BANKING ON THE MARGINS

Finding Ways to Build an Enabling Small-Dollar Credit Market

FEBRUARY 2016

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The borrower
is slave to the lender.
— PROVERBS 22:7

Front Photo: Wikimedia Commons | Vinceesq | Cash Money - 24 hour payday loan outlet on Yonge St. Toronto, Ontario, Canada

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Cardus (root: cardo) is a think tank dedicated to the renewal of North American social architecture. Drawing on more than 2,000 years of Christian social thought, we work to enrich and challenge public debate through research, events, and publications, for the common good.

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EXECUTIVE SUMMARY

First appearing in 1996, the payday loan industry has quickly become a significant source of consumer credit in Canada, providing approximately $2.5 billion in credit to an estimated 1.8 – 2.5 million borrowers each year. Although payday loans are widely used, there is much public disdain for them. With interest rates that can reach over 900 percent APR and regular news reports of borrowers hopelessly trapped in debt, it is understandable why people want to see the payday loan industry disappear.

There is, however, another side to the story. A payday loan can be a real lifesaver when the need for cash is urgent and credit from traditional sources is unavailable.

Consider, for example, a family whose hydro bill is in arrears and the utility company is threatening to disconnect their service. If the bill is $200, a payday loan in Ontario will cost the family $42. If their hydro was disconnected, it will cost $95 or more just to have the service reconnected. If they're unable to turn to family or friends, or to get credit elsewhere, a payday loan is not only their best option for credit, it actually makes economic sense.

The reality is that payday loans help some people, but the industry is far from perfect. The loans and the companies that provide them are structured and incentivized to keep customers dependent on their services. The lack of screening to ensure repayment, the short loan terms, the high interest rates, the repayment terms (users must pay back both the principle and the interest in one lump sum), and the lack of credit reporting all combine to keep borrowers coming back for more. This dependency acts as an economic deadweight on the borrower, their family, their community, and ultimately all of society.

So what should we do?

Simply doing away with payday loans will help some, but it will also hurt others. To truly improve the small dollar credit market, increased access to well-structured and more affordable small dollar credit (what this paper refers to as *enabling* small-dollar credit) is vital. Building an *enabling* small-dollar credit market will require action and collaboration from a variety of social actors: governments, banks, credit unions, and civil society.

We recommend that governments focus their efforts less on interest rate caps, and more on altering the payday structures which create dependency. The example of Colorado, which lengthened loan terms and made other targeted changes to repayment structures, allowed payday providers to continue to operate while significantly reducing the number of repeat borrowers.

Banks and credit unions can play a vital role in developing enabling alternatives to payday loans, but need support from governments and civil society to make it work. The economics of this market are not favourable and there is significant risk associated with these loans. Governments and community minded charitable foundations can support these projects with funding. Social impact bonds or funds for loan loss reserves can mitigate risk and shift the economics of this market to incentivize more innovation amongst mainstream institutions. Governments and community organizations can also support the development of these alternatives by utilizing their space and resources to promote mainstream products and reach consumers with enabling small dollar credit services.

There is no simple solution for Canada's payday loan problem, but cross-sector collaboration holds promise for building a better market for those in desperate need of credit who are banking on the margins.

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SECTION 1: INTRODUCTION

Payday lenders are widely hated. *Maclean's* magazine calls them an industry that "profits off the poor and bleed users dry."[1] A recent article in *The Walrus* likens payday-loan users to a "gerbil trapped on a wheel" and to users as "addicts."[2]

But they are also widely used. Payday-loan shops have popped up like mushrooms on high-traffic street corners in Canadian cities, and despite their bad reputation, they have become a ubiquitous institution across the country.

Their rapid growth, their heavy and increasingly brash advertising strategies,[3] and a recent rash of articles in national newspapers and magazines have contributed to a growing public debate over the ethics and value of the industry and the role they play in Canadian economic and social life.

Opponents of payday loans argue the industry exploits the poor, taking advantage of those in vulnerable circumstance with predatory-lending practices and usurious interest rates. Proponents believe payday loans are simply a market response to a real need, and that they provide illiquid consumers with quick and convenient cash for urgent expenses.

Most Canadian provinces have regulatory frameworks that attempt to protect consumers while still maintaining an active and legal payday-loan market.[4] Despite these efforts many still feel that more needs to be done. Currently a number of provincial and municipal governments are actively exploring legislation intended to help consumers. In short, the debate about payday loans is live, lively, and important.

The goal of this paper is to inform that debate by providing the best available evidence for policy makers and institutional leaders in the consumer credit landscape.

But as with many public debates, there is also a debate about which evidence should count in making policy or business decisions. The models by which we evaluate the role of payday lending in our society make, and give priority to, certain assumptions about individuals, society, and the roles and responsibilities of each. The public debate about payday lending is thus a debate not only about the evidence itself but also about the framework for interpreting that evidence—about deeper human and social questions regarding the purpose of money, markets, credit, and personal responsibility, and regarding the role of financial institutions, civil society, and the state in markets.

This paper seeks to bring insight into these conversations as well. Our goal is to introduce new considerations that get missed when the public debate focuses exclusively on the question of whether governments should, or should not, regulate. We argue that state regulation in this market is important but is not the sole, nor sufficient, response. We hope to move from focusing on whether payday loans are good or bad—which leaves unanswered whether they are optimal—to focusing on what good credit looks like. We suggest that efforts and interventions—by government, financial institutions, and civil society—should focus on transforming the structural issues within the current payday-loan system to improve outcomes for consumers. We argue that the debate needs to consider the immense value found in the utilization of the strengths and resources available in the existing institutional architecture of our communities. The hope is that this paper will encourage more conversation and work around the ways various institutions across sectors can play a role in building a better market for small-dollar credit.

1 Scott Gilmore, "The Other Scott Gilmore and the Cruelty of Payday Loans," *Maclean's*, 12 August 2015, http://www.macleans.ca/economy/money-economy/the-other-scott-gilmore-and-the-cruelty-of-payday-loans/.

2 Christopher Pollon, "Easy Money," *The Walrus*, June 2015, http://thewalrus.ca/easy-money/.

3 Kelly Bennett, "Money Mart Will Buy Your Gift Cards—for Half Their Value," *CBC Hamilton*, 4 December 2014, http://www.cbc.ca/news/canada/hamilton/news/money-mart-will-buy-your-gift-cards-for-half-their-value-1.2860704.

4 Seven provinces have establish regulation that allows payday lending. Quebec has passed legislation that effectively bans payday loans, Newfoundland has not passed any legislation as of 2015, and New Brunswick passed legislation in 2008, but it has yet to be proclaimed. See http://www.cpla-acps.ca/english/medialegislation.php for more information on government legislation across Canada.

SECTION 2: PAYDAY LENDING AND SMALL DOLLAR CREDIT MARKETS 101

2.1 What Is a Payday Loan?

A payday loan is a small, unsecured loan due on the borrower's next payday designed to provide relief for urgent, short-term cash needs. Under current federal law in Canada a payday loan cannot exceed a $1,500 value or a sixty-two-day term.[5] However, because loans are due on the borrowers' next payday, most loans fall within a two-week period. According to the Canadian Payday Loan Association the average payday loan in Canada is $300, with a ten-day term.[6] Other estimates, drawn from data collected by the provincial governments in British Columbia and Ontario, suggest that the average loan is around $450–460.[7]

The application process for a payday loan is much easier and faster than traditional sources of credit. To qualify for a payday loan a borrower must simply show that they have a regular source of income, have a bank account, be 18 years of age or older, and provide a postdated cheque or pre-authorized debit for the loan amount plus fees dated for the loan due date. First-time borrowers can be approved within thirty minutes of starting an application, and returning customers can be approved for cash even faster.

In the seven provinces that have an active and regulated payday-lending industry, the provincially regulated price of a payday loan ranges from a low of $17 per $100 borrowed in Manitoba to a high of $25 per $100 borrowed in Prince Edward Island. Although many lenders offer promotional offers to first-time borrowers, fees on payday loans do not typically fall below the regulated price ceiling. And, unlike most forms of credit, the cost of a payday loan does not change with the length of the term. With traditional credit, interest will accumulate over time, meaning the longer the term a borrower holds a loan the more money the borrower will pay. With a payday loan, the cost to the borrower is a set fee that does not change with the length of the loan term. This means that a borrower who takes a payday loan out with thirty days until their next payday will pay the same dollar amount in fees as the borrower who takes out the same loan but with only five days or fewer until their next payday.[8] On a thirty-day payday loan the effective annualize interest rate based on fees is 206 percent in Manitoba and 304 percent in Prince Edward Island. On a five-day loan the annualized rate is 1241 percent in Manitoba and 1825 percent in Prince Edward Island. On an average-term payday loan (ten days) rates range from 620.5 percent to 912.5 percent.

5 Andrew Kitching and Sheena Starky, "Bill C-26: An Act to Amend the Criminal Code (criminal Interest Rate)" (Parliament of Canada, 22 November 2006), http://www.lop.parl.gc.ca/About/Parliament/LegislativeSummaries/bills_ls.asp?ls=c26&Parl=39&Ses=1.

6 "What Is a Payday Loan and Who Uses It?," Canadian Payday Loan Association, http://www.cpla-acps.ca/english/mediabackgrounders1.php, accessed 2 September 2015.

7 "BC Aggregated Payday Loan Data—Reported for Licence Years Ended October 31" Consumer Protection BC, n.d., http://www.consumerprotectionbc.ca/images/pdl_2014aggregatedpaydayloandata.pdf; "Strengthening Ontario's Payday Loans Act: Payday Lending Panel Findings and Recommendations Report," May 2014, http://www.ontariocanada.com/registry/showAttachment.do?postingId=17182&attachmentId=26292, 1.

8 Though not prohibited under law, major payday lenders do not typically make loans with terms fewer than five days (7 for Money Mart).

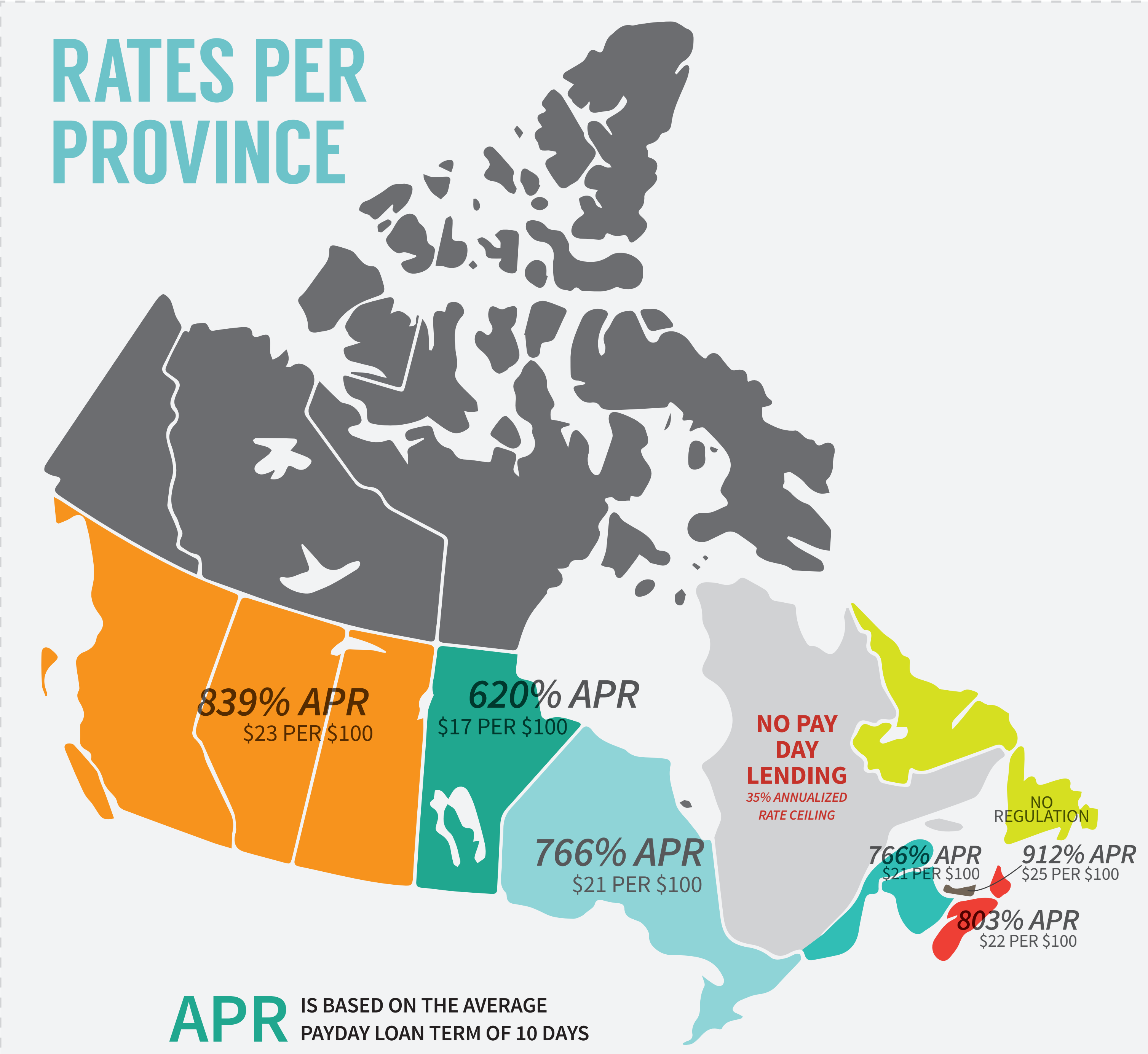
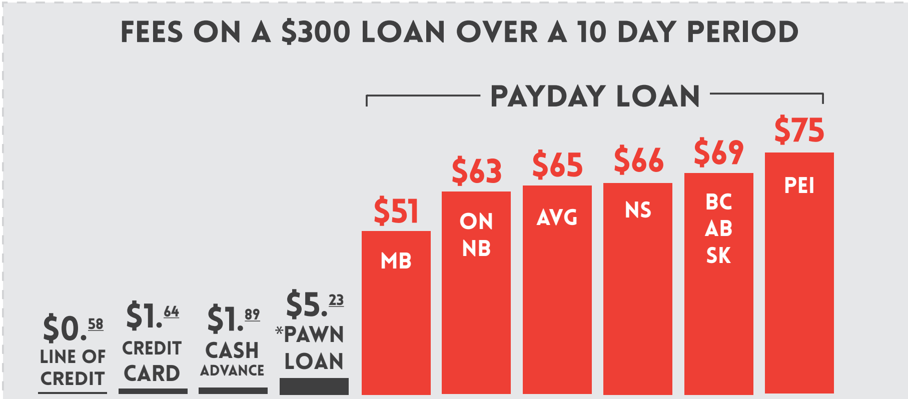


Fig. 1: Rates are based on provincially regulated rates.

* New Brunswick has passed legislation but it's not currently enforced. Money Mart currently offers payday loans in the province at $21.00 per $100.00 loan



*Pawn Loan price based on Ontario regulations

Fig 2.: Pawn loan cost based on regulated price in Ontario (https://www.ontario.ca/laws/statute/90p06). Prices in other jurisdictions have been known to reach much higher levels (see Jerry Buckland and Thibault Martin, "Two-Tier Banking: The Rise of Fringe Banks in Winnipeg's Inner City," *Canadian Journal of Urban Research* 14, no. 1 (Summer 2005): 158–81, here 164–65.

Although payday-loan fees are significantly higher than other commercial-credit options (see Fig. 2 for price comparison), payday lenders provide short-term value to consumers by providing quick and convenient access to cash with very low barriers to approval. In the landscape of consumer-credit products, payday loans satisfy demand for a niche market of consumers who either do not have access to or, for various reasons choose not to use other forms of readily available credit. Figure 3 provides a high-level overview of the consumer-credit landscape and the various competitive offerings of each product.

2.2 Comparing Consumer Credit Sources

	NATURAL COMMUNITY*	LINE OF CREDIT	CREDIT CARD	CASH ADVANCE	PAWN LOAN	PAYDAY LOAN	LOAN SHARK*
COST (BASED ON APR)	Very Low to Nil	Very Low	Low	Low	High to Very High	Very High	Very High
SIZE	Small to Large (Fixed)	Small to Large (Revolving)	Small to Moderate (Revolving)	Small (Revolving)	Small to Large (Fixed)	Small (fixed)	Small to Large (Fixed)
TERM	Short to Long	Short to Long	Short to Moderate	Short to Moderate	Short to Moderate	Short	Short to Long
COLLATERAL	None	Home or Guarantor	None	None	Physical Asset	None	Fear of Coercion
BARRIERS	Low to High: Social Capital	Very High: Assets, wealth	High: Credit Score	High: Credit Score	Low: Assets	Very Low: Regular Income, Bank Account	Very Low: None

Fig 3. *"Natural Community" refers to informal loans from friends, family, or community groups (either ethnic or religious, or both) that borrowers have ties to. Examples of the latter include, for instance, the Jewish Assistance Fund (http://www.jewishassistancefund.org/) or benevolence funds offered by churches. *"Loan Shark" refers to illegal lenders that operate outside any regulatory framework, often with ties to organized crime.

