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The Cost of Providing Payday Loans in Canada

A Report Prepared for the Canadian Association
of Community Financial Service Providers

 **ERNST & YOUNG**

Quality In Everything We Do



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By

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Introduction

There is a growing interest by governments and other industry observers in gaining a better understanding of the payday lending industry in Canada. At present, there is little quantitative information regarding the structure and performance of the industry and the costs of providing payday loans.

Ernst & Young was commissioned by the Canadian Association of Community Financial Service Providers (CACFS), the industry association representing payday lenders, to conduct an objective, independent survey on the costs of providing payday loans in Canada. The study has been conducted to inform the ongoing public policy debate around the potential regulation of interest rates and fees charged by the payday loan industry.

Since this is the first study of its kind in Canada, and because of the many unique features of the industry, it was important to ensure that the method of estimating the cost of payday loans was reasonable and acceptable to both the industry and government policy makers. For this reason, significant consultations took place with industry stakeholders at all stages of the study. The following key steps were taken in conducting this study in order to seek input of the stakeholders in estimating the costs of payday loans.

- 1. Preparation of the methodology for the estimation of costs:** Discussions with payday loan providers were conducted to gain a thorough understanding of different business models, their operations and cost accounting procedures. These discussions were complemented by a literature review of existing studies on the industry in Canada and the United States. The methodology reflects our understanding of the payday loan business, and the ways in which operators account for the payday loan business in their financial statements and company accounts.
- 2. Discussions with industry and government representatives on the methodology:** Once an initial methodology was developed, we undertook further discussions with both the industry and government representatives to ensure it reflected a reasonable and accurate approach to quantifying costs.
- 3. Preparation of a detailed questionnaire for data collection:** Development of the survey questionnaire involved carefully matching the key data requirements in the cost quantification methodology to specific survey questions. The main challenge was to balance the necessity for a significant amount of detailed information from each survey participant with the need to make the survey as simple as possible in order to obtain a high response rate.
- 4. Pilot testing of the questionnaire with selected payday loan operators:** The questionnaire was circulated to selected payday loan providers to determine if they understood what was being asked of them, and if the data requested was obtainable from their financial statements and internal company accounts.
- 5. Mailing of the questionnaire to the industry:** The final questionnaire was mailed out to members of the CACFS and to several other payday loan providers that had been identified

by the Association. Where we had e-mail addresses for company contacts, the survey was sent electronically. The questionnaire was mailed out only to the “bricks and mortar” industry (i.e., Internet-based service providers were not included in the survey).

- 6. Data capture, review and adjustments to industry data as per the methodology:** A database was developed to input survey responses. As survey responses came in, data was reviewed for completeness and unusual responses. Follow-up calls were made to respondents to ensure accuracy of the data.
- 7. Quantification of costs as per the methodology:** A spreadsheet model was developed to quantify the costs of providing payday loans.
- 8. Review of the detailed cost quantification steps with government representatives:** The cost quantification model was shared with government representatives to obtain feedback on reasonableness and accuracy. Where appropriate, this feedback was incorporated into the methodology, resulting in changes to the final model.
- 9. Preparation of the final estimates:** Following finalization of the data and the model, output tables were prepared to present the results of the study in various ways in order to permit analysis of the cost structure of the industry. In addition to presenting average results for the industry as a whole, average results were prepared for small, medium and large operators in order to illustrate the diversity within the industry.
- 10. Review of sample results with selected industry and government representatives:** Prior to the results being released to the broader stakeholders and preparation of the final report, the cost quantification results were presented to selected industry and government representatives to validate the reasonableness of the findings.

This report describes the methodology and survey results for payday loan costs. The report is divided into six parts. Part I provides background information about the nature and structure of the industry and characteristics of the payday loan product. Part II outlines in detail the methodology employed in quantifying the cost of providing payday loans. Part III provides a discussion of the data collection procedures, survey population, key statistics regarding the survey responses, and additional relevant information profiling the industry. Part IV deals with the key assumptions made in the cost analysis and describes the adjustments that were necessary where the industry was unable to provide the necessary data. Part V presents the estimates of the costs of providing payday loans, and certain observations that policy makers may find helpful in developing options for a regulatory regime. Finally, Part VI outlines the study’s main conclusions.

I. The Payday Loan Industry

A. NATURE OF THE PAYDAY LOAN PRODUCT

A payday loan is a short-term loan for a relatively small amount, to be repaid at the borrower's next payday. In order to qualify for such a loan, the borrower must have a steady job with documentation showing the periodic rate of pay. The borrower must also have a bank account since the loan is repaid using a post-dated cheque. Many payday loan borrowers lack an extensive credit history. They typically lack access to the mainstream financial institutions, find it more convenient to deal with payday loan operators, or may have exhausted other forms of credit available to them.

The lender will typically lend up to a specified percentage of the net pay (in most cases, 30%), for a period of 1 – 14 days, ending on the payday. The borrower writes a post-dated cheque for the principal plus interest and fees, dated on the payday.

If the cheque is returned because of insufficient funds in the account on the customer's payday, an additional NSF fee is applied.

If the borrower is unable to make arrangements for the payment, or does not wish to settle the debt when it is due, many loan providers allow the loan to be 'rolled over' or 'extended' for an additional fee. In some cases, a new loan will be created to settle the previous loan outstanding. This is called a 're-write' in the industry. "Rollovers", "extensions" and "re-writes" are treated as being equivalent in this study. It is our understanding that the industry association members in Canada have recently adopted a policy of banning rollovers. Under this policy, a debt not paid by the due date is treated like any other loan in default. It cannot be replaced by a fresh loan.

"Repeat" loans, for the purposes of this study, are new loans made to customers who have previously borrowed from that particular lender. Some lenders do not permit rollover, extensions or re-writes. In these cases, a customer must pay off a payday loan before getting a new loan. These transactions are treated as new loans to repeat customers, and not as rollovers because the customer must actually have the cash to pay off the first loan.

Loans that are not recoverable are written off as a bad debt expense.

B. INDUSTRY PROFILE

Payday lending is a relatively new business that has grown significantly since the early 1990s when this financial product was first introduced.¹ In the United States, the payday loan industry grew from approximately 200 outlets across the country in the early 1990s, to approximately 10,000 outlets in 2001. In Canada, the industry has grown at a similar rapid pace to reach an estimated 1,000 stores in 2003².

¹ Caskey, John P., *The Economics of Payday Lending*, Swarthmore College, April 2002, p. 3.

² Estimate provided by the Canadian Association of Community Financial Service Providers.

Payday lending is operated in some instances as part of a business that provides multiple services (multi-line providers). The business may provide cheque cashing, wire transfers, bill payments, tax refunds, and other ancillary services in addition to payday loans. In many instances, payday lenders were originally commercial check-cashing outlets that extended their business to provide payday loans. In other cases, payday lending is the only or substantially the only service provided (mono-line providers).

Most payday lenders service their customers through physical storefronts (the “bricks and mortar” segment of the industry). However, there have been a growing number of payday lenders that operate solely via the Internet. For the purposes of our survey, Internet-based lenders were not included, and references to the payday lending industry in this report reflect the “bricks and mortar” industry.

Despite being a relatively young industry, preliminary research indicated that there is a wide range of business models within the payday-lending sector. For example, one company that was interviewed does not lend its own money – it acts as a broker for the actual customer. In another case, the risk of bad debt is carried by a third-party insurer, and not by the lender.

Three distinct business models were identified during the study. The **traditional model** is one where the company (either a multi-line or mono-line operator) incurs all of the operating costs and provides the loans from its capital. Based on data collected and discussions with industry participants, most of these operators use equity capital to fund their business activities including the loans. When payday loans first appeared on the short-term loan market, banks and other financial institutions were averse to providing debt financing to these businesses because of the potential exposure to bad debts. While some financial institutions are now willing to provide debt financing to the industry, most companies rely on equity capital to finance their operations.

A newer type of business structure is the **broker model**. In this case the operator incurs all of the operating costs, but does not incur any of the risks of the loan capital as this is provided by a third party financial institution. Essentially, the operator acts as a broker for the customer. It processes the customers and the loans but does not bare any risk of the payday loan defaults. Therefore, the only difference between this and the traditional model is that a third party assumes the risk of a loan going into default.

The third type of business structure is known as the **insurance model**. Under this model, the operating company incurs all of the operating costs. It charges a fixed fee for each loan transaction. In addition, it charges the customer an insurance-type premium, which is intended to cover the cost of funds of providing the loan and the risk of loan default. The insurance premium component of the fee is assumed by an insurance company, which is typically owned by the operator.

While it was beyond the scope of this study to analyse the economics of each of the models discussed above, it is likely that the broker and the insurance models may have been adopted mainly to minimize the risk of the operator being charged for violating the 60% limit on interest under the *Criminal Code of Canada*.

In consultation with the survey respondents who employ the broker or insurance models, adjustments have been made to the data where necessary to ensure that the cost calculation is comparable across these different models. In effect, the costs presented in this report include all costs of payday loans, including the bad debt costs of a third-party lender or insurer under the non-traditional models.

Given the unique features of payday lending, direct comparisons with other household lenders or lending segments may not be relevant. It has been suggested that the fees charged for payday loans be compared to those charged by tax refund lenders. Tax refund lenders, however, face a much lower risk of the cheque being returned unpaid than a payday lender, since advances against tax refunds are in effect secured loans. A tax refund lender is also likely to be closely associated with a facility responsible for filing the tax return. For these reasons, it is important to look at the costs incurred by payday lenders specifically, rather than simply grouping the industry with providers of other non-traditional financial services.

II. Methodology

A. COST CHARACTERISTICS OF PAYDAY LOANS

Economic theory suggests that a producer of goods or services will continue to produce only as long as the marginal revenue from an additional unit of production is equal to or greater than the marginal cost of producing the additional unit. If the marginal cost were not recovered, then the producer would lose less money by simply not providing the additional unit. In addition, for the firm to be profitable and a going-concern, the marginal revenue must be at or above average total cost, including a return on equity and management time – that is, marginal revenue must be at or above the average total cost, including fixed and variable costs. Fixed costs (e.g., rent, utilities, head office functions) are incurred irrespective of the volume of loan transactions. Variable costs (e.g., front-line customer service staff), on the other hand, vary according to the volume of transactions.

In the context of the payday loan industry, any attempt to regulate the fees and/or interest charged must account for these underlying costs. Fees and interest must be sufficient to cover the average total costs related to providing payday loans in order to maintain a viable long-term payday loan industry.

Bad debt costs and the cost of capital are directly related to the value of loans provided in a given period and the risk associated with those loans. Given the nature of risk associated with payday loans, the bad debt costs are typically higher than those for other types of loans provided by financial institutions. This bad debt cost must be factored into the total cost of providing payday loans.

If the operator uses borrowed money from a third-party financial institution to provide payday loans to its customers, interest paid/payable to the institution will provide a measure of the cost of funds. Alternatively, the operator may use equity capital to finance its payday loan business. There is an implicit cost associated with the use of equity capital, which is an opportunity cost of capital (i.e., what it would have earned elsewhere in a business of similar size and risks). If equity is used to fund the business, the cost of equity capital associated with payday loans should also be included in the measure of total costs. The method for determining such costs is discussed in more detail below.

To allow a proper understanding of the costs, the activity of payday lending is decomposed into several elements, as discussed below. The total cost is then made up of the costs for each of the elements.

- The cost of originating a payday loan for a first-time customer involves more time and resources than originating a loan for an existing or repeat customer. Processing of the payday loan for a first-time customer involves the additional steps of opening a new client file and verifying information about the customer, such as the employer of the customer, and whether the customer has an active bank account.
- On the other hand, the cost of rolling over an existing loan, extending the term, or re-writing a new loan for an existing customer is likely to involve fewer resources than the initial origination for a first-time customer.

- In addition to the origination and processing of payday loans, payday lenders also incur costs associated with the collection and recovery of loans.

The study estimates the costs related to providing each of these different payday loan activities.

Larger companies are expected to have lower average costs because of economies of scale. The study estimates the costs for different sized companies. Analysis of the variance in costs across different sizes of firms will also be useful in informing the policy debate about the differential impact that fee regulations could have on different lenders.

B. SEGREGATION OF COSTS

For purposes of this study, the cost of payday loans is divided into four broad categories. These are:

1. Fixed and variable operating costs
2. Cost of loan capital
3. Cost of supplementary capital
4. Bad debts

1. Fixed and variable operating costs

For purposes of the analysis, *fixed* and *variable operating costs* are grouped together and segregated from the costs of capital and bad debt costs. Although service providers need to recover all of their costs, the study will capture information on operating costs separately.

Fixed costs are those that must be incurred by a payday loans company regardless of the volume of transactions: occupancy costs (rent, utilities), depreciation, advertising, head office expenses, security, etc.

Variable costs include costs that increase with the additional provision of an incremental unit. For example, an increase in the volume of transactions leads directly to an increase in banking transaction charges.

The distinction between fixed and variable expenses is often dependent on the magnitude of services. For example:

- Some firms may pay employees by the hour with flexible schedules based on the volume of loans, while other firms pay employees an annual salary. The former would clearly be a variable cost, while the latter has a fixed element.
- If the volume of loans increases such that another employee has to be hired to process the incremental loans, then clearly that employee's average cost would be considered variable.
- Similarly, if additional loans are achieved through the opening of an additional store, then the occupancy costs of the store could be considered variable rather than fixed.

This distinction, while not essential in calculating total costs of providing payday loans, is important for multi-line providers who view the provision of payday loans as an additional or incremental service. Those providers could add to their profit simply by charging revenue on payday loans above variable cost, since their fixed costs were already covered by their non-payday loan activities. In the case of multi-line providers, it is not easy to determine which of their business lines are incremental/marginal services and how the fixed costs should be allocated among different lines of business. Fixed costs could be allocated to all lines of business, treating them all as some form of joint production activity. Alternatively, they could be allocated exclusively to the primary activities, with incremental business lines receiving zero allocation. In the case of mono-line providers, all fixed and variable costs get allocated to their only business activity of payday lending. To ensure consistency across mono- and multi-line operators, fixed costs for multi-line operators are allocated to all lines of business using the joint-production model, and based on actual use made of the fixed inputs in each line of business. The focus of this approach is thus on total costs, not marginal costs alone. From an economic standpoint, maximum price regulations should allow providers to cover their total average costs, both fixed and variable operating costs, as well as the costs of capital, bad debts, and management time.

Lenders incur additional costs for collection of past due or defaulted loans. The principal costs associated with collection action are:

1. labour costs of employees to recover loans in default;
2. fees charged by banks to lenders for NSF cheques; and
3. payments to external vendors, such as collection agencies.

