Payday Lending: A Mature Industry with Chronic Challenges

Summary of the Academic Literature on Payday Lending

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1. Introduction

This report examines the literature on and related to payday lending. The literature considered examines the dynamics of the industry and the impact of payday loans and payday loan regulation on consumers. It also considers the related area of consumer behaviour studies as they pertain to payday loan use.

From its beginning the payday loan industry has been criticized by many because of a variety of features of payday lending such as claims that it targets marginalized people, charges high fees, all within an unsustainable –at least for the consumer– credit product. There have been proponents of the industry in the literature but they are fewer in number. The literature is the most extensive in the US but there is some literature in the UK, Canada, and Europe.

A core notion in the study of payday lending is financial exclusion. While this problem is most pronounced in 'poor' countries, it is exists in a complex and nuanced form in 'rich' countries. It is a condition in which primarily low-income and low asset people have no bank account or only limited financial services from a 'mainstream' financial institution, such as a bank or credit union.

Akin to the broader phenomenon of social exclusion, bank exclusion is caused by a number of broad socioeconomic factors including (Caskey 1994, Buckland 2012),

- On the 'demand-side,' consumer demand for financial products is influenced by socio-economic changes associated with inequality, which has been growing in Canada for several years. Inequality means that people at the bottom of the income hierarchy are experiencing less (or no) growth in their incomes as compared to people at the top of the hierarchy. The result is that poor people's demand for financial services becomes more modest and the non-poor's demands become more elaborate.
- On the 'supply-side' (i.e., business decisions about the provision of the product), one must consider both mainstream financial institutions, FIs (banks and credit unions), and fringe financial institutions (i.e., payday lenders, pawnshops, rent-to-own operations), for instance,
    - Mainstream FIs closing inner-city branches, not offering and/or promoting suitable services for asset-poor people, not valuing these people as clients, and, consequently not training staff to understand and work with them
    - Fringe FIs opening branches in inner-city and low-income neighborhoods, developing products that address particular needs of asset-poor people, and seeking to deliver these services to the poor.

It is estimated that between 3 and 5 percent of Canadian adults have no bank account, and a higher share are underbanked, in that they do not get sufficient

financial services from a bank and turn to payday lenders. This division of the market may appear to meet the needs of poor people but, it is argued by critics, this bifurcation leads to a small and expensive services being provided to poor people while large and less expensive services are offered to the non-poor. Moreover, the fringe FIs are often weakly regulated as compared with the mainstream FIs.

The 'modern' payday loan industry has matured in the last twenty years from its beginning in the US in the 1990s. Payday lending's growth in some countries, like the US and Canada, has slowed or stopped but it is expanding into other countries like South Africa and Eastern Europe. Payday lending is experiencing corporatization,[1] and online lending appears to be growing but its size is hard to accurately assess.

A question that goes to the heart of why payday lending is so controversial is whether payday loans benefit consumers? Opponents claim they do not and proponents claim they do. An additional layer of complexity has been added to the industry and in the form of different regulatory regimes: some more permissive of payday lending and some more restrictive. This leads to an additional question: do payday loan regulations help or harm consumers? Studies in Canada have found that the impact of Canadian payday lending on consumers is mixed, that regulation of payday lenders has limitations, and that a critical part of the social response to market segmentation of this sort is to boost mainstream financial institutions efforts in the area (Buckland 2012, Dijkema and McKendry 2016).

As the industry and its regulation matures so does the literature so that now the literature is including more extensive and sophisticated studies. Impact studies have not definitively ruled out consumer benefit from payday loans while other studies point to evidence that online borrowing, repeat borrowing, and bounded consumer rationality, ensure that some payday loan consumers are harmed.

1.1 Literature review method & characteristics of the literature

A literature review was undertaken primarily in October through November 2015 which first involved searching select academic databases including Econlit, PAIS International, and Jstor, using the keywords "payday loan" or "payday lender". Since a literature review was completed in 2013, this review focused on literature since 2010.

Articles and some books were reviewed to identify the key issues. These issues were then reviewed in relationship to payday lending regulations and issues closely

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1 By corporatization it is meant that small operations are consolidated into larger operations which take advantage of economies of scale. Similar products, such as cheque-cashing, bill payments, are added to the payday lender offerings and these take advantage of economies of scope. These changes enhance the efficiency of a large payday lender relative to smaller companies.

related to consumer concerns (fair and reasonable fee, repeat borrowing, internet payday loans, proliferation of payday lender services, privacy). Through this process the following key issues surfaced:

- industry profitability and growth,
- corporatization and online lending;
- consumers' experiences with payday loans; and
- The impact of regulation on payday lending.

The literature on payday lending has changed since the early days of the industry. In the 1990s more of the literature focused on the geographic location of these lenders. This literature established in many jurisdictions including Canada, the US, and the UK that payday lenders often locate in low-income neighbourhoods (Brennan, McGregor, and Buckland 2011; Prager 2014; Leyshon et al. 2006). Recent geographic location studies include Barth et al. (2015), and Simpson and Buckland (forthcoming 2016). These studies confirm that fringe banks are locating largely in low-income neighbourhoods.

Work continues to look at the question of whether payday loans benefit consumers and there is more research on the impact of regulation. There continues to be research into how to repair the problem of financial exclusion and this includes examining the role of mainstream financial institutions, the postal system, establishing capital funds, and reforming regulation. The literature continues to grapple with the ethical dilemma with which we are presented because of the existence and growth of the fringe bank sector.

Prior to the 2000s there were some major studies in the field of financial exclusion most importantly John Caskey's 1994 *Fringe Banking*, Squires and O'Connor's 2001 *Color and Money*, and Leyshon and Thrift's 1997 *Money/Space*. These are important studies and their scope is quite wide, examining a combination of issues that one might argue fall within the general heading of financial exclusion.

But, reflecting the growth and ongoing concern regarding payday lending, we have seen in the past three years the publication of several books examining the general field (Buckland 2012, Soederberg 2014) and focused studies on payday lending including two books: Carl Packman's 2014 *Payday Lending: Global Growth of the High-Cost Credit Market*, and Mehrsa Baradaran's 2015 *How the Other Half Banks: Exclusion, Exploitation, and the Threat to Democracy*.

In addition, tied to the aftermath of the sub-prime mortgage crisis's impact in the US, has been deeper examination of its financial service sector including payday lending by the newly minted Consumer Financial Protection Bureau and the major 2013 study by the Pew Charitable Trusts, the 4-part *Payday Lending in America*

report. The Pew reports involved a number of methods including a nationally representative survey and series of focus group meetings[2].

Focusing on payday lending in the US, Baradaran sees payday lending as a manifestation, like sub-prime mortgages, of an unequal economic system that hurts poor people and harms democracy. She quotes U.S. President Barak Obama,

> If you lend out money, you have to first make sure that the borrower can afford to pay it back…We don't mind seeing folks make a profit. But if you're making that profit by trapping hard-working Americans into a vicious cycle of debt, then you got to find a new business model. You need to find a new way of doing business (Baradaran 2015, p.126-127).

Baradaran's book examines the history and current reality of the payday loan phenomenon and advances the position that the postal service should intervene to provide small loans. Packman (2014) provides an international perspective by examining payday lending in several countries. He presents a political economy analysis of the rise and expansion of the payday lending model. He concludes that the payday loan model does more harm than good, "The business model of payday lending…has not been designed primarily to improve the financial situation or future financial capability of its borrowers, and in a high number of instances it has been shown to do the opposite, therefore the general perception of the industry being predatory appears correct (Packman 2014, p.135)."

Pew Charitable Trusts engaged in a major research project on payday lending in the U.S. which covers a number of practical and important issues regarding the economics of payday lending, the impact of payday lending on consumers, and it offers an important series of recommendations to improve the payday lending product (Pew Charitable Trusts 2012, 2013a, 2013b, 2014).

