A Rise in Illegal Lending and Criminal Activity

Implications of the new 35% Maximum Allowable Interest Rate in Canada

Contact us at

www.canadianlenders.org

03 **Abstract**

04 **Introduction**

06 **Historical Context**

12 **Distinguishing Installment Lending from Payday Lending:** A Practical Example of Cost to Consumer

15 **Policy Proposal to Reduce Spike in Illegal Lending:** Small Loans Exemption

19 **Case Studies:** Quebec, California, and the UK

34 **Conclusion**

36 **Endnotes**

Abstract

This report explores the potential repercussions of lowering the maximum allowable interest rate in Section 347 of the Criminal Code of Canada. In the last federal budget, the Liberal government in Canada moved to decrease the maximum allowable rate of interest that lenders may charge on loans from 60 percent effective annual rate (EAR), (equivalent to 47 percent annual percentage rate (APR)) down to 35 percent APR. This paper highlights the impact of this rate reduction on the impacted borrowers: non-prime Canadians.

Ultimately, this paper asserts that the lowering of the maximum allowable rate of interest to 35% will push approximately 4.7 million people to payday lending or illegal lending. Further, a significant number of regulated lenders will need to exit the market due to their inability to serve the higher-risk non-prime segment following the rate decrease. As international examples demonstrate, the reduction of access to credit in those markets led to an increase in criminal activities, including noncompliant lending and loan sharking and links to organized crime. In conclusion, this paper argues that the federal decision to lower the maximum allowable interest rate is misguided and will inadvertently contribute to an upsurge in criminal activities in Canada.

Introduction

Section 347 of the Criminal Code of Canada (the “Code”), enacted in 1980, sets the threshold for an effective interest rate above which an individual or entity can be charged with an offense. In Budget 2023, the government made a significant adjustment, reducing the maximum allowable rate of interest that lenders can charge on loans from 60 percent EAR (equivalent to 47 percent APR) to 35 percent APR.

The significance of this issue to the Canadian Lenders Association (CLA) and policing organizations, such as the Ontario Association of Chiefs of Police (OACP) stems from the profound consequences it will cause. First and foremost, there is the concern of restricting access to credit for Canadians that cannot access credit from traditional financial institutions. Any additional alterations in the regulatory framework could result in a dire situation where countless Canadians in the non-prime market find themselves on the brink of losing access to essential financial resources to manage their daily expenses. Such a restriction might force them to take more drastic and unfavorable actions, such as using costly payday loan providers or even push them towards illegal lenders operating in the shadows.

Equally troubling is the potential for a significant surge in illicit lending activities and related crimes. The reduction of the APR as prescribed by the Code threatens to disqualify a substantial portion of the Canadian population from accessing alternative installment loans under the new, lower interest rate cap. The number of Canadians that could be impacted is estimated to be between 4.8 and 6.7 million individuals.[1] This exclusion from legitimate lending sources raises the ominous specter of increased

criminal activities in the form of illegal lending and loan sharking
The repercussions of these actions could reverberate across society, endangering financial stability and the well-being of countless Canadians.

This paper examines the potential consequences of lowering this maximum allowable rate of interest and argues that such a reduction could have far-reaching implications for the Canadian financial system, including the expected rise in illegal lending, when comparing jurisdictions where similar policy decisions were taken.

Historical Context

In Canada, historical attention from federal lawmakers has been directed toward addressing the issue of loan sharking. The thinking from the government is that business can be influenced and will respond as expected to specific regulations of interest. For example, in 1914, the Money-Lenders Act was enacted by Parliament to regulate interest rates on small consumer loans, restricting charges to no more than 12% per annum on loans below $500.[2] However, when the private sector did not respond as the government expected and the legislation proved ineffective, this legislation was replaced by the Small Loans Act in 1939, mandating a maximum interest rate of one percent per month on loans up to $1,500. Over time, the $1,500 limit became impractical due to a significant rise in the cost of money and its relatively low amount, making it easy for lenders to find ways around it. In 1980, these concerns prompted Parliament to revisit this legislation by repealing the Small Loans Act and introducing a new section into the Code.

1980: INTRODUCTION OF THE MAXIMUM ALLOWABLE RATE OF INTEREST

Section 347 of the Code set a ceiling on the criminal rate of interest at 60% EAR, encompassing all loan costs, interest (i.e all charges paid or payable for the extension of credit, whether in the form of a fine, fee, penalty, commission, or any similar charge), and fees within the effective annual interest rate. The primary purpose of Section 347 is punitive in nature. It specifies that individuals offering loan terms at a "criminal rate" or receiving payment of "interest" at a "criminal rate" are committing an offense. In either scenario, the lender could face a $25,000 fine, a maximum of five years imprisonment, or a combination of both penalties. Any interest rate surpassing 60% annually is considered extortionate.

The adoption of Section 347 in the Code aimed to limit predatory lending and loan sharking. This provision was suggested at the request of law enforcement seeking a practical definition of loan sharking that did not necessitate proof of threats, violence, or fraud. There was a lack of discussion regarding the practical application of the law. By criminalizing a fixed rate of interest and imposing a universal ceiling on all credit arrangements, it became a blunt instrument. From its inception, the law was broad and failed to differentiate between sectors of lending, the amount involved, or the sophistication of the borrower. Moreover, the Code was established long before the emergence of the alternative lending industry, making it irrelevant to contemporary practices.

LACK OF CRIMINAL ENFORCEMENT OF SECTION 347

The functionality of Section 347 in the Code raises a question: given its infrequent enforcement in criminal courts, since its inception in 1980, why does it exist? The lack of enforcement is likely due to the area in which the law sits: federal criminal law, which is enforced by federal police powers. In the same instance, provinces each have consumer protection laws and frameworks that deal with the provision of credit and corresponding rules, with robust consumer protection offices that are funded to specifically enforce Consumer Protections Acts as they relate to lending. The same funding cannot be identified as it relates to federal groups or agencies enforcing this section of the Code. If the federal government wants an effective law, it must fund enforcement of the same. It is clear that additional funding for policing efforts is required to ensure adequate application of Section 347.

If the law is intended to address loan sharking, as it seems to be, Parliament could consider stipulating the requirement of violence, threat, or intimidation for the section to be applicable. Additionally, a more precise wording of the section could be crafted to exclude its application to lending transactions

involving willing participants who have been advised of the implications of the loan terms (a requirement of provincial consumer protection law). It is evident that, in its current form, the section does not effectively fulfill its intended prosecutorial mandate.

The legislation mandates that the Crown must secure the consent of the Attorney General prior to pursuing any charges. Given the expansive nature of the legislation, the Attorney General typically focuses on ensuring the prosecution of genuine criminals, specifically targeting loan sharks, while safeguarding legitimate commercial lenders. The presence of ambiguous wording and the necessity for Attorney General intervention has resulted in the absence of any charges being filed to date.

