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Home buyers face mortgage rate roulette

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Home hunter Vanessa Christie, 26, decided a condo is a more realistic choice for a first-time buyer.

Vanessa Christie wants to buy her first home. But it's been tougher than she thought. Since she started looking at properties in May, she has been outbid on five.

"It was really tough going because the market started to really pick up after I started looking," says the 26-year-old Toronto woman.

Her original $300,000 budget has also been pushed higher with every bidding war.

"I was getting out of my comfort zone," says Christie, who works in the marketing department at a financial services firm. "But the interest rates are so low it was tough to know when I'd get another opportunity."

Christie eventually took a few months off to re-evaluate whether she really could afford a house. This month she decided she would lower her sights and buy a more affordable one-bedroom condominium, hopefully downtown, near her office in the city's financial core.

In many ways, Christie is the role model for diligence, refusing to get caught up in a heated market that some analysts say may be on the verge of a bubble. But not all first-time buyers are as disciplined.

Analysts have been repeatedly warning that some potential buyers, enticed by low interest rates, are taking on too much risk and debt.

Finance Minister Jim Flaherty told the *Star* on Monday that he is considering reducing amortization periods and increasing the down payment required on homes if the housing market shows excessive demand.

"This concerns me that some Canadians might not pay enough attention to the affordability factor because inevitably, mortgage rates will go up," Flaherty says.

Many economists expect the Bank of Canada to hike rates by at least a percentage point or more by the end of next year.

This month the bank pledged to keep its key overnight rate at 0.25 per cent, even though bank governor Mark Carney has also expressed concern about a potential asset bubble forming in the housing market, stressing that household debt remains the biggest risk to the country's financial markets.

But for now, concerns over a still-struggling economy and a high Canadian dollar have trumped issues over housing.

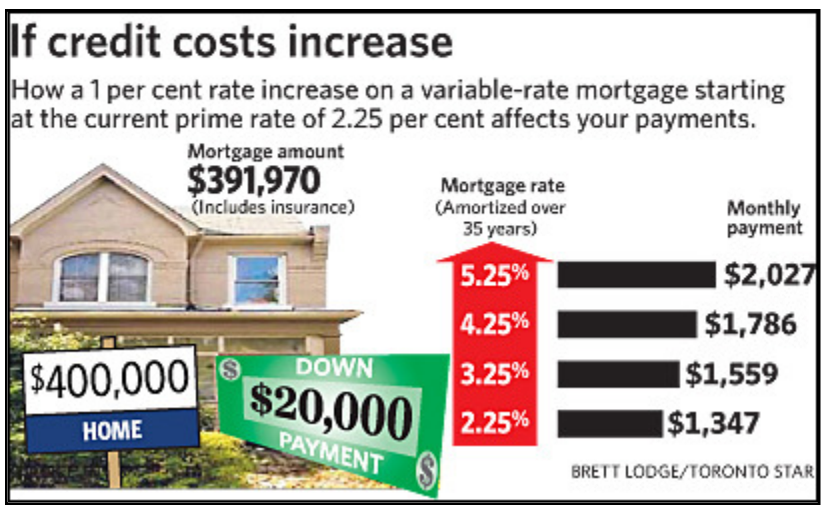
"People see the low rates and they jump in, they don't think twice," says Lois Volk, a mortgage broker with Toronto-based INVIS. "Most buyers don't think about the fact that mortgage rates could rise."

The most vulnerable clients are those who are self-employed, rely on one income, or are employed in susceptible industries such as manufacturing, Volk says.

"You have to put the question to them whether they are prepared to pay when their monthly payment goes up, because it will."

Potential buyer Christie says she's paying attention. "I've had it pounded into me by friends and family that I shouldn't get distracted by low interest rates. I know if it goes up by 3 per cent, that's a lot of money out of my pocket."

But living in a rented semi-detached home with three college students means she's eager to find her own space. She was also careful enough to save $40,000 for a down payment during her university years by running a College Pro Painters franchise.



Buyers today can get a variable-rate mortgage at prime or 2.25 per cent, and in many cases cheaper after discounting.

But even at the prime rate, it would cost only $1,347 to carry a $400,000 home with an amortization of 35 years and a 5 per cent down payment. By comparison, an average two-bedroom condo in the Toronto area costs $1,487 per month to rent.

That's a compelling reason for home ownership.

As a result, first-time buyers have been fuelling the exodus out of rentals and into new homes. Apartment landlords, meanwhile, have been scrambling to fill empty units with enticements of free rent and more amenities.

But as figures by INVIS show, even a 1 per cent increase next year means monthly payments jump from $1,347 to $1,559. That extra $212 is not extreme, but it is serious lunch money for most people.

While fixed rates can be had for 4 per cent, most people are taking the variable-rate mortgages with an option to lock in, says Jim Wong, a broker with RBC.

While no one knows where interest rates will settle in the long run, most say it is not inconceivable that they will rise by a percentage point every year for the next three years.

A 5.25 per cent mortgage rate would mean the $400,000 home would now cost $2,027 every month, or an additional $680 per month. That's a lot of extra money to be shelling out – especially if you're not expecting rate increases.

Some analysts estimate as many as 10 per cent of households risk losing a home if the Bank of Canada rate rises to just 4.5 per cent

"The question I usually ask is, if you needed to put an extra $400 or so every month in the bank, could you do it?" Wong says. "People need to know to build in a cushion."

However, broaching the subject with clients can be difficult, says Wong. Some may take offence to being lectured by their brokers.

"You have to ask the right way – people don't want you to be their parents and they may take it the wrong way."

Even at 5.25 per cent, mortgage rates would still be below long-term averages around 7 per cent.

And much further below the 14 per cent interest rates of the 1980s that helped implode the housing market back then, so those scenarios are conservative.

Housing economist Will Dunning says consumers who stretch themselves could see an impact down the road, but he doesn't see a problem so far, since most people are locking in their mortgages for five years.

Still, more than a quarter of the Canadian home-buying population, or 27 per cent, has a variable mortgages. For the 68 per cent with fixed mortgages, the hope is that housing prices will continue to rise and they will be more financially secure when it comes time to renew.

Another troubling issue for Flaherty and for regulators is the use of longer amortizations.

Bankers such as Peter Aceto, head of ING Direct Canada, have expressed concern that too many consumers are using the 35-year amortizations. The standard in the industry used to be 25 years. Consumers are also making smaller down payments, as little as 5 per cent instead of the standard 20 per cent of years past.

A recent study by the Canadian Association of Accredited Mortgage Professionals shows long-term amortizations now account for 18 per cent of the mortgage universe, compared with 16 per cent a year earlier. In 2007, only 9 per cent of all respondents said they had long-term mortgages.

Mortgage broker Volk says an overwhelming number of her first-time buyers choose longer amortizations. "In some cases, it's the only way they can get into the market."

Certainly, it's a lot cheaper per month. Paying for that $400,000 house on a fixed 3.99 per cent interest rate with 5 per cent down will cost only $1,725 a month. It costs $2,052 on a 25-year amortization.

But after five years, the consumer will barely have paid off any of the principal, since most of the money goes to interest payments.

The holder of a 35-year mortgage will still owe $363,300 at the end of five years, compared with $339,843 with a 25-year amortization.

Christie says she will likely take the 35-year amortization, but knows she will have to be disciplined. "I don't want to be retired and still trying to pay off my mortgage," she says. "I understand I have to be realistic, but it's hard not to get caught up in the frenzy."