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2 The Pew Charitable Trusts research project consists of 4 separate reports on different aspects of payday lending: borrower characteristics; how borrowers choose and repay loans; payday lending regulations; and internet payday lending. The research methodology involved several steps: inserting payday loan questions within an omnibus survey (containing questions on several topics); a follow-up survey with respondents that indicated in the omnibus survey that they had used payday loans; and focus group discussions with a sub-set of the follow-up survey respondents (Pew Charitable Trusts 2012, p.31). A total of 49,684 people were involved in the omnibus survey, a total of 451 people were surveyed in the follow-up survey, and there were 10 focus groups. The number of respondents in the follow-up survey represents 0.9% of the omnibus respondents but this level is consistent with other surveys that seek to include low and modest income households because they are more difficult to reach, by telephone, than middle and non-poor people, because they have fewer or no phones. Moreover, a small share of the US population actually uses payday loans.

2. Industry Dynamics

Payday loans were first popularized in the U.S.in the 1990s and in Canada in the 2000s. The concept is much older than that and payday loans were available in a different form in the U.S.in the early 20th century (Caskey 2012, Baradaran 2015) and available from some employers since then and today. The recent wave of growth is linked with the underlying process of financialization –a process linked with contemporary economic growth and globalization– *which is the expansion of financial motives and increase in the number and size of financial products*.

Payday lending is a mature industry and one that faces chronic challenges associated with critics' claims that the product harms its customers through location strategies, high fees, repeat loans, and now new problems associated with internet payday loans.

Naming companies that offer this service as strictly payday lenders is misleading because they offer a number of services. Some payday lenders got their start with cheque-cashing, and now offer bill payment service, money transfer, debit card loading, income tax returns, gold purchase, pawn loans, etc. These fringe banks focus on transactions services and are primarily targeting low- and modest-middle income consumers.

Corporatization is another descriptor of changes taking place in the fringe bank market in that companies that offer payday loans and other transactions services are dominated by growing chains with a proliferating number of services. Geographically the corporate fringe bank model continues to spread to the UK, Europe, Australia, New Zealand, and South Africa. The industry also continues to grow in countries where it has already established. The industry in the U.S.is now worth US$100 billion and has grown at 10% annually through the 1990s so that U.S. payday lenders now lend around US$40 billion per year (Baradaran 2015, p.122), supplying 12 million Americans with payday loans (Pew 2013a, p.4).

The industry is strong in Canada as evidenced by the growing presence of the largest player, National Money Mart, and second tier companies such as Cash Money and Cashco Financial. The folding of Rent Cash Financial Inc. and the taking over of many of its store fronts by Money Mart demonstrate the strength of the industry in Canada.

2.1. Growth

There are approximately 1,200 payday loan outlets in Canada today and there were virtually none in the mid-1990s[3]. Prior to the mid-1990s, there were cheque-cashers.

3According to the Canadian Payday Lenders Association website on 12 October 2015 there were 931outlets. The DFC Global Corp 2013 *10-K Report* states “We estimate that, across Canada, there are approximately 1,500 individual outlets

Once cheque-cashers, including National Money Mart, added payday lending to their services, this became their principal product and even led them to being renamed payday lender, from cheque-casher. The national payday loan market has been estimated to be $2.2 billion (Buckland 2012, p.128). The majority of payday loan outlets are located in Ontario, with 800 and it is estimated that they issue $1.1 to $1.5 billion in loans each year in that province (Deloitte 2014, p.1).

The origin and centre of the payday loan industry is the US. Caskey's 1994 seminal study identifies the growth of *fringe banks* but not payday lenders per se. At that time cheque-cashers were rapidly growing in importance and numbers, and payday loans were just beginning to be offered, often by the cheque cashers.

Caskey identified the growth of fringe banks at that time including cheque-cashers and pawnshops. For the pawnshop this was a reversal from previous years, when they were declining. Packman notes that by outlet numbers payday lenders shot up in the 1990s and early 2000s in the U.S. from approximately 10,000 in 1999 to 12-14,000 in 2001 to 20,000 by 2005 (2014, p.27), suggesting a growth in the industry. Packman notes that by 2005 U.S. payday loan volume hit US$40 billion per year.

If the supply of outlets and nonbank loans are growing, it would make sense that so is the demand. Drawing on a national survey in 2009 and 2011, Mills and Monson (2013) found that U.S. families' reliance on nonbank credit increased. 7 million households, or 6 percent of the total, used nonbank credit in the 12 months ending in June 2011 (Mills and Monson 2013, p.4). Overall reliance on 4 types of nonbank credit –payday loans, pawnshop loans, rent-to-own agreements, and refund anticipation loans—increased from 11.8 percent in 2009 to 14.2 percent in 2011 (Mills and Monson 2013, p.1-2). Pawnshop loans were the most widely used and the proportional increase in payday loans was the greatest at 42 percent.

Data on the Canadian payday loan industry are limited. There is little official data and private sources have dried up. Until recently the two largest payday lenders, National Money Mart through its parent company DFC Global Corporation, and Rent Cash Financial, owner of the Cash Store and Instaloans, were publicly traded so that there were some data on their size and trends. Dijkema and Rhys (2016) reinforce a common narrative that, based on outlet numbers, the industry grew rapidly in the early and mid-2000s and growth slowed by the early-2010s (p.27).

Surveying available data Buckland (2012) concluded, "[t]he data presented above demonstrate the strong, if somewhat bumpy financial performance of the larger fringe banks (Buckland 2012, p.139)." The bankruptcy of Rent Cash Financial[4] and DFC Global Corps sale to private equity firm Lone Star Funds mean that there are very limited data available to analyse this industry in Canada. The last year for

offering short-term single-payment consumer loans and/or check cashing, including only two other networks of stores exceeding 100 locations in Canada (DFC Global Corp 2013 p.7)."

which there are data available for DFC Global Corp is 2013. These data demonstrate growth in total revenues and payday lending, a decline in cheque-cashing revenue and a small rise in revenue from other sources, from 2009 to 2013.

The share of revenue from the Canadian operation increased from 2003 through 2008 but declined from there until 2013 (Figure 2). Its declining share relates to the more rapid growth of revenue from European operations and the very rapid growth from 'ecommerce.' In dollar-terms total revenue from Canada grew from $US 321 million in 2012 to $US323 million in 2013 and its consumer lending revenue increased from $US 177 million to $US191 million. Net income has been uneven over the years but has shown an increasing trend particularly in 2011 and 2012 (DFC Global Corp 2013, p.11).

2.2 Corporatization

Corporatization is the consolidation of business operations within one large company that takes advantage of economies of scale and scope. This has occurred to pawnbroking in the US in past and is well underway with payday lending in Canada.

In terms of contemporary pawn dynamics, Caskey notes that pawning in the U.S. declined from 1930 through 1970 based on the depression, restrictions on consumer spending during World War Two, and from the 1950s, growing access for middle classes to mainstream bank credit (Caskey 1994, p.27-28).

Caskey notes that from the mid-1970s, "these fringe banking industries grew explosively" (Caskey 1994, p.36). By the mid-1980s he notes the 'corporatization' of the pawnshop model through the appearance of chain-based pawnshops in lower-middle class suburban neighbourhoods (Caskey 1994, p.53).

Chains were established by Cash America Investments, that later purchased a pawnshop chain in the UK to become an international pawnbroker, and made its Initial Public Offering in 1987 with shares valued at $6.67 that are, as of August 2015, trading for $22.55 (Caskey 1994, p.54). This corporatization process involves the establishment of a corporate structure, the bundling of a series of similar services into a core offering, and the creation of store chain. This corporatization process has occurred with other fringe banks in the U.S. including, Advance America, Ace Cash Express, Cashland, and DFC Global Corp. (Table 3).

