Pragmatic Solutions to Payday Lending: Regulating Fringe Lending and "Alternative" Banking

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Executive Summary

This report is a follow-up to PIAC's November 2002 Report: "Fringe Lending and "Alternative" Banking: The Consumer Experience" ("Report 1"). From that report, a much clearer picture emerged of the "alternative financial sector" (AFS). The November 2002 report analyzed survey findings of users of the AFS and made several recommendations for consideration by policy makers. This report builds on those recommendations and undertakes an in-depth consideration of possible regulation of a major aspect of the AFS, the payday loan industry, from a consumer perspective. This report outlines several possible options for regulation of the payday loans industry and highlights the advantages and shortcomings of each possible approach. The report is timely, as provincial and federal regulators are presently meeting to determine the scope and method of regulating the AFS in general and the payday loans industry in particular.

Report 1 concluded that the best course of action to deal with problems in payday lending was fairly complete and specific regulation of the payday loan industry. Also discussed was the possible amendment of s. 347 of the *Criminal Code* (the criminal interest offence and related interest rate cap of 60% effective annual rate of interest) and the resultant need for effective regulation. In light of the possible amendment of s. 347 to permit small, short-term loans, more partial regulatory schemes such as simple licensing, (with or without industry self-regulation or codes of conduct), was rejected as likely to be inadequate to the task of protecting consumers.

This report continues these conclusions, expands upon the regulatory options and justifies extensive regulation. It also suggests which regulatory policies would be most likely to curb industry excesses while encouraging responsible provision of credit to users of payday loan services.

The Report concludes with a plea to mainstream financial institutions to enter the payday loan market once the necessary changes are made to the *Criminal Code* usury provision, however, it cautions that such an entry by federally-regulated financial institutions must be in accordance with the relevant provincial regulatory scheme.

The regulatory recommendations include:

- *Licensing of Operators*

- *Extensive Regulator Powers, including*
    - jurisdiction over all payday lenders, licensed or unlicensed;
    - Prosecution powers – fines, licence suspensions
    - consumer complaints mechanism (toll-free 1-800 number);
    - Require transaction data from lenders;
    - Educate borrowers about cost of credit and payday loans in particular;

  - Report on industry each year to provincial legislature with suggested changes to industry regulation

- *Cost of Credit Disclosure, including*
  - All fees and charges must be clearly detailed in writing in contracts and advertising and promotional materials;
  - Provide loan application and loan agreement before completion of application/transaction; allow customer to have copy of completed application/loan transaction
  - Standardized loan documentation should be produced by the regulator with regulatory requirements;
  - Reference to Consumer complaints mechanism on documents
  - Fees and charges may not be excluded from definition or calculation of interest (NSF fees may be excluded);

- *Annual Percentage Rate (APR) statement*
  - APR must be calculated for all loans and displayed on loan documentation.
  - Typical APRs for standard loan increments and standard loan terms should be available in chart form for borrowers.

- *Interest Rate Cap, including borrowing limits*

- *Limits on Specific Charges and Fees, including*
  - Allowable NSF fees should be limited to a modest amount, representing the real cost of administration;
  - Electronic NSF charges must be limited to one attempt to collect;
  - Lender-specific identification card charges must be modest and not become a revenue source.
  - No default or delinquency charges.
  - Interest may not accrue after a default.
  - No “broker” or “agency” fees permitted.

- *No Rollovers, Extensions, Back-to-Back Loans*

- *Advertising Rules, including*
  - Advertising must not be deceptive or misleading;
  - Must detail typical APR of standard loan amount for typical term in clear and conspicuous type;
  - Must detail all applicable fees and charges for loans, as well as other charges such as those for convenience cards.

- *Education and Awareness Campaigns for Consumers, including*
  - campaigns to increase financial literacy of payday borrowers, with specific emphasis on cost of this form of credit and alternative credit sources.
  - education and action programs to encourage consumer savings.

- Payday lender funding of consumer borrowing education

- *Other Borrower Rights*
  - Right of rescission immediately following a loan (cooling-off period).
  - Right of Prepayment of loan at any time and to pay it down in increments
  - floating or variable rates should be limited to the lowest rate
- prohibition on secondary marketing purposes borrowers. Lenders should clearly and conspicuously post privacy policies. Clear, express written consent of borrowers should be provided before lenders may use borrowers' personal information with related entities.

- *Collection and Litigation Limits, including*
  - No assignment of wages
  - No security or contingent security.
  - No personal guarantees from third parties
  - No interest in land
  - No threatening of prosecution for "crime" of bad cheque passing
  - method of cheaply and expeditiously contesting amounts illegally demanded by lenders, with right of set-off against present debts.
  - no private arbitration clauses– disputes to be handled by payday loans dispute tribunal or small claims court
  - Statutory damages should be recoverable to borrowers

- *Lender Database (Positive Credit Reports)*

- Should not be used as surveillance of borrowers but to create positive credit histories
- Positive payday lending records should be made portable to mainstream credit reporting agencies to allow borrowers to improve their credit rating while taking payday loans.