For consumers who do not have a credit card, cannot qualify for a line of credit, do not want to put up a personal item for a pawn loan, have limited capacity in their social network or do not feel comfortable asking friends or family for a loan a payday loan is often their best option when money is tight.

2.3 A Brief History of Payday Lending

The modern-day payday lender is a relatively recent development in the consumer-credit market. But small-dollar unsecured loans offered by commercial lenders stretch back to pre-confederation and, if we are to judge by Jewish, Christian, and Islamic scriptures, concern over high-interest lending stretches back to ancient times. The following section provides a glimpse into the recent history of high-interest small-dollar lending in North America.

Commercial unsecured small-sum loans first emerged with the growth of industry and urbanization in the nineteenth century.[9] The increasing population and concentration of steady wage earners in urban centers made cities a lucrative marketplace for small-dollar lending. The disruption of community ties that coincided with migration to urban areas also contributed to the growth of the practice. As the traditional source for small loans—family and friends—became less reliable, demand for commercial small-sum loans increased.[10] In the United States, even where small-sum lending was illegal under state usury laws, the practice was widespread by 1875.[11] One early American investigator noted that in 1911, there was at least one high-interest small-dollar lender per five to ten thousand people in cities with a population over thirty thousand.[12] The prevalence of small-dollar loan establishments in Canadian cities during this time is not as well documented. But considering these lenders had a significant presence in both the United States and Britain, and the close ties of the Canadian economy to both US and British markets, it's likely that the practice was common in Canadian cities as well.[13]

The small lending operations active during this time were very similar in structure to modern-day payday loans. Salary lenders provided loans ranging from $5 to $50 with interest rates ranging from 10 to 40 percent a month and relied on wage assignments as security. Typically, these loans were payable within a week, two weeks, or a month.[14] Like modern payday-loan operations, these salary lenders relied on high rates and volume to distribute risk and ensure profitability.[15]

The first credit unions in Canada at the turn of the twentieth century emerged, in large part, from a desire to protect this demographic from such high-interest lenders.

A clear divide between the credit available to the wealthy and the working poor, similar to that of today, developed as commercial lending emerged in the mid- to late nineteenth century. Lendol Calder notes that "businessmen could call on bankers for their business and personal needs, while blue-collar and lower-level white-collar workers were forced to borrow money from shadowy lenders, at high rates, under illegal conditions."[16] Indeed, the first credit unions in Canada at the turn of the twentieth century emerged, in large part, from a desire to protect this demographic from such high-interest lenders.[17]

In the early twentieth century, social agencies and governments began to recognize high-interest short-term lending as a problem, one that was hindering the economic well-being of many working-class families. In the United States the Russell Sage Foundation became a leading advocate in the fight to relieve borrowers from the burden of high-interest loans. The foundation supported and promoted philanthropic loan associations, but also recognized the need for regulation that allowed

9 Lendol Calder, *Financing the American Dream: A Cultural History of Consumer Credit* (Princeton: Princeton University Press, 1999), 55.
10 Ibid., 37–73.
11 Ibid., 112.
12 Rolf Nugent, "The Loan-Shark Problem," *Law and Contemporary Problems* 8, no. 1 (Winter 1941): 3–13.
13 Robert Mayer, "Loan Sharks, Interest-Rate Caps, and Deregulation," *Washington and Lee Law Review* 69, no. 2 (March 2012): 818–19.
14 Nugent, "The Loan-Shark Problem," 5.
15 Ibid.
16 Calder, *Financing the American Dream*, 124.
17 "Historical Context," *Desjardins*, https://www.desjardins.com/en/a_propos/profil/histoire/caisse/fondation.jsp, accessed 8 December 2015.

legitimate lenders to operate in the small-dollar-loan space to scale impact. This belief led the foundation to promote the adoption of the Uniform Small Loan Law (USLL), which the foundation helped develop.[18] By the 1950s three-quarters of state legislators had laws modelled after the USLL.[19] The Uniform Small Loan Laws raised the usury ceiling on small loans to a maximum charge of 3.5 percent per month and provided a regulatory framework that enabled legitimate lenders to provide small-installment loans to consumers.[20] States that established these laws saw a sharp decrease in the illegal money-lender business, so much so that by mid-century, observers believed they had been virtually eliminated in states where the law existed.[21]

The USLL approach to small-dollar-lending regulation differed from the completely deregulated approach tested in Great Britain and, as part of the British Empire at that time, Canada. In 1854 Great Britain repealed its usury statute, and the province of Canada followed suit, passing an Act in 1858 allowing rates to be set solely by mutual agreement between parties.[22] Legislators hoped a market free of regulation would allow for legitimate lenders to offer small-dollar loans at reasonable rates and push loan sharks out of the market. Unfortunately the market did not respond as they had hoped. High-interest lending and predatory practices continued in Great Britain, and borrowers continued to suffer.[23] In 1906 Canadian parliament passed the Money-Lenders Act, which attempted to impose an interest-rate ceiling on small loans. The act was ineffective because it lacked a clear definition of what constituted interest and no authority was designated to enforce the limit.[24] It wasn't until the Small Loans Act, modelled after the American Uniform Small Loan Laws, was passed in 1939 that an effective ceiling on interest rates was reintroduced into Canadian law.[25] Like its American counterpart the Canadian law appears to have been successful in supporting a fair and affordable industry of small-loan companies and money lenders. The law came into effect in 1940, and lenders abided by the new legislation without serious difficulty, laws were enforced, and many felt the law brought order to the industry.[26]

> *A significant portion of the population was not being effectively served by the existing small-sum loan market.*

Like today's modern-day payday lenders these small-loan lenders were, as a 1967 parliamentary committee report put it, "practically the sole source for desperate borrowers"; and, "Many customers of small loan companies and money-lenders are people who are unable to obtain credit elsewhere."[27] Yet there are key differences between these loan operations and today's payday loans. In 1967, 50 percent of applicants were rejected, and the average loan was for $570, equivalent to almost $4,000 in 2016 terms—a significant difference from today's average loan size and acceptance.[28]

Despite the apparent success of small-loan laws effectively eliminating predatory high-interest lending in both the United States and Canada, a significant portion of the population was not being effectively served by the existing small-sum loan market. A key concern highlighted by the federal committee's 1967 report on consumer credit was "the plight of low-income families who are from time to time

18 Calder, *Financing the American Dream*, 124–35.
19 Mayer, "Loan Sharks, Interest-Rate Caps, and Deregulation," 822.
20 Ibid., 823.
21 Ibid., 819–20.
22 Ibid., 819; David A. Croll and Ron Basford, "Report on Consumer Credit of the Special Joint Committee of the Senate and the House of Commons on Consumer Credit and Cost of Living," February 1967, 30.
23 Mayer, "Loan Sharks, Interest-Rate Caps, and Deregulation," 819.
24 Croll and Basford, "Report on Consumer Credit," 30–31.
25 Ibid.
26 Ibid., 55.
27 Ibid., 59.
28 Ibid., 56–59.

in desperate need of credit for necessary goods or services but to whom commercial credit is either not readily available or not available at all."[29] The report went on to recommend that the federal government make available guaranteed low-interest consumer loans for low-income families to address the lack of current commercial credit for those families.[30] This recommendation was never attempted by government and appears to have died.

It was this unfulfilled demand for credit that set the stage for the emergence of the modern payday-loan institution. As consumer credit became more readily available with the growing acceptance and use of credit cards, the indebtedness of households rose steadily. Household debt increased substantially in Canada from the 1960s onward, and after a brief decline in the early 1980s consumer credit as a percentage of disposable income rose steadily as well.[31] At the same time savings as a percentage of disposable income was in decline, leading to an increasing risk of household illiquidity.[32] This, along with increasing penalties for overdrafts and bounced cheques, increased the demand for small-dollar credit.[33] Starting in the 1960s, mainstream banks began shifting their focus to the growing and generally wealthier suburban population. Over the next number of decades mainstream bank presence in the inner city declined, leading to the emergence and growth of the cheque-cashing industry.[34] Starting in the US market in the 1980s, cheque-cashing stores began offering illiquid customers advances on their next paycheque. With the proliferation of chequing accounts among the low- to moderate-income earners, the cheque cashers were able to secure these advances on postdated cheques due on the borrowers' next payday.[35] This practice grew rapidly throughout the United States in the 1990s when it eventually made its way into the Canadian market.

It was this unfullfilled demand for credit that set the stage for the emergence of the modern pay day loan institution.

The modern-day payday-loan institution first appeared in Canada in 1996, when an American company, Dollar Financial Corporation, bought the Edmonton-based cheque-cashing chain Money Mart and began offering payday loans through its network of stores.[36] The industry grew rapidly across the country over the next ten years. From 1999 to 2005 the number of payday-loan outlets in Toronto, Vancouver, and Winnipeg grew by 149 percent.[37]

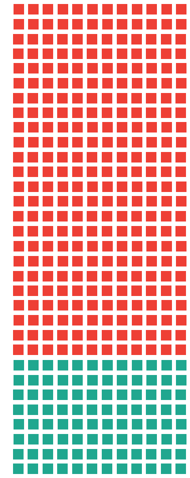
During this period the Canadian payday-loan industry was left essentially unregulated. Despite section 347 of the federal criminal code, prohibiting interest charges in excess of 60 percent per annum, lenders routinely operated well outside those bounds and no government action was taken against them.[38]

29 Ibid., 3.
30 Ibid.
31 Philip Cross, "A Longer-Term Perspective on Canada's Household Debt," Fraser Institute, 20 May 2015, https://www.fraserinstitute.org/research/longer-term-perspective-canada%E2%80%99s-household-debt; James MacGee, "The Rise in Consumer Credit and Bankruptcy: Cause for Concern?," C.D. Howe Institute, 4 April 2012, https://www.cdhowe.org/public-policy-research/rise-consumer-credit-and-bankruptcy-cause-concern.
32 Iain Ramsay, "Access to Credit in the Alternative Consumer Credit Market," report, dataset, Office of Consumer Affairs, Industry Canada, 1 February 2000, 2, http://www.ic.gc.ca/app/oca/crd/dcmnt.do?id=501&lang=eng.
33 Mayer, "Loan Sharks, Interest-Rate Caps, and Deregulation," 837.
34 Marilyn Brennan, "The Impact of Two-Tiered Banking: How Credit Unions Can Bridge The Divide," Filene Research Institute, 15 October 2014, 8, https://filene.org/research/report/the-impact-of-two-tiered-banking-how-credit-unions-can-bridge-the-divide.
35 Mayer, "Loan Sharks, Interest-Rate Caps, and Deregulation," 835–36.
36 Olena Kobzar, "Networking on the Margins: The Regulation of Payday Lending in Canada," University of Toronto, 2012, 60, https://tspace.library.utoronto.ca/bitstream/1807/34771/1/Kobzar_Olena_201211_PhD_Thesis.pdf.
37 Pollon, "Easy Money," 35.
38 Kitching and Starky, "Bill C-26."

From 1999-2005 the amount of payday loan stores grew by

149%

IN TORONTO, VANCOUVER AND WINNIPEG



In 2006 the federal government passed bill C-26, which exempted payday loans from the federal usury law in the criminal code and shifted regulatory responsibility to the provinces. The bill was developed and passed out of a belief that payday loans are an important part of the consumer credit landscape. A series of lawsuits against the payday-loan industry, as a result of federal usury regulations, risked bankrupting the industry, and there was fear that the lack of a payday-loan-company alternative would result in consumers using illegal loan sharks.[39] The passage of bill C-26 marks a step away from a consensus in Western law where usury was considered a matter of sufficient moral gravity to criminalize it. As with, for instance, prostitution, the move has been from a moral consensus whereby particular views on the propriety of a relationship are enforced by criminal law to a new moral consensus whereby autonomous rational agents act in their self-interest guided by regulation. Since 2006, nine out of the ten provinces have passed legislation regulating payday loans. Newfoundland has yet to table any legislation, New Brunswick's legislation is not yet enforced, and Quebec is the only province to have effectively banned the practice. The remaining provinces have passed legislation that seeks to both protect consumers and maintain an active and legal market for payday loans.

Today, an estimated 1.8–2.5 million households rely on payday loans each year for approximately $2.5 billion dollars in credit.[40] With an estimated 1,500 retail outlets across the country, there are more payday-loan outlets than the locations of the top 100 credit unions in Canada combined.[41]

39 Ibid.

40 "Application Record," 13 April 2014, 61, http://cfcanada.fticonsulting.com/cashstorefinancial/docs/Application%20Record.pdf.

41 Estimate based on reported licensed locations in BC (274), Ontario (796), SK (49) and AB (240) plus an estimated 150 locations in MB, NS, NB, and PEI based on Yellow Pages listings. As of Q4 2014 the largest 100 credit unions, excluding Quebec, had 1,373 locations: http://www.cu-central.ca/SitePages/Publications/FactsAndFigures.aspx.

A HISTORY OF INTEREST RATE REGULATION IN CANADA

	APR	
1777	6%	Legislation passes concerning "interest, usury and money-lending" establishing a maximum interest rate of 6% per annum for all contracts
1811	6%	New Act passes in Upper Canada maintaining 6% maximum
1853	6%	New Act passes which maintains the 6% ceiling, but reduces penalties for infraction
1858	No Limit	New Act passes permitting parties to agree to any rate, with the 6% ceiling retained if no rate is stipulated
1867	No Limit	The British North America Act specifically allocates the subject of interest to the Dominion of Canada
1886	No Limit	"An Act Respecting Interest" passes permitting any rate agreed upon
1906	12%	The Money-Lenders Act passes. The act establishes a 12% ceiling on all loans of $500 or less; however, it is not effectively enforced.
1939	24%	The Small Loans Act passes. Lenders that wish to charge more than 1% a month on loans less than $500 must be licensed. Licensed lenders are permitted to charge a maximum rate of 2% per month.
1956	24%	Parliament amends The Small Loans Act. The maximum loan size the act applies to increases to $1,500 and the 2% rate ceiling is substituted for a graded ceiling. The amendment limits interest to 2% per month on the first $300, 1% on the next $700 and 0.5% on the next $500.
1980	60%	Parliament repeals the Small Loans Act and amends the Criminal Code making it a criminal offence to charge interest in excess of 60% per annum
2006	60%	Bill C-26 exempts provincial licensed lenders providing loans of $1,500 or less for a maximum term of 62 days from the 60% interest rate ceiling
2009	839.5%	British Columbia establishes a 23% rate ceiling on payday loans, an effective annualize percentage rate of 839.5% on a 10 day loan
2009	766.5%	Ontario sets maximum payday loan fees at $21 per $100 borrowed, an effective annual percentage rate of 766.5% on a 10 day loan
2009	1131.5%	Nova scotia sets maximum payday loan fees at $31 per $100 borrowed, an effective annual percentage rate of 1131.5% on a 10 day loan
2010	839.5%	Alberta establishes a 23% rate ceiling on payday loans, an effective annual percentage rate of 839.5% on a 10 day loan
2010	620.5%	Manitoba establishes a 17% rate ceiling on payday loans, an effective annualize interest rate of 620.5% on a 10 day loan
2011	912.5%	Nova Scotia reduces the maximum allowed fee on payday loans to $25 per 100 borrowed, an effective annualize percentage rate of 912.5% on a 10 day loan
2012	839.5%	Saskatchewan establishes a 23% rate ceiling on payday loans, an effective annualized interest rate of 839.5% on a 10 day loan
2013	912.5%	Prince Edward Island sets maximum payday loan fees at $25 per $100 borrowed, an effective annual percentage rate of 912.5% on a 10 day loan
2015	803%	Nova Scotia reduces the maximum allowed fee on payday loans to $22 per $100 borrowed, an effective annual percentage rate of 803% on a 10 day loan

SECTION 3: BEHIND THE DEMAND FOR PAYDAY LOANS

3.1 Payday-Loan User Profile—Introducing ALICE

Meet Alice. Alice is twenty-four years old, a single mother, and works multiple low-paying jobs in the service sector. Alice typically makes around $35,000 a year, but her month-to-month income fluctuates depending on how many hours she gets at work. Alice does try to follow a strict budget and works hard to save money, but with volatile income and a young child to take care of, Alice often finds herself with less than $500 in the bank by the end of each month. Alice does not have a credit card. Due to some poor decisions she made when she was younger, her credit rating is not strong. The only credit cards she can qualify for come with significant annual fees, so she doesn't bother with them. Alice does not have any significant assets under ownership; she dreams of owning a home, but doesn't know how she'll ever afford it. Currently she rents a small two-bedroom apartment that works well for her and her son.

A couple months ago Alice's hours at one of her jobs were reduced unexpectedly and she has had trouble keeping up with her bills. She has no savings and is behind on her rent. In addition, she recently received a notice from her utilities provider telling her that her electricity will be shut off if she does not pay off her arrears in full within the next ten days. Alice contemplates asking her mom or one of her close friends for a small loan, but knows they don't have a lot of money to spare either and doesn't want to go through the embarrassment of asking them. With an urgent need for cash and no other options, Alice walks over to the payday lender down the street and walks out with a $400 loan within thirty minutes. With the $400 and the money left in her account Alice is able to cover her rent and pay off her utility bills without issue. Alice realizes the fees on the loan are relatively high, but the $84 worth of fees on her loan were much less than the hundreds of dollars in fees she may have had to pay if her utilities were disconnected.

