Financial Consumer Agency of Canada | Agence de la consommation en matière financière du Canada

ABCs OF MORTGAGES SERIES

MORTGAGE PREPAYMENT: KNOW YOUR OPTIONS

Smart mortgage decisions start here

Financial Consumer Agency of Canada
IT PAYS TO KNOW.

Canada

About Financial Consumer Agency of Canada (FCAC)

With educational materials and interactive tools, the Financial Consumer Agency of Canada (FCAC) provides objective information about financial products and services to help Canadians increase their financial knowledge and confidence in managing their personal finances. FCAC informs consumers about their rights and responsibilities when dealing with banks and federally regulated trust, loan and insurance companies. FCAC also makes sure that federally regulated financial institutions, payment card network operators and external complaints bodies comply with legislation and industry commitments intended to protect consumers.

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OVERVIEW

Mortgage prepayment refers to paying more than the regular mortgage payments you have agreed to pay in your mortgage contract.

Examples of prepayment:

- increasing the amount of your regular mortgage payments
- making lump-sum payments to reduce your mortgage balance
- paying off your mortgage in part or in full before your term is over.

If your mortgage gives you **prepayment privileges**, you can save thousands of dollars in interest charges by paying down your mortgage faster.

However, if you have a closed mortgage, your lender will generally require you to pay a charge to make a prepayment that is more than your privileges allow.

Prepayment charges can be costly, so it is important to know when they can apply and how they are calculated. Prepayment charges are sometimes called penalties or breakage costs.

If you have an open mortgage, you can prepay any amount without paying a prepayment charge.

When you shop around for a mortgage, look carefully at the prepayment privileges and charges as you consider your options.

WHAT ARE PREPAYMENT PRIVILEGES?

Prepayment privileges are terms of your mortgage contract that allow you to pay an amount toward a closed mortgage on top of your regular payments, without triggering a prepayment charge.

For example, each year, your privileges might allow you to:

- make a lump-sum payment up to 15 percent of the original mortgage amount, and
- increase your regular payments by up to 15 percent.

Privileges vary from lender to lender. Generally, if you do not use a privilege, you cannot carry it over to the next year.

EXAMPLE:

Farah received a raise which allowed her to save $20,000. She wants to use it to make a prepayment on her mortgage at the beginning of the second year.

- **Mortgage amount:** $200,000, amortized over 25 years
- **Prepayment privileges:** lump-sum payment of up to 10% of original mortgage amount allowed once a year
- **Assumptions:** for this example, the interest rate will be 5.45% for the entire 25-year mortgage.

(In reality, interest rates are only valid for the length of a fixed-rate term and will likely change.)

By using her privileges, Farah can make a lump-sum payment of $20,000. This prepayment will reduce the amount of interest Farah will pay over the life of the mortgage by more than **$44,000**. She will be able to pay off her mortgage over **four years** sooner.

You can use the Mortgage Calculator on FCAC's website at **www.fcac.gc.ca** to find out how much you can save by making prepayments.

WHAT ARE PREPAYMENT CHARGES?

If you have a closed mortgage, you may be required to pay a **prepayment charge** if you:

- pay more than the amount allowed by your prepayment privileges
- refinance your mortgage — for example, if you want to borrow additional funds using the equity you have built up over time
- renegotiate your mortgage — for example, if you want to break your mortgage contract to take advantage of lower interest rates
- transfer your mortgage to another lender before the end of your term.

Prepayment charges are based on factors such as:

- the amount you want to prepay (or pay off early)
- the number of months left until the end of your term
- interest rates
- the method your lender uses to calculate the prepayment charge.

Your **estimated** charge will change from day to day since it is based on factors that change over time, such as the amount left to pay on your mortgage.

You may also have to pay an administration fee to make a prepayment.

HOW WILL MY PREPAYMENT CHARGE BE CALCULATED?

These are the two most common methods for calculating a prepayment charge:

- **Three months' interest:** an amount equal to three months' interest on your outstanding mortgage balance.
- **Interest rate differential (IRD):** an amount based on the difference between two interest rates. The first is the interest rate for your existing mortgage term. The second is today's interest rate for a term that is similar in length to the time remaining on your existing term. For example, if you have three years left on a five-year term, your lender would use the interest rate it is currently offering for a three-year term to determine the second rate for comparison in the calculation.

