Seeing Beyond Risk

Canadian Institute of Actuaries / Institut canadien des actuaires

Voir au-delà du risque

August 14, 2015

The Hon. David Orazietti, MPP
Minister
c/o Consumer Policy and Liaison Branch
Ministry of Government and Consumer Services
777 Bay Street, 5th Floor
Toronto, ON
M7A 2J3

Dear Mr. Orazietti,

We understand that your ministry is consulting on approaches to improve consumer protection for alternative financial services, including payday loans. The Canadian Institute of Actuaries (CIA) has prepared the attached submission to assist you in that review.

Our key recommendations are that:

1. The implied effective annual rate of interest calculated in accordance with accepted actuarial practice and principles be considered in selecting a maximum total cost of borrowing for payday loans;
2. The maximum total cost of borrowing vary by the term length of the loan, in a manner consistent with our first recommendation;
3. Lenders be required to disclose the effective annual rate of interest for various lengths of loan; and
4. The Government proceed with the cost structure analysis proposed in the 2014 report Strengthening Ontario's Payday Loans Act.

Thank you for taking the time to review our submission. If you have any questions, please do not hesitate to contact Chris Fievoli, the CIA's resident actuary, at 613-656-1927 or chris.fievoli@cia-ica.ca.

Yours truly,

Robert H. Stapleford, FCIA, FSA
President

Submission of the Canadian Institute of Actuaries to the Government of Ontario Consultation on New Financial Protections for Consumers

Introduction

The Canadian Institute of Actuaries (CIA) offers the following comments to the Government of Ontario's review of alternative financial services. In particular, our comments pertain to the maximum total cost of borrowing for payday loans, and the effective annual rate of interest to the borrower implied by this limit.

The CIA is the national organization of the actuarial profession in Canada. As you know, actuaries apply their specialized knowledge in the mathematics of finance, statistics, contingencies, and risk theory to the problems faced by pension plans, government regulators, insurance companies, and other financial institutions, social programs, and individuals.

Of particular relevance here, actuaries hold a prominent role in Canada in evaluating the effective annual rate of interest on specific agreements or arrangements of credit advanced. Indeed, section 347 of the Criminal Code states that generally accepted actuarial practices and principles govern the calculation of the effective annual interest rate and the determination of whether that rate meets the threshold set for the criminal rate. Our professional standards of practice, along with our training in the theory of interest, have been recognized by section 347(4) of the code, which states that certification by a Fellow of the CIA regarding the effective annual rate of interest is proof, in the absence of evidence to the contrary, of that rate.

We believe that by using the effective annual rate of interest as a consistent and objective yardstick, one can easily compare the current (and any future) limit on the maximum total cost of borrowing to the previous limit, the criminal interest rate.

Effective Annual Rate of Interest Implied by Ontario's Maximum Total Cost of Borrowing

With the enactment of federal Bill C-26 in 2007 and Ontario's Payday Loans Act in 2009, the maximum total cost of borrowing of $21 per $100 of loans with a term of 62 days or less replaced the criminal interest rate of 60% (effective annual rate) as the limitation on the cost to the borrower. Section 31(1) of the act specifies that the total cost of borrowing is to be repaid at the end of the loan term. We offer the calculation of the effective rate of interest under the current limitation for comparison to the previous limitation.

The Strengthening Consumer Financial Protection discussion paper states that a loan of $100, at the maximum total cost of borrowing of $21, taken out every 14-day period for a year will accumulate costs to the borrower of 546% of the value of the loan. The paper points out that the effective annual rate of interest corresponding to a loan of this type is significantly higher than this figure—though the paper does not calculate or present the effective annual rate of interest. For the consideration of the Government, table 1 below presents the effective annual rates of interest using the calculation specified in the Criminal Code and in the CIA's Standards of Practice. These calculations use the definition of interest as specified in section 347(2) of the code.[1]

[1] ". . . The aggregate of all charges and expenses, whether in the form of a fee, fine, penalty, commission or other similar charge or expense or in any other form, paid or payable for the advancing of credit under an agreement or arrangement, by or on behalf of the person to whom the credit is to be advanced, irrespective of the person to whom any such charges and expenses are or are to be paid or payable, but does not include any repayment of credit advanced or any insurance charge, official fee, overdraft charge, required deposit balance, or in the case of a mortgage transaction, any amount required to be paid on account of property taxes".

Table 1 – The Effective Annual Rate of Interest at the
Ontario Maximum Total Cost of Borrowing, by Loan Term

Loan Term	Total Cost of Borrowing per $100 of Loans	Effective Annual Rate of Interest
62 days (maximum eligible term for payday loans)	$21	207%
14 days	$21	14,299%[2]
10 days	$21	105,015%
7 days	$21	2.1 million percent

It can be seen in table 1 that the lowest effective annual rate of interest at Ontario's maximum total cost of borrowing occurs at the longest loan term permitted for payday loans. According to section 32(1)(b) of the Payday Loans Act, the rules for payday loans apply only to loans with a term of 62 days or less. The effective annual rate of interest for a 62-day loan at the maximum total cost of borrowing ($21 per $100 of loan) is 207%.