This corporatization process has also been occurring among payday lenders in Canada as evidenced in the early 2000s beginning with National Money Mart Inc., followed by Cash Store Financial, and Cash Canada Group Ltd. (Buckland 2012,

4The reasons for the bankruptcy are not clear. There is evidence that the company was unable to operate within provinces such as Manitoba and Ontario with lower rate caps. In addition the company was facing some legal challenges.

p.128-129). Cash Store Financial has since gone out of business but Cash Canada, now Cashco Financial continues, and there are new firms including Easy Financial, and Cash Money. These corporate fringe banks offer a variety of services across a large network of stores. The services have recently included pawning.

Corporate fringe banks extend beyond the U.S. and Canada in part through the operations of American-based multinational fringe banks such as DFC Global Corp, which besides its unit in Canada, has operations in the UK and seven European countries.

2.2.1 DFC Global Corporation

DFC Global Corp. is a US-based multinational fringe bank that has grown in terms of revenues, the number of countries in which it operates, and the number of services it provides. Prior to its sale to Lone Star, DFC Global's public reporting to the U.S. Securities and Exchange Commission, including its Form 10-K, provided a very useful insight into the world of fringe banks.

DFC Global operates in the U.S. and in 9 other countries, which is up from working in 3 countries in total in 2008. National Money Mart Inc. operates in Canada as one of its largest fringe banks, and Canada is clearly an important core component of DFC Global's business. More recently DFC Global Corp. has invested in Europe including the UK, Sweden, Finland, Poland, Spain, Romania, the Czech Republic and the Republic of Ireland.

> We are a leading international non-bank provider of alternative financial services, principally unsecured short term consumer loans, secured pawn loans, check cashing, gold buying, money transfers and reloadable prepaid debit cards, serving primarily unbanked and under-banked consumers. We serve our customers through our over 1,500 current retail storefront locations and our multiple Internet platforms in ten countries across Europe and North America…Our networks of retail locations in the United Kingdom and Canada are the largest of their kind by revenue in each of those countries (DFC Global Corporation 2013).

Both revenue and net income have increased over the ten-year period, 2004 through 2013, in both current and inflation-adjusted real dollars. Real revenue stood at $US 271 million in 2004 and increased to $US 827 in 2013, and the annual growth averaged at 5.3%. Real net income is quite variable experiencing both positive and negative years, and stood at $US 38.3 in 2012 but dropped to -$US 0.7 in 2013. Average annual net income for the period stood at $US 9.8 million, in real dollars.

DFC Global Corp. offers a variety of fringe financial services to its clients, including payday loans, cheque-cashing, pawn loans, gold purchase, money transfers, and debit cards. They have invested into online payday lending so that they currently have "one of the largest online unsecured short-term consumer lending businesses

by revenue and loan portfolio in the United Kingdom (DFC Global Corporation 2013) (Table Y).” The share of their loan portfolio in ‘E-commerce’ jumped from 15.4% in 2011 to 33% in 2012. This led to a declining share of the ‘retail’ operations but particularly the Canadian retail operations which declined as a share of the total from 40% to 30%. They also plan to expand their internet lending capacity and the number of countries in which they offer it as well as their pawn services including in existing outlets in Canada and the US. So far they have invested into pawn operations in Europe so that they think they are now the largest pawn lender in Europe, measured by loan portfolio.

2.3 Online Payday Lending

Online payday loans are a relatively new approach some payday lenders are using to deliver their product. Given that store-front payday lenders sometimes deposit loans and receive repayment for loans electronically, it is not surprising that some existing payday lenders have established online delivery as an added channel and that new players that focus strictly on online processing have entered the market.

2.3.1 The Size of Online Lending

In terms of the industry’s size, Packman (2014), citing Stephens Inc., estimates the online payday lending industry increased from $US 2 billion in 2006 to $4.3 billion in 2012. The size of the online payday loan market in Ontario is estimated to represent 10% of the total market (Deloitte 2014 cited in Denise Barret Consulting 2015, p.20)

One estimate placed the internet payday loan market as encompassing one-quarter of all payday loans in the U.S. in 2012 (Pew Charitable Trusts 2012) while the most recent information suggests that share has increased to one-third of the market (Zibel 2015 cited in Denise Barrett Consulting 2015, p.21). The Australian online market is estimated to be one-third of its total (Denise Barret Consulting 2015, p.21). The UK’s Financial Conduct Authority estimates online payday lending represents 80% of the total (Denise Barret Consulting, p.20). One indicator of growth comes from DFC Global, parent company to National Money Mart. DFC Global reported a doubling of its revenue from this source in a two year period, representing 15.4% of its revenue in 2011 and 33.0% in 2013 (Table 2).

2.3.2 The Clients

There is limited data on the characteristics of online payday lending clients. Regarding Canadian online clients, a National Money Mart respondent noted that their online clients tend to be younger and better-off than in-store clients:

> Online trends younger, to people who are more comfortable with e-commerce as a safe platform. It also trends slightly higher in income. But many of our online customers are also in-store customers.” He added that online consumers are service sensitive, not price sensitive. “Ease and speed of service trumps price. That’s a general rule of all e-commerce” (Denise Barrett Consulting 2015, p.21-22).

Research in the U.S. also finds that online borrowers are more likely than in-store users to be younger, have higher income and a College degree (Pew Charitable Trusts 2012, p.28). This study also determined that almost three-quarters of payday loan clients rely exclusively on in-store loans, 16% rely on online exclusively, and 4% of clients use both avenues to obtain loans (Pew Charitable Trusts 2012, p.27).

2.3.3 Unique Issues of Online Loans

2.3.3.1 Asymmetric information

Online payday lending is associated with many of the same issues and concerns as in-store payday lending with some additional concerns. Most importantly, given the fact that the online lender can be based anywhere in the world, regulation is challenging. As research in Canada found, this concern is particularly associated with unlicensed payday lenders. So what do prospective consumers know about them? The prospective client would have more difficulty as compared with a local storefront lender, undertaking an analysis of the online lender.

And what do lenders know about prospective borrowers? With access to information about their income and bank account they can, of course, make assessments of the client's likelihood or repayment. One U.S. study noted that online lenders use sophisticated analyses to assess prospective borrowers (Pew Charitable Trusts 2014, p.4). A U.S. study found that online payday lenders rely on specialty credit reporting companies such as Teletrack (CFA 2011, p.3). Pew Charitable Trusts research found that online lenders are more selective than in-person lenders and they face higher loan losses. Some online lenders reject 80% of applicants while in-store lenders average rejection stands at 20%.

2.3.3.2 Costs differ for online vs. storefront loans

Pew Charitable Trusts estimated that the cost of providing a loan is lower for online lenders, but that loan losses are more than double: 17% for storefront lenders and 44% for online lenders (Pew Charitable Trusts 2014, p.5). Pew Charitable Trusts also estimates that Annual Percentage Rate, APR for online loans at 652% is almost double the APR for storefront loans, at 391%.

'Lead generators,' are an important element of the online loan industry. They "serve as intermediaries connecting Canadian borrowers to worldwide lenders (Denise Barrett Consulting 2015, p.20)." Lead generators are companies with websites that identify potential payday loan clients and then direct them to payday lenders, receiving a fee for doing so. According to another study these lead generators are paid up to $US 110-125 for qualified referrals (Community Federation of America 2011, p.1, 9), and therefore clearly add to the cost of the payday loan. In the U.S. lead generators, internet search ads, and TV/radio advertisements are used to promote payday lending (Pew Charitable Trusts 2014, p.6-7).

2.3.3.3 Online lenders less likely to follow regulations

Denise Barret Consulting (2015) examined online payday lending available to Canadians by analyzing websites and talking with key informants. They found that some online lenders are licensed and some are not and that this distinction effectively predicted whether the lender followed provincial regulations or not.