These costs are typically included in fixed and variable operating costs and may not be readily identifiable in company income statements. If the loan is never recovered and is written off as a bad debt, then these costs are necessarily allocable to the portfolio of good (non-default) loans.

Adjustments for special categories of costs:

To ensure consistency in measurement of costs across different operators, several adjustments are warranted for special categories of costs, as noted below:

(i) Inter-company transactions

Operators sometimes operate their business through a group of affiliated companies where inter-company transactions and management fees flow between related companies. For example, a payday store operation may acquire labour services, leasing of property and other services from an affiliated entity. The entity could charge the operating company its cost plus a mark-up.

Payday management fees to affiliated companies or the parent company may represent a form of profit distribution or the actual cost of the services provided by the parent, or a combination of both.

This raises the question of the extent to which management fees within a related group of companies should be recognized as legitimate costs of providing payday loans. To the extent these services provided to related entities would be charged for by a third party service provider, they should form part of the cost base of providing payday loans. On the other hand, if the fees charged to the operator were a form of profit distribution, then it would not make sense to include them as a reasonable cost.

(ii) Goodwill

The appropriate treatment of goodwill amortization expense is another issue that requires some attention. Goodwill is defined as the residual between the price of a business and the fair market value of all the identifiable assets. It represents such things as brand name, reputation and clientele that the vendor has established during his operation of the business prior to selling the business. It would not be recognized as a cost where the business is continued in the legal entity where it was started. However, when the business is sold to another person, goodwill gets crystallized and any amount attributable to it becomes a legitimate cost of doing business. For purposes of this study, amortization of goodwill is recognized as a legitimate cost, except where goodwill is attributable to transactions between entities within a group of related corporations.

(iii) Franchise issues

Some of the larger operators have franchise operations. It is important to ensure that the costs they report in the survey are for corporate stores only. These operators incur costs to support their franchise operations such as advertising and other head office functions. It is essential to distinguish corporate store costs from franchise support costs, since the latter would not reflect the underlying cost of providing payday loans from their corporate stores. If the respondent is a franchisee of one of the larger operators, its costs will include amortization of the franchise fee and annual franchise royalty payments. For the franchisee, these are essential components of the costs of the payday loan business and should be included in the payday loan costs.

2. & 3. Costs of loan and supplementary capital

The cost of loan and supplementary capital is the actual or opportunity cost of funds to the lender. These costs include the cost of capital for the amount lent to the customer, the cost of carrying fixed assets, and the cost of carrying the cash reserves necessary to ensure that money is available when the customer requests a loan.

Some payday lenders borrow the funds required for loan and supplementary capital. An appropriate interest rate for this capital must be determined. Many payday lenders use equity and retained earnings to provide payday loans. A suitable rate of return on equity must be assumed to reflect the opportunity cost of using that capital for payday lending, instead of for some other economic activity, in order to provide an accurate cost of providing a loan. It is important to note that equity investors take on more risk and therefore must be compensated with a higher rate of return than for the borrowed capital.

The methodology for determination and allocation of the cost of capital is outlined in detail below under “Task 5”.

4. Bad debt costs

There does not appear to be a standard approach to defining “bad debt” in the payday lending sector. Some lenders designate a debt as “bad” at the moment it is in default, e.g., when the borrower’s cheque is returned. Other lenders carry these loans as “NSF loans” or “returned cheques” for up to two years.

For the purposes of this study, bad debts are defined as debts that are not recovered within 90 days, as opposed to simply those loans that are in default.

The cost of the bad debts has to be recovered from the loans that get paid. A bank will typically incorporate the expected risk of bad debts in the interest rate that it charges on its loans. The risk premium is generally in the form of an adjustment to the rate, rather than a fixed dollar amount addition to the interest charge. Implicit in this adjustment is the assumption that the bigger the loan amount, the larger would be the loss from a given expected risk of bad debts.

Following this practice, bad debt costs are allocated to performing loans as a fixed percentage of the principal amount of the loans. They are not allocated to performing loans as a fixed dollar amount per loan, regardless of its size.

There are four costs associated with bad debts that must be recovered through higher charges on all performing loans:

- (a) the principal amount of the bad debts, i.e., the amount actually lent that is unrecoverable;
- (b) the fixed and variable operating costs incurred to process the loans that go bad;
- (c) the cost of carrying bad debt for both the initial period of the loan and for 90 days until the debt is written off for the purposes of this analysis; and
- (d) the cost of supplementary capital (fixed assets and cash reserves) that must be carried to provide the loans that go bad.

These costs are totalled, and then allocated across all “good” loans, i.e. those that are redeemed on time plus those that go into default but that are redeemed within 90 days.

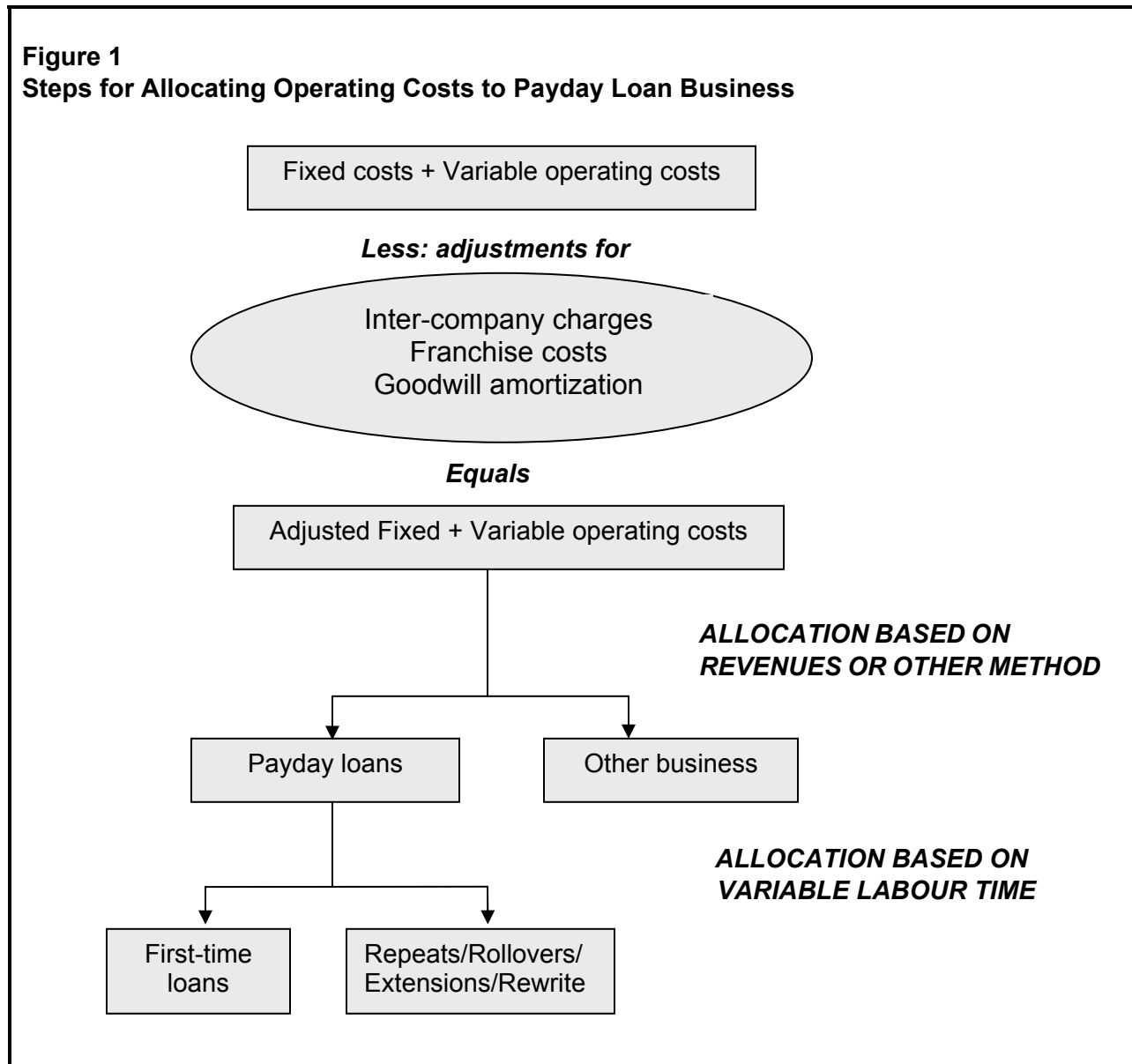
It should be noted that the operating costs and supplementary capital costs that relate to bad debt are not captured in the operating cost and supplementary cost items in the methodology, i.e., these amounts are not double counted - they are counted only once, under the bad debt item. A detailed description of the calculation for bad debt cost is provided in “Task 7” below.

C. KEY TASKS

Based on this segregation of costs, the following describes our methodology for estimating the cost of providing payday loans in Canada. The first step was to allocate the fixed and variable

operating costs from the income statements of payday loan operators. Figure 1 outlines the steps required for this allocation of costs from the financial statements.

Figure 1
Steps for Allocating Operating Costs to Payday Loan Business



Task 1: Adjustments to fixed and variable operating costs

Fixed costs and variable costs were adjusted to reflect inter-company charges, franchise costs, goodwill amortization expenses, and other costs not directly related to the provision of payday loans. This ensures that costs reflect actual underlying costs of providing payday loans. The survey revealed some additional costs that required similar adjustments. These adjustments ensure that amounts charged that might be distributions of profits, rather than costs related to providing payday loans, are not included in the cost estimate.

Amounts charged for taxes were deducted from total costs to ensure that the results are presented on a “before-income-tax” basis.

Task 2: Separation of payday lending fixed and variable costs for multi-line service providers

After removing any costs that do not reflect the cost of providing payday loans, such as management fees to affiliated entities, the first major task in the analysis was to allocate expenses of companies that are multi-line providers between the payday loan segment and other business lines, such as cheque-cashing, foreign exchange, and money transfers.

In the case of multi-line providers, it is important to separate the costs of payday lending from the costs of the additional services provided by the business. Therefore, a method of cost allocation across the different service lines of multi-line providers is necessary.

If a multi-line provider was able to provide an allocation of expenses that relate exclusively to their payday loan business, or a reasonable method of allocating expenses, that allocation was used.

If a multi-line provider was unable to provide a specific allocation for expenses, an allocation was made based on the share of total revenue earned from the payday loan segment. The default allocation used the following calculation:

$$\text{Payday Loan Expense}_i = \text{Expense}_i \times \frac{(\text{Payday loan fees} + \text{Payday loan interest})}{\text{Total Revenues}}$$

In the above expression, *Payday Loan Expense_i* is the amount of individual expense item *i* that is related to the provision of payday loans, and *Expense_i* is the total amount of individual expense item *i*. This assumes that if payday loans account for *x*% of a company's revenues, then *x*% of its operating costs, such as salaries, would also be related to the provision of payday loans. This allocation was used for costs other than the cost of capital and bad debts.

This allocation method assumes that the company's profit margin on payday loans is the same as that for other lines of business. As noted earlier, it was used only if alternative methods were not available.

In the methodology adopted for this study, the costs of capital and bad debts relate to the dollar volume of loans and advances, and not to the fees/revenues earned from them. As a result, a different allocation methodology was needed for these costs. In particular, a measure of annual percent cost of funds, akin to a measure of annual interest rate on borrowed funds, was calculated. It is a blended rate, reflecting the reasonable borrowing costs plus an assumed amount for the opportunity cost of the equity capital of the operator. Similarly, the aggregate bad debt costs for a given year are expressed as a percent of the total volume of loans granted during the year.

The cost of funds and bad debts for a given payday loan are then computed by multiplying the amount of the loan by these rates, and, in the case of cost of capital, making a suitable adjustment for the maturity period of the loan.

Task 3: Costs by different payday loan functions

Payday loans are not homogeneous: they have different time durations and different amounts loaned. The repayment experience can differ depending on the type of customers and by company. In this section, we describe how we estimated the costs for different types of activities associated with the functions related to payday lending. These functions are similar to the functions performed with other types of lending.

Originating loans for first-time customers:

The costs associated with originating a loan include advertising, the labour cost of initiating the loan and other costs such as those incurred for credit checks (if applicable) or background checks. Origination includes taking the loan application, determining the loan worthiness of the customer, explaining the terms of the agreement, processing the loan documents and the post-dated cheque of the customer, and making the cash payment.

The labour costs of originating loans for first-time customers are higher than the costs of writing loans for existing (repeat) customers or rolling over the loan of an existing customer. For existing customers, while the information on the loan application must be confirmed or updated, this process is not as thorough as the initial loan application. As well, the provider will not normally have to verify the loan worthiness to the same degree. The customer will also already be familiar with the terms of the agreement and the documents.

In order to make the distinction between different types of payday loan activities, the survey collected information on both the number and principal amounts of loan transactions for first-time customers, and for repeat customers and for loans that are considered rollovers, extensions or rewrites.

Repeat customers, rollover/extensions and re-writes:

Once the payday loan operator has an active file for the customer, then the time and effort required to serve that existing customer with a subsequent loan is less than that for a new customer. Similarly, rollovers, extensions and rewrites of loan will not be as time-intensive as for a first-time customer. Therefore, given that it is important to distinguish between loans provided to first-time customers and those to repeat customers or customers receiving rollovers, extensions or re-writes, a time-based approach was considered to be the most appropriate method of allocating costs, as described in the next section.

The questionnaire asked payday loan providers to estimate the amount of time that they thought each type of transaction would take. The information received from respondents, however, was highly variable. Consequently, the ratio of the time taken for first-time loans to repeat or rollover loans has been standardized across all payday loan providers by using the average ratio for all respondents, instead of each provider's own ratio.

Task 4: Allocation of fixed and variable costs between first-time customers and repeat customers

Since companies do not separately account for first-time and repeat customer business, these costs must be estimated. The following table outlines the steps required to allocate fixed and variable costs of payday loans between first-time and repeat customers. The example is provided to illustrate how the calculation was performed, and does not reflect actual costs.

