GETTING A MORTGAGE GUIDE

This guide provides an overview of how a home purchase is financed or an existing home is refinanced. Financing a new home or refinancing an existing home is very similar, if not the same process. Because the term of a mortgage is shorter than what is required to pay off the amount mortgaged completely, an existing home must be refinanced at the end of the term to come up with what is left to be paid, commonly called a balloon payment. This guide will introduce critical concepts and the terminology used in the financing world. A mortgage is an agreement to borrow money, typically from a bank; however, a lender can be anyone who has money to lend, including a family member or business person. This agreement is a negotiated one although there is an old maxim that says: “the one who has the money makes the rules.” Borrowers should nonetheless research what is available in the marketplace. Understanding what is available will put you in a better situation to negotiate.

UNDERSTANDING MORTGAGES

<u>Essential Concepts</u>

Mortgage – A mortgage (also called a “charge”) is a type of loan registered on the title to a property. It provides the lender security for repayment with direct rights against the property in the event of non-payment or other breach of the mortgage terms. This means that if the borrower defaults (fails to pay), the lender can sell the property to recover the money owed. A mortgage is a promise to repay together with the grant of security in real estate. Under a mortgage, the borrower (“mortgagor”) is responsible for making regular payments to the lender (“mortgagee”). The payments are known as “blended” in that they cover the interest on the loan plus part of the principal (i.e., the total outstanding amount of the loan). Payments may also include property taxes, insurance, and similar charges.

A mortgage is a unique kind of loan because it allows a lender to sell or take over ownership of the property if the borrower does not pay on time (i.e., “defaults”). Because the lender enjoys this right, we say that the property is “security” since it gives the lender peace of mind that if the borrower fails to pay, the lender will be able to recoup most if not all of its money (by taking possession and selling the house).

Mortgagor – The borrower is called the “mortgagor” because he/she borrows the money and gives the mortgage to the lender (“mortgagee”). Although this is the popular term, legally a mortgage is now known as a charge and the mortgagor, the chargor.

Mortgagee – The lender is called the “mortgagee” because it lends the money and receives the mortgage from the borrower (“mortgagor”). Although this is the popular term, legally a mortgage is now known as a charge and the mortgagee, the chargee.

Down payment – Most people cannot purchase a home without financial assistance, such as a mortgage. Lenders generally insist that the homeowner has equity in the property. This equity, commonly known as the “down payment”, is contributed by the buyer partly as the deposit in the agreement of purchase and sale and the balance of personal funds delivered on closing. The down payment is often described as a percentage of the purchase price. In Canada, the minimum down payment for residential owner-occupied properties is 5% but some lenders require more. The down payment is essentially the "cash" which the buyer pays out-of-pocket to purchase the property. The rest of the money comes from the "bank" in the form of a loan ("mortgage"). The larger the down payment you pay, the less interest you will pay over the life of the mortgage. Also, if your down payment is less than 20% of the purchase price, you will have to purchase mortgage insurance, which is a kind of insurance which protects the lender in case you can't pay. Mortgage insurance can be a significant additional cost; generally the premium is added to the capital and paid as part of the entire mortgage.

Principal/Interest – The actual money which is borrowed in a mortgage is called the "principal". "Interest" is what the lender charges the borrower for borrowing this money. You can think of interest as rent on the use of someone else's money. When you make a mortgage payment, the lender uses it first to cover the interest. Then anything left over goes to the principal and in some cases to taxes and insurance. At the beginning of the term, generally only a small amount goes to the principal, but gradually more of the payment goes to the principal until the mortgage is fully paid off. The key to saving money on your mortgage is to pay off the principal as fast as possible. If you can make extra payments under the terms of your mortgage, the lender will apply them directly to the principal. By reducing the principal, you can save thousands, or even tens of thousands, of dollars in interest charges.

