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# The Six Year Mortgage Strategy

Canadians looking to refinance their existing mortgage or purchase a new home within the next 6 months should obtain a 1 year Fixed Rate Mortgage. This will allow the well informed consumer to lock into a Variable Rate Mortgage (VRM) with a more favorable interest rate in the next 12 to 18 months. It is our belief that the premium currently being charged on these VRM's will disappear.

Like any financial product VRM's are priced by the market. We strongly believe that VRM's will decrease in price to consumers over the next 12 to 18 months. This decrease will be a result of an increase in mortgage lender demand for VRM's and a decrease in the cost associated with those lenders holding VRM's.

We will go on to explain why this has happened, what we expect will happen in the future and how the Canadian mortgage consumer will be able to benefit from a 6 year strategy.

**Why has this happened?**

In August of 2008 the Canadian Banks changed the pricing on their VRM's from 1% below prime to 1% above prime. In some cases mortgage lenders in Canada decided to discontinue their VRM products altogether.

http://www.youtube.com/watch?v=hFysfhO1x38 (CBC interview with Marcus Tzaferis on the subject)

VRM's are issued by many different financial institutions in the Canadian Market. What many of us do not see is that the institution that lends us the money on our funding date may not be the eventual holder of the mortgage. Even though we see one name on our mortgage statement every month the money for that mortgage could very possibly have come from another lender altogether.

The first step in any transaction is for the lender or mortgage servicer to lend the money to the borrower.

In many cases these mortgages are lent to borrowers and then sold off to either Financial Institutions that have a demand for mortgages to match against deposits that they hold, or to Mutual Funds and Pension Plans that have an appetite for the risk free return that these mortgages offer.

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The initial mortgage lenders carry your mortgage until it can be sold to another party. They are compensated for originating the mortgage and in most cases for servicing the mortgage (collecting payments and answering client calls). The costs or interest rate that the initial lender charges you for the mortgage are set by what they are able to sell it off for and how costly it is for them to hold it until they can sell it (carrying costs).

The carrying costs of these mortgages are determined by two factors:

1. The interest rate at which the bank borrows its money. (Bankers Acceptance Rate, explained below)

2. The length of time they must hold the mortgage for until it can be sold.

When we are able to directly break down the costs associated with these mortgages, it becomes much easier to figure out why they increased in price. The “credit crisis” had two major impacts on these fundamental components to the price of VRM’s.

1. Bankers Acceptance Rates skyrocketed
Institutional investors became weary of what the short term money being given to their counterparts was being used for, they realized that the short term, risk free investments in American Mortgages were perhaps not as insulated from default as they had expected. Trust levels in Financial Institutions collapsed and the spread between Bankers acceptances and the prime rate dropped to close to 1%. This drop significantly decreased the profit on VRM sales (see chart below).

2. Someone must want to buy these mortgages
The Bank of Canada has increased the dollar amount of mortgages that it will buy from Mortgage Lenders in Canada.

There are only two obstacles to lower VRM’s:

1. Banks like money,
They will not transfer the reduced cost associated with holding their VRM’s on to us until it becomes obvious that their margins on the VRM’s have been healthy for an extended period of time.

2. There are some great alternatives to investing in mortgages,
With the market doing so poorly and Banks looking for capital wherever they can, Institutional investors who have money to invest must now choose between the returns from relatively risk free Banks who are offering 8% on debt and mortgages which return much less. It will be up to these investors to deduce the actual risk in the competitive debt options and also to The Bank of Canada to ensure that the liquidity in the Consumer Debt market is maintained.

We strongly believe that these hurdles will be overcome within 12 to 18 months. Banks will be unable to keep their margins on mortgages so inflated and competition for Government backed Canadian homeowner debt will once again be an irreplaceable component to any portfolio.

**How Can I Benefit?**

We have developed a very simple 2 step process to steer our clients through this period of financial uncertainty.

**STEP 1**

*Obtain a 1 year Fixed Rate Mortgage.*

Currently these mortgages are priced between 3.8% and 4.1%.
In comparison the VRM's offered by most banks today are 0.80% above prime (a good broker will be able to get you 0.45% above prime). Since prime has decreased to 3.0%, these mortgages are very attractive to consumers who are locked into 5 year fixed rate mortgages.

Like any investment decision they should be compared against another option. At a rate of 3.8% (3.0% prime + 0.80% premium) and a forecast for the future that the prime rate will be dropping, there is little doubt that switching will save the average consumer some money.

We propose that this offer will only get better. By choosing a 1 year fixed rate product over the prevailing VRM price (4.1% for a 1 year vs. 3.8% for a 5 year variable) you would only be slightly worse off when the prime rate decreases further in the coming year. While this is a very likely, it is over shadowed by the increased certainty that the premium on these VRM's will be significantly eroded when the market returns to a more normal level.