Table 1 Time-based Allocation of Fixed and Variable Operating Costs for First-time and Repeat Payday Loan Transactions		
Action		Example
1	Unit of face-to-face staff time spent for a transaction = 10 minutes	
2	Face-to-face staff time required for originating a new loan to first time customer = 30 minutes OR 3 units	3 units
3	Face-to-face staff time required for processing the loan to a repeat customer or for a rollover/extension or re-write = 10 minutes OR 1 unit	1 unit
	Number of new customers in the year	1,000 new customers
4	Two options for determining number of new customers: a) Number of new customers provided by lenders; or b) Number of active client accounts at the end of the year minus active accounts at the end of previous year ¹	
5	Number of repeat transactions/loans (including rollovers/extensions and re-writes) This is calculated as total number of loan transactions minus total number of new accounts or new customer loans	3,000 repeat customers
6	Average cost per unit of effort = $\frac{\text{Fixed + Variable Operating Costs}}{(\text{Row 2} * \text{Row 4}) + (\text{Row 3} * \text{Row 5})}$	$\begin{aligned} &120,000 \div \\ &[(3 \times 1,000) + \\ &(1 \times 3,000)] \\ &= 20 \end{aligned}$
7	Fixed + Variable operating cost per new transaction = Row 6 * Row 2	$20 \times 3 = 60$
8	Fixed + Variable cost per repeat transaction = Row 6 * Row 3	$20 \times 1 = 20$
	1. "Active accounts" is a concept used by the payday loan industry (a file with the customer's profile e.g., contact information, bank account, employer). While a customer may have an account with the provider, after a period of time much of the account information may have changed and this customer would require the same attention in updating the information and processing his/her loan as a first-time customer.	

In the methodology table above, the costs are allocated between first-time loans and repeat loans on the basis of face-to-face staff time required to serve those loan customers. Thus, if a repeat loan takes 10 minutes of face-to-face staff time, and the first-time loan 30 minutes, the

total fixed and variable operating costs for a first-time loan are assumed to be three times larger than those for a repeat loan.

In order to estimate fixed and variable operating costs per transaction for new and repeat loan transactions, the survey collected additional data beyond the standard income statement items, such as breakouts of loan originations, rollovers/extensions and re-writes and their associated revenues between first-time and repeat customers. In addition, the survey asked for information on the average amount of time spent on the processing of these various payday loan functions (i.e., originating loans for first-time customers, repeat customers and on rolling over, extending or re-writing loans). This formed the basis for a time-based allocation of costs between the different payday loan functions.

Task 5: Estimating the cost of loan capital

Capital used to fund payday loans must be raised by the payday loan operators from third-party debt, equity and retained earnings in the business, or a combination of both.

The cost of loan capital is determined by multiplying the dollar value of loans by the weighted averaged rate of the cost of capital. This weighted average rate is determined by the interest rate paid on corporate debt, and the rate of return on equity in the business.

Data provided by the questionnaire respondents was not sufficient to calculate interest rate being paid by the payday loan providers.³ On the basis of discussions with payday loan providers, an interest rate of 7% is assumed. Sensitivity analysis is performed to determine the impact of alternative assumptions.

For equity (shareholder equity plus retained earnings), the shareholders must also receive a reasonable rate of return to cover their opportunity cost of providing funds to the business. An appropriate pre-tax market rate of return of 15% is assumed for this calculation, and sensitivity analysis is performed to determine the impact of this assumption, and the results of other possible assumptions.

The two rates are weighted by the relative proportion of long-term debt and equity used to finance the business. These amounts are determined from balance sheet information (capital stock, retained earnings, and long-term debt of each respondent).

The calculation is as follows:

$$\begin{aligned} i &= \text{assumed interest rate on company debt} \\ r &= \text{opportunity cost of equity} \\ \text{Total corporate capital} &= \text{debt} + \text{shareholder equity} + \text{retained earnings} \end{aligned}$$

$$\text{imputed annual rate of cost of capital} = \left(\frac{\text{Debt}}{\text{total corporate capital}} \times i \right) + \left(\frac{\text{shareholder equity} + \text{retained earnings}}{\text{total corporate capital}} \times r \right)$$

³ The survey provided data on the total interest costs, but not on the rate of interest at which the funds were borrowed. The interest rate could not be inferred from the interest amount, in the absence on information on the amount of borrowed and the period for which interest was paid.

The study will estimate the total cost of loan capital as follows:

Box 1: Cost of Loan Capital Calculation

Actual value of loans granted
multiplied by
Weighted average annual opportunity cost of capital
multiplied by
Average maturity of 'good' loans ÷ 365
equals
Cost of loan capital

Task 6: Cost of supplementary capital (cash reserves and fixed assets)

Cash balances and fixed assets are required to support the payday loan business. Capital required for payday loans, therefore, includes not only the principal amount of the funds lent, but also the cash on hand needed for the loan business, and fixed assets. The calculation in Task 5 relates to the cost of capital for only the principal amount of the loans.

The cost for the supplementary capital (i.e., cash balances and fixed assets) is calculated by multiplying the supplementary capital by the weighted average return on capital calculated in Task 5.

Task 7: Calculation of bad debt costs

Payday loans are generally unsecured, and the loan amount may become a bad debt if the post-dated cheque received from the borrower at the time of the loan is not honoured due to insufficient funds or fraud. The post-dated cheque is merely a mechanism of payment similar to an automatic debit at the time of the loan's maturity. The expected cost of the loss of principal on defaulted loans must be recovered with higher charges on all loans. These higher charges are effectively a credit risk premium.

The cost associated with bad debts includes not only the principal amount of the loan, but also the cost of capital for the funds lent.

In addition to these costs, this analysis includes in the total bad debt costs, the share of operating costs and supplementary capital costs that would otherwise be borne by the bad debts, had they not gone bad.

Where a loan is never recovered, the revenues from the remaining good loans must cover these costs.

It is important then to untangle the reported bad debts to reflect this amount. Discussions with payday loan operators revealed that operators differ in the way they account for bad debts. Some book the full amount of the cheque, including the fees and interest, as a bad debt the moment it is in default. For example, assume that the loan was for \$100 and the fee was \$15, then the posted cheque due on the payday is \$115. Some payday operators would book \$15 as fee revenue receivable and \$100 as a loan at the time the loan is granted. When the cheque is returned NSF, they would reverse the \$15 booked as fee revenue receivable and book \$100 as a bad debt. Others will initially book \$100 as a loan advance at the time the loan is given. If the cheque is returned NSF, then at that time \$115 is booked as a bad debt and \$15 as fee revenue receivable.

For purposes of this study, a bad debt is defined as a debt that is unrecoverable after 90 days. This treatment is based on what we understand to be the administrative position of the Canada Revenue Agency for income tax purposes. Industry representatives have indicated that very few loans in default for more than 90 days are recovered.

Only those costs actually incurred are counted here as bad debt costs. The foregone revenue in the form of fees and interest included in the customer's post-dated payday cheque is not included in this definition of bad debt.

Therefore, some careful analysis of bad debts is required to arrive at a consistent cost across companies. To determine the bad debt cost associated with payday loans, the survey collected information regarding the principal value of returned payday loan cheques and the value of recoveries (principal amount) that occurred following the default date of these loans. The difference between these two amounts is used to estimate the total principal value of bad debt costs for the payday loan provider.

Overall, the bad debt costs per payday loan are calculated as follows:

Total bad debt costs =

1. the principal amount of bad debts
2. the cost of carrying the debt for the period of the loan plus 90 days (after which, the bad debt is treated as being written off)
3. the operating costs allocated to the bad debts
4. the supplementary capital costs allocated to the bad debt

The total of these costs is expressed as a percent of good loans. The bad debt cost for a loan is then calculated as follows:

$$\frac{\text{total bad debt costs in a year}}{\text{total loans granted during the year minus bad debts}} \times \text{value of loan}$$

This calculation distributes the cost of bad debt (i.e., defaulted loans not recovered within 90 days) across the “good loans” because revenues from good loans (not all loans) must cover off the cost of the bad debt.

If a payday loan provider operates as a broker, where the financing of the loans comes from a third party financial institution, the operator does not incur any costs related to loan capital, nor does it have any bad debt costs as the third party financier assumes the risk of potential loan defaults. In these situations, the lender was asked to provide estimates of the cost of loan capital and bad debts based on information obtained from the third-party financial institution. This provided a consistent approach at comparing all costs between these types of payday loan providers and traditional payday loan businesses.

III. Industry Survey

A. DATA COLLECTION

The cost analysis is based on a survey of the CACFS members as well as additional Canadian payday loan providers who were willing to participate. A copy of the survey questionnaire is provided in Appendix A. The questionnaire reflects the data and information requirements necessary to conduct the comprehensive analysis based on the cost quantification methodology outlined above.

The following steps were followed to maximize the response rate of Canadian payday lenders and to improve the quality of data:

- an initial beta test of the questionnaire to determine if the information required would be available from payday loan providers;
- after the questionnaire had been sent out, follow up with respondents to increase response rates and to address data inconsistencies or incompleteness; and
- confirmation of unusual “outlier” responses.

The aim of the survey was to obtain responses from at least 15 companies, representing at least one-third of the industry’s total annual revenues or loan volume in 2003. As the aim of the survey was to obtain information on average costs of payday loan transactions, there was no need for the survey results to be extrapolated to the population of surveyed companies, as long as the sample of the companies responding to the survey satisfied the criterion of being representative of the population.

The data provided by the respondents has not been audited, and is accepted as reported, except for inconsistent, incomplete or unusual responses. A more detailed description of the procedures followed to verify information and scrutinize unusual responses is provided below. Respondents were asked to use actual financial statements of their most recent fiscal year to respond to the questions, and to provide a copy of their financial statements with their completed questionnaire.

A significant portion of the operating costs can be extracted directly from financial statements. The survey collected data from the income statements of payday loan providers, as well as additional information from their management reports to make the cost estimates. Table 2 outlines the type of data captured on revenues, and fixed and variable operating costs.

The survey collected information on the structure and business mix of the respondents, and asked if the respondent is a multi-line or a mono-line service provider. If the former, an allocation of costs is made to payday loan activities only as previously discussed. The questionnaire collected information on the business structure/model, which may have a bearing on how costs are characterized for different operators. Capital structure information was collected to estimate the cost of capital.

Table 2

Revenue and Expense Items Obtained from Income Statements of Payday Loan Providers

Revenues	Expenses (Costs)
Payday lending	Store Expenses:
Cheque cashing fees	Salaries and benefits
Money transfer services	Incentive plan expense
Collateral/Pawn loans	Security
Mortgage/bridge financing	Occupancy costs, including rent
Franchise fees	Bad debt recovery expense
Other revenues	Depreciation and amortization
Total revenues	Credit checks
	Bank services charges
	Other
	Head office and regional expenses:
	Franchise expenses
	Advertising
	Taxes
	Interest expense
	Other Expenses
	Total Expenses

Finally, the questionnaire asked payday loan providers for information relating to adjustments that should be made as a result of owner/manager compensation arrangements. These adjustments are required where compensation is paid that reflects distribution of profit, rather than compensation for effort.

B. SURVEY PROCEDURES

A questionnaire was used to collect the necessary data (see Appendix A). A draft of the questionnaire was tested with a selection of payday loan providers to ensure that the information requested would be available and that the questionnaire was not too onerous.

A key issue for payday loan providers was that their responses be kept strictly confidential. Because the industry is dominated by private companies, financial statements and financial statement information are not publicly available. Several payday loan providers contacted Ernst & Young to indicate that they would not be able to participate because of their reluctance to provide this information, and several more participated only after receiving assurance that the information would not be provided to the Canadian Association of Community Financial Service

Providers, to government, or to any other third parties. Ernst & Young asked participants to provide copies of their financial statements in order to verify data.

The questionnaire was mailed or e-mailed to the 95 members of the CACFS, and to 185 non-member companies that were identified by the CACFS as potentially providing payday loan services. The questionnaire was thus sent to virtually all of the “bricks & mortar” industry. Businesses that provide payday loans exclusively through the Internet were not included in the survey.

C. RESPONSE RATE

Ernst & Young received a total of 22 responses. Of these, three were unusable. In one case, the business was not willing to release financial statement information that was necessary to complete the analysis. In the other two cases, the businesses were unable to provide necessary information relating to the volume or number of loans.

For the remaining 19 respondents, Ernst & Young conducted follow-up calls with respondents to solicit additional information, and to confirm or clarify unusual responses. The responses were investigated by Ernst & Young to confirm the “reasonableness” of the results. Certain assumptions were made based on industry experience where data were unavailable in order to be able to include a larger number of the responses.

The 19 respondents represent 474 payday offices/stores and almost \$830 million of payday loan transactions in 2003.

Data on the number of offices/stores providing payday loans are not available, but the CACFS estimates that there are over 1,000 offices/stores in Canada.

D. VERIFICATION OF DATA PROVIDED

Ernst & Young reviewed the data provided to determine if the information was “reasonable”. For example, we checked the address of a business with high rental costs to determine if it was in a location where high rental costs could be expected.

Extensive discussions were held with respondents to fill in missing information, and to confirm or revisit unusual responses. Because each business collects data and reports results in different ways, many of the respondents were unable to complete the questionnaire in full. Ernst & Young worked with the respondents in order to determine the best estimates possible.

E. PROFILE OF RESPONDENTS

Results are reported for three size categories:

Large businesses are defined as those with over \$20 million in payday loan transactions in the year. There are five firms included in this group, representing a total of 410 stores and over \$760 million of payday loan transactions (92% of the total of all respondents).

Medium-sized businesses are defined as those with between \$2 million and \$20 million in payday loans. Six firms are included in this group, representing 52 stores and over \$60 million of payday loan transactions (7% of the total).

Small businesses are those with less than \$2 million in payday loans. Eight firms are included in this group, representing 11 stores, and under \$7 million in payday loan transactions (1% of the total).

The respondents represent all regions of Canada as illustrated in Table 3 below.

Table 3 Regional Distribution of Payday Loan Survey Respondents By Store Location		
	<u>Number of stores</u>	<u>Percentage of total</u>
British Columbia	120	25%
Alberta	112	24%
Saskatchewan/Manitoba	46	10%
Ontario	174	37%
Quebec	8	2%
Atlantic Canada	14	3%
Total	474	100%

Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004

Payday lending is not permitted in the Province of Quebec. The eight stores identified in the above table for Quebec are part of large, multi-line chains that provide other services such as cheque-cashing and money transfers in the province.

IV. Analysis of Costs and Key Assumptions

A. ADJUSTMENTS TO COSTS

As described in the sections above, several adjustments were made to the cost information to ensure consistency across firms, and to ensure that distributions of profits were not treated as costs for the businesses.

In addition, salary and benefit costs for owner/managers were reviewed to ensure that only reasonable salaries and benefits were treated as a cost of doing business. The questionnaire collected information on the amount of salaries and benefits paid to owners, shareholders and spouses, as well as the number of hours worked in an average week by these people. This enabled us to evaluate the salaries and benefits paid. The businesses were contacted and asked whether bonuses paid represented compensation or distribution of profits. In all of these cases, the businesses reported that these were distributions of profits, and were, therefore, excluded from the cost calculations.

Other charges that do not represent operating costs, such as goodwill amortization, royalties and certain other payments to affiliates, were excluded from the cost calculations.

Some payday loan providers charge clients for cashing a cheque to redeem a payday loan. In these cases, cheque-cashing fees have been included in payday loan revenue, rather than being allocated to non-payday lending revenues. While the original questionnaire did not collect this information, it was collected through follow-up calls to survey respondents.

