

SECTIONS 6 AND 7 OF THE CANADA INTEREST ACT: CURIOUSER AND CURIOUSER¹

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This article reviews the cases decided under sections 6 and 7 of the Canada Interest Act. It analyses the problems the courts have had with the application and interpretation of the sections during the more than one hundred years they have been in effect, and concludes that the sections have not served any of the purposes they may have been intended to serve. Finally, the article discusses the difficulties that the sections have given rise to in the light of commonly accepted principles of interest mathematics, and, on the basis of that discussion, concludes with some proposals for reform.

Il s'agit ici d'un compte-rendu de la jurisprudence sur les articles 6 et 7 de la Loi sur l'intérêt. L'auteur y analyse les problèmes d'application et d'interprétation auxquels se heurtent les tribunaux depuis plus de cent ans que ces articles sont en vigueur et en conclut que lesdits articles n'ont pas atteint les objectifs qui étaient probablement les leurs. En dernier lieu, l'auteur considère ces difficultés d'interprétation et les objectives de ces articles du point de vue des principes généralement admis comme base du calcul des intérêts et propose, en conclusion, quelques réformes.

Introduction

To the average borrower, the world of finance is a strange one indeed. Banks and other lenders constantly advertise easily available credit. Yet when he tries to borrow, the situation is much more complex and technical than it had appeared. Demands for security, incomprehensible documents, various competing payment plans, interest rates, fees and charges may overwhelm him. From time to time, public opinion rebels and a movement develops for legal reform. Nowhere has this lately been more apparent than in the area of mortgage lending.

Unfortunately, the most widely abhorred provisions of mortgages—the interest and payment clauses—are not the most widely understood. Legislators, lawyers and judges often lack even a basic understanding of compound interest calculations and debt extinction by amortized payments. Legislation currently existing in this area is frequently misunderstood and misapplied. In this article, I propose to examine two sections of Federal legislation that have so often endured this fate that they have now become more hindrance than help to legal professionals and borrowers

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¹ Lewis Carroll, *The Adventures of Alice in Wonderland and Through the Looking Glass*, C.S.W. Printing Works, Reddish, Stockport, p. 21.

alike. In the process, I will review some of the basic principles of interest calculation and perhaps open some new perspectives on this most curious legal, mathematical and social problem.

Section 6 of the Canada Interest Act² provides that where a mortgage is made repayable by one of three payments plans, the mortgage must contain a statement of the interest payable calculated³ yearly or half-yearly and not in advance. If the mortgage fails to contain this statement, no interest at all is payable. If the statement is present but another provision in the mortgage would increase the interest rate above that contained in the section 6 statement, section 7 requires the lower rate only to be charged.⁴

The meaning of section 6 is obscure. First, what payment schemes trigger the application of section 6 and section 7? Section 6 refers to mortgages repayable by "blended payments", on the "sinking fund plan" or providing for "an allowance of interest on stipulated repayments". As to the first, "blended payments" has caused much judicial comment and its meaning continues to be debatable.⁵ The other two have rarely been discussed, but to the extent they have are also not well defined by the cases.⁶ Particularly the phrase "allowance of interest on stipulated repayments", has been found unclear.⁷

Second, what must the section 6 statement contain? Must the interest disclosed include all amounts paid for the use of the money borrowed? Assuming a stated rate calculated yearly or half-yearly and not in advance, what method of interest calculation will result in only that rate and no higher, as required by section 7, being charged? None of these questions has been satisfactorily answered in the case law.

Having reviewed, in summary, the problems of sections 6 and 7 of the Act, one is left wondering what possible purpose could be fulfilled by such unclear and confusing legislation. The sections were first enacted⁸ over one hundred years ago in substantially the same form as they are today when Parliament, having decided that rates of interest would no longer be controlled as they had been under the British usury statutes, apparently

² Interest Act, R.S.C. 1970, c. I-18; referred to hereafter as "the Act" or "the Interest Act", without further citation.

³ Note that throughout this paper, I will use the word "calculated" as a synonym for "compounded". This is the sense the word is used in the Interest Act (see H. Woodard, *Canadian Mortgages* (1959)), not in the sense of mere mathematical determination.

⁴ Sections 6 and 7 of the Interest Act, *supra*, footnote 2, will be referred to in the remainder of this paper without further citation.

⁵ See *infra*, part I for further discussion.

⁶ See *infra*, part I for further discussion.

⁷ *Bowman v. Denison*, [1930] 4 D.L.R. 671, (1930), 65 O.L.R. 613 (Ont. A.D.).

⁸ An Act relating to Interest on moneys secured by Mortgage of Real Estate, S.C. 1880, c. 42, s. 1 and s. 2.

wanted to ensure disclosure of something approaching the effective cost⁹ of a loan to the borrower. In *Kilgoran Hotels v. Samek*¹⁰ the Supreme Court of Canada held that the purpose of the sections was to prevent concealment of the true interest payable. But how can words which no one has evidently been able to understand prevent concealment? Indeed courts have repeatedly treated the subject of interest calculation as being, in the words of Sir Charles Fitzpatrick C.J.C., "beyond the understanding of the majority of even educated men".¹¹

As well as raising the problems of interpretation I have mentioned, the sections also have failed to deal adequately with the common methods by which the amount paid for a loan may be increased beyond that which would seem to be produced by the rate stated in the mortgage document. To prevent concealment of the interest charged, the legislation should provide some quickly recognizable figure that will allow the borrower to know how much he will have to pay for the money he is receiving. A statement that the interest on his mortgage is 12% tells him very little about its effective cost. To know that cost, he must have information about four additional factors: the additional charges that are being made by the lender besides the interest rate stated; the frequency of compounding or, as it is often called, calculation of interest; the frequency of payment of the interest; and whether or not the interest is to be calculated in advance. In the words of section 6, "calculated yearly or half yearly" deals with the frequency of interest compounding; "not in advance" deals with the problem of time of calculation of interest. The other two factors are not directly referred to. The importance of these factors and the way in which the courts have applied sections 6 and 7 to these vital features of interest calculation will be stressed throughout this paper.

Obviously, understanding whether sections 6 and 7 apply to a mortgage and if they apply what they require is not a simple task. I suggest that it is not one from which the average mortgagor will derive much assistance in answering the questions important to him in borrowing. A less ambitious, but still useful policy which the section 6 statement could fulfill is in standardizing, for comparative purposes, the bewildering array of mortgage plans with which, in particular, the homebuyer is confronted. Even with the section 6 statement, he still will not know how much interest in actual dollars he must pay. But because the section provides for a standard

⁹ "Effective cost" will be used in this paper to mean the actual dollar amount paid for the loan. "Effective rate" will mean the interest rate compounded annually. "Equivalent rate" will mean the rate required to produce the same "effective cost" as the rate set out on the face of the mortgage when related to a different calculation period than specified in the mortgage.

¹⁰ [1968] S.C.R. 3, (1967), 65 D.L.R. (2d) 534.

¹¹ *Standard Reliance Mortgage Corporation v. Lewis St. George Stubbs* (1917), 55 S.C.R. 422, at p. 426, 38 D.L.R. 435, at p. 437.

form disclosure, he might know which plan is effectively more expensive. However, as I will discuss in this article, even this limited role for the sections has been gravely weakened by the courts' interpretation.¹²

If Parliament is to continue some regulation of mortgage interest, whether by requiring plain disclosure of the interest payable or a standardized form of disclosure to enable comparison of cost, a rethinking of sections 6 and 7 is necessary. A number of possibilities exist. For example, providing the total cost of borrowing over the term of the loan, or full amortization statements showing the division of each payment between principal and interest, would be much more successful in accomplishing both these goals than sections 6 and 7 have been. At the least, the words of the sections should be clarified and more detail given about the proper principles to be applied in interest calculation.

I. *The Application of Sections 6 and 7— Down the Rabbit Hole*

Once a payment is found to be within the application of section 6, the interest rate must be expressed as the equivalent rate calculated yearly or half-yearly and not in advance. The importance of the time of calculation and its effect on the interest rate stated in the mortgage document may be illustrated by an example. If I borrow \$1,000 for one year at 12% interest, and calculate that interest only once, at the end of the year, I will owe \$1,120. If I calculate the interest every month, compounding as I go and assuming no repayments, the first month I will owe \$1,000 principal and \$10 interest; the second \$1,010 principal and \$10.10 interest. Repeating this process until the end of the year, I will owe \$1,126.83. To summarize, compounding monthly increases the total amount I pay for the loan. For comparative purposes, I can say that in the first case, I paid 12% per annum, compounded or calculated annually; in the second, I paid the equivalent of 12.683% per annum, compounded annually. By mathematical formula, the borrower can calculate the equivalent rates calculated yearly or half-yearly from any calculation period. Section 6 requires that that rate to be provided in the mortgage. The effect is that a lender who might like to make his interest rate appear lower by stating it is a monthly rate (12% per annum calculated monthly), must reveal its higher yearly or half-yearly equivalent (12.683% per annum calculated annually).

In this section, I will discuss first, what repayment schemes fall within section 6, with particular emphasis on the disputed meaning of blended payments, and second, the closely related question of whether the application of the sections may be triggered by including additional charges for the loan above the stated interest.

¹² See *infra*, part I, C for discussion.

A. *Blended Payments*

Mortgages may be repaid in a variety of ways: interest only until the term of the loan; some combination of interest and principal before the term; neither interest nor principal before that final date. Many mortgages, particularly residential mortgages, adopt the second scheme. The division of each payment between principal and interest is usually based on an amortization schedule, that is, a plan by which the equal monthly payments would, if made over a particular time span, reduce the total principal with accumulated interest owing to zero. Generally, payments of interest and principal are made more frequently than the interest calculation period, and usually the interest is not calculated in advance. The result is payments which do not, on their face, reveal how much is reducing the principal and how much is paying the interest. For each payment, this blend is different. Early cases under the Interest Act assumed that this type of mortgage was one to which section 6 and section 7 applied. Without much discussion, the courts considered the payments blended.¹³

The definition of "blended" payments was not squarely at issue until the Supreme Court of Canada decision in *Kilgoran Hotels v. Samek*.¹⁴ Kilgoran Hotels granted a mortgage to John Samek, Mary Travinski and David Syck to secure a commercial loan of \$315,000. The interest was 6½% calculated quarterly and not in advance. Repayment was to be by quarterly payments of \$7,002 each, coinciding with the calculation dates and applied first in payment of interest, then to principal. There was no indication of unconscionability or unfairness in the mortgage; there was no dispute over the meaning of repayment provision. But, clearly, the statement required by section 6 was absent: the interest was to be calculated *quarterly* and no yearly or half-yearly equivalent rate was given. The consequences of applying section 6 would have been to deprive the mortgagee of all his interest.