Introduction

The regulation of the payday loans industry brings into sharp focus the interaction of the world of finance with that of social action. It is truly an area where the "rubber hits the road", that is, where the role of credit in modern Canadian consumer society is at its starkest. However, it is equally clear that the usual rules of credit that apply in the commercial world must be modified to protect consumers. Abuses in the present market and potential abuses must be addressed by regulation of the payday loans industry.

Complicating matters is the relation of the regulation of the payday loans market to the reform of Canada's criminal usury law. Other complications on the Canadian scene are the federal-provincial breakdown of constitutional powers over interest rates and financial services, as well as the differing types and levels of financial services regulation in the provinces.

Scope of the Report

Payday loans, as described in Report 1, are single-payment, short-term loans based on personal checks held for future deposit (often post-dated) or on electronic access to personal checking accounts.[1]

This report will focus only on the payday loan industry, despite the possible inclusion of other forms of quasi-credit: pawn shops, rent-to-own stores, tax rebate discounting and cheque cashing. The payday loan industry is the fastest growing and largest portion of the AFS in Canada and poses the greatest present risk of consumer abuses. Once a functional regulatory scheme were devised for payday loans, other forms of quasi-credit entities could be similarly regulated.

Report 1 Conclusions

Report 1 outlined several options regarding possible regulation of the payday loan industry. They were:

1. Enforce s. 347 of the *Criminal Code*
2. Amend s. 347 (to allow limited small, high interest loans)
3. Industry self-regulation
4. Provincial update of consumer protection statutes to capture the industry
5. Enact legislation to specifically regulate payday lenders

Report 1 concluded that option 5 (specific payday lending regulation) was the best option, especially in light of the likely adoption of option 2 by regulators in the near term. This report accepts Report 1's conclusion, and will expand on the

---

[1] National Conference of State Legislatures website definition. Online: http://www.ncsl.org/programs/banking/paydaylend-intro.htm, accessed 22 August 2003.

full regulatory option and respond to other developments in the industry and elsewhere, detailed below. It will become evident during this report that the full regulatory model is also compatible with options 3 (other consumer protection legislation) and 4 (industry self-regulation) above but that it cannot be replaced by either.

Updates and Developments Since Report 1

Reaction to Report 1

Industry reaction to Report 1 was limited to extensive comments made by the lead payday lender in Canada, National Money Mart Company (Money Mart). Money Mart raised several points of contention with the conclusions of Report 1 and also questioned some aspects of the survey methodology.[2] Some of these points are dealt with in Appendix 1, below.

Development of Class Actions

A major legal development since Report 1 are the filings of Canada's first class action lawsuits against the payday lending industry. A B.C. class action seeks restitution of fees paid to all payday lenders making loans in B.C.[3] The contention is that the loans were made with effective annual interest rates of greater than 60% (and which are therefore illegal under s. 347 of the *Criminal Code*).[4] The action also seeks damages for breach of B.C.'s *Unconscionable Transactions Act* and unspecified punitive damages. The action is limited, at present, to B.C. borrowers and payday lenders operating in B.C. This action has not yet been certified. The cost to B.C. payday lenders may approach $250 million by some estimates.

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[2] Letter from Money Mart President Syd Franchuk to PIAC, dated March 7, 2003 (Money Mart Letter).

[3] Kurt MacKinnon v. National Money Mart Company, Canadian Cheque Cashing Corporation, Payday Loans Ltd., Pay Credit (B.C.) Ltd., Stop N' Cash 1000 Inc., Instaloans Financial Solution Centres (Kelowna) Ltd., Instaloans Financial Solution Centres (Vernon) Ltd., Instaloans Financial Solution Centres (B.C.) Ltd., Sorensen's Loans 'Til Payday Inc., Cash Factory Loans Inc., 594506 B.C. Ltd., Kleincorp Mgmt. Inc., Check Station Inc., Ca$hier Inc., Nationwide Payday Loan Advance Ltd., The Little Loan Shoppe Ltd., Cash Advantage Services Inc., John Doe No. 1 dba Cash Exchange, Moneypot Financial Services Inc., 555538 B.C. Ltd., Mr. Payday Easy Loans Inc., The Yellow Cash Center Inc., Clinton Tynes dba Cash Quick Services, Cash Now Financial Services Inc., John Doe No. 2 dba Premier Cash Advance, Money Sense Check Services Inc. and Cash Corp. (Court file #S030572) Vancouver, B.C., Supreme Court of Justice (January 29, 2003).

