Everything You Need to Know About Mortgage Refinancing

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Overview

When you are looking to refinance, the mortgage waters can be incredibly difficult to navigate. Knowing what type of mortgage will work best, who to go to in order to get that mortgage, the various types of interest and how to refinance is a lot of information to arm yourself with before you even start to research.

With all of this in mind, this e-book will discuss the various different types of mortgages and the pros and cons for each type. It will also look at the different types of lenders who provide mortgage financing. Finally, it will look at the process of mortgage financing and discuss the ins and outs of mortgage refinancing, as well as applying for or receiving mortgage refinancing. After reading you will be better equipped to head out and obtain financing that meets your individual needs.

Chapter 1
Types of Mortgages

Types of Mortgages

In Canada, there are several different types of mortgages, and each one has its own pros and cons. This section will discuss each type of mortgage and explain how each one works. It will also look at mortgage interest and how this is calculated and applied.

First vs. Second Mortgages

First Mortgages

A first mortgage may be the original mortgage financing to fund the initial purchase of a home, or it could be renegotiating and refinancing to take equity from the home when a portion of that mortgage has been paid off.

Second Mortgages

A second mortgage is one that many individuals use when equity is not available in order to refinance the first mortgage but want to finance a large product such as to consolidate debt, finance home renovations, or pay for a child's education.

A second mortgage is completely separate from a first mortgage. This means that your interest rate and your terms are different (it could be much shorter and therefore paid off quicker).

Low Ratio vs. High Ratio Mortgages

Low Ratio Mortgages

In Canada, when you purchase a home, a down payment of 5% of the purchase price is required. However, if you have a down payment of 20% or more, you may qualify for a conventional/low ratio mortgage.

A low ratio mortgage does not normally require mortgage protection insurance.

High Ratio Mortgages

If you cannot put a down payment of 20% or more of the purchase price down, you will be required to get a high ratio mortgage. According to Canada Housing and Mortgage Corporation (CMHC) guidelines, high ratio mortgages must be covered by mortgage protection insurance.

Closed Term vs. Open Term Mortgages

When you decide on a mortgage, one of the other things that you will likely have to think about is whether or not you want it to be open or closed.

Closed Term Mortgages

A closed term mortgage is one that requires a set monthly payment and that is the only payment made. You cannot choose to make additional payments throughout the year or increase the amount of your payments when money permits. Additionally, you cannot renegotiate or refinance a closed term mortgage before it reaches maturity (although with some financial lenders you can refinance or renegotiate for a fee).

Closed term mortgages are well suited for those who feel that paying off the mortgage in the short term may not be feasible. This is because interest rates on closed term mortgages are usually lower than for open term mortgages.

Open Term Mortgages

An open term mortgage is one that has set monthly payment requirements, but these are flexible and you can increase the amount paid, or pay off the entire mortgage at any time without penalty. Open term mortgages usually have shorter terms, meaning the mortgage is paid off sooner.

Open term mortgages are best suited for those who have the ability to pay a greater amount each month or know that they will be able to pay off the entire mortgage at a certain time. Choosing an open term mortgage just to have the option to pay if the opportunity arises is not necessarily the best option, as open term mortgages usually have higher rates of interest than closed term mortgages.

Fixed Rate vs. Variable/Adjustable Rate Mortgages

Fixed Rate Mortgages

With a fixed rate mortgage, your rate (and thus your monthly payment and term) are fixed when your mortgage is finalized. This means that your interest rate is locked in and does not change over the course of your mortgage term.

There are several benefits to a fixed rate mortgage, most notably the fact that if mortgage interest rates increase, your interest rate will not increase. Additionally, the amount of your regular monthly payment will not change, the amount of your payment that goes towards principal and interest will not change, and you know exactly how long it will take to pay off the mortgage.

The downside with a fixed rate mortgage is that, if the market interest rate decreases, the interest rate that you are paying will not decrease with it.

Variable/Adjustable Rate Mortgage

With a variable rate mortgage, your term is set, but your interest rate changes when the market interest rate changes. This means that if the rate decreases, your interest rate will decrease as well. Your payment stays the same, but the amount being paid to principal will increase, meaning the mortgage is paid off at a faster rate.

On the flipside, the negative here is that if the market interest rate increases, your interest rate will increase as well.

Chapter 2
Types of Mortgage Interest

Mortgage Interest

There are many different forms of mortgage interest. What makes these interest rates different is the rate at which they compound.