The Supreme Court held that section 6 was not applicable because the payments were not blended. The definition of blended was "mixed so as to

¹³ For example, see *The Canadian Mortgage Investment Company v. Cameron* (1917), 55 S.C.R. 409, 38 D.L.R. 428, [1917] 3 W.W.R. 521 and *Standard Reliance v. Stubbs*, *supra*, footnote 11. See also *Re Desrochers et al. and Soules* (1956), 6 D.L.R. (2d) 293, [1956] O.W.N. 742 (Ont. H.C.).

¹⁴ *Supra*, footnote 10. The question of what was a blended payment was discussed earlier in *The London Loan and Savings Company of Canada v. Robert K. Meagher*, [1930] S.C.R. 378, [1930] 2 D.L.R. 849, where the court held that repayment of a lump sum stated in the mortgage to be the principal of the mortgage was not a blended payment despite the "blending" with the repayment of an amount held back out of the loan as a bonus. However, the court attempted no general definition of the term and indeed referred to the amortized payment schemes of *Canadian Mortgage v. Cameron supra*, footnote 13, and of *Standard Reliance v. Stubbs*, *supra*, footnote 11 as schemes coming within s. 6 on their face.

be inseparable and indistinguishable".¹⁵ In this case payments of principal and interest "are distinguished by the very wording of the [repayment] clause . . . The arithmetical calculation involved on each payment date could scarcely be simpler".¹⁶ Unfortunately, these brief statements of the Supreme Court suggest three possible grounds for finding the payments not to be blended. Each has been considered, in its turn, by the courts; each has failed to provide a satisfactory solution to the question of what payments are blended.

First, the court in *Re Tilson and Dougherty*¹⁷ distinguished *Kilgoran* on the basis that the interest calculation date and the interest payment date had coincided in the *Kilgoran* mortgage. This coincidence of dates meant that any person capable of doing some simple mathematics could determine the blend of principal and interest contained in each payment. This was simply a matter of dividing the interest rate by four and multiplying that result by the principal owing. The figure thereby obtained is the interest portion of each payment. The principal portion is found by subtracting the interest portion from the total payment.

In the *Tilson* case, interest calculation and payment dates were different. The mortgage provided for repayment of \$20,000 with interest at 7% per annum, calculated half-yearly and not in advance by monthly installments of \$150 per month. The mortgagor alleged that the method of calculation adopted by the mortgagee raised the rate of interest payable above that stated rate, thus violating section 7 of the Interest Act. Of course, to enable the court to apply section 7, it first had to find that the scheme of repayment fell within section 6. The court held the mortgage provided for blended payments because the lack of coincidence of interest calculation dates and payment dates made the calculation a much more complicated one than that required in *Kilgoran*. To determine the interest and principal portion of each payment here would require that account be taken of the payments made before the calculation date that reduced the principal balance payable. Equally, when interest was paid before the calculation date, a factor might be required to compensate the borrower for the loss of the use of the interest portion of the payment at a date before the interest was to be calculated. These principles will be discussed more fully later.¹⁸

The *Tilson* interpretation is an attractive one. It would include a substantial number of mortgages with amortized payments in the shelter of sections 6 and 7. Moreover, the principle introduces a theme of uncon-

¹⁵ *Supra*, footnote 10, at pp. 5 (S.C.R.), 536 (D.L.R.).

¹⁶ *Ibid*, at pp. 5-6 (S.C.R.), 536 (D.L.R.).

¹⁷ (1975), 57 D.L.R. (3d) 491, 8 O.R. (2d) 203 (Ont. Div. Ct.).

¹⁸ *Infra*, part II C and D.

scionability to the rigidity of the section: if a mortgagor would be able to tell how much interest is being paid, the harsh penalty of losing all interest on the loan is never applicable, even if the lender has failed to abide by the technical wording of the section.

But unconscionability is never a simple guide. It introduces a plethora of essential questions that must be addressed in case after case before its complex boundaries are defined. For example, to determine in the general case whether a payment is blended, how simple must the calculation be? If the average high school graduate could do it, is that simple enough? Since even complex interest clauses can be calculated by anyone with the appropriate factors, formulae and a brief explanation of how to use them, does the knowledge of the mortgagor matter? In the *Kilgoran* case, is it relevant that the mortgagor was a corporation, doubtless owned by business people who should have been easily capable of understanding the arithmetic involved? Earlier Supreme Court decisions rejected the idea that section 6 required sufficient information to protect the illiterate or uneducated.¹⁹ Would this, combined with the *Kilgoran* case, suggest some objective standard such as the understanding and ability of a reasonable mortgagor?

A second possible interpretation of the words in the court in *Kilgoran* was that principal and interest were distinguished by the presence of a clause stipulating that the payments be allocated first to interest and then to principal. This distinction was relied upon in the Ontario High Court decision in *Re McGoran and Cowan*.²⁰ There the mortgages contained no statement dividing payments between principal and interest. The court held that to escape being found blended, the payments had to be separable on the face of the mortgage without reference to implied terms. The problem with this interpretation is that such an allocation clause does not provide the mortgagor with much information about his mortgage. If its presence alone is sufficient to exclude a mortgage from the ambit of section 6, the disclosure requirements of section 6 will be largely thwarted. It will be possible for the mortgagee to avoid having to declare the equivalent half-yearly or yearly rate by including a clause that is a standard part of virtually every mortgage and that in no way assists the mortgagor in understanding the amount of interest he must pay.

A third interpretation of the *Kilgoran* case turns on the definition of blended as "indistinguishable". This may mean that in any case in which mathematical calculation can divide a payment between principal and interest, the payment is not blended. If this is the case, the phrase "blended payments". I suggest, is meaningless. If it is not possible to divide the

¹⁹ *Standard Reliance v. Stubbs*, *supra*, footnote 11, per Sir Charles Fitzpatrick C.J.C., at pp. 426 (S.C.R.), 437 (D.L.R.).

²⁰ (1973), 37 D.L.R. (3d) 481, [1973] 3 O.R. 557 (Ont. H.C.).

payment, then how is it possible to tell how much interest is being paid? If the amount of interest to be paid is unknown, the agreement would be uncertain. Similarly, no one could tell what principal balance was owing at any given time, equally a serious uncertainty.

However unacceptable the implications of this third interpretation, it appears to carry the greatest weight of authority. Even before the *Tilson* decision, this conclusion had been implicit in the Ontario High Court judgment of *Re Miglinn and Castleholm Construction*.²¹ The judge found that the payment under a mortgage providing for monthly installments of \$875.00 applied first in payment of interest, then in payment of principal with interest at 12% per annum calculated half-yearly and not in advance, were not blended payments. The Ontario Court of Appeal approved the trial judge's reasons in a brief statement.²² The decision, however, did not require a finding as to the applicability of sections 6 and 7. Instead, the issue in the case was the interpretation of the payment clause found in the mortgage, and particularly, what was the proper method of calculation when stipulated to be "not in advance". The approval of the Court of Appeal is so brief that it is impossible to determine whether the lower court's definition of blended payments is included in it.

Between *Miglinn* and *Tilson* however, and apparently not referred to in the latter case, was the decision of the Supreme Court of Canada in *Ferland v. Sun Life Assurance Company of Canada*.²³ The mortgage in *Ferland* required repayment of \$28,300 at 7% per annum, calculated yearly and not in advance, by consecutive monthly installments of \$247.00 each. The lender retained discretion to apply the payments to interest, advances made under the agreement or principal. The first objection by the mortgagor was to the accounts of the mortgagee. The court, however, found the accounts correct. His second point was that section 6 of the Act had not been satisfied and thus no interest was payable.

Although the mortgage apparently contained the required wording to comply with section 6, the court ruled that such compliance was unnecessary because the payments were not blended. Giving the majority judgment, Pigeon J., in discussing the mode of payment provided for in *Kilgoran* stated:²⁴

The Court held unanimously that this was not a *plan under which the payments of principal money and interest are blended* . . . because the rate of interest was clearly stipulated, and only a simple arithmetic calculation was necessary to determine the portions of each payment which were applicable to interest and principal respectively. In short the Court held that principal and interest are *blended* only if the deed does

²¹ (1974), 50 D.L.R. (3d) 524, 5 O.R. (2d) 444 (Ont. C.A.), adopting the reasoning of Wilson, J. below.

²² *Ibid.*

²³ [1975] 1 S.C.R. 266.

²⁴ *Ibid.*, at pp. 270-271.

not disclose the true rate of interest payable. Two decisions to this effect were rendered as early as 1917: *Canadian Mortgage Investment Co. v. Cameron* [[1917] 55 S.C.R. 409, (1917) 38 D.L.R. 428, [1917] 3 W.W.R. 527] and *Standard Reliance Mortgage Corp. v. Stubbs* [(1917), 55 S.C.R. 422, (1917), 38 D.L.R. 435.]

With respect, this passage is difficult to comprehend, although it is virtually the whole of the court's judgment relating to blended payments. The first sentence adds nothing in explanation of the ambiguities in *Kilgoran* already noted. The second sentence does not follow from the first. "True rate" must always be disclosed by a mortgagee. Otherwise, the contract would be void for uncertainty in failing to provide for an essential term;²⁵ or if the mortgagee was collecting more than the amount payable by interpretation of the mortgage terms, the terms of the agreement would have been breached.

Finally, the two judgments relied upon by Pigeon J. in the quoted passage have no relevance to the issue of blended payments. In both cases, the court assumed section 6 applied to the clause in question. The issue was whether the section had been violated by the failure of the mortgage to state any calculation date for the interest? The majority held the mortgage complied with section 6, apparently because they assumed the calculation was to be made annually if no other method was stated.²⁶ Failure to comply strictly with the words of the section was not a violation.

But whatever criticism may be directed at the court's reasons, the decision itself seems to eliminate the first two of the three possible interpretations of *Kilgoran*. First, the lack of coincidence of calculation and payment date seems to have been irrelevant; second, a clause requiring application of payments first to interest, then to principal was also unnecessary. Under the terms of this mortgage, the payments could be allocated at the mortgagee's discretion. They were thus not distinguishable on the face of the mortgage, but only after consultation with the mortgagee.

If this case supports the third interpretation of *Kilgoran*, can any meaning be attached to blended payments? Some residual meaning was given to the phrase by the majority judgment of the Ontario Court of Appeal in *Hudolin v. Premier Trust Co.*²⁷ The mortgage in that case contained a number of contradictory provisions in its payment clause. The majority of the court found the payments were blended because, considering the

²⁵ In *Arnold Nemetz Engineering Ltd. v. Tobien*, [1971] 4 W.W.R. 373, the British Columbia Court of Appeal considered an interim agreement for the purchase of real property which omitted some of the terms of financing. They held the contract uncertain and unenforceable. Missing, among other terms, was a stipulation as to whether the 8½% interest rate was to be per annum or otherwise. This was, in effect, a failure to disclose the true rate of interest. Even the number and amount of installments from which the rate might have been calculated were not specified.