[4] The effect of criminality on a civil contract at common law is generally that the contract is completely void. However, courts will occasionally sever the illegal aspect of the contract and allow the rest to stand. If payday loan contracts charge illegal interest rates, this means either that a consumer can resist repayment of the entire loan, or at the least, any interest (including fees or charges included in the definition of interest). It also means they can seek restitution of money paid as fees and interest to payday lenders, (and possibly damages and punitive damages) as is being done in these class actions.

In Ontario, class actions have been filed against payday lenders in three separate actions.[5] Money Mart is named alone in one of the actions.[6] The other two name Cash Money Cheque Cashing Inc.,[7] and Unicash Franchising Inc.[8] Each action claims losses to borrowers related to illegal interest rates,

Such actions are an obvious threat to the industry. It has already provided a stimulus to industry to become regulated.[9] Whether the development of class actions is a positive stimulus to change for consumers is debatable. The possibility exists that the industry may win on the "fees as interest" argument, taking much of the steam out of the Supreme Court of Canada's ruling in *Garland* v. *Consumers' Gas Co.*[10] and effectively legalizing payday loans (or loans structured in certain ways). On the other hand, a large judgment in favour of plaintiffs may cause the demise of one or more "mainstream" payday lenders, possibly opening up the field to less scrupulous competitors, unnamed in the class actions, who will continue to act largely unregulated. Regulation therefore seems a preferable, stable and long-term solution to this growing and unstable industry, rather than the uncertain and unstable legal status quo.[11] It is presently a unique time for regulation of the payday loans industry in Canada; the industry may be open to strong consumer measures in its search for regulatory legitimacy.

Industry Changes

Some changes in the payday lending industry have emerged since Report 1. Many of these recent changes are linked to electronic banking and the Internet.

INTERNET LENDING

Payday lending over the Internet has exploded in the last three years. Many of these payday lenders do not have an easily locatable business address and transact business by e-mail and 1-800 number. Since Internet payday lenders generally do not have access to proof of employment or other physical identity checks, they may employ questionable practices in over-demanding sensitive

[5] Press Release: "Three Class Actions Commenced Against 'Payday Lenders'" Toronto: October 22, 2003. See http://www.paliareroland.com/pdfs/predatorypress.pdf.

[6] Kenneth T. Mortillaro v. National Money Mart Company (Court file: 03-CV-257356CP) Toronto, Ontario, Superior Court of Justice (October 21, 2003).

[7] Kenneth T. Mortillaro v. Cash Money Cheque Cashing Inc. (Court file: 03-CV-257357CP) Toronto, Ontario, Superior Court of Justice (October 21, 2003).

[8] Kenneth T. Mortillaro v. Unicash Franchising Inc., c.o.b. as Unicash Financial Centres (Court file: 03-CV-257364CP) Toronto, Ontario, Superior Court of Justice (October 21, 2003).

[9] Money Mart counsel conversation.

[10] [1998] 3 S.C.R. 112. See also *Degelder Construction Co.* v. *Dancorp Developments Ltd.*, [1998] 3 S.C.R. 90.

[11] Another question that arises, therefore, would be whether any regulation (either from amending s. 347 of the *Criminal Code*, or by the provinces) should be made retroactive to remove the threat of class action lawsuits from the industry to allow it to grow responsibly without potential disastrous liabilities.

personal information far in excess of what is necessary to process a transaction.[12] Many Internet payday lenders operate from the U.S. or other countries into Canadian jurisdictions.[13] Many also operate wholly or largely within Canada.[14] Internet payday lending is wholly unregulated and often very aggressive in terms of lending limits and rollovers.

Electronic Cheque Cashing

In a much more pedestrian vein, the first steps towards electronic cheque cashing have been taken. Money Mart now offers "Zap It" service, allowing a borrower to have a cashed cheque, wire transfer or loan funds deposited directly into the customer's bank account via electronic deposit. This appears to address one complaint of customers, namely, nervousness over carrying large amount of cash. It does raise issues about the difference between this service and ATM deposits (for cheque cashing) and lines of credit (for the loan service). As for the collection end of the transaction, it appears that a personal cheque is still used to ensure repayment.

Smart Cards

Money Mart has now also begun to issue a Personal Cash Card ("a smart card") carrying not only the customer's profile (for faster loan and cheque cashing services) but also the ability to store value on the card.[15] Once "loaded" with electronic funds, a borrower may obtain cash from an Interac bank machine or use it to make electronic debit purchases exactly as if the card were a financial institution issued bank card.[16] No bank account is required and the card is not linked to banking information. Other lenders also offer this type of service.[17]

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[12] In 2000, the Massachusetts Division of Banks warned:

> A review of internet payday loan web sites found lenders seeking information far beyond what is typically required by a lender to make a credit decision. Examples of the type of information sought by some internet payday lenders include a consumer's ATM PIN (personal identification number), license plate number, social security number, date of birth, mother's maiden name, height, weight, and eye color.

"Internet Payday Loans – Risky Business" (May 30, 2000). Online: http://www.state.ma.us/dob/payday.htm.

