

**– Capping Borrowing Costs –
A Balanced Approach to Payday Loans in Ontario**

**Report of the Maximum Total Cost of Borrowing Advisory Board for the
Ontario Payday Lending Industry**

February 6, 2009

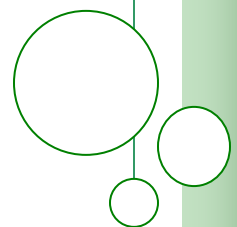


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OVERVIEW OF FINDINGS & RECOMMENDATIONS

The Ontario government created the Maximum Total Cost of Borrowing Advisory Board for the Ontario Payday Lending Industry to recommend an upper limit on the total cost of borrowing under payday loan agreements. The board was directed to propose an upper limit that will be fair for consumers while preserving a competitive payday lending industry to meet the needs of Ontario borrowers.

The board finds that payday loans are expensive because of their design as small, short-term loans, not because the industry is earning excessive returns. While most borrowers are in financial distress, the industry generally lends only to consumers who have jobs. Social assistance recipients do not qualify for loans from most payday lenders in Ontario.

The board concludes that payday loans should be available only to consumers who can realistically be expected to pay them back on time and use them as a tool for personal financial recovery. Some payday loans simply should not be made because they are too risky for both borrower and lender. To smooth repayment, borrowing costs to consumers should be kept as low as possible, consistent with the existence of a competitive industry. Payday lending to social assistance recipients should not be encouraged, as such loans would be of very high risk for both borrower and lender.

Based on extensive consultation and research, the board recommends that the Ontario government:

- **set the upper limit on the total cost of borrowing for payday loan agreements in Ontario at \$21 per \$100 borrowed;**
- **not recognize different classes of borrowers and not establish different upper limits to the total cost of borrowing for different classes of borrowers; and**
- **review the upper limit on the total cost of borrowing two years after it takes effect.**

INTRODUCTION

In July 2008, the Ontario government appointed the Maximum Total Cost of Borrowing Advisory Board for the Ontario Payday Lending Industry to recommend an upper limit on the consumer's total cost of borrowing for payday loans in the province.

Under Ontario's *Payday Loans Act, 2008*, passed in June 2008 and awaiting proclamation, payday lenders will be required to keep borrowing costs below limits set by government regulation. Through a report to the Minister of Small Business and Consumer Services, the board is to recommend the maximum total cost of borrowing that it considers appropriate and consistent with its mandate.

This is the board's report.

Legislative History

We on the board see our role as the next step in the process of shifting significant responsibilities for the oversight of payday lending in Canada from the federal government to the provinces. This process began with the May 2007 enactment of federal Bill C-26, which amends the *Criminal Code* regarding criminal interest rates. Section 347 of the Code makes it a criminal offence to charge more than 60 per cent interest per year.

Bill C-26 exempts payday lenders from criminal prosecution under section 347 if the loan is for \$1,500 or less with a term of 62 days or less and the lender is licensed by a province designated by the federal government. To obtain designation, a province must enact legislation that protects payday loan borrowers and provides for limits on the total cost of borrowing under payday loan agreements.

The Ontario government had urged Ottawa to regulate the total cost of borrowing for payday loans at the national level to ensure uniform protection for all Canadians. Since the federal government did not do this, the province has no choice but to seek federal designation to protect borrowers in Ontario.

Ontario's *Payday Loans Act, 2008* is intended to enable the province to meet the requirements for designation under Bill C-26. Developed after extensive public consultations, its key provisions include:

- a licensing system for payday lenders and payday loan brokers
- regulatory authority for the government to set a total cost of borrowing ceiling
- prohibition of certain industry practices such as concurrent loans and rollovers¹

¹ A rollover is a new loan to pay off an existing loan, made to a borrower who is unable to repay on time. The amount of the new loan consists of the principal and charges from the original loan plus additional charges based on the term of the new loan. This results in a rapid increase in the borrower's indebtedness without the lender advancing additional funds.

- a cooling-off period so borrowers can cancel loan agreements without penalty within two business days
- enforcement through inspections, prosecutions and suspension and revocation of licences
- an education fund supported by industry contributions to inform consumers of the dangers of high-cost credit and promote sound personal financial planning.

Previously, the government established payday-loan disclosure requirements through regulations under the *Consumer Protection Act, 2002*. Effective August 1, 2007, lenders must prominently display a poster showing the total cost of borrowing as the dollar cost per \$100 borrowed. They are also required to clearly set out borrowing information in a standard format on the first page of the payday loan agreement.

Advisory Board Terms of Reference

One of the criteria for federal designation is that the province must provide for limits on the total cost of borrowing for payday loans. The Ontario government is committed to taking an open and consultative approach in determining an appropriate ceiling. This is the reason it has created an independent, expert advisory board.

The board has been directed to recommend an upper limit to the total cost of borrowing that will be fair for borrowers while preserving a competitive payday lending industry in Ontario. Our recommendation is to be provided in a report to the Minister of Small Business and Consumer Services for his use in advising the government. Our report may include different upper limits to the total cost of borrowing for different classes of borrowers. Our role is only to provide advice. The government will decide what the upper limit or limits on the total cost of borrowing will be.

Specifically, we have been assigned the following duties:

- consult with industry, social, poverty, consumer and financial groups and other experts, as required
- consider the experience of other jurisdictions with a payday lending marketplace
- recommend an upper limit (or limits) to the total cost of borrowing for payday loan agreements
- recommend whether the government should recognize different classes of borrowers and, if so, recommend upper limits for the cost of borrowing for specific classes of borrowers.

