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The Case for Longer Mortgages: Addressing the Mismatch between Term and Amortization

Canadians are offered residential mortgages with 5-year terms and 25-year amortization periods. Fixing the mismatch between terms and amortization would expand consumer choice, facilitate a private securitization market and reduce government mortgage risk.

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The Study In Brief

The practice of offering maximum residential mortgage maturity terms of five years, even though amortization periods generally range from 25 to 40 years, is predominant in Canada. This mismatch between mortgage term and amortization creates a need to re-finance or renew the outstanding balloon payments at each maturity of five years or less. It also creates a twofold risk: first, that the lender would choose not to renew the loan if the fair market value of the mortgaged property is less than the principal amount and accrued interest of the loan (or that the lender is unable to renew the loan if it is insolvent), and, second, that the borrower might not find a new lender. At that point, mortgage enforcement might be necessary, and investors would suffer losses. This mismatch, therefore, impedes the development of a market for Residential Mortgage-backed Securities for uninsured mortgages – often referred to as "private label RMBS."

With private label RMBS, the investor – typically an institutional investor such as a pension fund, investment fund, mutual fund and insurance company – would invest directly in a pool of uninsured mortgages without any government backing for repayment. The development of such a market would provide a funding alternative that might enable the federal government to tighten further the requirements for government support of residential mortgages through the CMHC's securitization programs. Furthermore, it could also lead to further competition in the mortgage market by providing a funding source for mortgages that do not conform with CMHC requirements for insurance or those of the Office of the Superintendent of Financial Institutions (OSFI) applicable to federally regulated financial institutions.

This *Commentary* argues that the best way to address the refinancing risk arising from the term and amortization mismatch would be to facilitate the introduction of a residential mortgage product that does not mature every five years, but matures when it is fully amortized. This product could include an interest rate reset and penalty-free right of redemption at least every five years. Under the current state of the law this can be achieved only by amendment to Section 10(1) of the *Interest Act*. If Parliament decides to amend Section 10(1), it should also consider lengthening the five-year penalty free redemption right to up to 10 years, thus making it easier for lenders to offer longer-term fixed-rate mortgages to borrowers who would prefer a longer interest rate lock-in period – a move that would also encourage the development of the private label RMBS market in Canada.

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A young couple – call them Daryl and Darryl – has found the house of their dreams and start looking for a mortgage they can pay off over 25 years.

Every lender they talk to is willing to offer them a mortgage with a payment schedule of principal and interest that would reduce the principal to zero after 25 years (referred to as the "amortization term" of the mortgage), but few are willing to offer one that does not become fully due and payable on a date (referred to as the "maturity date" of the mortgage) more than five years from the advance date, and most of those few are willing to offer a maturity date of only 10 years or less.[1] Why are Daryl and Darryl having a difficult time finding what they want?

Sometimes, a local commercial practice becomes so entrenched that it is difficult to imagine any other way. Such is the case with the practice of maximum residential mortgage maturity terms of five years, even though amortization periods generally range from 25 to 40 years.[2] As a result, a large amount is due on the maturity date before the mortgage is fully amortized; such payments are sometimes referred to as "balloon payments." This practice has been predominant in Canada for several decades without giving rise to any significant problems. As housing debt continues to rise to record levels, however, policymakers fret about taxpayers' exposure to the housing market. A steady set of changes to mortgage insurance eligibility requirements and the cost of mortgage insurance over the past few years indicates that there is an implicit (and somewhat explicit) policy objective to reduce taxpayer exposure to the housing sector. The question thus arises: does the mismatch between amortization and term hinder policymakers' ability to control this risk?

The federal government currently supports the residential mortgage market (and hence the housing market) in two primary ways. One is through the *National Housing Act*'s mortgage-backed securities and Canada Mortgage Bond[3] securitization programs administered by Canada Mortgage and Housing Corporation (CMHC). Because of the guarantee CMHC provides both programs, the federal government is ultimately responsible for the timely payment of principal and interest under

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1 An informal online survey of the websites of the five largest Canadian banks at the time of writing indicated the following: (a) each bank offers 5-year fixed-rate mortgages at a posted rate of 4.89 percent or 4.99 percent per annum; (b) each offers 10-year fixed-rate mortgages at a posted rate of between 6.10 percent and 6.30 percent per annum (the longest term offered by four of the five banks); and (c) one bank offers a 25-year fixed-rate mortgage at a posted rate of 8.75 percent.

