Real Estate Bulletin

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High mortgage penalty can put strain on seller's finances

With interest rates at record lows, people may be considering upgrading to a new home or refinancing their current mortgage. The decision to purchase a new home merits the homeowner's attention as to the type of mortgage penalty he/she will be subject to when the term of the existing mortgage is broken.

When a seller breaks the term of his mortgage, the penalty was usually three months' interest. However, with the rates being so low, more financial institutions are opting to charge clients the interest rate differential (IRD) penalty. In simple terms, the IRD is the gap between the current and past interest rates, the outstanding balance and the number of months left in the mortgage term.

This issue is of importance to realtors: When a seller has little equity in the home, there may not be enough funds to cover the commission once the seller has discharged the existing mortgage. When acting for a seller in negotiating the final selling price, agents should raise this issue with their clients, as the penalty being applied may influence their bottom-line selling price.

While there is no standard way for lenders to calculate the IRD, the following example illustrates how many IRD mortgage penalties are calculated and why sellers should be alarmed.

Jim has a mortgage of $300,000 at an annual interest rate of 5.75 per cent. He has 36 months left in his 60-month term with an outstanding balance of $288,477. Jim is selling his house to upgrade to a new home and benefit from the lower interest rates. Assuming the current market rate for a mortgage for a 36-month period is 4.5 per cent, Jim would pay a penalty **based on the higher of the two amounts shown as follows** (because this is what his mortgage contract stipulates):

(a) *Three months' interest penalty*

Outstanding balance X monthly interest rate of Jim's mortgage X three months: ($288,477 X 5.75% ÷ 12 months X 3 months = **$4,147**

(b) *Interest Rate Differential* (based on the difference in interest rates)

To obtain the interest rate differential, take the interest rate on Jim's mortgage (5.75%) and subtract the current market mortgage rate (4.5%): 5.75% - 4.50% = 1.25% (interest rate differential). The IRD penalty is the monthly interest rate differential ÷ number of months remaining on Jim's mortgage X outstanding balance (1.25% ÷ 12 months) X 36 months X $288,477 = **$10,818**

If Jim breaks his mortgage, he would have to pay a penalty of $10,818—the greater amount. Note the IRD penalty is greater than the three-months' interest penalty by $6,671!

These scenarios have been simplified for illustration purposes as the method of IRD calculation differs according to each lending institution. In any event, it is a worthy topic to address with your clients who are selling.

Please note the IRD does not usually apply to variable rate mortgages, which are usually either fully open or subject to a three-month interest penalty. For those clients, it is probably a good time to lock into a low, fixed-rate mortgage.

Regards,

Robert Riopelle

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