In developing our recommendations, we may consider:

- the operating expenses and revenue requirements of payday lenders in relation to their payday lending business;
- the terms and conditions of payday loans;
- the circumstances and credit options available to users of payday loans;
- the risk taken by payday lenders in providing payday loans;
- the regulation of payday lenders and payday loans in other jurisdictions.

Research & Consultation Process

Through a notice posted on the ministry's website, we requested submissions from the industry, consumer associations, social advocacy groups, academics and individuals interested in the total cost of borrowing issue. We asked participants to provide feedback on a series of questions or to raise other relevant issues. The questions posed were:

1. What do you believe should be the maximum total cost of borrowing for payday loan agreements in Ontario?
2. What criteria should be used to determine a maximum total cost of borrowing for payday loan agreements in Ontario?
3. What societal values and/or impacts should be considered in determining a maximum total cost of borrowing for payday loan agreements in Ontario?
4. Should there be different upper limits to the total cost of borrowing for different classes of borrowers, i.e., how should different upper limits be determined and what should those limits be?
5. What impact or benefit would a different upper limit on the total cost of borrowing have on the behaviour or circumstances of the different classes of borrowers?

In all, we received 16 written submissions. We also held 14 consultation sessions in fall 2008 with key stakeholders who met with us in person to offer additional insights and information. All this input was carefully considered.

The board also reviewed extensive materials on payday lending across Canada, in the United States and overseas. As well, we engaged a consulting firm, Ernst & Young, to prepare a report on the financial structure of a sample of lenders providing payday loans in Ontario.

BACKGROUND ON PAYDAY LENDING

Some background information on payday lending will help set the stage for our findings, analysis and recommendations.

What Is a Payday Loan?

A payday loan is a short-term loan for a small sum of money advanced in exchange for a post-dated cheque, pre-authorized debit or similar future payment. The loan is not secured by property. The payment the borrower is required to make includes the principal amount plus all interest and fees charged. Payment is made by post-dated cheque or pre-authorized debit dated on the borrower's next payday and provided when the loan agreement is made.

Typically, lenders require the borrower to show pay stubs proving three months of continuous employment, supply proof of address such as a recent utility bill, and have an active chequing account. A credit check is rarely performed. The borrower receives the funds in cash, by direct deposit or on a preloaded debit card that can be accessed immediately. The money cannot be advanced through a credit card or line of credit.

In Canada, loans typically range up to 60 per cent of the borrower's net pay. Both federal and Ontario legislation restrict payday loans to \$1,500 or less, for a term of 62 days or less. However, these ceilings are seldom reached. The average loan in Canada is approximately \$300 for a term of two weeks.

The Industry in Profile

The payday lending industry has grown rapidly since arriving in western Canada in the early 1990s and then migrating eastward. Currently, there are approximately 1,350 payday loan storefronts operating in Canada – with more than half or about 750 stores in Ontario – plus a number of Internet or telephone lenders. Some payday loan outlets offer a suite of “alternative” financial services that includes cheque cashing, bill payments and wire transfers.

Despite recent growth, the payday loan industry remains a small player in the financial services sector. While different sources cite different figures, total payday loan volume in Canada is widely estimated to be approximately \$2 billion per annum. To give a sense of the scale, total payday lending nationwide is comparable to the amount lent by a single medium-to-large size branch of a Canadian chartered bank.

At the storefront level, it is estimated that the average payday-loan site lends approximately \$1.5 million and makes 5,000 individual loans a year (based on an average loan of \$300). This translates to an average of 16 loans per day and requires less than \$100,000 in total funding. While a few large firms comprise most of the market, the modest capital and funding needs create room for smaller players to operate.

Banks, trust companies and most credit unions have stopped participating in the small, short-term loan business. They offer their customers other products to supply funding for the brief periods when they run short of money or face an emergency – for example, credit card cash advances, overdraft protection and lines of credit. Typically these short-term cash flow remedies are available at a much lower cost than payday loans.

Payday Lenders in Ontario

Two major national players account for most of the Ontario market: National Money Mart Company and Cash Store Financial Services Inc. Money Mart, with approximately 230 Ontario storefronts, is a subsidiary of the U.S.-based Dollar Financial Group, Inc., which is publicly traded on the NASDAQ. Cash Store, with approximately 115 locations in Ontario, is headquartered in Edmonton and traded on the TSX Venture Exchange.

A third lender, Cash Money, operates approximately 75 locations in Ontario, but has a less extensive national presence than Money Mart and Cash Store. The balance of the Ontario payday lending market is made up of mid-sized firms with up to 30 locations; some small, single-outlet operators; and a few Internet lenders such as 310-LOAN that offer loans online or over the phone.

The Customer in Profile

Data is steadily emerging on who payday loan borrowers are.

Critics of the industry claim that payday lenders have become established in locations that are not served by banks or where bank branches have closed. While this may be true in some cases, upon closer examination this situation is not typical. A recent U.S. study of eight major cities found that the majority of payday loan storefronts are located in neighbourhoods with at least one bank.² This impression is borne out in Ontario by simply observing busy streets in Toronto and other communities, where payday lending sites are found a few blocks and often just doors from banks.

Statistics Canada reports that 353,300 Canadian families – almost 3 per cent of all families – in 2005 said they had taken out a payday loan in the past three years.³ Recent industry-sponsored surveys⁴, both in Ontario and Canada-wide, have found that the average payday loan customer is relatively young – 39 years old – and that 68 per cent of borrowers are employed full-time. Internet lenders report that online customers tend to have higher incomes and generally represent a more sophisticated market than other payday loan borrowers.

² Fannie Mae Foundation. Analysis of Alternative Financial Service Providers. Feb. 19, 2004, p.3.