U.S. research came to a similar conclusion, that unlicensed lenders are the most abusive (Pew Charitable Trusts 2014, p.27). The results pointed to particular concern about online lenders that required the prospective client's bank account number, passwords, and security question responses "that would give lenders direct access to the borrower's bank account," without giving the client information about the lender (Pew Charitable Trusts 2014, p.6).

The U.S. study found that online payday lenders sometimes do not disclose where they are physically located, sometimes disclose it as another country (e.g., British West Indies), and sometimes disclose it as another state within the U.S. (CFA 2011, p.5). These companies may indicate that they are subject to their local –and not the client's local—laws. The report found that there are a growing number of online lenders who claim exemption from state laws due to Tribal sovereignty (CFA 2011, p.1).

2.3.3.4 Troublesome consumer practices

Pew Charitable Trusts found that there are more complaints –at a 10:1 ratio-- to the Better Business Bureau about online as compared with storefront loans (Pew Charitable Trusts 2014, p.18) and that there are more threats from online lenders and associates towards clients unable to repay the loan, as compared with in-store loans (Pew Charitable Trusts 2014, p.10). "I had the law office call me. … He tells me I have to get my attorney, and he says we will come to your job, and we'll arrest you (Online borrower quote, Pew Charitable Trusts 2014, p.11)."

Pew Charitable Trusts found that 39% of respondents had their personal or financial information shared with a third party (Pew Charitable Trusts 2014, p.12). "I'm talking to the bank and he's like, 'Well, how did your information get out there?...And I'm thinking, 'No, I don't know how it got out there,' you know. Because I didn't want to say to anybody, yeah, I'm that stupid, I needed money that bad" (Online borrower quote, Pew Charitable Trusts 2014, p.12).

The Pew Charitable Trusts research also found that prospective online clients might receive several payday loan offers based on one request. Pew Charitable Trusts notes that this might be because of the high cost of obtaining names from lead generators so that the lead generators and their clients resell names and contact information to other online lenders: "I'm getting texts, and I'm getting phone calls, and I'm getting emails, and I'm getting all of this stuff (Online borrower quote, Pew Charitable Trusts 2014, p.13)."

Almost one-half of online borrowers reported that their bank accounts were overdrawn due to payday lender's charges, which is double the rate reported for in-store loans (Pew Charitable Trusts 2014, p.13). Another one-third of online consumers complained of unauthorized withdrawal of funds from their checking account (Pew Charitable Trusts 2014, p.14). Twenty-two percent of online borrowers either closed or had their bank account closed to prevent the lender from withdrawing more funds (Pew Charitable Trusts 2014, p.16).

2.3.3.5 Repeating Online Loans

Studies in the U.S. have found that online lending is often structured for the loan to be repeated for more than one pay cycle (CFA 2011, p.9; Pew Charitable Trusts 2014, p.8). In some cases online payday lenders can make it difficult to pay-off the loan by creating the default to not pay-off the loan. Sometimes online payday loans are structured to encourage repeat borrowing by only withdrawing interest and not principal charges for several paydays:

> MyPaydayLoan.com permits borrowers to extend loans with no limit as long as the finance charge is paid every due date. Nationwide Cash automatically rolls over the debt four times, withdrawing the finance charge each time without reducing principal. On the fifth and subsequent paydays, Nationwide Cash withdraws $50 of principal plus the finance charge. Using this payment method, the online lender collects $750 in finance charges ($150 over five paydays) on a $500 loan before the debt is reduced to $450 (CFA 2011, p.9).

Pew Charitable Trusts found that 31% of online borrowers engaged in payday loans that were automatically extended by withdrawing the fee and not the principal on payday (Pew Charitable Trusts 2014, p.8).

3. Do Payday Loans Benefit Consumers?

The vast majority of payday loan impact studies have been undertaken in the US. John Caskey (2010, 2012) engages what he terms 'the big question' regarding payday lending and that is, do payday loans benefit the borrowers? He argues that answering that question is complicated by the mixed empirical evidence and by ideological differences. Ideological tensions relate to assumptions about human nature such as whether people are rational, and about how well markets serve low-income and low-asset people. In his review of around one dozen impact studies Caskey concludes that the answer to the 'big question' is, so far, ambiguous due in part to these ideological tensions:

> These quasi-experimental studies reflect substantial and careful empirical work, but, in my view, they do not provide a reliable answer to the big question: Do payday lenders, on net, exacerbate or relieve customers' financial difficulties? For one, some of the studies find access to payday lending is beneficial and some find it harmful. But more important, the results of each of the studies are simply suggestive; that is, they are based on at least one of two strong assumptions that may well not be true and therefore cast doubt on the reliability of the results (Caskey 2010, p.25-26).

In a study completed since Caskey's review, Bhutta (2013) examines experiences of consumers in states and times in which payday loans are available and in which

they are not available. His conclusion is similar to Caskey in that he does not see a relationship between use of payday loans and credit scores, delinquencies, or the likelihood of overdrawing credit lines (Bhutta 2013, p.1). To address the limitations of these quasi-experimental studies, Caskey calls for fully randomized design trials and ethnographic studies[5] to understand the impact of payday lending.

Put a slightly different way, Melzer (2014) summarizes the literature to date by stating "there is evidence that the expansion of payday credit aggravates financial difficulties, *at least for a subset of borrowers* (italics added) (Melzer 2014, p.3)." Reporting on a survey of a small number of payday loan clients from the payday lender association database, Lawrence and Elliehausen (2008) report that most respondents were satisfied but concur with Melzer regarding concerns about the sub-group of clients who are repeatedly borrowing. Other studies have examined indirect consequences of payday loan use. Fitzpatrick and Coleman-Jensen (2014) found that borrowers in states with restrictive payday loan regulations were less food secure than people in states with permissive payday loan regulations (Fitzpatrick and Coleman-Jensen 2014, p.553). Melzer, on the other hand found that payday loan clients were more likely to use food assistance and not make child support payments (Melzer 2014, p.21).

Lohrenz (2013, p.21 cited in Wolff 2015) argued that payday lending fees drain money from borrowers who would otherwise have used those funds to purchase other goods and services that would have a multiplier effect on the macro economy. It was estimated that consumers losing those fees to payday lenders led to a drain of nearly US$ 1 billion and 14,000 jobs in the U.S. economy in 2012.

3.1 What do customers think about payday loan?

The Pew Charitable Trusts also undertook a major study since Caskey's review, including surveys and focus groups of payday clients. One key result is that payday loan clients themselves "experience complicated and conflicted feelings." This is because the borrowers have "appreciation for friendly service, dismay with the high cost, and frustration with lengthy indebtedness (Pew Charitable Trusts 2013, p.39)."

Moreover, 55% of respondents felt that payday loans take advantage of borrowers (Pew Charitable Trusts 2013, p.40). So what would borrowers do if payday loans were unavailable? The Pew Charitable Trusts-sponsored survey found

> If faced with a cash shortfall and payday loans were unavailable, 81 percent of borrowers say they would cut back on expenses. Many also

5Caskey proposes a "second fruitful approach that might help answer the big question would be ethnographic studies that carefully follow the budgeting decisions and thought processes of payday loan customers and their households over time. Such studies would necessarily have to be small scale and could be criticized for inevitable subjective data filtering by the ethnographers, but they could also offer rich insights to complement the traditional econometric and experimental approach of economists (Caskey 2010, p.37)."

> would delay paying some bills, rely on friends and family, or sell personal possessions (Pew Charitable Trusts 2012, p.16).

3.2 Repeat Borrowing

One of the chronic problems associated with payday lending is repetitive borrowing by some consumers. This is an issue because payday loans, as promoted by the industry, are small-sum and short term loans intended to deal with a short term liquidity problem. They are relatively expensive and are not intended to overcome longer term problems.