A ASSET
L LIMITED
I INCOME
C CONSTRAINED
E EMPLOYED

Alice is not just a figment of our imagination. ALICE is an acronym used by DFC Global Corporation (DFC), one of the globe's largest payday-loan providers and the owner of Canada's largest payday-loan brand, Money Mart, to describe its target customer. "ALICE" stands for "asset-limited, income-constrained, employed."[42] According to DFC,

> Consumers who use these services are often underserved by banks and other financial institutions. . . . They may not be able to, or even desire, to obtain loans from banks as a result of their immediate need for cash, the irregular receipt of payments from their employers, a lack of tangible collateral or the unavailability of bank loans in small denominations for relatively short periods of time.[43]

42 "Form 10-K," DFC Global Corp., 30 June 2013, 5, https://www.sec.gov/edgar.shtml.
43 Ibid.

Contrary to what some in the public assume, most payday-loan users, as the acronym ALICE suggests, are employed. According to a 2005 national survey of payday-loan users in Canada, 68 percent are employed full time, 8 percent are employed part time, and 2 percent are self-employed.[44] More recent data from a survey of users in the province of Manitoba reports that 65 percent of borrowers work full time or are self-employed and 10 percent work part time.[45]

*Many users are income constrained. But payday loan use is **not** limited to the **poor.***

Many users are, however, income constrained. According to the 2005 survey of borrower across Canada, 49 percent had household income of less than $35,000.[46] And, as of 2014, self-reported rates of payday-loan use are highest among the bottom quintile of income earners.[47] But payday-loan use is not limited to the poor. Self-reported rates of use in the middle-income quintile of income earners in Canada is close to the rate of low-income earners.[48] And it is the top two quintiles of earners that experienced the highest rate of growth in payday-loan used between 2008 and 2014.[49] According to the 2005 national survey of users, 19 percent of borrowers had household income between $35,000 and $50,000, 16 percent between $50,000 and $75,000, and 9 percent had income over $75,000.

3.2 Demographic Data of Canadian Payday-Loan Users

Data from Statistics Canada helps to paint a more detailed picture of the typical Canadian payday-loan borrower. The 2005 Survey of Financial Security affirms the asset-limited nature of payday-loan borrowers: 80 percent fall into the bottom 40 percent of net-worth distribution, with 50 percent falling into the lowest 20 percent. Seventy percent of payday-loan borrowers surveyed do not own a home, and renters are three times more likely to have used a payday loan than homeowners.[50]

The data from Statistics Canada also finds household income to be a predictor of payday-loan use. Low-income families are twice as likely to have used a payday loan.[51] However, income actually drops out as a predictor of use once savings is included in the model.

The data suggests that a lack of savings, rather than a low level of income, is the greater impetus for payday-loan use, though the two are certainly related. Households with less than $500 in the bank were 2.6 times more likely to have used a payday loan than those with over $2,000, suggesting that payday loans act as a substitute for savings.[52]

Not having a credit card was another significant predictor. Those who had been refused a credit card were 3.6 times more likely to have used a payday loan even after controlling for other factors such as income and savings, suggesting their role as a substitute for the less expensive credit, or cash advance offered by credit cards.[53] There is evidence, however, that having a credit card does not negate payday-loan use.

44 "Understanding Consumers of Canada's Payday Loans Industry," Environics Research Group, 9 June 2005.
45 "Payday Loan Users Study Manitoba," Environics Research Group, n.d., http://www.cpla-acps.ca/english/reports/CPLA%202013%20e%20Users%20MAN.PDF.
46 "Understanding Consumers of Canada's Payday Loans Industry."
47 Elizabeth Mulholland, "Health Check: Low-Income Household Finances in Canada," 2 November 2015, http://prospercanada.org/prospercanada/media/PDF/ABLE%202015%20Presentations/Plenary_Day1/Plenary_Health-Check-Liz-Mulholland.pdf.
48 Ibid.
49 Ibid.
50 Wendy Pyper, "Payday Loans," Statistics Canada, April 2007, 9, http://www.statcan.gc.ca/pub/75-001-x/10407/9617-eng.pdf.
51 Ibid., 7.
52 Ibid., 8.
53 Ibid.

WHAT YOU NEED TO KNOW ABOUT PAY DAY LOAN USERS

49% have a household income of less than **$35,000**

68% have less than **$50,000**

HOUSEHOLDS WITH A MAJOR EARNER BETWEEN THE AGES **15 TO 24** are **SIX TIMES** more likely to have used a payday loan than those with an income earner over **45**

50% ARE IN THE BOTTOM **20%** OF NET-WORTH DISTRIBUTION IN CANADA

80% ARE IN THE BOTTOM **40%**

THOSE WHO HAVE BEEN REFUSED A CREDIT CARD CARD ARE **3.6** TIMES MORE LIKELY

DENIED

Those with less than **$500** IN THE BANK were **2.6** times more likely TO HAVE USED A PAYDAY LOAN THAN THOSE WITH $2,000 IN THE BANK

According to the Statistics Canada survey, almost 60 percent of those who used a payday loan also had a credit card.[54] More recent provincial surveys by Environics put the rate at around 50 percent.[55] Why would an individual with a credit card use a payday loan? It is possible that some customers have maxed out their available credit and are turning to payday loans as a lender of last resort. A US-based survey found that almost 60 percent of payday loan users with a credit card had maxed it out at some point within the last year.[56] Another possibility is that some customers misunderstand the costs associated with a credit card versus a payday loan. In a 2012 survey of small-dollar credit consumers in the United States (included payday loans and other high-interest small loans), 16 percent of users indicated that they felt a credit card was too expensive.[57] In 2001, the Public Interest Advocacy Centre (PIAC) commissioned a survey of approximately two hundred Canadian households who had used "alternative financial services" in the past three years. Of the fifty-seven household that indicated they had used a payday loan, 37 percent did not know the cost of the loan, 35 percent underestimated the cost, 14 percent overestimated, and only 14 percent knew the correct cost (though the report indicates that the varying fee structure of payday loans at that time means the categorization of individuals understanding may not be completely accurate).[58] However, the PIAC data was collected prior to the establishment of provincial payday lending regulation. Today the payday-loan laws require lenders to clearly disclose the cost of the loan to the consumer, thus lessening concerns about consumers being intentionally "duped." In Ontario, for instance, each lender is required to give every borrower a flyer that clearly compares the cost of a payday loan with the cost for the same type of loan from a typical credit card.

Research suggests that payday-loan use can lead to increased difficulty paying bills.

Additional predictors of payday-loan use include status of bill payments and age. When controlling for other characteristics, households that were behind on payments were 4.3 times more likely to have used a payday loan than those who were up to date.[59] While the causal relationship is not clear, demand for credit will inevitably be higher in households that are behind on bill payments, and US-based research has suggested that payday-loan use can lead to increased difficulty paying bills.[60]

Finally, according to the Statistics Canada data, the age of a household's major income recipient (the person in the family with the highest income before tax) is also a significant predictor of payday-loan use. Households with a major income recipient between the age of fifteen and twenty-four are six times more likely to have used a payday loan than those with an income recipient over the age of forty-five, even when controlling for other characteristics such as income and bank balances.[61] Although not conclusive, this is suggestive of poorer financial management and decision making on the part of younger, less-experienced, and more naïve households. Younger households are also generally less asset rich and have less established credit histories, which can limit their access to other forms of credit.

54 Ibid.

55 "Payday Loan Users Study Manitoba"; "Payday Loan Users Study British Columbia," Environics Research Group, 15 April 2013, http://www.cpla-acps.ca/english/reports/CPLA%202013%20e%20Users%20BC.PDF; "Payday Loan Users Study Ontario," Environics Research Group, 15 April 2013, http://www.cpla-acps.ca/english/reports/CPLA%202013%20e%20Users%20ON.PDF; "Payday Loan Users Study Alberta," Environics Research Group, 15 April 2013, http://www.cpla-acps.ca/english/reports/CPLA%202012%20e%20Users%20AB.PDF.

56 "How Borrowers Choose and Repay Payday Loans," Payday Lending in America, Pew Charitable Trusts, 20 February 2013, 31, http://www.pewtrusts.org/en/research-and-analysis/reports/2013/02/19/how-borrowers-choose-and-repay-payday-loans.

57 Rob Levy and Joshua Sledge, "A Complex Portrait: An Examination of Small-Dollar Credit Consumers," Center for Financial Services Innovation, August 2012, 16, http://www.cfsinnovation.com/Document-Library/A-Complex-Portrait-An-Examination-of-Small-Dollar.aspx.

58 Sue Lott and Michael Grant, "Fringe Lending and 'Alternative' Banking: The Consumer Experience," report, dataset, Public Interest Advocacy Centre, November 2002, 44, http://www.ic.gc.ca/app/oca/crd/dcmnt.do?id=1643&lang=eng.

59 Pyper, "Payday Loans," 8.

60 Brian T. Melzer, "The Real Costs of Credit Access: Evidence from the Payday Lending Market*," *Quarterly Journal of Economics* 126, no. 1 (1 February 2011): 517–55, doi:10.1093/qje/qjq009.

61 Pyper, "Payday Loans," 8.

Not surprisingly the data reveals that those who are most likely to use payday loans are young families with few assets, limited savings, and constrained in their options for credit. Although many of these households would not be considered to be living in poverty, most find themselves financially vulnerable and struggling to make ends meet. A payday loan can seem like a lifesaver to them in a time of need, but it can also be a gateway to economic trouble. Vulnerable households that are unable to pay off and stave off the debt can easily find themselves trapped in a crippling cycle that leads them further down the economic ladder.

A payday loan can seem like a lifesaver to them in a time of need, but it can also be a gateway to economic trouble.

3.3 What Are Payday Loans Being Used For?

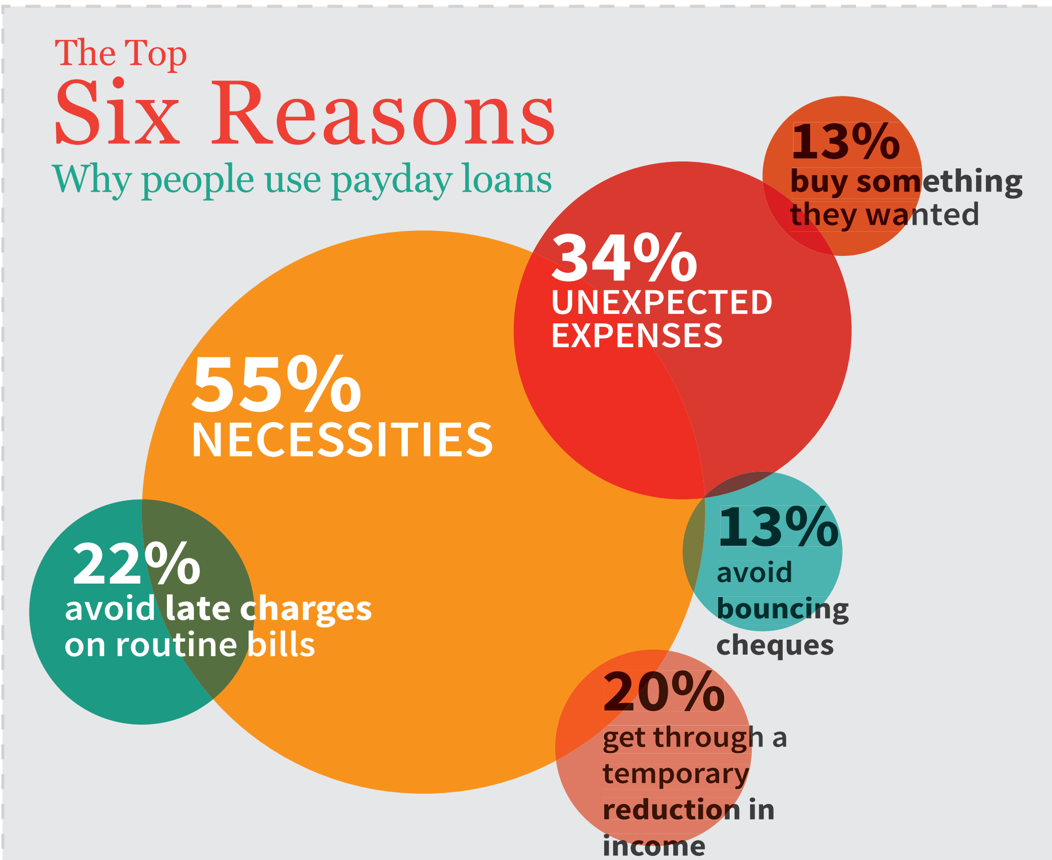


Fig. 4 Data Sourced: "Payday Loan Users Study British Columbia"; "Payday Loan Users Study Manitoba"; "Payday Loan Users Study Ontario"; "Payday Loan Users Study Alberta."

In a 2013 survey commissioned by the Canadian Payday Loan Association, Environics surveyed payday-loan users in Ontario, British Columbia, Alberta, and Manitoba on their reasons for taking out a payday loan. According to the surveys, which allowed subjects to select multiple answers, 55 percent of payday-loan users used a payday loan for "emergency cash" for necessities, 34 percent used one to cover an unexpected expense, 22 percent to avoid late charges on bills, and 13 percent to avoid bouncing a cheque (see fig. 4).

US data on the specific uses for payday loans falls in line with the broader categories covered in the Canadian data above. The Center for Financial Services Innovation (CFSI) surveyed very short-term product users (payday, pawn, and direct-deposit advance loans) and asked them, "What did you use the money for in this specific instance?" and "Why did you need to borrow money for this loan?" with respondents allowed to select up to three responses for each question. The top five uses for payday, pawn, and deposit advance loans were "to pay utility bills" (~42 percent), "for my general living expenses (e.g., food, clothing)" (~41 percent), "to pay rent" (~22 percent), "car-related (purchase or repair)" (~11 percent), and "to help out friend/family" (~7 percent).[62] The main reasons borrowers needed money were "I had a bill payment due before my paycheck arrived" (~38 percent), "My general living expenses are consistently more than my income" (~34 percent), "I had an unexpected expense (e.g., medical emergency, car broke down)" (~30 percent), "I had an unexpected drop in my income (e.g. lost job, hours cut, benefits cuts)" (~28 percent), and "I spent most of my money that month paying off a previous loan" (~10 percent).[63]

Many critics of consumer credit argue that too many households use credit to maintain a lifestyle that is unnecessarily beyond what they can afford, spending money they don't have on luxury goods and services such as big-screen TVs and lavish vacations. While this may be true for other forms of credit, it appears that payday loans are used for urgent needs that are necessary and costly to do without. Necessities such as food and medication are incredibly important to the health and productivity of a household, and costs associated with late bills can be quite high, especially if it involves bounced cheques or having utilities disconnected. (See section 6.1 for more detail on these costs.)

Of course this does not mean that payday-loan use is always a rational decision and/or the best solution for the borrower's needs. It is concerning that over 30 percent of payday, pawn, and deposit-advance loan users in the CFSI survey indicated that living expenses are consistently more than their income. Although a payday loan can still be a rational short-term solution for this demographic when a need is urgent and the consequences of nonpayment costly, expensive short-term credit is likely to exacerbate the household's inability to cover expenses in the future. Which, in turn, is likely to increase the household's dependency on credit. The correlation between repeat borrowing and the "why" driving the need for the loan supports this conclusion. CFSI reports that 41 percent of consumers with expenses regularly exceeding income took out six or more loans per year compared to only 23 percent of those whose small-dollar credit use was driven by unexpected expenses.[64] Credit cannot be a long-term solution for consumers whose expenses consistently exceed income. We must find ways to help this demographic of users live within their financial means and increase their monthly income.

There is also a segment of consumers that uses expensive payday loans for discretionary spending. According the Canadian data collected by Environics, 13 percent of payday-loan borrowers used a payday loan "to buy something I wanted," and according to a 2007 US survey 25 percent of payday-loan users agreed strongly that they "could have postponed the expense until the next payday but did not want to wait."[65] The majority of users that fall into these categories would likely benefit from reduced access to payday loans.

Even for the majority of borrowers who do have an urgent need for cash, there are a variety of other more affordable credit options in the Canadian marketplace, and yet many turn to a payday loan instead.

62 Levy and Sledge, "A Complex Portrait," 11.
63 Ibid., 12.
64 Rob Levy and Nick Bianchi, "Know Your Borrower—The Four Need Cases of Small-Dollar Credit Consumers," Center for Financial Services Innovation, 24 December 2013, 12, http://www.cfsinnovation.com/Document-Library/Know-Your-Borrower-The-Four-Need-Cases-of-Smal-(1).aspx.
65 "Payday Loan Users Study British Columbia"; "Payday Loan Users Study Manitoba"; "Payday Loan Users Study Ontario"; "Payday Loan Users Study Alberta"; Gregory Elliehausen, "An Analysis of Consumers' Use of Payday Loans," George Washington University School of Business, January 2009, 35, http://www.cfsaa.com/portals/0/RelatedContent/Attachments/GWUAnalysis_01-2009.pdf.