Equity – The portion of the value of a mortgaged property that the borrower actually owns. The rest is effectively the bank's money. Equity is calculated by subtracting the outstanding amount of the loan owed under the mortgage from the market value of the property at a given date. Equity consequently increases as the principal is reduced (via each monthly payment) and as the property appreciates (via market-driven increases in value). Equity can also diminish such as when property values shrink.

Mortgage Term – In Canada, lenders are not prepared to lend their money on the same rate and terms for the period of time it would take to fully repay it. The "mortgage term" is the length of time of the agreement between the borrower ("mortgagor") and lender ("mortgagee"). Both the borrower and lender agree to live with the same terms for that period of time (e.g., a mortgage amortized over 25 years may only have a term of five years). At the end of the term, the borrower has to repay the balance of the mortgage, which is called a "balloon payment". However, when the term is up, lenders will often extend the option to renew the mortgage for a new term at the best interest rate then available. Alternately, you can look for a better deal from other lenders, get a new mortgage loan, and then use this money to pay off the previous mortgage through the arrangement with the new mortgage lender.

Typical mortgage analysis:

Mortgage Principal Amount	$100,000
Term	5 years
Number of Payments/Payment Frequency	60/Monthly
Interest rate	5%
Amortization Period	25 years
Total Interest Paid Over Five Year Term (Paid to the 'Bank')	$23,404
Total Principal Paid Over Five Year Term (Owned by Borrower as 'Equity')	$11,493
Principal Balance After Five Year Term (Outstanding Debt Owed to the 'Bank')	$88,507

Amortization Period – The length of time it would take to pay off the mortgage in full, based on regular payments at a certain interest rate. A longer amortization period means you will pay more interest than if you got the same loan with a shorter amortization period. However, the benefit is that the mortgage payments will be lower, so some buyers prefer longer amortization periods to make the payments more affordable. Usually, the amortization period is 25 years but can be shorter, say 15 or 20 years. It is generally advantageous to choose the shortest amortization period —that is, the one with largest mortgage payments—that you can afford. This way you can pay off your mortgage faster and save thousands or even tens of thousands of dollars in interest.

Example of the impact of different amortization periods on payments & total interest paid:

	Scenario No. 1	Scenario No. 2	Scenario No. 3
Mortgage amount	$100,000	$100,000	$100,000
Amortization period	15 years	20 years	25 years
Number of Payments/ Payment Frequency	180/monthly	240/monthly	300/monthly
Interest rate	5%	5%	5%
Monthly blended payment	$788	$657	$582
Total interest paid After 25 Years	$41,862	$57,710.01	$74,482

Open/Closed Mortgages – Lenders frequently offer two types of mortgages: open and closed.

- **Open Mortgage** – With an "open mortgage", you can make extra payments (known as prepayments) at any time. You may even be able to pay the mortgage off completely before the end of the term without having to pay any prepayment charges whatsoever. However, the interest rate on an open mortgage is usually higher than on a closed mortgage with similar terms.
- **Closed Mortgage** – A "closed mortgage" is one that you cannot prepay or change before the end of the term without penalties being charged. If you want to make changes to the mortgage during the term (for example, to take advantage of lower interest rates), you will usually have to pay a prepayment charge. The mortgage lender may let you make extra payments (known as prepayments) without charge but usually with limitations. The interest rate on a closed mortgage is usually lower than the rate on an open mortgage with similar terms. A pre-payment penalty is often equal to three months interest or the difference in interest which would have been paid on the existing mortgage to maturity and the interest the lender can get lending that sum at the then current rates. Often it is said to be the higher of either calculation.

Interest Rates – Fixed vs. Variable – The interest rate in a mortgage may be fixed or variable.

- **Fixed Interest Rate** – With a "fixed interest rate mortgage", the borrower agrees to a certain fixed rate of interest for the duration of the mortgage term. Because the interest rate does not change, the borrower knows exactly how much interest he/she will have to pay and how much of the original loan principal amount will be paid off during the term. The benefit of a fixed interest rate mortgage is that it provides security and a predictable budget.