ENFORCEMENT IN COMMERCIAL TRANSACTIONS

Due to the expansive language of the law, the maximum allowable rate of interest has been applied to numerous commercial transactions within a civil context, despite these transactions bearing little resemblance to typical loan sharking agreements. While it is crucial to shield consumers from those charging an excessive rate of interest, there is also a necessity to foster commercial lending for ventures that, while risky, hold the potential for substantial benefits. Compensation for the costs associated with delayed recovery is inherent in credit arrangements. A prudent investor will engage in an investment only if the expected returns align adequately with the associated risks. In investment scenarios with higher risk, the anticipated returns must be proportionately elevated, as astute investors seek additional compensation for assuming that level of risk.

In 2007, the Supreme Court of Canada issued a clarification, asserting that legislators must explicitly delineate whether the Code pertains to commercial lending practices or exclusively to racketeering.[3] Consequently,

an amendment was introduced to specifically address a distinct form of lending known as cash advance or payday lending. This sector involved the charging of high-interest rates for short-term immediate credit, often linked to a portion of the borrower's next pay cheque. However, it is crucial to note that this amendment did not fundamentally transform the prosecution of the law- it simply carved out this category of loans from the Code, and mandated provinces to regulate the same.

AMENDMENT - PAYDAY LOANS EXEMPT FROM THE MAXIMUM ALLOWABLE RATE

Since 2007, the Criminal Code has explicitly exempted payday loans (those under $1,500 and repaid within 62 days) from the maximum allowable rate of interest under section 347.1, transferring regulation of the payday loan sector to the provinces. This has allowed payday lenders to charge significantly higher interest rates, surpassing 300% APR. In addition, these lenders are not required to report credit repayments to credit bureaus, hindering borrowers from rebuilding their credit scores and escaping the cycle of debt induced by short-term high-cost credit products.

TODAY'S OUTLOOK

Presently, more than 8 million Canadians encounter difficulty accessing loans from traditional financial institutions due to their credit scores, constituting 29% of all Canadians with credit reports.[4] The proposed modification to the maximum allowable interest rate in the Code to 35% APR would adversely affect approximately 4.7 million Canadians, as these individuals are ineligible for loans from traditional financial institutions and rely on alternative lenders to meet their credit needs.

To serve this tier of 8 million Canadians, installment loans currently provided by alternative lenders offer non-prime consumers seeking loans access to the credit they need (up to the maximum allowable interest rate of 47% APR, or 60% EAR that was established in 1980), manageable repayment schedules, and the opportunity to rebuild their credit. The absence of credit access for the 8 million-plus non-prime Canadians impedes their ability to rebuild credit scores, as borrowing and repaying credit in a timely manner account for a significant portion (48%) of an individual's credit score.[5]

Simply reducing the maximum allowable interest rate in the Code would exacerbate the plight of non-prime Canadians, limiting their options to access legal and regulated credit in the Canadian marketplace for essential needs such as consolidating debt or addressing car repairs. Lenders utilize a risk-based approach to determine interest rates, where riskier borrowers (with lower credit scores) are subject to higher interest rates, reflecting the likelihood of loan default.

Reducing the allowable interest rate would inadvertently exclude millions of Canadians from accessing credit legally and safely, as legal lenders would be unable to extend loans to certain customers at lower rates due to the risk profile of the non-prime borrower.

COMMISSION OF INQUIRY INTO MONEY LAUNDERING IN BRITISH COLUMBIA, 2022 (THE “CULLEN COMMISSION”)

The British Columbia Cullen Commission’s findings have shed light on a concerning correlation between the prevalence of loan sharking and the limited access to credit. The constraints placed on traditional lending channels may inadvertently push individuals towards illegal lending

practices. The Commission's findings also identified that loan sharking has also been used as a way of "laundering illicit funds generated by organized crime groups involved in other types of profit-oriented crime."[6] In many cases, the loan will be secured through a lien registered against property. As access to credit becomes increasingly challenging through formal financial institutions, there is a growing concern that the demand for alternative sources, such as illegal lenders will rise. This underscores the importance of a comprehensive review of the regulatory framework to strike a balance between safeguarding against predatory lending practices and ensuring that individuals have legitimate avenues for accessing credit in a responsible manner.

Distinguishing Installment Lending from Payday Lending: A Practical Example of Cost to Consumer

Historically, government and consumer advocacy groups have tended to conflate the payday loan industry with the alternative loan market. The definition of "payday loan" under the Payday Loans Act, 2008 is extremely broad and could inadvertently catch many products that do not warrant regulation as payday loans. In particular, installment lending is often mistakenly grouped together with payday lending in the media and with some policy markers because these types of loans can share certain features, like low principal amount of credit extended over a short term. Installment lending can provide creative and alternative lending options that benefit consumers while still being subject to regulation under both the Code and provincial consumer protection regimes.

Installment lenders adjust their interest rates to accommodate the significant cost of funds and the risk associated with potential defaults. To illustrate this, we'll examine the financial calculations of a $1,000 loan from an installment lender compared to that of a payday lender, as well as the less desirable alternative: filing for bankruptcy.

The APR formula featured in the graphic above yields a straightforward interest rate of 47% APR based on the total interest paid and the initial loan amount. However, an essential nuance to recognize is that this interest rate is applied to a diminishing loan balance over the course of the year.

Distinguishing Installment Lending from Payday Lending:
A Practical Example of Cost to Consumer

INSTALLMENT LOAN	PAYDAY LOAN	BANKRUPCY
• 1,000 at 47% APR with a 12 month term • Total cost: $235.88 • Bi-weekly payment of $43.53 • Positive impact on credit score	• 1,000 at 14%/month per loan, assuming 5 loans are taken • Total cost: $700.00 • One-time payment of $1,140.00 • Negative impact on credit score	• Extreme last resort with severe, long-term impact on credit score

Here's a breakdown of why we don't observe the expected $470 in interest with a 47% APR:

1. The loan begins at $1,000.
2. As the borrower makes payments, a portion of each payment is allocated towards reducing the principal balance. This gradual reduction in the principal occurs over time.
3. With each payment made, the interest is calculated based on the remaining balance, which diminishes due to the borrower's prior payments.

Consequently, even though the stated interest rate stands at 47% APR, it is being applied to a shrinking loan balance. This dynamic means that borrowers pay less interest as time progresses. The significance of this lies in the fact that interest rates from installment lenders are markedly lower than those offered by payday lenders. Moreover, installment loans offer consumers a valuable opportunity to enhance their credit profiles in two distinct ways:

a) They enable individuals to, in some cases, establish and build a credit history by accessing credit in the first place.

b) Through responsible repayment practices, borrowers can demonstrate their ability to manage credit effectively. Payment history, comprising at least 40% of the credit score calculation input[7], is a critical factor in credit score determination. By consistently making on-time payments, consumers can improve their credit scores, ultimately facilitating their exit from cycles of debt and opening the doors to prime credit.

