

Collateral Matters

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AIRD & BERLIS LLP
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Interest Rates: Why It Is in Everyone's Interest to Pay Close Attention

By Jacqueline (Jack) Goslett and Timothy Jones¹

In Canada, there are a number of regulations which encourage transparency by lenders when it comes to disclosing the cost of borrowing. Such regulations are intended to balance any real or perceived inequities between savvy financial institutions and borrowers. This article explores Section 4 of the *Interest Act (Canada)*² (“Section 4”) and describes how lenders can protect themselves from inadvertently taking a “haircut” on pricing.

An unhappy borrower can use Section 4 to attack (and ultimately lower) interest rates set forth in a written agreement.³ Section 4 provides that if interest in a written agreement (a loan agreement, for example) is calculated in any manner other than on a per year basis (i.e. “X% per month” or “Y% per 360 days”), then the equivalent annual rate must also be expressly stated. If this rule is not complied with, a borrower can apply to a court to have interest capped at a maximum of 5% per annum.

While this pitfall is easy to avoid for fixed-rate agreements, for loan agreements that use floating or variable adjustment rates, Section 4 can create drafting challenges. This is particularly true where the reference rate, such as LIBOR or the U.S. Base Rate, is calculated on a 360-day year, rather than the 365/366-day year as required by the *Interest Act*. Accordingly, a clause providing that “the per annum interest applicable under this Agreement shall be a rate equal to the LIBOR Rate plus 6%” or that “interest shall be 20% per annum, compounded monthly” will offend Section 4 unless further explanatory language is added. The following is an

example of explanatory language which can be added to a loan agreement to avoid inadvertently tripping a borrower's right to attack the interest rate provision set out therein, pursuant to Section 4:

For the purposes of the *Interest Act (Canada)*, whenever any interest or fee under this Agreement [or any other Loan Document] is calculated using a rate based on a number of days less than 365 or 366, as the case may be, the rate determined pursuant to such calculation, when expressed as an annual rate, is equivalent to (x) the applicable rate, (y) multiplied by the actual number of days in the calendar year in which the period for which such interest or fee is payable (or compounded) ends, and (z) divided by the number of days based on which such rate is calculated.

Lenders should be wary of not expressing interest as an annual effective rate, as non-compliance with Section 4 can radically prejudice a lender's rights. Adding the above noted explanatory language to a loan agreement is “cheap insurance” for lenders and also provides borrowers with the comfort of knowing exactly what their cost of borrowing is – a win-win for everyone involved.

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² R.S.C., 1985, c. I-15.

³ Section 4 does not apply to mortgages on real property (or, in Quebec, hypothecs on immovables.)

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