



CHARGING A HIGHER RATE OF INTEREST ON ARREARS? YOU CAN'T DO THAT

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Section 8 of Canada's *Interest Act* prohibits a lender from charging a higher rate of interest on arrears of principal secured by a real property mortgage than the interest rate payable on principal money not in arrears. In other words, a mortgage lender is prohibited from charging a higher interest rate on monies owing after default.

This provision has several implications for lenders. First, by limiting the rate of interest, it prevents lenders from addressing the ongoing risk associated with a loan in default. Second, section 8 applies exclusively to interest charges on loans secured by mortgages on real property. So, a lender is not prohibited from registering a security interest over personal property and charging a higher rate of interest after default. However, where a lender takes a collateral mortgage (i.e. security over real property for loans provided for purposes other than, or in addition to, the purchase of land such as a revolving loan, *or* secures funds advanced in the Personal Property Registry) and takes a real property mortgage that secures *all* of the obligations of the borrower, the lender is still prohibited from charging a higher rate of interest on default. This is because by its terms, the real property mortgage applies to both loans thereby engaging section 8.

The courts, however, have endorsed creative drafting which has enabled lending institutions to avoid the application of section 8. In 2006, the British Columbia Court of Appeal approved the strict reading of section 8 in *Reliant Capital Ltd. v. Silverdale Development Corp.* (leave to appeal denied by the Supreme Court of Canada). There, on a 13 month, 22 day term loan the lender charged 14% interest for the first 12 months and 20% interest for the remainder of the term. Presumably the thinking was that the loan was more likely to go into arrears towards the conclusion of the term, and the lender sought to protect itself against that possibility. The Court of Appeal upheld the increase in interest rate, finding that the provision did not offend section 8 of the *Interest Act* because on its face, the higher interest rate applied equally to arrears and to monies owing that are not in arrears. The courts in Alberta have also endorsed such drafting. In *Grandville Savings and Credit Union v. Pekich* the mortgage provided for interest at 9% increasing to 14% on any principal outstanding one month prior to maturity. The Court of Queen's Bench held that the mortgage did not offend section 8 since the increase in interest rate did not result from default but rather from the passage of time.

Lenders seeking to protect themselves in the case of default should be aware of these decisions and think about availing themselves of such protections, especially in a volatile economy.

Did you know? If you fail to specify the interest rate on an annual basis, you will be restricted to 5% per annum under section 4 of the *Interest Act*.