In contrast, payday loans fail to contribute positively to consumers' credit scores. Payday lenders are not obligated to report loan information to major credit bureaus, rendering these loans invisible in the credit history of borrowers.

Canadians should never be relegated solely to the realm of predatory payday lenders or illegal lenders when seeking financial assistance. Instead, they should always be provided the opportunity to establish and bolster their credit histories over time with the assistance of responsible and regulated lenders. This path can lead to lower interest rates and improved financial prospects in the future, aligning with the overarching goal of promoting financial stability and responsible lending practices. The federal government's change to 35% APR will push more Canadians to payday and illegal lenders to meet their credit needs, as responsible and regulated alternative lenders will be limited from extending credit to the group of borrowers representing the highest credit risks.

Policy Proposal to Reduce Spike in Illegal Lending: Small Loans Exemption

The federal government, in its amendment to the Code in Budget 2023, provided itself with regulatory authority to exempt certain types of loans from the new lower maximum allowable rate of 35% APR. On December 23, 2023, the Department of Finance released draft regulations, proposing exemptions for certain types of loans: small business loans and pawn loans. Overlooked were Canadian consumers – no exemption was put forward that would provide 4.7 million Canadians with another option, rather than having to rely on payday loans or illegal lending. This is a policy mistake that will put many non-prime Canadians in a worse position than they would have been prior to the rate cap reduction.

WHY CAN'T BANKS FILL THE GAP?

In the current landscape of traditional banking institutions, banks do not approve small-scale unsecured loans for individuals with limited or no credit history, as well as those with moderate to poor credit scores. This is due to a variety of reasons, including the following:

- Regulatory Constraints: Stringent federal regulations and compliance requirements create a significant barrier for financial institutions. Regulatory frameworks often dictate the terms and conditions of lending, including interest rates, which may limit the institutions' ability to offer competitive low-cost credit. Navigating complex regulatory landscapes requires substantial resources and can restrict the flexibility needed to tailor products for specific consumer segments.

- High Administrative Costs: The operational costs associated with managing small-value credit products, particularly those targeted at non-prime borrowers, can be disproportionately high. The administrative overhead, including underwriting processes, monitoring, and collection efforts, may outweigh the potential returns, making it challenging for financial institutions to justify or sustain such offerings.

- Perceived Risks of Non-Prime Borrowers: Financial institutions often perceive non-prime borrowers as higher risk due to factors such as lower credit scores, limited credit history, or irregular income. This perceived risk can lead to increased caution and conservative lending practices, making institutions hesitant to extend affordable credit options to this consumer segment.

- Limited Collateral and Security Options: Small-value credit products often lack substantial collateral or security, making them riskier for lenders. Financial institutions, particularly traditional banks, may be more accustomed to secured lending, where the borrower provides assets as collateral. The absence of robust collateral options can deter institutions from expanding offerings in this category.

As a result of not being able to receive loans from banks, non-prime consumers will have no option but to seek alternative financing sources, including payday loans or illegal lenders. This shift toward higher-cost borrowing options raises concerns about the potential consequences. It opens the door to a troubling scenario where consumers in urgent need of credit may find themselves exposed to illegal lenders. These unregulated lenders often operate outside the bounds of established financial regulations, raising the specter of illicit lending practices and aggressive debt collection strategies.

Ironically, the goal of consumer protection, which underpins the interest rate reduction, may inadvertently steer individuals toward riskier and less regulated lending avenues. Instead of safeguarding the interests of these borrowers, the policy change could inadvertently make their situations less affordable than previously.

LOANS UNDER $5,000 EXEMPTION

This lack of access to credit presents a significant challenge for a specific group of Canadians seeking financial assistance below $5,000. To address this issue and prioritize access to funds, unsecured loans below a $5,000 threshold should be eligible to be administered at the previously mandated rate cap. This policy would ensure that Canadians, regardless of their financial circumstances, have options to access necessary funds from regulated and reputable lenders when confronted with unexpected expenses or financial emergencies, such as car or home repairs, sudden funeral costs, or unplanned medical expenses. The suggested exemption seeks to bridge the existing gap in the financial market by encouraging lenders to offer practical solutions tailored to individuals seeking smaller unsecured loans. It will also prevent illegal lenders from entering the Canadian market to fill the void created by the new federal rate cap.

The most tangible result of this policy would be to divert this group of Canadians away from payday loans and illegal lenders. Without this exemption, the 4.7 million Canadians requiring loans of $5,000 or less would be compelled to rely on multiple payday loans at over 300% interest, rather than being able to obtain one installment loan for their credit needs It is essential to clarify that these Canadians would not simply qualify for unsecured loans at 35% APR, given their lack of credit scores or credit history. Examples of Canadians falling into this group include new immigrants, students, and individuals with limited lending history.

A $5,000 small loan exemption would also allow Canadians to substitute and consolidate their payday loans with loans from regulated and reputable lenders featuring lower interest rates. Through the consolidation of provincially regulated payday loans, Canadians have the potential to effectively reduce their borrowing costs, which currently stand at an astounding 360%. This exemption, if implemented, could offer considerable relief to Canadians grappling with multiple outstanding debts, enabling them to consolidate these obligations into a singular loan with a predictable repayment structure. In addition, payment on installment loans would be reported to the credit bureaus, thereby allowing borrowers to improve their credit scores – something that payday loans do not facilitate.

Case Studies: Quebec, California and the UK

This section highlights the consequences of a maximum allowable rate of interest reduction in three different geographies: Quebec, California, and the UK. It demonstrates that these jurisdictions, upon limiting access to credit by reducing the maximum allowable rate of interest, all saw: a decrease in alternative lenders in the marketplace and regulated credit and a corresponding increase of illegal lending, and in one case, organized crime, resulting in negative consequences for borrowers.

CALIFORNIA CASE STUDY: AN INCREASE IN ILLEGAL LENDING AND LOAN AMOUNTS:

- In 2019, the California Legislature passed the *Fair Access to Credit Act* (AB 539), which capped interest rates at 36% (plus the federal funds rate) for personal loans between $2,500 and $10,000 made by state-licensed lenders.
- The legislation did not address payday lenders, who can still charge triple-digit interest on loans.
- The change to the maximum allowable rate of interest had the effect of collapsing the state-regulated installment loan market, pushing borrowers to payday loans and “sovereign installment loans,” which are loans offered by Indigenous groups that operate outside state control and charge significantly higher interest rates.
- Some of these sovereign installment lenders offer loans with interest rates as high as 950% APR.