Your mortgage contract may state that the prepayment charge will be the higher of the two amounts that result from the calculations using the different methods.

EXAMPLES: PREPAYMENT CHARGE CALCULATIONS

Note: The calculations in the examples below are simplified for demonstration purposes. Review your mortgage agreement or contract to find out exactly how your charge will be calculated.

Jim is considering breaking his mortgage to take advantage of lower rates. He wants to **estimate** how much the prepayment charge would be.

- **Outstanding mortgage balance:** $200,000
- **Annual interest rate:** 6%
- **Number of months left in term:** 36 months (or three years) left in a five-year term
- **Today's interest rate for a term of the same length:** Jim's lender is offering a 4% interest rate for a mortgage with a 36-month term

METHOD I: THREE MONTHS' INTEREST

To estimate Jim's charge based on **three months' interest**, we can use this formula:

A × B ÷ 12 months × 3 months

- **A:** Outstanding mortgage balance
- **B:** Annual interest rate

Step	Amount	Enter your information
Step 1: Identify the outstanding balance on Jim's mortgage **(A)**.	$200,000	
Step 2: Multiply the outstanding mortgage balance **(A)** by the annual interest rate **(B)**. Write the annual interest rate as a decimal. For example, 6% = 0.06	$200,000 x 0.06 = $12,000	
Step 3: Divide the answer by 12 months to get the amount of interest payable for one month.	$12,000 ÷ 12 = $1,000	
Step 4: Multiply the answer by 3 months.	$1,000 x 3 = $3,000	
Prepayment charge estimate based on three months' interest:	**$3,000**	

METHOD II: INTEREST RATE DIFFERENTIAL (IRD)

To estimate Jim's charge based on the **interest rate differential (IRD)**, we can use this formula:

A × (B – C) ÷ 12 months × D

- **A:** Outstanding mortgage balance
- **B:** Annual interest rate
- **C:** Today's interest rate for term of similar length. Note: the lender may round up or down to the nearest term.
- **D:** Number of months left in term

Step	Amount	Enter your information
Step 1: Identify the annual interest rate on Jim's mortgage **(B)**.	6%	
Step 2: Identify today's interest rate for a term that is similar in length to the time left on Jim's term **(C)**.	4%	
Step 3: Subtract the answer from Step 2 from the answer in Step 1 to get the difference in interest rates **(B – C)**. Write this interest rate as a decimal. For example, 2% = 0.02	6% – 4% = 2% or 0.02	
Step 4: Multiply this answer by the outstanding mortgage balance **(A)** to get the interest differential for one year.	0.02 x $200,000 = $4,000	
Step 5: Divide this answer by 12 months to get the interest differential for one month.	$4,000 ÷ 12 = $333.33	
Step 6: Multiply this answer by the number of months left on Jim's term **(D)**.	$333.33 x 36 = $12,000	
Prepayment charge estimate based on interest rate differential:	**$12,000**	

HOW IS THE PREPAYMENT CHARGE CALCULATED IF YOU RECEIVED A DISCOUNT ON YOUR INTEREST RATE?

If you negotiated a discounted interest rate, the calculation of the interest rate differential will depend on the lender and the terms of your mortgage contract.

- Some lenders may use the posted (or advertised) interest rate at the time you signed your mortgage agreement and compare this to the current posted rate for the term remaining.
- Other lenders may use your actual discounted interest rate but also apply the discount to the current rate for the comparison. In this case, the difference in rates remains the same as if posted rates were used and the results of the calculation will be very similar.
- Some lenders may use your discounted interest rate for your existing term but will not apply the discount to the posted interest rate used for comparison. This will usually result in a lower prepayment charge.

HOW CAN YOU FIND OUT ABOUT YOUR PREPAYMENT CHARGES?

If your lender is a federally regulated financial institution, such as a bank, it must outline prepayment privileges and charges, along with other key details, in an information box at the beginning of your mortgage agreement.