2 In early 2006, the maximum length of a mortgage that Canada Mortgage and Housing Corporation (CMHC) would insure was 25 years. In the 2006 budget, the federal government increased the maximum amortization period for a CMHC mortgage to 40 years. In 2008, the maximum amortization period for individually insured mortgages was reduced to 35 years, in 2011 to 30 years and in 2012 to 25 years. There are no limitations on amortization periods for uninsured mortgages.

3 Canada Mortgage Bonds are term bonds issued by Canada Housing Trust, a special purpose entity sponsored by CMHC.

those programs. A second, less analyzed, less direct, but important form of federal government support is deposit insurance through the Canada Deposit Insurance Corporation (CDIC). Approximately 75 percent of residential mortgages are held by federally regulated financial institutions (FRFIs) (Crawford, Meh, and Zhou 2013). Although most FRFIs have access to funding through the mortgage-backed securities and Canada Mortgage Bond programs for their insured mortgages, all of them (aside from insurance companies) rely on deposits to fund their uninsured mortgages. The CDIC insures up to $100,000 per deposit made with CDIC members (covering all deposit-taking FRFIs), which allows FRFIs to obtain funding based on this federally supported deposit insurance.

The Department of Finance has indicated informally that taxpayers' exposure to the housing market could be reduced if a market were to develop for residential mortgage-backed securities (RMBS) – sometimes referred to as "private label RMBS" – that are not guaranteed by CMHC. There are, however, several market-based impediments to the development of such a market, the most important being that current yields on prime residential mortgages are not sufficient to provide investors in private label RMBS the returns they seek on a basis that would be beneficial to mortgage originators. Although these impediments might be reduced as market conditions change, there is also a structural barrier to the development of private label RMBS represented by the mismatch between term and amortization for residential mortgages. The risk that the mortgage originator would be unwilling or unable to offer a mortgage renewal at maturity of a securitized mortgage would expose the RMBS investor to the risk that the mortgage might not be refinanced at maturity, leading to the need to liquidate the mortgage, potentially at a loss. RMBS investors thus would require that this renewal risk be addressed, but there would be a cost to doing so.

With private label RMBS, the investor – typically an institutional investor such as a pension fund, investment fund, mutual fund and insurance company – would invest directly in a pool of uninsured mortgages without any government backing for repayment. The development of such a market would provide a funding alternative that might enable the federal government to tighten further the requirements for government support of residential mortgages through the CMHC's securitization programs. Furthermore, it could also lead to further competition in the mortgage market by providing a funding source for mortgages that do not conform with CMHC requirements for insurance or those of the Office of the Superintendent of Financial Institutions (OSFI) applicable to FRFIs.[4] This might then make it easier for Daryl and Darryl to find the mortgage they want.

For a $100,000 mortgage with an interest rate of 5.0 percent per annum and a 25-year amortization and that matures every five years with no prepayments, the amount outstanding after 60 months, 120 months, 180 months and 240 months would be approximately $88,500, $73,800, $54,900 and $30,800, respectively. This mismatch between amortization and maturity creates a need to refinance or renew the outstanding balloon payment at each maturity. Prospective investors in Canadian RMBS, as well as prospective US-based rating

4 OSFI recently released a revised Guideline B-20 (Residential Mortgage Underwriting Practices and Procedures) that imposes additional requirements on FRFIs in their mortgage-lending activities, particularly in relation to the calculation of debt-service coverage ratios. One of the expected consequences of the new guideline is that there will be more mortgage loans that do not conform to the requirements applicable to FRFIs, and hence can be issued only by lenders that are not FRFIs and do not have access to funding through CDIC-insured deposits.

agencies, are concerned about what could happen at maturity if real estate values declined significantly. There is a risk both that the lender would choose not to renew the loan if the fair market value of the mortgaged property is less than the principal amount and accrued interest of the loan and that the borrower might not find a new lender. At that point, mortgage enforcement might be necessary, and investors would suffer losses.

