

The ABCs of APRs

The Status of Consumer
Protection Across Canada



AUTHORS

Lily Cook & Dean John Velentzas

SPONSORED BY

Cassels

Contact us at

www.canadianlenders.org

03	Introduction
04	How Did We Get Here?
06	Loan Sharking
08	Payday Loans
10	Provincial Protection
11	Federal vs. Provincial
14	APR / Effective Interest Rate Discrepancies
19	A Continuum of Lending
21	Recommendations

Introduction

The Annual Percentage Rate (APR) and the Effective Annual Interest Rate (EAR) are formulas commonly used to yield a single number that incorporates all costs of a loan. These numbers can then theoretically be used for cost comparisons and credit making decisions.

Despite their widespread usage, there is confusion and inconsistency with how these rates are calculated. The maximum allowable EAR in Canada is 60%, which is equivalent to 47% by APR standards. If, for example, the maximum EAR was reduced to 35%, then the APR (on a 36 month loan) would be reduced to approximately 30%.

This document seeks to point out the flaws and inadequacies of these metrics in Canada at a federal and provincial level and make recommendations as to how lawmakers should use them to regulate the marketplace.

It is in the interest of provincial and federal legislators to standardize their metrics to better service Canadian consumers. Furthermore, the Criminal Code should not encompass commercial lending practices, which should be left to consumer protections regulations.

How Did We Get Here?

The regulation of interest is central to the way we conduct business; however, the manner in which this has been measured, and how those measurements have been used in legislation varies considerably.

In Canada, federal lawmakers have historically focused on the problem of loan sharking. In 1914, parliament regulated interest rates on small consumer loans through the creation of the Money-Lenders Act. The Act made it illegal to charge over 12% per annum on loans under \$500. Proving to be ineffective, this was replaced by the Small Loans Act in 1939 which required a maximum interest rate of one percent per month on loans up to \$1,500. The \$1,500 ceiling became unworkable given the dramatic increase in the cost of money. The amount was also relatively low, and therefore easy for lenders to circumvent. These concerns led Parliament to repeal the Small Loans Act, and in 1980 introduce a new section into the Criminal Code of Canada.

An issue remains, however, in the differences in EARs and APRs in terms of interest rate calculation. Furthermore, as will be shown, the Criminal Code contains numerous flaws that prevent it from being employed in a productive manner.

Loan Sharking

When Section 347 of the Criminal Code was unanimously adopted in 1980, it sought to stamp out predatory lending and loan sharking. It was proposed at the request of law enforcement who needed to find a workable definition of loan sharking that would not require proof of threats, violence or fraud.

Section 347 of the Code caps the criminal rate of interest at 60%, which embeds any loan costs, interest rates and fees into the effective annual interest rate. The intent of Section 347 is punitive. It states that anyone who offers loan terms at a “criminal rate,” or anyone who receives payment or partial payment of “interest” at a “criminal rate” is guilty of an offence. In either case, the creditor would be liable to a \$25,000 fine, a maximum of five years imprisonment, or both.

A “criminal rate” of interest is defined as, “an effective annual rate of interest calculated in accordance with generally accepted actuarial practice and principles that exceed 60% on the credit advanced under an agreement or arrangement.” The annual rate of interest is calculated on the “credit advanced” to the borrower, not what the lender would realize on his investment. Interest includes all charges

paid or payable for the advancing of credit, whether in the form of a fine, fee, penalty, commission or any other similar charge. Any rate of interest exceeding 60% annually is viewed as extortionate.

Again, the functionality question of the Code is underscored in Section 347: since it's rarely applied in criminal courts, why is it there?

Payday Loans

In 1980, Section 347 was passed unanimously with little to no parliamentary debate. At the time, there was no discussion as to how the law would be applied. By criminalizing a fixed rate of interest for the first time, and by imposing a ceiling on all types of credit arrangements to law, it was a blunt instrument. From inception, the law was generalized and did not distinguish between the lending sector, the sum involved nor the sophistication of the borrower. Furthermore, the Criminal Code was created far prior to the emergence of the alternative lending industry, so it could not possibly apply with relevance to current practices.

