Watch Out For Those Collateral Mortgages!

So...what is a 'collateral mortgage?'

A collateral mortgage is a loan that is secured against property for an amount that is typically 100% or in excess of the value of the property rather than the amount of money actually borrowed. Typically a collateral mortgage is registered for a secured line of credit. Today many banks are offering what are thought to be regular mortgage loans when in reality they are collateral mortgages secured against the entire amount of equity in a property.

A traditional mortgage let's you establish a set amount to be borrowed, the rate for the term chosen (e.g. 2.3% for 5 years) and the amortization so that the borrower will know exactly when the whole amount will be paid off and will also know what existing equity may be available in the property. If a borrower of a "traditional" mortgage wished to borrow more by using a second mortgage or registering a home equity line of credit, they could. However, a borrower of a "collateral mortgage" may not have this flexibility. This problem arises because the value of the bank's "security" differs from that of what is actually lent.

Several banks here in Canada are now going forward with this new approach. One notable culprit, TD Bank, is actually registering 125% of property value, even though that amount has not and never will be advanced to the borrower. Their objective is to have a greater chance of the client returning to the bank for more financing due to the fact that the bank would have secured their entire value of the borrower's property. A transfer to a new bank is going to be more costly because a lawyer must always be involved. The borrower is often trapped!

Another major issue that should be considered prior to stepping into a collateral mortgage involves the other debts the borrower may have. Under Canadian law a lender of a collateral mortgage may seize equity to cover other debt you have with the same lender. So, in essence, you are securing all of your loans, credit cards, lines, car loans, and overdrafts held with the lender of your collateral mortgage. Many borrowers are not even aware of what they're getting into since bank sales representatives often conveniently fail to mention these details. When the bank sends the paper work to your lawyer you may find an unpleasant surprise and often far too late to allow for arranging new financing.

If you are looking to purchase a second home or an investment property, any collateral loans you have will be registered on your credit bureau. When you approach a new lender for a mortgage the lender will have to calculate you eligibility/approval based on what is registered on your property, not just the amount received from the lender. You look leveraged and now your ratios may not allow you to qualify for an approval on other purchases. If you are a real estate investor, this is suicide to you. Real estate investing is about flexibility and the last thing you want to do is limit your access to equity.

TD isn't the only bank to offer collateral mortgages. Credit unions also use them; HSBC and the Royal Bank have a "re advanceable mortgage," which is a collateral mortgage. Scotiabank's STEP is also a collateral mortgage.

Most chartered banks will not accept "transfers" of collateral mortgages from other chartered banks so the borrower will have to pay larger fees to register a new conventional mortgage if the decision is made to move to a new lender. However, if you already have a mortgage with one of the lenders that register loans in this way, it would be wise to remove yourself as soon as possible in order to gain control over your debt!

Collateral mortgages allow lenders to change the interest rate after closing. All a borrower has to do to trigger an increase in interest rate is miss a payment. Since the collateral mortgages are being registered with rates as high as prime + 10% (regardless of the rate stated on your original mortgage document), lenders will cover their potential losses by increasing the rates if they feel a potential default in the horizon.

When looking for financing it is much better to have a broker working for you rather than putting your fate in the hands of a specific, branch level, bank mortgage specialist. It is the banks objective to keep you as a customer and only offer you an option from its limited selection of financing options. A mortgage broker/agent has access to several lenders that are not available at street level and can negotiate on your behalf, buy down rates, and confirm that the mortgage is best suited for you. Don't let big banks tease you with these low rates and get caught in a trap. When something looks too good to be true it usually is.

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