If people are taking out many loans in a short period of time they are very likely not choosing the most suitable product. In the early days of payday lending this issue was associated with roll-overs, which were loan extensions that involved additional fees so that APRs grew multiplicatively[6]. Roll-overs are largely disallowed by regulations but some consumers, through one outlet or more, are nonetheless able to obtain several loans in a short period of time. Data in the U.S. confirm that this is an ongoing challenge there. Data limitations in Canada make confirmation in this country difficult.

As discussed above, Caskey (2010) found that the impact evaluation literature comes to few global conclusions about the impact of payday lending on the consumer. This is partly because payday loans have different effects on different groups of people. One can imagine a variety of scenarios where an individual could benefit from a small loan, even if it is expensive. If the loan allows the person to meet an emergency need, avoid paying a hefty fee, or make a strategic investment, then one can imagine a positive impact. However, there is evidence of a subgroup of payday loan clients who rely repeatedly on payday loans. In this case when the borrower is taking out many loans in a short period of time, perhaps six or seven in less than one year, then this combination stops looking like a series of separate loans and rather it looks like the person has tried to piece together a longer-term loan, at much inconvenience and expense.

The U.S. Situation

There seems to be a consensus in the U.S. that for a subgroup of payday loan clients, repetitive payday loan borrowing is harmful. Lawrence and Elliehausen (2008) find that in their small sample there was a relatively small percentage of respondents who took out many payday loans in a short period of time. They note that,

> This behavior is not necessarily harmful because some consumers may need a longer period of time to improve their situation. However,

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6Early critics of payday lending found that rollovers were common among payday loan consumers. By this it was meant that on the repayment date the loan was extended, and the original fees were doubled, and additional fees were added. So fees more than doubled for the rolled over loan.

> reliance on payday loans for an extended period of time seems contrary to the short-term financing intention of the product and may exacerbate rather than relieve financial problems some consumers face (Lawrence and Elliehausen 2008, p.315).

Caskey notes a California study where 19% of borrowers took out 15 or more loans in a 1.5 year period and focus group respondents used terms like 'addictive', 'repetitive', and 'vicious cycle' (Caskey 2010, p.4-5). The Pew Charitable Trusts research project states that, for the U.S. payday loan consumer, "repeat [payday loan] borrowing is the norm" (Pew Charitable Trusts 2012, p.15). The Center for Responsible Lending (CRL) uses the term loan 'churn' to refer to the situation in which the consumer is really unable to pay-off the loan and is therefore either renewing it with the original lender or borrowing from another lender immediately on the date of repayment or soon thereafter (Montezemolo 2013, p.3). CRL argues that many payday loans are taken out in a short time period so that "the actual impact of repeat transactions is simply repaying fees to float the same debt rather than being extended new credit each time (Montezemolo 2013, p.4)." The cost to consumers for trying to convert the payday loan into a longer term loan is substantial in terms of fees:

- The Consumer Financial Protection Bureau found that "the median borrower in the CFPB sample took out ten payday loans from a single lender during the year, paying $458 in fees alone for $350 in non-churn principal (Montezemolo 2014, p.4)"
- Data from state regulator databases find borrowers take out 9, on average US$346, loans per year involving US$504 in fees
- The Pew Charitable Trusts research finds borrowers take out eight 18-day, on average US$375, loans in on year and owe US$520 in fees
- A study from the Center for Financial Services Innovation found that borrowers take out 11 loans in one year and Advance America, the US's largest payday lender, reports its clients on average take out eight loans per year (Montezemolo 2013, p.4).

Why so many payday loans?

Baradaran argues that payday lenders do not underwrite their loans[7] and this is an inherent weakness of the payday loan model. She argues that payday lenders do not check the credit worthiness of borrowers, do not test the difference between insolvent and illiquid people so that it is not a good credit model. This is an issue for payday lenders but particularly for the internet-based payday loan segment, discussed below.

> The current market for lending to the low and middle income does not distinguish between the two [insolvent and illiquid]. And often, the losses from those who are insolvent raise the prices for those who are

7 Test the consumer's ability to repay the loan through, e.g., a credit score.

> merely illiquid. If the two types of borrowers could be adequately sorted, those who are illiquid could get lower cost loans that would help them stay solvent. But here's the irony: the only loans available to the merely illiquid are high-cost loans that make it much more likely they will becomes insolvent (Baradaran 2015, p.135).

Lack of underwriting is linked with some payday loan clients taking out many loans. The Pew Charitable Trusts research project investigated consumer motivation behind borrowing many loans in a short period of time and point to the following factors (Pew Charitable Trusts 2012, p.19-29):

- Consumers needing cash to meet an urgent expense. Thirty-seven percent of borrowers said they would accept a loan on "any terms offered"
- Some borrowers who will be unable to pay-off the loan, unrealistically think they can pay-off the loan –principal and interest-- in two weeks
- No *caveat emptor*: consumers relying on payday lenders' information that themselves rely on repeat borrowers for their businesses to prosper. Fifty-four percent of borrowers relied 'completely' on payday lenders for information about the payday loan
- Some borrowers find the ease with which they can access payday loans as part of the problem as it creates a 'temptation' they cannot resist.

Canada

Data on payday lending in general, and repeat loans in particular, for Canada are more limited than in the U.S. because of fewer national surveys that include relevant questions and a lack of data available from government regulators.

Using the 2005 results of an FCAC-sponsored survey undertaken by Ipsos-Reid it was found that 52.4% of respondents who reported taking out a payday loan at least 12 times per year had household incomes of less than $30,000. This proportion declined as income rose: just over 40% of respondents with household incomes between $30,000 and $50,000 and around 5% for respondents with household income over $50,000 (Buckland et al. 2007, p.33). Drawing on more limited data from the 2009 Canadian Financial Capability Survey Simpson and Bazarkulova (2013) found more evidence of that repeat borrowing is more common among poor and modest income and asset-holding Canadians as compared to the non-poor.

British Columbia's payday loan regulator, Consumer Protection BC provided data that finds that the average annual number of loans per borrower in that province has moved from 5.9 in 2012 to 5.4 in 2013 to 4.3 in 2014 (Consumer Protection BC, undated). The number of individuals with more than 15 loans in one year increased by 34% to just fewer than nine thousand people. Nova Scotia's regulator noted that, for Nova Scotia in 2013-14, 52% of all payday loans were repeat loans of some type and, of those, 30% received 8 or more loans: "It is estimated that these

borrowers, which total about 5,000 individuals, received an average of 13 loans each in addition to initial loans (Service Nova Scotia 2015)."

A panel selected by the Ontario Ministry of Consumer Services was tasked with reviewing payday loan regulations and considered the repeat loan issue. Their report did not provide evidence of the repeat loan phenomenon but the group – which included industry stakeholders and consumer advocates— agreed that more action was needed to address the problem even though current regulation disallow rollovers and holding concurrent loans from the same lender.

The panel considered a variety of solutions and agreed that lenders should offer an extended payment plan to customers who are repeat customers, and that this regulation might be modelled on the BC regulation that is triggered when a borrower takes out 3 loans in a 62 day period (Deloitte 2014, p.18). The panel also agreed that payday lenders provide their customers with a list of credit counselling agencies. More data was called for before the panel could agree on loan restrictions across lenders, waiting periods, and limits on the total number of loans.

3.3 Privacy Issues Related to Payday Loans

Ensuring that client information remains private is an important consumer protection issue in Canada. If client information is shared with others it might be used for other purposes including compromising the client's identity and/or finances.

Generally speaking, a feature that fringe banks have accented in their services, as compared to mainstream banks, is client anonymity. To open a mainstream bank account clients are required to submit personal information like two forms of acceptable personal identification, and to access certain types of loan products, a credit bureau check will be undertaken. Fringe banks have lower standards, are more flexible regarding personal identification requirements, and they do not undertake credit checks for a payday loan. Typically clients of fringe bank have more anonymity than do clients of mainstream banks. Indeed greater anonymity is one factor that explains some people's use of fringe banks.