²⁶ For discussion, see *infra*, part II, B: "Calculation dates and *per annum* rates".

²⁷ (1977), 80 D.L.R. (3d) 414, 17 O.R. (2d) 257 (Ont. C.A.).

contradictions in the clause, the court found the process to be used in interest calculation unclear and thus interest payable was concealed. They ruled that section 6 had not been complied with and therefore section 7 applied to entitle the mortgagee only to the lower interest produced by the contradictory methods.

While section 6 provides that a failure to comply with its requirements results in a forfeiture of all interest payable, the court was probably correct in applying section 7 rather than the penalty under section 6. One part of the mortgage interest payment clause complied, on its face, with section 6, setting the rate at 11% per annum calculated half-yearly and not in advance. Other portions of the clause would have resulted in a higher interest charge or an impossible calculation. If the payments were blended, section 7, not section 6, was clearly applicable.

But the ambiguities in this mortgage were so extensive that it might well have been held too uncertain to be enforced at all.²⁸ Finding the payments "blended" provided the court with a tool to aid in the interpretation of the document and its enforcement. And only in this narrow area between ambiguity and uncertainty do "blended payments" have a meaning.

Wilson J.A. (as she then was) concurred in the result, but for different reasons. Under her approach, the court must first resolve the ambiguities in the document. Presumably, if they cannot be resolved, the contract is void. Then sections 6 and 7 should be applied to the mortgage clause as interpreted by the court. In this case, she held that the ambiguous clauses must mean interest at 11% per annum calculated half-yearly and not in advance. She arrived at that interpretation without reference to the Interest Act. However, she also expressed her opinion that, having reached that conclusion, she would hold the payments not to be blended. The kind of concealment envisaged by the statute was not that resulting from contradictory or ambiguous wording which the court had a duty to interpret; nor were payments blended when the calculation dates and interest payment dates failed to coincide. This, she held, was the result of *Ferland* and *Kilgoran*.

While the reasoning of Wilson J.A. is logical, it does not answer the question: What payments are blended? In fact, it appears to be the final link in the chain of cases extending from *Kilgoran* and ending in an impasse. If payments are only blended when the true rate of interest is not disclosed, then payments are only blended when the mortgage is void²⁹ or when the

²⁸ See discussion *supra*, footnote 25.

²⁹ Because if the true rate, that is the rate charged by the mortgagee cannot be calculated on the face of the mortgage, then either the mortgage on its face fails to state a fundamental term and is uncertain or the mortgagee is charging more than the rate disclosed by the mortgage and is therefore in breach of contract.

mortgagee is breaching the terms of his agreement.³⁰ And in those cases, the law is equipped with doctrines to deal with the rights of the parties. There is no need for the Interest Act.

This review of the history of interpretation of blended payments reveals a crucial flaw in the sections. Neither the policy of disclosure of interest payable, nor of standardizing the form of disclosure for comparative purposes can be fulfilled if the sections are never found to apply. The old case law, in assuming that section 6 applied to amortized payments, at least permitted the sections to be employed in a large number of mortgage situations. Wherever the payments contained a portion of capital and a portion of interest, they were blended.³¹ Even when the interest payment was expressed as a lump sum and repaid with the principal in one payment, courts at one time considered the payments to be blended.³²

The increasing reluctance of the courts to use this definition may be explained in various ways. I have already mentioned the attractiveness of relating doctrines of unconscionability to the sections. The penalty for violation of section 6 is extremely harsh: the lender loses all interest under the loan. Where the borrower knew or should have known the interest he was paying, a technical violation of the section enables him to take advantage of his lender. He is, in effect, unjustly enriched. Such a result is repugnant to the court, understandably, and explains to some degree the restrictive interpretation of section 6. This theme of fairness to the lender will be crucial to the discussion of other topics in this paper as well.

B. Other Repayment Plans within Section 6

The other two plans which are mentioned by section 6 have a much shorter history in the courts. "Sinking fund plan" has not been discussed at all. A leading textbook on business finance describes the process of debt extinction by sinking fund as follows:³³

In some cases, the principal of a long-term investment may be repaid on the maturity date, but the interest is paid periodically when it is due. Since a long-term debt is usually for a large amount, debtors often periodically deposit a sum of money in a fund, known as a sinking fund, in order to retire the principal on the maturity date.

In this method, the effective cost of the loan to the borrower is not immediately apparent any more than it is in an amortized mortgage. He is making periodic payments of interest on the whole amount borrowed, but is also paying into his own interest earning fund in amounts sufficient to pay

³⁰ See also discussion of *Re Tilson and Dougherty*, *supra*, footnote 17, contained in part II, C: "The re-investment principle".

³¹ *Supra*, footnote 14.

³² *Singer v. Goldhar*, [1924] 2 D.L.R. 141, (1924), 55 O.L.R. 267 (Ont. A.D.), overruled later on this point in *London Loan and Savings*, *supra*, footnote 14.

³³ G. Mullings and S.P. Shao, *Mathematics for Management and Finance*, (1979), p. 418.

off the full principal sum when accumulated with the interest income on the fund at a particular date. The amount that must be deposited poses, of course, the same mathematical problem as that contained in the amortization method of repayment that was once considered repayment by "blended payments". It may also be calculated by the appropriate formula. If this mathematical definition of sinking funds were accepted by the courts as a method to which section 6 should apply, we might have the anomalous situation in which a sophisticated corporate borrower using a sinking fund would have the protection of section 6 and section 7 while a homebuyer, able to determine his interest by the same calculation in an amortization schedule, but perhaps unable to do so himself, would be outside the application of the sections.

"An allowance of interest on stipulated repayments" is an obscure phrase. In *Re Brown*,³⁴ a case effectively overruled by *London Loan and Savings Company of Canada v. Meagher*³⁵ on another point, the court held that a mortgage with a principal sum to be repaid on a certain date with interest and, if not repaid on that date, with quarterly bonuses, fell within the definition. No attempt was made to define the phrase, however, nor to explain why the mortgage in question qualified under it. The court ruled that the repayment date was a stipulated repayment of principal.

The phrase was also considered in *Bowman v. Denison*,³⁶ two years later, but only to be held inapplicable to a mortgage with prepaid interest, payments of principal on specified dates and payment of interest in addition, quarterly. Again, no attempt was made at definition. And, in a similarly unhelpful decision, the British Columbia Court of Appeal³⁷ accepted, for the sake of argument and without deciding the issue, that a mortgage providing for a rebate of 3% on the interest rate if payments were made promptly might involve an allowance of interest on stipulated repayments.

C. Additional Charges: Magically Reducing the Interest

To be fully informed on how much a loan is costing, a borrower must have some understanding of the increase in return to a lender that results from the charge of additional fees. In mortgage borrowing, the mortgagor will commonly pay application fees, appraisal fees and legal costs. A bonus may also be included, either deducted from the advance of funds or repaid immediately by the borrower out of the proceeds from the loan. While these fees and bonus payments seem fully disclosed, their effect on

³⁴ [1928] 1 D.L.R. 1125 (Ont. A.D.).

³⁵ *Supra*, footnote 14.

³⁶ *Supra*, footnote 7.

³⁷ *Commonwealth Savings Plan Ltd. v. Triangle "C" Cattle Co. Ltd. and Possobon* (1966), 56 D.L.R. (2d) 453, (1966), 55 W.W.R. 52 (B.C.C.A.).

the cost of the loan is greater than initially appears. Usually the fees and the bonus, although never really received by the borrower, are treated notionally as part of the capital advanced and form part of the principal for purposes of interest calculation.

An example will illustrate this point. Suppose I borrow \$1,000 for 1 year at 12% interest per annum calculated annually, not in advance and to be repaid in a lump sum at the year end. But further suppose that out of the \$1,000 loan, I agree to pay the lender a "bonus", "commission", or "administration fee" of \$100 upon receipt of the funds. Obviously, I leave the lender's office with only \$900 in my pocket to use for my own purposes. The cost to me of that \$900 is $\$100 + 12\% (1,000)$ or \$220. Expressed as a percent of the actual \$900 loan, \$220 cost for one year is 24.44%.

This example also illustrates the two problems such fees create for section 6. First, would the repayment at the end of the year of \$1,120 be a blended payment falling within section 6? It does contain a capital portion and an interest component and, further, it is not immediately obvious that the true cost of the loan is \$220. Second, if the repayment of the \$1,120 falls within section 6, what kind of statement is required by that section? Would it be sufficient compliance to state the principal of the loan as \$1,000 and the interest as 12% per annum, calculated yearly and not in advance?

Both these questions, I suggest, can only be answered by determining what constitutes "interest" for purposes of applying sections 6 and 7 of the Act. If the \$100 bonus is "interest" within the Act, then, even by some recently applied tests, the repayment of \$1,120 might constitute a blended payment.³⁸ Separating the \$900 actual principal and the \$220 now considered "interest" is not an immediately obvious result, especially if the bonus is not declared on the face of the mortgage. Further, if the bonus is "interest," then the statement of \$1,000 with interest at 12% per annum should not be sufficient disclosure. The statement, to be accurate, must disclose principal of \$900 with interest at 24.44% per annum, calculated yearly and not in advance. The crucial question is: Is a bonus, or other charge not called interest by the lender, to be treated as interest for the purposes of the Act?

In a series of cases from 1924 to 1929, the Ontario courts decided that they were. The first and best known of these cases was *Singer v. Goldhar*.³⁹ The mortgage in that case purported to secure the sum of \$4,700 with no interest, repayable on certain specified dates. Only \$3,500

³⁸ If the difficult calculation test of *Kilgoran*, *supra*, footnote 10 were accepted. Of course, if the "indistinguishable" test apparently accepted by *Ferland*, *supra*, footnote 23, is correct, then the payment is probably not blended.

³⁹ *Supra*, footnote 32.

was in fact advanced and all parties were fully aware that the additional \$1,200 was a bonus to the lender. The court held that knowledge of the parties and the absence of fraud were irrelevant to a consideration of the Interest Act. The statute required the court to determine what was the principal money advanced and what was the interest. In ordinary language, principal meant the sum actually advanced and interest the compensation for use of the money. The court found the principal to be \$3,500, the interest to be \$1,200 and the repayments, which did not distinguish between principal and interest components, to be blended. Section 6 was applicable and had been violated because no interest rate at all was specified for the loan.

The *Singer* case caused some concern. Bonus transactions were common then as today and lenders were disturbed by the attitude of the court. An editorial note following the case report in the *Dominion Law Reports*⁴⁰ suggested that the application of the decision might be avoided were lenders to advance the full face value of the loan and then receive back from the borrower the bonus payment. This optimistic approach was rejected by the Ontario Supreme Court in *Lastar v. Poucher*.⁴¹ The mortgage was for \$5,000 at 7% per annum interest. A collateral agreement required the borrower to pay first out of proceeds a commission of \$2,000. The court held the case to be indistinguishable from *Singer*.

