

Consumer Measures Committee

Stakeholder Consultation Document on a Proposed Consumer Protection Framework for the Alternative Consumer Credit Market

The Consumer Measures Committee, with representation from the federal, provincial and territorial government departments responsible for consumer affairs, is consulting the public regarding how best to achieve viable consumer protection in the alternative consumer credit market. The alternative consumer credit market is the small short-term loan industry that operates outside of the mainstream banking sector, and includes payday lenders and pawn brokers.

Viable consumer protection may be achieved through one or a combination of complementary mechanisms that include federal law, provincial/territorial law, and an industry code of best practices. Enforcement of law could be left to court action or involve civil enforcement regulatory schemes such as licensing.

This paper sets out sixteen items for discussion. It includes an initial item addressing the maximum interest rate and its relationship to the viability of consumer protection framework for the small short-term loan industry. The remaining fifteen – representing items for possible inclusion within a consumer protection framework – are set out individually, but are inter-related. An eventual framework may be made up of some or all of these items, as stated or amended, or additional items developed through the ongoing work of the Consumer Measures Committee.

These sixteen items and their associated commentary are included for discussion purposes and are not necessarily reflective of government policy in any Canadian jurisdiction. In combination with other ongoing work, the results of this consultation will be considered by Ministers responsible for consumer affairs at their next meeting.

You are asked to respond to this consultation by completing the questionnaire that starts on page 10, following the discussion document. In the questionnaire, you are asked to consider and provide comments on:

- 1. Any or all of the sixteen items set out in this paper;***
- 2. The cumulative impact of addressing any or all of these sixteen items; and***
- 3. Any issues not included in this paper that need to be addressed, or any general comments.***

Please refer to the beginning of the questionnaire for detailed information on how to submit your response. Thank you for taking the time to review and respond to this paper.

Consumer Measures Committee

Context

The last decade has seen significant growth in small short-term lending in Canada. Loans are used for a variety of reasons, ranging from lifestyle choices, to covering unforeseen emergencies such as car repairs, to simply trying to make ends meet between paycheques. While many consumers see these loans as a convenience or even a necessity, they come at a high price and, in addition, some consumers experience abusive lending practices.

The circumstances under which alternative consumer credit market loans are advanced can leave consumers unable to repay them within their terms. The result can be a 'debt spiral' marked by the revolving use of small short-term credit in successive pay periods, and the compounding of the already high costs of borrowing. Inability to repay may lead to various supplementary charges and penalties, many of which are clearly excessive, such as the seizure of assets worth substantially more than the loan principal.

The alternative consumer credit market is a substantially unregulated financial services industry. Small short-term lenders are not deposit taking institutions, so statutes of specific application to mainstream financial institutions do not apply. The criminal interest rate limit at section 347 of the *Criminal Code of Canada* (henceforth, "s. 347") applies, but is not frequently enforced through criminal prosecution in the small short-term lending context, given the volume of activity and the low dollar amount associated with each potential contravention. While s. 347 does not represent a comprehensive consumer protection framework, its existence in its current form may hamper the ability of provincial and territorial jurisdictions to establish and enforce consumer protection regulations.

Some observers of the alternative consumer credit market contend that an appropriate consumer protection framework could address the critical concerns posed by the small short-term lending industry in a manner that permits consumers to access such loans. They point to the above discussion to conclude that a new public policy is needed that will address the issues and is readily enforceable. Other observers may think that there is no place for the alternative consumer credit market industry in Canada.

If a comprehensive consumer protection framework for the alternative consumer credit market could be created, it would have the potential to overcome enforcement difficulties associated with existing laws. The framework could include enforcement through provincial / territorial licensing, offence proceedings, civil litigation, or industry-based actions by an association.

Item 1 Allow for a maximum interest rate structure specific to small short-term loans.

Consumer advocates and other observers have calculated the effective rate for typical alternative consumer credit market loans to exceed the maximum rate allowed by s. 347, when all charges are included. The exponential effect that short

Consumer Measures Committee

terms have on the compounded annualized rate is a key reason for the high calculated effective rates. The fixed costs of administering a loan, which are high in proportion to the small sum principal, are recovered over a very short time period.

