you asked us

A publication of the Financial Consumer Agency of Canada

Knowledge Is Power

Issue # 1 May 15, 2002

The Financial Consumer Agency of Canada (FCAC) is committed to educating consumers about financial products and services, and protecting consumers in the federally regulated financial sector. We receive many calls, letters, e-mails and in-person visits from consumers on a wide variety of topics. *You Asked Us* deals with the most common and current questions raised by consumers who have contacted us.

From October 24, 2001 – when the Agency opened – to April 19, 2002 we received 6,318 telephone calls, letters, e-mails and in-person visits, of which 1,560 related to credit cards. We addressed a number of credit card issues in our report *Credit Cards and You* (found in the Publications section of our Web site). The next category of most frequently asked questions we have received relate to mortgages, and whether financial institutions have the right to impose a penalty if consumers want to pay off or renegotiate their mortgage, to benefit from new lower mortgage rates.

Key Issue: Mortgages

Q. Does my financial institution have a right to impose a penalty, or make me pay the difference in interest costs, when I want to pay off or renegotiate my mortgage so I can benefit from the new lower mortgage rates?

A. It depends on what was stated in the original mortgage agreement or most recent renewal agreement that you signed. Some agreements do not allow for a mortgage to be renegotiated, but most do.

If your agreement allows you to pay off or renegotiate your mortgage early, you will normally have to pay a penalty. This charge is generally equal to whichever is greater: a) three months' interest on your current mortgage balance; or b) the difference between the interest rate on your current mortgage and the new lower mortgage rate corresponding to the number of months remaining on your mortgage (see example on back). Some financial institutions may also add an administration fee for breaking your mortgage contract.

WHAT'S HOT ON THE FCAC WEB SITE

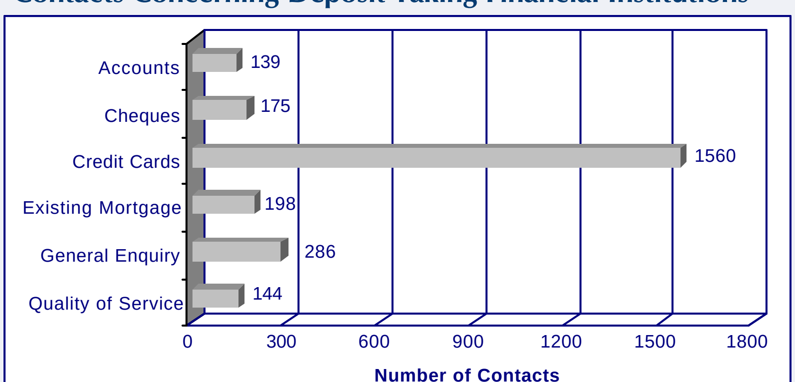
Most popular page:

Publications (www.fcac-acfc.gc.ca/publications)

Most popular document:

Brochure: *Low-Fee Accounts*

Contacts Concerning Deposit-Taking Financial Institutions



Period: October 24, 2001 - April 19, 2002

Total Contacts to Date:	6,318
Total Inquiries:	3,482
Total Complaints:	2,836

CONTACT US

The FCAC welcomes any questions or comments you may have.

For additional information, to provide comments or to obtain copies of this publication, please contact us at:

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Examples of Penalty Calculation*

Jim started with a mortgage of $100,000, at an annual interest rate of 8 per cent. He has 36 months left in his 60-month (five-year) term. His outstanding balance is $97,218. Jim wants to break his mortgage and take out a new mortgage contract, to benefit from the lower interest rates currently being offered. He wants to know what penalty he would pay for doing so. Assuming that the current market mortgage rate for a 36-month (or three-year) period is 6 per cent, Jim would pay a penalty **based on the higher of the two amounts shown below** (because this is what his mortgage contract stipulates).

Possible Penalty Options

a) *Three months' interest penalty*

The penalty would be:

Outstanding balance x Monthly interest rate of Jim's mortgage x 3 months.

This would amount to:

$97,218 x (8% ÷ 12 months) x 3 months = $1,944*

b) *Interest rate differential penalty* (based on the difference in interest rates)

To obtain the interest rate differential, take the interest rate on Jim's mortgage (8%), minus the current market mortgage rate (6%): 8% – 6% = 2% (interest rate differential).

The interest rate differential penalty would be:

Monthly interest rate differential x Number of months remaining on Jim's mortgage x Outstanding balance

This would amount to:

(2% ÷ 12 months) x 36 months x $97,218 = $ 5,833*

If Jim decided to break his mortgage, he would have to pay a penalty of $5,833, since this is the higher of the two penalty calculations.

*** Simplified for illustration purposes. The actual penalty calculated by your institution may be different.**

Why Financial Institutions Impose Penalties

The penalty or interest charge often relates to how your financial institution obtained the funds to lend you the money for your mortgage.

One way for institutions to obtain funds for a mortgage is to offer their customers term deposits on which they pay higher interest than on a normal savings account. For example, a customer who locks in his/her $60,000 deposit for a period of five years may receive five per cent annual interest on this deposit. The deposit is then used to fund a $60,000 mortgage for another customer who also wants a five-year mortgage. If, after three years (that is, before the end of the five-year term), the customer with the mortgage wants to break the existing agreement and renegotiate it because mortgage rates have gone down, the institution is still required to pay the other customer the higher rate on the deposit agreement for the full five years.

Tips to Minimize Penalty Charges

Many mortgage agreements offer a pre-payment option without penalty. This pre-payment option may let you pay off up to 20 per cent of your mortgage in any given year (this may vary from one financial institution to another). Refer to your mortgage agreement for the exact percentage. If it is possible to do so, you may want to pay a portion of your mortgage (if your financial institution allows this) before you renegotiate your mortgage. Your penalty would then be calculated on the outstanding balance after you have made your pre-payment.

The pre-payment option is not cumulative. In other words, if you did not make additional payments on your mortgage this year, you would not be able to accumulate the percentage of pre-payment allowed and double your pre-payment next year; for example, increase your pre-payment from 20 to 40 per cent. (Pre-payment options may vary depending on the financial institution.)

Some institutions may also allow you to extend the length of your mortgage, prior to your mortgage renewal date, to take advantage of the current low rates by creating a new blended rate and longer-term mortgage loan. This is called the "blend-and-extend" option. (See example below.) Not all financial institutions offer this option.

Example of Blend-and-Extend Option

Linda has 12 months left in her 60-month (five-year) mortgage, at an interest rate of 8 per cent. Let's assume that the current five-year mortgage rate is 6 per cent. If Linda decided to extend her mortgage before its term ended and take on another five-year mortgage, her new mortgage rate, using the blend-and-extend option, would be as follows:

[(8% x 12 remaining months in current term) + (6% x 48 months of new term)] ÷ 60 months (total new term) = 6.4% (the new, blended rate)

If Linda chooses the blend-and-extend option, her mortgage rate will be 6.4 per cent for the next 60 months. (*Note*: Your financial institution may add an administrative fee.)