³ Perspectives, Apr. 2007, Statistics Canada – Catalogue no. 75-001-XIE, p.3.

⁴ POLLARA telephone survey, Aug.-Sept. 2007; Environics, “Understanding Consumers of Canada’s Payday Loans Industry”, June 2005.

The Canadian payday lending industry depends heavily on repeat business. For every loan to a new customer, payday lenders make 15 loans to repeat customers on average across the country.⁵ As a result, even the largest stores have fewer than 1,500 different customers in a year, with a typical number of customers ranging from 200 to 500. A consumer survey⁶ indicates that almost half of Toronto's payday loan borrowers have taken out six or more payday loans in the last 12 months.

The Cost of Borrowing

Under Ontario's *Payday Loans Act, 2008*, "cost of borrowing" means the total of all amounts that a borrower is required to pay under, or as a condition of entering into, a payday loan agreement, except default charges and repayment of the advance. It does not matter if the amounts paid to the lender are called interest, brokerage fees, administration charges or any other name: they are part of the cost of borrowing.

Most companies charge borrowers a fee that represents a straight percentage of the amount loaned, regardless of the loan's size or term. These fees range from 15 to 35 per cent of the principal, but most fall between 19 and 25 per cent of the principal.

Some payday lending companies charge fees that reflect a combination of interest, a flat percentage of principal and a fixed dollar charge. The most notable example is Money Mart, the largest lender in the industry. It charges a fee of \$9.99 per transaction, plus interest accrued at a 59 per cent effective annual rate, plus a "cheque-cashing fee" of 7.99 per cent of the principal plus interest. The total fee works out to be lower on average than the fees charged by other firms, although it may be higher on the smallest loans.

A nationwide survey found that many payday loan borrowers are not aware of the true cost of their loan. More than one third – 37 per cent – believe that the interest rate for a payday loan is the same or lower than the interest rate for a credit card.⁷

Cash Store has a brokerage business model and operates by facilitating a loan agreement between a lender and a borrower. Their standard agreement charges 59 per cent interest that goes to the lender, and brokerage fees exceeding \$20 per \$100 borrowed that are paid to Cash Store. Cash Store is one of the few payday loan brokers known to operate in Ontario. In this arrangement, the lender absorbs most loan losses and collection expenses, while the broker provides the storefront services.

⁵ Ernst & Young, "The Cost of Providing Payday Loans in Canada", Oct. 2004, p. 36; Chris Robinson, "Regulating Payday Loans and the underbelly of Canadian Society", p. 4.

⁶ Strategic Communications, Inc. for Association of Community Organizations for Reform Now (ACORN), Survey of Payday Loan Users in Toronto and Vancouver, Nov. 2005, p. 3.

⁷ Ipsos-Reid, "Public Experience with Financial Services and Awareness of the FCAC", Mar. 2005.

To date, there have been no prosecutions of payday lenders under the *Criminal Code*, leaving the industry largely unregulated. A number of class action lawsuits against payday lenders are proceeding through Canadian courts, seeking to recover hundreds of millions of dollars in interest charges in excess of the rate allowed by the *Criminal Code*.

In 2004, the payday lending industry, led by Money Mart, formed the Canadian Payday Loan Association. The association has positioned itself as the voice of the industry and lobbied the federal and provincial governments to establish a regulatory framework that would permit the industry to operate without risk of criminal prosecution.

The Response of Other Provinces

British Columbia, Manitoba, Saskatchewan, New Brunswick and Nova Scotia – like Ontario – have passed payday lending legislation that is consistent with the requirements for designation under federal Bill C-26. These measures have not yet taken effect as this report is written. Quebec effectively prohibits payday loans by limiting the annual rate of interest for all lenders under provincial jurisdiction to 35 per cent.

Manitoba gave the Manitoba Public Utility Board (MPUB) responsibility for setting payday loan charges. The MPUB held hearings in late 2007 and released its recommendations in April 2008. For a payday loan of up to \$500, the board recommended a maximum cost of credit of 17 per cent of value received (that is, \$17 per \$100 borrowed). Lower rates were proposed for larger loans up to \$1,500. The MPUB also recommended a 6 per cent ceiling on the cost of credit for borrowers on social assistance or employment insurance, and for loans over 30 per cent of the borrower's net pay. The MPUB's order has not taken effect. In January 2009, the Manitoba government announced that it intends to introduce legislation to have maximum payday loan rates set by the government directly, rather than by the MPUB.

In Nova Scotia, the Nova Scotia Utility and Review Board (NSUARB) was assigned to set the maximum total cost of borrowing. The NSUARB held public hearings in January 2008 and released its decision in July 2008. It set the maximum cost of borrowing – including interest and all other expenses incurred to receive the requested cash – at \$31 per \$100 borrowed.

THE ONTARIO ADVISORY BOARD'S PERSPECTIVE

It is not our mandate as an advisory board to revisit the principles or provisions of the *Payday Loans Act, 2008*. The Ontario government has decided to regulate, rather than eliminate, payday lending and it is not our role to reassess this policy decision. Rather, we see our mandate as to help implement the approach taken in the legislation, which is to strike a balance between protecting consumers and maintaining a competitive business environment.

Ontario's new legislative framework reflects three principles⁸:

- to protect borrowers who use payday loans
- to build public confidence in the integrity of the payday lending market and
- to develop a regulatory system that allows payday lenders to continue to operate and serve a market that depends on their services.