Context: Prior to 2020, California had moderate regulation that limited interest rates on consumer loans. In particular, loans under $2,500 were capped. But loans larger than $2,500 were free of any restrictions. According to an annual report by the state's regulator of financial products, 55% of all consumer loans with a principal between $2,500 to $4,999 had an APR in excess of 100 percent; furthermore, 73% of all loans between $5,000 and $9,999 had interest rates between 25-40 percent.

Consumer advocacy groups attempted to set a limit on loans between $2,500 and $10,000 since at least 2008. This bracket accounted for nearly 45 percent of the entire consumer loan market. Advocacy groups believed that enacting rate limits would prevent predatory lending.

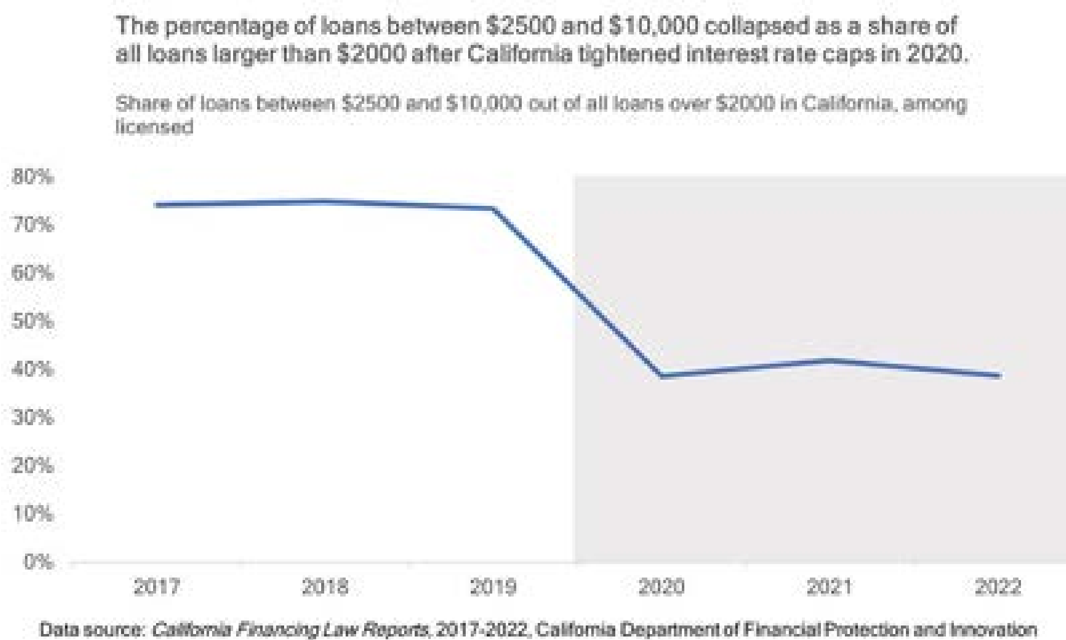
Legislation: In 2019, the advocacy succeeded: the Fair Access to Credit Act limited the simple APR of such loans to 36% plus the Federal Funds Rate (analogous to the Bank of Canada's overnight policy rate). With consumer loans under $2,500 making up another 40 percent of the entire market, effectively 85 percent of the entire licensed consumer loan market is now regulated with interest rate caps.

Consequence: There were two distinct consequences of the new legislation:

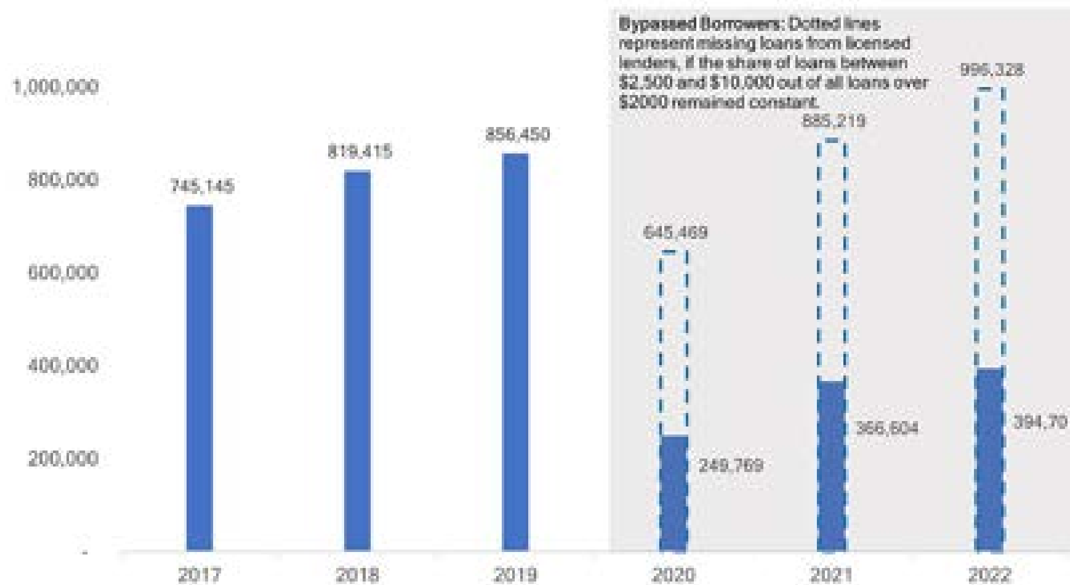
1. A drop in regulated lenders in the marketplace, resulted in the rise of payday and "sovereign lenders", as noted in the TransUnion data below, which indicates that the drop in regulated lending resulted in the rise of payday and "sovereign lenders".

2. The share of the number of loans in the $2,500 to $10,000 range fell drastically. The California Department of Financial Protection and Innovation publishes annual reports on the statistics from licensed

lenders in the state. Using data from their Financing Law Reports from 2017 to 2019, we can see that loans between $2,500 and $10,000 made up about 74% of all loans by licensed lenders over $2000. After 2020, this share dropped to about 40%.