By law, it must tell you how the prepayment charge will be calculated. It must also provide you with a description of the components used in the calculation of the charge. This information must be presented in a manner and written in language that is clear, simple and not misleading.

If the calculation is complex, your lender may provide a simplified example, illustration or method to help you estimate the prepayment charge.

Read your mortgage contract carefully to confirm these details before you sign. Ask questions about anything you do not understand.

HOW CAN YOU REDUCE OR AVOID PREPAYMENT CHARGES?

- **Shop around:** Before you sign, look for flexibility in a mortgage, such as prepayment privileges.
- **Make full use of your prepayment privileges:** This way, any prepayment charges will be based on a lower mortgage balance. If possible, make a lump-sum payment before you break your mortgage.
- **Wait until the end of your term to prepay:** If your prepayment charge will be a large amount, consider waiting until the maturity date, when you can make a lump-sum prepayment without triggering any charges.
- **Port your mortgage:** If you are buying a new home, your lender may allow you to "port" your mortgage, or take your existing interest rate and terms and conditions, with you to your new home.

QUESTIONS TO ASK WHEN SHOPPING FOR A MORTGAGE

- How much can I prepay without paying a charge or a fee?
- Is there a minimum or a maximum amount for a prepayment?
- When and how often can I make prepayments?
- Are there any conditions related to prepayments?
- If there are charges or fees, how much are they, and how are they calculated?

ABOUT THE *ABCS OF MORTGAGES* SERIES

The *ABCs of Mortgages* series explains the features and costs of mortgages. The following resources are part of the series and are available on FCAC's website at **www.fcac.gc.ca**:

Publications

- Buying Your First Home
- Paying Off Your Mortgage Faster
- Renewing and Renegotiating Your Mortgage
- Borrowing on Home Equity

Tip sheets

- Shopping Around for a Mortgage
- Buying and Maintaining a Home: Planning Your Housing Budget
- Choosing an Amortization Period: What is the Impact on Your Mortgage
- Understanding Variable Interest Rate Mortgages
- Understanding Reverse Mortgages
- Protect Yourself from Real Estate Fraud

Online tools

- Mortgage Qualifier Tool
- Mortgage Calculator Tool

Online Quiz

- Mortgage Quiz

GLOSSARY

Amortization period
The period of time it will take to pay off a mortgage in full. The most common amortization period for a new mortgage is 25 years. Not to be confused with the **term** of the mortgage.

Closed mortgage
A mortgage agreement that cannot be prepaid or changed before the end of the term. Your lender may let you make certain prepayments without paying a charge, but you will usually have to pay a charge to break your mortgage agreement.

Interest
The amount paid by a borrower to a lender for the use of the money.

Mortgage
A loan (usually for buying a property) in which the lender can take possession of the property if the loan is not repaid on time. Payments include the principal and the interest; they may also include a portion of the property taxes.

Open mortgage
A mortgage that can be prepaid at any time during the term, without paying a charge. The interest rate on an open mortgage may be higher than on a closed mortgage with an equivalent term.

Posted rate
The interest rate advertised or shown by a financial institution. Usually, financial institutions advertise their mortgage interest rates without any discounts. You may be able to negotiate a lower interest rate before you sign your mortgage agreement.

Prepayment
Payment of an additional portion or all of the principal balance before the end of your term. Lenders may charge fees when you use a prepayment option under a closed mortgage agreement.

Prepayment charge
A fee charged to you by the lender for making a prepayment greater than the amount allowed in your mortgage agreement, or for paying off a closed mortgage before the end of the term.

Prepayment privilege

Terms of your mortgage contract that allow you to pay an amount toward a closed mortgage on top of your regular payments, without triggering a prepayment charge.

Principal

The amount of money that you borrowed from a lender to pay for your home.

Term

The period of time your mortgage agreement will be in effect. At the end of the term, you either pay off the mortgage in full, renew it or possibly renegotiate your mortgage agreement (for example, decrease your amortization period). Terms are generally for six months to 10 years. Not to be confused with the **amortization period**.