In this context, our task is to recommend a maximum total cost of borrowing that will be fair for borrowers while preserving a competitive payday lending industry in Ontario. The object of this exercise is to protect the thousands of Ontarians who, from time to time, may rely on payday loans to help them through short-term financial pressures. Limiting the total cost of borrowing will reduce the risk of consumers entering or feeding a cycle of mounting, unmanageable debt. On the other hand, we recognize that our recommendation should not in effect undermine the premise of the legislation by setting a limit so low that a competitive industry cannot function and payday lending services become unavailable.

Again, the task is to find the right balance.

We stress that a ceiling on the total cost of borrowing is only one aspect of a comprehensive consumer protection regime being put in place by the Ontario government. As noted above, the *Payday Loans Act, 2008*, which awaits proclamation, establishes a licensing system for payday lenders. It prohibits concurrent loans and rollovers – harmful practices that take advantage of desperate borrowers and can drive a spiral of debt from which it is hard to escape. The new legislation also allows borrowers to cancel loan agreements without penalty within two business days. Moreover, under the *Consumer Protection Act, 2002*, regulations are now in force that requires payday lenders to prominently post the total cost of borrowing as the dollar cost per \$100 borrowed. Disclosure of borrowing information is also obligatory in the payday loan agreement itself. It is our view that these other safeguards, especially the ban on rollovers, are just as important as the upper limit on borrowing costs in protecting the interests of consumers.

⁸ Consultation Paper – A Limit to the Cost of Borrowing for Payday Loans in Ontario, Ministry of Small Business and Consumer Services, 2008.

THE BOARD'S FINDINGS

As we began our analysis, a key question was to determine why consumers turn to payday lenders when they face an unexpected expense or other financial emergency.

Why Consumers Use Payday Loans

We heard differing opinions. Industry representatives contend that payday loan customers are average Canadians with near-median household incomes.⁹ They say borrowers are attracted by the quick and simple lending process and convenient store locations, with only a small minority of customers having no other borrowing options.

Some payday lenders, on the other hand, indicate that most of their customers have simply exhausted other alternatives such as credit card cash advances. These lenders observe that repeat loans are often necessary because borrowers are in financial difficulty and it takes time for them to turn their situation around. Social advocates believe that most payday loan borrowers are in significant financial distress.

Statscan Survey

We note that Statistics Canada's Survey of Financial Security¹⁰, which covered about 5,300 Canadian families in 2005, asked about borrowing through payday loans over the previous three years. Key findings linked the use of payday loans with financial difficulties. For example:

- Low-income families were twice as likely to have taken out payday loans as those not in low income (4.6 per cent compared with 2.3 per cent).
- More than half of families who used payday loans were in the bottom fifth of the net worth distribution.
- Seven in 10 families who used payday loans were renters, while less than four in 10 families who did not use payday loans were renters.
- Families who had been refused a credit card were more than three times as likely to have taken out a payday loan.
- 15 per cent of payday loan borrowers were two or more months behind in rent or mortgage payments.
- One fifth of payday loan borrowers had dealt with a pawnbroker.
- Families behind in loan or bill payments were more than four times as likely to have used payday loans.
- Four in 10 families who borrowed through payday loans had spending that exceeded income, more than double the proportion of families who had not used payday loans.

⁹ Canadian Payday Loan Association website, "Who Uses Payday Loans" at - <http://www.cpla-acps.ca/english/aboutloans2.php>.

¹⁰ Perspectives, Apr. 2007, Statistics Canada – Catalogue no. 75-001-XIE, pp. 5-13.

Statscan's analysis comes to the following conclusion:

While the Survey of Financial Security does not directly tell us why families borrow through payday loans, important indicators of past and current financial difficulties suggest that families who do have few other options.

Borrowers in Financial Distress

Overall, we challenge the picture painted by some members of the industry that payday loan borrowers are "average Canadians." The preponderance of evidence, whether anecdotal or statistical, is that the majority of these consumers are in financial distress and have limited options.

We acknowledge that a sizable minority of borrowers may use payday loans out of convenience rather than necessity. We are troubled, however, by the finding that nearly 40 per cent of borrowers apparently do not realize that their payday loan is more expensive than other forms of consumer credit. It is to be hoped that the new disclosure requirements now in force, coupled with initiatives under the planned education fund, will help improve consumer awareness. Perhaps some of these borrowers, who may well have other options, will pursue them if they are better informed.

Even borrowers who resort to payday loans out of necessity rather than convenience may not be impoverished. In most cases, one must have a job with a regular payday to obtain a payday loan. While payday loans can sometimes start or accelerate a slide into bankruptcy, we also heard of borrowers who used these loans effectively to get out of financial difficulties. For example, borrowers may take a second job, work overtime or cut back on their expenses to gradually turn their finances around. It is cases like these, we believe, that have helped convince both the federal and provincial governments not to impose an outright ban on payday lending.

In fact, social advocacy and consumer groups and payday lenders all agreed that a competitive payday lending industry must be preserved. Nationwide, nearly 3 per cent of families have used a payday loan in the past three years. Clearly a demand for this service exists.

Measuring the Cost of Borrowing

Another point most stakeholders agreed on was the inappropriateness of an annual percentage rate of interest as a way to measure payday-loan borrowing costs. Both the industry and social advocacy and consumer groups were of one mind on this question. We regard this as a significant issue, as reference to annualized rates has tended to distort perceptions of the cost of borrowing.

The media often report that the industry charges astronomical interest rates. For example, a \$100 loan for a fee of \$20 would represent an annual percentage rate of 20 per cent if the term is one year. But the annual percentage rate balloons to 520 per cent, un compounded, when the term is two weeks, as is normally the case with payday loans. Expressing the cost of a small, short-term loan on an annualized basis makes no more sense than expressing the cost of a night in a hotel on a yearly basis. At \$200 per night, a hotel room would cost more than \$73,000 for a full year – a sum no one would ever pay because no one would take a room at the nightly rate for a full year – which is the point.