The result of this line of cases is typified by the Ontario Appellate Division decision in *Rogers v. Labow*.⁴² In that case a mortgage provided for a principal sum of \$800, with interest at 8% and a bonus of \$50.00. The court held that the interest rate expressed should have been the amount of interest plus bonus based on \$750 principal, an effective rate of about 9 3/5%. Section 7 of the Interest Act was not applicable because no rate applicable to the principal actually advanced (\$750) was stated, and so the Court held that no interest at all had to be paid by the borrower.

These cases were overruled by the Supreme Court of Canada in 1930 in *London Loan & Savings Company of Canada v. Meagher*.⁴³ The case was an appeal from the decision of the Ontario Appellate Division which had returned to the liquidator of Trans-Canada Theatres Ltd. a bonus of \$3,000 plus interest. The liquidator had repaid a mortgage to London Loan of \$30,000 plus interest at 7½% per annum. He had been unaware at that time that the actual advance to Trans-Canada had been only \$27,000, \$3,000 having been immediately repaid to London Loan as a bonus not declared on the face of the mortgage. The Ontario Court followed its own earlier decision in *Singer*.

⁴⁰ *Ibid.*, at pp. 145-146 (D.L.R.).

⁴¹ [1926] 2 D.L.R. 993, (1926); 58 O.L.R. 589 (Ont. S.C.).

⁴² [1929] 3 D.L.R. 845, (1929), 64 O.L.R. 309 (Ont. A.D.).

⁴³ *Supra*, footnote 14.

The decision of the Supreme Court appears to rest on three separate grounds: first, that the mortgage did not, on its face, fall within the provisions of section 6, that is, the payment was not blended; secondly, that too many commercial transactions would be adversely affected by the reasoning of the Ontario decision; and thirdly, that the spirit of the Act was not offended by the mortgage.

In delineating the first ground of its decision, the court noted that the argument for bringing this mortgage within the provisions of section 6 was that the mortgagor was to pay for use of the money \$3,000 in addition to the interest at 7½%. Thus, the argument ran, this \$3,000 was also interest on the \$27,000 retained by the borrower and the covenant to pay \$30,000 was thus a blended payment. In response, the court said:⁴⁴

As already pointed out the \$3,000 that the mortgagor agreed to pay as consideration for the loan, whether regarded as interest or as something differing from interest, could have been recovered as a debt, not under the mortgage, but under the agreement for the loan, and the full \$30,000 was advanced, whether the bonus is taken as paid by the mortgagor's cheque or by retention from the loan, unless the Act applies. To hold, therefore, that only \$27,000 was advanced, it must first be determined that the Act does apply, and that any right to the \$3,000 bonus was by its provisions prevented from arising.

The court's reasoning in this passage is faulty. Whether or not the \$3,000 could have been recovered in an action under the agreement for the loan, apart from the mortgage, does not dispose of the first and essential question: what constitutes interest within the meaning of section 6? This underlying question cannot be dismissed by characterizing the bonus as "interest or as something differing from interest". Nor need section 6 be applied in order to determine what the principal sum advanced is for the purposes of the section. To do so would obviously be to beg the question and make the section impossible to apply. Instead, the court must characterize monies payable under the mortgage as principal or as interest. Only after these characterizations are made can it decide whether section 6 is applicable and, if it is, what statement is necessary.

The result of the court's conclusion that "the provisions of the statute apply only to mortgages which on their face come within the description set out in section 6"⁴⁵ is that the parties themselves decide what is interest and what is principal for their loan. Any consideration for the loan, expressed as a capital amount, is accepted by the court as such. In this way, a lender can increase his rate of return while expressing the "interest" payable on the loan as a much smaller per cent.

The court then described three common commercial transactions to which it considered the application of section 6 would be unfair. These

⁴⁴ *Supra*, footnote 14, at pp. 382-383 (S.C.R.), 852 (D.L.R.).

⁴⁵ *Ibid.*, at pp. 383 (S.C.R.), 853 (D.L.R.).

were the assignment of mortgages to innocent third parties, a bond issue secured upon real property and sold by a corporation to the public, and the retention by the mortgagee of the amount of his solicitor's fees. One might argue that a court ought to concern itself with applying the law, not with inconvenience that might result from it; one might also suggest that the last two transactions at least would in no way be hindered by compliance with section 6. Indeed, particularly in the case of corporate bonds, emphasizing the higher rate of return produced by the discount, as the section 6 statement might require, would no doubt produce a more saleable bond. As for the solicitor's fees, reimbursement of out-of-pocket expenses might easily be characterized as something other than interest or compensation for the loan.

However, these arguments would obscure a major issue already noted that surrounds the case law on section 6, the harshness of the penalty for failure to comply. A failure of form — failure to state the interest according to a magic formula of words — results in the lender foregoing all compensation for the use of his money, whether or not he intended to be fraudulent, harsh, fair or generous. Particularly when applied to the innocent third party purchaser of a mortgage, this result seems even more unjust. In this case, commercial efficacy urged upon the court a strict interpretation of the application of the section.

The final ground of the court's decision is also related to considerations of fairness. This mortgage, it was held, did not offend the spirit of the Act.

... it does not fail to disclose to an ordinary borrower what he is to pay for the loan, though he might not realize what rate per cent, the \$3,000 cash in advance, added to the 7½% would amount to. The \$3,000 cash payment might, however, give him a clearer idea of what the loan was costing him than if provided for in terms of an added rate of interest.⁴⁶

The court as in the "blended payment" cases examined earlier, was unwilling to impose the penalty under section 6 where there had been no concealment or fraud.

Later cases on extra payments to increase the lender's return have either followed the first or third ground. If the bonus or other payment is a separate agreement, not disclosed in the mortgage deed, the courts have held that the amount has been "capitalized" by the collateral agreement and forms part of the principal sum advanced.⁴⁷ However, the *Meagher* decision had left open the question of whether the extra charge would have to be included in the section 6 statement if the charge was provided for in

⁴⁶ *Ibid.*, at pp. 384 (S.C.R.), 853 (D.L.R.).

⁴⁷ *Asconi Building Corporation and J. Paul Vermette v. Vocisano*, [1947] S.C.R. 358, [1948] 1 D.L.R. 794; *Longley v. Barbrick* (1962), 36 D.L.R. (2d) 672 (N.S.S.C.); *Stephen Investments Ltd. v. Le Blanc and Geddes* (1963), 37 D.L.R. (2d) 346, 41 W.W.R. 422 (Alta S.C.).

the mortgage itself. This situation came before the courts three years later in *Mutual Finance Corporation v. Jost*⁴⁸ and the court relied on the third ground in *Meagher* to hold that section 6 was not violated. The court held that the amount to be paid was merely a matter of calculation and quite clear to a person of ordinary intelligence.

Unfortunately, the interest to be paid is always a "mere matter of calculation". Lump sum payments may in one sense be easier for borrowers to understand, but the combination of a bonus payment, for example, with a stated rate is confusing. It makes comparisons with other mortgage rates, with perhaps their own bonus requirements, quite difficult. This confusion could, in a limited role for section 6, have been eliminated by the standardized disclosure the section requires. The decisions of the courts permitting combinations of extra payments plus interest rate on the total sum without any final expression of the effective rate has thus defeated one of the most useful purposes of the section.

II. *Principles of Interest Calculation— A Word Means Just What I Want*

If the courts have found difficulties in section 6 and section 7, both as to criteria for application and as to the content of the required disclosure statement, they have fared little better in interpreting that statement to determine what principles of interest calculation it imposes. This is also a vital procedure, first because as in all contracts, the parties are entitled only to what they have agreed upon. In this context, the principles of interest calculation I will discuss will be applicable to all mortgages, whether or not section 6 applies to them. Additionally, if section 6 does apply because the mortgage falls within one of three repayment schemes in the section, interpretation of the disclosure statement takes on an added dimension under section 7. The court must also determine if another part of the mortgage would increase the interest payable and, if so, disallow the greater amount. All these tasks require an understanding of how mortgage interest works.

Whether or not section 6 applies to a mortgage, similar words are generally used in the interest payment clause. Interest is usually expressed as "X% per annum, calculated semi-annually (monthly, yearly, half-yearly, etc.) and not in advance". Unfortunately, despite the widespread use of this formula, the courts have not always interpreted it clearly or consistently. Customs and thus evidence before the court may vary. In many instances, lenders and mathematicians would calculate the same interest clause quite differently.⁴⁹ Should the courts be guided by expert

⁴⁸ [1933] O.W.N. 17 (Ont. H.C.). See also *Re Desrochers et al. and Soules*, *supra*, footnote 13.

⁴⁹ For example, see the discussion of "add on" interest calculation, *infra*, Part II, C: "Not in advance". Another example is the calculation of the outstanding principal by the

evidence based on mathematical formulae, or on the most convenient (and profitable) methods in use in the lending community? The former guide has the advantages of certainty, uniformity, and availability to any member of the public who cares to learn the principles; the latter permits those who benefit most directly to set their own rules and standards. The lender becomes like Humpty-Dumpty, able to use words for his own purpose⁵⁰ without regard to accepted accuracy.

A. A Mathematical Approach

Although the reader need not understand the derivation of the sometimes intricate formulae for interest calculation, I have already suggested that some understanding of the principles by which mortgage interest is calculated is essential to an evaluation of the case law. In this section, I will outline the most commonly used principles of interest calculation applicable to mortgages.

Mathematicians regard mortgage interest calculations as one set of a general area called annuities.⁵¹ Annuities are simply series of periodic payments, usually equal, made at equal intervals of time and containing a component of compound interest.⁵² Thus, what the layman would think of an annuity falls within this classification, but so also do instalment payment plans, interest on bonds and mortgages. More specifically, mortgages are usually examples of ordinary annuities, that is annuities in which the payments are made at the end of each payment interval.⁵³

In any annuity, the important factors are the present value of the annuity (in mortgage terms, the principal of the mortgage), the number of payments, the interest rate per payment period (compounded at the end of each payment period), the amount of each payment, and the final amount (the final value at the end of the annuity including all payments and the compound interest). If one of these factors is unknown, it may be derived from the others by formula.

The construction of the formula to solve annuity problems always begins with the simple but tedious method of calculating the compound

“Rule of 78”. Not surprisingly, these methods favoured by lenders usually result in the borrower paying more over the life of the loan.

⁵⁰ Lewis Carroll, *op. cit.*, footnote 1, p. 224. “When I use a word”, Humpty Dumpty said in rather a scornful tone, “it means just what I choose it to mean—neither more nor less”. “The question is”, said Alice, “whether you *can* make words mean different things.” “The question is,” said Humpty-Dumpty, “which is to be master—that’s all.”

⁵¹ See Mullings and Shao, *op. cit.*, footnote 33, pp. 351-527.

