**Opening Remarks from Jerry Buckland, PhD**

**To the Standing Committee on Banking, Trade and Commerce (BANC)**

**1 February 2018**

Thank-you for this opportunity to come to your committee and share my thoughts about your proposal.

My understanding is that you are proposing to change aspects of the criminal rate of interest, and most notably the rate itself, moving from 60% to 20% + the Bank of Canada's overnight rate. Practically speaking, since the Bank of Canada rate is currently quite low (1.25% recently), this change would mean a substantial reduction in the criminal rate of interest, at least in the near term.

What I would like to do in the next few minutes is to share with you my thoughts about financial inclusion, tie financial inclusion into the change that you are proposing, and suggest some other points you might consider if you are interested in boosting financial inclusion.

## *Financial inclusion*

Financial inclusion is an important policy goal and usury caps are one component of financial inclusion, but perhaps not the most important component.

Financial inclusion is about bringing into the *mainstream banking system* –including banks and credit unions– people who are outside of it. The purpose of financial inclusion is to improve the quality and safety of the financial services that excluded people use in order to advance their financial and over-all well-being. Financially excluded people include those who are either completely excluded and have no services through mainstream banking and those who are partly excluded and get some of their financial services from mainstream providers.

Financial exclusion affects between 1 and 5 percent of Canadian adults. The reason for the range is that accurate data on this matter are scarce because the methodology used for national surveys tends to under-represent low-income people who are more likely to be financially excluded. This means that 306 thousand to 1.53 million adults do not have a bank account[1]. A much larger number of adults get insufficient financial services from mainstream banks. In either case, financially excluded people get all or some of their banking services from *fringe banks* including payday lenders, pawnshops, instalment lenders, and rent-to-own companies. Generally speaking these fringe banks are weakly, if at all, regulated, have some unsafe products (e.g., that encourage repeat borrowing), and charge interest rates on credit products near or above the criminal rate of interest.

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[1] This is based on the 2016 population of 35.15 million (Statistics Canada 2017. 'Canada at a Glance 2017: Population,' Available: http://www.statcan.gc.ca/pub/12-581-x/2017000/pop-eng.htm, accessed 29 Jan 2018) and assuming the adult share as 87%.

The evidence finds that people who are most affected by financial exclusion include low-income, Indigenous People, and single-parent families. With reference to the committee's request to make reference to Indigenous and gender issues, I think that financial exclusion is a phenomenon that affects Indigenous Peoples and single parents, some of whom are female, among other groups.

With respect to the causes of financial exclusion the research finds that mainstream financial institutions do not do enough in three areas: 1) providing their services in convenient locations and in appropriate ways, 2) developing and promoting safe products for people with low-income, and 3) training staff to work with low-income people regarding their finances.

- Regarding point number one, mainstream banks have for quite some time been shutting down branches in low-income neighborhoods and this is a particular challenge for people with few transportation options and limited access to banking via the internet or mobile phones. This issue is very pronounced for Indigenous Peoples in remote locations.
- Point number two is that mainstream banks have safe and appropriate services for low-income people but there are obstacles such as personal identification, cheque-hold periods, and a lack of advertising that act as barriers. Fringe banks have been able to get around these barriers and this has led people to use their more expensive services instead.
- Point three has to do with how low-income clients, and communities are treated by mainstream bank staff. Research has found that when some people are poorly treated that they move to fringe banks and that word spreads and this leads to large numbers of community members going elsewhere, often fringe banks.

Financial literacy is another component of financial inclusion. The Canadian Financial Literacy Leader is working very hard in this area and I think that this work needs to continue, particularly for Indigenous Peoples and low-income Canadians. I believe that education that is created with and for Indigenous Peoples and low-income Canadians will be most successful.

Moreover, I think it is important to strike a balance between investments in education, on the one hand, and financial consumer protection regulation, on the other hand. Focusing on one at the expense of the other would, I think, undermine the effectiveness of education and regulation.

## *Usury caps*

The purpose of an interest rate cap is to prevent borrowers from being charged usurious, or excessive interest rates. The effectiveness of interest rate (or more generally price) caps is debated in the academic literature and while there is a great diversity of views there are two particularly interesting views based in structural theories and neoclassical economic theory.