In fact, if one insists on describing borrowing costs on an annualized basis, one should also look at bad debt costs on an annualized basis. Bad debt costs of \$4 per \$100 lent are not unusual. This means that \$4 of every \$100 lent is not recovered. But the money is typically lent for only two weeks, so the lender is losing 4 per cent of the principal every two weeks. Annualized, the loss rate would be in the order of 104 per cent, far in excess of conventional lending norms.

We concur that the appropriate measure of what a payday loan costs the consumer is the total dollar cost per \$100 borrowed – the measure adopted by the Ontario government in its consumer disclosure regulations.

Why Payday Loans Cost So Much

To set an upper limit on borrowing costs paid by the consumer, we need to understand what it costs the lender to provide the loan.

By definition a payday loan has a low dollar value and a short term. The typical payday loan is \$300 for two weeks. Yet for this short term and small amount, the lender must do all the paperwork involved in setting up the loan and keep the lights on, that is, provide the infrastructure for the business.

Operating costs such as staff salaries, computer systems and building occupancy are the largest component in the cost structure. The lender must also absorb the cost of loan capital – that is, the cost to the lender to obtain the funds to be lent – as well as carrying costs for fixed assets and cash reserves. But these costs of capital in fact represent only a small fraction of the overall cost structure. A major item, on the other hand, is the cost of bad debts. Since the payday loan industry lends to higher-risk customers than conventional financial institutions do, its default rates and bad debt costs are also higher.

Lenders must recoup these various costs from revenues, while leaving enough of a return to justify the existence of the business. It is the design of these financial products as short-term, small loans, and the resulting cost structure, that explains why they are so expensive.

To gain a better understanding of the cost structure, the board commissioned Ernst & Young to prepare a report on the cost of providing payday loans in Ontario. They collected and analyzed financial information from nine lenders with a total of 67 stores and a combined loan volume of more than \$30 million in their most recent fiscal year (2007 or 2008)

As the accompanying table and chart indicate, the average cost of providing a payday loan in this sample is \$21.50 per \$100 loaned. Operating costs represent about three quarters of total costs. Bad debt costs account for nearly one fifth of total costs, while the cost of loan and supplementary capital¹¹ makes up the remaining 4½ per cent. The cost figures are weighted on the basis of the lender's relative share of the total loan volume in the sample.

The Ernst & Young report finds that the average payday lending outlet in the sample has annual loan revenues of \$119,000 and operating costs of \$89,000. Combined with bad debt expense of \$22,000 a year, total annual costs are \$111,000 – leaving only \$8,000 for the cost of capital and operating profit. The largest operating costs are salaries and benefits at \$47,000 and rent at \$19,500.

The overall cost structure outlined in the Ernst & Young report is consistent with a recent survey of Ontario payday lenders commissioned by the industry, which covered 15 companies with a total of 111 stores and total annual payday lending of \$170 million. This study¹² estimated the cost of providing a \$100 payday loan to be \$20.63.

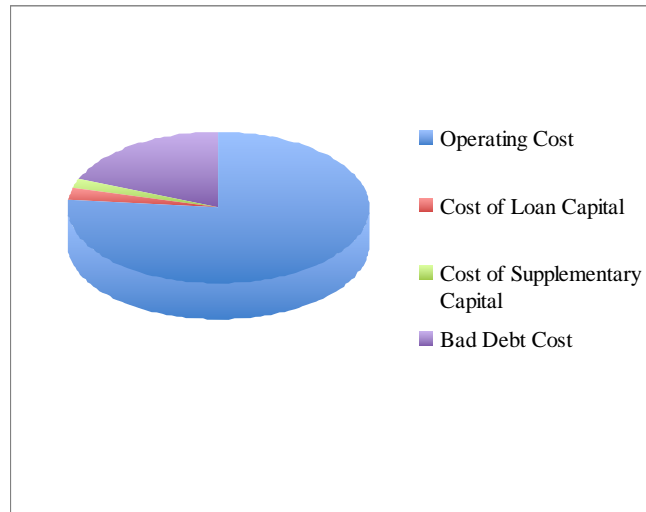
¹¹ Costs for loan and supplementary capital are the actual or opportunity costs of funds to the lender. They include the cost of funds lent to borrowers, as well as the carrying costs for fixed assets and cash reserves needed to ensure money is available for lending.

¹² Deloitte. Cost of providing payday loans in Ontario. Oct. 7, 2008.

Cost of Providing Payday Loans in Ontario

Cost per \$100 of Payday Loans

Operating Cost	\$16.48
Cost of Loan Capital	\$0.55
Cost of Supplementary Capital	\$0.41
Bad Debt Cost	\$4.06
Total	\$21.50



Amounts weighted based on lender's relative share of total loan volume in sample.
Source: Ernst & Young. The Cost of Providing Payday Loans in Ontario. Jan. 2009.

An Inefficient Retail System

The board observes that payday lending is a relatively young industry in Ontario and may not yet have found its most efficient business model. We are particularly struck by the high level of operating costs as a portion of revenues.

Like many new industries, the payday lending sector may have expanded too fast. Some firms have chosen to compete on the basis of location and customer service, but this strategy can lead to high facility and staffing costs. If loan volumes do not grow fast enough to cover these expenses, consumers may face even higher borrowing costs.