It can also be seen from these calculations that the maximum permitted rate of interest increased significantly from its previous limit of 60% when the Payday Loans Act was enacted.

Total Cost of Borrowing Implied by the Criminal Rate of Interest

The maximum effective annual rate of interest permitted for loans governed by the Criminal Code is 60%.

Table 2 below presents, at various loan terms, the maximum total cost of borrowing corresponding to a maximum effective annual rate of interest of 60%, using the calculation specified in the Criminal Code and in the CIA Standards of Practice. It can be seen in table 2 that a maximum effective annual rate of interest of 60% at loan terms permitted by the Payday Loans Act would imply a maximum total cost of borrowing well below the current maximum of $21 per $100 of loans.

Table 2 – The Maximum Total Cost of Borrowing per $100 of Loans Implied
by a Maximum Effective Annual Rate of Interest of 60%, by Loan Term

Loan Term	Maximum Total Cost of Borrowing per $100 of Loans	Maximum Effective Annual Rate of Interest
62 days (maximum eligible term for payday loans)	$8.31	60%
14 days	$1.82	60%
10 days	$1.30	60%
7 days	$0.91	60%
1 year (not an eligible term for payday loans)	$60	60%

[2] The calculation of the effective annual rate of interest is as follows: $[(121/100)^{(365/14)} - 1] \times 100\% = 14{,}299\%$.

The Appropriateness of the Effective Annual Rate of Interest as a Key Measure of the Cost of Borrowing

Ontario's Maximum Total Cost of Borrowing Advisory Board in 2009 reported that a "point most stakeholders agreed on was the inappropriateness of an annual percentage rate of interest as a way to measure payday-loan borrowing costs." Continuing, the board said: "Expressing the cost of a small, short-term loan on an annualized basis makes no more sense than expressing the cost of a night in a hotel on a yearly basis."

We would respectfully disagree with this perspective for reasons relating to the following:

a. Repeat Borrowing

The Canadian Payday Loan Association says: "Payday loans are specifically designed to help customers with one-off, unanticipated expenses. A payday loan is not a form of 'revolving' credit that keeps a customer in a permanent debt position."

Notwithstanding the design of payday loans, the market has evolved such that customers of the industry are taking out payday loans repeatedly. The 2009 advisory board reported that "for every loan to a new customer, payday lenders make 15 loans to repeat customers on average across the country." The discussion paper Strengthening Consumer Financial Protection reported: "Ontario's survey of payday loan borrowers found that 18% of these borrowers took out 10 or more payday loans in the last year and that those who borrowed the most frequently borrowed the largest amounts."

The paper adds that borrowers are financing the costs of borrowing through increased borrowings: ". . . If consumers' expenses consistently exceed their income, short-term loans like payday loans can create another expense which consumers cannot afford to repay. This can drive future payday loan use . . . A recent study of Ontario's borrowers found that 50% used payday loans to cover recurring expenses such as rent, mortgage, or regular bills. U.S. data indicates the majority of payday loans in a sequence see no decrease in the principal until the loan is paid off and that the longer a sequence goes on the more likely it is that the loan size will increase."

The greater the frequency of repeated borrowings, and the more that the costs of borrowing are financed through higher borrowings, the closer the effective annual interest rate comes to the costs to the borrower for the year and the more relevant the effective annual rate of interest becomes.

b. Interest Earned by the Lender

In addition to the cost to the borrower, an important metric in the discussion of payday loans is the rate of interest earned by the lender, particularly net of the lender's expenses. If the rate of interest earned by lenders, net of their expenses, is too low, payday loans will become less available to those who might benefit from them. For the following reasons, the effective annual interest rate, as calculated from the lender's perspective, has merit as a measure to be considered by the Government as it works to improve consumer protection.

While payday loans are designed to be used on a one-off basis by borrowers, lenders do not expect to loan funds on a one-off basis. Payday loans are their core business—thus, the lender is in business to rapidly re-loan funds as soon as they are repaid. The more efficiently and quickly the repaid funds are loaned again, the more closely the effective annual rate of interest, net of the lender's expenses, approaches the lender's interest earnings over a year. Further, the

rate of interest earned by the lender increases rapidly in response to a lower level of lender expenses.

The 2009 advisory board report states: "We have observed much variation in cost structures from lender to lender." The report cites the 2009 Ernst & Young study The Cost of Providing Payday Loans in Ontario, which was based on a sample of nine payday lenders, for which the lowest average expense level found was $15.57 per $100 of loans, and the highest was $33.39 per $100 of loans (with an average of $21.50 per $100 of loans). There are hypotheses that may explain the variation in lenders' administrative costs. For example, administrative costs related to a repeat borrower may be lower than those pertaining to a loan to a first-time borrower. Also, the administrative costs per $100 of loans may decrease with the size of the loan. The study proposed later in this submission could prove or disprove such hypotheses and assist the Government in understanding the dynamics of this industry.

Table 3 below illustrates how quickly the lender's effective interest rate rises, in response to a lower level of expenses.