3.4 Why Do Users Choose to Use Payday Loans over Other Forms?

Why do households choose a payday loan over the other formal and informal forms of credit available on the market? Evidence suggests a variety of reasons. An important, and often unappreciated, reason is that a payday loan is often the fastest and most accessible option when there is an urgent need for cash.

SPEED AND CONVENIENCE

"Quick and easy process" was indicated as the main reason for using a payday loan by 54 percent of Canadian users surveyed by Environics, topping the list of reasons by a significant margin.[66] In a survey conducted by CFSI in the United States, "How quickly I can get the money" was at the top of the list of most important attributes driving the decision to choose a payday loan.[67] The speed of a transaction was also emphasized as a major factor in the decision to use fringe financial services among eighty-three users who participated in a survey conducted in Toronto, Vancouver, and Winnipeg. Jerry Buckland writes that "despite never being asked directly about it, one of the most common mentioned benefits of fringe financial services was the short time needed for completing transactions."[68] Households that are facing an immediate need for cash don't have time to go through an application process that can take hours to complete only to wait a few days or even weeks to find out whether they have been approved. With a payday loan, borrowers know that they are likely to be approved and that the process can take fewer than thirty minutes.

Accessibility also matters. The location, extended operating hours, and high saturation of payday-loan retail locations in urban areas make them a more convenient option than alternatives for some consumers, especially those in the inner city. In the survey of payday-loan users in Toronto, Vancouver, and Winnipeg, 86.4 percent of respondents indicated that the location of fringe financial institutions were "convenient" or "very convenient," while only 61.4 percent felt that way about mainstream financial institutions. The difference was even more pronounced when users were asked about the convenience of operating hours. 84.1 percent of respondents felt fringe bank hours were convenient, while only 39.7 percent felt that way about mainstream banks. Although these factors add to the convenience value offered to consumers, Buckland notes that they are not as important as the speed and ease of the process.[69] According to the survey conducted by Environics, only 12 percent of users indicated "convenience of location" as the main reason for using a payday loan.[70] Outside the inner city, payday-loan stores are often located near mainstream financial institutions, a sign that location is not necessarily a main driver of use, but rather product differentiation.[71]

66 "Payday Loan Users Study British Columbia"; "Payday Loan Users Study Manitoba"; "Payday Loan Users Study Ontario"; "Payday Loan Users Study Alberta."

67 Levy and Sledge, "A Complex Portrait," 15.

68 Jerry Buckland and Antonia Fikkert, "Choosing Financial Services Where the Options Are Limited: A Report on a Survey of Financial Service Choice of Residents in Inner-City Neighbourhoods in Toronto, Vancouver and Winnipeg," 9 May 2008, 20.

69 Buckland and Fikkert, "Choosing Financial Services Where the Options Are Limited."

70 "Payday Loan Users Study British Columbia"; "Payday Loan Users Study Manitoba"; "Payday Loan Users Study Ontario"; "Payday Loan Users Study Alberta."

71 Brennan, "Impact of Two-Tiered Banking," 16.

PERCEPTIONS AND CUSTOMER SERVICE

Psychological perceptions of financial institutions are also a factor. In 2008 the Public Interest Advocacy Centre questioned focus groups of fringe bank users in Toronto, Edmonton, and Vancouver about their view of traditional banks. A number of the participants explained that they felt more comfortable at a fringe institution than a traditional bank. Participants explained that not only was the process easier, but also staff were nicer and more accommodating. This was not true of everyone, however, as some participants communicated that they preferred the mainstream banking experience.[72] Buckland's report also highlighted a mixed response. While some users, especially those from Toronto, shared their frustration with experiences at mainstream banks, in general there was not a significant difference in how respected users felt and their comfort level with staff at the two different types of financial institutions. In fact, in Winnipeg more fringe-financial-service users indicated that they felt comfortable at mainstream banks than at fringe financial institutions.[73] The evidence suggests that while an individual's attitude toward and perception of different financial institutions does influence payday-loan use, it is not the major factor in choice for most borrowers.

Limited ability to access traditional forms of credit is a major factor.

LACK OF ACCESS TO ALTERNATIVES

Limited ability to access traditional forms of credit is a major factor, however. Poor credit ratings and limited assets prevent households from qualifying for a bank loan, line of credit, or credit card, while others may have maxed out their available credit from those options. According to the CFSI survey conducted in the United States, 32 percent of small-dollar credit users used a payday loan instead of a credit card because they could not qualify for one, and 19 percent had maxed out their available credit on their cards.[74] A Statistics Canada study found that those who had been refused a credit card were more than three and a half times more likely to have used a payday loan than those who had access to a credit card.[75] Credit from "natural communities" like friends and family can also be difficult to access. CFSI found that 21 percent of small-dollar credit users were able to access a limited amount of credit from friends and family, but not enough to cover their need. Twenty percent felt it was too inconvenient, and 17 percent did not have friends or family nearby that were willing to offer them a loan.[76]

PRODUCT DESIGN

For some households, it's not necessarily that they are unable to qualify for other forms of credit, but that the design of these products does not work well for them. Most mainstream financial institutions do not offer unsecured small loans other than through credit cards. And for some, households credit cards are a product they want to avoid. The point-of-purchase credit access and relatively large credit limits on credit cards are too tempting and have created problems for them in the past.[77] For these users the small, fixed, short-term structure of a payday loan is much more appealing.

72 Esteban Uribe, "Not Ready for Prime Time: Canadians In the Sub-Prime, and High-Interest Lending," Public Interest Advocacy Centre, June 2008, 113, https://www.piac.ca/wp-content/uploads/2014/11/subprime_report_piac_final_website_2.pdf.
73 Buckland and Fikkert, "Choosing Financial Services Where the Options Are Limited," 23.
74 Levy and Sledge, "A Complex Portrait," 16.
75 Pyper, "Payday Loans," 8.
76 Levy and Sledge, "A Complex Portrait," 16.
77 Lott and Grant, "Fringe Lending and 'Alternative' Banking," 105.

IRRATIONAL DECISION MAKING

There is often concern that a significant number of payday-loan users borrow without an accurate understanding of the costs associated with payday-loan use. While there is evidence to suggest that a portion of consumers do not accurately understand the costs of payday loans relative to other options like a credit card (see section 3.2), improved price disclosure has not shown to significantly reduce demand for payday loans. The *Journal of Finance* published a study in 2011 that analyzed the impact of various information disclosures on payday-loan use. The study found that improved disclosure around the cost of payday loans over multiple months relative to a credit card resulted in an 11 percent decrease in borrowing relative to the control group.[78] Although price disclosure is certainly an important policy to enforce to protect consumers, the limited impact on payday-loan use suggests that factors other than price or perception of price are driving demand for the product.

The limited impact of improved price disclosure does not necessarily mean that payday-loan borrowers are always making a rational decision. As a result of inattention to information, cognitive biases, limited ability to evaluate risk, and bounded rationality, research has shown that improved disclosure does not always lead to better decision making.[79] US-based data suggests that a significant segment of borrowers make seemingly irrational economic decisions. According to the 2007 survey, 17.5 percent of borrowers indicated they could have used money in a chequing or savings account, 32.5 percent of users could have used available credit on a credit card, and 28.2 percent could have borrowed from a friend or relative.[80] There are certainly circumstances when it is an economically rational decision to use a payday loan, but the qualities of payday loans identified above can motivate irrational use as well.

78 Marianne Bertrand and Adair Morse, "Information Disclosure, Cognitive Biases, and Payday Borrowing," *Journal of Finance* 66, no. 6 (1 December 2011): 1865–93, doi:10.1111/j.1540-6261.2011.01698.x.

79 Lauren E. Jones, Cäzilia Loibl, and Sharon Tennyson, "Effects of Informational Nudges on Consumer Debt Repayment Behaviors," *Journal of Economic Psychology* 51 (December 2015): 16–33, doi:10.1016/j.joep.2015.06.009.

80 Elliehausen, "An Analysis of Consumers' Use of Payday Loans," 39.

SECTION 4: PAYDAY LOAN INDUSTRY PROFILE: A PEEK AT THE SUPPLIERS

Anyone living or working in urban centres over the last fifteen to twenty years will have noticed the rapid growth in the number of payday-loan outlets lining the streets. But less is known about the industry itself. We see the shiny facades and the advertisements, but we know less about the competitive landscape, the operating structure of the typical payday-loan business, and the profitability of the traditional payday-loan model. But if there is to be a policy response, or a competitive industry response, this knowledge is crucial.

4.1 Industry Presence—Rapid Growth and a Plateau

Despite the rapid growth of payday-lending outlets over their first ten to fifteen years in Canada, growth has slowed significantly, and it appears the market has reached its saturation point. Canada's largest lender, Money Mart, experienced a decline in retail locations in 2009 followed by a slow rate of growth from 2010 to 2013. And, prior to its collapse, Cash Store Financial closed a number of stores in 2012 and 2013 (see Fig. 5). In its 2014 bankruptcy protection court fillings, Cash Store Financial stated that the Canadian payday-loan market is "not growing and is largely saturated by a number of providers."[81] The Canadian Payday Loan Association reports that the industry is shrinking.[82] Despite the decline in recent years, the number of payday-lending locations across the country is still quite significant, with an estimated 1,500-plus licensed locations nationwide. In Canada's largest market, Ontario, there were 796 licensed payday-loan outlets operated by 249 different businesses issuing an estimated $1.1–1.5 billion in loans to 400,000 households in 2014.[83] Industry estimates suggest that nationally lenders provide approximately $2.5 billion in loans to 1.8–2.5 million borrowers each year.[84]

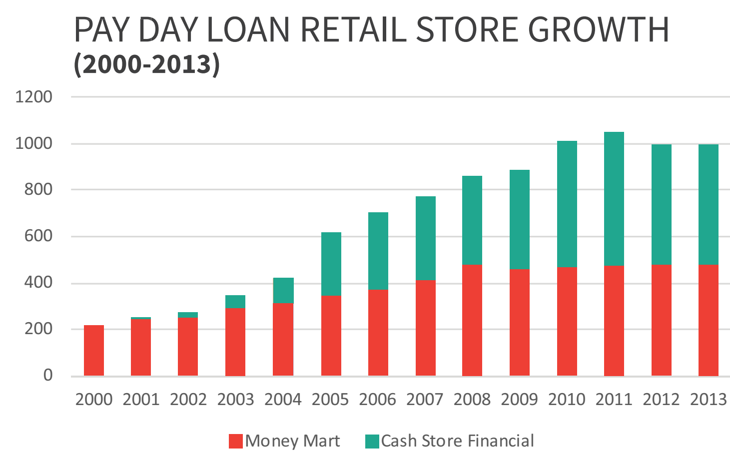


Fig. 5 Data sourced from publicly available reports submitted annually by each company.

81 "Application Record," 61.
82 "Councillor Wants to Keep Payday Loan Shops from Targeting Low-Income Neighbourhoods," *Metro News*, 1 February 2016, http://www.metronews.ca/news/ottawa/2016/02/01/payday-loans-and-low-incomes-neighbourhoods.html.
83 "Strengthening Ontario's Payday Loans Act," 1.
84 "Application Record," 61.

The industry is dominated by large corporate chains, though many small and independently operated enterprises continue to exist in local markets. The National Money Mart Company (Money Mart), a subsidiary of DFC Global Corp.,[85] has become the undisputed leader in the Canadian payday-loan market after the collapse of its largest competitor, Cash Store Financial, in 2014. In 2015 Money Mart was able to further establish its market-leadership position by acquiring 150 retail outlets formerly owned by Cash Store Financial.[86] Today, Money Mart operates 574 payday-lending outlets in every province except Prince Edward Island, Newfoundland, and Quebec, representing approximately 38 percent of total outlets in Canada. Money Mart's largest competitor is Cash Money, operating 175 outlets nationwide, of which 111 are located in Ontario. Other large brands include Cash 4 You (80 storefronts in Ontario), Cash Canada (56 outlets, 51 in Alberta), and Speedy Cash (24 outlets across British Columbia, Alberta, Saskatchewan, and Nova Scotia).[87]

MARKET SHARE: BASED ON RETAIL LOCATIONS

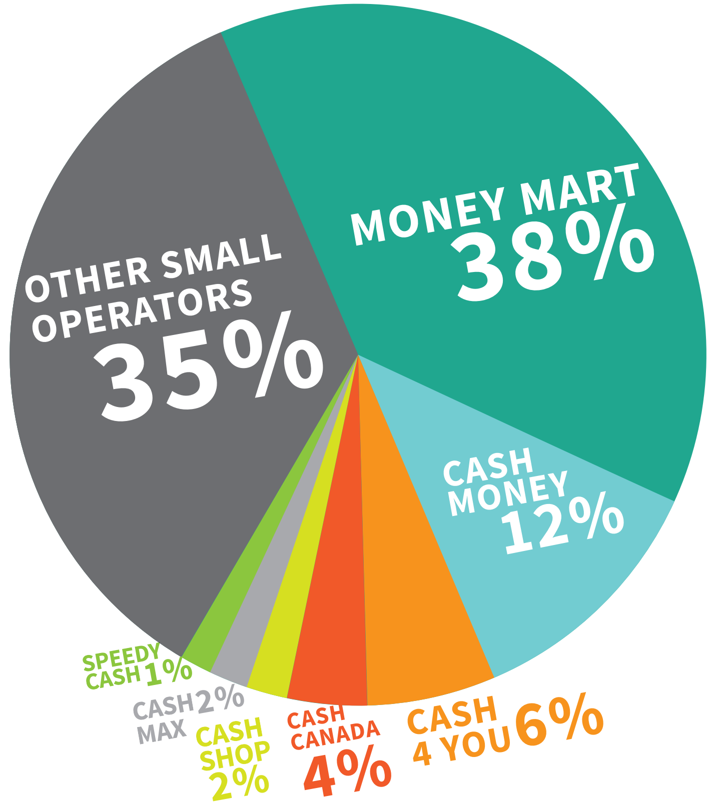


Fig. 6: Data based on publicly available information on store location

Although the number of retail locations is not a true representation of market share, it is the best publicly available metric and suggests the market is moderately to highly concentrated (Herfindahl-Hirschman score of at least 1600).[88] In all likelihood the share of total loan volume is probably weighted more heavily to the larger players because of their ability to devote significant resources to advertising and customer retention. The consolidation of power in the market is a concern for consumers, as it reduces incentives to innovate, and compete on cost, quality, and service. The propensity of regulation to increase market consolidation—which occurred after provincial payday-loan laws came into place—is a consideration for policy makers planning interventions. An increasing regulatory burden can favour larger suppliers, who are better equipped to deal with the costs associated with change, and push smaller suppliers out.

85 Formerly a publicly traded company, DFC Global Corp. was acquired in 2014 by Lone Star Funds.

86 "The Cash Store Financial Services Inc.—Status Updates," FTI Consulting, http://cfcanada.fticonsulting.com/cashstorefinancial/updates.htm, accessed 2 December 2015.

87 "Member Store Locations and Contact Information," Canada Payday Loan Association, http://www.cpla-acps.ca/english/aboutmemberslist.php, accessed 21 October 2015.

88 The Herfindahl-Hirschman index (HHI) is a commonly used measure of market concentration and competitiveness. The HHI score is calculated by summing the squared products of each competitor's market share. We used market-share numbers based on retail outlets to calculate the HHI score of the Canadian payday-loan market to calculate a score of 1,653; however, if Money Marts actual market share is only three percentage points higher than what it is based on store locations, the HHI score increase to over 1,800. A market with a score of less than 1,000 is considered to be a competitive marketplace, 1,000–1,800 is considered to be moderately concentrated, and over 1,800 is considered highly concentrated. Better measurement of market concentration—loan numbers and loan volume—is not possible with the available public data.

4.2 Online Payday Loans

Payday loans obtained from online sources are a relatively small but growing segment of the market, and their presence increases the difficulty of precise measurement of market concentration. All of the major payday-lending firms in Canada offer online loans in each of the provinces they operate in, except for New Brunswick and Manitoba. In these two provinces borrowers can still begin an application online, but must visit a store to complete it. Estimates put the current portion of loans obtained online to be around 10 percent of the Canadian market.[89] Research conducted by Pew Charitable Trust in the United States found 16 percent of borrowers had obtained payday loans exclusively online and 4 percent had used both a storefront and online lender. According to the research done by Pew, online borrowers tend to be younger, have household incomes above $50,000, and have a college degree.[90]

The presence of online lenders has the potential to significantly change the industry's structure—both positively and negatively—as well as to pose significant difficulties to government regulators.

The biggest concern with the growth of online lending is the ease of illegal, unlicensed lenders to provide payday loans to Canadian consumers over the Internet. Risks of fraud and malpractice are much higher, as many of these lenders operate from outside Canadian borders and with no regard for provincial regulations.[91]

Despite these concerns, a growing acceptance and use of online-lending platforms has the potential to benefit payday-loan users, something we discuss further below.

4.3 Business Structure

Payday lenders generally operate under one of two business models: the traditional model, where lenders provide the loan capital and assume the risk, and the broker model, where the lender brokers the relationship between the borrower and a third-party lender, who provides the capital and assumes the risk.