B. KEY ASSUMPTIONS

This section identifies additional adjustments that were made to the data to better reflect costs associated with payday lending.

1. Extra cash

In determining the amount of supplementary capital used by the firm for payday loan purposes, an adjustment was made in order to avoid including cash that may have been held at year-end for other business purposes.

Generally, the cash held by the company was allocated between different lines of business according to the revenues from each line. Some businesses, however, were holding large amounts of cash at year-end, perhaps to fund expected expansion, or to meet upcoming liabilities.

To account for this, the amount of cash for payday loan purposes was taken to be the maximum of:

- (a) the cash as allocated by revenues, and

- (b) 1/26th of the total payday loan volume in the year, reflecting the assumption that cash balances do not exceed the total value of loans granted in a given two-week period.

2. Ratio of first-time to repeat customers

The first time that a customer takes a payday loan, the operator incurs significant costs for verifying the customer's personal and employment information. Without exception, respondents indicated that first-time loans take longer than loans to repeat customers.

The draft methodology anticipated disaggregating costs between first-time and repeat or rollover transactions based on time spent on different types of transactions, as estimated by the respondents. These estimates were often provided as ranges, and varied widely between respondents. Some respondents reported that a first-time transaction takes twice as long, while others indicated that it took up to 11 times as long.

Because of this wide variation, and our lack of confidence in individual responses for this indicator, the average of all responses was used to disaggregate costs between first-time and repeat/rollover transactions. On average, respondents reported that first-time transactions take 2.68 longer than repeat/rollover/rewrite transactions.

The number of first-time customers that a business has as a proportion of the total will have an impact on the business's cost structure, especially for start-up firms who have only first-time customers initially. The ratio of first-time customers to all customers varied between 2% to 66% among the respondents.

3. Imputed cost of capital (debt and equity)

The cost of capital is composed of two parts:

- (a) the interest costs of debt, and
- (b) the return to equity.

An interest cost for corporate debt has been assumed in this analysis, and sensitivity analysis is performed. In companies' financial statements, interest costs are reported, and long-term debt at year-end is reported. However, it is not possible to infer an interest rate from these two figures because:

- the interest figure may reflect interest paid on all forms of debt, not just long-term debt, and
- the long-term debt figure is not the average daily or monthly balance, but that reported at year-end – significant additions and reductions in long-term debt close to the end of the year will distort the relationship between interest and debt.

A corporate interest rate on long-term debt of 7% is assumed, based on consultations with industry. This rate reflects the difficulty that this industry has experienced in securing conventional financing. In fact, only 11 of the 19 respondents reported having long-term debt at year-end. Because long-term debt reflects only a small portion of overall capital, there is little impact on the results of varying the assumed rate.

Similarly, a measure of the opportunity cost of equity must be assumed. Table 4 below indicates rates of return on equity for a variety of industries in Canada. For the purposes of this study, a rate of return on equity of 15% has been assumed. This assumption is conservative: banks are the closest analogue to payday lenders among the industries listed above. Between 1997 and 2003, they earned an average 18.97% annual rate of return on equity. This performance has continued through the first nine months of the 2004 fiscal year, where the Big Five banks in Canada have earned an average annualized return on equity of 19.14%⁴. Payday loan providers generally have less diversified product lines (many receiving over 90% of their revenues from payday lending), and are generally much smaller businesses.

**Table 4
Return on Equity – Canadian Industry Averages
Book Value, 7-year Average (1997-2003)**

Industry	Return on Equity	Industry	Return on Equity
Food & Staples Retailing	21.93	Steel	3.60
Telecommunication Services	19.27	Oil & Gas	3.26
Banks	18.97	Paper & Forest Products	2.10
Consumer Durables & Apparel	12.57	Automobiles & Components	1.09
Real Estate Management & Development	10.57	Food, Beverage & Tobacco	-2.36
Insurance	10.45	Chemicals	-2.95
Utilities	10.39	Media	-5.36
Retailing	10.37	Metals & Mining	-6.06
Miscellaneous Income Trusts	9.99	Computers & Electronic Equipment	-7.56
Energy Trusts	9.55	IT Services	-10.09
Real Estate Investment Trusts	9.27	Gold	-13.48
Energy Equipment & Services	8.93	Pharmaceuticals	-23.46
Diversified Financials	8.77	Communications Equipment	-24.04
Commercial Services & Supplies	7.37	Health Care Equipment & Services	-29.27
Capital Goods	6.08	Biotechnology	-41.81
Hotels, Restaurants & Leisure	5.02	Software	-45.82
Transportation	4.33		

Source: Financial Post Industry Reports

⁴ *Globe and Mail*, September 18, 2004, p. B7.

The choice of rate of return on equity and the interest rate on debt does not make a significant difference in the analysis. The reason for this is that operating costs are by far the largest costs faced by payday loan providers, while the cost of capital is relatively small. Nevertheless, we present a sensitivity analysis on these assumptions. A number of different scenarios are presented using different assumptions for the returns on capital that demonstrate the relatively minor impact of these assumptions on the overall costs of providing payday loans.

4. Other adjustments

The calculation of the cost of carrying supplementary capital (fixed assets and cash reserves) is complicated by data limitations. The data received reflect year-end balances of these amounts, not average daily or monthly balances. Fixed assets will change for a business over a year as depreciation will reduce the value of fixed assets, and new investment will increase the value of fixed assets, especially where the business is expanding.

On balance, it is likely that the analysis overestimates the cost of carrying supplementary capital. Because this cost is a relatively small part of a payday loan provider's overall costs, the impact will be marginal.

C. DEVELOPMENT OF SPREADSHEET-BASED MODEL FOR ANALYZING COSTS

Once the data for each respondent were finalized through verification and the adjustments outlined above, a model was developed to perform calculations on each firm's data in order to compute the results reported in this report. These calculations were verified through a number of crosschecks. A simplified version of the formula-driven spreadsheet model is presented in Appendix B.

V. Key Findings

Box 2: Presentation of results

Results of the analysis are presented for:

Different types of loans:

- All loans (comprising first-time, repeat, rollover, extension, and re-write loans)
- First-time loans only
- Repeat, rollover, extension and re-write loans

Different types of businesses:

- Average of all firms
- Large businesses (those providing over \$20 million of payday loans in the year),
- Medium-sized businesses (those providing over \$2 million but less than \$20 million of payday loans in the year), and
- Small businesses (those providing under \$2 million of payday loans in the year)

Average cost results are presented as:

- Unweighted (simple) averages of the 19 companies in the survey; and
- Weighted averages based on market share of the companies in the survey by volume of payday loan transactions.

A. COST OF PROVIDING PAYDAY LOANS

Since data for the entire universe of payday lenders in Canada is not available, it is not possible to determine the exact weights (share of payday loan volume in the entire industry) for each survey participant, which has implications when conducting a weighted average of industry costs.

The industry is dominated by certain large operators, which influences the data sample. A weighted average does not adequately reflect the cost structure of smaller operators, who are active in the industry, but whose overall share of the industry is relatively small.

To address these issues, we have presented the data as:

- unweighted averages of the nineteen survey respondents, and
- weighted averages for the survey sample.

For the weighted average calculation, the weights were constructed as follows. The largest operator in the industry, which is included in the survey sample, was assigned a weight of 33%. This weight is based on some key industry observations. The corporate-owned stores of the largest provider constitute approximately twenty percent of the total number of stores in the industry. However, it is a high-volume operator on a per-store basis, and its share of total volume of loans is much higher. Therefore, based on discussions with industry representatives

and the operator's own intelligence about the market for payday loans in Canada, it was assumed that it accounted for one-third of the total payday loan volume in Canada. For the remaining operators in the sample, weights were assigned on the basis of their relative share in the volume of payday loans within the sample but calibrated to an overall share of 67% (i.e., they are representative of the remaining two-thirds of the industry).

Table 5a provides the total cost of providing payday loans, disaggregated by individual cost components and by major lender size category. The estimates in the table are unweighted averages.

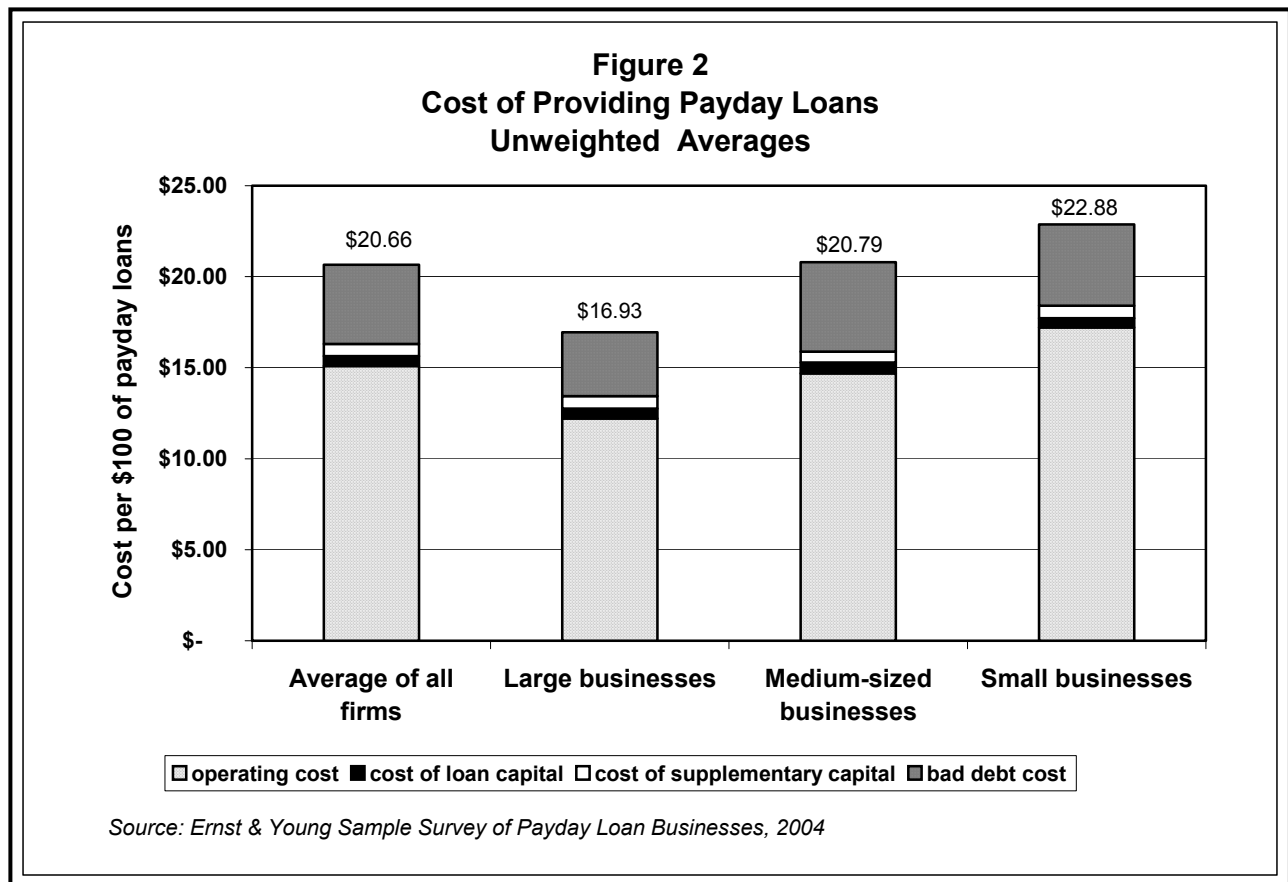
	Cost per \$100 of Payday Loans			
	Average of All Firms	Large Businesses	Medium-sized Businesses	Small Businesses
Operating cost	\$15.10	\$12.21	\$14.69	\$17.21
Cost of loan capital	\$0.55	\$0.54	\$0.59	\$0.52
Cost of supplementary capital	\$0.66	\$0.69	\$0.60	\$0.68
Bad debt cost	<u>\$4.35</u>	<u>\$3.49</u>	<u>\$4.91</u>	<u>\$4.47</u>
Total	\$20.66	\$16.93	\$20.79	\$22.88

Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004

The total cost of providing a payday loan for the industry as a whole is \$20.66 per \$100 of a payday loan. Therefore, for an average loan of \$279 (average loan size based on survey results), the total average cost is \$57.64.

As depicted in Figure 2 below, operating costs are by far the largest cost component, representing nearly three-quarters of total costs. The costs of loan and supplementary capital are the smallest components of the total cost, accounting for less than 6%, while the bad debt cost accounts for the remaining 21% of the total cost.

There is a significant variance in costs between large, medium and small payday loan providers. Total costs per \$100 of loan for large payday lenders are 18% below that of the industry on average. Large lenders have significantly lower operating and bad debt costs compared to medium and small lenders. Total costs of small operators are 35% higher than those of large lenders. The cost of loan and supplementary capital is not a factor in this differential, as these costs are relatively uniform across the industry, representing a relatively small fraction of the total costs.



While the costs are lower for larger providers, each cost component's share of total cost does not vary much between large, medium and small companies. Operating costs are between 71% (medium-sized lenders) and 75% (small lenders) across the average of all company sizes. Similarly, bad debt costs do not vary much across different sizes of operators: 20% of total costs for small companies and 24% for medium-sized companies.

The fact that operating costs represent the most significant cost component of providing a payday loan, and that these are more or less fixed, regardless of the term of the loan, means that regulating the price of a payday loan solely through an interest rate mechanism is problematic. An interest rate mechanism would be appropriate only if the cost of capital were the most significant component of the overall cost. (See section E below for further elaboration).

If regulators set a price ceiling on transaction fees, operators with costs below the ceiling would continue to operate in the market, while high-cost operators would be squeezed out. Setting a regulated fixed fee ceiling that is too high could result in some lenders increasing their prices to the "legitimized" (ceiling) price. Too low a price would eliminate a number of high-cost loan providers and inhibit entry into the market of new providers. These effects would reduce competition and innovation, resulting in higher costs and fewer services for consumers.

The weighted average cost of providing payday loans for the industry as a whole and by major lender size category are provided in Table 5b.

Table 5b Cost of Providing Payday Loans, by Type of Cost, and by Size of Business Weighted Averages of Survey Respondents				
	Cost per \$100 of Payday Loans			
	Average of All Firms	Large Businesses	Medium-sized Businesses	Small Businesses
Operating cost	10.58	10.31	12.04	16.92
Cost of loan capital	0.52	0.50	0.63	0.50
Cost of supplementary capital	0.57	0.56	0.63	0.69
Bad debt cost	<u>4.02</u>	<u>3.98</u>	<u>4.52</u>	<u>3.11</u>
Total	15.69	15.35	17.82	21.22

Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004

Compared to Table 5a (unweighted averages), the total cost on a weighted average basis of providing payday loans is significantly smaller (i.e., \$15.69 compared to \$20.66). The reason for this is that the largest payday lenders, which have significantly lower operating costs, represent a very large share of the total payday loan volume in the sample.