Mortgage lenders usually meet this "balloon risk" or "renewal risk" by arguing that, in the case of a performing mortgage, the lender always has an incentive to continue to receive mortgage payments by offering a series of short renewals in the hope of restructuring the mortgage and maximizing its recovery. That might nearly always be true if the lender still has an economic stake in the mortgage. With RMBS, however, the lender would transfer the risk of ownership to investors, keeping only a relatively small economic investment in the RMBS pool for itself. Typically this interest would be represented by the most junior tranche of ownership certificates that absorb initial losses in an RMBS pool. Once losses in the pool exceeded this relatively small "first loss tranche," the lender might no longer have an incentive to continue to extend the loan unless there was value in maintaining the customer relationship even if the mortgage were under water.

There could also be legal impediments to a lender's renewing a mortgage loan if the underlying property value has decreased significantly. By law, a residential mortgage underwritten by an FRFI for the purpose of purchasing, renovating or improving a property must be insured if the loan-to-value ratio is greater than 80 percent.[5] The loan-to-value calculation is to be made "at the time of the loan." If a renewal must be a new loan – notwithstanding that it would continue to be secured by the same mortgage document – and if the value of the mortgaged property has decreased since the time of the origination or last renewal, then unless the mortgage was insured an FRFI might find itself unable to renew the loan if the loan-to-value ratio would exceed 80 percent at the time of renewal.[6]

Another problem for the rating agencies is what would happen if the lender were unable to continue to grant mortgage renewals. If real estate values dropped significantly, lenders would be under stress and some would fail. If a lender became insolvent, it likely could continue to offer mortgage renewals to its customers if it were in the process of making a proposal to restructure its debt and continue or sell its business. If restructuring or sale efforts fail, however, a lender in liquidation could well be constrained in its ability to offer mortgage renewals, even for performing mortgages. Since issuers of RMBS generally would seek to have rating agencies provide a rating of AAA on the top tranche of an RMBS transaction (typically comprising 80–90 percent of all RMBS backed by a mortgage pool), such a rating might not be achievable if mortgages were derived from lenders that were not highly rated themselves, since the prospect of recovering balloon payments over time might depend upon the ability of the original lender to offer renewals at maturity. This risk would be increased for mortgages that did not meet all of

5 *Bank Act*, s. 418(1); *Trust and Loan Companies Act*, s. 418(1); *Insurance Companies Act*, s. 469(1); *Cooperative Credit Associations Act*, s. 382.1(1).

6 OSFI Guideline B-20 does not always require an FRFI to re-underwrite a mortgage loan at each renewal. This should not be taken, however, as overriding the requirements of the statutory loan-to-value restriction, since an OSFI Guideline cannot override a federal statute. Therefore, since a renewal is technically a new loan (as opposed to an extension of an existing loan), if an FRFI renews a loan when the loan-to-value exceeds 80 percent, it is responsible for determining if the renewal would violate its applicable statute.

the criteria necessary to be categorized as "prime conventional" mortgages and that would be more difficult to refinance with a new lender if the original lender became insolvent.

To facilitate a private label RMBS transaction, it might be possible to mitigate the renewal risk by arranging for a highly rated bank or insurance company to agree in advance to offer renewals for all performing mortgages in the RMBS pool on their renewal dates if the mortgage originator did not offer a renewal for any reason (other than that the mortgage was in arrears). There are, however, problems with this solution. First, it would likely be necessary for the backup lender to pre-approve all mortgages in the pool, which would take time and effort. Second, the backup lender would require a fee, which would increase the cost of the RMBS transaction. Third, if the value of the mortgaged property has significantly decreased since the time of the RMBS transaction – and one would expect there to be a correlation between a sharp decrease in real estate values and the inability of the original mortgage lender to offer a renewal – and if the backup lender is itself an FRFI, the backup lender might be precluded from offering the renewal under its governing statute if the loan-to-value ratio would exceed 80 percent.

When a mortgage lender becomes insolvent, stories always surface about borrowers who have struggled faithfully to pay down their mortgage for five years, only to lose their homes when they are unable to renew or refinance their mortgages with the insolvent mortgage lender. Daryl and Darryl could avoid that risk if they could find a mortgage with a legal maturity that matched its amortization schedule. If the federal government could facilitate a shift to longer mortgage maturities, borrowers would be better protected from mortgage lenders that become insolvent. On the other hand, having a mortgage mature every five years allows the borrower to repay the mortgage in whole or in part on the maturity date, thereby encouraging the borrower to take advantage of these periodic opportunities to reduce mortgage debt without incurring prepayment penalties. As I discuss below, however, the fact that a mortgage might have a long maturity date does not mean that the borrower cannot be given an opportunity to prepay without penalty periodically during the term of the mortgage.

