May 20, 2016

The Hon. David Orazietti, MPP
Minister
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 whether to reduce the maximum total cost of borrowing a payday loan. You will recall that the Canadian Institute of Actuaries (CIA) responded on August 14, 2015 to your ministry's consultation on alternative financial services. In response to your ministry's current consultation, we have prepared the attached submission, specific to the four options being considered.

Based on our findings on the four options, 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;

4. The government proceed with the cost structure analysis proposed in the 2014 report, titled Strengthening Ontario's Payday Loans Act; and

5. The maximum total cost of borrowing vary between initial loans and subsequent loans, to reflect any cost differential identified between the two.

For your convenience, our August 14, 2015 submission may be accessed here.

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 a Possible Reduction of the Maximum Total Cost of Borrowing a Payday Loan

Introduction

The Canadian Institute of Actuaries (CIA) offers the following comments to the Government of Ontario's review of the maximum total cost of borrowing a payday loan. In particular, our comments pertain to the effective annual rate of interest to the borrower at the four options proposed for the maximum total cost of borrowing for payday loans.

The CIA is the national organization of the actuarial profession in Canada. 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. Our professional standards of practice, along with our training in the theory of interest, have been recognized by section 347(4) of the Criminal 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 the effective annual rate of interest is a consistent and objective yardstick by which one can compare the options proposed to each other and to the current limit on the maximum total cost of borrowing.

Effective Annual Rate of Interest Implied by the Four Options Considered for the Maximum Total Cost of Borrowing

This consultation is considering four options for the maximum total cost of borrowing. The four options are:

- Option 1: $15 per $100 advanced (most common limit in U.S. states);
- Option 2: $17 per $100 advanced (lowest limit in Canada);
- Option 3: $19 per $100 advanced; and
- Option 4: $21 per $100 advanced (the current limitation).

For the consideration of the government, table 1 below presents the effective annual rate of interest at each of the four options, using the calculation specified in the Criminal Code and in the CIA's Standards of Practice.

It can be seen that the effective annual rate of interest at a fixed maximum total cost of borrowing varies by loan term. For that reason, table 1 presents, for each of the four options, the effective annual rate of interest at each of four loan terms.

It can be seen in table 1, even for those options that are reduced from the current maximum, that all the options result in a very high maximum effective rate of interest, and that there is significant variation in the effective rate of interest by loan term.

**Table 1 – The Effective Annual Rate of Interest at the
Four Proposed Options for the Maximum Total Cost of Borrowing, by Loan Term**

Loan Term	Effective Annual Rate of Interest			
	Option 1: $15 per $100 of loans	Option 2: $17 per $100 of loans	Option 3: $19 per $100 of loans	Option 4: $21 per $100 of loans (the current limitation)
62 days (maximum eligible term for payday loans)	128%	152%	178%	207%
14 days	3,724%[1]	5,894%	9,224%	14,299%
10 days	16,324%	30,717%	57,109%	105,015%
7 days	146,104%	359,157%	869,330%	2.1 million %

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

As the average length of a payday loan is 10 days, the question arises of whether it is appropriate to use an annual rate of interest, such as the effective annual rate of interest, to measure the cost of such loans.

We believe that the effective annual rate of interest provides valuable information about such loans, for the following three reasons:

a. Repeat Borrowing

While individual loans are short-term, repeated borrowings by individuals are common, and the more frequent the repeated borrowings, the more likely that borrowings will be financed by increased borrowings.

b. Interest Earned by the Lender

Lenders naturally wish to make most efficient use of their fixed assets, and thus aim to rapidly re-loan funds as soon as they are repaid. The more 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.

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

A charge of $17 per $100 of loans is more costly to the borrower for a seven-day loan than for a 62-day loan. The use of the effective annual rate of interest allows the borrower to compare the magnitude of the cost difference. It also makes it easier to compare the cost of payday loans to more traditional consumer loans offered by other financial institutions.

The three points above are discussed in more depth in our August 2015 submission.

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[1] The calculation of the effective annual rate of interest is as follows: $[(115/100)^{(365/14)} - 1] \times 100\% = 3{,}724\%$.

The Proposed Options and the Cost Structure of the Payday Loan Industry

We understand and acknowledge the statement made in the consultation document that "most North American jurisdictions that allow payday lending set a lower cost of borrowing a payday loan than Ontario," and that "the lower price does not appear to prevent consumer access to payday loans."

However, three of the four options under consideration will change the economic dynamics of the payday loan industry. We would therefore suggest that the government conduct an up-to-date assessment of the economic fundamentals of the industry before or soon after making changes such as those being proposed.

In 2009, Ernst & Young conducted a study, titled The Cost of Providing Payday Loans in Ontario, based on a sample of nine payday lenders. The study found an average expense level of $21.50 per $100 of loans. The lowest average expense level found was $15.57 per $100 of loans, while the highest was $33.39 per $100 of loans.

Clearly, at an average expense level of $21.50 per $100 of loans, the four options being considered in this consultation will not cover the costs of the industry, and could result in payday loans becoming less available to consumers.

However, table 2 below illustrates how quickly the lender's effective interest rate rises, in response to a lower level of expenses. We infer from these calculations that the feasibility of the considered options is very much dependent on the current cost structure of 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." It was anticipated in 2009 that a restructuring and consequent change in the industry's cost structure would occur. An up-to-date study of the industry cost structure will ascertain whether that restructuring took place, and what its results were. This will indicate whether the proposed revision of the maximum total cost of borrowing can be accomplished without a greater-than-desired reduction in the availability of payday loans.

Such a study could 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.

It is likely that the marketing and processing costs of a first loan are greater than for subsequent loans. If this is confirmed by the proposed study, it would follow that revenues and expenses might be better matched with a maximum total cost of loans that differs between first loans and repeated loans. A reduced cost of loans to the repeat borrower, if justified by the cost study, would be expected to alleviate the phenomenon, indicated in our August 2015 submission, of repeated loans being financed by increased borrowings.

Table 2 – The Effective Annual Rate of Interest Net of Expenses, Earned by the Lender, at a Total Cost of Borrowing (to the Borrower) of Each of the Four Options Considered, by Average Lender Expenses per $100 of Loans, at a Loan Term of 14 Days

Average Lender Expenses per $100 of loans	Effective Annual Rate of Interest, Net of Expenses, Earned by Lender			
	Option 1: $15 per $100 of loans	Option 2: $17 per $100 of loans	Option 3: $19 per $100 of loans	Option 4: $21 per $100 of loans (the current limitation)
$21.50 (average expense level in Ernst & Young study)	Loss to lender	Loss to lender	Loss to lender	Loss to lender
$19.35 (10% below average)	Loss to lender	Loss to lender	Loss to lender	43%
$17.20 (20% below average)	Loss to lender	Loss to lender	49%	130%
$15.57 (lowest expense level in Ernst & Young study)	Loss to lender	38%	114%	231%
$14.01 (10% below the lowest expense level in Ernst & Young study)	25%	96%	206%	372%

Conclusion

We applaud the government's interest in protecting consumers.

Based on the analysis above, 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;

4. The government proceed with the cost structure analysis proposed in the 2014 report Strengthening Ontario's Payday Loans Act; and

5. The maximum total cost of borrowing vary between initial loans and subsequent loans, to reflect any cost differential identified between the two.

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.