Nevertheless, privacy issues arise with payday lenders and in particular with online payday lending. Payday lenders require information such as the client's bank account number and sample statements; employment payroll statements, and in some cases the client's Social Insurance Number.

Some of the risks that the consumer faces involve lenders, lead generators, or others gaining unconstrained access to the client's bank account; use of the client's references for harassment purposes; use of client data as one point in creating a database to target consumers for other products (Denise Barret Consulting 2015). A

recent Canadian report highlights the complexity of protecting one's privacy in regards to online payday lending:

> [A] customer cannot be sure she is dealing with the same company if she returns to a web site. Domain names become available to be sold to new owners, making it difficult for consumers to know if they are dealing with the same entity. Besides not knowing who or where the lender is located, difficulty in enforcing consumer protection laws or compliance with state licensing requirements, these financial transactions expose consumers to identity theft and loss of privacy and control over personal financial information. All Internet payday loans involve transmitting bank account numbers, social security numbers, name and address, and extensive other personal information to a distant lender (Fox and Petrini 2014, p.12 cited in CAC Mb 2015, p.9).

In its review of privacy concerns related to payday lending, CAC Manitoba found evidence of abuse on the part of some web-based lenders and noted that the majority of online payday loan consumers it surveyed did not read the lender's privacy policies (CAC Mb 2015, p.20). Respondents noted that privacy policies were long, difficult to understand, and repetitive.

In addition to interviewing online payday loan clients, this study examined seven online payday loan websites and assessed them vis-à-vis requirements associated with the Canadian Personal Information Protection and Electronic Documents Act, PIPEDA. The examination found compliance with the guidelines varied across lenders and a number of concerns were identified including: not requesting client consent to use personal information; ambiguity regarding how lead generators share information; requiring clients to provide Social Insurance Numbers when this may be contravening PIPEDA; and, using client information to promote other products when this is not allowed in Manitoba regulations.

3.4 Consumer Behaviour and Literacy

It is often assumed within standard economic theory, a theory that is very influential in policymaking circles, that humans are entirely rational and that this is reflected in self-interested behaviour that is deliberately achieved by careful data collection and optimization calculations. But in the past 15 years a growing collection of scholars and scholarship have critically explored that assumption through various types of research and experiments falling within the area of behavioural economics. For instance, Dijkema and McKendry (2016) note, "[o]f course this does not mean that payday-loan use is always a rational decision and/or the best solution for the borrower's needs (p.23)."

While the study of economics has always involved questions about human rationality the contemporary school of behavioural economics has emerged through work by Shefrin and Thaler (1988), Thaler and Sunstein (2008), Mullainathan and Shafir (2013). This research addresses a variety of economic issues including consumer use of credit and its analysis encompasses use by a variety of socio-economic groups including income- and asset-poor people. The scholarship begins with the assumption that people do not consistently behave rationally and, through research, seeks to identify our irrationality or what the literature calls 'bounded' rationality. For instance Thaler and Sunstein (2008) identify a series of characteristics of bounded rationality including anchoring[8] and overconfidence.

3.4.1 Tunneling

Mullainathan and Shafir (2013) specifically examine low-income people's decision-making. What they argue is that while poor people are just like non-poor people in many ways, including being limited by bounded rationality, they do face particular kinds of scarcities that constrain their thinking. They argue that, by definition, a poor person faces scarce resources, liquidity constraints, e.g., income and assets. This scarcity forces them to focus thought and energy on meeting their immediate needs. The opportunity cost is that they are unable to focus on longer term issues like medium and long-term financial and social goals. They describe this focus on the short-run as *tunneling*, in the sense that scarcity causes them to focus on a narrow space of life, the tunnel, and this precludes them from examining other spaces, because they are in this tunnel. Mullainathan and Shafir conducted experiments with people from a variety of backgrounds (poor and non-poor) in simulation experiments and find that the . consequences of tunneling include . reduced executive control, increased distraction, forgetfulness, and impulse control (Mullainathan and Shafir 2013, p.47-65).

3.4.2 Payday loan marketing

Taking up low-quality credit products may be the result of market scarcity –i.e., there are no alternatives on the market– or it may, as Mullainathan and Shafir point, be the result of bounded rationality. Bertrand et al. (2009) experimented on this matter and related to how sellers frame their products, around uptake of loans from a South African bank. The banker sent out flyers about a loan product which contained different types and amounts of information. The researchers examined the credit products that people chose to determine if they behaved rationally by choosing the lowest interest rate loan, but they found that people's decision making was influenced by other factors, such as simplified loan presentations and photos of attractive people.

8This is a heuristic that involves using a known state or condition to assess a current state or condition, even if the known state or condition has no relationship to do with the new one. For instance, we might estimate the population of a city we are visiting by 'anchoring' that estimate to our own city, even if they are completely different sizes.

In a study focused on payday loan uptake Bertrand and Morse (2011) experimented with payday loan clients by providing different types of information. One group got the standard amount and date due for taking out the loan and the other group was given the fee for a payday loan and extension for up to 3 months along with the equivalent fee for borrowing with a credit card (Bertrand and Morse 2011 cited in World Bank 2015, p.6). The results found that those who received the comparison fee data were 11 percent less likely to re-borrow 4 months after the experiment.

3.4.3 Financial literacy

Financial literacy measurement and education, like behavioural economics, is of interest among policymakers and they relate to each other in important ways. Behavioural economics seeks to understand human decision making, dropping the assumption that people always behave fully rationally. Financial literacy practice seeks to educate people so that they make sound financial decisions.

Financial literacy is generally defined as having the knowledge, skills, and attitude to manage one's finances effectively to achieve one's financial and life goals. This includes knowledge about concepts such as risk-reward trade-off with investments, skills such as budgeting, and attitude that enables a person to think and act, even with the constraints they face, to maximize their financial and life goals.

A common finding in financial literacy studies is that many people's capacity to deal with a rapidly financializing economy is inadequate. For instance, Lusardi and Mitchell (2014) scan the literature and find that a large share of Westerners (US, Canada, Europe, etc.) are not fully financially literate: they lack certain literacies, *and* they are over-confident about their ability, the latter a bigger problem for men compared with women. Using universal standards of measurement, women do worse than men, poor people do worse than rich people, and ethnic minorities do worse than majorities, in assessments of U.S. financial literacy.

Of course these universal standards are less relevant for poor people because, for instance, they are less likely to make investments or have mortgages. Lusardi and Mitchell note that financial illiteracy can make people more vulnerable to scammers, and less able to plan for retirement. Gathergood (2012) notes that consumers with high debt levels lacked self-control, heavily discounted future spending, and exhibited low levels of financial literacy levels. Individual financial illiteracy also has a negative consequence for national economic growth.

4. The Impact of Regulation on Payday Lending

In their current form payday loans have been offered in the U.S. for over twenty years, in Canada and the UK for over ten years, and in other parts of Europe and the world (e.g., South Africa) more recently. Payday loan regulation in the U.S. and Canada has been a state- or provincial-responsibility, which adds diversity to the regulations in these two countries. Some municipalities in Canada and the US have

also engaged in limited regulation through, e.g., zoning rules that require certain distances between outlets.

Under the UK Office of Fair Trading, payday lending was influenced by non-binding guidelines but now, under the Financial Conduct Authority, it faces binding regulations including repeat loan limits and a price cap (Frejos 2015). As a consequence of the substantive time and large number of jurisdictions in which payday lenders have operated –and noting that some jurisdictions have changed their policy regime over time– there is the opportunity to study the impact of different regulations on the payday loan market and consumer.