Mortgages in Other Countries

Other countries, such as the United States, the United Kingdom and Australia, that have some history of private label RMBS do not have the refinancing risk present in Canada because their mortgages might be for longer terms.

Mortgages in the United States

In the United States, the standard mortgage is the 30-year fixed-rate open mortgage (Krainer 2006). A 2006 report by the Federal Reserve Bank of San Francisco suggests that this practice arose to "avoid the refinancing risk that contributed to the banking crisis during the Great Depression" (Canada Mortgage and Housing Corporation 2014). Due to the prevalence of this standard mortgage type, lenders face an increased risk if interest rates fall. As a result, they often compensate by charging higher interest rates to begin with. Patrick Lawler, the chief economist of the US Federal Housing Finance Agency, suggests that US borrowers pay at least an extra 0.25 percent to 0.50 percent interest in exchange for the option of prepayment without penalty (Sorenson 2013). It is worth noting that, in the United States, unlike in Canada, interest on residential mortgages is tax deductible, resulting in a lower incentive to prepay.

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* bans prepayment penalties on all loans except fixed-rate loans with an interest rate that does not exceed the conventional rate by more than 1.5 percent (Bocian 2012). For these loans, prepayment penalties are limited in amount and duration, and borrowers must be offered a loan without a prepayment penalty. A prepayment penalty is allowed only during the first three years after the loan is consummated. As well, there is a cap on the dollar amount of the prepayment penalty: for the first two years after the loan is consummated, the penalty cannot be greater than 2 percent of the amount of the outstanding loan balance; for the third year, the penalty is capped at 1 percent of the outstanding loan balance. Finally, before the borrower enters into the mortgage, the lender must offer an alternative loan that does not include a prepayment penalty. In doing so, the lender must have a good faith belief that the consumer likely qualifies for the alternative loan (Loftsgordon n.d.; Thompson Coburn LLP 2010).

Mortgages in the United Kingdom

The majority of mortgages in the United Kingdom are variable rate, fully amortizing mortgages with fixed periodic payments and with a maturity of 20 to 25 years. Prepayment penalties are governed by contract law. At an early stage, before the borrower accepts the mortgage contract, the offer must contain a tariff of charges for the contract, including any prepayment penalty that the borrower might be obliged to pay. More specifically, the disclosure on the early repayment charge must meet the following requirements: (i) it must be expressed as a cash sum, and (ii) it must be a reasonable pre-estimate of the cost to the lender of the borrower's repaying early. Furthermore, any illustration that depicts an early repayment charge must include an explanation of the charge, the basis on which it is calculated, the maximum charge under the contract as a cash sum and information about transferring mortgage arrangements. Finally, if the charge is to be calculated in accordance with a formula set out in the mortgage agreement, it should represent a reasonable pre-estimate of the refinancing cost to the lender of the loan's being repaid early (Cohen and Lessard 1975). Practically speaking, the prepayment penalty is between 2 percent and 5 percent of the amount being repaid (Fernández de Lis et al. 2013; Lea 2010).

Mortgages in Australia

The most popular mortgage products offered in Australia are the three-year variable-rate mortgage (Lea 2010) and the three-year fixed-rate mortgage (Chung 2015). Variable mortgages account for approximately 85 percent of all mortgages in Australia (Yanotti 2013). Both variable- and fixed-rate mortgages can be taken for a maximum term of 30 years, with the typical term being 25 years (Yeates 2015). On July 1, 2011, the Australian government officially banned mortgage exit fees for variable-rate mortgages, but such fees remain for fixed-rate mortgages (Australian Securities and Investments Commission 2008).

How Did We Get Here?

The situation in Canada has resulted from a combination of a 137-year-old statute and a 30-year Supreme Court of Canada decision. Section 10(1) of the *Interest Act* reads as follows:

> 10(1) Whenever any principal money or interest secured by mortgage of real estate is not, under the terms of the mortgage, payable until a time more than five years after the date of the mortgage, then, if at any time after the expiration of such five years, any person liable to pay or entitled to redeem the mortgage tenders or pays, to the person entitled to receive the money, the amount due for principal money and interest to the time of payment,…together with three months further interest in lieu of notice, no further interest shall be chargeable, payable or recoverable at any time thereafter on the principal money or interest due under the mortgage.

