgage planner can connect you with the right one.

## **Types of Mortgages**

For most of us, buying a home usually requires taking out a mortgage, which means, borrowing money to buy a home and using that home as collateral for the loan. The mortgage payments are made up of a principal sum (amount borrowed) and interest (cost to you of borrowing money). There are also many mortgage features from which to choose. Listed below are the most common types of basic mortgages, with descriptions.

**Closed Mortgage** – A closed mortgage will have a penalty if it is paid off prior to the maturity of the term. They usually offer the lowest interest rate available.

**Open Mortgage** – This means you can repay the loan, in part or in full, at any time without penalty. Interest rates are usually higher on this type of loan. An open mortgage can be a good choice if you plan to sell your home in the near future. Most lenders will allow you to convert to a closed mortgage at any time.

**Variable Rate Mortgage** – A mortgage for which the interest rate fluctuates based on changes in prime. Frequently, the monthly payment can change as well.

**Fixed Rate Mortgage** – A mortgage for which the interest is set for the term of the mortgage. Payments remain unchanged for the duration of the term and it is a good choice if you would like to have a fixed payment to work your budget around for a few years.

**HELOC (Home Equity Line of Credit) Mortgage** – A personal line of credit secured against the borrower's property. Generally, up to 75% of the purchase price or appraised value of the property is allowed to be borrowed with this product.

**Popular ways promoted to pay off your mortgage faster:**

1. Double-up payments
2. Anniversary payments
3. Annual increase in payments
4. Accelerated bi-weekly payments
5. Shorter amortization period
6. Pre-payments

If you listen to the media, and to the institutional marketing, there is a multitude of ways to pay your mortgage off faster. Many are listed above. There are many other variations on a theme. There is even an “un-mortgage”. Well, truth-be-told, there is only one way - put more money on the principal. That can really only be accomplished two ways:

- 1) Lower the interest rate and keep the payments the same so that less of each payment is devoted to interest, and more to principal.
- 2) Take more of your personal cash and apply it as an additional payment against the principal.

That's it. There is no other way. Oh, many will maintain that different payment programs have varying levels of effectiveness and, to the degree that they keep the borrower paying extra payments, I agree. But there is no financial advantage beyond that.

Let's look at what seems to be the most commonly believed “magical” formula – the accelerated bi-weekly payment. Plenty of borrowers are fond of describing how they paid their mortgage down faster because they made more frequent payments, thereby saving interest. In fact, the savings generated by the increased frequency of payment is

miniscule to the point of being insignificant. The reason the mortgage got paid down faster is because the borrower took additional money out of his pocket and applied it against the principal. As an example, assume a mortgage with a \$1,200/month payment. During the course of one year, principal and interest payments of \$14,400 will be made. If that same mortgage were set up with accelerated bi-weekly payments instead the \$600 would be paid every 2<sup>nd</sup> week for 52 weeks for 26 payments X \$600 = \$15,600/year. So the extra amount paid against the principal comes from 2 extra payments of \$600 each, not from a significant reduction in interest. The same thing can be accomplished by keeping the payment on a monthly schedule and increasing the payment by \$100 or by making one extra payment of \$1,200 mid-way through the year. In all these scenarios the annual amount out of pocket by the borrower is \$15,600 vs. \$14,400 for the non-accelerated minimum monthly payment.

**IMPORTANT:** Bear in mind that the opposite is also true. Those handy skip-a-payment options are great when you really need them but their regular use can add years to the life of a mortgage, just like extra payments can shave years off a mortgage.

### **“When is a good time to refinance my mortgage or move lenders?”**

This is not an easy question to answer. Assuming for the moment that certain intangibles such as preference away from a particular lender, benefits derived from an ongoing business relationship, etc. are not a factor. Then the decision becomes primarily monetary. Even so, it is not an exact science as, usually, certain assumptions regarding future interest rates, personal plans, spending requirements going forward, etc. will need to be made. Also, future capital needs, consolidation of current debt, possible upcoming changes in income and the like will further muddy the waters. Once all of these factors are determined, as best as possible, it becomes a matter of weighing the costs involved (legal fees, appraisals, penalties, personal time) against the savings to be made (reduced interest on mortgage, elimination of high interest credit card debt, use of additional capital for business or investment, etc.). At times, the numbers may suggest that the refinance is not recommended, but there may be an over-riding requirement to reduce monthly cash flow, or generate capital, that takes priority.

<b>Costs</b>	<b>Savings</b>
Penalties	Lower interest rate
Legal fees	Consolidate consumer debt
Appraisal fees	Additional capital/cash flow
Your time	Shorter mortgage term

Due to the multitude of factors involved, and the complexity of the calculations, most borrowers would be well-advised to get an impartial opinion, firstly from their financial planner, and secondarily (if need be), from a mortgage planner.

### **Is it possible to make a mortgage tax deductible?**

Unlike the United States, interest paid on residential mortgages in Canada is not directly tax deductible. However, there are some specific ways to arrange one's finances to allow that mortgage interest to be written off against:

- Business income for self-employed individuals
- Income from existing investment portfolios
- Rental properties
- Suite income
- Newly acquired investments

Usually, the process is best facilitated by the use of a Home Equity Line of Credit. Canada Revenue Agency readily accepts such concepts as "The Smith Manoeuvre" or other similar plans, but the requirements are extremely specific and should always be executed under the direction of a trusted professional. Of course, you will want your financial planner quarter-backing the procedure and which would also involve a tax specialist or mortgage planner.