[13] For example, MyPaydayLoan.com, operating from web address http://www.cwfhc.on.ca/internet_payday_loans.html, states "All aspects and transactions on this site, will be deemed to have taken place in our office in Costa Rica, regardless of where you may be viewing or accessing this site.".

[14] For example: www.zippycash.ca; http://www.310loan.com/;

[15] See http://www.nextwavecard.com/. The service appears to be a partnership between Next Wave Card Corp. and Money Mart. It is presently in test phase in B.C. only.

[16] http://www.nextwavecard.com/help/index.cfm?action=faq.

[17] See, for example, The Cash Store: http://www.cashstore.ca/getmymoney.htm

Rentcash Inc. (operating as "The Cash Store" and "Insta-rent") and Canada's number two lender in terms of number of outlets, also offers a "Cash Card". This "private branded card" allows borrowers instant withdrawals (up to the loan amount) from an ATM. However, Rentcash lauds the Cash Cards as providing a mainstream ATM-type service to the unbanked:

> Our private branded Cash Card is an innovation that demonstrates the flexibility of the Company's concept. By offering our Cash Card, The Cash Store can load cash advances and other amounts on a card enabling non-banked customers to make purchases and cash withdrawals at any ATM or debit card terminal in Canada.
>
> The Cash Card carries a double benefit: we reduce our costs by reducing the amount of cash kept on our premises and the consumer obtains privileges otherwise unavailable through the traditional banking system. The 10,000-plus consumers who have thus far taken advantage of this service are proud of their cards—proud to be included in a system that may have previously excluded them. Some $2,500,000 has been loaded on these cards and we look for even greater amounts to be brokered in this manner as we open more stores. Conventional banks have all but abandoned this market segment thus providing an excellent opportunity for our Company.[18]

These services again raise questions about the presence of payday lenders (but not mainstream financial institutions) offering a mainstream banking product (ATM banking) to the AFS market (but on borrowed funds).[19]

RETURN OF THE BROKERING BUSINESS MODEL (RENTCASH)

Rentcash Inc. has re-introduced the broker business model to Canadian payday lending.[20] Rentcash claims to not actually advance the funds, but rather acts as an intermediary with undisclosed financial partners to provide the payday loan, and takes a "brokering fee" from borrowers (which is added to the interest rate charged by the actual "lender"). As described in the latest Rentcash Annual Report, p.1:

> We operate under a very dynamic business model. In The Cash Store business segment, we primarily act as a broker for consumers seeking

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[18] See Rentcash Annual Report 2002 (available from http://www.sedar.com).

[19] In addition, it raises the prospect that, if ATM withdrawal convenience fees are added to cash withdrawals made with these smart cards, there may be an inadvertent breach of s. 347, as these extra fees may be considered "interest" under the *Criminal Code*.

[20] The broker model has been used in the past. See, for example, *Cash Store (Advance Finance Company)* v. *Lajoie*, [2002] A.J. No. 780, 2002 ABPC 96 (Alta. Prov. Ct.), where the broker was denied the recovery of a payday loan in default, as the brokerage fees added to the interest charged by the financing company was clearly in excess of the limit in s. 347 of the *Criminal Code*.

> short-term loans—typically a payday advance of $100 to $500 (no more than 33% of net take home pay) that is usually repaid within a 14-day period. Since third party lenders provide the funds and the Company does not advance its own capital, we significantly lower our capital risk. The Cash Store manages the application and approval process and collects the funds for repayment to the third-party lender.
>
> The criteria set for consumer acceptance minimizes the lending risk and attracts what we consider to be the ideal customer. The customer must have a chequing account, be employed and submit copies of his two most recent bank statements and pay stubs. These requirements, in addition to a proof of residence and current telephone and utility bills, elevate the target market to a relatively stable group—income earning consumers. We believe this is a highly promising model, suited to rapid national expansion.

This model appears to be attempting to skirt s. 347 of the *Criminal Code* by imposing an agent (Rentcash) between the borrower and the undisclosed "lender" and stating that Rentcash is providing a professional service to the borrowers of finding the "right" lender.[21] Such broker fees, therefore, could be considered separate from the interest charged by the third party lenders (at 59% APR). This model also appears to have rent-a-bank-type potential should restrictive provincial laws be adopted. Rentcash's hidden lender model also appears to provide a possible anonymous entry point into the market for mainstream financial institutions.

U.S. Regulatory Changes

The U.S. appears to be slowly increasing the level and type of regulation aimed at payday lending, largely at the state level, and with some administrative action to restrict activities at the federal level. This trend is detailed more fully below in case studies. In particular, national bank regulators have recently taken a dim view of payday lending,[22] although at least one regulator, the FDIC, apparently still tolerates "rent-a-bank" arrangements. Such increased regulation should encourage similar efforts in Canada, while providing timely lessons to Canadian regulators about potential regulatory pitfalls.