Section 10 was first enacted by Parliament in 1880.[7] Parliamentary debate from the time indicates that this provision was intended to remedy the problem of farmers' being locked into long-term mortgages at high interest rates and subjected to large penalties when they sought to prepay.[8] As noted by the Supreme Court of Canada in a seminal decision, section 10 was enacted "in response to conditions prevailing a century ago when farmers were locked into long term mortgages at exorbitant interest rates by money lenders who were 'eating up the vitals of the yeomanry of the Country'."[9] Approximately ten years after section 10 was first enacted, subsection 10(2) was added to exempt the application of that section in respect of any mortgage "given by a joint stock company or other corporation."[10] A few years ago, this exemption was expanded to cover additional business organizations.[11] As it relates to mortgages given by individuals, however, the statutory provision has remained intact for over 130 years. It is worth noting that section 10 applies to all mortgage lenders in Canada, not just to federally regulated ones.

One might ask if section 10 continues to reflect good public policy. Why not permit borrowers and lenders to negotiate the terms of their mortgages, including prepayment terms, without state interference? This might be a valid question, but it is beyond the scope of this *Commentary*, and I assume that the consumer protection policy behind section 10 continues to be valid public policy.

The Supreme Court of Canada considered the interpretation of section 10(1) of the *Interest Act* in the *Royal Trust* case, effectively holding that a renewal agreement redates the mortgage for purposes of section 10(1) so as to begin a new five-year maximum lock-in period. In that case, the borrower had entered into a five-year renewal agreement after an initial five-year term plus a one-year renewal. The borrower wished to prepay the mortgage in full about two years into the five-year renewal. The borrower's argument was straightforward: there was only one mortgage – the renewal might have changed the terms of the mortgage, but it was still the same mortgage on the same property. To find that it was a different mortgage would have required the lender to search title again to determine once more if there had been any intervening mortgages or liens. Moreover, the phrase "date of the mortgage" in section 10(1) is unambiguous since there is only one mortgage. As a result, section 10(1) should be given its plain meaning – namely, that, for any mortgage having a term of greater than five years, the borrower would be entitled to prepay the mortgage at any time after the first five years subject to a maximum prepayment penalty of three months' interest.

The lender argued, in contrast, that section 10(1) should be given a liberal interpretation in keeping with then-current commercial realities. Counsel submitted that the purpose of the section was to ensure that borrowers were not "locked in" to high interest rates for more than five years without an opportunity to renegotiate terms. This would be done by reading "date of the mortgage" as "date of the mortgage as amended," so that the date of the renewal would become the new date of the mortgage.

As referred to in the Supreme Court of Canada's *Royal Trust* decision, the Ontario Law Reform

7 *Litowitz et al. v. Royal Trust Company of Canada*, (1996) 30 OR (3d), 579 (CA), 584.

8 Canada, Parliament, House of Commons, *Debates*, March 31, 1880, 954.

9 *The Royal Trust Company v. Potash* [1986] 2 SCR 351, 358.

10 *Litowitz et al. v. Royal Trust Company of Canada*, 584.

11 *Prescribed Entities and Classes of Mortgages and Hypothecs Regulations*, SOR 2011-230, s. 1.

Commission, in a 1971 report on the equivalent section of the *Mortgages Act* (Ontario), supported the borrower's interpretation:

> Some lenders are of the opinion that the renewal represents a new agreement and that the five-year period must therefore be re-calculated from the date of renewal.…These views, however, ignore the facts that by the terms of the legislation the five year period runs from the date of the mortgage, in other words from the date that the conveyance to the mortgagee of the original mortgagor's interest was made, that renewal in this context merely alters the date for termination, and that if renewal truly effected a new mortgage contract there would be doubt as to whether priority for the principal debt over second and later encumbrances could be preserved.[12]

The Supreme Court, however, opted for the alternative interpretation advocated by counsel for the lender – namely, that the purpose of section 10(1) was not to require that a mortgage remain open after the first five years, but that a borrower has the right to redeem the mortgage at least once every five years with no interest differential penalty. As the Court noted.

