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Canada's evolving mortgage market

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Remember the days when "no-money-down" was used only to entice people to buy a new couch? Brace yourself: these deals are now entering the real estate arena. With the slew of innovations coming to the mortgage market, Canadians are now able to take on more debt then ever before. And while the risks of missing payment on a sofa pale in comparison to missed instalments on a semi-detached home, these new mortgage-financing products serve a purpose — for the right person.

The most notable innovations to come to the mortgage market in the past year are the zero-down and interest-only mortgage options. But others are on their way: most notably, a hybrid of a zero-down, interest-only option. And that's not all. Earlier this year, the Canadian Mortgage and Housing Corporation said it will start insuring mortgages with a 40-year amortization period. (Click here to compare the payment schedule on a zero-down-payment mortgage vs. interest-only mortgage.)

While these sorts of products seem designed to entice people who couldn't otherwise afford to own a home, they're not only that. Andrew Moor, president of mortgage brokerage firm Invis, says these new product innovations have a clear place in the market. They are for the doctor fresh out of medical school who has no capital saved up, or a young couple where one is working and the other is finishing up school, he says. "These are good responsible people who look after their debts but haven't yet saved [for a down payment]."

Moor, a veteran of the mortgage business, says this is the type of product that he could have used growing up. When Moor was in university, he bought his first house as a way to build equity. He was 22. But when he couldn't afford that house any longer, he had to get guarantees from his mother and scramble around to trust companies. "These kinds of products would have allowed me to go in with exactly that intention stated," Moor says. "These aren't products of last resort; these are products for good credit-worth people."

That's not to say he doesn't have any concerns about the rapid changes that are overtaking the mortgage space. "There are consumers that will now be able to buy a house, but couldn't before," Moor says. "But my concern on the flip side of that is these products can be abused."

It's a matter of living within your means, he adds. If you have a client with no expectation of rising income using these products just because they can afford to pay the introductory rate, but can't afford to pay more, then this is not the right product, Moor explains.

Marc Lamontagne, CFP, Ryan Lamontagne Inc. in Ottawa (a fee-only financial planning firm), also cautions that these products may attract the wrong sort of clientele. "I think it is the people who are the higher risk; either they already have too much risk or they have bad credit ratings," he says.

These sorts of products might also limit an individual's or a family's mobility — at least from an investment standpoint. If you sell the property sometime during the five-year interest-only payment period, and the value of the home has not increased, then it would be equivalent to renting. And if the value of the property went down over that time, he continues, the investor still owes the value of the original loan.

"The obligation of the advisor is to look at the client's goals," Lamontagne says. There are alternatives to the new mortgage options. One option, if a client is determined to crack into the real estate market, would be to get them to consider purchasing a duplex with some friends where part of it can be rented out, instead of buying a place on their own. "If your goal is to get into the real estate market to build up some equity, this is another option that you have to look at," he says.

In the end, it's the consumer's choice. Some, no doubt, will be swayed by the apparent low cost of owning a home today without the means to pay for it should rates go up. For the immediate future, at least, that's not a concern.

The Bank of Canada on Tuesday said it is holding the key interest rate steady at 4.25%, which means variable rate payments will remain unchanged. Meanwhile, the price of some fixed-rate mortgages has been inching down in recent weeks. Low rates added to the new product innovations are boosting the buying power of mortgage consumers, Moor notes. Following the Bank's decision, Moor reiterated an important point: "Each new product that comes to market underscores the importance of getting the right advice."

There are many reasons why these new types of mortgages are popping up. Increasing competition from private companies, mostly U.S.-based firms, that are gearing up to compete with the mortgage-insurance market currently dominated by the CHMC, has certainly been a factor.

The Canadian subsidiary of U.S.-based AIG United Guaranty has been one of the first to announce its intention to enter this space. "We have seen significant activity in the Canadian mortgage insurance industry over the past six months in anticipation of increased competition," says AIG's president and CEO, Andy Charles. "New product introductions, along with the elimination of certain application fees, have greatly benefited Canadian consumers."

The other reason boils down to necessity. It's simply a matter of demographics. With the baby boomer generation reaching a stage in their lives where they don't need to borrow large sums of money, banks are looking to chase a smaller part of the market.

"Years ago you reserved your best rate for your best client," says Lamontagne. "Now, if you go to the bank and ask for a mortgage, almost everyone gets the best rate." These new types of products allow the banks to enter a space that they had otherwise avoided.

Interest Only Mortgage Scenarios

Scenario 1:
$200,000 5-year fixed-rate mortgage at 5.25% with a 25-year amortization.

Monthly blended payment on interest and principal: **$1,192**

Scenario 2:
$200,000 5-year fixed-rate mortgage at 5.25% with a "5/20" interest only option.

Initial monthly payment on interest only for first 5 years: **$866**. Monthly payment on both interest and principal after 5-year interest-only period has ended (assuming the same rate of 5.25%) with an amortization of 20 years: **$1,341**

Scenario 3:
$200,000 5-year fixed-rate mortgage at 5.25% with a "10/15" interest-only option.

Initial monthly payment on interest only for first 10 years (assuming renewal after five years at same rate of 5.25%): **$866**. Monthly payment on both interest and principal after 10-year interest-only period has ended (assuming the same rate of 5.25%) with an amortization of 15 years: **$1,602**.

Zero Down Mortgage Scenarios

Scenario 1:
$200,000 purchase price with $200,000 mortgage, insured by Genworth at 100% LTV.

Mortgage insurance rate: 3.75%
Mortgage insurance cost: $7,500

Total cost of mortgage with insurance: $207,500.

Monthly payments on $207,500 mortgage with 25-year amortization at discounted 5-year fixed rate of 5.25%: **$1,237**.

Scenario 2:
$200,000 purchase price with $190,000 mortgage, insured to 95%, and 5% down payment ($10,000) from borrowed sources.

Mortgage insurance rate: 2.9%
Mortgage insurance cost: $5,510

Total cost of mortgage with insurance: $195,510

Monthly payments on $195,510 mortgage with 25-year amortization at discounted 5-year fixed rate of 5.25%: **$1,165**

Monthly payments on $10,000 unsecured line of credit with minimum 3% monthly payments: $300

Total monthly payments: **$1,465**

Scenario 3:
$200,000 purchase price with $190,000 mortgage, insured to 95%, and 5% down payment ($10,000) from lender cashback.

Mortgage insurance rate: 2.9%
Mortgage insurance cost: $5,510

Total cost of mortgage including insurance: $195,510

Monthly payments on $195,510 mortgage with 25-year amortization at posted 5-year fixed rate of 6.6%: **$1,321**

Source: Invis Inc.

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