Understanding the mortgage prepayment charge

When choosing the type of mortgage you want, there are many factors you need to consider. Do you want a short- or long-term mortgage? Do you want a fixed or variable rate mortgage? Do you want an open-term or closed-term mortgage? Each of these decisions may affect how quickly you will be able to pay off your mortgage and how much interest you will have to pay.

For example, if you choose a short-term mortgage, your rate may be lower; however, you may not want to frequently renegotiate your mortgage terms and may feel comfortable knowing your rate or payment will be set for a longer term. In this case, a long-term mortgage may be a better choice for you.

Likewise, if you choose a variable rate mortgage, typically you will benefit from a lower rate; however, your rate will go up and down as the RBC® prime interest rate¹ goes up and down. You may feel better paying a slightly higher rate knowing your rate will be set throughout the term; in this case, a fixed rate mortgage may be a better choice for you.

Alternatively, the RBC Homeline Plan® allows you to split your mortgage and enjoy the advantages of both variable and fixed rates. The variable portion lets

you take advantage of potential longterm savings, while the fixed rate portion protects you if rates rise.

And your interest rate and length of term aren't the only factors that can contribute to how quickly you will pay off your mortgage. Depending on the type of term you choose (open or closed), you will have to consider the prepayment charge should you decide to pay off your mortgage before the end of the mortgage term.

All these factors are important and can be intimidating, especially when you're buying a home for the first time. This article will help you to better understand the prepayment charge — when it's required, how it's calculated, how you may avoid it and what you should consider when you are trying to choose between different types of mortgages.

Differences between long-term and short-term mortgages

Long-term mortgage

Rates are normally higher than short-term mortgage rates. A longterm mortgage may be attractive if you want the security of budgeting for the future and knowing that your payments are set for the full term.

Short-term mortgage

Rates are normally lower than longterm mortgage rates. A short-term mortgage is a good option if you expect rates to decrease before the end of your mortgage term.



What is the difference between a closed-term mortgage and an open-term mortgage?

Closed-term mortgage

- With a closed-term mortgage, you have to pay a prepayment charge if you prepay more than your mortgage allows or if you pay the full amount before the end of the term. (See "How is the prepayment charge calculated?" on this page for more information.)
- Interest rates for a closed-term mortgage are generally lower than they are for an open-term mortgage, providing you with an opportunity to pay less interest and pay off your mortgage faster.

Open-term mortgage

- There is no prepayment charge for an open mortgage; it can be prepaid (minimum \$500) in part or in full or converted to any other term, at any time.
- Interest rates for open mortgages are generally higher than they are for closed mortgages because of the added prepayment flexibility.
- Open-term mortgages may be appealing if you are planning to pay off your mortgage in the near future or if you want the flexibility to lock in at a fixed rate in the near future.

Why is there a prepayment charge for a closed-term mortgage?

The purpose of a prepayment charge is to compensate the lender for the economic costs it incurs when a prepayment amount exceeds the prepayment privileges permitted under the mortgage. These costs include prepayment transaction costs, plus the full term amount of interest that was designed, in part, to acquire the mortgage and that the lender will not recover when a mortgage is prepaid.

A prepayment charge is required when you:

- Prepay an amount greater than your mortgage agreement allows
- Refinance your mortgage before the end of the term
- Transfer your mortgage to another financial institution before the end of the term
- Prepay the full amount of your mortgage before the end of the term
- Sell your home for less than the outstanding balance of your mortgage
- Move your mortgage to a new home and transfer less than the outstanding balance of your mortgage to the new home
- Renew your mortgage before the end of the term

How is the prepayment charge calculated?

How RBC Royal Bank calculates the prepayment charge

The prepayment charge for a **fixed-rate mortgage** is the greater of

- (i) three months' interest on the amount prepaid at the interest rate; or
- (ii) interest for the remainder of the term on the amount prepaid, calculated using the "interest rate differential" (IRD). The IRD is the difference between the interest rate and our posted rate on the prepayment date for a mortgage with a term similar to the time remaining in the term and having the same prepayment options. If, when you obtained the mortgage, you received a reduced rate that is below our posted rate, we will deduct the amount of this rate reduction from the posted rate before calculating the difference between the interest rates.

