

Is Refinancing Worth The Pre-Payment Penalty/IRD?

With interest rates at all time lows, the temptation to refinance an existing mortgage for most is a strong one. Mortgage professionals will all agree that the number one call received lately has been inquiries into mortgage refinancing. For some the benefits are great, yet for others this may actually set them back years in their mortgage. In the following article I will attempt to answer some common questions and give you the ability to know if refinancing is a good idea for you.

What is a prepayment penalty?

A prepayment penalty is a fee charged by the bank when you pay out your mortgage during the course of an existing fixed term. There are 2 types of prepayment penalties. A charge based on a certain number of months interest such as 3 months interest, or an Interest Rate Differential (IRD). Different products charge different penalties.

Fixed term mortgages (5 yr, 3 yr, etc.) charge either a 3 month interest penalty or IRD, whichever is higher. If it was a “Cash Back” mortgage where a percentage of the mortgage amount was given as cash based on signing for a specific term and rate then a portion of the cash back amount will also be “clawed back” depending on the remaining months in the term.

Variable Interest Rate Mortgages charge a 3 month interest penalty only.

Home Equity Lines Of Credit do not charge any penalty at all.

How are these penalties calculated?

Please always contact your bank for correct penalty amounts. These calculations will not give you the exact penalty amounts and are only a rough guide.

3 months interest

To calculate the approximate 3 month interest penalty:

Current principal balance X (interest rate/12)% X 3 months

Example: \$400,000 X 0.4375% X 3 months = \$5,250

(5.25% / 12 = 0.4375%)

This is a rough number however it will give you a ballpark figure

IRD

IRD is a much more complicated calculation. To calculate the approximate IRD penalty:

(Original Interest Rate – Current Interest Rate for comparable term of what is remaining)
/ 100 / 12 X remaining term in months X current mortgage balance

Example: (5.25-3.35)/100/12 X 13 months X \$400,000 = \$8,233

Always call your bank to obtain a correct and accurate IRD penalty amount.

Why does the bank charge an IRD?

This explanation is a bit simplified. When the bank lends for a mortgage they borrow the funds from investors by issuing a Guaranteed Investment Certificate or an investment vehicle (Bond) that guarantees the buyers a certain return on investment over a specific term. The bank pays out interest to borrow those funds at a fixed rate of return. When done properly everything balances in the end and the bank makes a small margin. This is called hedging and it is actually done on a grand scale every day in every lending

institution in the world. If someone breaks the term of their mortgage the bank must recoup the interest income in the contract in order to properly cover the cost of the investment vehicle issued due to that mortgage. The IRD takes into account the difference between relending funds at today's rates for the remainder of the term and balance of the mortgage so the books still balance. IRD is the cost to cover the difference to relend the same funds at today's rates and allow its customers to walk away from their contract. That is why when rates go down the IRD goes up as the bank cannot make the same income required to cover the cost of the Bond it issued for your mortgage. If rates go up to above what you originally had there is no IRD because the bank can make the same income by relending your funds thus preventing a loss on the cost of the Bond/investment vehicle.

So when is it worth paying a penalty?

There are a few things to take into consideration here. Can you make back your cost in interest savings? If not, is a lower monthly payment worth the difference to you? What is my amortization? (I will discuss the importance of amortization and IRD further below)

Example Scenarios. There are so many scenarios available that I obviously will not be able to cover them all here so if you are interested in an additional scenario please contact me and I can run the numbers for you.

Scenario 1

Original mortgage amount of \$260,000

Current rate is 5.45%

IRD is \$16,380

Principal balance of \$254,696.87

Remaining term of 36 months

Remaining amortization of 33 years

Payment of \$1377.41

Total of payments for next 36 months = \$49,586.76

Approximate interest paid over next 36 months = \$40,482.06

If we put into a 3yr fixed at 3.15%

New principal balance \$261,972.17 (balance + penalty)

Amortized over same 33 years

Payment of \$1,061.72

Total payments for 36 months = \$38,221.92

Approximate interest paid over term=\$23,954.76

There was a monthly payment savings of \$11,364.84 over the term and an interest savings of \$16,527.30. So interest savings exceeded the IRD penalty by only \$147.30 so in this scenario interest savings are a wash. This is where you have to ask yourself however, how important is a lower payment to me? By not refinancing your mortgage at this time your balance at the end of your term will be \$245,592.17 vs. a refinanced balance of \$247,704.94 (a difference of \$2,112.77). Some people feel the cost of

having a balance \$2,112.77 higher at the end of their term is worth the additional \$315.69 in their pocket each month from a lower monthly payment.

This next scenario will help you compound the savings further and even put a negative savings into a HUGE overall advantage.

Scenario 2

This same scenario reinvests the monthly savings into the mortgage and reduces the amortization.

Current rate is 5.45%

IRD is \$16,380

Principal balance of \$254,696.87

Remaining term of 36 months

Remaining amortization of 33 years

Payment of \$1377.41

Total of payments for 36 months = \$49,586.76

Approximate interest paid = \$40,482.06

New rate is 3.15% in a 3 year fixed

New balance is \$261,972.17 (balance + penalty)

Reduced amortization to 23 years

Payment of \$1,332.59

Total of payments for 36 months = \$47,973.24

Approximate interest paid = \$23,496.27

Instead of taking the savings each month as in the previous example, they have been reinvested against the principal of the mortgage each month reducing the life of the mortgage by 10 years at this pace.

What does that mean for you?

Consider this: assuming your interest rate and payment were to remain the same throughout the life of your mortgage and assume your payment were made every 30 days on time, every time; this is what the remainder of your mortgage would look like in both scenarios:

33 years at 5.45% with payments of \$1,377.41 = \$545,454.36 (principal and interest)

23 years at 3.15% with payments of \$1,332.59 = \$367,794.84 (principal and interest)

That's a savings of \$177,659.52 with both scenarios ending in a balance of \$0. If you have the discipline to keep your payment as is and apply your savings each month, the benefits are clear.

If you would like to review your mortgage and see if refinancing is right for you please contact me.