Comments on Bill S-237, *An Act to amend the Criminal Code (criminal interest rate)*

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Summary

Thank you for the opportunity to present my opinion to you on Bill S-237. I applaud your intention to help less fortunate Canadians, but I disagree with your proposal entirely. In my opinion, it will provide almost no help to anyone and is likely to hurt some of the people you are trying to assist. I have not seen you present any evidence or analysis to support the proposed reduction in the Criminal Interest rate. I will explain what the evidence does show, because there is quite a bit we know about the subject. I will propose an alternative that I recommend as a replacement for your proposed Bill, if you wish to introduce legislation regarding interest rates at all.

What does Bill S-237 do?

If implemented today, it would reduce the Criminal Rate of Interest to about 25%, from the current 60% limit in Section 347 of the Criminal Code, for loans to individual persons. It does not remove Section 347.1, which is the section that excludes payday loans from the restriction of the Criminal Code if a province enacts its own regulation governing payday loans. Therefore, Bill S-237 only affects two sorts of lenders:

- Lenders who lend money or defer collection of debts (e.g. credit card companies allowing payment of less than the balance owing) and who charge more than 25% p.a. but not more than 60%, on loans greater than $1,500 and/or for terms longer than 62 days;
- Companies selling goods to persons on long-term deferred credit, and who charge more than 25% p.a. but not more than 60%.

Any company charging more than 60%, other than a payday lender, would already have been in violation of Section 347 and this bill doesn't change that.

I will tell you which companies are affected by Bill S-237, but first a digression is required. Two important factors affect how you interpret what a company is charging for a loan or credit. One is how you measure interest rates that compound more than once a year. Most instalment loans require monthly payments, while most payday loans are even shorter term. There are two ways to express the annual rate of interest on a loan that compounds more frequently. One is the

Annual Percentage Rate (APR) which multiplies the periodic rate, usually monthly, by the number of periods. A monthly charge of 2% yields an APR of 2% X 12 = 24%.

The other method, which is economically more valid, is the Effective Annual Rate (EAR), which includes the effect of compounding. The lender gets part of the money back every month and can reinvest it. The EAR compounds the monthly rate. Mathematically for a monthly loan, the EAR = $(1 + \text{monthly rate})^{12} - 1$. For a rate of 2% per month, the EAR is 26.8%, considerably higher than the APR. You will see why this matters in a bit. Most practice and law in Canada seems to accept APR, even though it is economically an inaccurate way to measure the effect of compounding.

Lenders have been quite inventive in trying to find ways to charge borrowers something that is not included in the interest rate. The language of Section 347 and the provincial acts government payday loans is very broad and catches all of those attempts to circumvent the intention of the limits on charges for borrowing.

The other factor that affect how you interpret the interest charged relates to companies that are selling goods on long-term credit. Unlike the companies that simply loan money, they have lots of opportunities to bury other charges in the cost of the goods and hence it is hard to regulate their interest rates effectively.

The companies that Bill S-237 will affect are:

- Finance companies and payday lenders who offer instalment loans for relatively small amounts, say $500 to $5,000. This is a recent development in the alternative finance sector. Money Mart now offers instalment loans with varying repayment schedules, at an annual rate of 59%. At least, that seems to be the rate, but Money Mart won’t actually tell you on the website, you have to get the loan approved before you know what it costs. Other payday lenders have followed that lead and offer similar loans. Mogo, Progressa and other web-based lenders offer similar loans at rates from 40 – 60%. None of these loans would be offered at 25% unless the size were quite large. I would guess that you wouldn’t be able to borrow less than $20,000 at 25%, and at that size, you would likely to a bank.
- Companies selling large household goods like furniture, TVs, appliances and computers, with extended credit provisions. Their interest rates seem to range from 24% - 30% p.a., though I have not tried to make an exhaustive survey, and some claim to charge no interest for the first part of the loan period. The problem with regulating them based on interest rates is the price of the good simply rises. Go shopping with cash in your hand and you will get a better price.

- Companies offering rent to own. This is different from the previous category because title doesn't pass until the payments are finished. The same problem of burying costs in the cost of the good itself exists. The largest firm that I know of in this business is easyhome financial (the name is not capitalised), which advertises an interest rate of 29.9%.
- Pawn shops. They typically charge 5% per month, and the laws cap the loan at one year. If the pawn ticket is not redeemed, the pawnbroker can sell the security. However, McTamney's, the largest one I know of in Canada, charges only 2% per month and you can extend it by agreement. There are some other very small charges for the ticket itself and storage of larger items, but they are not significant and are limited by provincial laws.

These Loans are Expensive to Provide

The common belief, and the implicit rationale behind this bill, is that these lenders are able to overcharge the customers on these loans and competition in the marketplace doesn't work. That argument is true to some extent for payday loans, but not necessarily for these other loans that are charged at 40 – 60% p.a. These companies are small operations with low loan volumes compared with banks and credit unions. Their fixed costs are so high relative to the small dollar value of their loan volume, that they have to charge very high interest rates. They also have much higher loan losses, but it is the fixed operating costs that are main reason for high interest rates. The finance companies and the payday lenders are very inefficient from a social point of view, because of the low volume. Banks and credit unions can deliver the same loans at much lower interest rates simply because of the much larger scale of operations at every branch.