CMC Efforts to Regulate Payday Lending and ACCM (AFS)

In Canada, meanwhile, the issue of regulating payday lenders, and possibly most elements of the AFS, has been undertaken by the Consumer Measures

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[21] In the *Lajoie* decision, discussed in the above footnote, the court allowed for the possibility that a borrower could retain an independent agent to broker a loan, and therefore possibly avoid s. 347. However, the court found that in that case the true lender chose the broker to act for the borrower, which appears to be the case also with Rentcash.

[22] Including the Federal Reserve, the Office of the Comptroller of Currency (OCC) and the Office of Thrift Supervision (OTS).

Committee, comprised of consumer and business regulators from the provincial and federal governments. The CMC has recently completed extensive draft cost of credit disclosure regulations which are intended to apply to the entire "Alternative Consumer Credit Market" (ACCM), which have been, or are due to be, enacted as provincial legislation. Such legislation will influence the scope of any eventual regulation of the payday lending industry, since it may largely cover the cost of credit disclosure aspects of payday lending.

Recently, the CMC has been directly considering potential "regulation" of the payday lending industry through amendment of s. 347 of the *Criminal Code* and possibly other provincial measures. Although these deliberations are secret for the moment, the CMC regulators are scheduled to meet on this subject and are likely to provide something to the provincial ministers of consumer protection at their upcoming meeting in early 2004 in Winnipeg. Government therefore appears to be willing to consider the regulation of payday lending as a discrete subject.

Banking Changes (Lifeline Banking and Bill C-8)

Some recommendations of the 2001 White Paper on Financial Services were implemented by Bill C-8. Most banks now offer a low-cost "lifeline" banking account. The encouragement of savings is a critical part of any plan to wean borrowers off of high-cost credit. However, as pointed out by Professor Iain Ramsay, great efforts will have to be undertaken by banks to market these services to a distrustful low-income market.[23] Having a low-cost bank account will not help payday borrowers specifically, either, since these borrowers are already required by payday lenders to maintain a chequing account.

The creation of the Financial Consumer Agency of Canada (another White Paper recommendation) is also a welcome step. FCAC should ensure banks offer better services to low-income depositors and can educate users of payday loans about changes to the banking industry. FCAC is presently preparing a pamphlet for consumers on payday loans.[24] FCAC may also be able to lobby banks to enter low-income loan market. However, without "lifeline lending" requirements, payday lenders will still thrive in the underserved niche of fringe credit.

Justifying Regulation

Report 1 suggested regulation was the only practical course for consumers and payday lenders. This report therefore concentrates on this regulation. However,

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[23] I. Ramsay, "Access to Credit in the Alternative Consumer Credit Market". Paper prepared for the Office of Consumer Affairs, Industry Canada and the Ministry of the Attorney General, British Columbia February 1, 2000 ("Ramsay Report"), p. 37. Online: http://dsp-psd.communication.gc.ca/Collection/C2-543-2000E.pdf

[24] FCAC in its Annual Report for 2002 undertook to issue pamphlets on the "pitfalls of payday loans". See http://www.fcac-acfc.gc.ca/AnnualReports/2002_2003/eng/contents.asp

governments and industry now demand a thorough rationale for regulation. This rationale is detailed below.

Regulation Abroad

One basis for regulation is general practice. Most other states now do regulate payday lending *as a specific industry*, or at least licence it, and this number is growing. Indeed, one stated goal of the Community Financial Services Administration (a U.S. payday lenders' industry group) is "Support balanced legislation." As noted below, the industry is regulated in South Africa, Australia, the U.K. and most states of the U.S. While the situation in Canadian jurisdictions may not be identical to those abroad, there are by far more similarities than differences, so it makes sense to look at that experience and to conclude industry-specific regulation is probably required.

Neo-classical Economic Theory

Regulation can be justified on several other bases. Firstly, many governments now explicitly or implicitly subscribe to a variation of neo-classical economic theory.[25] This dominant theory holds that regulation is an interference with the natural balancing forces of the market and so the benefits of regulation must clearly outweigh the detriments to justify regulation. Regulation must only be made to the extent necessary to bring the cost-benefit ratio into balance and not go any further.

One of the situations which calls out for regulation is "market failure". This can occur for a number of reasons, but a main culprit is often "information failure". Information failure occurs in lending where the terms of lending are not transparent to the borrower, making it difficult or impossible for the borrower to compare interest rates and fees (the actual cost of loans).[26] The U.S. *Truth in Lending Act* is an attempt to right such an imbalance through detailed regulation. For example, Regulation Z under that Act requires posting Annual Percentage Rates (APRs) for nearly all types of lending transactions, including payday loans.[27] There is little clear research on the extent to which borrowers are misled by the costs of borrowing via payday loans as compared to other forms of borrowing, but what little exists shows consumer confusion to be a distinct possibility.[28]

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[25] See, for example, Government of Canada Regulatory Policy, Treasury Board Secretariat, (November 1999) (online: http://www.pco-bcp.gc.ca/raoics-srdc/docs/publications/regulatory_policy_e.pdf).