The variance in weighted average costs between large, medium-sized and small business is also significant. The difference in costs is being driven almost entirely by the variance in operating costs between the different-sized operators.

In terms of the individual components, the allocation of costs is not materially different from that of the unweighted cost structure (Table 5a).

B. MULTI-LINE VERSUS MONO-LINE PAYDAY LENDERS

Table 5c illustrates the cost differences between multi-line and mono-line payday lenders. For purposes of this study, multi-line businesses are defined as those that earn less than 90% of their revenues from payday lending. There are seven respondents in the survey who are classified as multi-line operators on the basis of this definition. These seven businesses represent 94% of the volume of payday loans of the 19 businesses that participated in the study and 419 of the 474 stores represented in the entire sample.

Mono-line businesses earn 90% or more of their revenues from payday lending, and include all of the “small businesses”. While most of the twelve businesses in this group are single- or two-store businesses, there are two businesses that are multi-store chains.

**Table 5c
Cost of Providing Payday Loans, by Type of Cost, and by Type of Business
Weighted Averages of Survey Respondents**

	Cost per \$100 of Payday Loans		
	Average of All Firms	Multi-line Businesses	Mono-line Businesses
Operating cost	10.58	10.25	14.22
Cost of loan capital	0.52	0.51	0.62
Cost of supplementary capital	0.57	0.57	0.60
Bad debt cost	<u>4.02</u>	<u>3.96</u>	<u>4.73</u>
Total	15.69	15.29	20.17

Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004

There is little difference between the cost structure of multi-line businesses and that of large businesses in Table 5b above. The reason for this is that the largest companies in the survey are also multi-line service providers. Overall, the costs for multi-line operators are significantly lower than those for mono-line operators. This provides some assurance that there has not been an artificial over-allocation of costs to payday lending by multi-line businesses. Recall, that our methodology allocated payday loan business costs of multi-line providers on the basis of revenues unless a specific allocation was provided by the survey participant. The breakdown of estimated costs between multi-line and mono-line payday lenders acts as a test against this cost allocation approach.

C. THE COSTS OF PROVIDING FIRST-TIME AND REPEAT/ROLLOVER LOANS

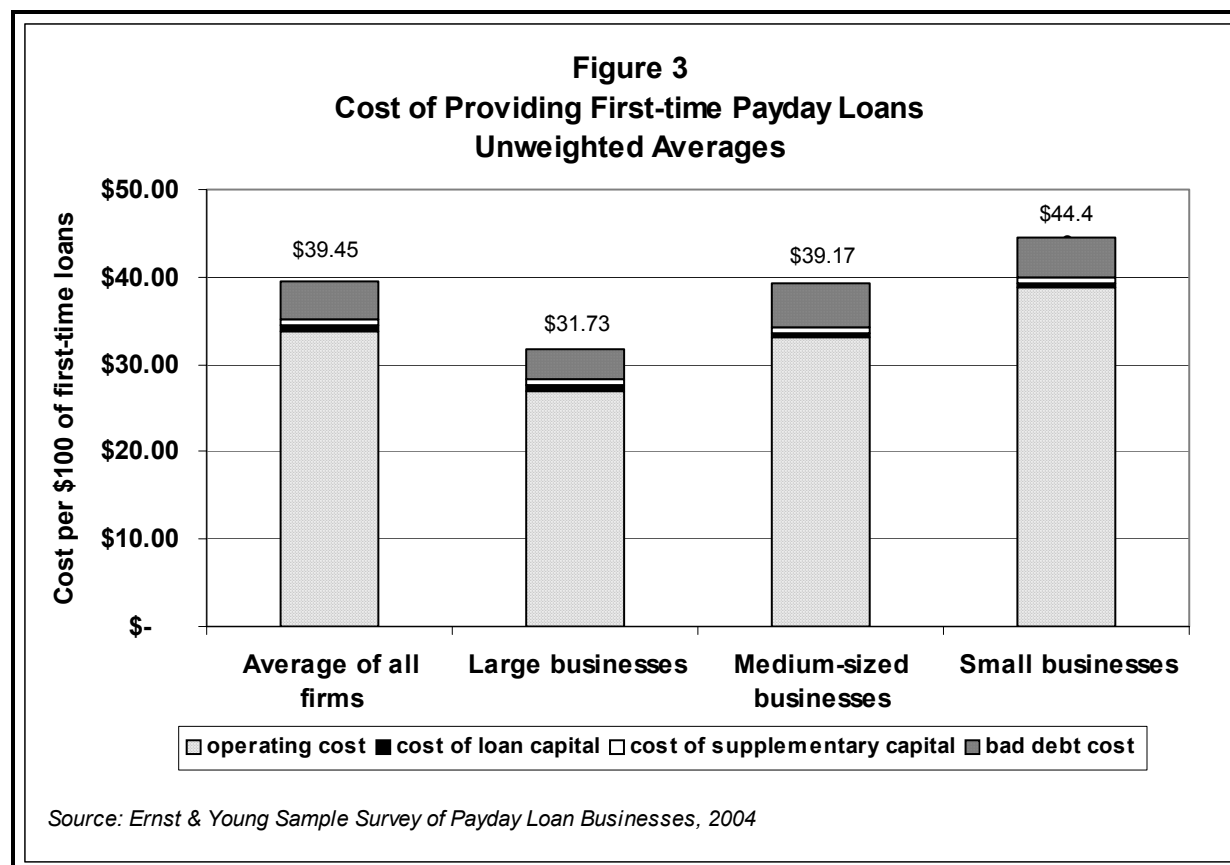
Table 6a and Figure 3 illustrate the cost per \$100 of providing payday loans to a first-time customer. Table 7a and Figure 4 illustrate the cost per \$100 of providing payday loans to a repeat customer or for a loan rollover, extension or re-write.

There are two types of observations worth noting. One relates to the differences between large, medium and small operators for both first-time loans and repeat/rollover loans. The second is the factors impacting the differences in costs between first-time loans and rollover/repeat loans. With respect to the latter, the only cost component that is directly impacting the differences in costs between first-time and repeat/rollover loans is operating costs, since it is this cost component that has been specifically allocated between the different types of loan transactions.

Table 6a
Cost of Providing First-time Payday Loans, by Type of Cost, and by Size of Business
Unweighted Averages of Survey Respondents

	Cost per \$100 of First-time Loans			
	Average of All Firms	Large Businesses	Medium-sized Businesses	Small Businesses
Operating cost	\$33.89	\$27.01	\$33.07	\$38.81
Cost of loan capital	\$0.55	\$0.54	\$0.59	\$0.52
Cost of supplementary capital	\$0.66	\$0.69	\$0.60	\$0.68
Bad debt cost	\$4.35	\$3.49	\$4.91	\$4.47
Total	\$39.45	\$31.73	\$39.17	\$44.48

Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004



The operating costs of first time loans are 2.68 times higher than repeat/rollover loan costs across all industry breakouts. This allocation between first-time and repeat/rollover loans simply reflects the difference in time it takes to process the different types of loans (see Key Assumptions – Ratio of First-time to Repeat Customers).

The operating costs of servicing new customers represent over 85% of the total costs across the industry. This ranges from 84% for medium-sized lenders to 87% for small payday loan providers.

The variance in the cost of providing first-time loans between large, medium and small lenders is substantial. The cost of providing payday loans to first-time customers of small operators is 40% higher than that of large lenders. This reflects the higher efficiency of larger operators that could be resulting from economies of scale.

Table 6b illustrates the costs of providing first-time payday loans on a weighted average basis. As expected, these costs are lower than those in Table 6a (unweighted average), because of the impact of lower costs of the large businesses.

Table 6b Cost of Providing <u>First-time</u> Payday Loans, by Type of Cost, and by Size of Business Weighted Averages of Survey Respondents				
	Cost per \$100 of First-time Loans			
	Average of All Firms	Large Businesses	Medium-sized Businesses	Small Businesses
Operating cost	24.24	23.46	28.81	39.03
Cost of loan capital	0.52	0.50	0.63	0.50
Cost of supplementary capital	0.57	0.56	0.63	0.69
Bad debt cost	<u>4.02</u>	<u>3.98</u>	<u>4.52</u>	<u>3.11</u>
Total	29.35	28.50	34.60	43.33

Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004

However, the operating costs of the large business represent 81% of the total cost of providing first-time loans, while operating costs of small businesses represent just over 90% of total costs.

Table 7a and Figure 4 show that, as with the costs of providing first-time loans, the variance in repeat loan costs between large and small operators is considerable. Operating costs of large operators are 30% lower than the operating costs of small firms.

Table 7a
Cost of Providing Repeat or Rollover Payday Loans, by Type of Cost, and by Size of Business
Unweighted Averages of Survey Respondents

	Cost per \$100 of Repeat or Rollover Loans			
	Average of All firms	Large Businesses	Medium-sized Businesses	Small Businesses
Operating cost	\$12.64	\$10.08	\$12.34	\$14.48
Cost of loan capital	\$0.55	\$0.54	\$0.59	\$0.52
Cost of supplementary capital	\$0.66	\$0.69	\$0.60	\$0.68
Bad debt cost	<u>\$4.35</u>	<u>\$3.49</u>	<u>\$4.91</u>	<u>\$4.47</u>
Total	\$18.20	\$14.80	\$18.44	\$20.14

Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004

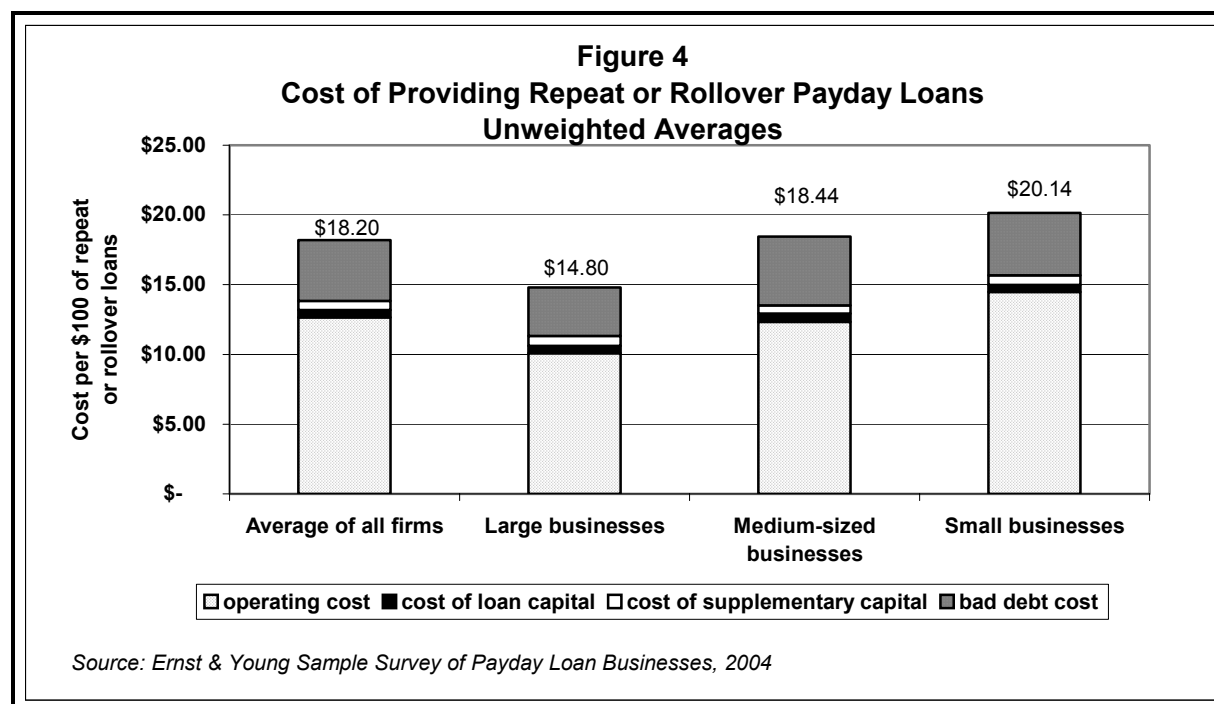


Table 7b below presents the costs of providing repeat loans on a weighted average basis. The operating costs of large businesses are less than 60% those of small businesses. Again, this likely reflects experience in the industry and significant returns to scale of the larger firms.

Table 7b
Cost of Providing Repeat or Rollover Payday Loans, by Type of Cost, and by Size of Business
Weighted Averages of Survey Respondents

	Cost per \$100 of Repeat or Rollover Loans			
	Average of All Firms	Large Businesses	Medium-sized Businesses	Small Businesses
Operating cost	9.04	8.75	10.75	14.56
Cost of loan capital	0.52	0.50	0.63	0.50
Cost of supplementary capital	0.57	0.56	0.63	0.69
Bad debt cost	4.02	3.98	4.52	3.11
Total	14.15	13.79	16.53	18.86

Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004

Table 8 illustrates that, on average, payday lenders provide 15 repeat or rollover loans for each first-time loan they provide. This ratio is fairly consistent across the industry on average. However, there are some operators that exhibit a higher proportion of first-time loans, because they are opening new stores.

Table 8
Number of Repeat/Rollover Loans to First-time Payday Loans, by Size of Business
Weighted Averages of Survey Participants

	Number of Repeat/Rollover Loans to First-time Payday Loans			
	Average of All firms	Large Businesses	Medium-sized Businesses	Small Businesses
Total	15.2	15.0	17.5	15.4

Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004

One of the key factors impacting the differences in cost between first-time loans and rollover/repeat loans is the customer mix. Companies that have a high proportion of new customers will have higher costs. This is an important factor for companies that have just entered the market and for companies that are in a rapid expansion phase. Until a steady customer base is developed, these operators will be facing higher costs associated with signing

up and processing first-time customers. Clearly, the long-run survival of a payday loan operator will depend on achieving a steady repeat customer business.

D. SENSITIVITY ANALYSIS ON ASSUMPTIONS ABOUT THE COST OF CAPITAL

As discussed earlier, the cost of loan capital and supplementary capital is a relatively small component of the total cost (6% on average).

In quantifying the cost of loan and supplementary capital, a 15% return on equity and a 7% interest rate were applied to the capital structure of each lender. The cost of capital loan and supplementary capital varies directly with the return on equity and interest rate used. Many factors impact the return on equity and loan interest and these could vary significantly over time. Therefore, we conducted a sensitivity analysis under different return on equity and interest assumptions to determine what impact these would have on the overall cost of providing payday loans.

