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Interest-only mortgages best left to high rollers, not real home buyers



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Rob Carrick

A weakening U.S. housing market provided a cautionary backdrop to a major lender's announcement yesterday that it will offer interest-only mortgages.

First National Financial LP said the mortgages allow first-time buyers or existing homeowners to pay just interest on their mortgages for either the first five or 10 years of the loan. First National bills the new product as a tool for people who want lower monthly payments for a period of time so they can direct money into things like renovations, investment opportunities or retirement savings.

Canada Mortgage and Housing Corp. announced the availability of interest-only mortgages on June 28, but lenders haven't exactly been queuing up to sell them. Mortgage brokers report that a firm called Merix Financial is offering interest-only mortgages, but it hasn't done much marketing. First National has taken a more assertive approach by issuing a news release.

Interest-only mortgages came into existence in the United States years ago as a product for wealthy people who preferred to invest money in the markets rather than use it to pay down their mortgage principal. If this describes your personal situation, then interest-only mortgages may make some sense to you.

For the rest of us, these mortgages are best dismissed as a sign that housing in Canada is vulnerable to the kind of correction we're seeing in the U.S. market.

Yesterday, the U.S. National Association of Realtors announced that the level of existing home sales in the United States last month was the lowest level since early 2004, and that prices fell on a year-over-year basis for the first time since April, 1995. The U.S. housing market is going down, and there's no basis for smugness that home prices in Canada won't give back some of their gains of the past several years.

The connection between interest-only mortgages and house prices has to do with affordability. The national average price of a house in August hit \$277,189, while Toronto, Calgary and

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Vancouver averaged from \$338,192 to \$520,686. With incomes growing modestly at best for many people, houses are becoming steadily less affordable.

Interest-only mortgages can theoretically help sustain the housing boom by lightening the burden of making your payments for while. First National offers an example: On a five-year \$175,000 loan at 5.3 per cent, you'll pay \$1,050 per month in a traditional mortgage and \$765 in an interest-only mortgage.

You have to be able to afford the higher principal-plus-interest payments to get an interest-only mortgage. But given how liberal the affordability measures are, there's no question that people can use interest-only mortgages to buy houses that are by all rights too pricey for them.

In a market where house prices are going to keep rising, this isn't an especially big problem. Even if you're not building equity in your home by paying down principal, the marketplace is pitching in by raising the overall value of the property.

Today, though, Canadian homeowners have to be mindful of the potential for price stagnation at best and price declines at worst. Imagine making interest-only payments on a home that is falling in value. At the end of a five-year period you could own substantially less of your home than you did when you bought it, even after paying tens of thousands in interest.

That wouldn't be your only challenge in an interest-only mortgage. CMHC rules stipulate that after the initial interest-free period ends, your loan is converted into a standard mortgage with an amortization period of 20 years for the five-year version of the interest-only product, or 15 years for the 10-year version. This means a jump in payments that could be in the area of 50 per cent.

Let's not exaggerate the threat of interest-only mortgages. They account for roughly 20 per cent of the U.S. mortgage market, but they're destined for fringe status here unless the Big Five banks are misguided enough to start offering them.

Also, there are signs that the Canadian market is too conservative for interest-only mortgages to get much traction. "I haven't sold one yet," said mortgage broker Richard Hanoski of Ottawa-Carleton Mortgages in Ottawa. "Have I mentioned it to clients? Yes, but it doesn't seem to be generating much interest."

John Panagakos, a broker-owner at People's Choice Mortgage Corp. in Toronto, said he sees a market for interest-only mortgages strictly among high-net-worth individuals or people who are investing in real estate. "For first-time home-buyers without a significant down payment, I urge them not to go this route."

Alternatives for those struggling to afford a home include mortgages that extend the usual 25-year amortization period to 30 or 35 years, thereby reducing monthly payments. Another option for the patient types: Bide your time until sales drop enough for sellers to lower their prices.

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