Some important qualifications are warranted before proceeding:

- First, data are often a limiting factor in assessing the payday loan market, particularly in Canada. Without sufficient quality and quantity of data it is difficult to make assessments of the market and the impact of regulations.
- Second, since jurisdictions are quite small –a U.S. state or a Canadian province– their regulations are not absolute in that residents, especially residents that live near a border, are able to access payday loans under a different regime in an adjoining state of province.
- Third, and related to the jurisdiction size point, the internet is another source for payday loans, and there is some evidence that it is a growing source.
- Finally, payday loans are a product that has attracted strong opinion in one form or another. There are proponents and opponents of payday lending, or more broadly, the use of microloans to advance the interests of asset- and income-poor people. It is sometimes difficult to distinguish between strong results and strong passions.

1.4 Payday Lending Regulation Varies in the US and Canada

Payday lending is a mature industry and continues to face major criticism and to be the subject of discussion for reform. This is particularly the case in the U.S., the origin of the modern payday loan industry and the location of the largest payday loan market. For instance the newly established Consumer Financial Protection Bureau is exploring new payday loan regulations.

Discussion in Canada has continued in the media (Grant and McFarland 2015; Pollon 2015) but policymaker dialogue is relatively muted. Payday lending regulations in the UK have ‘caught up’ to regulations in the US and Canada. But it is in the US where there continues to be the most lively discussion about payday loans and their reform. In Canada there was a proposal that the postal system be used to deliver banking services to unbanked people (Anderson 2013). More recently there was some interesting discussion that took place within a cross-sectoral panel put together by the Ontario government but their areas of consensus were very weak.

1.4.2 Some New U.S. Payday Loan Regulations

The creation of the Consumer Financial Protection Bureau is one of the main outcomes of the U.S. government response to the sub-prime mortgage crisis. One of its major initiatives is a broad-based proposal to reform the small sum credit market including short-term loans such as payday loans and longer-term loans such as title loans. The proposal includes regulations that are intended to 'prevent' a debt trap and to 'protect' borrowers from a debt trap.

With respect to reforms targeting payday loans, debt trap prevention involves underwriting loans and limiting loans to one or two in a 60-day period. In terms of debt protection the regulations involve limiting rollovers to two followed by a 60-day cooling off period and, if needed one option would involve installment repayment.

In 2010 the state of Colorado in the US implemented a serious reform requiring payday lenders to transform their loans into a longer term six month loan that is repaid with installments. The rationale for this reform was that 2-week high-fee balloon payment payday loans were considered too harmful and that, to reduce consumer harm and improve consumer benefit, the state of Colorado advanced a new payday loan model. The maximum loan size is $US500 and the APR is limited to 129% (Pew Charitable Trusts 2013b, p.9).

According to a report by Pew Charitable Trusts, the new payday loan model in Colorado found that since the law was enacted, there are fewer payday lender outlets but they are still broadly available, there are fewer payday loans, fees are lower and more transparent, the vast majority of loans are repaid within 5 months, and consumers are more satisfied with the new service as compared with the old one.

1.4.1 The Ontario Panel

Recently the Ontario government formed a panel of representatives from consumer, government, and business sectors to strengthen Ontario's payday lending regulations (Deloitte 2014). The panel report reviews Ontario's regulations point by point and notes some areas in which the panel came to a consensus and other areas where a consensus was not reached. They noted that the industry and loan model is always changing so that effective regulations must be broad enough to continue to regulate the sector. They also agreed that more data are needed to make effective regulations, that regulations should also be strengthened for non-compliant payday lenders and products, and there needs to be more financial education available to consumers. The panel was unable to agree on recommendations about other items such as fee caps, repeat loan limits, loan size limits, etc.

4.1 Payday Lender Costs

A common goal of payday loan regulation is protect consumers from unsafe payday loan products. One way this has been achieved is to devise regulation that allows

efficient payday lenders to operate but disallows inefficient lenders to do so. Price caps and other regulations –e.g., restricting the number and type of repeat loans– are put in place to enable the former but not the latter. An underlying assumption of this approach is that (1) some consumers want and can benefit from payday loans, and (2) payday loans are an expensive service to offer. On the latter point, why is delivering payday loans more costly than, e.g., a mortgage?

> [T]he cost structure of the consumer finance industry is such that operating costs increase less than proportionately with loan size. This relationship exists because many of the costs occur whenever an application is accepted, a loan is made, or payments are serviced. These activities must be performed regardless of the size of the loan. Companies producing larger loans have lower costs per dollar of credit extended than those producing smaller loans. Thus, for a given interest rate, larger loans are more profitable than smaller loans (Lawrence and Elliehausen 2008, p.301).

Other variables that affect payday loan costs include loan volume which relates to economies of scale and number of related services offered, which relates to economies of scope (Table 1). Other factors affecting costs include the default rate, the cost of capital, the price or price cap, the firm's profit margin, the number of first time customers (an expensive clientele for payday lenders), and the number of loans per client per year (more is better for the payday lender; the reverse is the case for the borrower).

Table 1. Some Important Factors Effecting Payday Lenders Costs

Cost item	Type of cost
Volume of loans per period	Economies of scale
Number of services, in addition to payday loans offered	Economies of scope
Loan default rate	Particular cost
Cost of capital	Particular cost
Price / price cap	Market or set price
Firm's profit margin	Owner expectations
Share of first-time borrowers	Consumer characteristic
Share of borrowers taking out multiple loans per period	Consumer characteristic

4.2 The impact of price caps

The most extensive studies of the impact of payday loan regulations come from the U.S. (Pew Charitable Trusts 2012, 2013; McKern 2010; Edmiston 2011; Kaufman 2013).

Price caps are a common component of regulation. What happens when a price cap is implemented? One theory is that remaining firms move their prices –up or down– to the price cap. This in fact has been the case in the U.S. (Kaufman 2013). Baradaran argues that there is evidence that payday loan firms, at times, either implicitly or explicitly, collude around price caps, "consistent with Thomas Schelling's theory of implicit collusion around pricing focal points (Baradaran 2015, p.131)." The argument is that the price cap enables firms to not compete and rather, to price their loans at the cap level.

What is a reasonable price cap that enables an efficient payday lender? The Pew Charitable Trusts study noted, "according to an industry analysis, 'In a state with a $15 per $100 rate, an operator…will need a new customer to take out 4 to 5 loans before that customer becomes profitable' (Pew Charitable Trusts 2012, p.15)." And Pew Charitable Trusts's research demonstrated that in states with 'hybrid' regulations --caps around $10 per $100 borrowed, restrictions of the number of loans per year a person can take, and allowing installment repayment—that payday lenders continue to operate in large numbers (Pew Charitable Trusts 2012, p.20). Caskey reporting on Zinman's (2010) study that examined payday lending in the state of Oregon before and after introducing restrictive caps, $10 for $100 loaned:

> The new law capped finance charges at roughly $10 per $100 advanced and set a minimum loan term of 31 days for a maximum APR of 150 percent. Most payday lenders decided that their business would not be sufficiently profitable under this restriction. At year-end 2006, there were 346 payday loan storefronts in the state. By February 2008 there were 105 (Caskey 2010, p.7).

While these studies disagree about the viability of operating a payday loan outlet within a $10 per $100 cap, clearly some were able to do so even in the Zinman study. Presumably loan volumes and other factors (e.g., providing complementary services) would lend to the viability of offering payday loans at this rate.

4.3 Limiting the amount of borrowing

Another common component of regulation is to limit the total amount that a person is able to borrow through payday lending. This is done in various ways such as limiting the number, size, or frequency of the payday loans. But Kaufman (2013) found that efforts to limit total borrowing have been less successful:

> Overall, it appears that customers were able to borrow the desired amount no matter whether the limit was structured as a size cap or a simultaneous borrowing ban. This suggests that unless states enact much more binding limits on the maximum amount borrowed it may

> not matter whether or not they also have limits on simultaneous borrowing (Kaufman 2013, p.16).

4.4 The impact of general payday loan restrictions

One argument is that restrictive regulations push credit-strapped people to alternative lenders, including anything from other fringe banks to illegal and dangerous loan sharks. But several studies in the U.S. find this is not the case. Pew Charitable Trusts, McKern, Kaufman and Wolf find that in states with more restrictive regulations there are fewer payday lenders and that there is no evidence that people are relying more on other loan sources.