⁵² *Ibid.*, at p. 351.

⁵³ *Ibid.*, at p. 352. Other types of annuities are the annuity due, in which payments are made at the beginning of the payment interval, and the deferred annuity, in which the annuity does not begin until after a designated period.

interest on a gradually changing balance.⁵⁴ Applying a similar process to debt extinction, an amortization table for the debt can be constructed and it will answer most questions about the interest, principal and payments of the loan. For example, suppose I borrow \$1,000 to be repaid in equal payments of \$88.85 each month with interest at 12% per annum calculated monthly. At the end of the first month, I have accumulated a debt of \$1,010, calculated as follows:

$$\$1,000 + \frac{(12\% \times \$1,000)}{12} = \$1,010$$

I make a payment of \$88.85 and am left with a balance of \$921.15. At the end of the second month, the process is repeated. The results are illustrated in the following table:

Amortization Table

(Principal of \$1,000 Borrowed for 12 Months at 12% Per Annum Compounded Monthly With Monthly Payments of \$88.85)

Period (1 month) (1)	Outstanding Principal at Beginning of Each Period (2)	Interest Due at End of Each Period (3)	Payment at End of Each Period (4)	Portion of Principal Reduced by Each Payment (5)
1	\$1,000.00	\$10.00	\$88.85	\$78.85
2	921.15	9.21	88.85	79.64
3	841.51	8.42	88.85	80.43
4	761.08	7.61	88.85	81.24
5	679.84	6.80	88.85	82.05
6	597.79	5.98	88.85	82.87
7	514.92	5.15	88.85	83.70
8	431.22	4.31	88.85	84.54
9	346.68	3.47	88.85	85.38
10	261.30	2.61	88.85	86.24
11	175.06	1.75	88.85	87.10
12	87.96*	.88	88.85	87.97*

*Note that the \$.01 discrepancy is a result of rounding to the nearest cent during computations.

⁵⁴ The value of each payment in an ordinary annuity may be calculated by applying the normal compound interest formula:

TOTAL COMPOUND AMOUNT (S) = PAYMENT $\times$ (1 + INTEREST RATE PER CONVERSION PERIOD)ⁿ, where n = number of conversion periods. Then the total value of the annuity is found by adding these amounts. Working from this process, the following formula is derived:

$$S_n = R \cdot \frac{(1 + i)^n - 1}{i}$$

S_n is the total amount of the annuity; R, the size of each payment; i, the interest rate per conversion period; and n, the number of conversion periods.

The annuity formulae, derived from algebraic abstractions of similar calculations to this one, permit a much quicker solution to various problems of annuities and related amortized payment schedules. For example, the formula for the final amount of an ordinary annuity is:

$$\text{Final Amount} = (\text{Size of Payment}) \times \left[\frac{(1 + \text{Interest Rate Per Conv. Period})^n - 1}{\text{Interest Rate Per Conv. Period}} \right]$$

In this formula "n" is the number of payments and the number of interest conversions or, as mortgage terminology would express it, calculation periods. Related to the above chart, the amount of an annuity of \$88.85 per month invested at the same rate given for the loan reduction would be:

$$\$88.85 \times \frac{(1 + .01)^{12} - 1}{.01} = \$1126.84$$

In other words, if the recipient of the monthly payments invested them in a fund at the same interest rate, this would be the final amount of that fund after 12 months. Similarly, the present value of an annuity and the interest rate per calculation period have been translated into formulae.⁵⁵ Additionally, tables have been constructed for the commonly used factors in the formulae.

These formulae are also used to answer common questions about amortized mortgages. For example, a frequent problem is to find the outstanding principal balance on a mortgage at any particular time. This problem can be solved by equating the principal balance owing to the present value of an annuity formed by the remaining equal payments at the given interest rate per conversion period. Relating this example to the above amortization table, the balance owing after 6 payments would be:

$$88.85 \times \frac{[1 - (1.01)^{-6}]}{.01} = \$514.93$$

But all these formulae and principles are based on the assumption that the payment period and the interest calculation (conversion) period are the

⁵⁵ $A_n = R \cdot \frac{1 - (1 + i)^{-n}}{i}$ and where A_n = the present value of the annuity.

Finding the interest rate per conversion period, of course, is simply solving for "i" either in this formula or that given in footnote 54, depending on whether the total amount or the present value of the annuity is known. In practice, tables give the values for

$$\frac{1 - (1 + i)^{-n}}{i} \quad \text{and} \quad \frac{(1 + i)^n - 1}{i}$$

at different values of "i" and "n".

same. When, as in most mortgages, the calculation dates and payment dates do not coincide, mathematicians consider the annuity to require an additional step for its solution. This is a *complex* rather than a *simple* annuity and its solution lies in first being converted into a simple annuity and then solved by the formulae discussed above, that is, the interest conversion periods and the payments periods must be made to coincide.⁵⁶ This may be treated as another annuity problem in which the original (or actual) payment is the final amount (or total amount of the equivalent payments plus their accumulated interest) of the annuity. The mathematician solves the simple annuity formula to discover the amount of an equivalent payment per conversion period that would, at the given rate of interest, produce a final amount equal to the original payment.⁵⁷ Obviously, because the annuity formula is being applied to this intermediate step, the equivalent payment obtained will be different than the original payment divided by the number of conversion periods contained in the original payment period. For example, related again to the amortization table, if we had one annual payment of \$1,126.84 with interest calculated monthly, the equivalent monthly payment would be found by formula to be \$88.85. That is the equivalent payment needed to produce a final amount equal to the original payment (\$1,126.84).

Another approach is to perform the same type of alteration on the interest rate. In other words, a formula is used to determine a rate of interest per payment period equivalent to the rate of interest given in the complex annuity.⁵⁸ Again, the result will not be simply equal to the interest rate divided by the number of payment periods. For example, if quarterly payments are made on an annuity with interest at 6% compounded monthly, the first step is to find the equivalent interest rate per quarter. Using the appropriate formula, the equivalent is 1.5075% per quarter, not 1.5%, the value obtained simply by dividing 6% by twelve and then multiplying by 3. In mortgage terminology, a borrower who made quarterly payments while his interest was being calculated monthly would effectively be paying somewhat more interest than if it was being calculated quarterly.

In a more common situation, where the annuity requires monthly payments with a quarterly interest calculation of 8% per annum, the interest

⁵⁶ See Mullings and Shao, *op. cit.*, footnote 33, pp. 398-406.

⁵⁷ The formula for this operation is:

$$R = E \cdot \frac{(1 + i)^c - 1}{i}$$

R = the actual periodic payment; E is the new equivalent payment at the end of each interest period; i is the given interest rate per conversion period; c is payment interval; and n is the number of actual payments.

⁵⁸ The formula is $r = (1 + i)^c - 1$ where "r" is the interest rate per payment interval; i is the given interest rate per conversion period and c again is payment interval .
interest periods

rate equivalent per month, again using the formula discussed in the preceding paragraph, will be .00662271, somewhat less than the figure .006666¹, obtained by dividing 8% by 12. In mortgage terminology, the solution to various problems of a mortgage with monthly payments but longer calculation periods would be made by using annuity formulae with a somewhat smaller interest rate per month than the division of the per annum rate by 12 would suggest.

B. Calculation dates and "per annum" rates

The above discussion shows the importance of calculation dates in a mortgage. Depending on how the interest is calculated, the borrower will pay a somewhat larger or smaller total amount over the life of the mortgage, and thus the effective annual rate will be somewhat greater or less. Occasionally a mortgage will fail to state the calculation period. This has raised a number of issues for the courts: is such a mortgage sufficiently certain to be enforced at all; has section 6 been violated; and if section 6 has been complied with, has section 7 been violated. The question underlying all three issues is what presumptions will the court make about the calculation date if the mortgage is silent.

In two leading cases dealing with the omission of a calculation date in a mortgage clause, the mortgages were clearly sufficiently certain. The clause in question in both *Canadian Mortgage Investment Co. v. Cameron*⁵⁹ and *Standard Reliance Mortgage Corporation v. Stubbs*⁶⁰ contained the principal, the amount of the payments, the number and times of the payments and a stated annual rate. From this information, an annuity formula⁶¹ can be used to calculate the actual interest rate per payment period. This can then be multiplied by 12 to give the effective annual rate⁶² which is, of course, the important variable dependent on differing calculation periods.

However, the omission meant that a difference in the effective annual rate and the stated rate would not be immediately apparent. For example, the mortgage in *Cameron* provided for repayment of a principal sum of \$1,400 "in installments of one hundred and seventy-nine 90/100 dollars half-yearly on the 24th days of June and December in each year until the whole of said principal sum and the interest thereon is fully paid and satisfied, making in all ten half-yearly instalments . . . and . . . interest on the said sum or so much thereof as remains unpaid at the rate of ten per cent per annum". Obviously the repayment clause results in the borrower

⁵⁹ *Supra*, footnote 13.

⁶⁰ *Supra*, footnote 11.

⁶¹ *Supra*, footnote 55.

⁶² In both cases, the payments were made monthly.

paying a total amount of \$1,799 over five years to repay the \$1,400 principal. But has he paid an effective rate of 10% per annum or not? If the borrower had no access to the formulae we have reviewed that are needed to calculate the interest rate for an annuity, he would find it difficult to answer the question. The same problem arose in *Stubbs*.

The issue in both the cases was whether the mortgagee had fulfilled the requirements of section 6 of the Act. Since section 6 requires the disclosure of the calculation date, the court had to decide what the effect of a failure to state the calculation date was. The cases were considered together by the same panel of five judges. All assumed that these mortgages did involve blended payments and were governed by section 6; the idea that amortized payments containing a component of principal and interest might not be blended had not yet been suggested.⁶³ Of the five, two, Davies and Idington JJ. dissented, holding that section 6 had not been satisfied because the section required each blended payment to be separated as to its principal and interest components, and a statement of the rate of interest at which the calculation was made, yearly or half-yearly not in advance.⁶⁴

Sir Charles Fitzpatrick C.J.C. and Duff J. concluded that section 6 had been satisfied, apparently because the information required by the section could be determined from the information given in the mortgage. Thus, presumably if the effective rate could be determined the requirements of section 6 were fulfilled. However, there are passages in their judgments which are, to say the least, obscure. The Chief Justice stated:⁶⁵

... I think the requirements of the Act are satisfied by the agreement between the parties expressed in the mortgage, "that the principal is \$700 and the rate of interest chargeable thereon is 10% per annum."

Duff J. concluded:⁶⁶

Now these two paragraphs state with perfect clearness that each of the stipulated half-yearly installments contains a sum charged for interest at the rate of 10% payable half-yearly and that interest, at this rate, is chargeable under the mortgage and payable at such intervals. That, I think, is a sufficient compliance with the statute.