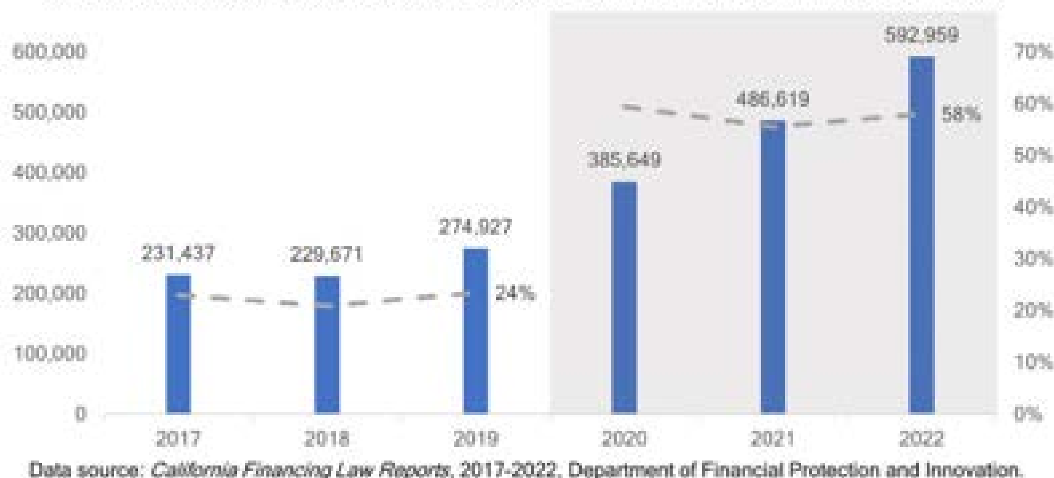


This change in the percentage of loans borne out in the total number of such loans as well. In 2019, a total of 856,450 loans between $2,500 and $9,999 were issued by licensed lenders in California. In 2020, the first year of the COVID-19 pandemic, the number of such loans fell to 249,769. (This decrease is even more startling when taking into account that there was a 6x increase in private consumer loans issued by licensed lenders during that time–almost all of which were for loans under $1000.)[8] While this number did increase over the next two years, it remains more than 54% lower than the pre-interest-rate-cap levels, indicating that even with COVID-19, the pattern remained the same due to the legislative change.



The impact on the interest rate cap can be seen on the average loan amounts in two ways. Firstly, the average principal borrowed for loans between $2,500 and $10,000 increased from approximately $4,000 before the introduction of the interest rate caps, to over $5,200 in the three years since. As lenders are forced to accept lower interest rates, this makes borrowing higher amounts relatively less costly. Thus, those with smaller borrowing needs had even less ability to borrow.

Also, and almost certainly as a direct consequence of the previous point, both total number of loans over $10,000 and the share of such loans out of all loans over $2,000 increased. Proportionately, they doubled. For those looking to borrow less than $10,000, the new restrictions likely to pushed to borrow higher amounts and pay higher interest rates (with fewer restrictions on lenders) as a result.

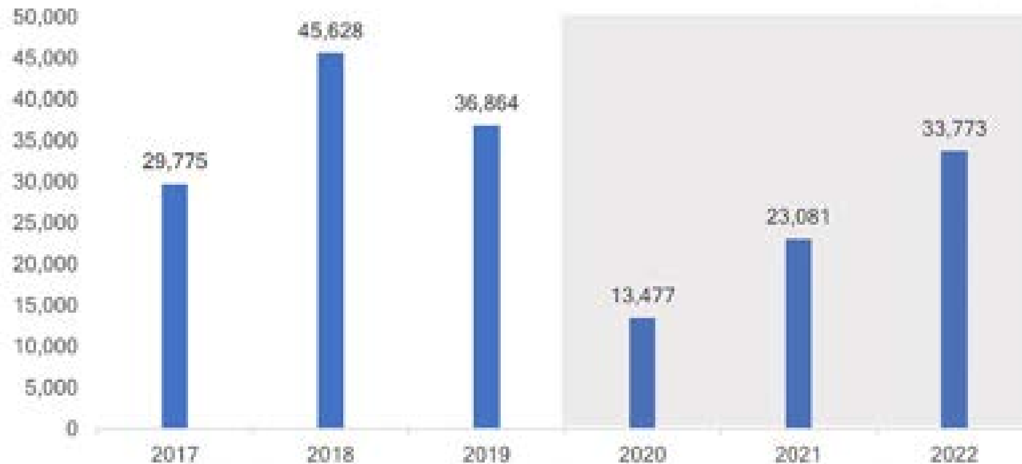


Data source: *California Financing Law Reports*, 2017-2022, Department of Financial Protection and Innovation.

This implies that if California would have never introduced those rate caps, the number of Californians taking out consumer loans greater than $10,000 would be nearly half of what it is today. With lower principal amounts, such borrowers would thus be paying less in total interest as well.

What's more is that we can rule out that borrowers sought to borrow less money in response. This is because the number of loans between $2,000 and $2,500 (which were already under an interest rate cap) actually decreased after the implementation of the new rules in 2020—and as of 2022, they still have not recovered to pre-2020 levels.

Lessons Learned: California's implementation of rate caps on loans between $2,500 and $10,000 had significant impacts on the borrowing market. It drastically reduced the number of loans in that range, it increased the average loan amount in that range, and increased the number of uncapped $10,000-and-more loans.



Data source: *California Financing Law Reports*, 2017-2022, Department of Financial Protection and Innovation

Some of these effects can be interpreted as unintended consequences: in trying to protect borrowers from high interest rates, the increase in average loan value, especially among loans over $10,000, implies borrowers in the licensed market are paying higher interest payments than they otherwise would have. This is an increase in the financial burden of borrowers, as opposed to a relief.

As well, hundreds of thousands of legal loans that would have otherwise occurred if interest rate caps were never implemented. They are not accounted for by either the increase in loans over $10,000, or under $2,500 Where did these borrowers go? As the data only tracks loans from licensed lenders, one harrowing conclusion is that borrowers had to resorted to unlicensed lenders. This only adds to the failure of the policy: borrowers are both paying higher rates and have been pushed into unregulated and illegal markets.

Personal Loans

In California, new regulation cleared the installment market, pushing traffic to sovereign lenders and payday loans

QUEBEC CASE STUDY: MAXIMUM LENDING AT 35% CAUSES SURGE IN ILLEGAL LENDING

Context: Interest rate regulation in Canada has its origins in the *Criminal Code*. Section 347 regulated that all loans be restricted to an annual rate no greater than 60%. Moreover, the Criminal Code makes an exception for payday loans (getting money upfront in exchange for a post-dated cheque) if the loan amount is for less than $1,500 and the term agreement is 62 days or less.

In 2007, however, Parliament passed bill C-26, *An Act to Amend the Criminal Code (Criminal Interest Rates)*, which introduced language to the *Code* that allowed provincial governments to enact their own rules to regulate the high-interest loan industry. This applied to both payday loans and other high-interest lending.

