Making sense of mortgages today

The unpredictability of mortgage rates over the last few years has caused consumers to look more closely at their mortgage options when purchasing a home or any other property. New types of loans have appeared, like the variable-rate and the 10-year term of yesteryear has disappeared. A six-month or one-year mortgage is now commonplace and as a result, consumers are asking questions about rate, length and conditions of mortgages. **Carolyn Green, reporter for The Financial Post,** *has supplied the answers to some often-asked mortgage questions on this page.*

What is a mortgage?

According to the Canadian Real Estate Association, it's "a conveyance of property to a creditor as a security for payment of a debt with a right of redemption by the borrower at a specified date."

In plain English, this means the purchaser (the mortgagor) borrowed some money and gave title of the property as security to the lender (the mortgagee). The lending institution guarantees to return title when the loan is repaid.

Who gives mortgages?

The main lenders are banks and trust companies. However, mortgages are also available from life insurers, credit unions, loan companies, brokers (who charge a fee of 1% - 1-1/4% of the value of the loan), or individuals like friends and relatives.

What are standard and high-ratio loans?

A standard mortgage is for an amount up to 75% of the property's appraised value. A high-ratio mortgage is for more than 75%, and usually must be insured by Canada Mortgage & Housing Corp. or private insurer Mortgage Insurance Co. of Canada. If a property or borrower is considered risky, the lender may require insurance on loans less than 75%.

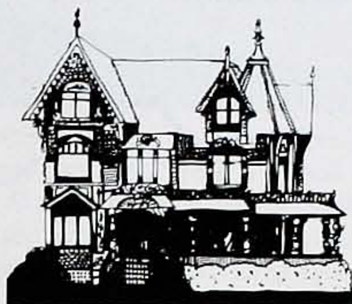
Although insurance protects the lender from default, the borrower must pay the fee - 1% - 1-1/2% of the loan value.

What terms are offered?

Borrowers can get six-month, one-, two-, three-, four- and five-year terms. For most of 1982, five-year loans were unavailable, because investors in guaranteed investment certificates - a prime source of mortgage funds - were only going short-term.

Also available is the variable-rate mortgage (VRM), introduced two years ago when rates were bouncing around. While VRMs vary, they basically work this way: a floating rate is set monthly by the lender, generally based on the bank prime rate. However, if the rate is, say, 11% when the loan is made, payments are based on that rate for the duration of the term.

If during the term, the floating rate drops to 10-1/2%, a monthly payment will be calculated at that level. The difference between this amount and what the borrower is actually paying is used to reduce the principal.



However, if the floating rate increases to 11-1/2%, more of the monthly payment goes on interest and at the end of the term, the principal may have increased.

Most VRM lenders allow the borrower to switch to a fixed-rate mortgage at any time, often for a small fee. Rules to prepay are more lenient than with fixed-rate mortgages. The snag is that many lenders require 30% equity before giving a VRM.

What is amortization?

This is the time (normally 25 years) required to pay off the debt in monthly payments of principal and interest.

At one time, "amortization" and "term" were the same, but in the early-1970s, lenders changed their policy, lending at a fixed rate for only up to five years.

By reducing the amortization period, can I save money?

Yes. Take a $50,000 mortgage at 13%. Amortized over 25 years, total amount paid would be $165,363. Over 15 years, payments drop to $111,873.60, or over 10 years to $88,392.

Amortization periods can be determined when taking out the mortgage or can be shortened on renewal.

What are open and closed mortgages?

An open mortgage is one in which the borrower can repay - partially or in full - at any time without penalty or notice to the lender. (In recent months, most lenders allow this for only variable rate, six-month and one-year terms although even the one-year open is rare). With a completely closed mortgage, the lender accepts no prepayment.

There is a compromise, the partially open mortgage which can permit 10% prepayment on certain anniversary dates, subject to a three-month interest penalty in some cases. At one time, mortgagors could fully prepay, subject to a three-month penalty. But many lenders are reluctant to allow this because they're afraid that with full payment, they'll lose interest money.

What's the advantage of prepayment privileges?

These allow you to reduce the amortization period, and ultimately the total amount paid. Take a $1,000 loan at 12-1/2%, amortized over 25 years. At the end of the first year, the principal has been reduced by $6.66, leaving a balance of $993.34.

By prepaying 10% ($99.33) at that time, the principal balance would be reduced to $894.01 and the time taken to pay off the loan would drop to 15 years, 11 months. If 10% is prepaid every year, in five years the balance would be reduced to $451.93 and the time to zero balance would be four years and nine months.

What if I sell my house in mid-term?

Depending on the wishes of both parties, there are two alternatives. The mortgage usually can be discharged, with the purchaser arranging new financing, although a penalty is often charged to make up for lost interest. As well, most lenders will allow a new purchaser to assume an existing mortgage, although some require them to go through the process of qualifying for the loan.

If a mortgage is assumed, however, the original mortgagor may still be liable should the new or any subsequent mortgage-holder default. In other words, if the mortgage on your house is assumed by the new purchaser, the banks can come after you in event of default.