Varying Tolerance for Risk

As the board studied the industry's cost structure, one industry trait remained puzzling. We and others have observed that two or more payday lenders can survive in the same neighbourhood while charging much different rates. On the surface, logic suggests that rates should move to the same level, or else all customers would gravitate to the lowest-price lender. We realize that some lenders may have more convenient locations, more welcoming facilities or friendlier employees. But it seems unlikely that these factors alone could overcome a large price disadvantage.

Based on conversations with lenders, review of financial information and our own judgment, we have concluded that payday lenders compete, not only on the basis of price, service and location, but also on the basis of their tolerance for risk. That is, some lenders will lend to higher-risk customers than will their competitors. Higher risks translate into higher default rates and higher loan losses. The charges of higher-cost lenders may reflect a willingness to lend to higher-risk borrowers, pushing up borrowing costs.

The Profitability of the Industry

It is widely held that payday lenders are making huge if not obscene profits. At the outset, in fact, the board members suspected this impression was not too far off the mark.

However, in the course of our consultations we have talked with many members of the industry about the financial realities they face. We have had the opportunity to review the financial statements of a cross-section of Ontario payday lenders. To supplement our findings, as noted above, we engaged a consulting firm to independently collect and analyze financial data from the industry.

We observe that the best performers in the industry are making solid but unspectacular returns that would be considered acceptable in other major sectors under normal economic conditions. Other firms seem to alternate between good years and lean years, and still others are struggling.

The Ernst & Young report calculated that the average operating profit margin for payday loans in the sample was 6.9 per cent. This figure reflects the ratio of operating profit to total revenue for payday lending (weighted on the basis of the lender's relative share of loan volume in the sample). Profit margins ranged from a loss of 0.9 per cent to a profit of 17.6 per cent. For purposes of comparison, the report cites Statistics Canada data showing that the average operating profit margin for all Canadian industries in 2007 was 8.8 per cent. Non-financial industries had an average profit margin of 6.9 per cent, while finance and insurance industries averaged 26.4 per cent.

Overall, we believe the payday loan industry is not making exorbitant profits from lending activities.

Lending to Low-Income Groups

The perception about excess profits ties in to another negative stereotype about payday lenders – that they prey upon the poor. If both of these perceptions were shown to be true, it might make sense to address them both by making the industry subsidize its loans to people with very low incomes.

As noted, however, profits do not seem exorbitant. Moreover, our consultations revealed that in fact there are almost no payday loans to those with very low incomes, defined mainly as individuals receiving social assistance. In fact, the Code of Best Business Practices of the Canadian Payday Loan Association, which is binding on its members, prohibits making loans on the basis of social assistance payments. We met only one lender who lends to people on welfare, and then only on a highly selective basis. Most lenders require employment as a condition of getting a loan. This means that social assistance recipients will not qualify for a loan from most payday lenders in Ontario today.

ANALYSIS & RECOMMENDATIONS

As noted above, an upper limit on the total cost of borrowing is one element in a larger, emerging regulatory regime for the payday lending industry. A major goal of this regime is to protect consumers from harmful lending practices – such as loan rollovers and concurrent loans – that take advantage of people in desperate financial straits. We believe that the maximum total cost of borrowing we recommend should be rooted in this fundamental objective of protecting financially disadvantaged consumers from exploitation.

Protection from Excessive Risk

With this in mind, we observe that a loan that is high-risk for the lender is also high-risk for the borrower. It is obvious to us that borrowers at the upper end of the risk curve have much more difficulty repaying loans. Consumers can easily find themselves in a worse financial situation than they were before they took the loan.

We must ask ourselves, then, if some payday loans should not be made because they are simply too risky – too risky for the borrower and, we suspect, for the lender as well. We believe that limits should be placed on risk. It is our conviction that unduly risky loans are not in the interest of borrowers or the public.

We conclude that the best way to limit risk is to control the consumer's total cost of borrowing, so that lenders are deterred from making excessively risky loans. We are quite certain that lenders will not make loans at the upper end of the risk curve if they cannot charge enough to cover their loan losses.

Protection from Excessive Costs

A second factor we considered in developing our recommendation for the maximum total cost of borrowing is the need to protect consumers, not only from excessive risk, but also from excessive borrowing costs. Cost and risk are related, of course, as the more the loan costs, the harder it is to repay. Consumers who are turning to payday loans as a last resort are especially vulnerable to excessive costs.

Consider an example. We have been told that many borrowers take out six or more payday loans a year. If an individual borrows \$300 for two weeks at a cost of \$30 per \$100 – which is at the high end of rates in the industry – the loan will cost \$90. If the individual does this six times during the year, it will cost \$540 to borrow \$300 for a total of 12 weeks. And the principal of \$300 must also be repaid each time. It is obvious to us that it would be very difficult if not impossible for consumers paying such high borrowing costs to turn their finances around.

It is our view that payday loans should be provided only to customers who can realistically be expected to pay them back on time and use them as a tool to get back on their feet financially. Payday loans should not be used as a stop-gap measure to delay an inevitable slide into financial collapse. Payday lenders should not be allowed to profit from the desperation of borrowers who have nowhere else to turn.

Accordingly, we believe that the cost of borrowing should be set as low as possible, consistent with the existence of a competitive industry. Again, it is a question of balance.

A Middle Ground

Having weighed these factors, we recommend that the Ontario government set the upper limit on the total cost of borrowing for payday loan agreements in Ontario at \$21 per \$100 borrowed. This cost limit is all-inclusive. To be entirely clear, we reiterate the definition of “cost of borrowing”: it represents the total of all amounts that a borrower is required to pay under, or as a condition of entering into, a payday loan agreement, except default charges and repayment of the advance. It includes all amounts paid to the lender, whether described as interest, brokerage fees, debit card charges, cheque-cashing fees, administrative fees or any other name.