In the late nineteenth century when the section was first enacted, the term of a mortgage and its amortization period coincided. Today this is seldom the case, most residential mortgages being for less than five years, but amortized over twenty or thirty years. This was a situation not envisaged by legislatures in the 1880's and 1890's. It would have made no difference therefore to the early draftsman whether the objective of section 10 was stated as being to make mortgages open after five years or to ensure that mortgages were never locked in for more than five years.…Both are equally consistent with Parliamentary intent and the only basis for choosing between them, it seems to me, is to ask which is more in keeping with common commercial practice.[13]

So why can we not now have the best of both worlds? Why could residential mortgages not have maturity dates that match amortization periods, with automatic resetting of interest rates and a right of the borrower to redeem without penalty at least every five years? This would satisfy the policy objectives of section 10(1), as found by the Supreme Court, closely reflect current market practice and address concerns of US rating agencies and investors relating to renewal risk if a mortgage matures every five years. The answer is that the Court did not give section 10(1) as broad and liberal an interpretation as it might have. For the purposes of section 10(1), the "date of the mortgage" is changed only when (i) there is a renewal agreement (not just any amending agreement) that (ii) deems the date of the mortgage to be the date of maturity of the existing loan and (iii) if the renewal term itself does not exceed five years. A cautious interpretation of the Royal Trust decision leads to the conclusion that, in any other circumstance where the original mortgage term exceeds five years, the borrower would be entitled to pay off the mortgage any time after the first five years without an interest differential penalty. The Court set out its conclusion on these points as follows:

> 1. The purpose of Section 10(1) of the *Interest Act*…is to ensure that mortgagors have the right to pay off their mortgages at the end of each five-year period. They cannot be "locked in" for more than five years.

12 *The Royal Trust Company v. Potash*, 361.
13 Ibid., 368.

2. Where the original term of a mortgage exceeds five years, the mortgagor has the right to pay it off at the end of five years in compliance with the section.

3. Where the original term of the mortgage is for five years or less and the term is extended by agreement beyond the five-year period (the "date of the mortgage" remaining unchanged), the mortgagor has the right to pay it off at the end of five years.

4. Where a mortgagor elects not to exercise his right under Section 10(1) but instead enters into an otherwise valid and enforceable renewal agreement which "deems" the date of the original mortgage to be the date of maturity of the existing loan, and the term of the renewal agreement does not itself exceed five years, he cannot pay off the mortgage until the end of the five year renewal period.[14]

As a result, the only way to make use of the Court's liberal interpretation in the *Royal Trust* decision is for the original mortgage loan to mature and for it to be renewed. A 25-year mortgage that provides for a right of redemption every 5 years (and consequently resets the interest rate at least every 5 years) would not fit within the *Royal Trust* decision and would simply be prepayable by the borrower at any time after the fifth anniversary with a maximum penalty of three months' interest.

How to Achieve the Best of Both Worlds

To achieve the best of both worlds, it would be necessary to amend section 10 of the *Interest Act* to allow explicitly for five-year interest rate lock-in periods other than through a renewal, regardless of the maturity date of the mortgage, while still permitting the practice of extending mortgages through renewal. It is important to look at the purpose of the section as allowing borrowers to redeem every five years, regardless of the maturity date of the mortgage, but also to allow the parties to a mortgage to waive this right and to reset the interest rate under the mortgage for up to another five years.

Proposed Amendments to Section 10

Proposal 1

The clearest way to redraft section 10(1) of the *Interest Act* would be to do so in a way that simply provides that the borrower under a residential mortgage has the right to redeem the mortgage at least every five years, regardless of the term of the mortgage, with a penalty capped at three months' interest. To that end, I propose the following modest redraft of section 10(1):

> Any person liable to pay or entitled to redeem a mortgage of real estate, other than persons described in subsection (2), shall have the right to redeem such mortgage on the fifth anniversary of the date of such mortgage and at any time thereafter by tendering or paying to the person entitled to receive the money the amount due for principal and interest to the time of payment together with three months' further interest in lieu of notice; provided that the person liable to pay or entitled to redeem such mortgage may from time to time agree to waive such redemption right in a written renewal or amendment of the terms of such mortgage for up to five years from the date of such renewal or amendment.