It is important to note that because the IRD calculation is the difference between your existing mortgage rate and today's rate, if today's rate changes, your IRD will also change. In addition, the IRD may change if payments are not made.

The prepayment charge for a **variable-rate mortgage** is three months' interest.

■ Prepaying a mortgage with a term of more than five years

If your original mortgage term is longer than five years and you prepay your mortgage after five years have passed from the date of the mortgage (this is the Interest Adjustment Date shown on your mortgage documents), the prepayment charge will be three months' interest.

The prepayment charge for a Ratecapper² mortgage is three months' interest at the Ratecapper maximum rate.

How you can estimate your prepayment charge

■ Example for a closed, fixed-rate mortgage

Let's assume you have a mortgage for a five-year term with a 9% interest rate, taking into account the 0.5% reduction in the interest rate you received at the beginning of the current term. You still owe \$100,000; however, you have inherited \$100,000 and are thinking of using it to pay off your mortgage. You have used all the prepayment options available to you. There are 36 months left before the mortgage maturity date. The current interest rate for a mortgage with a similar term is 6%.

Here's how you would estimate the charge:

| 1. Estimate the cost of three months' interest | | |
|--|---------------|--|
| Step 1 | | |
| Amount you want to pay | \$100,000 (A) | |
| Mortgage interest rate (written as a decimal) | 0.09 (B) | |
| A x B = C (\$100,000 x 0.09) = | \$9,000 (C) | |
| Step 2 | | |
| C ÷ 4* = D (\$9,000 ÷ 4*) = | \$2,250 (D) | |

| 2. Estimate the interest rate differential | | |
|---|---------------|--|
| Step 1 | | |
| Mortgage interest rate (expressed as a percentage) | 9% (A) | |
| Posted annual interest rate of 6% for a new mortgage with a term that is closest to the remaining term in your existing mortgage less the discount of 0.5% you received on your existing mortgage | 5.5% (B) | |
| The difference between your existing interest rate and the current rate $(A - B = C)$, written as a decimal | 0.035 (C) | |
| Amount you want to pay off | \$100,000 (D) | |
| Step 2 | | |
| Number of months left until the mortgage maturity date | 36 months (E) | |
| $(C \times D \times E) \div 12 = F[(0.035 \times 100,000 \times 36) \div 12]$ | \$10,500 (F) | |

In this example, we estimate it would cost you \$10,500 to pay off your mortgage before the maturity date since this amount is higher than the three months' interest cost.

Note: This example is based on a formula for estimating the cost of prepaying a mortgage before the end of the term.

RBC Royal Bank® uses a more complex calculation that will result in a lower charge than the estimate. You will have to contact us for your exact prepayment charge.

Example for a closed, variable-rate mortgage

If you prepay your mortgage before the end of the term, your prepayment charge will be calculated based on three months' interest on the outstanding amount, which can be calculated using this formula:

Outstanding Balance (or amount you want to prepay) x Your Current Interest Rate \div 4*

■ Example for a RateCapper mortgage

If you prepay your mortgage before the end of the term, your prepayment charge will be calculated based on three months' interest on the outstanding amount using your RateCapper maximum rate, which can be calculated using this formula:

Outstanding Balance (or amount you want to prepay) x RateCapper Maximum Rate $\div 4^*$

■ Incentive repayment

It is important to remember that if you received cash back when you got your mortgage or at the time of renewal, you will have to repay a portion of the cash-back amount when you prepay your mortgage before the end of the term.

Differences between fixed rate and variable rate mortgages

Fixed rate mortgage

- The interest rate for a fixed rate mortgage is locked in and will not change for the full term of the mortgage.
- Principal and interest payment amounts are set in advance for the full term, so you will know precisely how much your payments will be throughout the entire term.
- Interest is compounded semi-annually, not in advance, and is payable on the payment cycle you select.

Variable rate mortgage

 The interest rate for a variable rate mortgage fluctuates as our RBC prime interest rate fluctuates.

- A variable rate is generally the lowest mortgage rate offered.
- If your payment amount is insufficient to cover the interest, your payment will be increased.
- If the RBC prime interest rate decreases, your payment will remain the same, and more of the payment will be applied to the principal.
- If the RBC prime interest rate increases, more of your payment will be applied to the interest.
- Interest is compounded at the same frequency as your payment frequency and is payable on each payment date.
- The RBC Homeline Plan allows you to split your mortgage and enjoy the advantages of both variable and fixed rates. The variable portion lets you take advantage of potential long-term savings, while the fixed rate portion protects you if rates rise.

