

Mortgage penalty can be a shocker

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As interest rates fall to record lows, you may want to break your mortgage and negotiate a lower rate.

But the penalty charges can be prohibitive if you're in the early years of a long-term mortgage at a fixed rate.

Take Marilyn, who recently sold her house because she couldn't afford to keep it. She had a \$308,000 mortgage, with three years left on a five-year term at 5.74 per cent.

She was shocked when told by the bank that the penalty cost would be about \$20,000.

"That means I only pay off the bank, the real estate agent and the lawyer," she says.

"I was hoping to have enough cash in my pocket to cover my basic survival needs while searching for my next position."

Another customer, Michael, sold his condo just a year after taking out a \$208,000 mortgage at 5.85 per cent.

He was charged \$11,000 to break the mortgage, despite having applied for financing on another property he bought.

Both customers assumed they would pay a penalty of three months' interest. That used to be the case many years ago.

Today, most lenders charge a penalty based on the gap between current and past interest rates, the outstanding balance and the number of months left in the mortgage term.

Called the interest rate differential (or IRD), the penalty is higher now than in the past because of how far interest rates have fallen in the past six months.

There's no standard way for lenders to calculate the IRD, says Isabelle Rodrigue, acting team leader of consumer education at the Financial Consumer Agency of Canada.

"It's not an easy thing to understand and most people can't do it on their own. We advise them to shop around and talk to lenders about the benefits of renewing early."

If you're faced with a stiff penalty, you may have some leverage by negotiating with other lenders first.

"Then, go back to your current lender and say: 'I'm planning to leave. Can you do something about the penalty if I stay?'" says Robert McLister, a mortgage planner with Mortgage Architects, who edits a popular blog, [CanadianMortgageTrends.com](#).

Another tip is to make a lump-sum payment before renegotiating.

Many mortgages allow you to pay up to 20 per cent of the balance in any given year.

This lets you lower the penalty, which is calculated on the balance after you have made your prepayment.

Some mortgage brokers find that people are changing their minds about floating rate mortgages.

"There's a significant trend toward variable-rate clients moving into longer term fixed-rate loans," says Calum Ross, senior vice-president at The Mortgage Centre.

"Yes, they're paying a higher rate. But with the current economic uncertainty, they don't feel comfortable taking on additional risk."







With variable-rate mortgages at 3.3 per cent to 4 per cent and five-year closed mortgages at 4.99 per cent to 5.25 per cent, the price gap has narrowed.


In an influential study in 2001, finance professor Moshe Milevsky said that most of the time, people pay less interest over the long run by choosing a variable-rate mortgage.

But in an interview last month at the Canadian Mortgage Trends blog, he said it pays to be in a fixed-rate mortgage 10 to 12 per cent of the time – and this might be one of those times.

Not only has the premium of fixed rates over variable rates largely disappeared, but there are added risks from falling home prices, reduced availability of credit and employment instability.

An environment like we're seeing today brings into question any type of historical study, Milevsky added.

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