



## **REVERSE MORTGAGES**

by Peter Dolezal [The Naked Homeowner](#)

A previous column emphasized the importance of comparison-shopping, as well as the negotiation of best-value in selecting mortgage type, term and rate.

Since mortgages have the single largest impact on the amount you ultimately pay for a home, it's worth touching on several additional opportunities and pitfalls, which flow directly from the mortgage choices you make.

### **AMORTIZATION:**

Amortization term is the period over which your mortgage would be paid off, if your payments remained unchanged at the level approved, for the entire period of the loan.

Until two years ago, front-line Lenders such as banks, credit unions and trust companies, would generally limit your amortization period to a maximum of 25 years. Then the rules changed. Amortization periods for up to 40 years became acceptable, not only to these Lenders, but also to CMHC and Genworth Financial, responsible for insuring any mortgage with less than a 25% down payment (now 20%).

### **THE BENEFITS**

The benefits of this change were huge, especially for first-time buyers struggling to qualify with minimal down payments on quickly escalating home prices. Even buyers with substantial equity in their existing home, now found it much easier to buy-up to their next home, earlier than they had planned.

The great benefit is easily seen, when we look at the relative monthly payments on a typical mortgage. We'll again use a \$300,000 mortgage, and assume a 5% fixed-rate mortgage with a 5-year term. The monthly payment required, if the mortgage was amortized over the previously typical 25 years, would be \$1745. However, if the borrower chose a 40-year amortization instead, this same mortgage would require monthly payments of only \$1436.

Such a significant reduction in monthly payments allows into the market, many buyers who would otherwise not have the income to qualify. When this change is combined with the newly-allowed zero-down payment option, first-time buyers have reason to cheer, as they are now more easily able to move into their first home.

### **THE DOWNSIDE**

While a great tool to earlier entry into a high-priced market such as ours, the 40-year mortgage carries a substantial price tag, if the borrower does not move to shorten that period as quickly as an increasing income permits.

Let's compare the total eventual cost of a 25-year vs. a 40-year mortgage on our \$300,000 example. We'll assume that all other terms are identical and that the mortgage is renewed every 5 years at the same 5% rate.

With the 25-year amortization the borrower will have paid approximately \$523,000 by the time his loan is liquidated. Had he maintained the payments required for a 40-year amortization, his total costs would have sky-rocketed to around \$689,000.

For the privilege of lowering his monthly payments by \$309, the borrower with the 40-year amortization would have added a staggering \$166,000 to the total cost of his home!

The clear lesson in this for every mortgage holder is:

- 1) Select the shortest affordable amortization period
- 2) If, as in the case of many first-time buyers, you are forced into a long amortization, do your utmost to increase your payments as your financial situation improves, thereby shortening the period of amortization.

#### A MAJOR PITFALL

Longer-amortization flexibility provides one great temptation for homeowners with existing mortgages. When a mortgage comes up for renewal, many are tempted to add substantial sums to their refinanced mortgage amount. They reason that by lengthening the amortization period, they can access tens of thousands of dollars of built-up equity, without increasing their monthly payments.

Often these extra funds are used to purchase a vehicle, take a vacation, refinance other debt, buy furniture, add to RRSP investments, or to make major home improvements. Usually, only the latter, which adds value to the home, can begin to be economically justified.

As earlier shown, lengthening amortization periods can add huge sums to the amount which must be paid before the mortgage is liquidated. By the same token, buying a car from the extra proceeds of a refinanced mortgage, may well result in the car eventually costing double or triple its original purchase price

The lure of accessing extra cash when refinancing has always existed, even with the previous 25-year amortizations. But the 40-year option has simply provided much more leeway to do so, which many of us are finding difficult to resist.

**Take great care to fully understand the total future cost of using mortgage- refinancing as a tool for generating extra cash, no matter its intended use.**

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It is difficult for most of us to avoid having a long-term mortgage, if we wish to own a home. However, we should always remember that there are few investments that produce a better long-term return *after tax*, than paying off our mortgage as quickly as possible.

The only possible exception to this rule of thumb may be, to make the interest on our mortgage tax-deductible, effectively slashing dramatically, the real cost of our borrowing. This subject is well covered in the best-selling book, **The Smith Manoeuvre**, by Fraser Smith. It's worth a read for those of you interested in this subject.