It may be doubted if either judge understood the significance of a calculation date in an amortized mortgage. Indeed, in *Stubbs*, the Chief Justice remarked:⁶⁷

... whatever interpretation is put upon the words "calculated yearly or half-yearly not in advance," the difference in the *rate* chargeable would be only fractional, and, I

⁶³ See the discussion *supra*, footnote 14.

⁶⁴ This, of course, is more than section 6 on its face apparently requires. The judges were suggesting an amortization table which was, in their opinion, the only way to inform clearly the borrower, as the spirit of the section required.

⁶⁵ *Stubbs*, *supra*, footnote 11, at pp. 426 (S.C.R.), 437 (D.L.R.).

⁶⁶ *Cameron*, *supra*, footnote 13, at pp. 420 (S.C.R.), 434 (D.L.R.), 527 (W.W.R.).

⁶⁷ *Supra*, footnote 11, at pp. 425 (S.C.R.), 436 (D.L.R.).

think . . . the statute is satisfied without absolutely exact figures which the difference in permissible schemes of repayment renders practically impossible to state.

The judgment of Anglin J. is the clearest. He obviously understood the importance of the frequency of calculation and the distinction between the calculation dates and payment dates. He also appreciated the importance of whether or not interest could be calculated in advance. His conclusion was that section 6 had been satisfied because when a per annum rate is stated without further qualification a reasonable implication was that the interest was to be computed or calculated yearly and not in advance. He alone among the judges appears to have realized that, however the lenders were in fact calculating the interest in these cases, the effective annual rate produced by the payment schedule set out was somewhat less than 10% per annum calculated annually and not in advance.⁶⁸ He noted that the effect of section 7 of the Act was to restrict,⁶⁹

the mortgagee's right of recovery to the amount secured according to [the section 6] statement. If the sum of the blended instalments amounts to less than the principal and interest secured by the mortgage according to the statement, and the mortgagee has agreed to be redeemed on payment of the specified instalments, it may be that he would have difficulty in seeking to avail himself of the statement to enforce payment of any larger sum. But any error in the computation of the blended payments or instalments does not affect the sufficiency of the statement to meet the requirements of the statute.

In the recent Supreme Court of Canada decision, *Metropolitan Trust Co. v. Mornish Land Developments Ltd.*,⁷⁰ a mortgage which failed to state either calculation date, or whether the interest was to be calculated in advance, was given a somewhat different interpretation. The *Morenish* mortgage, however, was not one to which section 6 applied.⁷¹ More significantly, it was not a mortgage falling within this class of annuity problems at all. It secured a principal of \$8,200,000.00 which was to be repaid in a lump sum in three years time and, in the interim, monthly payments of interest only were to be made. The court found that the lender was entitled to compute the interest monthly. This appears to contradict the court's ruling in *Cameron* and in *Stubbs* but, as I will discuss in the next section,⁷² the effect of this judgment is to approve the use by the lender of a simple interest calculation method rather than compound (as annuities, by their nature, require) and in such cases, only the payment dates, not the calculation dates are relevant.

The court in *Morenish* recognized a distinction between mortgages based on amortized repayment plans and other mortgages. It seemed to find

⁶⁸ In *Cameron*, the effective rate was between 9% and 10%; in *Stubbs*, it was 9.2%.

⁶⁹ *Stubbs*, *supra*, footnote 11, at pp. 431 (S.C.R.), 440-41 (D.L.R.).

⁷⁰ [1981] 1 S.C.R. 171, (1981), 118 D.L.R. (3d) 385.

⁷¹ Interest payments only were to be made, although the mortgagor could, and did, make separate prepayments of capital.

⁷² Section C, "The re-investment principle", *infra*.

that the type of mortgage before them required only simple interest methods,⁷³ and was not an annuity. Estey J., speaking for the court, stated that "we are not concerned with considerations relating to compound interest",⁷⁴ and again, that "... we are not concerned with compound interest but rather with an agreed procedure for the payment of interest as expressed in the mortgage".⁷⁵ On this basis, he distinguished the judgment of Anglin J., saying that such cases were "helpful only where terms common to mortgages *without blended payments* are before the court".⁷⁶

I suggest that because of the distinctions recognized by the Supreme Court in *Morenish* a court is likely to follow the approach of Anglin J. when dealing with a mortgage repayable by blended payments. Thus, if a mortgage with blended payments fails to state a calculation date, the implication should be that the calculation will be annual. Then, following the result in *Cameron* and *Stubbs*, if the lender has charged no more than that interest, he will be both abiding by the terms of his agreement and he will be in compliance with section 6. If he is charging more than that interest calculated annually then because section 6 applies, section 7 would prevent him collecting the amount greater than that produced by the implied annual calculation. Although the decision of Anglin J. may weaken somewhat the effect of section 6 in that a lender need not expressly state the calculation date for the borrower's information, it does confine the lender to the lowest effective annual rate that the stated rate can produce and, combined with section 7, prohibits him from collecting a higher amount. It is, perhaps, a workable compromise with the harsh results of a determination that section 6 has not been complied with.

Of course, a situation never contemplated by the court in *Cameron* and *Stubbs* now appears possible. One may have an amortized mortgage the payments of which would not be considered blended or payable within any repayment plan covered by section 6. In that case, the presumption of Anglin J. would produce, if there were an attached repayment schedule which resulted in more interest than that payable upon an annual calculation, two irreconcilable methods. In that case, the words of the contract should govern and if the repayment schedule permits the calculation of the effective rate, failure to state the calculation date should be irrelevant. If,

⁷³ Of course, it is quite possible, mathematically, to argue that the *Morenish* mortgage was indeed an annuity requiring the use of annuity formulae for calculation. Compound interest is then involved and the approach of the court would be incorrect based upon the principles I later argue in C, "The re-investment principle". However, this was not the approach taken by the court. They treated it as a case of simple interest with partial payments, and I shall proceed on this footing.

⁷⁴ *Supra*, footnote 70, at pp. 180 (S.C.R.), 392 (D.L.R.).

⁷⁵ *Ibid.*, at pp. 181 (S.C.R.), 393 (D.L.R.).

⁷⁶ *Ibid.*, at pp. 183 (S.C.R.), 395 (D.L.R.) (emphasis added).

however, the effective rate cannot be calculated because some information is missing (perhaps the total number of payments, for example), then the presumption of Anglin J. could be usefully applied to save the document from failing for uncertainty. This would be a sensible approach, although no authority currently has pronounced upon it. The *Morenish* alternative of permitting calculation at the same intervals as payments should be confined as, I suggest, the Supreme Court confined it, to non-amortized mortgage payment schemes.

C. The Re-investment Principle

The re-investment principle, in its simplest form, is a reflection of the basic fact of financial planning that a dollar payable today is worth more to a lender and costs more to a borrower than a dollar payable at some future date. Anyone who appreciates the value of deferring taxes appreciates that point.

An example will illustrate. Suppose that again I borrow \$1,000 at 12% per annum, calculated annually. This time, let us assume that I am to pay the interest on the loan each month. If I pay \$10 every month, by the end of the year I will have paid \$120. Initially, this appears to be the correct sum to yield the lender and cost me, the borrower, exactly the rate that has been disclosed. This may be misleading. I have conferred upon my lender the opportunity of investing the interest paid before the calculation date. Similarly, I have lost that same opportunity. Assuming the borrower or the lender could have invested this prepaid interest at the same rate as their loan stipulates, at the end of the first month, the lender has \$10 which he can invest for 11 months; at the end of the second, he has \$10 which he can invest for 10 months and so on. The effect is that he will earn interest on interest, just as though he had been allowed to compound it. If interest is to be paid more frequently than it is to be calculated, then arguably the lender should charge less interest than the stipulated rate divided by the number of payment periods or, just as in more frequent compounding, he will receive a greater yield from the loan, with a consequent greater cost to the borrower. Again a mathematical factor can calculate this result. The principle is known as the re-investment principle.⁷⁷

The mathematical principles that I have also already discussed for the calculation of complex annuities incorporate re-investment.⁷⁸ Where payments containing a component of interest are made more frequently than

⁷⁷ I suggest that this term is used to describe three ideas: the business concept of money paid in advance; the mathematical rules for calculating complex annuities; and the choice available to the parties between two rules for calculating the unpaid balance on a loan with simple interest. This example illustrates the first and third only. The example given in the next section, "Not in advance" illustrates the first and second use.

⁷⁸ See discussion, *supra*, part II, A: "A Mathematical approach".

the interest is calculated, the total amount to be paid by the borrower and the amount of his payments required to extinguish the loan in a specified time are determined by using an interest rate per payment period somewhat less than the interest per calculation period divided by the number of payment periods it contains. In other words, the borrower is being given an interest credit on the amount of interest paid before the calculation date, as if that pre-paid interest were itself bearing interest in the hands of the lender. To express the same result using the other method of solving complex annuities described, the borrower is required to make somewhat smaller payments to pay the loan than would be the case if equivalent payments were made only on the calculation dates or at intervals longer than the calculation periods.

An excellent discussion of the effect of these calculations was given by H. Woodard.⁷⁹ The courts have almost invariably quoted his summary when dealing with the "re-investment principle" and, for convenience, the whole of the relevant passage is set out below:⁸⁰

Just as the frequency of compounding, as expressed by the word "calculated" or its synonyms, has no bearing on when the interest is to be paid, neither has it any necessary bearing on how frequently the lender may charge the interest to the borrower's account. There is often some confusion on this point owing to the misunderstanding of the word "calculated" in its mathematical sense. For example, an interest rate may be expressed as "calculated semi-annually", yet the borrower may contract to pay the interest monthly. The lender, in turn, may be charging the borrower's account with interest each month. There is nothing incorrect in such procedures, provided (and it is an important proviso) that the effective annual yield to the lender is not higher than that derived from the contractual interest rate. When interest is payable by the borrower more frequently than once each period of compounding as expressed in the contractual interest rate, all interest mathematics are based on the theory that the lender re-invests the interest received from time to time, at the same rate. Therefore, the amounts of interest received from the borrower, plus the theoretical re-investment earnings on them, produce, for the lender, the effective yield contemplated in the borrowing instrument, be it mortgage deed, promissory note, or otherwise.

Following along on this principle then, it will be apparent immediately that if, for example, the contractual rate is "6% calculated *semi-annually* not in advance", the lender cannot collect $\frac{1}{2}\%$ each month, for that would be a rate of "6% calculated *monthly* not in advance" and would be an over-charge. However, if the borrower is paying his interest monthly and the lender wishes to charge the interest to the account monthly, then some rate of charge must be determined which is the proper equivalent and which obviously must be less than $\frac{1}{2}\%$ each month. To allow the monthly or other periodic charging and collection of interest without impairment of the contractual rate, mathematicians provide us with the applicable figures to be used when payments of interest are to be made and charged more often than the interest is to be compounded, calculated, or converted, according to the rate established in the contract. These figures are generally known, in the mortgage business, as *interest factors*. Thus, in the previous example, where interest is being collected and charged

⁷⁹ H. Woodard, *op. cit.*, footnote 3.