Table 9 Sensitivity of Cost of Providing Payday Loans to Variations in the Cost of Capital by Size of Business Weighted Averages of Survey Participants					
Assumed Cost of Capital		Cost per \$100 of Payday Loans			
<u>Equity Capital</u>	<u>Debt Capital (Interest)</u>	<u>Average of All firms</u>	<u>Large Businesses</u>	<u>Medium- sized Businesses</u>	<u>Small Businesses</u>
15%*	7%*	15.69	15.35	17.82	21.22
0%	7%	14.60	14.29	16.49	20.05
10%	6%	15.31	14.98	17.36	20.82
20%	8%	16.08	15.73	18.28	21.63
30%	10%	16.84	16.47	19.19	22.44
<i>* Base case assumptions</i>					
<i>Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004</i>					

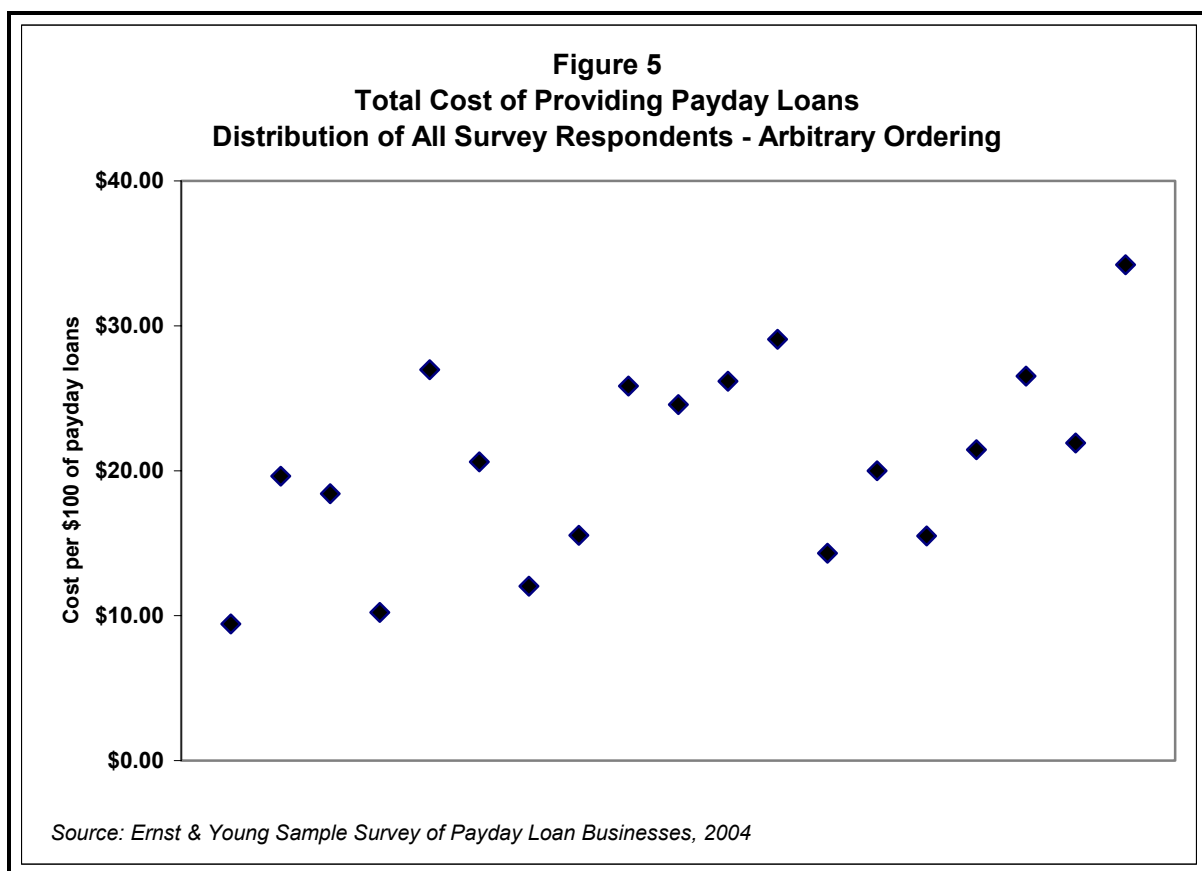
Table 9 above illustrates the impact on total costs under different assumptions ranging from 0% to 30% for the opportunity cost of capital and a 6% to 10% interest rate on debt. The difference in total cost between the low cost assumption (0% return on equity and 7% interest) and the high cost assumption (30% return on equity and 10% interest) for the industry as a whole is approximately 15% (\$14.60 vs. \$16.84). Furthermore, there is little variance between large and

small lenders. The high assumption/low assumption cost differential varies from 12% for small lenders to 16% for medium-sized businesses.

The base case for our analysis of a 15% rate of return on equity represents an extremely conservative view of the risks associated with this industry, considering mainstream financial institutions such as banks with extremely high asset bases and financial product diversification are earning nearly 20% return on equity. Nonetheless, the differences in assumptions do not have much impact on the overall cost because of the relative insignificance of the cost of capital to the total cost of providing payday loans.

E. VARIANCE OF THE COST OF PROVIDING PAYDAY LOANS

While Tables 5a and 5b above illustrate an overall industry average of costs and average costs of small, medium and large lenders, Figure 5 demonstrates the diversity of these costs within the payday loan industry.



Each point on the diagram represents a different payday loan provider that participated in the survey. The lowest cost provider in the survey provides loans at a cost of just under \$10 per \$100 loan, while the highest cost was reported at nearly \$35 per \$100 loan. This demonstrates the significant cost variance across the industry on a per-operator basis.

The next three sections of the report explain why average costs are so high in the payday loan industry and why there is significant variance across the industry.

F. WHY ARE PAYDAY LOAN COSTS SO HIGH COMPARED TO OTHER FORMS OF LENDING?

Often, observers comment that the cost to consumers of payday loans as a percentage of the loan amount is considerably higher than for other types of lending, such as credit cards, lines of credit, personal loans, and mortgages.

The results of this study confirm this: the total cost of providing payday loans, expressed on a per \$100 basis, are high. The reason for this is that the lender must cover all of its costs (operating costs, bad debt costs and the cost of capital) of each loan transaction over a small capital base (average loan size of \$279) and a relatively short maturity period (two weeks for most payday loans). These costs, which relate primarily not to the cost of capital but to the cost of providing the service of writing and approving a loan, cannot be covered simply by applying the 60% per annum interest rate permitted under the *Criminal Code* of Canada. Consequently, payday lenders normally levy an administrative or transaction charge in addition or in lieu of interest.

**Table 10
Equivalence of a Fixed Transaction Cost to Additional Annual Interest Charge**

\$50 Transaction Cost as Equivalent Annual Interest Charge				
Loan size	Loan Maturity Period			
	<u>2 weeks</u>	<u>1 month</u>	<u>1 year</u>	<u>5 years</u>
\$100	1,300.0%	600.0%	50.0%	10.0%
\$500	260.0%	120.0%	10.0%	2.0%
\$1,000	130.0%	60.0%	5.0%	1.0%
\$10,000	13.0%	6.0%	0.5%	0.1%
\$25,000	5.2%	2.4%	0.2%	0.04%

Source: Ernst & Young Sample Survey of Payday Loan Businesses, 2004

To demonstrate this point, consider the hypothetical example represented in Table 10 above. Suppose that total fixed transaction costs of providing a loan are \$50, regardless of the loan size. For a \$1,000 loan that matures in 1 year, if the operator were to cover its cost only through an “interest-type charge”, it would need to charge a 5% interest charge to cover the \$50 transaction cost (i.e., \$1,000 x 5% x 1 year maturity = \$50). As the loan size and maturity period decreases, the equivalent interest charge must rise in order for the lender to fully

amortize the \$50 transaction cost. The table provides an amortization schedule for different loan sizes over different maturity periods.

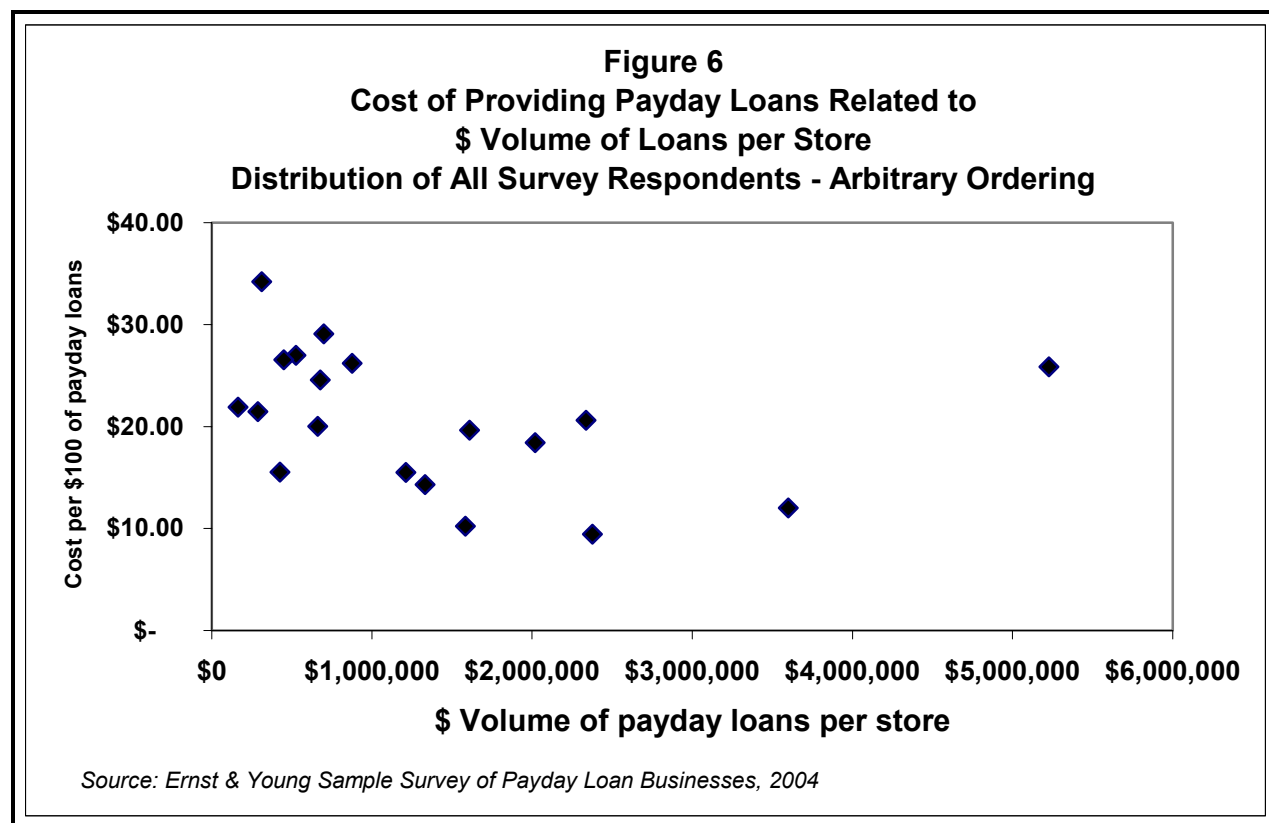
Payday loans typically mature in a two-week period and are less than \$500. For a \$100 loan, the lender would have to charge a 1,300% interest charge to recover the \$50 transaction cost [i.e., $\$100 \times 1,300\% \times (2 \text{ weeks}/52 \text{ weeks})$].

G. WHY DO COSTS VARY?

(i) Economies of scale

One explanation for observing lower costs for larger lenders and higher costs for small lenders is efficiency gains achieved through significant economies of scale.

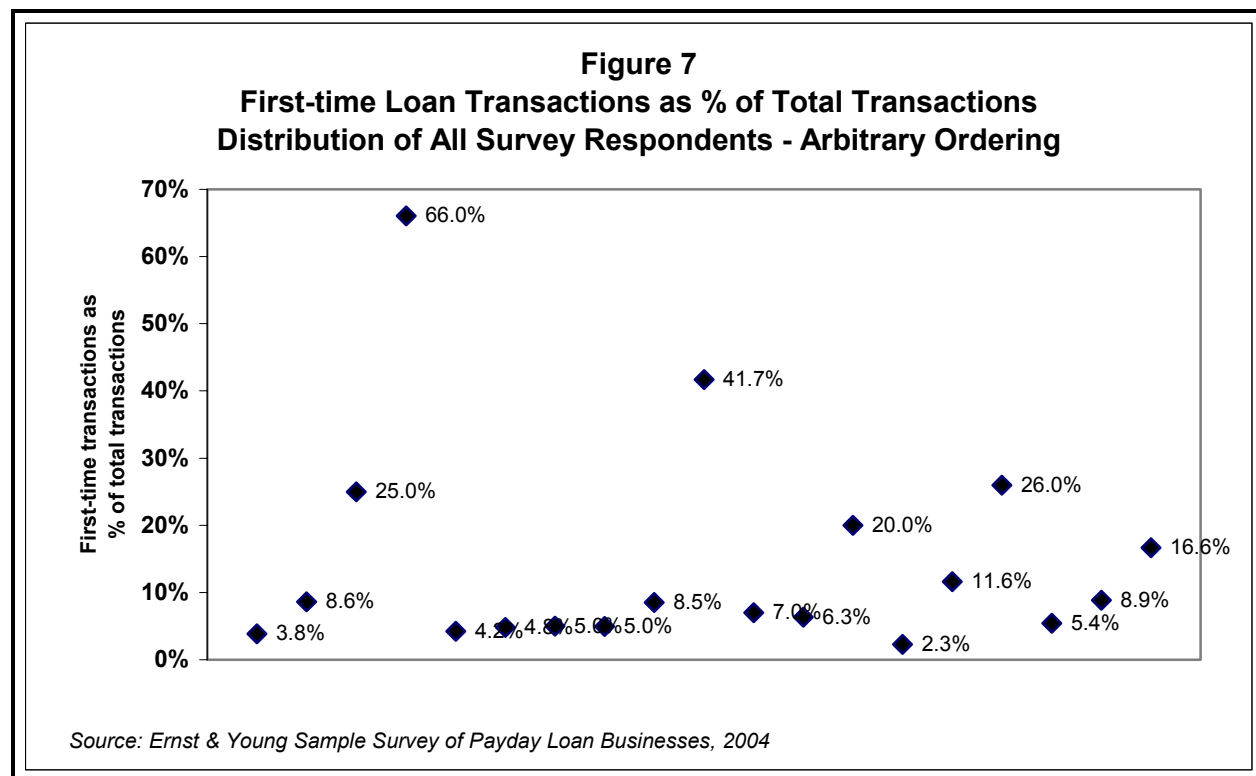
Figure 6 plots the cost of each payday loan provider by the volume of loans per store. Two distinct clusters are evident. The first cluster is for lenders with per-store volume of less than \$1 million. With the exception of two observations in this cluster and the one outlier (greater than \$5 million in loan volume), lenders in this cluster have higher costs. The other major cluster includes lenders with loan volumes per store between \$1 million and \$2.5 million. These payday loan providers tend to have lower total costs.