Under s. 347 of the *Criminal Code of Canada*, it is an offence to enter into an arrangement to receive – or to actually receive – interest in excess of 60% per year. For purposes of s. 347, “interest” is defined to capture a wide variety of charges and is required to be calculated using actuarial principles. This means that the 60% cap applies to a rate that is compounded over the course of a year. A \$35 charge on a 10 day loan of \$300 represents a straight-line annualized rate of 426%*, but a compounded annualized rate of over 5,500%†.

A fundamental question may be raised regarding whether it is feasible to lend money at a rate of 60% or less for small short-term loans. Using the example above of a typical small short-term loan – \$300 lent for 10 days – s. 347 would permit charges not exceeding \$3.89‡. The costs associated with administering a loan could easily exceed this permitted charge. Consequently, some observers of the industry may argue that an alternative maximum interest rate structure should be allowed for these loans that reflects the cost structure of the industry.

Other observers may argue that the interest rate limit imposed by s. 347 is already high and that there would be little basis in fairness to allow a higher interest rate for small short-term loans. The resolution of this issue may affect the long term availability of small short-term consumer credit. Mainstream lenders, such as banks, caisses populaires and credit unions, do not offer discrete credit products similar to alternative consumer credit market loans and indicate that they would not do so under the current legislative framework.

Item 2 Define alternative consumer credit market loans as small, short-term loans where the initial principal does not exceed \$1,500 and the term does not exceed 62 days.

A definition is required in order to clearly articulate the loans to which a consumer protection framework specific to small short-term lending would apply. The maximum thresholds for both principal and term must be met in order for a loan to fall within the scope of this definition. Having both helps to ensure that mainstream credit products offered within the detailed consumer protection environment applicable to mainstream lending are not inadvertently captured within the scope of the alternative consumer credit market.

Both maximum thresholds exceed industry practices and are recognized to capture the vast majority of the small short-term lending industry as it exists today. The threshold for principal would need to be periodically reviewed against the possible

* $(35/300) \times (365/10) \times 100$

† $\left(\left(\frac{335}{300} \right)^{365/10} - 1 \right) \times 100$

‡ $\left(300 \times \left(\frac{60}{100} + 1 \right)^{10/365} \right) - 300$

Consumer Measures Committee

effects of inflation. With respect to term, a loan should not cease to be considered an alternative consumer credit market loan if default or extensions resulted in the actual term being longer than 62 days.

Item 3 Restrict default and penalty charges, such as restricting NSF charges to the charges imposed by financial institutions, that can be passed on to borrowers of small short-term loans.

Treatment of borrowers upon default is a prime area for abuse within the alternative consumer credit market. This item responds to arbitrary penalty charges that have no bearing on actual costs incurred. While it may be appropriate to apply some monetary incentive to ensure repayment, punishing penalty charges serve no purpose other than to keep the borrower in a state of indebtedness to the lender applying those charges.

Item 4 Clearly prohibit misrepresenting the reasons for fees charged with respect to small short-term loans, such as a charge for a credit check when no credit check is performed.

Investigators are increasingly finding alternative consumer credit market loan documentation inclusive of appropriate sounding fees and charges that do not reflect services provided or costs incurred. They appear to be attached simply to increase the lender's return. One common example is a fee for doing a credit check, even though no credit checks are performed. While this practice might be deceptive or fraudulent in any case, a clear prohibition targeting the alternative consumer credit market would provide clarification.

Item 5 Fully apply cost of consumer credit disclosure rules (commonly called "truth in lending" laws) to small short-term lending.

All Canadian jurisdictions are committed to modernizing their cost of consumer credit disclosure rules in accordance with a harmonized template agreed to by all. The harmonized template did not exempt the alternative consumer credit market.

A central tenet of this harmonized template is the direct comparability of various credit products through the disclosure of an annualized percentage rate, or APR. While disclosure of an APR may not seem pertinent to a loan where the term is expressed in days rather than years, the intent is to provide a number that the borrower can use to directly compare the cost of credit products they are using with the cost of other credit products that may be available to them.

The harmonization template requires the credit grantor to disclose the required information clearly, concisely, in a logical order and in a manner that is likely to bring the information to the borrower's attention. In addition to APR, the harmonized template would require the credit grantor to disclose the following information:

Consumer Measures Committee

- Principal;
- Sum of all required payments;
- Total dollar cost of borrowing;
- Term;
- Annual interest rate applied to principal;
- Date when interest begins to accrue;
- Nature and amount of each non-interest charge;
- Amount and timing of all payments;
- Optional services, with costs and cancellation rights;
- Prepayment rights and charges;
- Method of applying each payment to principal and cost of borrowing;
- Default charges;
- Subject matter of any security interest in personal property; and
- Brokerage fees.

