COPING WITH MORTGAGE PENALTIES IN CANADA

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1. Introduction

In Canada, according to the current practice, when a borrower decides to prepay the full balance of his closed mortgage loan at a fixed rate, the lender imposes a penalty that is equal to the highest of:

- three months of interest payments, or
- an amount based on the differential between the rate applicable at the beginning of the loan and the rate in effect at the prepayment date.

In theory, the rate differential amount should cover the economic or financial loss incurred in the lender's investment when the interest rate goes down.

However, in real-life cases, this penalty is often higher than 200% of the actual loss incurred by the lender. In the absence of more stringent guidelines, Canadian mortgage lenders have the ability to set, manage, and plan abnormally high mortgage penalties, as well as to add unjustified surcharges.

In Canada, mortgage penalties are asymmetrical: Mortgage lenders gain not only when the interest rates fall, but also when interest rates rise. Thus, rules have to be changed and calculations need to be made symmetrical.

In the U.S., most mortgage loans do not have built-in mortgage penalties. The absence of mortgage penalties has nothing to do with the issues recently faced by the U.S. mortgage industry.

The practice followed by U.S. mortgage lenders regarding these penalties can be explained by a simple principle of balance (or symmetry): when a loan is prepaid and rates fall, U.S. lenders incur losses, and when rates increase, they realize gains on the prepayment.

Unlike mortgage borrowers, Canadian and U.S. mortgage lenders have access to various tools to manage the risks arising from interest fluctuations (such tools include financial strategies involving options, futures, interest rate swaps and other hedging strategies), making lenders immune to interest rate fluctuations.

2. Canadian legislators must address the following issues:

1. **Do we want to maintain the imposition of a penalty when the balance of a closed mortgage loan at a fixed rate is fully reimbursed before the maturity date?**
2. **If so, how can we make sure that Canadians will only pay a fair penalty by eliminating any surcharges and the asymmetry when the rates fall as well as when they rise?**

Plain, simple abolition is an acceptable and feasible alternative to the actual practice. This would resolve the issue once and for all. This solution may result in a slight increase in the mortgage interest rates.

Another solution would be to limit the mortgage penalty to the change in the fair value of the lender's mortgage investment resulting from the actual interest rate fluctuation. In addition, the penalty should be symmetrical, meaning that it could be positive (penalty) or negative (refund). Any additional amount should be treated as a surcharge and should be prohibited. If a fair and symmetrical calculation of a penalty cannot be established, no penalty should be imposed.

In theory, mortgage penalties should cover the financial loss of value incurred by the mortgage lender when interest rates go down. Indeed, if rates go down, the fair value of the lender's investment goes up. If the borrower decides to prepay the full amount of the loan, the amortized nominal value of the loan will be worth less than the present value of future payments, which conveys a loss. The same logic applies the other way around - if actual rates go up, the fair value of the lender investment goes down. However, the current asymmetrical nature of the mortgage penalty calculations prevents the payment of negative penalties (refunds to the borrowers) to the detriment of the borrowers.

3. Current Issues

The real estate brokerage industry has identified certain issues regarding the calculations used to determine mortgage penalties:

1. Use of a "published" rate, rather than a "negotiated" rate as the starting point to estimate the penalty (in order to maximize the Rate A or Initial Rate).
2. Use of a lower rate, which would otherwise be negotiated for a similar loan, as the arriving point for the calculation of the penalty (e.g. a no-risk rate, or the rate of the Government of Canada's fixed term bonds to minimize Rate B or Prepayment Rate) (See the Example in Section 4).
3. Use of the initial rate spread (published rate minus negotiated rate) to reduce the prepayment published rate. As a result, the published rates are used twice, leading to surcharges.
4. Use of undiscounted cash flows to compute the mortgage penalty for the remaining period.
5. Mortgage agreements generally allow the borrower to prepay a certain percentage (e.g. 15% per year) without penalty. Several class action lawsuits have been filed, since some mortgage penalties have not been reduced accordingly.
6. The asymmetrical nature of the penalties' calculation, which prevents the borrower from obtaining a refund in case of a negative penalty resulting from a rise in the interest rate.
7. Use of a special clause for additional surcharges by financial institutions to recover various “benefits” initially offered to the borrower. For instance, an initial rate reduction clause to recover the spread between the published rate and the negotiated rate, or even a clause requiring the borrower to reimburse transaction fees such as notary fees.
8. Similar issues on prepayment of fixed-rate closed loans to individuals, personal businesses, partnerships, non-profit organisations, and corporations.
9. Inconsistency/confusion in the calculation procedure to estimate the penalty.
10. No written disclosure of the total amount of the penalty in dollars at the initial signature date.

During the quarter ending January 31, 2010, a total of 301 complaints were filed before the Ombudsman for Banking Services and Investments (OBSI), which is the double of complaints filed for the same quarter in 2009, and three times the amount in 2008. In essence, the complaints are about the amounts of the penalties on mortgage rate prepayments, which often amount to several thousands of dollars.