Legislation: As of 2023, nine out of ten provinces have regulated payday loans. The sole exception is Quebec. Instead of enacting legislation to set

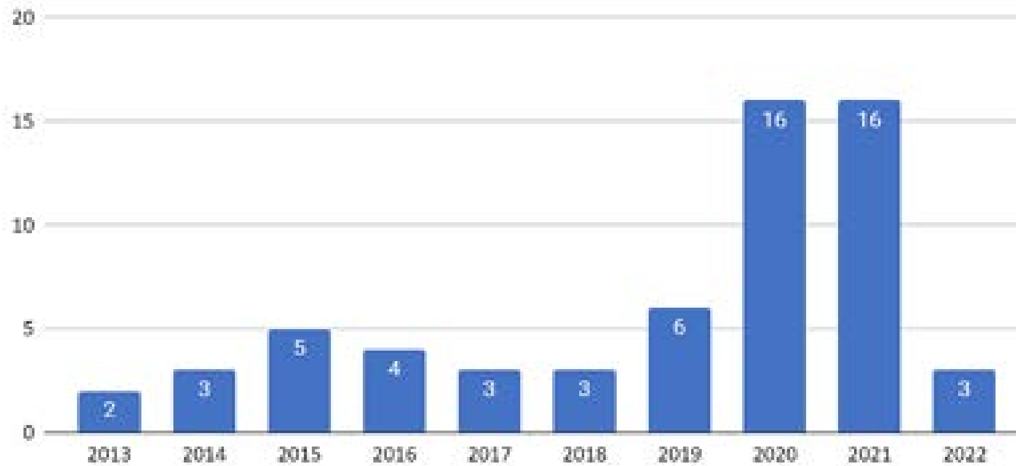
their own limits on interest rates, the Court of Quebec interpreted interest rate disputes in the context of their existing Consumer Protection Act (in particular, section 8 of Chapter 1 giving consumers the right to nullify a contract if their obligation is “excessive, harsh, or unconscionable”). In 2018, the Quebec Consumer Protection Office added the requirement to its lending license applications that lenders were required to lend at a maximum of 35% APR.

According to a report by the Consumers Council of Canada, Quebec courts have decided that rates in excess of 35% APR are unenforceable. In theory, this should prohibit payday lending in the province, as the prevailing rates in this industry are much higher than what is allowed under Quebec law.

Consequences: The limit by Quebec on interest rates has had two simultaneous effects: on the one hand, payday lenders operate illegally in the province. On the other hand, there has been a surge in illegal lenders targeting Quebec borrowers online, often based outside of the province and in some cases even being based internationally, known as “micro lenders”.

The Canadian Lenders Association conducted a web-scraping study to analyze this issue. Despite the de jure restriction on the supply of payday loans, the underlying demand for them has created a large de facto online market for micro loans.

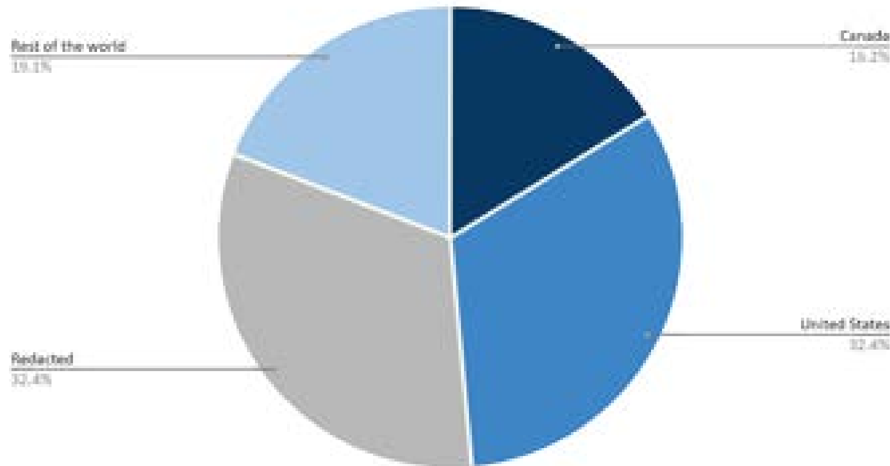
The study used a Montreal-based IP address to search for payday lending options online, using common terms in both French and English (e.g., “pret rapide”, “payday loan Quebec”, etc.). Each search result was then examined individually to judge whether it allowed borrowers from Quebec to apply for a loan, and the terms (including the interest rate) offered for that loan. Particular attention was made for loans available under $2000, as loans under this amount most often required no credit check.



The resulting websites were then investigated using two additional means: a "Wayback Machine" search to determine how long the business had been offering services to Quebecers, and a "Whois" search to determine where and to whom the website was registered. A total of 63 websites were found to offer "microloans" under $2,000 to Quebecers.

What's more is that most of these websites are likely not Canadian. By examining the country of registration of these websites, only 11 out of 63 websites were registered in Canada. While a further 21 had their information redacted from the Whois listing for privacy reasons, the remaining 33 websites were registered outside of Canada (mostly in the United States, but also France, Panama, Malaysia, among other countries).

A deeper analysis of how these websites operate revealed that they are charging APRs in excess of the statutory maximum. While most were charging between 100% to 250% on an annualized basis for short-term loans, others were offering rates in excess of 600%.



By being based internationally, it becomes more difficult for the Quebec judicial system to enforce its domestic law on these “microlenders”. As a result, Quebecers are essentially participating in a gray market for payday loans, as opposed to a well-regulated and legal domestic market. Perhaps this is why the Financial Post reported that it is difficult to get interest from regulators to investigating these foreign firms.

Lessons Learned: Quebec attempted to control the market for high-interest loans by imposing very strict interest rate caps, up to only 35% APR. In an interesting twist, this number was not set directly by legislation, but rather arrived at via court rulings in consumer protection cases, which was echoed though provincial consumer protection licensing regimes.

The most pressing effect of this rule has been to effectively ban lending above 35% APR in the province. While other provinces have carved out exceptions for payday lenders, Quebec has applied the same standards to everyone. This has made the legal market unprofitable for lenders in Quebec and has also reduced options for Quebecers when it comes to non-prime lending. Out of the major payday loan providers in Canada, only Money Mart

operates in Quebec as of 2015—but only offering "cheque cashing, bill payment and money transfer services through its Insta-Cheques affiliate, but not payday lending," according to the Consumers Council of Canada.

But banning a legal domestic market does not get rid of the problem. Instead, it pushes it into darker corners. The demand exists for payday lending, so lenders from outside of Quebec have emerged to fill the gap. Many of these providers are offering their services online and from abroad, making it more difficult for law enforcement to reach them; however, some are still offering services from other parts of Canada.