- **Variable Interest Rate –** With a “variable interest rate mortgage”, the interest rate can change during the term in accordance with changes in open market interest rates. These market rates generally track the Bank of Canada Bank Rate. Between 2000 and 2009, the Bank of Canada Bank Rate varied from 6.0 percent to 0.5 percent. The interest rates on variable-rate mortgages are often lower than on fixed interest rate mortgages with the same term length, so variable interest rate mortgages may be attractive and reduce interest charges in the long term. However, it is very difficult to predict which will be the lower-cost option over the term of the mortgage. Although variable interest rate mortgages are riskier and less predictable than fixed interest rate mortgages, they do offer greater potential interest cost savings.

Payments – Fixed vs. Variable – Like interest rates, mortgage payments can also be fixed or variable. Note, however, that fixed interest rate mortgages always have fixed payments, whereas variable interest rate mortgages can have fixed payments, variable payments or a combination of both.

- **Fixed Payments –** With “fixed payments”, you pay a fixed periodic (traditionally, monthly but can also be semi-monthly, biweekly or weekly) payment amount which does not change regardless of changes in the interest rate. If combined with a variable interest rate, when the interest rate goes down, more of the payment applies to the principal and you pay off the mortgage faster. However, if the interest rate goes up, more of the payment applies to interest, and less to principal. This extends the length of time it will take to pay off your mortgage. Because the variable interest rate affects how much of each payment is applied to cover interest, you cannot know in advance how much of the principal will be paid off by the end of the term.
- **Variable Payments –** With “variable payments”, your monthly payment amount changes if the interest rate changes. If the interest rate rises, your payments also rise. Because it is more difficult to plan your mortgage payments over the term of the agreement, a borrower needs to be sure he/she can adjust his/her budget to make higher payments. However, because the amortization period stays the same, you can determine in advance how much of the mortgage will be paid off by the end of the term.

Payment Frequency – Most lenders allow borrowers to choose from a variety of payment schedules (e.g., monthly, semi-monthly (24 payments/year), biweekly (26 payments/year) or weekly). If you choose a more frequent schedule, you save money because more of your money will be applied to the principal sooner, and less interest will accumulate in total. If you can afford an “accelerated” schedule, you can get significant savings on your mortgage interest. An accelerated schedule divides your monthly payments over a weekly or biweekly schedule so that you pay an extra monthly payment each year.

Example of the impact of different frequency of payments on total interest paid:

MORTGAGE PRINCIPAL AMOUNT		$100,000	
TERM		25 YEARS	
INTEREST RATE		5%	
AMORTIZATION PERIOD		25 YEARS	
PAYMENT FREQUENCY	DESCRIPTION	PAYMENTS	INTEREST COST (25 YEARS)
Monthly	• One payment per month for a total of 12 payments each year.	$582/mo.	$74,482
Semi-Monthly	• Two payments per month for a total of 24 payments each year. • The monthly payment is halved and first half applied sooner hence shrinking the interest cost.	$291/twice per mo.	$74,391
Biweekly	• One payment every two weeks for a total of 26 payments each year. • With this payment option, the total amount paid annually is identical to the total paid annually with the monthly payment option (monthly payment x 12 months / 26)	$268/ every 2 weeks	$74,384
Accelerated Biweekly	• One payment every two weeks for a total of 26 payments each year. • With this payment option, the biweekly payment amount is exactly half the monthly payment, payable every two weeks, resulting in payment of the equivalent of one extra monthly payment per year	$291/every 2 weeks	$62,395
Weekly	• One payment per week for a total of 52 payments each year. • With this payment option, the total amount paid annually is identical to the total paid annually with the monthly payment option (monthly payment x 12 months / 52)	$134/week	$74,342
Accelerated Weekly	• One payment per week for a total of 52 payments each year. • With this payment option, the weekly payment amount is exactly one-quarter of the monthly payment, payable every week, resulting in payment of the equivalent of one extra monthly payment per year	$145/week	62,257

GETTING A MORTGAGE

Factors in Qualifying for a Mortgage

Employment/Income – The rule of thumb is that most borrowers can afford and hence most lenders are willing to lend money for a home that runs about two and a half to three times the borrower's annual salary.

