



MORE ON MORTGAGES

by Peter Dolezal [The Naked Homeowner](#)

A previous column emphasized the value and impact 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 total amount you ultimately pay for a home, it's worth examining 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 were to remain unchanged at the level approved, for the entire period of the loan.

For many years, the maximum permitted was a 25-year amortization. Two years ago that maximum was raised to 40 years. As of October 15, 2008, this *reverses downward*, to a 35-year maximum.

THE BENEFITS:

The benefits of the longer 35-year amortization are huge, especially for first-time buyers struggling to qualify with minimal down-payments, on near-record home prices. Even those buyers with substantial equity in their existing home find it much easier to “buy-up” to their next home, earlier than would otherwise be possible if limited to a 25-year amortization of their mortgage.

The benefit is easily understood when we compare the monthly payments on a typical mortgage. Consider a \$300,000 condo purchase price, with the requisite \$15,000, minimum 5% down-payment (as of October 15, 2008). Assume a 5% fixed-rate mortgage with a 5-year term. The monthly payment, if the \$285,000 mortgage were amortized over the previously typical 25 years, would be \$1657. However, if a 35-year amortization were chosen instead, this same mortgage would require monthly payments of only \$1479.

Such a significant reduction in monthly payments allows entry into the housing market for many buyers who would otherwise not have the income to qualify.

THE DOWNSIDE:

While a great tool to earlier ownership in a high-priced market such as ours, the 35-year mortgage carries a substantial price tag, *if* the borrower does not move to reduce that term as quickly as an increasing income permits.

Let's look at the total eventual cost of the 25-year vs. 35-year mortgage in our 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 \$497,000 by the time his loan is liquidated. Had he maintained the payments required for a 35-year amortization, his total cost would have sky-rocketed to approximately \$621,000.

For the privilege of lowering his monthly payments by \$178, the borrower with the 35-year amortization would have added a staggering \$124,000 to the total cost of his home!

The clear lesson in this for every mortgage-holder is:

- Select the shortest affordable amortization period;
- If, as is the case for many first-time buyers, you are forced into a long amortization, do your utmost to shorten the period by increasing your payments as your financial situation improves.

A MAJOR PITFALL:

Longer-amortization flexibility offers a 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. Reasoning that by lengthening the amortization period, they gain easy access to tens of thousands of dollars of built-up equity, often without increasing monthly payments.

These *extra* funds are used to purchase vehicles, take vacations, refinance other debt, buy furniture, add to RRSP investments, or make major home improvements. Only the latter, which adds value to the home, can begin to be economically justified.

As earlier discussed, lengthening amortization periods can add huge sums to the debt which must be paid before the mortgage is liquidated. By the same token, buying a vehicle from the *extra* borrowing on a refinanced mortgage, may well result in that automobile eventually costing double or even triple its original purchase price.

The lure of having access to extra cash when refinancing has always existed, even with the previous 25-year amortizations. The 35-year option has simply provided much more leeway, which many find difficult to resist.

Ensure that you fully understand the *total* future cost of mortgage-refinancing as a tool for generating extra cash, no matter its intended use.

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If we wish to own a home, it is difficult for most of us to avoid a long-term mortgage. However, we would be wise to remember that there are few investments that produce a better long-term return *after-tax*, than paying off our mortgage as quickly as possible.