Interest Only Mortgages

Private mortgages are often interest only, which means that your minimum payment is based on the amount of interest owed for that month and no portion of your payment is allocated to principal. When you have an interest only mortgage it is important to set mortgage terms that allow you to pay more than your minimum monthly payment and then take advantage of those terms. If you do not – you will never pay down the principal owed on your mortgage.

Monthly Compound Interest

Most lines of credit and even some mortgages have monthly compound interest. This means that interest compounds 12 times per year and often the interest you end up paying is much higher than your annual rate of interest. Monthly compound interest in these cases works the same way as the interest charged on a credit card. Pay attention to the amount of your mortgage payment. If your interest compounds monthly and you have a very low mortgage payment this will mean that very little of your payment is being applied to principal so you will want to ensure that you have set repayment terms that enable you to make more than the minimum monthly payment.

Semi-Annual and Annual Interest

Interest that compounds semi-annually (twice per year) or annually (once per year) is standard with most conventional mortgages and most ideal.

Chapter 3
Types of Lenders

Types of Lenders

There are a number of different types of institutions that you can go to in order to secure mortgage financing. These include banks, mortgage brokers and private lenders. Here is some information, as well as some pros and cons, with respect to each type.

Bank

When you go to the bank for a mortgage, you work with a loan officer who can review your situation and help decide on the best fit for a mortgage for you. For many people, this is coupled with an already established relationship with the banking institution, which may not be the case with a mortgage broker. Another pro here is that you can consolidate all of your services – your mortgage will be handled by the same institution that handles most (if not all) of your other finances. Low interest rate is not guaranteed, but is highly likely. With a bank, negotiation is sometimes possible, but you have to initiate it, so don't just accept the first rate given to you.

However, one of the biggest negatives with going to a bank for a mortgage is that a bank can only give you their deal (it may be the best, it may not be, but you don't have a choice). There is little room for negotiation here when it comes down to the wire.

Mortgage Broker

When you go to a mortgage brokerage for financing, you work with a broker who will, like a loan officer at a bank, review your situation and help determine the best mortgage fit for you. However, unlike a loan officer, a mortgage broker will shop around for the best deals, rates, etc. and can offer these to you. This means that you will likely get a better rate than the one offered to you by the bank.

Additionally, dealing with a mortgage broker may be beneficial when it comes to your credit. Each time you apply for credit, a credit inquiry is done by the lending institution. If you go to a number of different banks, and each one pulls your credit report, this can adversely impact your credit sore. With a mortgage broker, only one inquiry is done and that same inquiry is used when sourcing out a number of different institutions' deals.

Yet another pro to working with a mortgage broker is that they have more ability when it comes to providing credit to those with a lower credit rating. They know which lenders service individuals with poor credit, and can leverage those relationships to secure the funding for you.

A negative to this route is that there may not be a well-established relationship in place with a mortgage broker – but if that is not an issue, it doesn't necessarily need to be a negative. Also, your mortgage will likely end up being through a different financial institution than the rest of your regular banking, so consolidating may not be possible.

Private Lender

For some, a private lender may seem like the only option if credit is poor, but a private lender should be your last resort. They usually charge an upfront fee and very high interest. Additionally, they are regulated by far fewer guidelines (meaning they can be more flexible), and require less documentation for approval than a bank or mortgage broker. Unless all other avenues are closed to you, this option should probably be avoided.

Chapter 3
Mortgage Refinancing 101

What is Mortgage Refinancing?

Firstly, what is mortgage refinancing? When you refinance your mortgage, you are essentially replacing your current mortgage contract in order to obtain additional funding through your current mortgage. This may mean redrafting a new mortgage contact or obtaining a home equity line of credit.

Some people confuse mortgage refinancing with a second mortgage, but these two are not the same. When you take on a second mortgage, this is an additional mortgage that is completely separate from the first.

Why Refinance?

Mortgage refinancing in Canada remains an incredibly popular financial decision, and individuals choose to refinance for a number of different reasons. These include:

- To take advantage of low interest rates
- To access home equity
- To consolidate debt

To Take Advantage of Low Interest Rates

When you obtained your original mortgage, you may have chosen to go with a fixed rate mortgage (where the interest rate is fixed and remains the same throughout the entire length of your mortgage) or a variable rate mortgage (where the interest rate that you pay fluctuates to reflect the current market interest rate). With both of these options there is always a chance that this means paying more interest than you could be paying.