Importantly, given the broad language of the law, it has been applied to a great number of commercial transactions in a civil context, which bear little resemblance to true loan sharking agreements. While there is a need to protect consumers from those who lend money at an excessive rate of interest, there is also a need to encourage commercial lending for risky yet potentially beneficial transactions. Compensation for the cost of delayed recovery is the hallmark of credit arrangements. The rational investor will invest only if the expected returns are sufficient given the risks – the riskier the investment, the higher the anticipated return will be because the savvy investor will demand additional compensation for that risk.

If the law is targeted at loan sharking—as it appears to be—then Parliament might also specify that there should be some element of violence, threat or intimidation involved before the section will apply. Parliament could also more tightly word the section so as to exclude its application to lending transactions which involve willing participants with the benefit of legal advice. Clearly, as the section presently stands, it does not fulfill its ultimate, or even intended, prosecutorial mandate.

The legislation requires the Crown to obtain the Attorney General's consent before any charge. Due to the scope of the legislation, the Attorney General is usually preoccupied with making sure only real criminals (loan sharks) and not legitimate commercial lenders are prosecuted. Due to the ambiguous wording and requirements of AG intervention, there has never been a single charge levied.

To clarify matters, in 2007, the Supreme Court of Canada ruled that legislators needed to make clear whether the Criminal Code applies to commercial lending practices or solely racketeering. This resulted in an amendment to address a specific category of lending called cash advance or payday lending, a sector which demanded high interest rates for short-term immediate credit as a portion of the borrower's next paycheck. Still, this amendment did not fundamentally alter the way the law was prosecuted.

Provincial Protection

While the federal government focused its efforts on controlling criminal conduct, some provinces enacted payday lending and other high-cost credit regulation within their own consumer protection legislation. The result is two different channels of regulation in Canada: the **Criminal Code**, which was originally intended to capture racketeering; and all of the **consumer protection provisions**, which use an APR formula to determine the cost of borrowing. These provisions are intended to regulate commercial lending practices, but vary by province.

Federal vs. Provincial

There are two approaches to predatory lending: the federal government's control of criminal conduct and the provincial government's focus on consumer protection. Neither can be applied effectively to the alternative lending industry. Both use different metrics, and neither is being used to achieve the desired effect.

The method defined in the Criminal Code is based on an effective annual rate of interest, calculated in accordance with generally accepted actuarial principles (under the Canadian Institute of Actuaries (CIA) Standard of Practice section 4600). Regardless of whether or not the lender charges interest on a compounded or simple interest rate basis, the methodology of the Criminal Code includes a compounding effect.

This methodology for calculating the effective annual rate produces a figure that differs from the APR prescribed under provincial consumer protection legislation. Most consumers are familiar with APR and most

financial institutions use it to quote the cost of their financial products and services. Below is a demonstration of the differences between the two:

	Criminal Code	Consumer Protection Statutes
Purpose	Identify the criminal rate of interest and to prohibit the charging or collection of that interest.	Protect borrowers during all consumer loan transactions and protect consumers through disclosure of that information.
Metrics	Calculated by an actuary, i=effective rate of interest compounded annually $\sum_{r=1}^m A_r \times (1+i)^{-r} = \sum_{s=1}^n B_s \times (1+i)^{-s}$ • m=total number of payments advanced by the lender to the borrower • n= total number of payments repaid by the borrower to the lender • A_r=amount of the r^{th} payment advanced by the lender • B_s= the amount of the s^{th} payment repaid by the borrower, consisting of principal, "interest" as defined, or a combination of both	General APR calculation $\left[\frac{\text{Interest paid over life of loan}}{\text{Loan Amount}} \right] \times \frac{365 \text{ days}}{\text{\# of days in loan period}}$

The main difference between the effective annual interest rate calculation and APR is that the former also considers the frequency of

payments within the loan period on a compounding basis rather than simply how much interest is paid in any given year.