It would appear that economies of scale could be having some impact on the total costs of providing payday loans as higher volume stores are exhibiting lower costs in most cases.

(ii) Repeat/rollover versus first-time loan transactions

Figure 7 demonstrates the diversity of experience within the industry with respect to the proportion of first-time customers as a percentage of the total customer base. While many companies rely largely on repeat business, there are some companies that have high or very high proportions of first-time customers. These businesses are likely to be new or rapidly expanding businesses.



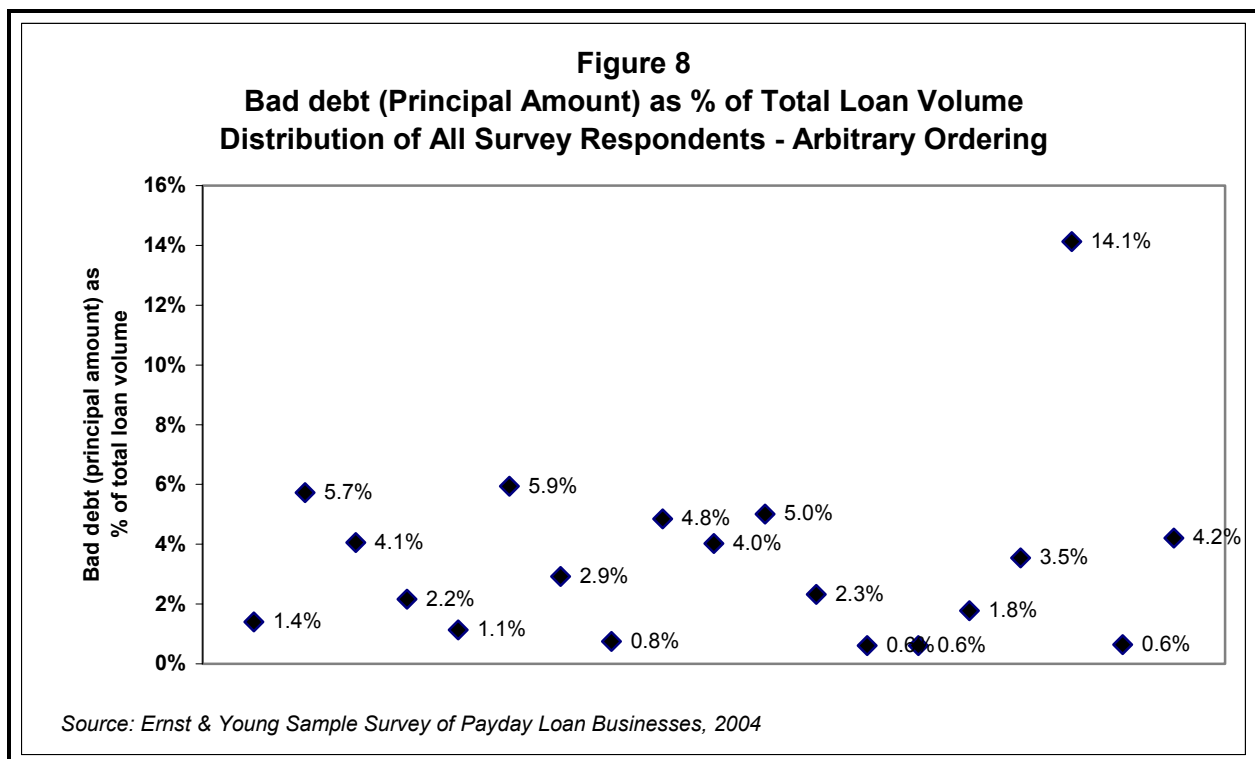
H. BAD DEBTS

While the bad debt cost is significant for the payday loan industry, bad debt experience varies significantly across the industry. Figure 8 below illustrates the bad debts as a percentage of the loan volume for all surveyed payday lenders. Bad debts depicted here are only the principal amount of the loan that is non-recoverable.

The principal amount of bad debt ranges from a low of 0.6% of total loan volume to as high as 14.1%. It is important to note that this variance is not a result of the different bad debt accounting policies of the individual lenders. For the purposes of this study, bad debt was defined to be a loan that is written off after 90 days from the maturity date. This definition was

developed to provide uniformity across the industry in order to enable appropriate cross industry comparisons.

The variance in bad debts can reflect a number of factors. Some lenders cater to a different customer base, which can be targeted through the fee structure for payday loans. Also, payday loan providers may have different policies regarding customers that have a high default experience. For example, some payday lenders charge lower fees in order to attract a clientele that is less likely to default. These lenders are able to reject the business of customers they believe are likely to be a higher bad debt risk. Other lenders accept a wider range of risk, and cover this additional cost through higher fees.



One lender interviewed for this study indicated that despite lowering his fees significantly, he has been unable to reduce his incidence of bad debt, and therefore will be closing his business shortly. Another lender, who believes that many of his customers are borrowing more than once against a paycheque within his geographic market, has reduced his incidence of bad debt by lending only small amounts, generally under \$100. This lender believes that if a client is unable to cover all of his/her debts from a paycheque, he/she will pay off the smallest debts first.

While seven of the nineteen lenders have a bad debt experience that is less than 2% of the total loan volume, the bad debt experience of this industry is still much greater than mainstream financial institutions such as banks.

Table 11 provides the loan loss provisions (an indicator of bad debt) as a percentage of total loans for each of the five big Canadian banks. The average of 0.46% is much lower than that of the payday loan industry (over 4%), and only one bank has a worse loan loss provision than the lowest bad debt cost from surveyed payday loan providers.

Table 11
Loan Loss Provisions of Canada's Largest Banks (2003 Annual Reports)

Bank	Provision for credit losses as % of net average loans
Bank of Montreal	0.30%
Bank of Nova Scotia	0.48%
Canadian Imperial Bank of Commerce*	0.82%
Royal Bank of Canada	0.55%
Toronto-Dominion Bank	0.15%
Average	0.46%

* Credit losses charged as % of net loans

I. PROFITABILITY OF THE INDUSTRY

The rapid growth of the industry suggests that:

- (a) There is demand for the industry's product, and
- (b) The industry is making or expects to make a reasonable return on its investment.

While the focus of the study was not on the profitability of the industry, the survey did produce some data that may shed some light on the industry's profitability. These data enable us to make a few observations that may be useful for stakeholders and policy makers in the debate about the regulation of the payday loan industry. Contrary to what one could infer from the rapid growth of the industry, the survey data do not indicate that the industry as a whole is making excess profits.

Seven of the nineteen payday loan providers that responded to the questionnaire reported an overall business loss from payday lending, i.e., they were not achieving sufficient revenues from their payday loans to cover the costs of providing the loan (including the opportunity cost of capital).

The losses are caused by their high operating and bad debt costs. As previously discussed, the opportunity cost of capital is only a small part of the overall cost. If the opportunity cost of capital is excluded (i.e., a 0% return on equity capital is assumed), these seven providers still do not cover their costs, although their losses are somewhat smaller. On the other hand, if a higher opportunity cost of capital (20%) and higher interest rate on corporate debt (8%) are

assumed, the number of providers that do not cover their costs rises to nine, and another two providers earn only marginal profits.

It is possible that some payday loan providers are losing money because of the high start-up costs associated with expansion. However, anecdotal evidence collected during discussions with operators suggests that some payday loan providers are suffering losses because of high operating and bad debts costs that are not associated with expansion. We were contacted by some operators who have ceased operations or stopped providing payday loans, or who are planning to cease operations or stop providing payday loans altogether. As well, a number of the survey questionnaires were returned because the businesses had closed.

One of the operators who contacted us specifically stated that he was closing because he was unable to reduce his high rate of bad debts. Another business stopped providing payday loans for the same reason.

While this evidence is only anecdotal in nature, it indicates that the payday loan industry, like other industries, has businesses that are unable to survive given the cost structure they face and revenues they are able to earn.

This industry, like any other industry, suffers from inefficiencies that could relate to operating costs and the ability to verify creditworthiness of customers. The wide variance in bad debt experience among payday loan providers may indicate that some providers are simply not as successful at screening customers for risk of bad debt.

It can also be expected that new businesses will suffer from inefficiencies until they are able to build a customer base sufficient to support the business infrastructure. Businesses that do not build up a repeat customer base will find it difficult to survive given that the costs of servicing repeat customers is substantially lower than for new or one-time customers. The industry will evolve over time as providers gain experience in developing procedures and tools for managing these costs, and as businesses mature.

In conclusion, while payday loan providers as a whole are earning returns on equity that are comparable in other segments of the financial industry, a significant proportion of the industry is not making adequate returns. The industry has its share of losers who are forced to close their business or stop offering the product. While we did not undertake a detailed investigation on the question of profitability, the data available to us does not support the perception of excess profits in the payday loan industry as a whole.

VI. Conclusions

This study was commissioned in order to provide valuable information to various stakeholders about the cost structure of the payday loan industry. Since it is the first study of its kind in Canada, it was necessary to undertake significant consultations with payday loan providers and government in order to fully understand the unique features of the industry and to ensure that the methodology for quantifying costs was acceptable to the stakeholders and that the results accurately portrayed the cost structure of the industry.

The methodology was developed to capture four broad categories of costs: operating costs; cost of loan capital; cost of supplementary capital; and bad debts. In addition, costs were estimated for the various types of payday loan transactions, namely first-time loans, repeat loans, and rollover / rewrite loans.

Data on costs and the various business models employed in the industry were collected by way of a detailed survey questionnaire. Survey respondents represented nearly half of the estimated number of stores across Canada, making this a statistically significant sample.

A number of allocations and adjustments were necessary to reflect the various business models and accounting procedures of different payday loan operators in order to develop comparable costs across the industry sample. For example, in the case of multi-line service providers, cost allocations for their payday loan business were necessary. To compare bad debt costs, a common definition was used and applied to all companies in the survey. Moreover, as a base case, a 15% return on equity and a 7% interest rate were applied to the capital structure of each lender to determine the cost of capital.

Results of the analysis were presented for all loans and various types of loans (e.g., first time loans, rollover loans, etc.). Average costs were presented for all firms, small, medium and large firms to illustrate differences across the industry, and for multi-line and mono-line operators.

Since the industry is dominated by a few large operators, which tend to skew weighted average results on the basis of market share in the industry, cost estimates are presented in the report on both a weighted and unweighted (simple) average basis. Unweighted averages more appropriately reflect the cost structure of smaller operators whose overall share in the industry is relatively small.

The main findings of the study are as follows:

- The average (unweighted) cost of providing payday loans for the industry as a whole is \$20.66 per \$100 of payday loans (\$15.69 on a weighted average basis). The largest single component of costs is operating costs, representing three-quarters of the total cost. Bad debt costs account for approximately 20% of the costs, while the cost of loan and supplementary capital represent just over 5% of total costs. Since the cost of capital is such a small component of the overall costs, sensitivity analysis revealed that vastly different assumptions for the return on equity and interest on debt applied in determining the cost of capital had little impact on the overall cost.

- The largest operators have the lowest costs, while small operators have the highest total costs, which are impacted entirely by higher operating costs. However, costs of the individual survey respondents vary from as little as \$10 to as high as \$35 per \$100 of payday loans.
- Cost of providing first-time loans are twice as high as the costs of all loans. This reflects the time and effort required to process first-time loans to new customers. As expected, the cost of repeat, rollover/rewrite loans are significantly smaller than the cost of first time loans. For every first time loan the average payday loan provider transacts 15 repeat and rollover/rewrite loans on average.

The survival of payday loan operators depends on establishing and maintaining a substantial repeat customer base. First time loans as a percentage of total transactions vary significantly across the industry, ranging between 3% and 66%. Companies that are rapidly expanding exhibit higher costs because of the higher costs associated with processing of first-time loans.

Lower costs of large operators can be attributed in part to economies of scale and to experience, both from a business operations perspective and their ability to assess risk of loan default. Bad debts are a significant cost in the payday loan industry. Bad debt costs in the industry vary from as low as one-half of one percent of total loan volume to as high as 14%, with the average between 4-5%. This is still much higher than the bad debt experience of mainstream financial institutions.

The fact that operating costs are the largest component of total costs by a wide margin, and are fixed (i.e., any financial transaction, no matter how large or small has an associated fixed transaction cost), has implications for regulating the price of payday loans. An interest rate mechanism is inappropriate, since the cost of capital represents a relatively insignificant portion of total costs, which is why payday loan operators charge a fixed fee per \$100 of payday loans plus an interest charge. Put differently, payday loan operators must cover their loan transaction costs over a small loan size (under \$300 on average) over a short maturity period (typical maturity period of a payday loan is two weeks), which, if factored as interest, would result in a very high interest charge to recover the transaction cost.

This industry is not unlike other industries in that it has both efficient and inefficient operators. Inefficiencies could relate to operating costs or the ability to assess credit risk of customers. The industry is continuing to expand to keep pace with the demand for payday loans. Over time successful operators will have to build a steady repeat customer base and reduce costs through economies of scale or through experience in managing these costs.

Finally, while examining profitability of the industry was beyond the scope of this study, the information collected during the study revealed that payday loan providers are earning returns on equity that are somewhat comparable in other segments of the financial service sector. However, several companies are not making adequate returns and are being forced to close down or discontinue offering payday loans.

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APPENDIX A: Survey of Canadian Payday Loan Providers

Conducted by Ernst & Young LLP on behalf of the Canadian Association of Community Financial Service Providers

All information will be kept strictly confidential by Ernst & Young LLP

Please provide the name and telephone number of a contact person in case clarification is required on any responses. To ensure complete confidentiality of this information, Ernst & Young will remove the contact name and phone number from the questionnaire when it has completed its review of the information.

Name of contact person:

Telephone number of contact person: ()

In addition to completing the questionnaire, please send a copy of your annual financial statements for the most recent fiscal year to the address below, accompanied by the name and telephone number of the contact person.

Please return to:

Tax Policy Services Group

tel.: (416) 943-2625

Ernst & Young LLP

fax: (416) 943-3792

222 Bay Street, P.O. Box 251

e-mail: kevin.ogrady@ca.ey.com

Toronto ON M5K 1J7

Company Structure and Business Mix

1 Please identify (X) which service lines are provided by your company:

- Payday lending
- Cheque cashing
- Money transfers
- Collateral / pawn loans
- Title loans
- Mortgage / bridge financing
- Other** (please identify):
-

2 How many stores did your company operate in each region by at the end of the most recent fiscal year?

How many were franchised by your company to other operators?