The majority of payday lenders today operate under the traditional model. These lenders typically rely on equity capital to fund their business activities and loans, although there is evidence that as the industry has matured, large financial institutions have become more willing to provide debt financing to the industry.[92] DFC Global Corp. disclosed in its 2013 annual report that it has a $235 million secured revolving credit facility with a syndicate of lenders administered by a large American bank. DFC uses this credit facility to finance its business operations and loans for its global operations, including Money Mart, in Canada.[93] We do not have enough data to determine whether returns from this financing serve as a disincentive for banks to enter the small-dollar-loan market.

There are also a number of payday lenders, particularly online and unlicensed lenders, that operate under the broker model. Cash Store Financial, prior to its collapse, operated under both models at different times and in different jurisdictions.[94]

Within these two operating models there are also the subcategories of monoline and multiline busi-

89 "Strengthening Ontario's Payday Loans Act," 7.
90 "Payday Lending in America: Who Borrows, Where They Borrow, and Why," Pew Charitable Trusts, 19 July 2012, 27, http://www.pewtrusts.org/en/research-and-analysis/reports/2012/07/19/who-borrows-where-they-borrow-and-why.
91 "Strengthening Ontario's Payday Loans Act," 9.
92 "The Cost of Providing Payday Loans in Canada," Ernst and Young, October 2004, 5, http://www.cpla-acps.ca/english/reports/EYPayday-LoanReport.pdf.
93 "Form 10-K," 10.
94 "Annual Information Form: Cash Store Financial," Cash Store Financial, 11 December 2013, http://www.sedar.com/.

In Canada payday lenders are not deposit-taking institutions and, unlike mainstream financial institutions, are not structured to offer services that help customers build wealth.

nesses. Monoline businesses are operations that generate virtually all of their revenue from payday lending, whereas multiline businesses generate significant additional revenue from other services. Money Mart is a prime example of the latter. In addition to payday loans, Money Mart also provides cheque cashing, advances on tax returns, cash for gold, money transfers, bill payments, and currency-exchange services. However, most multiline businesses generate most of their revenue from payday loans. In 2013 payday loans accounted for approximately 60 percent of Money Mart's total revenues, up from 28 percent in 2002. Cheque cashing is Money Mart's second largest revenue generator, accounting for 21 percent of revenues in 2013 (see Exhibit 1). The vast majority of payday lenders operate as a multiline business, and only a few small lenders operate as monoline.[95]

In Canada payday lenders are not deposit-taking institutions and, unlike mainstream financial institutions, are not structured to offer services that help customers build wealth. These operations are primarily in the business of issuing debt with a small number of complementary, transaction-based financial services. As a result, there is an inherent misalignment with the economic incentives of payday lenders and the long-term financial success of consumers. We discuss this incentive structure further below.

4.4 Payday-Loan Cost Structure and Profitability

Payday lending, though often assumed to be lucrative, is not as profitable as some might believe. Even with annual rates that can reach over 900 percent (APR), industry profitability is modest. In 2009 Ernst and Young (EY), commissioned by the Ontario Ministry of Small Business and Consumer Services, conducted a study of 9 payday lenders representing 67 storefronts in Ontario. Using financial data from each of these lenders, EY calculated an average total cost of provision of $22.07 per $100 borrowed and a weighted average of $21.50 per $100 (weighted based on loan volume of each lender).[96] In 2004, EY conducted a similar study on a larger scale, analyzing the financials of 19 payday lenders across the country representing 474 storefronts. Based on the national data, EY calculated an average cost of provision of $20.66 per $100 borrowed and a weighted average of $15.69 per $100.[97] Considering that provincially regulated price ceilings range from $17 to $25, the data suggests that average margins on payday loans are not substantial, especially for smaller operators.

According to the 2009 study, the operating profit margin of Ontario-based lenders ranged from -0.9 percent to 17.6 percent on payday-loan revenue, with a weighted average of 6.9 percent.[98] During the same operating period, the average operating profit margin of institutions within the Statistics Canada industry classification of depository credit intermediation (i.e., banks and credit unions) was 26.6 percent and averaged 43 percent for institutions classified within the nondepository credit intermediation category.[99]

Analysis of the National Money Mart Company's publicly available financial information suggests that Canada's largest payday lender fared better than most of the industry. Over the five-year period from 2009 to 2013 (the last year the company's financials were publicly reported), Money Mart's operating

95 "The Cost of Providing Payday Loans in Canada," 31.
96 "The Cost of Providing Payday Loans in Ontario," Ernst and Young, 24 January 2009, 14, http://www.cpla-acps.ca/english/reports/Cost%20Study.pdf.
97 "The Cost of Providing Payday Loans in Canada," 29–31.
98 "The Cost of Providing Payday Loans in Ontario," 20.
99 Ibid.

profits averaged 36.6 percent of sales.[100] However, despite its substantial operating margin, Money Mart's bottom line over the same period was relatively modest, averaging only 8.5 percent of sales before taxes (see Exhibit 2). The company's poor bottom-line performance relative to operating margins was mainly due to the company's highly leveraged capital structure (resulting in substantial interest payments), losses associated with litigations, and other non-reoccurring expenses.

Money Mart's superior operating margin may be indicative of efficiencies achieved through scale and market reach; however, the company's largest competitor at the time, Cash Store Financial (CSF), did not experience the same success. CSF struggled to operate profitability in the years prior to its prohibition from the Ontario market. From 2009 to 2013 CSF's annual operating profits averaged only 12.8 percent of sales, and average annual income before profits was -1.7 percent over the same period (see Exhibit 2).

According to financial data published by Ernst and Young study, bad debt—the cost factor many might consider to be the largest—accounts for about $4 for every $100 loaned (about 20 percent of cost) on average. Operating expenses, mainly rent and staff salaries, average about $16.50 for every $100 dollars loaned (about 75 percent of total cost).[101] This suggests that while the industry is profitable, its delivery model and customer-acquisition strategy act as considerable constraints on those profits.

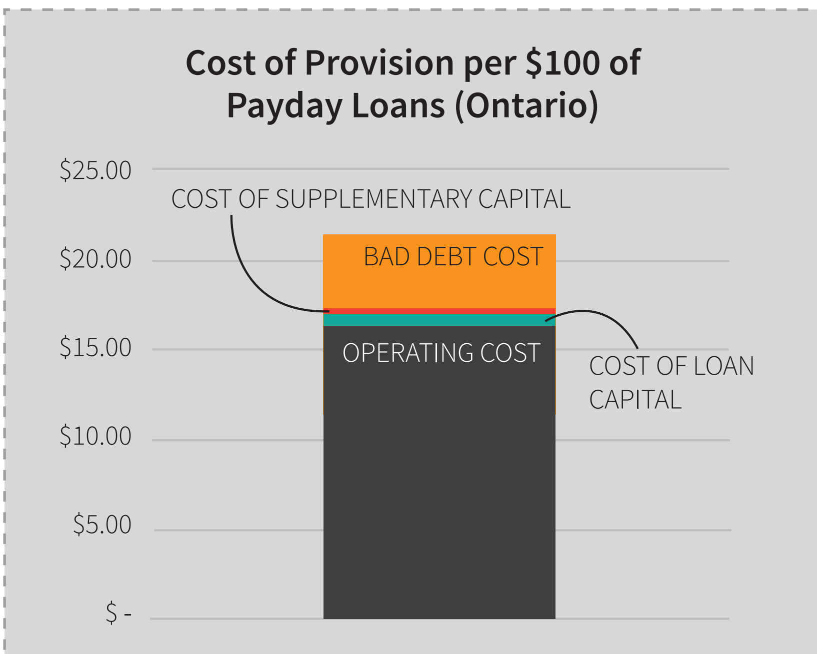


Fig. 7: "The Cost of Providing Payday Loans in Ontario," 16.

100 Operating profits are equal to revenue minus expenses, not including interest expense, amortization or assets, income tax, and gains or losses associated with non-reccurring events.
101 "The Cost of Providing Payday Loans in Ontario," 16.

SECTION 5: DEALING IN DEBT,

INCENTIVIZING DEPENDENCY: THE STRUCTURAL PROBLEM OF PAYDAY LENDING

How does this industry data inform our public debate about payday loans? We suggest that, although the high rates of interest on payday loans get the most attention in public debate, there is a deeper, structural challenge: the reliance of payday-loan firms on repeat borrowers.

Analysis of the traditional bricks-and-mortar business model suggests that the industry relies heavily on repeat borrowing to drive profitability. Based on the average total cost of provision for small, medium, and large payday-lending operations calculated by Ernst and Young, the average payday lender, regardless of size, does not break even on first-time borrowers under any of the provincially regulated rates (see Fig. 8).[102] The time it takes to process a loan for a new borrower is, on average, 2.68 times longer than a loan to a returning customer. As a result the average total cost of provision per $100 loaned for a first-time borrower actually exceeds the fees lenders can charge.[103] In Manitoba the average lender will not break even on a first-time borrower until he or she subsequently borrows more than four times the original loan value. The breakeven rate varies depending on which province a payday lender is operating in, but even in British Columbia, where the price ceiling is among the highest in the country, the average payday lender requires the borrower to reborrow over 0.7 times their original loan amount to break even.

	BC	AB	SK	MB	ON	NS	NB	PEI	AVERAGE
RATE CEILING	$ 23.00	$ 23.00	$ 23.00	$ 17.00	$ 21.00	$ 22.00	$ 21.00	$ 25.00	$ 21.88
AVERAGE COST OF PROVISION FOR FIRST-TIME LOAN (PER $100) BY SIZE OF LENDER									
AVERAGE	$ 29.35	$ 29.35	$ 29.35	$ 29.35	$ 29.35	$ 29.35	$ 29.35	$ 29.35	$ 29.35
LARGE	$ 28.50	$ 28.50	$ 28.50	$ 28.50	$ 28.50	$ 28.50	$ 28.50	$ 28.50	$ 28.50
MEDIUM	$ 34.59	$ 34.59	$ 34.59	$ 34.59	$ 34.59	$ 34.59	$ 34.59	$ 34.59	$ 34.59
SMALL	$ 43.33	$ 43.33	$ 43.33	$ 43.33	$ 43.33	$ 43.33	$ 43.33	$ 43.33	$ 43.33
LOSS ON FIRST LOAN (PER $100) BY SIZE OF LENDER									
AVERAGE	-$ 6.35	-$ 6.35	-$ 6.35	-$ 12.35	-$ 8.35	-$ 7.35	-$ 8.35	-$ 4.35	-$ 7.48
LARGE	-$ 5.50	-$ 5.50	-$ 5.50	-$ 11.50	-$ 7.50	-$ 6.50	-$ 7.50	-$ 3.50	-$ 6.63
MEDIUM	-$ 11.59	-$ 11.59	-$ 11.59	-$ 17.59	-$ 13.59	-$ 12.59	-$ 13.59	-$ 9.59	-$ 12.72
SMALL	-$ 20.33	-$ 20.33	-$ 20.33	-$ 26.33	-$ 22.33	-$ 21.33	-$ 22.33	-$ 18.33	-$ 21.46
MARGIN ON REPEAT (PER $100) BY SIZE OF LENDER									
AVERAGE	$ 8.85	$ 8.85	$ 8.85	$ 2.85	$ 6.85	$ 7.85	$ 6.85	$ 10.85	$ 7.73
LARGE	$ 9.21	$ 9.21	$ 9.21	$ 3.21	$ 7.21	$ 8.21	$ 7.21	$ 11.21	$ 8.09
MEDIUM	$ 6.47	$ 6.47	$ 6.47	$ 0.47	$ 4.47	$ 5.47	$ 4.47	$ 8.47	$ 5.35
SMALL	$ 4.14	$ 4.14	$ 4.14	-$ 1.86	$ 2.14	$ 3.14	$ 2.14	$ 6.14	$ 3.02
REPEAT LOAN VOLUME MULTIPLE FOR BREAKEVEN BY SIZE OF LENDER									
AVERAGE	0.72	0.72	0.72	4.33	1.22	0.94	1.22	0.40	0.85
LARGE	0.60	0.60	0.60	3.58	1.04	0.79	1.04	0.31	1.07
MEDIUM	1.79	1.79	1.79	37.43	3.04	2.30	3.04	1.13	2.13
SMALL	4.91	4.91	4.91	-14.16	10.43	6.79	10.43	2.99	6.48

Fig. 8: Data for average cost of first time and repeat loans sourced from "The Cost of Providing Payday Loans in Canada."

102 Small lender is defined as those with less than $2 million in payday loans annually. A medium lender provides between $2 million and $20 million in payday loans each year. And a large lender provides over $20 million in payday loans annually; "The Cost of Providing Payday Loans in Canada," 23.

103 Ibid., 25.

Although the high rates of interest on payday loans get the most attention in public debate, there is a deeper, structural challenge: the reliance of payday-loan firms on repeat borrowers.

Of course this breakeven analysis is highly dependent on payday-loan dollar volume and the number of transactions per store. The majority of costs associated with payday-loan provision per store are fixed (rent, utilities, security, etc.) and/or not dependent on the dollar amount of the loan (staff time and other process-related charges). As the average dollar volume per loan increases and the number of transactions per store increase, the average *operating* costs per $100 provided will decrease, decreasing the number of loans needed to break even on an individual borrower.

There is evidence to suggest that the industry has become more efficient since this cost data was collected in 2004. In 2004 Ernst and Young calculated the average loan size in Canada to be $279.[104] In 2009 a survey of lenders in Ontario calculated the average to be $304.[105] And by 2014 the average loan size in Ontario had reached an estimated $460 and $449 in British Columbia.[106]

Unfortunately data on the number of loan transactions across the industry is limited; however, in British Columbia, where these numbers are collected and reported, the average number of loans per store increased by 16 percent from 2012 to 2014 to an average of 3,130 per year, much more than the average of 1,467 reported in Ontario in 2009.[107]

Although the data is only limited to two provinces, it suggests that average payday-loan sizes and number of transactions per store are on the rise. Assuming that payday-lending cost structures have remained relatively consistent over the last ten years, it is likely that the average total cost of payday-loan provision has come down.

However, despite improving efficiencies, payday-loan operations are still primarily in the business of debt and have a clear profit incentive to keep borrowers coming back for more. Unlike banks and credit unions, payday lenders are not deposit-taking institutions and have fewer revenue-generating product offerings. Payday lenders have no incentive to encourage savings or investment among their customers and rely heavily on payday-loan volumes to cover operating expenses, as many lenders receive over 90 percent of their revenues from payday lending.[108]

The economics of the traditional payday-loan business model raise concerns about misalignment between supplier incentives and consumer well-being. In short, there is a direct incentive for lenders to encourage dependency on their product. Statistics drawn from Canadian and US markets reveal that repeat borrowing is common. According to various studies done in the United States, 76 percent of payday loans are renewals or secondary payday loans, more than 60 percent of loans are to individuals that borrow twelve or more loans per year, and the average borrower is indebted for five months during the year.[109] Not as much work has been done to understand the prevalence of repeat borrowing in the Canadian market; however, the national study of the industry conducted by Ernst and Young in 2004 found that the average payday lender provide fifteen repeat or rollover loans for every first-time loan.[110] British Columbia also collects data around repeat lending within the province. According to the data reported in 2014, 70,000 borrowers in British Columbia—36 percent—took out six or more payday loans in 2014, 43 percent of which borrowed more than ten times.[111]

Analysis of the structure and design of a payday loan also raises concern of a system designed to create consumer dependency.

104 Ibid., 29.
105 “The Cost of Providing Payday Loans in Ontario,” 12.
106 “Strengthening Ontario’s Payday Loans Act”; “BC Aggregated Payday Loan Data.”
107 “BC Aggregated Payday Loan Data”; “The Cost of Providing Payday Loans in Ontario,” 17.
108 “The Cost of Providing Payday Loans in Canada,” 26.
109 “How Borrowers Choose and Repay Payday Loans,” 13.
110 “The Cost of Providing Payday Loans in Ontario,” 36.
111 “BC Aggregated Payday Loan Data.”

5.1 Terminal Dependency—Short Loan Terms, Short Cash-Flow Terms

On short loans the cost of provision in annualized rate terms is much higher than a longer term loan.

Arguably the most critical problem with payday loans, the one that creates the most damage for consumers, is their short-term nature. A payday loan is typically structured so that the full amount (principal + interest) is due on the borrower's next payday. Upon approval for a loan, the lender typically requires the borrower to provide a postdated cheque or pre-authorized debit payment for the amount due. As most employers pay on a biweekly or semimonthly basis, most payday loan terms range between one and fourteen days. According to the Canadian Payday Loan Association, the average loan term is ten days.[112] The loans effectively move the burden of illiquidity from one pay period to the next. For consumers that have budget flexibility, this can be a prudent measure. But for consumers living paycheque to paycheque, this puts them at high risk of needing to either refinance the payday loan in their next pay period or borrow again shortly after paying off the original loan. For consumers who are never able to get completely ahead of the deficit left by a loan payment in their cash-flow cycle, the result can be a crippling cycle of debt that lasts until the individual receives a large-enough influx of cash such as a tax return. According to Pew research, this risk of a debt cycle isn't restricted to a small minority of payday-loan users. It is actually a significant majority. In the US market only 14 percent of payday-loan users are able to afford the average payday-loan payment (principal + interest) out of their monthly budget.[113] The absolute cost of originating a loan does not change significantly based on the loan volume or term length, so on short loans the cost of provision in annualized rate terms is much higher than a longer-term loan.