[26] Ramsay Report at p. 19.

[27] See Regulation Z, 12 C.F.R. Ch. II, Pt. 226, Supp. I, p. 360, para. 2 (1-1-03 Edition).

[28] See J. Buckland and T. Martin, *The Rise of Fringe Financial Services in Winnipeg's North End: Client Experiences, Firm Legitimacy and Commmunity-Based Alternatives* (Winnipeg: Winnipeg Inner-city Research Alliance, August 2003) ("WIRA Report"), p. 29: "Most of the respondents were unaware of the charges for this service [payday loans]."; G. Elliehausen & E. Lawrence, Payday Advance Credit in America: An Analysis of Customer Demand, April 2001, Credit Research Center, McDonough School of

"Negative externalities" are another reason for interference under the market theory. A negative externality is a social cost that arises from the activities of two consenting (contracting) parties which costs are not factored into the transaction. With payday loans, there is at least anecdotal evidence of the creation of debt treadmills (usually from some form of "rollover"), use of payday loans as a source of long term credit (revolving or open credit), a disproportionate effect on lower income debtors and excessive stress on borrowers.[29]

There are other facts that may indicate a market failure now or in the future. Despite the increase in the number of lenders, there seems to be little evidence of falling prices. Given the demonstrated (growing) profitability of the industry,[30] this may indicate a market failure.

Of course, under classical economic theory, this explosive growth and high price is simply the playing out of the law of demand: there is still a great need for short-term credit amongst lower-to-middle-income earners. However, when the market reaches saturation, upcoming revenue requirements may push lenders to alter business models to embrace more aggressive and profitable lending practices, such as rollovers and encouraging repeat borrowing, even in the face of regulatory restrictions.[31]

Social Welfare Theory / PAE Economic Theory

"Post-autistic economics" (PAE) is a movement rejecting the narrowness of neo-classical economic analysis. PAE relies upon market observation rather than an abstract theory of equal seller and buyer forces. PAE allows for "irrational" acting of individuals in the marketplace. Ramsay has already suggested that borrowers in the AFS market exhibit "bounded rationality" for a number of reasons, namely the short term of the loan, the instant provision of cash, and the small amount of the loan. These effects are not limited to borrowers in the AFS, however, the AFS, and particularly payday lending have a number of these factors in combination, making the market particularly open to manipulation on price. PAE also more easily accepts evidence of market abuse in the sense of a wider view of negative effects upon consumers. There is ample evidence in the U.S. of

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Business, Georgetown University, p. 36-7 (only 33.5% of survey respondents correctly stated payday loans were more expensive than credit card debt, 29% stated they were the same, 24.4% stated payday loans were *cheaper* than credit card debt and 13.1% didn't know); PIAC Report 1, p. 44: 20% underestimated cost of payday loans, 21% did not know, 8% correctly estimated, 8% overestimated.

[29] WIRA Report; PIAC Report 1.

[30] For example, see Dollar Financial Group Inc. 2003 SEC 10-K filing, p. 25, "$7.8 million [U.S.], or 34.2%, increase in revenues in Canada resulting from higher lending volumes and increased finance charges".

[31] Recently Kansas regulators sought to use licensing conditions to control two Nevada-based Internet payday lenders: "State orders two online lenders to stop doing business" Wichita Eagle, 13 November 2003. Online: http://www.kansas.com/mld/kansas/business/7248041.htm.

abusive industry practices such as reckless overlending and aggressive collection practices.

The concepts of “merit goods” or “demerit goods” are also accepted by PAE. A “merit good” is one that is intrinsically beneficial to society, even outside of its measurable economic “cost”. Access to small, short-term credit can be viewed in this light. Demerit goods, by contrast, are intrinsically harmful to a society, again outside of pure “cost”, and can be regulated simply due to their serious nature. An example is tobacco regulation. However, some have suggested payday loans are an intrinsic “demerit good” – being designed to extract money from the poorest wage-earners. There is, unfortunately, this “janus good” quality to payday loans – they both seem entirely necessary short-term loans (merit goods) and entirely evil debt-treadmill inducing loans (demerit goods) at once. One approach to dealing with a janus good is balanced regulation, as it can be argued that given a particular set of circumstances access to credit can be crucial, while in another set of circumstances, excruciating.

Groups affected by Regulation (Consultation)

Modern regulatory regimes require consultation with stakeholders in any regulatory proposal. The following groups would likely be the most affected by the regulation of payday loans:

1. The payday loans industry and eventual new entrants.
2. Borrowers and their immediate families.
3. Mainstream credit providers (banks, credit unions, other AFS lenders).
4. Social services and credit counseling services in particular.
5. Federal and provincial governments.
6. Police forces.