Table 3 – The Effective Annual Rate of Interest Net of Expenses, Earned by the Lender, at a Total Cost of Borrowing (to the Borrower) of $21 per $100 of Loans, by Average Lender Expenses per $100 of Loans

Loan Term	Average Lender Expenses per $100 of Loans	Effective Annual Rate of Interest, Net of Expenses, Earned by Lender
14 days	$21.00	0%
14 days	$20.42 (5% below average)	13%
14 days	$19.35 (10% below average)	43%
14 days	$15.57 (lowest expense level in Ernst & Young study)	231%

c. Consistent Comparison of Loans of Differing Terms and From Different Providers

A charge of $21 per $100 of loans is more costly to the borrower for a seven-day loan than for a 62-day loan—yet some may present the two loan options as having the same out-of-pocket cost. Further, even for those borrowers who understand that the costs differ, it can be difficult to compare the magnitude of the difference. The use of the effective annual rate of interest allows the borrower to understand and compare these two loan options.

Also, use of the effective annual rate of interest would permit a borrower to compare the payday loan option to more traditional consumer loan options offered by banks, credit unions, and other financial institutions.

For the reasons stated above, we recommend that the implied effective annual rate of interest calculated in accordance with accepted actuarial practice and principles be considered in selecting a maximum total cost of borrowing for payday loans.

Specification of the Term of the Loan

According to the Canadian Payday Loan Association, payday loans are typically in effect for one to 14 days, ending on the borrower's next payday, and the average payday loan is for 10 days. As the calculations above illustrate, at the maximum total cost of borrowing, the effective

annual rate of interest rises significantly with shorter terms. We recommend that the maximum total cost of borrowing vary with the term of the loan, so that the maximum effective annual rate of interest is consistent across loan terms from one to 62 days. We further recommend that lenders be required to disclose the effective annual rate of interest for various lengths of loan.

Contemplated Amendments to Section 347 of the Criminal Code

As noted earlier, the maximum total cost of borrowing yields an effective annual rate of interest much higher than the maximum interest rate permitted by the Criminal Code. In this light, recent efforts to reduce the criminal interest rate may be of note.

Bill S-210, An Act to Amend the Criminal Code (criminal interest rate), was introduced in November 2013 by Senator Pierrette Ringuette, and was being studied by the Senate Standing Committee on Banking, Trade and Commerce prior to the recent election call. The bill proposed reducing the criminal interest rate for personal, household, and not-for-profit loans from the current threshold of 60% to 20% above the Bank of Canada rate; at the current rate, the proposed threshold would be 20.5%.

The Importance of Financial Literacy Among Potential Borrowers

You will recall the findings of the 2009 Maximum Total Cost of Borrowing Advisory Board and of the Strengthening Consumer Financial Protection discussion paper—that repeat borrowings of payday loans are common, even though the loans are not designed for that purpose. This suggests that borrowers—and perhaps the public at large—may not appreciate the extent to which the interest on such repeat borrowings can accumulate, and thus how disadvantageous this practice is.

This underlines the importance of financial literacy on the part of potential borrowers. To that end, the actuarial profession is making efforts to improve financial literacy of adults and youth through initiatives of the Actuarial Foundation of Canada (www.afc-fac.ca), a registered charity. These initiatives emphasize that the effective annual rate of interest is crucial to permitting individuals to compare various loan and investment alternatives during their lifetime.

Study of the Cost Structure of the Payday Loan Industry

In the 2009 report Capping Borrowing Costs – A Balanced Approach to Payday Loans in Ontario, the Maximum Total Cost of Borrowing Advisory Board reported that the average cost per $100 of payday loans was $21.50. In this, the board cited the 2009 Ernst & Young study and set the maximum total cost of borrowing at $21, slightly below the average cost, in the belief that the payday loan industry "may not yet have found its most efficient business model" and that setting the maximum at that level would "lead to significant restructuring in the industry."

The 2014 report Strengthening Ontario's Payday Loans Act advised the Government to "determine the cost of making a payday loan in Ontario through a statistically significant assessment of lender costs." Such a study can be expected to bring to light whether the restructuring of the industry anticipated in 2009 has occurred and whether it has brought about a change in the industry's cost structure. Such a study should analyze aspects of the industry's cost structure such as the:

- Cost to lend to a first-time borrower versus the cost to lend to a repeat borrower;
- Costs of administering a loan versus provisions for loan losses; and
- Costs that are fixed versus costs that vary with the loan's size and/or term.

This additional information would be useful to the Government in determining what changes may be appropriate.

Conclusion

To recap, we recommend that:

1. The implied effective annual rate of interest calculated in accordance with accepted actuarial practice and principles be considered in selecting a maximum total cost of borrowing for payday loans;
2. The maximum total cost of borrowing vary by the term length of the loan, in a manner consistent with our first recommendation;
3. Lenders be required to disclose the effective annual rate of interest for various lengths of loan; and
4. The Government proceed with the cost structure analysis proposed in the 2014 report Strengthening Ontario's Payday Loans Act.

We hope that you find this submission helpful. Please do not hesitate to contact Chris Fievoli, the CIA's resident actuary, at 613-656-1927 or chris.fievoli@cia-ica.ca if you require clarification of any element of it.