

Shopping for a mortgage

Compare rates for savings

The latest wrinkle in consumer home financing is something called the "declining rate" mortgage.

Launched in May, the new-style mortgage comes in two terms, a 7-year and a 5-year. For the 7-year term the rate starts out at 9.25 per cent and the 5-year at 8.75 per cent. In each case the rate drops (declines!) by a quarter point each year to a final rate of 7.5 per cent.

On the surface that may appear to be pretty good. But hold on. As any chartered accountant will point out - how does that compare with going rates for regular mortgages?

Currently the 1-year mortgage rate stands around 5.5 (or better), the 2-year at 7.75 per cent, the 3-year at 8.25 per cent and the 5-year at 8.5 per cent.

A closer look

So already some of the shine is going off the declining rate deal. But let's take a closer look.

Suppose you go for the the 7-year declining rate package. That means on a \$100,000 mortgage the monthly payments start out at \$844, reducing by about \$16 a month each year for the remainder of the term, with a final year's monthly payment of \$746.

Now, if you opted instead for the standard 1-year mortgage at 6.5 per cent, your monthly payments on the same \$100,000 would be only \$670 - \$174 less per month than the other.

The risk, of course, is that interest rates will be higher when it comes time to review. But that may not be such a big gamble.

To leave you in exactly the same financial situation as the declining rate mortgage, interest rates would have to increase substantially - and they'd have to average 9.125 per cent a year.

So even if the rate increased next year to 7 or 8 per cent (a major-increase indeed), you'd still be well ahead by going with the 1-year term - if you don't mind a little risk.

The other thing is that it gives you a great opportunity to really tame your mortgage. And that's the name of the game.

Increasing payment

Suppose that you upped your monthly payment from \$670 to \$844, the same as the first year declining rate payment. This way you would shave about \$2,100 right off the top of your mortgage. So when it comes time to renew, the principal would be less than \$98,000 - and not \$100,000. You'd also save a lot in interest.

And further suppose that if interest rates

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stayed at the 6.5 per cent level while you kept paying \$844 a month; you'd have your entire mortgage paid off in less than 16 years, instead of 25.

The big plus here is that in such an event your total interest cost would be \$58,790 compared with \$133,118 in the case of the 7-year declining rate mortgage.

So it pays to check the numbers very carefully.

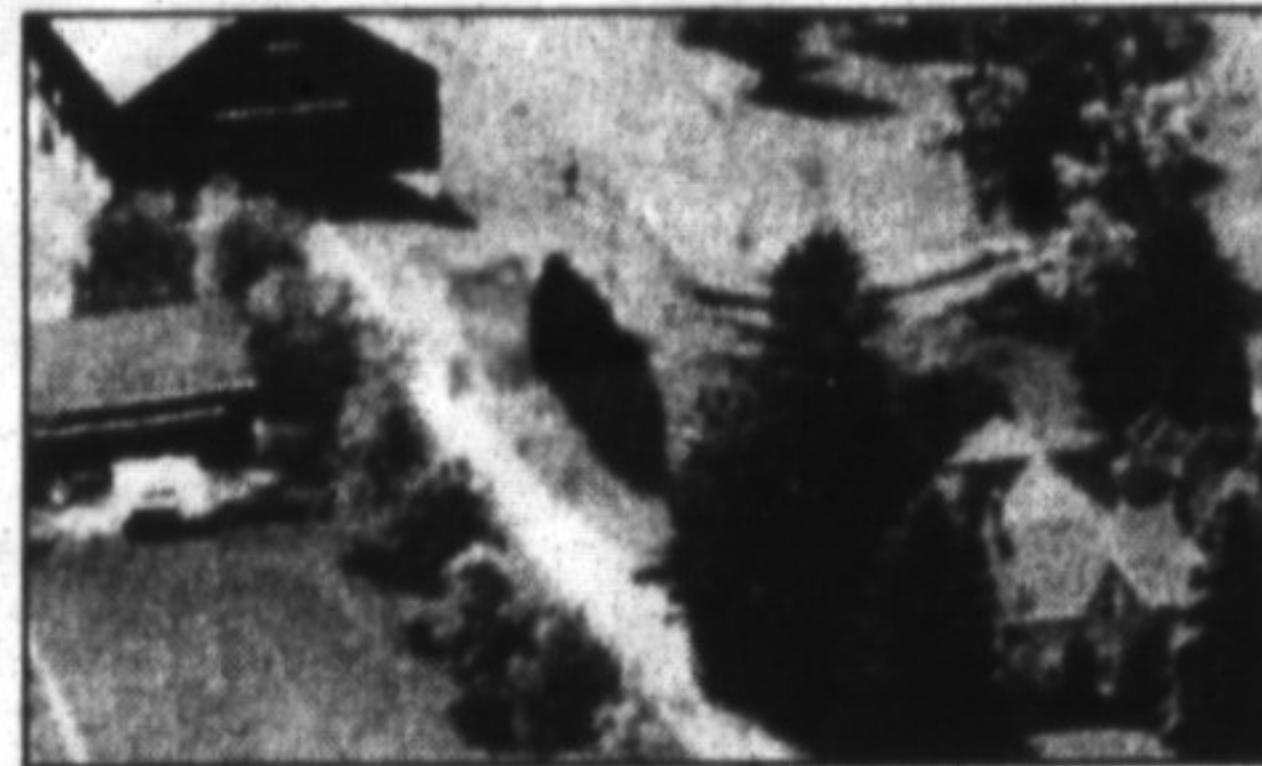
Moneycare is general financial advice by Canada's chartered accountants. Rick Bates is assistant professor of accounting & finance at the University of Guelph.



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