Every attempt has been made in the below to consider the issues from the perspectives of these stakeholders, and to involve them in discussion of this Report, however, the effect upon consumers is the main focus.

Consumer Response

As noted, at least one major payday lender in Canada desires regulation. Consumer advocates desire regulation as well. Borrowers appear to understand that payday loans and other AFS loans are not cost-effective.[32] Still, more research should be undertaken regarding borrowers attitudes to regulation of payday lending.

Goals of Regulation

[32] Report 1, Winnipeg Inner-city Research Alliance Report, p. vi.

Given this report's conclusion that regulation is required, what are the overall goals of such regulation? Our research has indicated that consumers would be best served by properly balancing the following regulatory goals:

- Encourage availability of short-term (high risk) credit to lower income individuals and the unbanked
- Encourage a socially responsible industry; with no reckless or predatory lending
- Ensure consumer price protection: reasonable rates should be assured through rate caps or otherwise
- Protect consumers from misleading advertising and abusive collection techniques
- "Deepen" payday loan offerings and offerors (encourage entrance of banks and mainstream financial institutions)
- Ensure disclosure of cost of credit, in keeping with financial transparency in other areas of the credit market
- Encourage uniformity across Canada (but allow flexibility to permit more particular requirements and different provincial cultures – e.g. Québec)
- Allow borrowers access to mainstream credit (most likely through the creation of a small loans registry and attendant positive small loan credit ratings)
- Encourage borrowers to develop savings possibilities
- Educate borrowers as to relative costs of payday lending and other borrowing
- Design regulatory environment to be
  - extensible to other parts of AFS market such as pawnbroking
  - durable: not requiring constant adjustment or be open to excessive lobbying
  - enforceable and accountable – stop avoidance techniques, create level playing field, ensure adequate enforcement

What Form Should Regulation Take?

What form should regulation of payday lending take to best achieve these goals? Fortunately, regulators in Canada are not working in the dark on the issue of payday lending regulation, as there have been several examples of fairly highly-regulated jurisdictions. Many jurisdictions regulate only payday loans, separately from other AFS aspects like pawnshops, rent-to-own and consumer products credit.

One model to regulate payday lending is the complete regulator model with licensing of lenders, and full regulation scheme overseen by a dedicated regulator, in accordance with a specific law outlining payday lending requirements. This first model has been attempted in South Africa. A less extensive regulatory model has been pursued in most U.S. states which have "legalized" payday lending, with minimal regulatory requirements such as caps on fees and rollover limits and many variable additional requirements. These state laws usually involve a licensing requirement. Another model sees a very

minimal licensing regime with oversight by a financial services commissioner (with or without a voluntary industry code of conduct). This exists in some states such as New Mexico.

South African MFRC Experience

Until the fall of apartheid, formal loans to the working poor, overwhelmingly from the black majority, were almost non-existent. Informal credit systems did exist but were inadequate to fund the flood of consumer pressures that flowed into South Africa upon the fall of the apartheid system. In short, South Africa in the 1990s was a perfect environment for the growth of payday lending.

South Africa's AFS sector grew rapidly. However, as in Canada, interest on loans above a certain level was, and still is, prohibited by the *Usury Act, 1968*. South Africa responded to this conundrum in 1992 with a system whereby small loans (6,000 Rand – approximately $1000)) could be made under an Exemption from the *Usury Act*. The Exemption Notice was revised upwards in 1999 to 10,000 R ($1900) and limited to loans made for a term of 36 months or less (excluding credit cards and bank overdraft on chequing accounts).

Interestingly, there was an interest rate cap on exempt loans under the Exemption Notice, which purported to limit allowable interest in an amount 10 times the average overdraft rate of the major South African banks. In effect, this works out to a floating rate of about 300%-400%. However, in a legal action by payday lenders challenging the regulation of the industry, the rate cap was struck down by the court. South Africa therefore has no interest rate cap for lenders qualifying under the *Usury Act* Exemption Notice.

The Exemption Notice, however, not only legalized these loans but also set out what are in effect regulatory requirements as conditions of qualifying under the Exemption Notice. Some of these are:

- Confidentiality requirements
- Disclosure requirements such as: providing copies of the loan documents for perusal prior to the loan being advanced; providing copies of the Exemption Notice Rules; providing cost of credit disclosure on all charges under the loan; statement of the APR
- Standard contractual loan documentation mandated or approved by the regulatory institution
- Requirements to print Exemption Notice lending rules on contracts, provide copies of contracts at the time of lending and to print toll-free complaint numbers on contracts
- Certain restrictions on communications with credit bureaus; right of rescission, right of prepayment
- Restrictions on certain collection practices such as retaining bank cards and PINs and signing of legal process documents in blank