In some jurisdictions payday loan regulations essentially disallow payday loans. For instance in North Carolina in 2001 a usury limit of 36% took effect for payday loans (Wolf 2015). Payday loan outlets were all closed by 2006. Credit union small loans remained but the APR for these was 12%. Wolf (2015) concluded,

> Research by the University of North Carolina's Center for Community Capital (2007) documented that the rate cap benefited North Carolinians, and that most low- and moderate-income residents—even those who had previously used payday loans—welcomed the change. Researchers concluded, "[m]ost surveyed households consider themselves better off or unaffected by the closing of payday loan stores." Households found a variety of ways to manage financial stresses and expressed their happiness that payday loans were no longer in the state" (Wolf 2015, p.33).

Edmiston (2011) reviewed U.S. data and literature on this point. He noted that indebtedness in Georgia, U.S. declined after the mid-2004 move to more restrictive regulations. What he found was that the trend line of growing indebtedness started to drop after the introduction of greater restrictions while the trend continued on at roughly the same rate for the rest of the U.S. (Edmiston 2011, p.41). But Edmiston found that people in low-income counties with payday loan outlets have slightly higher credit scores than the national average (Edmiston 2011, p.45). He concludes,

> The evidence showed that consumers in low-income counties may have limited access to credit in the absence of payday loan options. As a result, they may be forced to seek more costly sources of credit. The evidence also showed that, in countries without access to payday lending, consumers have a lower credit standing than consumers in counties with access (Edmiston 2011, p.51).

McKern et al. (2010) used data from a nationally representative U.S. survey to examine the relationship between state-level regulation and consumer use of fringe banks. They found that prohibition of payday lending caused people in that state to

reduce their use of payday lending by 35% as compared to states without prohibition. These residents can still obtain a payday loan in an adjoining state that does not prohibit payday lending or through the internet. Lower rate caps did not affect consumer uptake of payday loans. And they noted that prohibitions and price caps on one type fringe bank product, e.g., payday loans, do not lead consumers to increase their use of other products, e.g., pawnshop loan (McKern et al. 2010, p.19).

The Pew Charitable Trusts (2012) investigated this question using their nationally representative dataset in which almost 50,000 people were screened through an omnibus survey leading to 451 participants of a full-length survey and eight focus groups specifically on payday lending. They explored the question of how state regulations affected payday loan use.[9] They found that in states with restrictive regulations people do not increase their use of online payday loans or other fringe banks products (Pew Charitable Trusts 2012, p.22-24). States with more restrictive regulations have fewer payday loan outlets and people simply use fewer physical and online fringe bank loans. Pew Charitable Trusts found that where payday loans were not available people cut back on expenses, delay paying some bills, borrow from friends/family, and/or sell or pawn personal possessions (Pew Charitable Trusts 2012, p.16). Pew Charitable Trusts noted,

> Prior research has found “no evidence that prohibitions and price caps on one AFS (Alternative Financial Services) product lead consumers to use other AFS products.” Our research builds on that finding, revealing that the vast majority of would-be borrowers do not even substitute a new method (using the Internet instead of a storefront) to obtain the same AFS product, which in this case is a payday loan (Pew Charitable Trusts 2012, p.24).

The Pew Charitable Trusts study revealed that the majority of payday loan customers want more regulation of payday lending (Pew Charitable Trusts 2013, p.47-50).

Regulation of payday lending involves benefits and costs to businesses, consumers, and government. In the case of potentially harmful products a minimum level of regulation is justified to protect consumers from harm. This is the route that has been taken by most Canadian provinces and many US states. The purpose of this

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9For their study the Pew Charitable Trusts categorized U.S. states into 3 categories: (1) Twenty-eight ‘permissive’ states, where most Americans live, where the payday loan rate caps are greater or equal to $15/$100; (2) ‘Hybrid’ states where rate caps are approximately $10/$100, there are restrictions on the number of loans each borrower can take, and sometimes borrowers are allowed to repay the loan over several pay periods; and (3) ‘Restrictive’ states where the rate cap is placed at 36% APR, and payday loan storefronts are not found (Pew 2012, p.20).

regulatory approach is to enable payday lending to operate within certain accepted standards, e.g., disallowing rollovers, outlawing fees above certain caps. The state of Colorado has been more prescriptive by requiring the payday loan industry to move towards a more traditional longer term and installment loan product. The province of Quebec and some US states have regulations that disallow payday lending, basing the justification, presumably on the argument that regulations cannot modify the product sufficiently to prevent social harm. Each of these approaches have strengths and weaknesses and the evidence is mixed about which approach is superior but arguably the strongest evidence supports at least a moderate regulatory approach associated with the approach in Canada with the exception of Quebec or the approach taken by the state of Colorado. The more restrictive model in Quebec may be justified but without more data and analysis it is hard to make a conclusion.

But this is examining only one aspect of regulation, related to a fringe bank, payday lenders. A holistic response to bank exclusion evidenced by the growth of payday lending includes regulation of mainstream FIs (Buckland 2012; Dijkema and McKendry 2016). Restricting, reforming, or allowing fringe banks through state intervention are insufficient to address bank exclusion. A critical component to the solution to payday lending is that mainstream FIs identify the need, learn from the current providers (i.e., the payday lenders), and put in place products that meet this need. This is not happening through the 'market mechanism' so it is justifiable that the federal government step in to engage with mainstream FIs to generate this outcome. For instance, the federal government, through the Financial Consumer Agency of Canada, could broaden and deepen the Access to Basic Banking Regulations so that banks are required to maintain branches in modest income neighbourhoods, develop financial services the income-poor people need, and train staff to understand the financial reality of asset-poor people.

5. Discussion

While there is evidence that growth of the payday loan industry has slowed in some rich countries, companies are expanding their services to include online loans and expanding into new regions such as South Africa and Eastern Europe. Payday loan companies, perhaps better labelled fringe banks since they offer many services, have consolidated and now many have a corporate footprint.

While there is limited data about online lending, what data are available does point to higher risks for consumers. This should not, however, be used as a rationale to not regulate physical payday lending. Repeat borrowing continues to be a major concern and this problem is well documented in the US. Repeat borrowing points to the need for substantial reform of the sector as has been done in Colorado, for instance.

In Canada we simply have insufficient data to determine if this is a problem. There is a clear need for government to collect these data so that careful analysis can be done. Federal agencies such as the Financial Consumer Agency of Canada and/or the Industry Canada-based Consumer Measures Committee are obvious choices to take on this task.

The state-based and varied regulation of the payday loan industry in the US has led to a number of interesting studies. While impact assessments cannot definitively determine whether or not payday loans benefit consumers it is clear that some consumers –relying on repetitive borrowing, accessing their loans online, tunneling as a result of personal and professional pressures– can be harmed by payday loans. Continued regulation is needed as is consumer education that draws on the insights from behavioural economics.

Appendix

Canadian Regulations by Province

Province	Price cap	APR disclosure	Borrowing limit	Cancellation period	Maximum NSF fee	Post default interest rate
BC	23	Yes	50% net pay	Next business day	$20	30%
Alberta	23	Yes	$1,500	2 business days	$25	2.5% per month
Saskatchewan	23	NO	50% net pay	Next business day	$50	30%
Manitoba	17	Yes	30% net pay	48 hours	$20	2.5% per month
Ontario	21	No	$1,500	2 business days	'Reasonable charges'	Not applicable
Nova Scotia	25	Yes	$1,500	Next business day	$40	60%
New Brunswick	Pending	Not applicable	Pending	48 hours	$40	Pending
PEI	25	No	$1,500	2 business days	'Reasonable charges'	Pending

Source: Barrett Consulting Services Inc. 2015, p.18

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