Structural theories –theories that find that certain structures like monopolists or more generally, companies with market power– find that credit suppliers are earning excess profits through high interest rates. A prescription for this problem is to establish a cap to prohibit lenders from charging high interest rates. The lender will observe the cap, according to this theory because, lenders can still earn a 'fair' profit at a lower interest rate.

Neoclassical economics theories, on the other hand, argue that markets are competitive so that creditors are not earning excess profits but instead earning fair (or 'normal') profits. Interest rate caps (like other price caps) will make the provision of some credit to some people unprofitable to the lender so that creditors will offer less credit and/or offer credit in a more targeted way. This leads to a distortion in the market and leaves some people without access to credit. According to proponents of this view the outcome of interest rate caps will lead some people to seek out credit from less desirable and more expensive sources, e.g., online or criminal lenders.

Which theory (or theories) is most relevant is, of course, debated, and varies from place to place. For instance, a suburban community might have lots more competition on financial services than an inner-city neighborhood or a remote Indigenous community.

Empirical evidence about the impact of usury rate regulations is mixed. It is from the United States and with reference to payday loan usury caps where we find most of the evidence. Some studies find the caps curtail credit access while other studies find that restrictive caps simply lead people to borrow less or borrow more from other source such as family and friends.

Possibly one reason why the empirical evidence varies has to do with the enforcement of usury caps. I understand that there is even some disagreement among Canadian policymakers about what type of credit product the criminal rate of interest applies to. Some policymakers argue (or assume) that the usury cap applies only to criminal organizations and *not financial retailers*.

Moreover, even if the usury cap is intended for financial retailers it must be enforced. And there has been little evidence of government enforcement of the criminal rate of interest in Canada.

- For instance, before the criminal rate of interest exemption was created for payday lending, payday loans companies across the country except for Québec charged interest rates in excess of the criminal rate of interest. Some of these companies were subject to class action law suits but I am not aware of any completed government action using the criminal rate of interest against payday loan companies during the pre-exemption period.
- Also, payday lenders continue to operate in provinces without the criminal rate of interest exemption, e.g., Newfoundland and Labrador.
- Finally, other fringe banks, such as pawnshops, not operating within the payday loan exemption, charge rates in excess of the criminal rate of interest. I am not aware of government action in either of these cases.

## *Other reforms to consider*

In addition to your work on revising the criminal rate of interest I wonder if you might pursue some other issues to address the financial service needs of low-income people, Indigenous Peoples, and single parent households such as,

1) Deepen and enforce the current Canadian Access to Basic Banking Regulations that currently are, in my view, too limited and not well-enforced. Deepening the regulations would require consideration

of the three points I raised above, improving physical access of banking, promoting safe financial products, and improving staff training. Enforcement requires a more pro-active strategy and moving away from relying exclusively on consumer complaints.

2) Work at financial consumer protection to ensure that financial products are safe, e.g., fair disclosure about product rules and fees, ensuring that credit products do not lead people into a vicious debt cycle, etc. The United States Consumer Financial Protection Bureau and the Australian Securities and Investments Commission have been doing some interesting work here.

3) Collect data from mainstream and fringe banks regarding their provision of financial products to low-income and Indigenous Peoples in order to engage in more effective evidence-based policymaking.

4) Develop a unified plan to address financial exclusion in certain financial service 'deserts,' particularly low-income urban neighbourhoods and remote rural and Indigenous communities:

    a. *Inner-city and low-income neighborhoods*: Credit unions, e.g., Assiniboine, Vancity, Alterna have made strides in addressing financial service gaps in certain neighborhoods. But, relative to the banks, they are smaller and therefore cannot cover all of these neighborhoods. Given their size, profitability, and government protection, the mainstream banks have a responsibility to address these gaps in a more universal manner

    b. *Remote rural communities such as Indigenous communities*: these communities require a different approach to financial inclusion as compared with urban centers because of the large geography and dispersed populations. The response may need to rely more heavily on information technologies but only if internet connectivity is upgraded in these locations. Relying on a combination of information technologies including and the phone system, the Commonwealth Bank in Australia has a unique model of working with Indigenous Peoples that could act as model for Canada.

Once again thank-you so much for giving me the opportunity to share with you my thoughts on your proposed action.