5.2 No Credit Checks, No Reporting: A Double-Edged Sword

Payday lenders do little to assess a borrower's ability to repay a loan. Lenders do not typically factor in a borrower's credit history, outstanding third-party debts, or additional financial commitments. As long as a borrower has a bank account, a regular source of income, and can verify their identity, they can get a payday loan. Ostensibly this would increase the risk of default, but payday lenders structure loans in a manner that maximizes their ability to be repaid. They do this by structuring repayment on paydays, when lenders know cash flow will be at its peak and odds of repayment will be highest. This increases the ability of the lender to be paid—to effectively move to the front of the line of the borrower's creditors and expenses, even if the borrower cannot truly afford the loan—and decreases the likelihood of default. The lack of credit checks and other assessments allows quick and easy access to credit, but it also means that those who cannot truly afford the payment out of their regular cash-flow cycle will need to borrow again and likely end up in a high-interest debt cycle.

The fact that payday lenders do not report to credit bureaus is also a double-edged sword. The lack of reporting lowers the risk for the borrower and eases the consumers' ability to access needed cash. But reporting to credit agencies also has both potential benefits and losses to the consumers. Consumers can build their rating through proper servicing of their loans, or erode them through missed payments. The lack of accountability punishes good financial behaviour by borrowers and rewards bad financial behaviour. Even if an individual pays off their payday loan on time, they are not rewarded with an improved credit rating, perpetuating their inability to access higher-tier credit products and thus their reliance on payday loans for their credit needs.

112 "What Is a Payday Loan and Who Uses It?"
113 "How Borrowers Choose and Repay Payday Loans," 13.

SECTION 6: GOOD ENOUGH, OR BETTER?
ASKING THE RIGHT QUESTIONS ABOUT PAYDAY LOANS

Despite the structural problems with loans, they are still widely used. Isn't that an indication that they are serving a real need? This question gets to the heart of the public debate: How should we evaluate the relative net benefits and costs of payday-loan access?

The big question, according to John Caskey, one of the leading academics on fringe financial services, is, "Do payday lenders, on net, exacerbate or relieve customers' financial difficulties?"[114] A number of empirical studies have attempted to answer, or at least provide some insight into, "the big question." These include a 2008 paper by Jonathan Zinman and a 2012 paper by Donald Morgan, Michael Strain, and Ihab Seblani that find links between payday-loan access and decreases in overdrafts and bounced cheques;[115] a 2009 paper by Adair Morse and a 2014 paper by Christine Dobridge that link payday-loan access with increased financial resiliency after natural disasters;[116] two papers by Brian Melzer, published in 2011 and 2014, which find that payday-loan access reduces the ability for households to pay important bills and increases dependency on food-assistance benefits;[117] a 2011 paper by Paige Marta Skiba and Jeremy Tobacman and the 2012 paper by Morgan, Strain, and Seblani, which link payday loans to increases in Chapter 13 bankruptcy rates;[118] and finally a 2011 paper by Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, who find payday loans have no long-run effect on financial well-being.[119]

Despite all of these studies, the answer to the big question is no clearer today than it was in 2010, when Caskey concluded that the empirical evidence is inconclusive. As Caskey notes, despite efforts to isolate the effects of payday loans in many of these studies, each one relies on one or two assumptions that may or not be true, and as such, the findings of these studies can at best only be suggestive. Studies have found evidence of harm *and* good and suggest that the net effect of payday loans is complicated and inconclusive.[120]

If anything, empirical evidence suggests that the "net-benefit" question might be the wrong question. What if we used the data to answer the question: Is this market serving the needs of consumers as well as it could? Or, *how might the market better serve consumers*?

This framework can move the public conversation from a zero-sum, polarized space to a growth-oriented, innovative space by allowing the public to develop a more nuanced understanding of both the value payday loans can create for consumers and their tendency to limit or destroy long-term economic health. To begin to build a better market, we need to understand both sides.

114 John Caskey, "Payday Lending: New Research and the Big Question," SSRN Scholarly Paper, 1 October 2010, http://papers.ssrn.com/abstract=1696019.
115 Jonathan Zinman, "Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap," SSRN Scholarly Paper, 1 December 2008, http://papers.ssrn.com/abstract=1335438; Donald P. Morgan, Michael R. Strain, and Ihab Seblani, "How Payday Credit Access Affects Overdrafts and Other Outcomes," *Journal of Money, Credit and Banking* 44, no. 2–3 (1 March 2012): 519–31, doi:10.1111/j.1538-4616.2011.00499.x.
116 Adair Morse, "Payday Lenders: Heroes or Villains?," SSRN Scholarly Paper, 1 January 2009, http://papers.ssrn.com/abstract=1344397; Christine L. Dobridge, "Heterogeneous Effects of Household Credit: The Payday Lending Case," The Wharton School, University of Pennsylvania, November 2014, https://fnce.wharton.upenn.edu/index.cfm/research/research-listing/?whdmsaction=publications.list&pubFilter=all&pubYearFilter=2014.
117 Melzer, "Real Costs of Credit Access"; Melzer, "Spillovers from Costly Credit," Kellogg School of Management, Northwestern University, August 2014, http://www.kellogg.northwestern.edu/faculty/melzer/papers/spillovers%20from%20costly%20credit_08_13_14.pdf.
118 Paige Marta Skiba and Jeremy Tobacman, "Do Payday Loans Cause Bankruptcy?," SSRN Scholarly Paper, 9 November 2009, http://papers.ssrn.com/abstract=1266215; Morgan, Strain, and Seblani, "How Payday Credit Access Affects Overdrafts and Other Outcomes."
119 Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, "Payday Loan Choices and Consequences," SSRN Scholarly Paper, 11 October 2012, http://papers.ssrn.com/abstract=2160947.
120 Caskey, "Payday Lending," 25.

6.1 Damning with Faint Praise: Why Making a Terrible Decision Is More Rational Than Making a Worse Decision

The chief value of consumer-credit products like payday loans is that they provide liquidity to consumers who need cash to meet urgent needs. Everyone needs cash to purchase goods and services in order to sustain an adequate standard of living. Financial illiquidity, even over the period of just a few days, can have substantial costs. Whether it's not being able to purchase something as essential as food for your family, or a financial cost such as charges on a bounced cheque, there are many ways short-term illiquidity can be detrimental to the economic and overall well-being of a household. Ideally every household would have consistent income, adequate savings, and a well-managed budget. But the reality is, many do not and at some point will be illiquid—without the ability to pay. To bridge the liquidity gap many households utilize consumer credit.

> *What if we used the data to answer the question: Is this market serving the needs of consumers as well as it could? Or,* ***how might the market better serve customers?***

Many are of the mindset that consumer credit is bad, that households should avoid credit cards and credit lines, and that they should instead learn to rely on what one earns and saves. Many financial-empowerment efforts have rightly focused on programs and policies that seek to decrease debt dependency by helping households manage their money effectively, build savings, and find adequate employment; and increasingly we are discussing the deeper, long-term cultural elements that contribute to our current household-debt situation.[121] Yet millions of Canadians still face liquidity challenges on a regular basis, and it's likely that a significant portion will continue to for the foreseeable future.[122]

In certain circumstances, the use of a payday loan makes sense.

Take, for example, the costs associated with a household's having its electricity disconnected because of an overdue bill. In addition to any indirect costs associated with not having electricity for a certain period of time in Ontario, it will cost $95 or more to have the service reconnected, plus interest on the outstanding balance, compounded at 1.5 percent per month.[123] Households can request an extended payment plan, but those that have been on a payment plan within the last two years cannot qualify for another one. And the provider can take action to disconnect the service if a household misses more than one payment on the plan or a subsequent bill.[124] A $200 payday loan with a $42 fee can make a lot of sense for a family that does not have enough money or credit to pay off a $200 electricity bill on time.

Avoiding fees for a bounced cheque or insufficient funds on an automatic withdrawal is another instance when a payday loan can make sense. Most major financial institutions charge $40 or more every time a withdrawal is attempted from an account with insufficient funds (see Fig. 9). If a landlord or service provider attempts to deposit a cheque or withdraw money multiple times, these charges can add up fast. And service providers will often charge additional administrative fees for bounced

121 See, for instance, "For a New Thrift: Confronting the Debt Culture," Institute for American Values, 2008, http://americanvalues.org/catalog/pdfs/for_a_new_thrift.pdf.
122 In 2015 49 percent of Canadians would find it difficult to meet their financial obligations if their paycheque was delayed for one week, up from a 48 percent average from 2012 to 2014. "The Canadian Payroll Association's 2015 National Payroll Week Research Surveys of Employed Canadians, Results," The Canadian Payroll Association, September 2015, 6, http://www.payroll.ca/cpadocs/media/npw2015/NPW_2015_MEDIA_DECK_FINAL.pdf.
123 "Customer Service Rules for Electricity," *Ontario Energy Board: Consumers*, http://www.ontarioenergyboard.ca/OEB/Consumers/Electricity/Customer+Service+Rules, accessed 8 December 2015.
124 Ibid.

payments on top of what the bank charges. In the city of Toronto, for example, a bounced payment on a municipal utility bill will result in an additional $40 processing fee.[125]

BANK	NSF CHARGE
Scotia Bank	$42.50
RBC	$45
CIBC	$45
TD Canada Trust	$48
BMO	$48

Fig. 9: Data sourced from advertised rates of each bank

Other circumstances, such as not having enough money to put food on the table, purchase medication, or repair a car, can also have associated costs that, while more difficult to measure, are significant enough to merit payday-loan use.

A family (or individual) that is in a desperate situation and needs money, but likely won't be able to pay back a payday loan on time, is a desperate user. However, a strong case can be made that the desperate user is still making the best decision on the margin. It is, in effect, a case of substituting a very bad outcome with a slightly less bad outcome. Nonetheless the user can still be left with a significant problem. If users cannot pay off their payday loan and are forced to reborrow as a result of their first loan, the value proposition of a payday loan changes.

This is not to say that all payday-loan use is rational or in the best interest of the borrower. There is certainly evidence to suggest that a segment of payday-loan borrowers act irrationally when making a decision to use a payday loan (See sections 3.3 and 3.4). Rather, this is meant to highlight the value of credit access on the margins. In the efforts to improve outcomes for consumers relying on payday loans, we cannot ignore the value small-dollar credit can provide. Although restrictions on payday-loan access will likely benefit irrational users, restrictions without increased access to alternatives will likely leave others in a worse position.

6.2 The Costs of Dependency on Society—When Individual Choice Incurs Social Costs

If a payday-loan borrower gets caught in a cycle of regular payday-loan use, the direct financial costs can add up quickly. Take, for example, a consumer who takes out a $450 payday loan to pay for a car repair. She's able to pay off the loan plus interest ($544.50) on her next payday, but by the end of the month the deficit left in her cash flow by that loan payment has left her short on her regular expenses, so she takes out another payday loan. That cycle continues for five months until she gets her tax return and is able to get out of the cycle. With five subsequent loans as a result of that first loan, the borrower essentially paid over $450 in interest on her original loan. Under provincially regulated prices, payday-loan borrowers will pay more interest than the principal of their original loan after five subsequent loans of equal or greater value (six in Manitoba) and that could be over as short a term as ten weeks.

> *If a payday-loan borrower gets caught in a cycle of regular payday-loan use, the direct financial costs add up quickly.*

As the majority of payday-loan consumers are households that are already struggling to get by and living on low to moderate incomes, these costs, even though they are not huge in absolute terms, mean less money for food, medication, savings, and other productive resources that can have a significant effect on the well-being of the individual and their family. One couple the authors spoke with during the research for this paper shared that at one point their payday-loan debt got so bad that 80–90 percent of their paycheque was going toward paying off multiple payday lenders. The couple wasn't able to cover their necessary expenses without going into further debt, and this created significant stress. This is not uncommon.

125 "2015 Fees—Utility Bills—Revenue Services," City of Toronto, accessed 4 January 2016, http://www1.toronto.ca/wps/portal/contentonly?vgnextoid=38297b805ebe1410VgnVCM10000071d60f89RCRD&vgnextchannel=f554fc2beecb1410VgnVCM10000071d60f89RCRD.

A number of studies have shown that debt, particularly high-interest debt, and financial strain are strongly correlated with adverse health effects on borrowers and their families. Two studies conducted in the United Kingdom, Howard Meltzer et al. and Pamela Lenton and Paul Mosley, find strong correlations between high-interest debt and higher instances of mental-health disorders. Meltzer et al. found that common mental-health disorders were over four times more prevalent among those with debt outstanding with a high-interest money lender than those with no debt.[126] Lenton and Mosley also find a correlation between physical health and higher levels of debt.[127] Both studies acknowledge that the direction of causation between debt and health likely goes both ways. Lenton and Mosley particularly emphasize the dangerous cycle that can result from poor health and debt. As a borrower's health declines with increasing levels of debt, it becomes increasingly difficult for an individual to work, leading to a greater dependency on debt.[128] Additional studies have also highlighted the correlation between debt and financial concern with negative health effects, including Donna Jessop, Carolina Herberts, and Lucy Solomon, who find significant correlation between increased financial concern and worse mental and physical health;[129] John Gathergood, who finds links between problems with repaying debt and worse psychological health;[130] and Sarah Bridges and Richard Disney, who find links between debt and depression.[131]

Negative outcomes of private decisions ripple beyond individuals to households, and have negative social consequences with real public costs.

Dependency on payday loans and particularly dependency that results in a cycle of debt has harmful effects on the individuals. But they also showcase an instance where the negative outcomes of private decisions ripple beyond individuals to households, and have negative social and public consequences with real public costs.

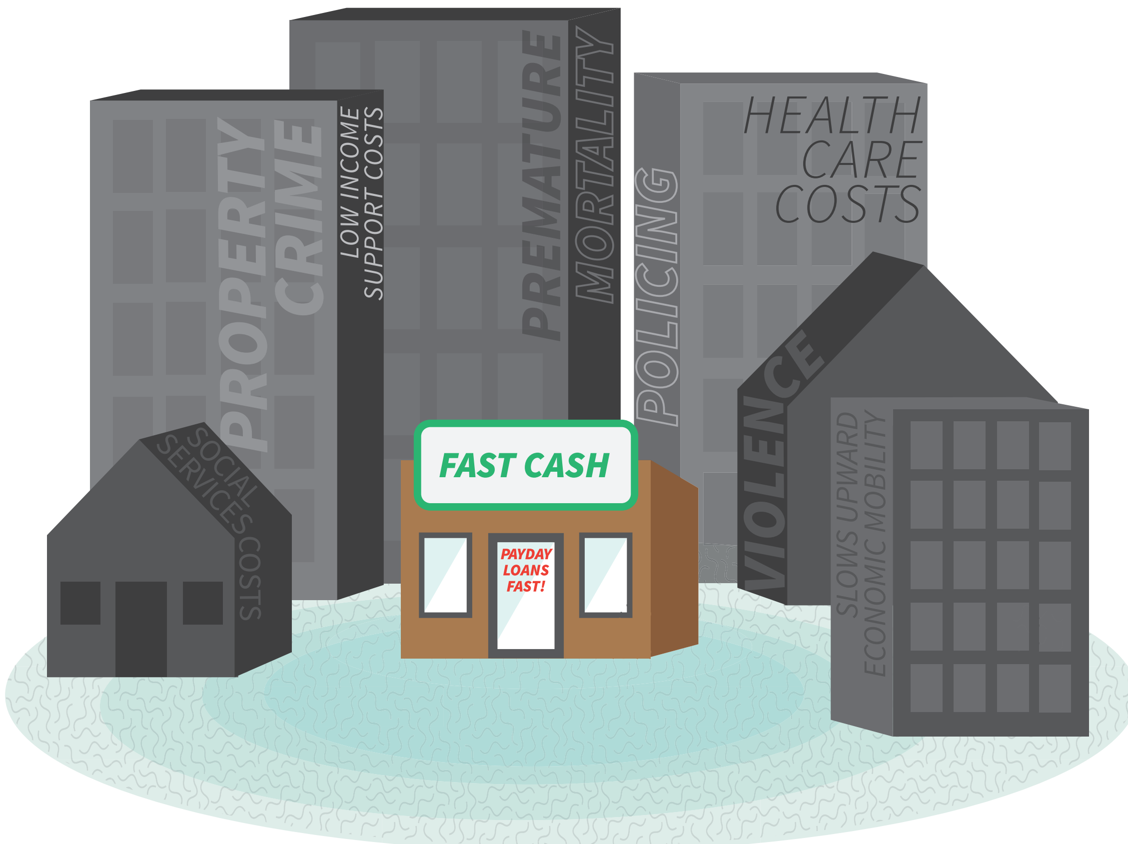
6.3 The Harmful Ripple Effect of Payday Loan Dependency

In 2014, Brian Melzer, assistant professor at the Kellogg School of Management, studied the effects of payday-loan access on food-stamp participation and child-support payments in the US market. Melzer's findings suggest that payday-loan use increases the likelihood that a household will require transfer benefits to supplement income and reduces their ability to make child-support payments as the money is redirected toward paying off their payday-loan debt.[132] As Melzer notes, "In both ways, the impact of payday lending spreads beyond the borrowing household and results in negative externalities."[133]

Additional studies have indicated that payday loans have an independent harmful effect on neighbourhoods in which their use is prevalent. One study, published in 2011 by the American Society of Criminology using data from the city of Seattle, Washington, found a statistically significant correlation between payday lending and violent and property crime even after other factors associated with

126 Howard Meltzer et al., "The Relationship between Personal Debt and Specific Common Mental Disorders," *European Journal of Public Health* 23, no. 1 (1 February 2013): 108–13, doi:10.1093/eurpub/cks021.
127 Pamela Lenton and Paul Mosley, "Debt and Health," Sheffield Economic Research Paper Series, University of Sheffield, April 2008, https://www.sheffield.ac.uk/economics/research/serps/articles/2008_004.
128 Ibid., 11.
129 Donna C. Jessop, Carolina Herberts, and Lucy Solomon, "The Impact of Financial Circumstances on Student Health," *British Journal of Health Psychology* 10, no. 3 (September 2005): 421–39, doi:10.1348/135910705X25480.
130 John Gathergood, "Debt and Depression: Causal Links and Social Norm Effects*," *Economic Journal* 122, no. 563 (1 September 2012): 1094–114, doi:10.1111/j.1468-0297.2012.02519.x.
131 Sarah Bridges and Richard Disney, "Debt and Depression," *Journal of Health Economics* 29, no. 3 (May 2010): 388–403, doi:10.1016/j.jhealeco.2010.02.003.
132 Melzer, "Spillovers from Costly Credit."
133 Ibid., 21.

crime had been controlled for.[134] Another study using data from Toronto, Ontario, and published in the *British Medical Journal* in 2014, found that moderate-to-high density of cheque-cashing outlets (the majority of which also provide payday loans) within a neighbourhood was "significantly associated with a higher risk of premature mortality" even after controlling for poverty, crime, and the number of banks.[135]



Though measuring or estimating the magnitude of the externalized costs of payday-loan use is difficult and not conclusive (it does not, for instance, account for social costs that would emerge if there was no access to the cash provided by payday loans), data suggests that dependency on costly emergency loans extends costs beyond the borrowing household. The financial strain, health effects, and hindrance to the upward economic mobility of the household increase the burden on our whole society due to costs associated with health care, policing, low-income support, and other social services.