⁸⁰ *Ibid.*, pp. 193-94.

monthly, on a mortgage loan on which the interest rate is "6% calculated semi-annually not in advance," the lender would charge .493862% at the end of each month. . . . The method of calculation of these factors is one of the aspects which must be accepted herein by the non-mathematician at face value.

In *Re Tilson and Dougherty*,⁸¹ the Ontario Divisional Court considered these principles and the effect of sections 6 and 7 of the Act. The mortgage in question provided for repayment of a principal sum of \$20,000 with interest at "seven (7%) per centum per annum calculated half-yearly not in advance" by monthly payments of principal and interest of \$150 over 118 months with a final payment of the balance, an unspecified amount. The issue was the amount required, if any, to discharge the mortgage, taking into account the payments made by the mortgagors.

The mortgagee had adopted a simple method of calculating the mortgage. Each six month period, he calculated the interest for that period and added it to the principal balance owing at the beginning of the period. He then deducted the monthly payments of the mortgagors as they were made and, at the end of the six month period, was left with a balance from which to begin the same process again. In fact, although the mortgage specifically prohibited calculation in advance, this process produces that effect. No credit is being given the mortgagor for the capital portion of each payment which must be applied to reduce the principal.⁸² The mortgagor submitted into evidence a statement which showed he had satisfied the mortgage. Presumably, the statement had calculated the amount to be paid by using the annuity formula.⁸³ Effectively, of course, this amounts to calculating the monthly rate equivalent to 7% per annum calculated half-yearly and, using that rate to divide each payment between principal and interest, writing down the principal sum by the appropriate amount each month so that interest is charged only on the remaining principal balance.

The court approved the statements of Woodard⁸⁴ as a guide to calculating the mortgage interest. It also found this mortgage to require blended payments within the meaning of section 6, as already discussed. In the result, the court used section 7 and held that since mortgagee's method of calculation produced a higher rate than that stated by the section 6 disclosure, only the lower rate could be claimed.

With respect, I suggest that sections 6 and 7 were totally unnecessary to the result reached by the court. Their use illustrates some confusion about interest calculation. The method used by the mortgagee was not a

⁸¹ *Supra*, footnote 17.

⁸² See discussion, *infra*, section D, "Not in advance".

⁸³ However, sufficient evidence was not introduced to assure the court that the interest factor used was the appropriate one. The interest factor is the equivalent interest rate per payment period that was discussed above in part II, A: "A mathematical approach". This rate would then be used in the annuity formulae.

⁸⁴ *Supra*, footnote 79.

correct mathematical calculation of the rate stipulated in the mortgage. He was therefore in breach of the contract. Sections 6 and 7 of the Act are only needed to enable a court to decide between two contradictory provisions for repayment in the mortgage itself. This was the case in *Stubbs* and in *Cameron*.⁸⁵ However, in *Tilson* there was no such contradiction.

The next important case to discuss the reinvestment principle was *Re Fobasco Ltd. and Abrams*.⁸⁶ In that case, the principal amount of the mortgage was \$2,200,000. No payments were required on account of principal until the date of final settlement, but the interest was to be paid monthly at a rate expressed as "9½% per annum". The mortgagee calculated the interest payments owing by dividing a full year's interest by 12, i.e.:

$$\frac{9\frac{1}{2}\% \times \$2,200,000.}{12}$$

The mortgagor argued that the payment should be smaller because the mortgagee should be deemed to re-invest each payment at the same rate immediately upon receipt. The mortgagor relied on the *Tilson* decision and on Woodard's analysis previously quoted.

The mortgagees attempted to make a distinction between their mortgage and a typical amortized repayment mortgage. The court noted:⁸⁷

Counsel for the mortgagees concedes that the law is now settled that where the monthly payments comprise blended interest and principal in a mortgage where interest is not to be calculated as paid in advance, and compounding is to be effective at longer than monthly intervals . . . the principle of deemed re-investment applies.

One might add that, as we have seen, this is merely a reflection of the mathematics required to solve the problem. However, the court saw no reason to confine the re-investment principle to such mortgages. Keith J. concluded:⁸⁸

Once it is conceded that where a mortgage requires interest to be paid monthly and stipulates an annual rate, with compounding at lengthier intervals not in advance, the deemed re-investment principle ought to be applicable unless some other terms are spelled out . . . It ought not to matter whether the monthly payments of a fixed sum are blended with principal payments . . . or whether, as in this case, no principal payments are required.

Fobasco was overruled by the Supreme Court of Canada in *Metropolitan Trust Co. v. Morenish Land Development Ltd.*⁸⁹ The facts of that case have already been stated.⁹⁰ The positions of the mortgagor and mortgagee

⁸⁵ See discussion part II.

⁸⁶ (1976), 71 D.L.R. (3d) 43 (Ont. H.C.).

⁸⁷ *Ibid.*, at p. 45.

⁸⁸ *Ibid.*

⁸⁹ *Supra*, footnote 70.

⁹⁰ *Supra*, p. 169.

were essentially the same as in the *Fobasco* decision. The mortgagor was, in mathematical terms, asking the court to treat his mortgage as a complex annuity requiring the same mathematical treatment as had been accorded the mortgage in *Tilson*. The court refused to apply the deemed re-investment principle. Estey J. stated:⁹¹

From a practical viewpoint, the assumption that the lender will reinvest interest payments when received at the rate specified in the mortgage is tantamount to establishing, without express agreement between the parties, a mythical interest fund owned by the mortgagee . . . without any right in ownership, statutory provision, or term of contract to support the practice.

Initially, this appears to be a flat contradiction of the mathematical system necessary to calculate the cost of mortgages. However, I suggest it is possible to see the case in a somewhat different context. As already noted, the Supreme Court made a crucial distinction between mortgages of the type before it, in which interest only was to be paid, and mortgages of the type found in the *Tilson* case. It did not treat the mortgage requiring payments of interest only as involving, as do annuities by their nature, any compound interest. In fact, instead of seeing the *Morenish* mortgage as an annuity, it appeared to treat it as involving only simple interest. The payments of interest are treated as partial payments over the life of the loan. This may be a surprising result from a mathematical perspective, but it appears to be explanatory of much of the dicta in *Morenish* that otherwise seems confusing.

This may be illustrated by a brief review of the mathematical treatment of simple interest loans with partial payments. In such cases, there are two possible ways to deal with payments, either of which is mathematically sound. One method is called the "Declining Balance" method.⁹² When a payment is made, the lender calculates the simple interest outstanding on the loan at the date of payment by multiplying the annual rate by the number of days to the date of payment expressed as a fraction of a year. Then the payment is applied to reduce this interest outstanding. If any amount of the payment remains, it is applied to reduce the principal balance. The same procedure is carried out at the next payment date with the remaining balance.

The second method, called the "Merchant's Rule,"⁹³ credits the borrower with interest on his payments over the life of the loan. Simple interest is calculated on the amount owing and added in at once. Then, as each payment is made, it too is credited with interest at the same rate to the end of the period. The balance outstanding is calculated by subtracting the payments plus their accumulated interest from the amount of the loan plus its interest.

⁹¹ *Supra*, footnote 70, at pp. 181 (S.C.R.), 393 (D.L.R.).

⁹² For discussion, see Mullings and Shao, *op. cit.*, footnote 33, p. 265.

⁹³ *Ibid.*, p. 264.

The similarities between these two concepts and the positions of the parties as seen by the court are striking. As the court found, no mathematical compulsion exists to govern the choice between these methods when the loan agreement is silent. The contract essentially contains a gap which the court must fill or which must result in a finding of uncertainty. To fill the gap, the court may look at lending practices, as evidence of custom of the trade. Great reliance was indeed placed by the court on such evidence. The choice must essentially be one of policy and this too was recognized by Estey J. Speaking for the court he said:⁹⁴

. . . it may be that in the process one is in reality reaching a policy decision on the appropriate interpretation of the expressions "per cent per annum" and "due and payable," all occurring in the absence of any provision forbidding the calculation of interest "not in advance". Whatever policy view one might take . . . I found my conclusion as to its interpretation squarely on the language chosen by the parties and giving it a meaning unvarnished by any mathematical practices and theories. . . .

The result then of *Morenish* is that the court will not treat mortgages with interest only payments as annuities unless specific language in the agreement requires them to do so. Instead, they will permit the lender to calculate the interest payable by a method analogous to the declining balance method used for simple interest loan problems and will deny the claims of the borrower to be credited with interest on his payments in such situations. The result of this interpretation is to leave unaffected the application of the so-called re-investment principle to amortized loans. This, I suggest is essential. For the court to treat mortgages with interest only payments as analogous to simple interest problems may be surprising; but for the court to refuse to apply the recognized mathematical system as expressed in lay terms by the word "re-investment" to mortgages that undeniably form complex annuities would be to leave lenders and borrowers alike with no mathematically sound method of solving their problems. It would be equivalent to a declaration by the court that mathematics will no longer apply to mortgage loans; as if they were to decree that two plus two would no longer equal four.

But even given this restrictive interpretation of *Morenish*, one may still quarrel with the policy choice made by the court. It is unfortunate perhaps, that as well as giving consideration to the custom of the lending industry, the court did not consider the common sense rule reflected by the re-investment principle that "a dollar today is worth more than a dollar tomorrow". This might also have been an appropriate setting for the court to consider the *contra proferentum* doctrine if the mortgage had been prepared, as is often the case, by the lender.⁹⁵ Finally, particularly when

⁹⁴ *Supra*, footnote 70, at pp. 185 (S.C.R.), 396 (D.L.R.).

⁹⁵ Of course the decision in *Bauer v. The Bank of Montreal* (1980), 110 D.L.R. (3d) 424, (1980), 32 N.R. 191 (S.C.C.) may have restricted the use of this doctrine to exclusionary clauses. However, I suggest that this is an appropriate role for the doctrine; to

dealing with institutional lenders, one may quarrel with the description of the interest such lenders receive as forming a "mythical interest fund". Indeed, the idea that such lenders will earn interest on interest in their hands seems a realistic description of the lending process.

