Intelligence MEMOS

From: Jeremy M. Kronick

To: Finance Minister Minister Chrystia Freeland

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Re: **THE UNINTENDED CONSEQUENCES OF OTTAWA'S 35-PERCENT INTEREST RATE CAP**

Ottawa has set its sights on reining in predatory lending rates. Last year it set out draft regulations that would lower the rate non-prime lenders can charge from 48 to 35 percent annual percentage rate or APR.

Will that keep those prey to predatory lending from entering a cycle of debt? Probably not.

There are two types of borrowers, prime and non-prime. Prime borrowers have strong credit scores that give banks and credit unions confidence they will pay their loans on time and in full. As a result, they can borrow at reasonable interest rates.

Non-prime borrowers are more diverse. Some have a checkered repayment history. Others, including immigrants, have no Canadian credit history. Because banks and credit unions often won't lend to them, they have to look elsewhere. To offset the higher risks involved, lenders in alternative markets charge higher interest rates. Higher rates for riskier loans will strike most people as common sense.

Until last year's budget, and with only a few exceptions, 48 percent was the most a lender could legally charge. The decision to set a legal maximum interest rate suggests governments believe that, a) rates can rise above and beyond what non-prime borrowers should face and b) only price regulation can fix it.

Was Ottawa right about both?

Its **cost-benefit analysis** of lowering the rate estimated $256.8 million in consumer saving over 11 years as borrowers search for lower cost debt or delay discretionary spending in the face of this new lower maximum interest rate. Lenders, on the other hand, would lose $238.5 million. The net benefit is therefore slightly more than $18 million over 11 years – less than $2 million a year. That's the government's estimate of the cost of the market failure it claims to have identified.

But its analysis focused only on payday lenders and borrowers. Plenty of non-prime borrowers go to alternative lenders that offer less extreme terms and conditions. The Canadian Lenders Association **says** that in fact about half the country's 8 million non-prime borrowers face interest rates above 35 percent. If that becomes the legal maximum, they would be in danger of losing all access to credit. Four million seems high to me, but it's a fair assumption the number of Canadians who will lose access is considerably more than the 93,000 assumed by the government's cost-benefit analysis.

The lenders' position is that the interest rates being charged do not represent a market failure but are appropriate given the risk profiles of non-prime borrowers. A ceiling on rates would therefore wipe out the market for those borrowers. Research from other jurisdictions supports that view. A **study** of Illinois' decision to cap rates at 36 percent showed a big drop in the number of non-prime loans – almost double the corresponding increase in prime loans – and a reduction in the average amount lent to non-prime borrowers who did still receive a loan.

If Ottawa's real goal is to go after payday lending, it could exempt non-payday alternative lenders, defined appropriately. If it wanted to do more, it could pursue policies to protect consumers and increase competition for non-prime borrowers, thus lessening the need for price regulation.

On consumer protection, it could do more to ensure that loan terms, including all fees, are as **transparent** as possible and are explained in simple language prospective borrowers understand. Clear, simple language about the interest rate, how it is calculated, and what happens if borrowers fail to repay on time would help weed out bad actors and drive down average rates.

On competition, Canada has lagged behind other countries in open banking, which among its many **attributes**, can more accurately assess credit scores, thus **helping** borrowers access more loans on more appropriate, affordable terms. Last fall's federal economic statement committed the government to introducing open banking legislation in this year's budget, with implementation in 2025. That will be a good step, if it's taken.

Capping market prices should be a policy of very last resort. Better to focus on targeting the most predatory lenders and improving competition and consumer protection. What the government really shouldn't do is make life even harder for people who are already having trouble accessing credit.

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