4. Example of lender's calculations

REAL-LIFE CASE

Illustration of a current issue as described in the aforementioned Section 3, Paragraph b)

Use of a lower rate, which would otherwise be negotiated for a similar loan, as the arriving point for the calculation of the penalty (e.g. a no-risk rate, or the rate of the Government of Canada's fixed term bonds) (to minimize the B rate or prepayment rate)

Mortgage lender	Caisse Desjardins
Client/borrower:	Bourgouin/Desgagné Couple
Initial Capital	$367,305.00
Prepayment Date	March 9, 2010
No. of remaining instalments:	29 months
Balance to date:	$346,694.20
Prepayment:	$346,694.20
Rate A or Initial Loan Rate	6.000%
Rate B or Reference Rate applicable for the remainder of the loan:	
• *Canadian Government Term Bonds Rate*	1.680%
Indemnity from the rate differential:	$33,661.76
Indemnity based on 3 months of interest:	$5,200.41

According to Desjardins calculations, the client must pay **$33,661.76** in penalties, which is 9.7% of the owing amount.

5. What changes should be made in the calculation of mortgage penalties?

The real estate brokerage industry offers several ideas to better cope with the mortgage penalties:

1. No penalty at the beginning of the loan. The fact that a borrower has to start a loan already containing a considerable penalty for him is neither justified nor desirable.
2. No penalty when there is no market change in the interest rates for a similar product. Use of a method based on the current initially negotiated instalments as a starting point to estimate the penalty, as well as the future instalments that would be negotiated with a client with a similar risk profile for the remainder of the loan.
3. Compute the present value of the future instalments differentials to calculate the mortgage penalty.
4. Prohibit the clauses aimed to nullify the benefits of partial prepayments (example: 10% or 15% per year) when a payment covers the full balance or exceeds the authorised amount to be prepaid.
5. Require clauses aimed to allow the benefits of partial prepayments when a payment covers the full balance or exceeds the authorised amount to be prepaid.
6. Demand symmetry (penalties when rates go down and refunds when rates go up).
7. Use the rate that was negotiated at the beginning of the loan (Rate A).
8. Use as prepayment rate (Reference Rate or Rate B), the rate that would otherwise be negotiated otherwise (similar loan, equivalent to the remainder of the term, with similar credit profile at the beginning of the loan).
9. The Reference Rate (Rate B) to estimate the penalty should be the higher of :
    - A "Shotgun" rate: the rate the lender would be willing to grant a loan for the remaining period for the same client, or
    - The market rate obtained from a source like Bloomberg, for a portfolio of fixed income investments carrying similar risks at the beginning of the loan and for the remaining term.
10. The Yield Curve Method: The use of a yield curve set periodically by an independent organisation (e.g. The Bank of Canada), which shows the rates for 1 to 5 years, which would be theoretically negotiated between a Canadian mortgage lender and a Canadian mortgage borrower with a typical credit profile and personal situation. This curve would help to establish the maximum penalty based on the rate differential, and it should also reflect the market conditions prevailing at the time of publication.
11. Periodical reporting to the borrower to disclose the potential penalty.

6. Conclusion

Mortgage penalties in Canada have sparked wide criticism. Too high, unfair, inconsistent - these are some of the words used when referring to them. The methods used to estimate mortgage penalties in Canada lack control and uniformity.

Options to resolve this issue include:

1. Plain and simple abolition of mortgage penalties in Canada;
2. Setting limits (e.g. a minimum of three months interest – a maximum of six months interest);
3. The "Shotgun" Method: Rate A (the rate that was negotiated at the beginning of the loan) minus Rate B (the rate that the institution is willing to offer to the borrower for the remaining period, for a similar amount to finance another property).
4. The Yield Curve Method: The use of a yield curve representing negotiated rates set periodically by an independent organisation (e.g. The Bank of Canada). This curve would help to establish the maximum penalty, and it should also reflect the market conditions prevailing at the time of publication.

These rates should be required to set a maximum penalty for any mortgage loan taken on in Canada by

- an individual,
- a personal business,
- a partnership,
- a non-profit organization, or
- a private company meeting the criteria of a small and medium size business;

and applicable for all residential properties and income properties (residential, semi-commercial and commercial) of any size and

In order to improve the liquidity of the Canadian real estate market, legislation is urgently needed to eliminate and prevent abuses with which mortgage lenders in Canada benefit at the expense of Canadian consumers and private investors.

The FCIQ

The Fédération des chambres immobilières du Québec (Quebec Federation of Real Estate Boards) is a non-profit organisation that is comprised of the 12 real estate boards in Quebec as associate members, as well as more than 15,000 real estate brokers as affiliated members. Its mission consists of protecting the interests of the Quebec real estate industry so that its chambers and members can successfully accomplish their business goals.

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