In our consultations, we received proposals for the maximum cost of borrowing that ranged from \$2 to \$33 per \$100 borrowed. In our view, the \$2 proposal, if implemented, would shut down the industry. It would do by regulation what was not done or intended by the legislation. As noted, this would be outside our mandate. On the other hand, a \$33 rate cap would essentially ratify the status quo. It would change nothing in the industry and do nothing to protect consumers. Such a recommendation would be an abdication of our responsibilities as an advisory board.

Instead of the extremes, we have chosen the middle ground by recommending an upper limit that we believe protects consumers from excessive risks and costs, while allowing lenders to continue to serve a market that demands and can afford these loans.

Impact on the Marketplace

We have taken great care in selecting the upper limit. We understand that if the ceiling is too low, many lenders will be driven out of the industry, probably never to return. Since the damage would be irreversible, we have chosen to err on the side of caution.

We believe that the industry will be able to thrive with a lower limit than we are recommending. However, the adjustment may take time and in the interim our objective is to preserve reasonable access to payday loans for Ontario consumers. We do not want to create a monopoly or duopoly in major centres, a series of local monopolies in smaller communities, or a complete absence of service in some areas. Such an outcome would put an end to competition in the industry, removing incentives to improve service and lower costs, and leaving consumers with little choice of payday lenders.

We stress that what we are recommending is the **maximum** total cost of borrowing – not a single rate that would apply across the board. We estimate that at least half of the payday loan outlets in the province are now operating with borrowing charges that are at or below our recommended maximum. These lenders will have no difficulty continuing to offer payday loans with our proposed cap in place. Moreover, our consultations with the industry give us no reason to think that these rates will increase in the presence of a higher limit on the total cost of borrowing.

Not that we are aiming to freeze the status quo. We believe our recommendation will in fact lead to significant restructuring in the industry.

We have observed much variation in cost structures from lender to lender. In part these differences are due to differences in risk tolerance. More significant, however, are differences in operating costs – for expenses like rent, staff salaries and computer systems. Lenders operating above the recommended ceiling will be forced to reduce their costs, likely by cutting operating expenses or decreasing their exposure to high-risk loans or both. Their challenge will be to lower their costs per loan and per store.

As discussed above, lenders have competed for customers on the basis of location and customer service and, in some cases, the resulting costs may be unduly high. The changes required may be substantial and lenders will need time to adapt and especially to reduce their fixed expenses.

New business strategies are conceivable, such as changing locations or adding new product lines. Some lenders may choose to leave the market rather than re-engineer their operations or adopt a different business model. We suggest that the government give the industry an opportunity to adjust by deferring implementation of the maximum total cost of borrowing for a reasonable period, perhaps six months, after it is announced.

We were impressed by the entrepreneurial spirit of the payday lenders we met. We are confident that the industry will make a successful transition to the new operating environment.

An Emerging Regulatory Regime

The limit on the total cost of borrowing is not the only development that will drive change in the industry. As discussed, the upper limit on borrowing costs is one aspect of an emerging comprehensive regulatory regime for payday lending which is designed to eliminate practices that trap borrowers in a debt spiral. We expect the ban on rollovers in particular to have a dramatic impact on lenders that have not already stopped this practice. Members of the Canadian Payday Loan Association and some other lenders have voluntarily ended rollovers in recent years. Many of them recorded a sharp drop in revenue and a steep rise in bad debt costs as a result. Similar consequences can be expected when the rest of the industry is forced to comply with the legislated ban on rollovers. The bottom line is that the industry will simply have to adapt to a regulated marketplace.

In calculating the proposed upper limit, we have been mindful that the industry will face new regulatory costs with the proclamation of Ontario's payday loan legislation. After discussion with ministry officials, we are satisfied that licensing fees and mandatory contributions to the education fund will be easily managed by the industry. We believe the upper limit we have recommended will allow lenders to readily cover these costs.

Overall Result

The board is satisfied that when all is said and done, Ontario will be left with a competitive payday lending industry that will make loans available to consumers who can reasonably be expected to pay them back on time. Consumers across Ontario who are in a position to use payday loans constructively will have access to them at an affordable cost.

Granted, consumers who should not have been borrowing in the first place will lose access to payday loans as the industry shifts focus to a lower-cost, lower-risk market. However, for these consumers, a payday loan is often nothing more than a temporary and expensive band-aid that can make a bad financial situation even worse. It is our view that payday loans should be available only to individuals with a real chance of getting their finances in order, and not to those on the brink of financial collapse.

Different Classes of Borrower

In line with our mandate, we also considered the possibility of establishing a different, presumably lower, ceiling for social assistance recipients and other individuals similarly disadvantaged as gauged by income level. In our consultations, social advocacy groups supported a different limit for social assistance recipients, but the industry and consumer groups by and large were opposed.

As noted above, the industry in general does not currently lend to social assistance recipients, as they do not meet the employment requirement for a loan. While we have heard the concerns of social advocates about access to credit, we cannot lose sight of the basic fact that the borrower must have the capacity to repay the loan. Given current social assistance rates, it is hard to see how a loan payment could fit into the budget of someone on social assistance. Clearly, such loans would be of very high risk for both borrower and lender. Since one of our key aims is to reduce risk, it makes no sense to encourage lenders to make even riskier loans than they do now.

In fact, some lenders told us, social assistance recipients should be charged more for payday loans due to the higher risk of default among borrowers in this category. One consumer group suggested a higher rate for social assistance recipients to deter them from taking payday loans altogether, to prevent entering or feeding a cycle of debt.