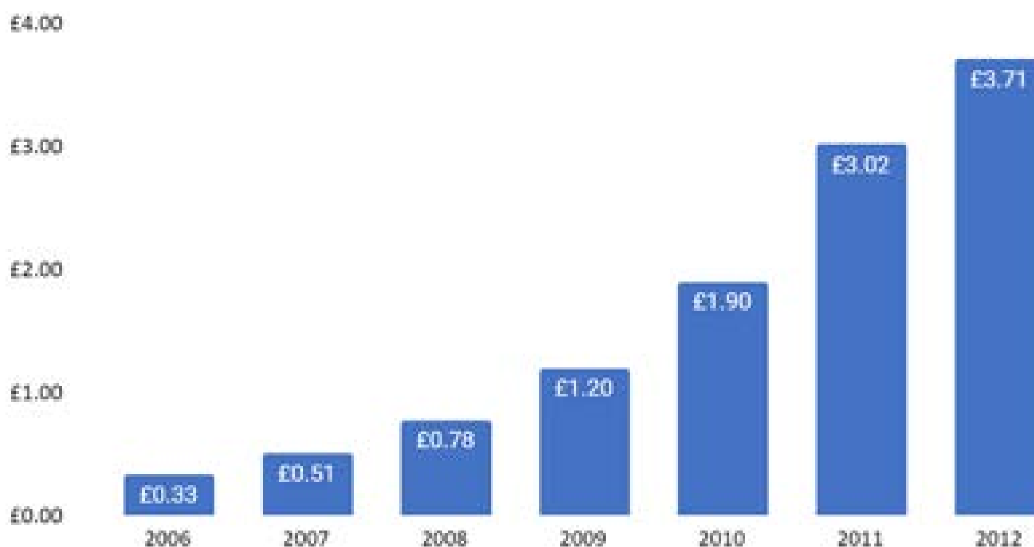
These lessons generalize to all of Canada because the principle is the same. By restricting more legal and regulated options domestically, Canadians will be compelled to seek out unregulated and illegal sources internationally.

UK CASE STUDY: DECREASE IN LEGAL LENDING AND INCREASE IN ILLEGAL LENDING PRACTICES

Context: Micro-lending in the United Kingdom has a long history, but to understand the current legislative context it is enough to only focus on the regulatory framework since the 1970s.

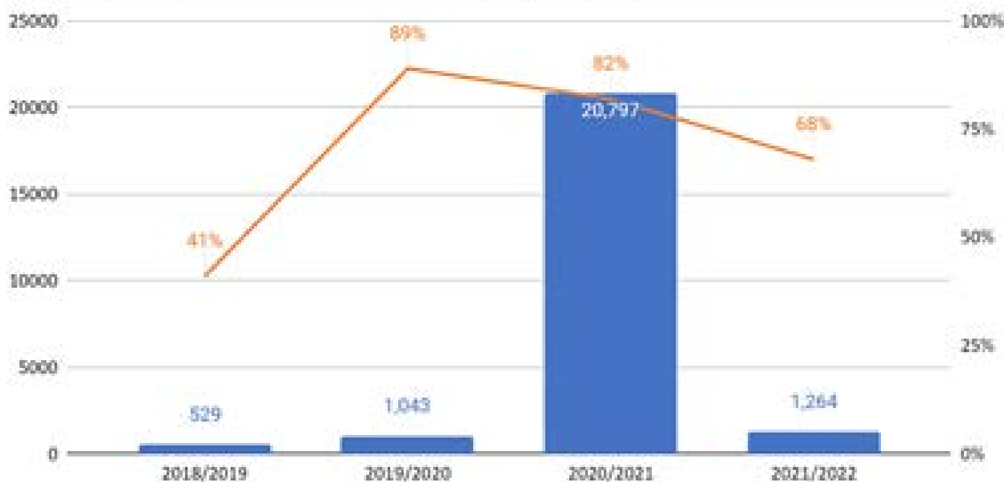
Increasing usage of consumer credit in the 1960s led to the creation of a parliamentary committee to investigate the consumer credit industry. The so-called "Crowther Report" was published in 1971, and its major recommendations were implemented in 1974 through the *Consumer Credit Act*.[9] In general, the *Act* provided basic definitions, contracting practices, advertising rules, as well as a licensing scheme for lenders. Crucially, however, it did not regulate any maximums on interest rates that lenders could charge.[10]

One quirk of the UK market compared to Canada is the existence of so-called "doorstep lenders." These are businesses that deliver cash to a borrower's home and conduct the transaction in person. This was the dominant way of borrowing money, this changed with the Great Financial Crisis. A report from the Association of Chartered Certified Accountants notes that while the payday loan market extended about 300-million GBP in 2006, this sum ballooned by more than 10-times to 3.7-billion GBP by 2012.[11] This massive increase led to many calls for stricter rules on this new-to-the-UK industry, led largely by credit unions.[12]



Legislation: Beginning in 2014, regulators instigated a series of regulatory tightening against all short-term loan providers. After issuing a report in 2013, the Financial Conduct Authority restricted advertising rights, loan rollover rates[13], and, later in 2014, caps on interest rates (0.8% per day), default fees (£15), and the total cost of borrowing (100% of the loan amount).

But the pressure did not stop there, nor was it restricted only to payday lenders. The Financial Ombudsman Service, a government agency that handles complaints in the financial industry, began a new regime. First, they began upholding (thereby awarding damages) to more complainants: from 41% of complaints against guarantor loan providers (like the major brand Amigo Loans) in 2018/2019, to 89% in 2019/2020. This led to a drastic increase in complaints filed: from 1,043 in 2019/2020 to 20,797 in 2020/2021, of which they upheld a staggering 82% of complaints.



Consequences: This one-two wallop from the regulators proved untenable. First, the payday lenders began closing down, then the online "doorstep" lenders also began declaring bankruptcy. According to the Financial Times, as of 2021, "the number of [high-cost, short-term credit] lenders has fallen by nearly two-thirds since 2016, and the number of quarterly loans is down more like 90 per cent."[14]

Even more have failed since. As Michael Bow of The Telegraph reported in December 2023:

"Doorstep lenders such as Morses Club [founded in 1870], Provident Financial [founded in 1880], and Non-Standard Finance, which offered slightly different loans to Amigo [Loans, an online guarantor lending company founded in 2005], have disappeared… Swamped by claims, Amigo, Provident and Morses creaked under the pressure. All three were forced into a scheme of arrangement, which led to an orderly wind-down of the companies."[15]

The problem is not getting better. The Joseph Rowntree Foundation reports that as of from May 2021 to May 2023, "2.8 million low-income households (24%) report having been declined lending."[16]

But far from being a success for consumer protection, the repercussions have been decidedly negative. While the supply of high-interest lending has been decimated, the demand has not. And what has filled the vacuum of legal and regulated lenders has been worse: illegal lenders.

In tandem with this reduction in credit was the corresponding rise of illegal lending, the UK think tank Centre for Social Justice (CSJ) has recently published an in-depth report on the issue of the illegal lending market. In *Swimming with Sharks*, published in 2022, they profile who uses of illegal lending services, and the extent of the market. They estimate "as many as 1.08 million people could be borrowing from an illegal money lender." Previous estimates from 2010 (albeit using different methodologies) 310,000, implying a substantial increase in use in the last few years.[17]

The CSJ report goes on to stress that while most of the illegal lending is done by individuals, there have been some connections to organized

crime; they "We heard of several London boroughs where a victim found themselves in the grip of an organised crime group and struggled to come forward for fear of the consequences."[18]

The problem of organized crime is not limited to London. The Merseyside Police department (an area which covers Liverpool) issued a statement warning locals of the dangers of illegal loans around the Christmas season: "Some illegal money lenders help to facilitate the finances of organised crime groups and we work closely with our partners, including the England Illegal Money Lending Team (IMLT), to find them and stop them."[19]

Lessons Learned: There are at least two ways of driving out legal lenders: first is by imposing caps on the prices and rates that they can charge on their services; and second is to force them to pay endless fines for standard operating procedure. Both ways eliminate the legal supply of high-cost loans but create a vacuum of demand that is filled with illegal lenders and causes a rise in illegal activity.