D. *Not in Advance*

Section 6 of the Interest Act requires that the stated rate in a mortgage be calculated not in advance. The significance of this term in a mortgage has already been briefly referred to, and an example may illustrate it further. Suppose again, I borrow \$1,000 at 12% per annum interest, calculated half-yearly. This time assume that payments of \$100 are to be made monthly, applied first in payment of interest, then of principal. If I calculate or add in the interest at the beginning of the 6 month period, I will again pay more than I would be required to if the calculation is not to be made in advance, because with each monthly payment a capital portion is being paid which has the effect of reducing the outstanding principal owing before the 6 month date. Thus, calculating the six months interest in advance, I start with \$1,060 owing. Deducting the 6 monthly instalments at the end of the six months, I owe \$460. However, if I am given credit for the capital portion of each payment, then after the first month, I have accumulated \$1,010 debt, and the first \$10 of my \$100 payment pays the interest; the remaining \$90 reduces the principal to \$910. The second month, I owe \$919.10 by the time I make my \$100 payment. Applying the first \$9.10 to interest and balance to principal, I owe \$819.10. By the end of six months, my remaining balance is only \$446.35, not \$460.00. Note again, however, that I have still paid more than the lender is arguably entitled to receive; I have paid the interest over the six month period more frequently than it was to be calculated and have conferred upon my lender that added benefit. Thus, combining the requirements of calculation "not in advance" with the principles discussed by Woodard,⁹⁶ the remaining balance is even lower.

Closely related to calculation in advance is the "add-on" method of interest calculation by which lenders commonly determine the amount of loan payments.⁹⁷ By this procedure, the total interest over the relevant period is added to the loan at the beginning. The amount of the payments needed to retire the loan is that sum divided by the number of payments to be made. This can result in a substantial increase in the total amount paid.

resolve an ambiguity in the terms of the agreement by choosing the interpretation less favourable to the party who prepared the document. Here the doctrine operates as an aid to support an agreement, just as s. 7 may have done in the *Hudolin* case, *supra*, footnote 47.

⁹⁶ *Op. cit.*, footnote 3. Thus to produce an accurate balance owing, the rate equivalent when calculated monthly should be used.

⁹⁷ See Mullings and Shao, *op. cit.*, footnote 33, pp. 425-527.

In *Re Tilson and Dougherty*,⁹⁸ already discussed, the court required the lender to abide by his contract. Determining the remaining principal balance by calculation in advance was disapproved by the court. The same procedure was also disallowed in *Re Miglinn and Castleholm Construction*.⁹⁹ In the latter case, although the mortgage was payable by annuity payments, the court held it did not fall within section 6 because, following *Kilgoran*, it was not repayable by blended payments. However, the contract between the parties had specified that the interest would not be calculated in advance, and the lender's method of calculation was therefore incorrect. The court's decision emphasizes the importance of the proper mathematical procedure being used when the parties have contracted for interest calculation in a particular manner.

Conclusion—You're Nothing But a Pack of Cards

Sections 6 and 7 of the Interest Act were intended to serve a number of desirable purposes: preventing the concealment of excessive rates of interest in blended payments;¹⁰⁰ informing the uneducated of what he or she is required to pay;¹⁰¹ standardizing rates of interest to make comparison easier.¹⁰² Unfortunately the sections have ceased to serve any of these purposes, and indeed, as presently interpreted, may do more harm than good.

There are a number of reasons why the sections have failed to be of value. Their wording is undoubtedly obscure. Even allowing for that, it may be that the legal profession and the courts have not tried as effectively as they might have to make the sections work. Much of the difficulty stems from the mathematics of the calculation of interest; that is not necessarily an easy subject, but it is not as magical or incomprehensible as it has been made to appear. It may be that the courts were reluctant to give full scope to the sections because of the potentially harsh consequences of a failure to comply with the statutory provisions. On occasion, however, there are some suggestions that the courts are not in sympathy with the purposes behind the legislation. One judge asked what point was there to blended payments if a lender had to separate them into principal and interest components for the borrower.¹⁰³ The question, of course, suggests that the judge saw no reason why there should not be some element of concealment in dealing between lenders and borrowers. A number of cases have sug-

⁹⁸ *Supra*, footnote 17.

⁹⁹ *Supra*, footnote 2.

¹⁰⁰ The rationale given in *Kilgoran*, *supra*, footnote 10.

¹⁰¹ The rationale suggested in *Stubbs*, *supra*, footnote 11 and *Cameron*, *supra*, footnote 13, but ultimately rejected by the Supreme Court of Canada.

¹⁰² The rationale of the *Singer*, *supra*, footnote 55, line of cases.

¹⁰³ Sir Charles Fitzpatrick C.J.C., in *Stubbs*, *supra*, footnote 11, at pp. 426 (S.C.R.), 437 (D.L.R.).

gested that the legislation must not be construed to put too great a burden on the mortgagee.¹⁰⁴ Whatever validity that argument may have had at the time, it has none now. Any mortgagee can, if properly directed by legislation, understand the disclosure required of him. The principles are simple and well within the educative functions of regulations. Any mortgagee can easily disclose to the mortgagor all relevant information about the loan. Even if the mortgagee cannot calculate it himself, this information is readily produced by an inexpensive computer schedule. Assuming that honest disclosure of interest in borrowing is now an acceptable minimum in the marketplace,¹⁰⁵ we have the technology to achieve it easily and simply.

The goals the sections were intended to serve are still therefore worth pursuing, and they can be achieved. That would, however, require a complete redrafting of the two sections. The following considerations would need to be borne in mind in any redrafting that might be undertaken.

First, a major problem with sections 6 and 7 is that their wording does not correspond with any commonly accepted mathematical terminology; yet, we must turn to the mathematics to appreciate the effect of interest rates. The terms "blended payments", "sinking fund" and "allowance of interest on stipulated repayments"¹⁰⁶ could be eliminated and replaced by a category that will include a majority of mortgages in which some mathematical expertise would be required to know how much interest was being paid. As we have seen, mathematicians have a perfectly workable category for mortgages to which most disclosure problems apply: annuities. Using mathematical terminology, the legislation might be made applicable to all mortgages repayable by periodic payments, or, if that category is thought to be too wide, at least to mortgages repayable by amortized payments. That would make it much easier to interpret and apply the sections and would restore at least some vitality to them.

Second, a number of other pieces of information might be added to the required disclosure. The following are of considerable importance to a borrower:

- (a) the amount of each payment, including the amount of the final unequal payment of principal and interest required at the end of the mortgage term;
- (b) the interest rate (with "interest" broadly defined) expressed as the equivalent rate when calculated at each payment date;
- (c) an amortization schedule showing the division of each payment between principal and interest;
- (d) the total amount the borrower will have paid to the lender over the life of the loan, if he makes all the payments as contemplated.

¹⁰⁴ For example, *Morenish*, *supra*, footnote 70.

¹⁰⁵ Provincial legislation in the area suggests this is so: see *infra*, footnote 108.

¹⁰⁶ From section 6, see discussion *supra*, Part I.

Third, although there is value in preserving a standard phrase such as "calculated half-yearly and not in advance"¹⁰⁷ for comparison purposes, the validity of that comparison must be maintained despite varying finders' fees, bonuses, or administration fees that the lender may require. Following more modern legislation on disclosure, such as that created by some provinces for mortgage brokers¹⁰⁸ or by the federal authority under the Criminal Code,¹⁰⁹ the sections should include all payments made by the borrower for the use of the money in the definition of interest.¹¹⁰ The rate calculated in this manner is then the one that should be disclosed by the uniform phrase.

Fourth, we should consider some legislation dealing with the problems of loans requiring payments of interest only which the Supreme Court has treated by simple interest methods. The result of the *Morenish* decision is that mortgage lenders can, where two mathematically acceptable methods are available to calculate the amount payable for a loan, leave the contract silent on the point and adopt the more profitable method. At the least, lending contracts should be required to state the method of calculation adopted by the mortgagee where the method is not determined by mathematical principles.

Fifth, the problems of failure to comply should be treated more completely. Essentially, three separate cases arise: (1) where all the information needed to calculate the effective rate and the total amount of the repayment are contained in the mortgage, but some statutorily required piece of information is absent;¹¹¹ (2) where there is not sufficient information in the mortgage to calculate the rate and amount;¹¹² and (3) where, although the mortgage contains sufficient information, the rate actually calculated by the mortgage differs from that disclosed.¹¹³ In the first case, section 6 currently prohibits collecting any interest. As I have suggested, the harshness of this penalty has probably contributed to the weakening of the sections. A requirement to provide the relevant information, together

¹⁰⁷ The word "calculated" might perhaps be changed to the mathematical term "computed".

¹⁰⁸ For example, see Mortgage Broker Act, R.S.B.C. 1979, c. 283; Mortgage Brokers Act, Stats. Nfld. 1975-76, no. 49; O. Reg. 461/71, pursuant to the Mortgage Brokers Act, R.S.O. 1980, c. 295.

¹⁰⁹ R.S.C. 1970, c. C-34, s. 305.1.

¹¹⁰ *Ibid.*, s. 305.1(2).

¹¹¹ This was the agreement, as I have discussed, in *Cameron*, *supra*, footnote 13, *Stubbs*, *supra*, footnote 11, and in *Kilgoran*, *supra*, footnote 10.

¹¹² Possibly the situation in *Morenish*, *supra*, footnote 70, and *Fobasco*, *supra*, footnote 86.

¹¹³ The case in *Tilson*, *supra*, footnote 17, and in *Miglinn*, *supra*, footnote 21.

with a right of a borrower to repudiate the agreement within a brief time on terms¹¹⁴ and a reasonable fine for the violator would be more appropriate.

The logical legal consequence of the second case is that the mortgage is void for uncertainty.¹¹⁵ This is a substantially more serious fault in a mortgage loan because the borrower now becomes unable, no matter how willing, to determine the important information about how much he in fact owes. Perhaps, in this case, invalidity is a reasonable result unless the problem can be solved by the presumption of an annual calculation date.¹¹⁶

Section 7 is the current solution to the third category of non-compliance. However, its applicability should be clarified. In the normal case, the lender will be entitled only to the rate of interest he has contracted for. No calculations can be used by him to raise the rate above that agreed to by the borrower.¹¹⁷ Where a mortgage contains contradictory terms about the interest charged, section 7 provides a method of deciding between the two, rather than declaring the mortgage void for uncertainty or straining credibility to fit the provisions together. Again, I suggest that section 7 provides a reasonable solution. The mortgage remains valid, but only the lower rate may be charged.

Finally, consideration should be given to requiring, in residential mortgage loans, at least, a "plain English" repayment clause. Such a clause would not be difficult to prepare, provided lenders are willing to disclose all relevant information about the cost of the loan. A borrower might not be able to calculate mortgage interest himself; he might be unable to derive or even use the formulae for solving annuity problems; but I suggest there is little doubt that he would benefit from a simple statement of how much the loan is costing as a portion of each payment, as an effective annual interest rate, and over the total life of the loan. Mortgage interest might then become something other than a bewildering trip through Wonderland.

¹¹⁴ Such as is provided by consumer legislation or securities legislation in many provinces.

¹¹⁵ See discussion on the *Morenish* case, *supra*, part II, C.

¹¹⁶ The presumption of Anglin J. discussed *supra*, part II, B: "Calculation dates and per annum rates".

¹¹⁷ See *Tilson*, *supra*, footnote 17, and *Miglinn*, *supra*, footnote 21.