 $^{^{\}ast}$ There are four segments of three months in a year.

How can I pay off my fixed rate mortgage faster without paying a prepayment charge?

■ Making lump-sum mortgage principal prepayments

You may prepay up to 10% of the original principal amount of your mortgage once in a 12-month period.

For example, let's assume you made an \$8,000 principal payment at the beginning of the first five years on a 25-year \$80,000 mortgage at 8%. Your mortgage would be paid out in 16.3 years, rather than 25 years, and your interest over the life of the mortgage would be reduced from \$103,165 to \$79,873.

■ Making Double-Up® mortgage payments

RBC Royal Bank's powerful Double-Up option gives you the flexibility to prepay any amount between \$100 and the equivalent of the principal and interest of your regular monthly mortgage payment on any or every payment date. This extra payment is applied directly to the principal balance of your mortgage, which cuts down the life of your mortgage and saves on interest costs.

For example, let's assume the total interest cost of an \$80,000 mortgage paid monthly at 8% for the life of the mortgage with a 25-year amortization is \$103,165.40. A Double-Up payment of \$100 monthly would reduce your interest over the life of the mortgage to \$65,745.35, a savings of \$37,420.05. This would reduce the life of your mortgage to 17.2 years.

■ Increasing your monthly mortgage payments

Once in each 12-month period, you can choose to increase the amount of your mortgage payments by as much as 10%. The increased payment amount goes directly towards reducing the principal balance of your mortgage.

■ Increasing your payment frequency

RBC Royal Bank offers you a great choice of payment options:

- Monthly
- Semi-monthly
- Biweekly
- Weekly
- Accelerated biweekly
- Accelerated weekly

You can save on your interest costs by increasing your mortgage payment frequency, especially when you select an accelerated weekly or biweekly payment option. You essentially make the equivalent of one additional monthly payment each year, which will help you pay off your mortgage faster.

For example, here's how it would work for an \$80,000 mortgage at 8%:

| Payment frequency | Payment amount | Life of mortgage (years) | Life of mortgage interest cost |
|-------------------------|-------------------|--------------------------------|--------------------------------------|
| Monthly | \$610.58 | 25.0 | \$103,165 |
| Semi-monthly | \$305.29 | 25.0 | \$102,238 |
| Biweekly | \$281.81 | 24.6 | \$100,870 |
| Weekly | \$140.91 | 24.6 | \$100,443 |
| Accelerated weekly | \$152.65 | 19.8 | \$77,723 |
| Accelerated biweekly | \$305.29 | 19.9 | \$78,015 |

Other ways you can avoid the prepayment charge:

- If you are planning to pay off your mortgage before the end of the term, consider choosing an open mortgage when you set up or renegotiate your mortgage.
- Make principal prepayments as allowed under the terms of your mortgage.
- No prepayment charge is applicable if you reduce or pay out your mortgage at the end of your mortgage term.
- If you move your mortgage to a new home and you transfer the existing mortgage balance, rate and term to the new home, you will avoid the prepayment charge.
- If you sell your home and your buyer assumes the existing term, rate and balance of your mortgage, you will avoid paying a prepayment charge. However, if your buyer assumes less than the outstanding balance, you will have to pay a prepayment charge on the reduced amount.

Deciding on which type of mortgage you want can be a big decision. We can help with mortgage insight and advice that can help you get to the right choice. Come talk to us at the branch, call 1-800-769-2511 or visit us online at www.rbcroyalbank.com/mortgages/index.html — whichever way suits you best!



RBC Royal Bank

¹The RBC prime interest rate is the rate of interest announced by the Royal Bank of Canada from time to time as its prime rate.

² RateCapper Mortgage discontinued effective Aug 20, 2014.

All residential mortgages and lending products are offered by Royal Bank of Canada and are subject to its standard lending criteria.

Refer to your registered mortgage document or Approval of Mortgage and Cost of Borrowing Disclosure Statement for the details specific to your mortgage. Please visit your branch or call us at 1-800-769-2511 to obtain more recent information.

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