
Criminal Rate of Interest

In Canada, interest in excess of 60% is considered as criminal. The Criminal Code sets out a very specific calculation methodology for determining the interest rate actually charged in a transaction – the effective rate of interest.

What is an Effective Rate of Interest?

There are many ways to calculate and to report an interest rate. For example, two people could analyse a single transaction and one could report the interest rate as 59% and the other as 80%. Both would be a correct determination, but only one would meet the requirement of section 347 of the Criminal Code.

Section 347 requires the determination of an effective annual rate of interest. This term is well defined and well understood by actuaries in Canada. Given a set of facts about a transaction, any two actuaries should calculate the same effective annual interest rate. An effective annual interest rate provides information in a standard form about a transaction equivalent to the one being analyzed. It indicates the amount of interest that a borrower would pay if there is a cash advance on one day and both principal and interest are fully repaid in a single lump sum exactly one year later.

Where a borrower pays off a loan in less than one year, the effective interest rate calculation essentially assumes that equivalent standard transaction would have the principal payment delayed until the end of the year and the same pattern of interest payments will be made repeatedly during each period of time equal to the period within which the borrower actually paid. In other words, the effective interest rate calculation assumes that all interest (including one time fees and charges) would be paid again and again in each payment period until a full year has been completed.

For instance, suppose I lend you \$100 and 73 days later you repay me \$110.00. That's the return of the original loan plus \$10.00 interest. The effective annual rate of interest is similar to a "standard" calculation where I lend you \$100 and every 73 days you pay me \$10.00. One year later, in addition to the \$10 of interest, you also repay the original loan of \$100. That works out to 5 interest payments of \$10.00 plus the principal repayment of \$100.00.

You might think that a total of \$50 of interest would work out to a 50% interest rate. But the effective annual rate of interest must take into account the time value of money. In this example, the interest rate is 10% every 73 days, which is equal to an effective annual interest rate of 61.05%.

So a loan of \$100 that is repaid 73 days later by \$110 would be criminal.

There is a rigorous mathematical calculation used in determining an effective annual interest rate. It depends on determining the exact dates of all advances and payments as well as the exact amounts

of periodic interest and all charges and expenses¹.

What is considered to be “interest”?

For purposes of section 347, one is required to recognize two types of charges as interest:

- ◆ Periodic interest
- ◆ Aggregate of all charges and expenses whether in the form of a fee, fine, penalty, commission or other similar charge or expense, but excludes any insurance charge, official fee, overdraft charge, required deposit balance or, in the case of a mortgage transaction, any amount required to be paid on account of property taxes;

Basically, if an amount is not one of the excluded items listed, you can probably consider that it will be classified as interest.

What constitutes a criminal interest rate?

Criminal Code section 347 provides that if you

- a. enter into an agreement that requires the payment of interest at a rate greater than 60%, or
 - b. receive interest at a rate that is greater than 60%,
- then you are guilty of a criminal act.

However, there is a specific exemption for certain payday loans provided by a lender licensed by a province.

Other ways to express interest rates

Most of the interest rates we encounter in Canada are expressed as a “nominal rate”.

Nominal interest rates are also usually expressed as an annual rate, but nominal rates are not well defined unless the compounding period is also given. There is a unique effective annual interest rate for any nominal rate. A nominal interest rate will usually be expressed as a lower value when compared to the equivalent effective annual rate. Most interest rates one encounters in financial transactions are nominal rates. For example, residential mortgage interest rates are required by law to be expressed as a nominal rate, compounded semi-annually.

For example, an interest rate of 47.88% compounded monthly (3.99% per month) gives an effective annual interest rate of 59.92% and would not be criminal. But if you charge 48% compounded monthly (4.00% per month), the effective annual interest rate would be 60.10% and would be a criminal rate.

A nominal interest rate is not appropriate for the purposes of Criminal Code section 347.

The legislation

The specific legislation about the criminal rate of interest is in section 347 and 347.1 of the Criminal Code of Canada, which can be found here:

Section 347: <http://laws-lois.justice.gc.ca/eng/acts/C-46/page-148.html#h-98>

Section 347.1: <http://laws-lois.justice.gc.ca/eng/acts/C-46/page-149.html>

¹ It should be noted that it is possible to calculate an effective interest rate for a period other than one year. For example, an effective monthly interest rate. This is also a well defined term, although periods other than one year are rarely used for effective interest rates.