I provide a detailed analysis of the appropriate level of fees for payday lenders in a book that will be published in March 2018, *Payday Lending in Canada in a Global Context: A Mature Industry with Chronic Challenges*, Jerry Buckland, Chris Robinson & Brenda Spotton Visano (Eds.) Palgrave Macmillan 2018. I have no data to do the same analysis for finance companies and payday lenders offering installment loans, but the same general problem of low volume and high fixed costs applies to all of them.

The Unintended Consequences of Bill S-237

You would like the reduction in the Criminal Rate of Interest to force these lenders to offer much lower rates on these small loans. Unfortunately, that is very unlikely to be the result. The much more likely result is that they will stop offering these loans, and at least part of their clientele will turn to payday lenders, whose charges under provincial regulation are much higher. When payday lender fees are expressed as annual interest rates, the values are in the hundreds and thousands of per cent.

You will recall the question of whether an APR or EAR should be used. Note that a common credit card rate is 2% per month. If expressed as an APR right now, it would not be prevented by Bill S-237, but if expressed as an EAR, it would break the proposed limit. Depending on the exact size and length of time an overdraft on a bank account exists, the bank overdraft charges will also exceed the proposed limit. Possibly you wanted this result, but the difference is very small and will not provide significant benefits.

In a speech about the bill, the implicit assumption is that very high interest rates are part of the cause of the very high consumer debt levels in Canada. That is not true; rather, the very low interest rates of recent years have allowed consumers to borrow excessively. The one place where the loan charges are a serious problem is in the payday lending industry, and this bill does not affect payday loan rates at all.

Furthermore, the much lower loan cap will extinguish the offering of somewhat larger installment loans at rates of 40 – 60% p.a. It is true these are quite high interest rates, but this move to installment loans is actually an improvement on payday loans. The biggest problem with payday loans is not the very high fees, but the requirement to repay the entire loan on the next payday. If a family has no emergency fund, cannot use a credit card or bank overdraft and is short $460 (average payday loan size in British Columbia) before the next payday, how do you suppose this family will be able to survive next month when more than $500 comes off the top of the paycheque? Replacing payday loans with installment loans mitigates this problem, though it doesn't solve it. Colorado has forced the payday lenders to offer only installment loans and Oregon now forces it as an alternative for every borrower. BC and Ontario now require someone who borrows very often to take out the next loan as a longer installment loan.

Finally, most of the pawnshops may be forced out of business, though I cannot be sure of that, lacking any public data on their financial performance. The cheapest two week payday loan in Canada will cost you $15 for every hundred you borrow. At 5% per month or part of a month, a pawn loan for one month is one-third the cost. And if you are unable to repay at the end of a year, the loan doesn't keep compounding, you simply lose the security you put up. Pawnshops do not take the necessities of life as security, and so the loss may hurt, but it will not ruin a family.

<u>A Useful Alternative to Bill S-237</u>

In order to achieve your laudable objective of helping lower income Canadians who are struggling with debt, we need a whole lot more than tinkering with the criminal rate of interest. Too much debt is a consequence of poverty, lack of education, and other social ills, it does not cause most of these problems. Too high interest rates do not cause these problems, though for some they may worsen the situation. Changing consumer behaviour through education, such as the national financial literacy initiative may help. Tackling poverty goes far beyond what a change to interest rates can accomplish.

However, if you do want to try to do something to reduce the cost of borrowing for low income Canadians, there is a different, more challenging, route you could try. It requires three actions combined, as we explain in *Payday Lending in Canada in a Global Context.*

1. Force the banks and credit unions to offer unsecured overdraft protection to every customer, not just to those who can pass credit checks. They are so much more efficient than the payday lenders they can underprice them by a factor of 1/6 to 1/10. This has the added benefit of bringing everyone fully into the mainstream financial system where there are many more protections and advantages;
2. At the same time, remove Section 347.1 of the Criminal Code. That is the section that enabled payday lending in the first place. Allow perhaps two years for it to take effect to allow the payday lenders to wind down their businesses or find some new way to operate under 60%.
3. Persuade the banks to educate front line staff to treat all customers with respect, not just well-off white guys like Chris Robinson, the author of this paper. Our research and extensive work in the US finds that many payday loan customers feel that banks treat them with disrespect. I have educated thousands of finance graduates already, from every possibly ethnic group, and they are perfectly capable of treating everyone with respect. And it is my graduates who are working the front counters at the start of their careers. TD Canada Trust has recently used an advertising campaign featuring a big armchair and the slogan, “Banking can be this comfortable.” We need to change that to: “Banking should be this comfortable for every Canadian.”

<u>Last words</u>

You have asked for indigenous issues. Indigenous people and recent immigrants, who are primarily visible minorities, are disproportionately represented in the clientele of the alternative finance companies. Providing them with a better service in the mainstream is a worthwhile contribution to their wellbeing. Finally, if you want to make a change that would indirectly help these groups and particularly the homeless get proper access to the social benefits that all Canadians should enjoy, develop a universal free identity card for those who need it. Social welfare agencies have told me countless times that getting proper identification documents for their clients is an ongoing struggle. Without them, they cannot get access to basic medical care, government programs and financial services.

These comments represent my views, not the views of my employer, York University.