A key element of the method used by the CIA is that any interest collected prior to the end of the loan period is effectively compounded and hence the effective rate will be higher than the APR. The effective annual interest rate calculated in accordance with the CIA's methodology will always be equal or higher than the stated interest rate charged, and this gap will widen as the term of the loan (in years) increases.

APR / Effective Interest Rate Discrepancies: Case Studies

The APR is intended to be a universal figure that allows its users to compare the cost of a loan. The APR in general was meant to mimic the effective annual interest rate, however, the formulas vary across the provinces and they often yield inaccurate numbers. The formula is intended to capture **nominal interest + extra costs of the loan**.

Therefore, if there are **no extra costs of a loan**, the APR should equal the nominal interest rate. However, in some provinces even if there are no extra costs of the loan, when the APR is calculated using the statutory formula, the result differs slightly from the nominal rate. These formulas don't all work as intended.

Using an inconsistent APR formula in provincial consumer protection legislation isn't the only unpredictable variable for consumer protection statutes: different banks create these numbers and disclosures differently, despite a cost of credit regulation under the Bank Act.

This flawed APR formula paired with little overall enforcement results in an ineffective landscape for consumer protection.

Furthermore, to illustrate why the effective interest rate differs from the APR, consider the following example using a \$1000 loan with an interest rate of 24% and with the principal due in full upon maturity at month 12:

Example 1

Month	1	2	3	4	5	6	7	8	9	10	11	12	Total
APR	24%												
One Annual Interest Payment													
Principal													
Opening	-	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	-
Amounts Advance to Borrower	1,000	-	-	-	-	-	-	-	-	-	-	-	1,000
Principal Payments	-	-	-	-	-	-	-	-	-	-	-	(1,000)	(1,000)
Closing	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	-	-
Interest Payments	-	-	-	-	-	-	-	-	-	-	-	240	240

Recalling the generalized APR formula, the APR is calculated to be 24% as the borrower is paying \$240 in interest over a principal balance of \$1000 with a one-year term. As the interest payment is made at the end of the loan, the effective interest rate (calculated below) equals the APR of 24%.

$$i = (1 + \text{coupon rate})^n - 1$$

$$i = (1 + 24\%)^1 - 1$$

$$i = 24.0\%$$

where $n = 1$ payment

Example 2

Consider the same loan as Example 1 except that interest is paid monthly. Note that in both loans the amount of interest paid by the consumer is identical at \$240.

Month	1	2	3	4	5	6	7	8	9	10	11	12	Total
APR	24%												
Interest Paid Monthly													
Principal													
Opening	-	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	-
Amounts Advance to Borrower	1,000	-	-	-	-	-	-	-	-	-	-	-	1,000
Principal Payments	-	-	-	-	-	-	-	-	-	-	-	(1,000)	(1,000)
Closing	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	-	-
Interest Payments	20	20	20	20	20	20	20	20	20	20	20	20	240

Again, recalling the APR formula, the APR is calculated as 24% as the borrower is paying \$240 in interest over a principal balance of \$1000 with one year term (the same as Example 1 as APR doesn't change when the payment frequency changes).

However, the effective interest rate will change. As the interest is paid monthly the effective interest rate is now higher than the APR. $i = (1 + \text{coupon rate})^n - 1$ $i = (1 + 24\%)^{12} - 1 = 26.8\%$ (as compared to an APR of 24%) where $n=12$ The amount of interest paid under both scenarios is the same at \$240 so why is the effective interest rate higher than the coupon rate or APR? The logic is that when the borrower is paying more frequently (in this case monthly) they are worse off than paying at the end of the loan whereas the lender is getting their interest earlier and hence better off.

The result is intuitive. Someone is better off having \$100 now rather than waiting 12 months to receive that \$100. This is the key to the concept of time value of money. But the inconsistency in metrics is unhelpful to business and consumers alike when designing and comparing lending products.