While it's true that financial literacy is a problem faced especially by low-income borrowers (the CSJ reports that the UK ranks 15th among G20 countries), the more important factor is accessibility to credit. Those who borrow from illegal lenders report that they have tried getting credit from multiple legal sources first; the black market is their last hope in a dire situation.[20] By limiting the number of regulated lenders, more people are forced to look elsewhere, which have negative consequences.

Conclusion

This research paper compellingly illustrates the profound impact of reducing the annual percentage rate (APR) from 47% to 35% in the Canadian marketplace will lead to unintended consequences of shutting out millions of Canadians from access to credit and pushing them to payday and illegal lending sources, as was the case in three other markets that imposed rate caps.

Throughout the paper, we delve into the historical context of Section 347, emphasizing its pivotal role in regulating interest rates and safeguarding consumers against predatory lending practices. Our examination underscores the critical need for precise regulations that discern between installment lending and payday lending, and the benefits provided by installment products for consumers, which are not offered by payday lenders.

Furthermore, we scrutinize the potential consequences of lowering the maximum allowable interest rate on non-prime borrowers, a vulnerable demographic often grappling with unforeseen financial challenges. Such a reduction may impede their access to credit, limiting their ability to meet essential financial requirements. An exemption for unsecured installment loans under $5,000 would provide a much-needed option for non-prime lenders to avoid the use of payday or illegal loan options.

By drawing insights from international case studies in Quebec, California, and the UK, we uncover the consequences resulting from interest rate reductions in different regions. The research illuminates a growing concern related to the escalating issues arising from illegal lending practices, particularly in regions where stringent interest rate regulations have been implemented. In Quebec,

for instance, a reduction in interest rates prompted a shift in the lending landscape, leading to an increase in illicit lending activities as desperate borrowers sought alternative, albeit illegal, sources of credit. Similarly, in California and the UK, where interest rate reductions were observed, there was a corresponding surge in underground lending operations, often characterized by exploitative practices and lack of consumer protection. These instances underscore the need for a nuanced and comprehensive approach to interest rate regulations, considering the unintended consequences that may fuel the rise of illegal lending, jeopardizing the financial security of at-risk individuals.

In conclusion, it is imperative to ensure that all Canadians, irrespective of their financial standing, have fair access to affordable credit. This commitment is crucial not only for their financial well-being but also for fostering the responsible evolution of the lending industry. We implore on the federal government to study this issue carefully prior to implementing the rate cap drop to 35% to ensure that unintended consequences don't negatively impact non-prime Canadians.

Endnotes

[1] Canadian Lenders Association Risk Roundtable, "Calculating the Adverse Impacts of a Reduction in the Qualifying APR." (2022).

[2] Samantha Gale and Dean Velentzas, "The ABCs of APRs: The Status of Consumer Protection Across Canada," Canadian Lenders Association, https://www.canadianlenders.org/apr-whitepaper/.

[3] Ibid.

[4] Data based on TransUnion's Credit Vision Risk Score: 8.2M Canadians are considered non-prime and an additional 300,000 are without a credit score Balances include those held by co-borrowers.

[5] Ibid.

[6] Commission of Inquiry into Money Laundering in British Columbia, June 2022. https://cullencommission.ca/files/reports/CullenCommission-FinalReport-Full.pdf

[7] Guide to Credit Score Factors," TransUnion Blog, https://www.transunion.com/blog/credit-advice/guide-to-credit-score-factors.

[8] From the *California Financing Law Reports*. For example, in 2019, California lenders issued 725,170 loans under $2,000; in 2020, this jumped to 11.3 million; and in 2022 (the last year which data is available), it had reached 81.3 million.

[9] Review of Retained Provisions of the Consumer Credit Act: Final Report," Financial Conduct Authority, https://www.fca.org.uk/publication/corporate/review-of-retained-provisions-of-the-consumer-credit-act-final-report.pdf.

[10] Consumer Credit Act 1974," legislation.gov.uk, a https://www.legislation.gov.uk/ukpga/1974/39/enacted.

[11] Payday Lending," ACCA (Association of Chartered Certified Accountants), https://www.accaglobal.com/content/dam/acca/global/PDF-technical/other-PDFs/pol-tp-pdlfab-payday-lending.pdf.

[12] See, for example, https://www.centreforsocialjustice.org.uk/wp-content/uploads/2022/03/CSJ-Illegal-lending-paper.pdf. The Archbishop of Canterbury also got involved: “I’ve met the head of Wonga [a leading payday loan provider at the time, which has since filed for bankruptcy] and we had a very good conversation and I said to him quite bluntly ‘we’re not in the business of trying to legislate you out of existence, we’re trying to compete you out of existence.’” https://www.independent.co.uk/news/uk/home-news/war-on-wonga-we-re-putting-you-out-of-business-archbishop-of-canterbury-justin-welby-tells-payday-loans-company-8730839.html.

[13] FCA sets out detail on how it will regulate consumer credit, including payday," Financial Conduct Authority (FCA), https://www.fca.org.uk/news/press-releases/fca-sets-out-detail-how-it-will-regulate-consumer-credit-including-payday.

[14] https://www.ft.com/content/72b3e83a-4e6e-479d-b5df-e5c572e7d477

[15] http://www.telegraph.co.uk/business/2023/12/19/death-doorstep-lenders-leaves-loan-sharks-lurking/

[16] https://www.jrf.org.uk/cost-of-living/unable-to-escape-persistent-hardship-jrfs-cost-of-living-tracker-summer-2023

[17] https://www.centreforsocialjustice.org.uk/wp-content/uploads/2022/03/CSJ-Illegal-lending-paper.pdf, pages 16-17.

[18] https://www.centreforsocialjustice.org.uk/wp-content/uploads/2022/03/CSJ-Illegal-lending-paper.pdf, page 28

[19] https://www.merseyside.police.uk/news/merseyside/news/2023/november/warning-to-avoid-loan-sharks-in-the-run-up-to-christmas/

[20] https://www.centreforsocialjustice.org.uk/wp-content/uploads/2022/03/CSJ-Illegal-lending-paper.pdf, 65-67

A Rise in Illegal Lending and Criminal Activity

Implications of the new 35% Maximum Allowable Interest Rate in Canada

Contact us at
www.canadianlenders.org