There is strong evidence to suggest that our current payday-loan market, even if it is meeting the basic needs of consumers on the margins, is not optimal. There is enough evidence of social and individual cost to suggest that the market could be improved to reduce those individual and social costs.

134 Charis E. Kubrin et al., "Does Fringe Banking Exacerbate Neighborhood Crime Rates? Investigating the Social Ecology of Payday Lending," *Criminology and Public Policy* 10, no. 2 (2011): 437–66, here 457.
135 Flora I. Matheson et al., "A Population-Based Study of Premature Mortality in Relation to Neighbourhood Density of Alcohol Sales and Cheque Cashing Outlets in Toronto, Canada," *BMJ Open* 4, no. 12 (1 December 2014): e006032, doi:10.1136/bmjopen-2014-006032.

SECTION 7: BEYOND SOLUTIONISM:
ELEMENTS OF ENABLING SMALL DOLLAR CREDIT ALTERNATIVES

7.1 What Does Enabling Small-Dollar Credit Look Like? A Framework

At the core of creating enabling small-dollar credit is a desire to provide a product that satisfies the demand for accessible small-dollar credit without the risks and problems associated with the traditional payday loan. The US based Center for Financial Services Innovation (CFSI) has developed a framework of principles, guidelines, and practices for the design and delivery of high-quality small dollar credit. Released in 2014, *The Compass Guide to Small-Dollar Credit* provides seven guidelines for what high-quality small-dollar credit should look like.[136] We summarize those guidelines here in light of our analysis of the structural issues of payday loans in sections 4 and 5.

A high-quality small-dollar loan has the following characteristics:

1. *It is made with a high confidence in the borrower's ability to repay.*

A traditional payday-loan product does very little to assess a borrower's ability to actually afford and repay a loan. As a result a single payday loan can result in months of successive repeat borrowing and a substantial amount of money lost to fees. To prevent borrowers from getting trapped in a cycle of debt, CFSI recommends that lenders employ strong underwriting techniques to assess the financial position of the borrower and to only offer options that fit within the borrower's ability to repay.[137] To remain competitive, lenders must balance the depth and range of the assessment and approval process with the need for a quick and convenient process. Developing processes that are efficient, accurate, and cost effective are vital for satisfying consumer demand and maintaining profitability on small loans.

2. *It is structured to support repayment.*

One of the key issues with the current payday-loan model is its short-term lump-sum payment structure. To support the affordability of small-dollar credit and prevent borrowers from entering a cycle of debt, it is vital to structure the credit product with payments that are affordable for the borrower. A variety of loan options in terms of length, dollar amount, and payment schedules that are based on the borrowers assessed financial position and ability to repay can dramatically increase the rate of successful repayment.[138] CFSI also recommends that products have safeguards such as limits on the number of loans given in a period to prevent overuse as well as providing flexibility and support to borrowers when they have trouble making payments.[139] Innovative loan structures that reduce the rate of default and the prevalence of repeat borrowing will help consumers avoid costly fees and a cycle of debt.

3. *It is priced to align profitability for the provider with success for the borrower.*

The current payday-lending business model relies heavily on repeat borrowing for profitability. Thus the economic incentives of payday lenders are misaligned with the long-term success of consumers. The CFSI guide provides some best practices for ensuring that the revenue-generating elements of a loan are built to align with borrower success, including rewarding borrowers who demonstrate positive behaviour with lower costs and other benefits, not relying on penalty fees and reborrowing to drive

136 "The Compass Guide to Small-Dollar Credit," Center for Financial Services Innovation, 24 November 2014, http://www.cfsinnovation.com/Document-Library/The-Compass-Guide-to-Small-Dollar-Credit.
137 Ibid., 9.
138 Ibid., 10.
139 Ibid.

profits, and ensuring borrowers the most appropriate and lowest-cost loan for which they qualify.[140] This will require a deeper transformation of the business model that provides such loans, and entails that the lender will need to discover ways to derive value from borrowers who are able to pay off and stave off debt.

4. *It creates opportunities for upward mobility and greater financial health.*

Under their current structure, payday loans do very little to help borrowers access higher-tier credit products, build savings, and improve their overall financial condition. Traditional payday lenders do not report successful payments to credit bureaus, reward good behaviour with access to better credit, or provide any products or incentives to help borrowers build savings. CFSI suggests that a high-quality credit product should provide incentives, rewards, and support to help borrowers access better credit, build savings, and manage credit well, all areas where there is alignment between consumer success and profit.[141]

5. *It has transparent marketing, communications, and disclosures.*

Even though payday-lending regulations in Canada already recognize the importance of disclosure, it is important to emphasize this quality in delivering high-quality small-dollar credit. Evidence has suggested that some borrowers do not fully comprehend the costs associated with payday-loan use, and behavioural research on how information is disclosed can affect loan usage.[142] It is important that borrowers be provided with clear information and explanation around the costs of credit and the comparative costs of other products in a way they can understand. This type of information and support can help improve decision making.

6. *It is accessible and convenient.*

One of the main drivers of payday-loan usage is the loan's accessibility and convenience in relation to other credit products. It is vital that high-quality small-dollar credit remains accessible and convenient for as many borrowers as possible to adequately satisfy the demand for payday loans. Of course accessibility must be balanced with properly assessing a borrower's ability to repay a loan. This is why innovative loan structures and delivery models that can provide enough flexibility to meet a variety of financial needs and increase a borrower's ability to repay are so important for improving this market. Developing an efficient application and approval process that is both quick and effective at assessing a borrower's financial position is important for high-quality small-dollar credit.

7. *It provides support and rights for borrowers.*

Small-dollar credit that is designed to be accessible and inclusive, regardless of the strength of the assessment process and loan design, will eventually result in some disputes and defaults. Ensuring the processes and practices for managing those issues are fair to the borrower and provide support to ensure successful resolution are important for consumer well-being. Providing helpful, accessible, and respectful customer support throughout the loan process is key to building strong and lasting relationships with borrowers and supporting their long-term success.

This framework provides a strong vision for what high-quality small-dollar credit should look like. In our efforts to improve outcomes for financially vulnerable households and protect them from the potential harm of payday-loan use, the aim of our policies, programs, and initiatives should seek to create a marketplace where consumers can turn to an enabling credit option instead of a payday loan. But how do we get there? What elements are needed to move from a vision to a transformed market?

140 Ibid., 12.
141 Ibid.
142 Lott and Grant, "Fringe Lending and 'Alternative' Banking," 44; Bertrand and Morse, "Information Disclosure, Cognitive Biases, and Payday Borrowing."

SECTION 8: ELEMENTS OF A BETTER MARKET:
GOVERNMENT, FINANCIAL, AND SOCIAL ARCHITECTURE

Building an enabling a small-dollar credit market requires an institutional response from a variety of social actors: governments, financial institutions, and civil society. It is unlikely that any one intervention will fundamentally change the market, whereas combined efforts within respective spheres of competency are more likely to lead to success. This section outlines some of the temptations, challenges, and opportunities for each of these actors.

8.1 Government—Limited but Important Role

In the conversation surrounding payday loans, it is often interest rates that get the most attention, and thus it is interest-rate regulation (IRR) that is often at the centre of the policy discussion. The debate is polarized by those who advocate for rates well below the typical level and those who believe rates should be left for the market to decide.

The majority of provinces in Canada have adopted regulation that falls somewhat in the middle, placing a moderate ceiling on prices at a level that allows the industry to sustain operations. Although these regulations have helped to control prices and create consistency for consumers, this moderate IRR policy has failed to transform the industry in any significant way. The structural problems of the payday industry still exist: lenders still have an economic incentive to encourage repeat borrowing and to keep consumers dependent on subprime credit.

Many concerned parties continue to advocate for further reductions of interest-rate ceilings that would effectively prohibit legal payday loans. Although this desire to further protect consumers is commendable, there are legitimate concerns over the unintended consequences that restrictive IRR policy will have on consumers as demand shifts to potentially inferior alternatives.

We believe IRR, whether moderate or significant, is not the most effective way to help consumers.

THE PROBLEM WITH INTEREST RATE REGULATION

As a standalone policy, IRR, regardless of the level of restrictiveness, does little to help consumers and can do unintended harm.

As a result of the high cost structure of the current payday-lending model (see section 4.4), any significant reductions in interest-rate ceilings governing payday loans will risk preventing lenders from operating legally within the applicable jurisdiction. This has been the case in Quebec and a number of US states where an interest-rate cap of 36 percent or lower (35 percent in Quebec) has resulted in markets void of licensed payday lenders. Although many opponents of payday loans view this as a victory for consumers, the effective impact is complex and likely harmful to a significant segment of consumers.

The largest problem with a restrictive IRR policy is its inability to address consumer demand with a viable alternative. Restrictive IRR does not remove any of consumers' previously existing barriers to higher-tier credit products. As a result, an effective ban on payday loan forces consumers to find other, potentially inferior alternatives to address their need for small-dollar liquidity relief.

One inferior substitute some consumers turn to is illegal lenders. Despite some controversy around existing evidence, there is legitimate concern that demand for credit shifts at least partially to illegal unlicensed lenders when restrictive interest rates are introduced. Though no empirical studies have been conducted on the prevalence of illegal lending in Quebec, anecdotal evidence suggest that there are a number of unlicensed lenders who offer payday loans and other high-interest products to consumers in the province. Representatives from consumer-protection agencies and credit unions in Quebec, and reports from *Protégez-Vous*, a consumer-information publication in Quebec, have both confirmed the existence of lenders operating outside the legal framework in Quebec.[143]

Studies of other jurisdictions where interest rates have been restricted also indicate increases in use of illegal lenders. In 2007, the year after the government of Japan tightened its rate ceiling on consumer loans, the number of enquiries to a Tokyo-based agency supporting victims of illegal lending nearly doubled, and arrests of illegal lending rose 50 percent.[144] A survey conducted that same year by Hiroshi Domoto of Tokyo University found that those who had been declined a loan by a legitimate lender were twice as likely to contact a loan shark as those who obtained the amount they wanted.[145] However, the picture painted by the Japanese data is complicated by increases in criminal sanctions against illegal lenders and the subsequent decline of complaints about illegal lenders in the years following. In 2007, the Japanese government increased the maximum sentence for illegal lending from five to ten years in prison. Some have suggested the subsequent decline in complaints about illegal lenders is suggestive of the effectiveness of the reduction in the interest-rate ceiling, but it is difficult to separate the effects of the interest-rate policy from that of the increased criminal sanctions against illegal lending.[146]

Data from different European jurisdictions also indicates a relation between restrictive interest-rate policy and an increased prevalence of illegal lending. A survey of poor households in France, Germany, and the United Kingdom found that the rate of households in contact with illegal lenders was two to three times higher in France and Germany, countries that employ restrictive IRR, than it was in the United Kingdom, a country without IRR.[147] The conclusiveness of this data, however, is controversial as well. The comparison must assume that demand for credit is uniform across jurisdictions, and others have questioned the data based on a lack of disclosure around how it was collected.[148]

Even if consumers avoid using illegal lenders, there is still concern that a segment of consumers will be forced to face the potentially crippling costs of other inferior substitutes to payday loans discussed above. This concern is supported by a study conducted by Jonathan Zinman, professor of economics at Dartmouth College, on the effects of payday-loan restrictions in the state of Oregon. Zinman found that there was a sharp decrease in payday-loan use after new regulatory restrictions were introduced. The decrease in payday-loan access resulted in a number of consumers substituting their payday-loan use with overdrafts and late bill payments.[149] As described above, these costs can be significant and potentially more damaging than the costs and risks associated with a payday loan.

Kelly Edmiston, senior economist at the Federal Reserve Bank of Kansas City, also raises the concern that payday-loan restrictions may hurt consumers. In seeking to answer the question of whether a ban on payday lending sends borrowers back to traditional sources of credit, Edmiston examines the level

143 The authors of this paper spoke with representatives from Quebec-based credit unions and consumer-protection agencies; "EXCLUSIF—Ils Se Remplissent Les Poches Avec Des Prêts à 350 %," Protégez-Vous.ca, http://www.protegez-vous.ca/affaires-et-societe/ils-se-remplissent-les-poches-prets-350.html, accessed 4 February 2016.
144 Anna Ellison and Robert Forster, "The Impact of Interest Rate Ceilings: The Evidence from International Experience and the Implications for Regulation and Consumer Protection in the Credit Market in Australia," Policis, 2008, 47, https://www.policis.com/pdf/Old/Australia_The_impact_of_interest_rate_ceilings_20080326.pdf.
145 Ibid., 48.
146 Damon Gibbons, "Taking on the Money Lenders: Lessons from Japan," Centre for Responsible Credit, November 2012, 22, http://www.responsible-credit.org.uk/uimages/File/Taking%20on%20the%20money%20lenders%20lessons%20from%20Japan%20final.pdf.
147 Ellison and Forster, "The Impact of Interest Rate Ceilings," 46–47.
148 Udo Reifner, Sebastien Clerc-Renaud, and RA Michael Knobloch, "Study on Interest Rate Restrictions in the EU: Final Report," Institut für Finanzdienstleistungen e.V., 2010, 269, http://ec.europa.eu/internal_market/finservices-retail/docs/credit/irr_report_en.pdf.
149 Zinman, "Restricting Consumer Credit Access."

of lending from traditional sources in Georgia. The data highlighted in Edmiston's paper shows a divergence between the growth rate of traditional lending in Georgia and the national average shortly after Georgia banned payday loans. As Edmiston points out, this effect is opposite of what one would expect. It appears that instead of shifting to traditional sources of credit, barriers for consumers forced them into other, inferior alternatives.[150]

The data is not definitive, but there is enough to suggest that restrictive IRR policy leaves a significant segment of consumers worse off. Of course, an effective ban on payday lending will likely benefit a segment of consumers as well. There will be some payday-loan users who overcome barriers to better credit as well as consumers who will be protected from their own irrational decision making. However, a policy that makes some better off while making others worse off is not ideal.

But IRR is not the only policy tool governments possess. There are other appropriate tools that can be used to ensure the market is operating according to principles of justice, including, for instance, the requiring of disclosure that accounts for the behavioural responses to the presentation of information,[151] altering legislation around loan terms, as well as offering enabling assistance to financial and civil-society institutions. Policy decisions around payday lending should not be shaped by a reflexive interventionism or minimalism, but by a vision of markets that recognizes the legitimate place of individual responsibility and the liberty of businesses to meet legitimate human needs and desires. Yet, as our current laws on competition, usury rates, and so on suggest, government policy is intended to ensure that these relationships are not marked by gross inequality between parties, and that such transactions do not negatively affect other parts of society by undermining the ability of citizens to fulfill their multiple social roles. In short, government's role is to, insofar as possible, shape laws that enhance just economic growth *and* social vitality.