This redraft would shift the focus of the section to the waiver of the redemption right for another five years, not to the form in which the waiver takes (renewal or amendment). The amendment

14 Ibid., 374.

would facilitate the development of a residential mortgage with a maturity term matching its amortization term. The interest rate under this new mortgage product would be fixed for up to five years, at which point either (i) the mortgage would convert to a floating rate mortgage – for example, the prime rate plus or minus a spread – and would become prepayable by the borrower at any time upon payment of a penalty equal to three months' interest (with unequal monthly payments reflecting the same amortization of principal as the original amortization schedule) or (ii) the borrower and the lender would agree to set a new fixed rate for up to five years and the borrower would waive its redemption right for the balance of the fixed-rate period. This process would be repeated at the end of each fixed-rate period. Because the interest rate at the end of each fixed-rate period would convert automatically to a floating-rate mortgage if the lender was unable or unwilling to set a new fixed rate, the need for the borrower to refinance the mortgage in these circumstances would be eliminated. To ensure that a long-term mortgage was more likely than not to have its interest rate reset for a new fixed-rate period, the floating rate for an automatic reset could be established with a spread that would encourage a new interest rate reset and waiver of redemption right.

If a borrower under a 25-year mortgage waived the redemption right, then the mortgage would not mature. It would continue to be outstanding, and the interest rate under the mortgage would be whatever the parties agreed it should be. It is important to note, however, that the resetting of the mortgage interest rate without a legal mortgage maturity after five years, as proposed, is not permitted under the Supreme Court's interpretation of section 10(1) of the *Interest Act* in the Royal Trust decision.

Current private label RMBS structures do not address what should happen to mortgages that are automatically extended to floating-rate mortgages. If the RMBS itself has a fixed interest rate, this mortgage rate reset would introduce a new issue. Recall that, if the borrower and lender do agree to reset a new rate, this could be treated in the same way as any other renewal in a private label RMBS transaction; only if the lender were unable to offer a renewal would an extended floating-rate mortgage become an issue. One way to address this issue would be for the floating rate to be reset at a level that would encourage borrowers who are able to refinance their mortgages elsewhere to do so. To the extent it is necessary to further protect against this interest rate mismatch risk, the automatic floating-rate reset could be established with a minimum rate equal to the fixed rate in effect just prior to the conversion to a floating rate to ensure that the new floating rate would be sufficient to service the fixed rate of the RMBS.

Proposal 2

Another way to amend section 10 would be to extend the five-year interest reset provision to a longer period – say, ten years. This would enable borrowers to lock in their interest rates for longer periods and would provide more choice in the marketplace. Currently if Daryl and Darryl wanted to lock in today's low interest rate on their mortgage for ten years, they might be able to find a lender willing to accommodate them, but they would likely pay a premium on their interest rate, because there is no way for the lender to avoid the risk of prepayment after five years because of section 10 of the *Interest Act*.

Since mortgage lenders tend to match the terms of their assets and liabilities, and since the CDIC will insure deposits only for up to five years, deposit-taking financial institutions likely will continue to favour mortgages with terms of five years or less and use the current practice of renewing every five years unless they were interested in originating mortgages for securitization. Other mortgage lenders, however, might be more flexible in offering longer-term mortgages if they were able to recover a full interest differential prepayment penalty. Mortgages with longer interest rate reset periods could result in private label RMBS with longer expected duration and make this investment product more attractive to certain institutional investors. It would also provide borrowers with a means to defer the risks of interest rate fluctuations in the shorter term.

A ten-year fixed-rate mortgage might not be suitable for all borrowers, but a competitive market should mitigate the impact of steeper prepayment penalties by permitting greater amounts of penalty-free annual prepayments and the portability of the mortgage upon the sale of the property. Consumer protection laws have come a long way since the 1880s, and the disclosure of the cost of borrowing currently required of mortgage lenders ensures that borrowers receive a better explanation of the costs and benefits of locking in their mortgage rates for longer periods.

Conclusion

The five-year residential mortgage term that is common practice in Canada is not so elsewhere. This product's renewal risk is an impediment to the development of a private label RMBS market and, although borrowers are generally not conscious of it when they take out their mortgage, it is a risk to them as well, since, in the event of their lender's insolvency, they might find themselves unable to refinance their mortgage with another lender. The only way to address this refinancing risk would be to facilitate the introduction of a residential mortgage product that does not mature every five years, but that instead provides for an interest rate reset and penalty-free right of redemption at least every five years. Under the current state of the law, this could be achieved only by amending section 10(1) of the *Interest Act*. If Parliament were to decide to amend the section, it should also consider lengthening the five-year redemption right to ten years, thus making it easier for lenders to offer longer-term fixed-rate mortgages to borrowers who would prefer a longer interest rate lock-in period. Such a move would also encourage the development of a private label RMBS market in Canada.

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