



Why 40-Year Mortgages Aren't 40 Years Long

By Peter Vukanovich

Much has been written recently about extended amortization mortgage products and whether they could lead to real estate market problems like those experienced in the United States. Those concerns are misplaced, and I will tell you why.

Extended amortization mortgage products offer homebuyers the option of repaying their mortgages over 30, 35 or 40 years, up from the traditional 25 years. These options became popular in 2006, when major lenders, such as banks and credit unions, began offering them to consumers.

Mortgages with extended amortization options should not be confused with subprime mortgages. They are very different concepts.

Subprime mortgages are loans made to borrowers with a history of credit problems. They have higher interest rates than "prime" mortgages, and in the U.S. often offer the homebuyer very low payments for a short period of time before quickly jumping to substantially higher levels. Many homeowners subsequently defaulted on their subprime mortgages, a problem that has been—and continues to be—confined to the United States.

These serious difficulties in the U.S. real estate market have led some observers to suggest that extended amortization products in Canada will eventually lead to the same dire circumstances—in other words, people buying homes that they can't afford and subsequently defaulting on their mortgages.

This is not the case. Extended amortization products do not lower the bar for homeownership. Rather, they are an option available to make homeownership more affordable by reducing the minimum monthly mortgage payment. To many, this is particularly helpful during the initial years of homeownership. Unlike subprime loans, extended amortization products are intended for "prime" borrowers with a good credit history. The majority of individuals who choose an extended amortization option could also qualify for a traditional 25-year amortization mortgage.

Good candidates for extended amortization mortgages include: early-career borrowers with higher income earning potential, those who anticipate significant other short-term expenses and people trying to buy into higher priced urban markets.

Extended amortization mortgage products are not for everyone. For example, a home purchased with a 40-year mortgage will carry significantly higher interest costs over the life of the mortgage than one purchased with a traditional 25-year mortgage, assuming the homeowner uses the entire amortization period to repay the loan (see Table 1).

Table 1*

Amortization (Years)	25	30	35	40
Monthly Payment	\$1,674.56	\$1,566.01	\$1,495.59	\$1,448.30
Interest (First month)	\$1,336.19	\$1,336.19	\$1,336.19	\$1,336.19
Principal (First month)	\$338.37	\$229.82	\$159.40	\$112.11
Total Interest Paid	\$252,367.94	\$313,759.50	\$378,151.77	\$445,177.19

*These calculations are based on a mortgage of \$250,000 at 6.5%.

However, there are many options for paying down mortgage debt sooner, including accelerated payment options and lump sum payments. For example, moving from a monthly to an accelerated bi-weekly payment schedule reduces a 40-year amortization period to 32 years. With lump sum payments, the mortgage could be paid off in about 25 years. Table 2 illustrates those interest savings.

Table 2**

40 year amortization with monthly payments of \$1,448	40 year amortization with accelerated bi-weekly payments of \$724
Total Interest Paid = \$445,177	Total Interest Paid = \$309,184
Mortgage paid off in 40 years at total cost of \$695,177	Mortgage paid off in 32 years at total cost of \$559,184

** Mortgage of \$250,000 @ 6.50 % interest rate (numbers rounded)

To date, Canadians regularly exercise these and other options for paying down their mortgage debt. Most homeowners will repay their mortgages in 15 to 20 years.

There are a few reasons for this. First, homeowners tend to be conservative about mortgage debt. For example, a recent survey of new home purchasers reported that 78 percent want to pay off their mortgages as fast as possible. The fact that Canada does not allow the deduction of mortgage interest for the purposes of calculating personal income tax is an important driver of this behaviour.

Not only do Canadian homeowners *want* to pay down their mortgages sooner, they regularly *must* reconsider their options for doing so—including the amortization period. For example, mortgage loans in Canada generally end after five years, after which time the homeowner has the option of choosing a shorter amortization period. Similarly, the average Canadian moves every seven years, ending the mortgage.

Canadian homeowners are very capable of handling their mortgage obligations as evidenced by the current very low incidence of mortgage defaults. This situation is not expected to change as we gain more experience with extended amortization products.

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