8.2 The Colorado Example of Success (and Its Limitations)

In 2010 Colorado legislators passed new laws governing payday loans that transformed the structure of the industry without reducing access to consumers. After legislative reform of payday-loan laws in 2007 failed to help consumers in any significant way, Colorado legislators took a new approach and in 2010 passed a law that required all loans to be repayable over at least six months, established a new three-part fee structure, and provided consumers the ability to pay back loans early without penalty.

BASIC STRUCTURE OF 2010 COLORADO PAYDAY-LOAN LEGISLATION

Minimum Loan Term	6 months
Early Repayment Penalty	None
Maximum Loan Amount	$500
FEES	
Finance Charge	Max 20% on first $300 Max 7.5% on amount in excess of $300 Finance charges are deemed fully earned as of the date of transaction (though data suggests that in practice lenders provide prorated rebates for early repayment)
Interest Charge	Max 45% per annum
Monthly Maintenance Fee	Charged monthly for each month the loan is outstanding thirty days after the transaction date Not to exceed $7.50 per $100 loaned, max $30/month

Fig. 11: Colorado Uniform Consumer Credit Code, Colorado Attorney General, 2011, http://coag.gov/sites/default/files/contentuploads/cp/ConsumerCreditUnit/UCCC/uccc_relatedlaws_rules_7.1.15.pdf.

150 Kelly D. Edmiston, "Could Restrictions on Payday Lending Hurt Consumers?," *Federal Reserve Bank of Kansas City Economic Review* (March 2011): 31–61.
151 Per Bertrand and Morse, "Information Disclosure, Cognitive Biases, and Payday Borrowing."

After these laws were introduced in 2010, 60 percent of suppliers completely shut down operations and the number of retail locations was cut in half. However, despite concern, credit accessibility did not decrease significantly. Instead individual operations became more efficient. The number of borrowers per store doubled from 554 to 1,102, loan revenue per store increased, and the demographics of borrowers did not change substantially (see Fig. 12).

The new regulatory framework effectively transformed the underlying economics of the industry to better align supplier profitability with consumer affordability. Although the total revenue generated by the industry fell, revenue per individual store actually increased by almost 25 percent. Knowing that the large majority of costs associated with loan provision are fixed costs as well as variable costs associated with the administration of each loan, one can assume profitability on a per-store basis in Colorado has increased as total revenues per store increased while loans per store fell. At the same time, although the fees consumers pay per individual loan in absolute dollar terms are higher under the new law, the payments are extended over a longer period, significantly alleviating the core concern associated with payday loans: cash flow. The new lending structure decreased the average share a loan payment takes from a borrower's next paycheque, from 31 percent to 4 percent. With more-affordable payments, borrowers' risk of falling into a cycle of repeat borrowing is significantly reduced.

THE IMPACT OF COLORADO PAYDAY LENDING REFORM - PART 1

	BEFORE 2010 REFORM (2009 DATA)	AFTER 2010 REFORM (2013 DATA)	CHANGE
Total Loan Volume	$576,242,827	$189,125,729	-67%
Total Loans	1,565,481	481,122	-69%
Total Revenue	$95,087,460	$60,587,020	-36%
Number of Lenders	97	39	-60%
Number of Stores[5]	505	260	-49%
Number of Borrowers	279,570	259,000	-7%
Borrowers per Store	554	1,102	99%
Loans per Store	3,100	1,850	-40%
Loan Revenue per Store	$188,292	$233,027	24%
Borrowers' Average Annual Income	$29,496	$31,668	7%
Borrowers' Median Annual Income	$26,388	$27,024	2%

Fig. 12: "Trial, Error, and Success in Colorado's Payday Lending Reforms," Pew Charitable Trusts, 17 December 2014, http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2014/12/trial-error-and-success-in-colorados-payday-lending-reforms; "2009 Deferred Deposit Lenders Annual Report," State of Colorado Department of Law Office of the Attorney General, 2009, http://www2.cde.state.co.us/artemis/lawserials/law6211internet/; "2013 Deferred Deposit Lenders Annual Report," State of Colorado Department of Law Office of the Attorney General, 2013, http://www2.cde.state.co.us/artemis/lawserials/law6211internet/.

The legislation passed in Colorado in 2010 has arguably been the most effective regulatory framework for payday lending in North America. But despite improvements in almost every category important to consumer outcomes, there are still concerns with the state of the industry. With an average annual rate of 115 percent, fees are still quite high relative to other forms of credit, competition in the industry has decreased, default rates are still significant, and the number of loan renewals and quick reborrowers is still concerning (see Fig. 13).

THE IMPACT OF COLORADO PAYDAY LENDING REFORM - PART 2			
	BEFORE 2010 REFORM (2009 DATA)	AFTER 2010 REFORM (2013 DATA)	CHANGE
Average Loan Size	$368.09	$396.30	8%
Average Payment	$60.74	$113.82	87%
Average Term	18.91 days	98.62 days	421%
Average APR	318.51%	114.53%	-64%
Average Biweekly Payment (based on $400 loan)	$460	$58.96 (pre-prorated rebate for early payment)	-87%
Average Share of Borrower's Biweekly Income Taken Up by the Next Loan Payment (Based on $1500 Paycheque)	31%	4%	-87%
Lender-Charged Bounced Cheque Fees	$960,201	$497,611	-48%
Defaults per Borrower	0.493	0.379	-23%
Loan Default Rate	8.8%	20.4%	132%
Share of Loans That Were Renewals or Taken Out the Same Day	61.2%	36.7%	-40%

Fig. 13 Data Sourced: "Trial, Error, and Success in Colorado's Payday Lending Reforms"; "2009 Deferred Deposit Lenders Annual Report"; "2013 Deferred Deposit Lenders Annual Report."

These continuing challenges within the Colorado industry emphasize the limitations of a solely regulatory approach to creating a high-quality small-dollar credit market. When new regulatory restrictions are introduced to a market, suppliers will generally take the path of least resistance in order to adapt their existing model as little as possible to meet requirements. In this way regulation can often produce marginal improvements, but is limited in its ability to inspire real innovation that produces optimal markets. And regulatory reform can be a dangerous dance. The market does not always adapt the way regulators hope for, which can induce unintended harm to consumers and the economy. Regulatory reform is often a slow, inefficient, and potentially harmful process that is limited in its ability to produce optimal outcomes for both consumers and suppliers. This suggests that a market full of enabling credit options is more likely to be achieved by focusing efforts on the research and development of innovative new models to deliver high-quality small-dollar credit alternatives.

> *Accessible high-quality credit options is more likely to be achieved by focusing efforts on the research and development of innovative new models.*

8.3 Development of Market-Based Community-Focused Small-Dollar Credit Alternatives

A lack of access to alternative small-sum sources of credit is one of the main reasons Canadian households turn to payday loans, and one of the key reasons why regulation alone cannot adequately address concerns. If we want borrowers in need of credit to avoid the risks associated with payday-loan use, we must provide borrowers with access to high-quality small-dollar credit. Efforts supporting the research and development of new and innovative high-quality models for delivering small-dollar credit alternatives hold much more promise for addressing the problems associated with payday loans.

Mainstream financial institutions can play an important role in providing high-quality alternatives to payday loans. Banks and credit unions already have much of the existing infrastructure and operational expertise to deliver small-dollar loans to households. And they are also built on business models that are much more aligned with long-term customer success. Offering a full suite of financial services, these mainstream institutions have an economic incentive to help their customers achieve financial stability and build wealth. Unfortunately, however, the majority of mainstream financial institutions in Canada have avoided this market.

The greatest barrier to the development of high-quality alternatives is the challenging economics of the subprime small-dollar credit market. With low margins and high-risk borrowers, the profit potential of this market is limited. Finding ways to overcome this is critical for supporting the development and scale of high-quality products. We believe there are two ways to shift the economics of this market in support of sustainable high-quality alternatives to payday loans:

1. **Reduce the cost of provision.**
2. **Capture the externalized social value created by accessible high-quality credit alternatives.**

Utilizing the strengths and resources available in community-focused institutions across our social architecture can play an important role in both.

REDUCE THE COST OF PROVISION

Finding ways to deliver small-dollar credit to consumers in a more efficient and cost-effective way is vital for producing financially sustainable options that are affordable for consumers. One way to do this is to eliminate the costly retail-branch model entirely and utilize an Internet-based platform. Although there is concern about the growth of Internet-based lenders, particularly unlicensed ones that continue to charge borrowers exorbitant fees, the reality is that Internet-based platforms significantly reduce the cost of provision. The rent and salary costs of operating a retail-branch network alone account for about 60 percent of the cost of providing a traditional payday loan.[152] Lenders that operate online and utilize an automated borrower-assessment-and-approval process can completely forego these costs.

In Canada, one company is already utilizing an Internet-based platform to target payday-loan consumers with a more affordable alternative. Mogo Finance Technology, Inc. (Mogo), offers a direct alternative to payday loans at about half the price. The product, called MogoZip, priced at $10.50 per $100, is available to any borrower across Canada who does not qualify for the MogoMini. Mogo also rewards borrowers who make payments on time by enabling them to accesses better credit. After four successful payments with a MogoZip loan, borrowers can level up to a MogoMini loan with an extended payment plan that can be stretched over a twelve-month period and rates starting at 39.9 percent APR. Borrowers can continue to access progressively lower rates every twelve months if the borrower continues to make payments on time.[153] Although the short-term nature of the MogoZip product is still not the ideal structure for consumer affordability, Mogo has effectively used an Internet-based platform to create a financially sustainable payday loan product at a substantially reduced rate to the consumer. And with their level-up program consumers can earn their way into higher-quality credit products and escape dependency on payday loans.

How do we reach more of the market with high-quality Internet based alternatives?

152 "The Cost of Providing Payday Loans in Ontario," 16.
153 "MogoMoney," https://www.mogo.ca/mogo-money, accessed 11 January 2016.

Unfortunately the current reach and impact of Internet-based lenders like Mogo is limited. Although its share of the market is growing, the majority of borrowers continue to use traditional brick-and-mortar lenders. An important question we must continue to explore is, *how do we reach more of the market with high-quality Internet-based alternatives?* If we can bridge the gap for households who are unfamiliar or uncomfortable with lenders like Mogo, we can help them access better credit and protect them from the risks of traditional payday loans. But there are also other opportunities outside of Internet-based solutions that we cannot ignore. The resources available in many of the community-focused institutions across our social architecture can also be utilized to reduce the cost of provision.

In almost every community there is already an existing branch network of community-service organizations that many payday-loan users may already frequent or have a relationship with. These organizations hold tremendous potential for delivering high-quality small-dollar credit alternatives. Finding ways to utilize the space in these institutions to process and delivery high-quality credit to consumers in need could significantly reduce the costs associated with operating a large branch network.

This model is utilized by Good Shepherd Microfinance in Australia. Good Shepherd Microfinance is a not-for-profit microfinance organization that seeks to empower financially vulnerable Australians through no-interest and low-interest loans as well as other financial services. Good Shepherd has established an extensive network of retail branches for its products throughout Australia by utilizing the space and staff of existing community-focused institutions to delivery their services.[154]

Community institutions and governments, particularly municipal governments, can also help reduce costs by freely promoting services to consumers. Many municipalities have vacant advertising space on public transit that could be put to use to support lending alternatives run by credit unions, banks, or other institutions in their communities.

LEVERAGING CIVIL SOCIETY FOR SOCIAL IMPACT—CAPTURING EXTERNALIZED SOCIAL VALUE

Governments, or well-capitalized community institutions, such as community foundations, churches, or charitable organizations, could also play a role in decreasing risk for financial institutions such as credit unions by offering funds to credit unions or other community financial institutions to backstop loan losses. The need to reserve capital to backstop potential losses serves as significant restraint on financial-institution innovation in this space. Partnerships between civil-society institutions and financial institutions or, as was recommended in 1967, partnerships between government and financial institutions would open space for credit unions and banks to enter the small-dollar loan market.

Community foundations might also reduce the cost of provision by providing capital to high-quality lending operations at a below-market rate. Unfortunately, despite interest from community foundations in using their capital for influence oriented investments, the Canadian Revenue Agency does not allow charitable funds to be invested into a for-profit initiative at a below-market rate even if there is a charitable or social-value return built in to the investment. This rule prevents community foundations from providing below-market-rate capital to lending operations to help reduce the cost of credit provision. It does, however, indicate one place where government may be able to assist by reducing restrictions on civil society and freeing them to pursue market-based, community-focused initiatives that straddle the charitable, financial, and social-service sectors.

Another approach is for community-focused financial institutions to exchange a financial return (in the form of profit) for a social return.

154 Good Shepherd Microfinance, http://goodshepherdmicrofinance.org.au/, accessed 11 January 2016.

Vancity Credit Union, located in Vancouver, British Columbia, developed a high-quality small-dollar credit product out of a motivation to better serve their members and protect them from the risks of payday-loan use.[155] Vancity leveraged their existing banking infrastructure and operational expertise to develop a financially sustainable product, but one that is not a major profit centre, and their motivation for developing it was not profit.

What this approach recognizes is the fact that there are real personal and social costs to payday lending that need to be borne somewhere, by someone, or some organization. To take an analogy from the resource sector, initiatives like those undertaken by Vancity are internalizing the costs that are otherwise externalized (and therefore, socialized) by the current payday-loan providers.

> *Enabling alternatives can create value for individual borrowers, their families, communities, and ultimately all of society.*

The fact that payday lending contributes to significant social costs—many of which, in the Canadian context, are borne by government—suggests another possibility: the offering of social-impact bonds to institutions that achieve certain financial objectives associated with payday lending.

Enabling alternatives can create value for individual borrowers, their families, communities, and ultimately all of society. By empowering borrowers to achieve financial stability, build better credit, and avoid the potential harms of payday-loan use, enabling small-dollar loans could reduce or eliminate the harmful ripple effects of payday-loan dependency and reduce government costs associated with health and other services that are strained by our current model. While we acknowledge that quantifying these costs is a challenge, social-impact bonds could serve as an incentive for providers to innovate in this sector.

SECTION 9: CONCLUSION

Canada is a peaceful and prosperous country. We pride ourselves not only on our sound institutions and long history of peace but also on being one of the freest and wealthiest countries in the world. Despite this wealth, many Canadians remain stuck in cycles of debt that restrain that freedom and act as a ball and chain on their, and our, country's long-term vitality and economic prospects. Indeed, while that freedom is true in law, many who use payday loans can identify with the ancient proverb that "the borrower is the slave to the lender." But there is no 'silver bullet' solution to the problems associated with payday loans. The impact of the industry is complex and while restrictive government regulation is likely to help some, it is also likely to hurt others. We must find ways to address the structural issues in the current system without restricting access to small-dollar credit for those on the margins. To do so requires us to find ways to build an enabling small-dollar credit market. While targeted government regulation can help, we suggest true market transformation will require action and collaboration among governments, banks, credit unions, and civil society with a focus on developing new and innovative enabling small-dollar credit products.

155 "Vancity Fair and Fast Loan," Vancity Credit Union, https://www.vancity.com/Loans/TypesOfLoans/FairAndFastLoan/, accessed 11 January 2016.

APPENDIX

EXHIBIT 1

REVENUE DISTRIBUTION - MONEY MART

Revenue	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Consumer Lending	28%	32%	36%	43%	47%	52%	53%	51%	53%	55%	56%	60%
Cheque Cashing	52%	47%	44%	38%	35%	31%	29%	29%	25%	24%	23%	21%
Other	20%	21%	20%	19%	18%	17%	18%	20%	22%	21%	22%	19%
Total Revenues	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

REVENUE DISTRIBUTION - THE CASH STORE FINANCIAL SERVICES

Revenue	2009	2010	2011	2012	2013
Consumer Lending	81%	77%	72%	74%	80%
Other*	19%	23%	28%	26%	20%
Total Revenues	100%	100%	100%	100%	100%

*Includes revenues generated from cash chequing services.

EXHIBIT 2

OPERATING PROFIT

	2009	2010	2011	2012	2013	5-Year Avg.
Money Mart	35.6%	35.5%	36.7%	37.4%	37.7%	36.6%

Operating profits are equal to revenue minus expenses, not including interest expense, amortization or assets, income tax, and gains or losses associated with non-reccurring events.

Cash Store Financial	22.9%	22.4%	13.9%	4.5%	0.1%	12.8%

INCOME BEFORE TAXES

	2009	2010	2011	2012	2013	5-Year Avg.
Money Mart	1.8%	0.8%	18.5%	9.6%	12%	8.5%
Cash Store Financial	14.3%	17%	8.9%	-30.3%	-18.5%	-1.7%

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ABOUT CARDUS

Cardus is a think tank dedicated to the renewal of North American social architecture. Headquartered in Hamilton, ON, Cardus has a track record of deliverin original research, quality events, and thoughtful publications. Cardus's Work and Economics Program recognizes that finance can enhance and strengthen civil society and the public good, but that fi nance and economic life also rely on sound social architecture. As noted by Mark Carney and Roger Martin at a recent Cardus lecture, capitalism relies on intangible virtues such as trust, without which banking, and markets will fail. As such we publish papers, and host events which explore the complex and complimentary relationship between virtues, social structures, sound finance, and a strong economy. Cardus is a registered charity.