- British Columbia
- Alberta
- Saskatchewan / Manitoba
- Ontario
- Quebec
- Atlantic Canada
- Total**

**Company-
operated Franchised
Stores**

0 0

3 Do you act as the principal for payday loans, or as a broker for loans provided by a bank or another third party? (X)

**as principal
as broker**

**4 Are your loans insured for default risk? (X)
If so, by an independent insurer or by an affiliated company? (X)**

**not insured
independent insurer
affiliated company**

5 Are there any other relevant features of your operations that may affect the cost of your payday loan business? Please describe:

Owner Compensation

6 What is the legal structure of the business? (X)

Proprietorship
Partnership
Private company
Public company

If your business is not a public company, please answer Questions 7-9 with respect to the following people:

- (a) proprietors of the business,
- (b) partners in the business,
- (c) significant shareholders (i.e., those who own 25% or more of the equity interest in the business), and
- (d) the spouses of proprietors, partners and significant shareholders.

7 What is the total amount of salary paid to the individuals identified above? \$

8 What is the total amount of bonuses/benefits/other compensation paid to the individuals identified above? \$

9 Please provide an estimate of the total hours spent on the business in a typical week by the individuals identified above.

Financial Statement Information

Please answer Questions 10 - 16 on the basis of your financial statements for the most recent fiscal year available.

10	Please indicate (X) whether your financial statements are:	Audited Provided to a bank or another lender		
11	What is the date of the year-end for these statements? (day / month / year)			
12	Your total revenues for major business lines:	Payday lending Cheque cashing Money transfers Collateral / pawn loans Mortgage / bridge financing Franchise revenues Other (please identify): - Total revenues	\$ \$ \$ \$ \$ \$ \$ \$ \$	0
13	Your company's costs for:	Salaries and benefits Incentive plan expense Security (armoured car service, alarm systems) Rent Utilities Insurance NSF, credit check, and other bank service charges Advertising Depreciation and amortization Goodwill amortization expense (if any) Provision for loan losses and doubtful accounts	<u>All business lines</u> \$ \$ \$ \$ \$ \$ \$ \$ \$ \$ \$	<u>Payday loans</u> \$ \$ \$ \$ \$ \$ \$ \$ \$ \$ \$
	(a) all business lines, and (b) payday lending only.			
	(If you do not account for payday lending separately, please provide your best estimate.)			

Interest	\$	\$	
Taxes	\$	\$	
Franchise expenses (i.e., services <u>to</u> franchisees)	\$	\$	
Payments to affiliated companies (e.g., management fees, royalties, etc. - please identify):			
-	\$	\$	
Other (please identify):			
-	\$	\$	
Total expenses		\$0	\$0

14 Your company's assets:

Cash		\$	
Accounts receivable - payday loans		\$	
Accounts receivable - other		\$	
Pre-paids		\$	
Inventory		\$	
Net Fixed Assets		\$	
Other (please identify):			
-		\$	
Total assets		\$	0

15 Your company's liabilities:

Accounts payable		\$	
Salaries payable		\$	
Other payables		\$	
Inter-company liabilities		\$	
Long-term debt		\$	
Other (please identify):			
-		\$	

16	Your company's equity:	Total liabilities	\$	0
		Capital stock/paid-in capital	\$	
		Retained earning (opening)	\$	
		Net income for the year	\$	
		Other (please identify):		
		-	\$	
	Total equity	\$	0	

17	For each of the following amounts, please provide the <u>average</u> daily OR monthly OR quarterly balances for the year:	Payday loans outstanding (principal amount only)	\$	
		Total liabilities	\$	
		Total equity	\$	

Product Line Activity

18	How many payday loans were issued during the year that were:	Payday loans to first-time customers	
		Payday loans to repeat customers	
		Rollovers/extensions and rewrites	

If you cannot provide the number of loans to first-time customers, please provide the number of active accounts at the end of your most recent fiscal year minus the number of active accounts at the end of the previous fiscal year.

If transaction information is not available for payday loans only, please provide your best estimate, check (X) this box:

19	What is the average <u>initial</u> term (number of days) of payday loans? (i.e., not including rollovers/extensions, re-writes)
----	--

Returned Cheques and Unrecoverable Debts

20	What was the total cumulative value of payday loans:	
	issued in the year?	\$

- that went into default? (i.e., cheques returned NSF) \$
- 21 What percentage of payday loans in default were collected within 90 days?
- 22 Not including amounts that are unrecoverable within 90 days, on average how long would you estimate that it typically takes to collect on returned cheques?
- 23 For financial accounting purposes, do you write off loans in default at the time the cheques are returned as NSF? Yes
No
- 24 If you answered NO to Question 23, how many days after the cheques are returned do you write them off as bad debt?

Time and Effort for Transactions

- 25 On average, how much face-to-face employee time (in minutes) is spent issuing a payday loan (paperwork, interview, follow-up, etc.):
- to a first-time customer?
to a repeat customer?
for a rollover/extension or re-write?

Size Distribution of Payday Loans

		<u>Number</u>	<u>Amount</u>
26	What is the total <u>number</u> and <u>amount</u> of payday loans issued during the year in each size category:		
	\$0 – \$100		\$
	\$101 – \$200		\$
	\$201 – \$300		\$
	\$301 – \$400		\$
	\$401 – \$500		\$
	Greater than \$500		\$

Breakdown of Fees

27 Please describe the fee structure for:

- Payday loans:
- Rollovers/extensions or re-writes:
- NSF cheques:

APPENDIX B: Illustration of Model Used to Calculate the Cost of Providing Payday Loans

This example illustrates the model that was used to analyze the data collected for this study. These data represent a composite firm. This is not an average firm, but could be considered to be a typical firm. The results for this composite firm should not be interpreted as having any meaning in relation to the results of the study.

	All loans	First-time loans	Repeat/rollover
KEY OBSERVATIONS			
Operating cost per \$100 of loan	14.97	35.57	13.27
Cost of loan capital for \$100 of loan	0.66	0.66	0.66
Cost of supplementary capital per \$100 of loan	0.60	0.60	0.60
Total bad debt costs per \$100 of good loans	<u>7.06</u>	<u>7.06</u>	<u>7.06</u>
Total costs per \$100 of good loans	23.28	43.89	21.59
1 N Number of stores		9	
2 G Number of transactions (all types of payday loans)	= $g1 + g2 + g3$	38,755	
3 j Total payday loan volume in year	= j	8,491,480	
4 a' Average loan size	= j / G	219	
5 Loan volume per store	= j / N	903,349	
6 w" Number of first-time loans as % of total	= $g1 / G$	7.6%	
7 g" bad debt principal as % of total volume	= $f" / j$	5.6%	
CALCULATIONS			
Total costs			
8 h' Operating cost per \$100 of loan		14.97	
9 v' Cost of basic capital for \$100 of loan		0.66	
10 d" Cost of supplementary capital per \$100 of loan		0.60	
11 n" Total bad debt costs per \$100 of good loans		7.06	
12 o" Total costs per \$100 of good loans	= $h' + v' + d" + n"$	23.28	
13 z" Operating cost per \$100 of first-time loan	= $v" / x" \times 100$	35.57	
14 b"" Total costs per \$100 of good first-time loans	= $z" + v' + d" + n"$	43.89	
15			
16 q" Operating cost per \$100 of repeat/rollover loan	= $w" / y" \times 100$	13.27	
17 c"" Total costs per \$100 of good repeat/rollover loans	= $q" + v' + d" + n"$	21.59	
Operating costs			
18 B Total fixed & variable costs	= B	1,571,784	
19 B' Adjustments to fixed and variable costs	= $b10+b11+b12+b15+b18$	300,850	
20 e' Adjusted fixed and variable costs	= $B - B'$	1,270,934	
21 f' Allocation of costs for payday lending	= A^{\wedge}	100%	
22 g' Operating costs for payday lending	= $e' \times f'$	1,270,934	
23 h' operating cost per \$100 of loan	= $g' / j \times 100$	14.97	
24 g1 first-time loan time units	= $g1 \times Q$	7,900	

25	r" repeat/rollover time units	= (g2 + g3) x 1	35,807
26	s" total units	= g1 + r"	43,708
27	t" first-time loans share of op. costs	= g1 / s"	18.1%
28	u" repeat/rollover loans share of op. costs	= r" / s"	81.9%
29	v" Operating costs for first-time loans	= g' x t"	229,721
30	w" Operating costs for repeat/rollover loans	= g' x u"	1,041,213
31	x" \$ Volume of first time loans	= a' x g1	645,758
33	y" \$ Volume of repeat/rollover loans	= a' x (g2 + g3)	7,845,722
34	z" Operating cost per \$100 of first-time loan	= v" / x" x 100	35.57
35	q" Operating cost per \$100 of repeat/rollover loan	= w" / y" x 100	13.27
36	ratio of operating costs per \$100	= z" / q"	2.68
Cost of loan capital			
37	d5 Long-term debt	= d5	90,940
38	E Total equity	= E	420,801
39	u' debt / (equity + debt)	= d5 / (d5 + E)	18%
40	i* Corporate debt interest rate	7% assumed	7%
41	r* rate of return on equity	15% assumed	15%
42	k* imputed rate of cost of basic capital	= (u' x i*) + ((1-u') x r*)	13.6%
Weighting for good redeemed and default loans			
43	j Loans issued in year	= j	8,491,480
44	k Loans that went into default	= k	1,076,792
45	m % of default loans collected within 90 days	= m	56%
46	n time taken to collect on loans within 90 days	= n	50.8
47	b' \$ volume of "good redeemed" loans	= j - k	7,414,687
48	c' \$ volume of "good default" loans	= k x m	603,004
49	d' \$ volume of all good loans	= b' + c'	8,017,691
50	a* = (b'/d' x h) + (1 - b'/d') x (h+n))	maturity of good loans	17.72
51	w' Cost of basic capital	= k* x a*/365 x j	55,978
52	v' Cost of basic capital for \$100 of loan	= k* x a*/365 x 100	0.66
Cost of supplementary capital			
53	x' revenue-based allocation to payday lending	= A* / A	93%
54	y' fixed assets allocated to payday lending (by revenue)	= c6 x x'	204,551
55	z' Cash allocated to payday lending (by revenue)	= c1 x x'	169,086
56	a" provision for available cash reserves	= min(z' , 1/26 x j)	169,086
57	b" Supplementary capital	= a" + y'	373,637
58	c" Cost of supplementary capital	= b" x k*	50,734
59	d" Cost of supplementary capital per \$100 of loan	= c" / j x 100	0.60
Bad debt costs			
60	f" Bad debts - principal amount	= k x (1 - m)	473,789
61	g" bad debt principal as % of total volume	= f" / j	5.6%
62	h" operating costs allocated to bad debt	= g' x g"	70,913
63	i" Supplementary capital cost allocated to bad debt	= c" x g"	2,831
64	j" Bad debt interest expense	= f" x k* x (h+90)/365	18,313
65	k" Total bad debt costs	= f" + h" + i" + j"	565,845

66	m" Total loans excluding bad debt ("good loans")	= j - f"	8,017,691
67	n" Total bad debt costs per \$100 of good loans	= k" / m" x 100	7.06
DATA			
Total revenues for major business lines:			
68	a1 Payday lending		1,828,537
69	a2 Cheque cashing		92,894
70	a3 Money transfers		3,234
71	a4 Collateral / pawn loans		-
72	a5 Mortgage / bridge financing		-
73	a6 Franchise revenues		-
74	a7 Other		25,907
75	A17 3rd party lender interest-payday		-
76	a19 NSF fees from payday lending		-
77	A Total revenues		1,964,278
78	A* Total revenues from payday loans	= a1 + a17 + a19	1,828,537
79	A^ Allocation of costs to payday (=100% where costs for PDL provided)		
Company's costs:			
80	b1 Salaries and benefits		694,975
81	b2 Incentive plan expense		3,053
82	b3 Security		3,227
83	b4 Rent		114,896
84	b5 Utilities		48,462
85	b6 Insurance		6,220
86	b7 NSF, credit check, other bank service charges		27,582
87	b8 Advertising		122,654
88	b9 Depreciation and amortization		21,146
89	b10 Goodwill amortization expense (if any)		-
90	b11 Provision for loan losses/doubtful accounts		185,716
91	b12 Interest on long-term debt		104,440
92	b13 Taxes		39,118
Payments to other companies			
93	b14 Franchise expenses (i.e., services to franchisees)		-
94	b15 management fees		27,593
95	b16 Royalties		-
96	b18 shareholder profit distribution		-
97	b21 Other		172,701
98	B Total expenses		1,571,784
Company's assets:			
99	c1 Cash		181,638
100	c2 Accounts receivable - payday loans		570,344
101	c3 Accounts receivable - other		27,820
102	c4 Pre-paids		7,931
103	c5 Inventory		-
104	c6 Net Fixed Assets		219,736
105	c7 Other		199,996

106	C	Total assets	1,207,465
Company's liabilities:			
107	d1	Accounts payable	77,233
108	d2	Salaries payable	2,920
109	d3	Other payables	38,443
110	d4	Inter-company liabilities	106,767
111	d5	Long-term debt	90,940
112	d6	Other	470,345
113	D	Total liabilities	786,648
Company's equity:			
114	e1	Capital stock/paid-in capital	2,002
115	e2	Retained earning (opening)	296,189
116	e3	Net income for the year	125,110
117	e4	- Dividends (Paid) Receivable	(2,500)
118	e5	- Shareholder Loans	-
119	E	Total equity	420,801
Average daily OR monthly OR quarterly balances for the year:			
120	f1	Payday loans outstanding (principal amount only)	766,897
121	f2	Total liabilities	1,100,501
122	f3	Total equity	(166,902)
Product Line Activity			
123	Payday loans issued during the year that were:		
124	g1	Payday loans to first-time customers	2,947
125	g2	Payday loans to repeat customers	35,607
126	g3	Rollovers/extensions and rewrites	200
127	h	Average initial term (number of days) of payday loans (not including rollovers/extensions, and re-writes)	14
Returned Cheques and Unrecoverable Debts			
128	Total cumulative value of payday loans:		
129	j	issued in the year	8,491,480
130	k	that went into default (i.e., cheques returned NSF)	1,076,792
131	m	Percentage of payday loans in default were collected within 90 days	56%
132	n	Average time to collect on returned cheques, not including amounts that are unrecoverable within 90 days	51
133		Ratio of time taken by first-time transactions to repeat/rollover/rewrite	2.68

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