As the cost to originate and sell these VRM's decreases, their rates will drop. Waiting will most certainly prove advantageous. Obtaining a 5 Year VRM today would mean that you would pay a premium of 0.80% over prime. By waiting 1 year, it is our belief that you will be able to lock into a VRM at a discount to prime and therefore, save considerably on the 5 year term of that mortgage.

**STEP 2**

*As the term on your 1 year mortgage draws closer evaluate prevailing VRM's with your Mortgage Broker.*

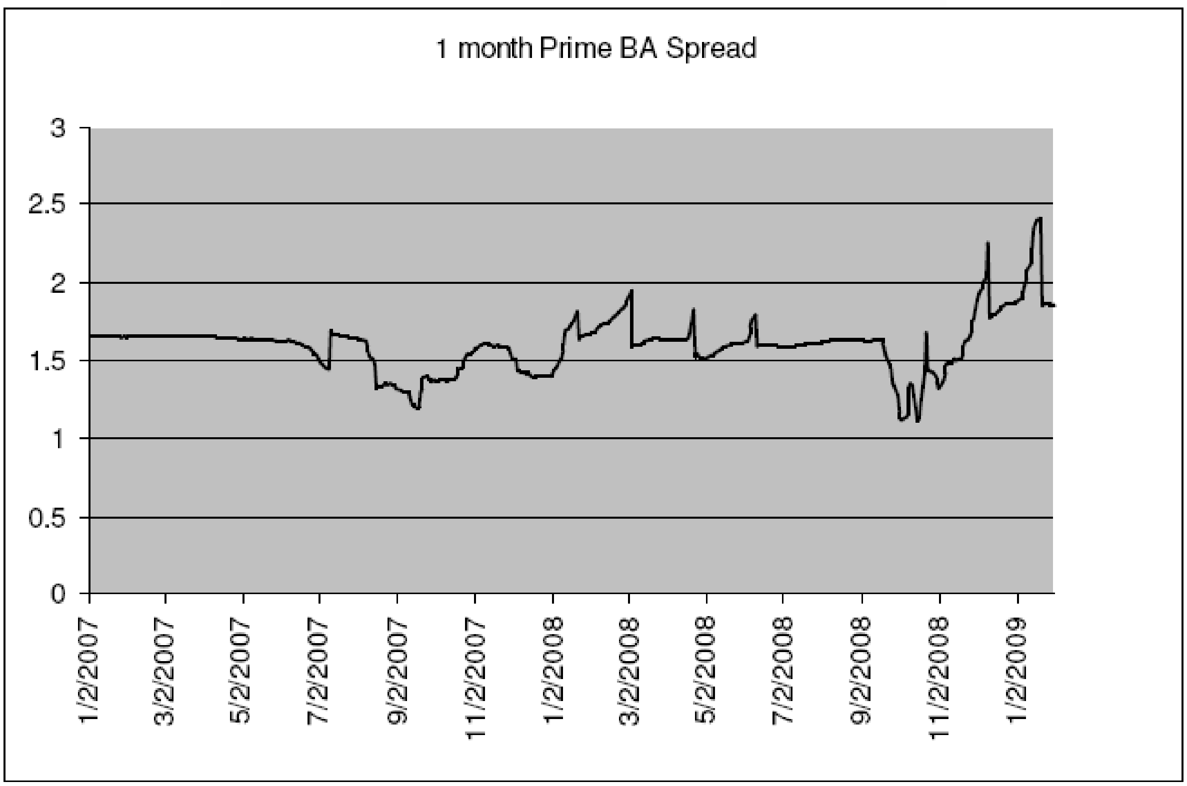
We believe that in 12 months the VRM market will be priced far more aggressively. If the anticipated discount of 0.50% off of prime can be obtained in 1 year you will be able to save considerably.

Comparing yourself to a person who obtained a VRM 1 year before you at 3.8% (prime +0.80%) you will be looking at savings of close to $1,300 per year for every $100,000 of mortgage.

**SOMEADDITIONAL INFORMATION**

**Bankers Acceptances Rate (BA's**), this is the rate at which banks lend money amongst themselves for short periods of time. The chart below shows the difference between prime and the 1 month Bankers Acceptance Rate.

**Actual pricing of VRM's:**
Since VRM's are often carried on a Banks balance sheet for several months before being sold to an Institutional buyer looking for a risk free fixed income stream, the short term carrying cost incurred by the bank is actually BA's (Bankers Acceptances). The following chart shows the decrease in the spread between BA's and Canadian Prime Rate in October of 2008. Since these VRM's are currently being sold at (prime + 0.8%) this provides us with an indication of the margin involved in selling these VRM's.

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**"Credit Crisis" American Mortgage Problem:**
The American people were offered money at ever decreasing mortgage rates and with an ever decreasing list of qualification criteria. This increased demand for American Consumer debt was a result of an insatiable appetite created by Wall Streets Derivatives Creators. It appeared as though Credit Default Swaps, a derivative created by some very creative Wall Street quantitative types, would eliminate all risk associated with high risk high return mortgages, by packaging all the risk together and paying some big, or in some cases, not so big institution to take it.

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