Regulating Payday Lending in Manitoba: Three Recommendations

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Three Recommendations

1. Maximum fee 15% of principal

2. Borrower can convert to an installment loan on or before the due date.

3. Leave maximum loan limit at 30% of net income.

What do we know about the business?

- Small business:
  - Few hundred thousand revenue p.a.
  - 5 – 20 loans per day
  - Perhaps cash a few cheques, sell money orders
- Costs:
  - Wages, occupancy, bad debts
  - Mostly fixed just to open the doors each day
  - Little capital required

What do we know about the business?

- The key challenge for small business is volume to cover fixed costs.
- Economy of scale:
  - Most costs are fixed. Costs rise much more slowly than loan volume.
  - Large chains can generate more volume with advertising, and share some costs like info tech.
- Economy of scope:
  - Add more products: gold, pawn shop, tax prep
  - Has not succeeded in mainstream products
  - Small towns must have several businesses

Who are the lenders?

- Concentrated and consolidating
- Money Mart (Dollar Financial owns it)
  - half of the market, 574/1,427 stores
  - 21/40 stores in Manitoba
- Cash Money (private)
  - 184/1,427 stores
  - 4/40 stores in Manitoba
- Some larger provincial chains (e.g. Cash4You in Ontario, 91; Cash Canada in Alberta, 56); single stores or small chains in one or two provinces.

What do we know about the market?

- Borrowers are relatively disadvantaged.
- Most loans are to repeat borrowers – some more than 10 p.a.
- Debt trap for many borrowers
- Lenders depend on repeat business, which is also less costly to process

What do we know about the market?

No meaningful price competition.

- Pre-regulation rates:
  - Money Mart complex fee schedule, average loan cost was about $19 per hundred
  - Cash Money charged flat $20 per hundred.
- Ontario regulated at $21, some other provinces at $23.
- Cash Money and Money Mart rates are at the maximum in those provinces now.

What do we know about other jurisdictions?

- US – some states ban, almost all the rest regulate
  - Commonest rate cap is $15 per hundred. Some lower, e.g. Michigan; some around Manitoba rate; some with no limits
  - Lots of stores in states with $15 cap and lower
  - Not as much corporate concentration as Canada
  - Loan volume per store lower than Canada, on average.

What do we know about other jurisdictions?

- UK: regulation is 0.8% per day
  - On an average Canadian loan of 12 days this is $9.60 per hundred
  - Maximum total charge is value of principal, no matter how long outstanding.
  - Dollar Financial's UK Money Shop has 220 outlets
  - More companies offering installment loans though you find them by searching "payday loan UK)

Profitability in other jurisdictions

Operating Margin of Dollar Financial: Earnings before interest, taxes and arbitrary allocation of head office cost divided by total revenue.

	2013	2012	2011
Europe retail	24%	30%	34%
Canada retail	49	51	50
US retail	25	27	26
E-commerce	19	32	30

How do I get 15%?

Classic regulatory model.

1. Operation must be efficient – no excess costs allowed. Money Mart is the starting point.
2. Model one store.
3. All values include the share of chain costs; so this one store represents a chain as well.
4. End result is no excess profit, after paying off all capital providers

How do I justify using this model?

Ethical justification:

- Disadvantaged borrower population
- Empirical evidence shows no price competition.

Economic justification:

- If the industry is not competitive, regulate so that it doesn't earn more than the fair return on what it invests.

How do I get 15%?

1. Estimate volume, or range of volume
2. Figure out all the cash costs – in this case expressed as $operating/100 loan volume
3. How much do you have to invest?
4. Estimate cost of capital as a rate
5. #23X #4 = cost of capital
6. What price (= fee per hundred) yields zero profit after operating and cost of capital?

Another way to explain it

- Value a company by discounting all the future free cash flow (FCF) by the weighted average cost of capital.
- What is FCF? Revenue – cash outlays needed to keep the business going.
- Regulatory model turns cost of capital into an expense line.
- In a perfect market, the net value is 0; => the company is fairly valued.

The devil is in the details

Let's take a look at the Excel spreadsheet that runs my model to calculate an appropriate rate cap.

What are the big issues?

Well now, wasn't that stimulating?

The big questions about the numbers are:

- Volume per store
- Operating costs
- Bad debt expense
- And much less important, cost of capital

The Loan Volume Issue

- Start with Money Mart 2013 volume.
- Estimate volume it would have captured when Cash Store Financial closed down and Money Mart bought it.
- Tables 2 and 3, pages 16-19, Tab 3.

Cost of capital issue

- I provided detailed calculations both in Tab 3 and in a response to an Information Request.
- 8% is actually a high weighted average cost of capital.
- Ernst & Young (2004) and Deloitte (2015) do not follow the accepted practices.
- They also fail to recognise this model is a perpetuity and hence the cost of capital must be in real terms; that is, with inflation taken out.

Operating cost and bad debts

For those who are still awake and don't wish they were somewhere else, turn to page 20 of Tab 3.

An issue with bad debts

- Deloitte and Ernst & Young measure bad debt rates in a way that is not accepted accounting and cannot be used in my model, which is a cash flow model.
- They add the opportunity cost of the foregone fee to the lost principal.
- I do not include the fee from the bad debt in the revenue line, and hence for my model the bad debt rate should be the cash cost, which is how Dollar Financial and Cash Store Financial recorded it.

So what does all this lead to?

- I conclude that $15 per hundred is fair, but you might reach a different conclusion.
- Let's turn to Tab 3, which is my written opinion, page 25, for a table of different results depending on the inputs. Look first at Panel 2.

Installment Option

- We have seen all the evidence of repeat borrowing and its problems.
- How can a borrower repay hundreds of dollars next paycheque when he or she couldn't make ends meet last week?
- Washington State has instituted an option that borrowers can convert to an installment loan.

Installment Option

- Colorado State has changed the laws to allow only installment loans.
  - Fee structure is really complicated, cheaper than repeated standard payday loans but far more expensive than regular consumer credit.
  - Loan volume declined greatly.
  - Still a substantial industry that offers these loans instead of payday loans.
- Some UK companies seem to be moving to installment loans.

Which installment option?

- Consultation with industry is essential.
- I don't know enough to prescribe, but I suggest:
  1. Not force all loans that route, like Colorado
  2. Every borrower told there is an option to convert to installment loan.
  3. How long? No more than 12 months, offer varied terms.
  4. Fee? Make it simple. E.g. Add 5% of principal as now allowed in Manitoba. Divide the total by the number of payments to get level payments each subsequent payday.

Loan size limit

- Leave it at 30% of net income
- The huge problem occurs with a single repayment.
- If you have net pay of $1,600 every two weeks, how likely are you to be able to repay either $561.60 (30% limit) or $468 (25%) from the next pay?

Loan size limit: unintended consequences

- I believe the industry is right to raise these issues:
  - Lower limits force some borrowers to two lenders
  - More loans at smaller amounts raise lender costs.
- My solution is the installment option, not lower loan sizes. Installments allow larger loans with fewer problems.

Thank you for your attention.
Questions?