For example, if you chose a fixed rate mortgage 5 years ago, and the market interest rate has decreased since then, refinancing could mean an interest rate decrease for you. Conversely, if you chose to go with a variable rate mortgage and the market fluctuations mean you are paying more than you'd like when rates increase, you can refinance and switch to a fixed rate mortgage and your rate will remain the same.

To Access Home Equity

As you pay off your mortgage, your home gains equity, and if you choose to refinance you can access this equity. This cash can then be used to finance any number of things: home renovations, your child's education, paying off debt, or large ticket purchases. According to CMHC, when you refinance you can access up to 80% of your home's value (minus any outstanding mortgage balance), so depending on how much of the balance you have paid off, as well as the current market value of your home, this could be a substantial amount of money.

To Consolidate Debt

This is a very popular option for those individuals who may be finding it difficult to make all the required monthly payments, on time, every month. If you are making a number of high-interest payments each month (car loan, credit cards, etc.), refinancing your mortgage to consolidate debt can mean one single monthly payment at a far lower rate of interest, thus saving you a ton of money.

This also has the added bonus of helping to improve your credit score because you will have paid off a number of credit products and are making a regular payment on time, every month.

Types of Refinancing

Refinancing an Existing Mortgage

When you do this, you are essentially breaking your existing mortgage contract and creating a new one. In this case, you eliminate the existing mortgage and take on a new one that reflects your goals.

Since you are breaking the contract terms early, there is usually a fee associated with this type of refinancing, called a prepayment fee. This fee varies depending on the term and type of mortgage that you had.

Adding a Home Equity Line of Credit

As mentioned, as you pay down the balance of an existing mortgage, the equity your home has grows. A home equity line of credit allows you to access this equity because it is essentially like having one big credit card, just secured against your home. Because home equity lines of credit are secured on your home they are almost always far less interest than a conventional credit card.

Costs Associated with Refinancing

As mentioned, in most cases, when you refinance you are breaking your current mortgage and this means a prepayment fee charged by the original lender. This depends on the terms and the type of mortgage.

Additionally, since you are essentially taking on a new mortgage, the same costs associated with your first mortgage exist with the new one (legal, appraisal, title change, etc.). Depending on the lending institution, these fees may be waived or incorporated, but they are something to think about. Also, in the end, if the interest rate is better or you are consolidating debt through a refinance, the money you save in the long run is likely much greater than the initial output to refinance.

When is a Good Time to Refinance?

If you are thinking about refinancing for any of the reasons mentioned above, there are a few things to be considered. For some, refinancing is a great idea, but for others, it may be better to wait or to choose a different option.

Good idea to refinance:

- If you plan on staying in your home for the foreseeable future. Generally, the longer you plan on staying in your current home, the better idea it is to refinance.
- If you want to refinance to consolidate debt, and the total debt you owe (plus current mortgage balance) is less than 80% of the value of your home, this can mean huge savings interest-wise and the convenience of one single monthly payment.

Good idea to wait:

- If you plan on moving in the near future. This is because you may never realize the potential savings from refinancing.
- If the current interest rate is higher than the rate you locked in with your current mortgage. If you break a mortgage with an interest rate of 2.5%, and then refinance at a rate of 3.5%, you may not save as much money. It may be better to wait until interest rates decrease.
- If you want to refinance to consolidate debt, but the total debt you owe (plus current mortgage balance) is more than 80% of the value of your home, you won't be able to incorporate all of that debt, meaning that you

will incur the penalties associated with refinancing and not all of the benefits.

Conclusion

We hope that you have found this information useful. After reading this e-book, we hope that you find that you have a much better understanding of mortgage refinancing and the many pros and cons that come with this financial decision. Mortgage refinancing can be a great way to lower your interest rate and consolidate debt, but, as we've shown, there is far more to consider than just that monthly payment.

If you are thinking about refinancing, make sure that you know what you want to achieve, and ask questions. The best financial decision you can make is a well-informed one!

Author Bio

This e-book was written by Michael Goldenberg. Michael Goldenberg is the founder and President of DebtCare Canada Inc.

DebtCare Canada offers a service for those who struggle with debt. When Michael formed DebtCare Canada he refused to offer the typical 'credit counselling/debt services' offered by other credit counselling agencies.

Seeing that many bankruptcy trustees and credit counselling agencies are one dimensional, Michael formed a multi-faceted team.

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