Extreme Example: high costs, short term (real world)

Action	Details
Total Loan	\$500,000
Broker Fee	\$50,000
Legal Fee	\$1,500
Total Principal	\$448,500
Mortgage Type	Interest Only
Nominal Annual Rate	15%
Term Period (months)	3
Payment Period	Monthly

Results

Jurisdiction	APR
Criminal Code	80.299%
Canada	62.653%
Ontario	62.653%
Alberta	80.299%
MBA of BC	56.200%
BPCPA of BC	62.653%

A Continuum of Lending

Let's take the credit journey of an average Sue Canadian. Sue has a financial emergency. She walks into her bank and asks for a loan. The bank pulls her credit profile and will provide an APR which matches her risk score. If she is outside the bank's risk appetite, she may have to use her credit card at a 24% APR. However, if Sue, like 7 million Canadians, doesn't qualify for any form of credit at her corner bank, she needs to look elsewhere for a loan.

Sue could be new to Canada without an adequate credit history, her credit could have been negatively impacted by a divorce or a layoff. Regardless, Sue requires credit. There are a wide range of installment loan options that service high-risk profiles but if Sue falls into a high-risk credit bracket, the cost of providing the capital that she requires for an emergency health issue or car repair could be higher than the bank's rate.

Now if a lawmaker tries to protect Sue from high APRs by pulling down the legal rate, Sue could find herself on the wrong side of the

business case based on her credit rating. She would likely find that she is no longer served by mainstream lenders. What are the alternatives at this point? Are we driving Sue into an unregulated marketplace? Are we pushing Sue towards high-cost payday loans which do nothing to nurture Sue towards a prime rate?

Presently the criminal interest rate under the Criminal Code of Canada (Section 347) has a ceiling of 60%. On a province-by-province basis, Sue is protected by customer protection laws. If we mistakenly try to help Sue by focusing on forcibly lowering APRs, we eliminate much of Sue's, and other Canadians', safety nets.

Ultimately, we need to think of lending as a continuum. There is no line that delineates one loan from another. What we, as a community, need to do is help to move higher-risk borrowers that are charged a higher cost for lending towards prime lending opportunities. As a community this is our goal. Every lender makes sure that all loan decisioning takes into account Sue's ability to repay and importantly, nurtures her towards prime by reporting her repayment history to the credit bureau. Sue won't get this kind of treatment from payday lenders or loan sharks, but responsible alternative lenders do just this.

If you do not consider APRs as a continuum, you create artificial lines in the sand that limit or in many cases eliminate access to credit.

Recommendations

Responsible lenders aim to offer affordable credit to consumers while still operating under relatively strict consumer protection regulations. Changes can be made to interest rate calculations and regulation in Canada to standardize interest rate metrics, and only penalize irresponsible lenders.

Since demand for credit isn't going anywhere, regulators should improve guidance on the types and structure of interest rates on loans, and legislate a blanket APR formula to be used across the provinces.

Section 347 of the Criminal Code uses the EAR as a benchmark because it is comparable across loans that have different compounding frequencies, amounts, and loan terms. Ultimately, however, loans provided to consumers and the loan amortization schedules and payment tables are based on APRs, and APRs are a more recognizable metric for consumers.

While Section 347 of the Criminal Code limits the interest rate to a maximum of 60% it essentially limits the equivalent rate in APR to 47%. If the criminal code rate was reduced to 35% then the APR (on a 36 month loan) would be reduced to approximately 30%.

A lending consultation that includes the representation of lenders would be an optimal platform to systematically address the issues discussed above. Looking at statistics and APR/effective annual interest rate discrepancies can help identify a workable formula for interest rate calculation, and a product suitability model should be employed to provide the flexibility to adjust the existing legislation and address different types of loans.

It is far superior to build upon the foundation of the current Criminal Code and consumer protection legislation rather than starting from scratch. It will be important to tackle each for its drawbacks and offer targeted solutions for the future.

The ABCs of APRs

The Status of Consumer
Protection Across Canada

Contact us at

www.canadianlenders.org



AUTHORS

Lily Cook & Dean John Velentzas

SPONSORED BY

Cassels