Credit Rating – Before banks extend credit, they assess the borrower's credit rating. Lenders use the credit rating to decide whether to lend money, how much, and at what interest rate. The credit rating consists of a credit report and a credit score. A credit report is a report of a person's credit history. A credit score is a number that represents the creditworthiness or the lending risk that the person represents for lenders, compared with other consumers, on a scale from 300 to 900. High scores on this scale are good. The higher the score, the lower the likelihood the person will "default" on his/her mortgage (i.e., not pay), and hence the more likely lenders will extend credit at lower rates. This score is based on an assessment of the person's character, income, economic history (e.g., duration and type of employment), debt payment history (e.g., timeliness of payments), and assets (e.g., savings or other property).

To get the best possible mortgage rate, lenders recommend a person keep his/her credit history healthy and accurate. Aim to raise a credit score above 750 in order to qualify for the best interest rates. Independent agencies, known as credit bureaus, collect and provide this information to prospective lenders whenever borrowers apply for credit. The two main credit bureaus in Canada are Equifax Canada Inc. (www.equifax.ca) and TransUnion Canada (www.transunion.com). Each offers a free copy of their credit report on request.

Loan-to-Value Ratio (LTV) – LTV is a financial measure used by lenders that helps to assess the risk of not recovering the total amount of the loan in the event the borrower defaults. It is one of the key risk factors lenders consider when qualifying borrowers for a mortgage. LTV quantifies the amount of the loan relative to the value of the asset being purchased. To calculate the LTV, divide the loan amount by the property's value. If the LTV is above 80% (in other words, less than a 20% down payment) the rates may increase significantly. Moreover, the borrower will also likely have to purchase mortgage default insurance to protect the lender from his/her defaulting, which increases the cost of the mortgage. Alternately, one can find a less expensive home or save up for a larger down payment to lower the LTV below the 80% threshold. Lenders prefer not to loan out more than 80% of an asset's value for the simple reason that doing so might result in lenders having to suffer a loss in the event the asset decreases in value on the open market. By getting borrowers to front 20% of the cost means the lender will not likely suffer any loss due to depreciation in value.

Debt-to-Income Ratio (DTI) – DTI is a financial measure used by lenders to assess the burden of an individual's debt obligations relative to his/her income. DTI is the percentage of income that goes toward paying all monthly debts. DTI is another key risk factor lenders consider when assessing borrowers for mortgages. Mortgage lenders use DTI to determine how large a mortgage the borrower can afford after all his/her monthly debts are paid. To calculate DTI, add up all monthly debts (not only mortgages) and divide by the monthly income. A DTI between 20-39% is usually considered good and will help a person be perceived as financially stable.

The Financial Consumer Agency of Canada (FCAC) has an online Mortgage Qualifier Tool to help prospective buyers get an idea about how large a loan they would likely be approved for based on formulas lenders regularly use to evaluate mortgage loan applications. The site can give someone a realistic sense of his/her ability to pay for a mortgage. Note that when someone buys a home, he/she will also have to be ready to pay for a variety of additional expenses and taxes.

NEGOTIATING THE TERMS OF A MORTGAGE

The following terms are typically addressed when negotiating a mortgage:

- The amount of the down payment you can pay (determines whether mortgage insurance must be obtained);
- The amortization period that will best fit your monthly budget (e.g., 15, 20 or 25 years);
- The mortgage term (e.g., 1, 3 or 5 years);
- An open or closed term mortgage
- A fixed or variable interest rate;
- Fixed or variable payments;
- Payment frequency (e.g., monthly, weekly, biweekly or accelerated payment schedule);
- Pre-Payment option (e.g., 10% or 20% annually, double-up payments, skip a payment, etc.).