Item 6 Require that contract or disclosure documentation related to alternative consumer credit market loans include a plain language warning of their high cost as well as contact information for making a complaint.

Studies reveal that the demographic of the small short-term borrower does not differ greatly from the overall Canadian demographic, with the primary distinction being a lack of financial literacy. Clear disclosure of the terms of the contract (item 5) may not be enough to get the message across that the alternative consumer credit market loan is a high cost credit product. Application of item 6 would require a statement such as "**THIS IS A HIGH COST LOAN**" to be clearly included in documentation given the borrower.

The inclusion of contact information for making complaint could mean contact information for local regulatory authorities, or an industry-based redress mechanism, depending on the delivery mechanism chosen for such an aspect of a consumer protection framework. Inclusion of this would provide the borrower with a meaningful avenue to hold the small short-term lender to the standards established within a consumer protection framework.

Item 7 Prohibit "rollovers" and require that, where the borrower cannot repay an alternative consumer credit market loan on its repayment date, the lender accept repayment by instalment within the borrower's ability to pay.

A "rollover" is the extension of a loan for a fee. Typically, in this sector, a rollover results in penalty fees associated with non-payment plus the administrative fees and charges associated with a new loan added to the outstanding balance of the loan. This increases the borrower's short term debt load, makes the loan increasingly difficult to repay, and may put the borrower in an escalating spiral of debt. Rollovers are recognized as a primary avenue for abuse within the alternative consumer credit market by industry, consumer advocates, academics and the enforcement community.

A prohibition on rollovers must be applied against the substance of the practice. A prohibition targeting rollovers would need to recognize that concurrent or immediately subsequent loans may be rollovers disguised as separate transactions.

Consumer Measures Committee

It is not enough, however, to simply prohibit rollovers. Rollovers, despite their abusive nature, do serve the purpose of providing a mechanism to extend a loan where the loan cannot be repaid when it is due. Given that small short-term loans often claim a significant portion of the borrower's next net pay, many find themselves in the position of not being able to afford repayment. A replacement mechanism for rollovers is needed to ensure that borrowers can extend their loans without facing exorbitant fees.

Item 8 Prohibit the practice of discounting alternative consumer credit market loans.

"Discounting" is the practice of advancing to the borrower an amount less than the principal stated in the loan contract. With discounting, the actual amount provided to the borrower is not typically recorded in the contract, leaving the borrower without any hard evidence of the true cost of the loan.

Item 9 Prohibit the use of wage assignments with respect to alternative consumer credit market loans.

A "wage assignment" is an authorization by an employee for the employer to pay all or part of their wages to another person. With a wage assignment, the small short-term lender could approach the borrower's employer for repayment. Wage assignments are prohibited in some jurisdictions, such as Ontario, because of their burdensome and intrusive nature.

Item 10 Prohibit title loans (auto pawns).

An "auto pawn" is a specific, egregious and, in some jurisdictions, increasingly prevalent example of a "title loan". For purposes of this item, a "title loan" is defined as a loan against title (that is, a security interest) in personal property, except where:

- The lender's security interest is properly registered pursuant to provincial or territorial legislation, or
- The lender has possession of the personal property during the term.

This first exception ensures that traditional means of financing the purchase of major consumer products are not inadvertently prohibited. The second exception is for "traditional pawn" transactions. A lender's possession of vehicle keys or transfer documentation should not be considered possession of the personal property.

Borrowers willing to use their vehicle or their major household assets as security on small loans are vulnerable to abuse. Loans are made based on the asset's value, rather than on an assessment of the borrower's ability to repay. Lenders seek to circumvent the protections given to individuals under legislation governing collection activities and security interests. Seizures occur immediately upon

Consumer Measures Committee

default, without regard to payments made. The full value of the asset is typically claimed by the lender.

While the media report individual experiences with “auto pawns” in an anecdotal way, investigations to date within some jurisdictions confirm the more egregious practices. It is not unusual to find an example where a consumer’s vehicle has been seized despite having repaid to the lender amounts totalling more than four times the loan principal.