Industry representatives also advised us that offering different rates to different classes of borrowers would present them with operational difficulties that could increase costs. They were also concerned that borrowers who were charged the higher rate might complain about unfair treatment.

Moreover, it is our understanding that if the government were to establish a lower limit on the total cost of borrowing for people with low incomes, lenders would be legally obliged to make loans to borrowers in this category – and to do so at the lower rate. It is our view that such requirements would in effect take risk management decisions out of the hands of the lender. Such policies have led to problems elsewhere. For example, they were one of the factors contributing to the current subprime mortgage situation in the United States. This approach is not to be recommended.

Cross-subsidization Issue

In addition, we are convinced that the cost of a subsidy for some consumers will inevitably be passed on to other consumers. Lenders confirmed that cross-subsidization would be the likely result of introducing different rates for different classes of borrowers. As discussed above, the industry is not making excessive profits. It therefore does not have the resources to absorb the cost of giving some consumers a price advantage.

Most payday loan borrowers are financially disadvantaged, at least to some extent, and it is hard to see why they should be asked to subsidize loans to other classes of borrowers. Different rates could very well result in cheaper loans for social assistance recipients, paid for by higher borrowing costs for the working poor.

Manitoba's Approach

We note that the Manitoba Public Utilities Board has recommended substantially lower borrowing charges for social assistance recipients and certain other disadvantaged groups. However, it is our impression that the Manitoba board has done this, not so much to reduce costs for these borrowers, as to discourage the industry from making these loans in the first place.¹³ In Ontario, we see no need to discourage lenders from doing something they are not doing.

For all these reasons, we recommend that the Ontario government not recognize different classes of borrowers and not establish different upper limits to the total cost of borrowing for different classes of borrowers.

Revisiting the Upper Limit

We believe in continuous improvement and are confident that the payday lending industry can gradually reduce its charges to consumers. As the industry matures, borrowing costs can and should come down.

For this reason, we recommend that the government review the upper limit on the total cost of borrowing two years after it takes effect. It is our opinion that the limit could well be lowered at that time if the industry has successfully adapted to our recommended cap and clearly remains competitive, as we expect it will. Moreover, if no real change in industry structure or business models has occurred, or in the unlikely event borrowing costs across the industry have tended to rise to the upper limit, the government might conclude that the ceiling was set too high and should be sharply reduced.

The two-year period will permit time for the upper limit on borrowing costs and other aspects of the regulatory regime to make an impact. It will also provide an opportunity for the industry to make these changes work. During this period we would expect the government to monitor the marketplace to determine if payday lending services remain accessible across the province with a meaningful level of competition. This assessment will be crucial for any future adjustment to the maximum total cost of borrowing.

¹ "The Board cannot eradicate poverty....However, the Board can act to restrict the charges the payday lenders charge their customers, and can employ a maximum charge schedule to discourage certain disadvantaged categories of borrowers...." Manitoba Public Utilities Board – Order No. 39/08, p. 246.

CONCLUSION

The board was appointed to recommend an upper limit on the total cost of borrowing under payday loan agreements that will be fair to borrowers while maintaining a competitive payday lending industry in Ontario. We are confident that our recommendation of \$21 per \$100 borrowed as the upper limit will achieve this dual objective. It is our view that this ceiling will preclude consumers from taking on excessive risks, because lenders will reduce their exposure to high-risk loans. It will also prevent excessive borrowing costs that trap financially disadvantaged consumers in a spiral of debt from which it is hard to escape. At the same time, our proposed maximum total cost of borrowing will keep payday loans accessible to borrowers who can realistically be expected to use them as a tool for personal financial recovery.

We expect that implementation of our recommended maximum total cost of borrowing, coupled with the ban on rollovers and other measures under Ontario's payday loans legislation, will lead to significant restructuring in the industry. However, we believe we have erred on the side of caution in proposing this limit and fully anticipate a successful industry transition to the new regulated marketplace.

The board members would like to take this opportunity to thank all the individuals, firms and organizations who participated in our consultations and increased our understanding of the industry and its consumers. It has been a remarkable learning experience for us that would not have been possible without the detailed and candid input we received from these stakeholders. We very much appreciate this invaluable contribution to Ontario's regulation-making process.

We also want to express our thanks to the Ernst & Young consulting team and to the dedicated public servants who provided support for our work.

APPENDIX

Written Submissions

Written submissions were received from:

- Association of Community Organizations for Reform Now (ACORN) Canada
- Public Interest Advocacy Centre (PIAC) and National Anti-Poverty Organization (NAPO)
- Ontario Association of Credit Counselling Services
- Canadian Payday Loan Association (CPLA)
- Cash Store Financial
- Cash Zone
- Northern Cash Advance
- Central 1 Credit Union
- Simply Cash
- 310-LOAN
- Deloitte & Touche LLP*
- Lawrence I. Gould* – Centre for International Business Studies, University of Manitoba
- Avner Levin – Law & Business Department, Ryerson University
- Four consumers

Participants in Meetings

Stakeholder meetings were held with:

- Association of Community Organizations for Reform Now (ACORN) Canada
- Public Interest Advocacy Centre (PIAC) and the National Anti-Poverty Organization (NAPO)
- Ontario Association of Credit Counselling Services
- Consumers' Association of Canada
- Consumers Council of Canada
- Canadian Payday Loan Association (CPLA)
- Cash 4 You
- Cash Money
- Cash Store Financial
- Northern Cash Advance
- 310-Loan
- Deloitte & Touche LLP*.
- Lawrence I. Gould* – Centre for International Business Studies, University of Manitoba
- Avner Levin – Law & Business Department, Ryerson University

* Engaged by the Canadian Payday Loan Association.