The key factor in choosing a mortgage is what you can afford in your monthly budget. A mortgage calculator can help you compare the costs of different mortgage options.

Traditionally, banks will post information of their mortgage for borrowers to see and consider. This is their offer. Depending on the negotiating strength of the borrower, a borrower can negotiate better conditions than posted by the banks in their windows, website or campaign. Often borrowers will simply accept the conditions offered much as we buy an item at the grocery store. However, lenders are often prepared to negotiate the conditions (i.e., the interest rate, payment schedule, term, amortization period, pre-payment, or other rights, etc.). Anyone looking to negotiate a mortgage should inquire not only of his/her regular financial institution but also of others, as only then can he/she discover if he/she is getting the best conditions. Mortgage conditions are personal to each borrower; depending on his/her risk level, income, financial situation, and life plans.

In addition to approaching a bank for a mortgage, a borrower could approach a mortgage broker to determine what conditions are available. A broker typically deals with many lenders, banks, trust companies, and private lenders. They often are a centralized option to quickly and efficiently canvass the market. There is no need to use a broker, but many find it beneficial or easier to do so.

A borrower might also shop for a mortgage based on the options that best serves him/her. For example, if someone anticipated selling his/her home, he/she would opt for a shorter term (e.g., 1 year) or an open mortgage to minimize or avoid paying any pre-payment penalties to the lender.

A borrower who knows his/her income will likely increase in the years ahead will seek a mortgage with options to increase his/her payments (e.g., double-up) or offer him/her the ability to make lump sum payments (e.g., 10% of the original principal once a year, whether on a calendar year or anniversary of the mortgage), in addition to seeking a fixed term and interest rate to ensure stability in the early years.

Caution – Line of Credit

It has become very desirable and common to be approved by a lender for a line of credit. Contrary to a mortgage, which only has a declining balance (i.e., only pay off the loan and once paid, it ends), a line of credit, also called a revolving loan, permits new borrowing that can be paid off many times during its existence. The principal amount may go up or down over the years as new money is borrowed and payments are made. A line of credit may be secured or unsecured. A secured line of credit is most often a mortgage on a home. It is possible to have a regular first mortgage and if there is sufficient equity in the home, a line of credit secured as a second mortgage. Many homeowners will sign up at their bank for a line of credit and not understand that they are in fact giving the bank a mortgage on their home. This mortgage to secure the line of credit is often called a "collateral mortgage" and can be problematic as it might in fact be providing security for the bank for not only the line of credit but also any other indebtedness of the borrower to the bank, existing or in the future, including credit cards. When providing a mortgage or collateral mortgage to a lender it is advisable to consult with a lawyer to have the loan and mortgage documentation reviewed and explained.