Item 11 Apply harmonized debt collection practices to collection activities related to small short-term loans.

Canadian jurisdictions have agreed to a harmonized template of prohibited debt collection practices which many jurisdictions are now in the process bringing forward in their legislation or regulations. This list is available on-line at << <http://cmcweb.ca/epic/internet/incmc-cmc.nsf/en/fe00036e.html> >>.

Some jurisdictions apply prohibited collection practices to anyone collecting a debt, others only against third-party debt collectors. With respect to alternative consumer credit market loans, this item proposes that the prohibited debt collection practices be applied regardless of whether collection activities were carried out by the lender or a third-party collector. This would place a consistent high standard on the collection activities associated with small short-term loans.

Item 12 Require contract or disclosure documentation for small short-term loans to be inclusive of contact information for credit counselling services independent of the alternative consumer credit market industry and require that such credit counselling information be prominently posted within outlets offering small short-term loans.

Habitual usage of the alternative consumer credit market’s loan products has been noted as a particular problem. Despite facing high costs with respect to a single transaction, consumers return to the alternative consumer credit market for new loans – both because a previous repayment has left them short until their subsequent paycheque or because the convenience of the earlier access to cash has an enticement effect. This results in multiple loans at high cost being charged against those with the lowest levels of financial literacy.

Instead of trying to identify habitual usage of small short-term credit products and requiring lenders to refer those habitual users to credit counselling, adoption of item 12 would establish a requirement to put credit counselling information into the hands of every borrower. This would respond to the issues of habitual usage in a proactive and preventative way

Consumer Measures Committee

Item 13 Require small short-term lenders to provide borrowers with copies of contract documentation, receipts for payments, and statements of account for instalment payments.

This is a straightforward requirement for the lender to provide the borrower with copies of documentation related to the loan. Investigators often find a limited paper trail when investigating complaints within the alternative consumer credit market. This is partly attributable to the record keeping habits of borrowers, but some lenders do not produce appropriate documentation or, in some cases, offer borrowers the "service" of retaining copies so as to not overwhelm the borrower with paperwork.

Item 14 Provide borrowers with the right to rescind an alternative consumer credit market loan by the close of the business day immediately following the day on which the loan was entered into, subject to any longer rescission rights that exist in law.

A right to rescission would allow a borrower to extricate himself or herself without penalty from any obligations with respect to an alternative consumer credit market loan by returning the principal to the lender within a specified time period. A rescission right, or cooling off period, is typically enshrined in law in situations where scams or abusive practices are chronic. For example, Canadian provinces and territories have legislated rescission rights with respect to door-to-door sales.

A clear time period is essential for application of a rescission right. Item 14 mirrors rescission rights currently voluntarily applied by some small short-term lenders. The final clause recognizes that borrowers in Québec currently benefit from a 48 hour rescission right.

Item 15 Prohibit the reporting of all information, including default information, related to small short-term loans in the mainstream credit reporting system.

Alternative consumer credit market loans are not based on a borrower's ability to pay, but on the value of the loan relative to either the borrower's next paycheque or a specific asset. Some would argue that small short-term loans are structured to result in default so that high back-end fees can be realized. They may further argue that since credit reports can be accessed for a variety of reasons, including the evaluation of an individual for employment or residential tenancy purposes, there is a significant threat to consumers if default information resulting from loans structured to encourage default are entered into the credit reporting system.

Item 16 Prohibit lenders offering small short-term loans from co-locating with or within gaming facilities (i.e., casinos).

There is increasing survey and anecdotal evidence of a link between alternative consumer credit market lending and gambling debts. This is not a causal link, but a link associated with gambling addicts going to desperate means to stay at the table.

Consumer Measures Committee

While not observed in Canada, at least one other jurisdiction has reported cases of alternative consumer credit market lenders specifically targeting gamblers as potential customers in their advertising.

Gambling addictions can have devastating effects on individuals and their families. Item 16 is a modest proposal aimed at keeping gambling and alternative consumer credit market lending separate, at least geographically.

Conclusion

Please provide comments by completing the questionnaire which follows.

Please include your name and, if applicable, the name of the company or organization that you represent. This information is necessary to assist in our analysis of all responses made. Information collected through this consultation will not be used in a manner that attributes such information to a specific respondent.

Thank you for taking the time to review and respond to this consultation document.