MORTGAGE TERMINOLOGY GLOSSARY

Term	Definition
Amortization Period	The period of time it will take to pay off a mortgage in full.
Appraisal	Evaluation by a certified appraiser to confirm the value of the property. This may be different than the purchase price. Lenders will require an appraisal as they cannot legally lend more than a certain value and the purchase price is not acceptable as the sole determination of the value.
Blended Mortgage	A combination of two mortgages, one with a higher interest rate than the other, to create a new mortgage with an interest rate somewhere between the two original rates. Often seen when buying a new home and an existing mortgage remains.
Blended Payments	Payments made up of principal and interest components.
Closed Mortgage	A mortgage that you cannot prepay or change before the end of the term.
Collateral Mortgage	A loan, often for something other than the purchase of your main home (e.g., home renovations, the purchase of a second home, or a business venture) that is secured against your home. Often, a collateral mortgage is registered to a secure line of credit.
Conventional Mortgage	A first mortgage issued for up to 80% of the property's appraised value or purchase price, whichever is lower.
Debt Service Ratio	Measure used by lenders to qualify a borrower for a mortgage, being the percentage of a borrower's gross income that can be used for housing costs, including mortgage payment and taxes (and condominium fees, where applicable).
Discharge of Mortgage	Once the mortgage has been completely paid, the lender must register evidence that it has been paid on title to the property. The registration has the effect of removing the lender's registered interest in the property.
Down Payment	The amount of money the buyers contribute to the purchase of the property on closing. This may be as little as the deposit, but generally includes further monies paid on closing to be at least 5% of the value of the property.
Equity	The current market value of a home or property minus the amount remaining on any mortgages.
Fixed Interest Rate Mortgage	A mortgage with an interest rate that does not change during the term.
Fixed Payments	Payments that do not change even if the mortgage interest rate changes.
Foreclosure	A legal process by which the lender takes possession and ownership of a property when the borrower defaults on the mortgage obligations – this is a court process.

High Ratio Mortgage	A mortgage for more than 80% of the property's appraised value or purchase price. Many lenders are prohibited from lending over 80% of value, unless the mortgage is insured.
Interest	The amount you pay the lender for the use of the lender's money.
Line of Credit	A loan that is usually used for something other than the purchase of a home (e.g., home renovations). It may be secured (e.g., with a "collateral mortgage") or unsecured. You can "withdraw" the full amount at one time or use smaller amounts up to the full amount of the loan. The lender charges interest on the total amount withdrawn and not yet repaid.
Maturity Date	The date when the mortgage must be either paid in full or another term negotiated through a renewal agreement. Also called Balance Due Date.
Mortgage/Charge	A loan registered on title providing the lender security for repayment with direct rights against the property in the event of non-payment, such that in the event of default the lender can sell the property to recover the money owed. Mortgage is the old terminology and Charge is the new term.
Mortgage Approval	Written approval from the mortgage lender, indicating how much will be advanced under the mortgage and what conditions must be met for the mortgage. Also called Commitment Letter.
Mortgage Insurance	Government-backed or private-backed insurance protecting the lender against the borrower's default on high ratio (or other types) of mortgages, issued by Canada Mortgage and Housing Corporation (CMHC) or Genworth Financial Inc., or Canada Guaranty Mortgage Insurance Company.
Open Mortgage	A mortgage that you can prepay at any time during the term, without charge/penalty.
P.I.T.	Principal, interest and taxes. If property taxes are included in your mortgage payments, these three components will make up the regular payment on your mortgage.
Power of Sale	A legal process by which the lender can sell a property when the borrower defaults on the mortgage obligation – this is called a self-help process as it does not involve the courts.
Pre-Payment Penalty	A penalty imposed in accordance with the terms of the mortgage when a mortgage is paid off before it comes due (i.e. end of the term), often representing three months' interest or the interest differential between the rate in the mortgage being paid off and the current rates, whichever is higher.
Pre-Payment Privilege	A mortgage feature that allows the borrower to repay a portion or all of the principal balance with our without penalty. This privilege is frequently restricted to specific

	amounts as a percentage of the principal and when it can be exercised (e.g., 10% once per year).
Principal	The amount borrowed under the loan.
Second (and Third) Mortgages	A mortgage registered on title after the first mortgage, so that the second mortgage lender's rights are secondary to the rights of the first mortgage lender.
Term	The length of time your mortgage agreement will be in effect.
Variable Interest Rate Mortgage	A mortgage with an interest rate that can change during the term.
Variable Payments	Payments that may change as interest rates change.

FOR MORE INFORMATION

If you have any questions arising from this guide or concerns which have not been addressed, please contact a lawyer in your area for consultation. You can locate a lawyer who deals with these matters by doing an internet search or by going to lsrs.lsuc.on.ca/lsrs/ or www.titleplus.ca.