- Recently, new requirements to submit loans details to the "National Loans Register" (NLR) – an independent credit reporting system for small loans and a rule against "reckless lending", which requires the lender to consider the borrower's ability to repay (with the assistance of the NLR) and still meet living expenses

The Exemption Notice makes exemption conditional upon the lender being "registered with a regulatory institution" and then sets out a number of requirements for regulatory institutions of payday lenders, in effect setting out the entire regulatory scheme without the need to pass a specific statute. Some of the regulatory institution requirements as set out in the Exemption Notice are to:

- Register lenders and ensure compliance with the Exemption Notice and rules
- Respond to public complaints
- Deal with licensing applications, renewals, suspensions and revocations; lender discipline; as well as any appeals by borrowers or lenders from dispute resolution systems
- Educate and inform the general public about their rights and obligations
- Annually publish information on the payday loans industry, including types and amounts of charges by lenders in a comparable format
- Collect complete information and statistics on lenders and complaints
- Provide the Minister with an annual report on lenders and on the regulator's actions
- Review the effectiveness of the system and provide recommendations for change to the Minister

Although theoretically any body meeting the Exemption Notice requirements for a "regulatory institution" could register lenders in competition, in fact only one regulator exists in South Africa: the Micro Finance Regulatory Council (MFRC).

The MFRC has undertaken all of the activities required in the Exemption Notice and appears to have discharged them fairly admirably.[33] Microcredit is now available and deceptive credit as well as high-handed and destructive collection practices now are under control. Mainstream financial institutions have entered the market via subsidiaries, broadening consumer choice and demonstrating that reasonable profit on reasonable terms can be made in the consumer credit market by these (and of course other) lenders. All this, and the MFRC is, as required by the Exemption Notice, largely self-funded by lender fees.[34]

One particular failing, however, related to the lack of power in the MFRC to police those lenders who did not purport to be exempt under the Exemption Notice. In short, these "unregistered" lenders were, and still are, competing directly with

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[33] See, for example, the MFRC Third Annual Report at: http://www.mfrc.co.za/files/mfrc_a_report_000703.pdf.

[34] *Ibid.*, at p. 24. Lender fees make up nearly 75% of operating revenues and the remainder consists of development grants and transfers from the Department of Trade and Industry.

registered lenders, yet until recently the MFRC had no jurisdiction to regulate the activity. This has now been rectified by the *Usury Amendment Act*, which came into effect on 23 April 2003. "It extends the MFRC's inspection powers to include unregistered lenders and will ensure that the unacceptably high level of unregistered micro lender activities are decisively addressed."[35]

Obviously the cultural and social differences between Canada and South Africa make direct comparison difficult, however, there are many similarities between average borrowers in each country:

> One could contrast this [microcredit clients in developing countries] with the average microfinance client in South Africa, who is an employee of a government or private sector institution, earning a monthly income of between 1000 and 5000 rand per month. He is paid through a bank savings or "transmission" account, but his low level of income precludes a bank loan. He works for others, lives in an urban or peri-urban area, and is suffering from a declining real wage level with few alternatives. The needs of this individual are far different from those of a poor rural laborer or a budding microentrepreneur. Superficially, the South African client group overall is less entrepreneurial and more risk-averse than microfinance clients elsewhere—but the availability of paid employment surely explains most of this.[36]

In addition, the above-quoted study concludes that unlike borrowers using microfinance in developing countries, South Africa borrowers tend to obtain small loans for the following reasons, which are very reminiscent of the conclusions for the reasons given by Canadian borrowers for taking out payday loans:

> The average South African micro borrower will use his loan for education costs (also an investment human capital, but of a different order), housing, purchase of durable goods for his home, consumption, an emergency such as a family illness or death or robbery, or onlending to a relative for microenterprise or other income generation purposes.[37]

Certainly, at the least, the South African "full regulatory" model bears considerable scrutiny by Canadian regulators. It is an approach which appears to be working (credit is available) while controlling the worst abuses by lenders by specifically regulating the payday lending industry. It is also a system that grew out of an exemption from a general usury law, which otherwise stays in place to police unauthorized lending. It is just such an exemption that presently is being considered by Canadian regulators.

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[35] MFRC Third Annual Report, at 1.

[36] P. Meagher and B. Wilkinson, Filling the Gap in South Africa's Small and Micro Credit Market: An Analysis of Major Policy, Legal, and Regulatory Issues, IRIS Center, University of Maryland, Revised Report, September 26, 2001 ("Iris Report"), at p. 10 (footnotes omitted). Online: http://www.mfrc.co.za/files/iris_report.doc.

[37] Iris Report, p. 10 (footnotes omitted).

Australian Experience

Like Canada, Australia has a federal system which, until recently, impeded efforts to regulate payday lenders. Valuable lessons in implementing a payday lending regulation can therefore be gleaned from this highly comparable experience.

Like Canadian provinces, Australian states have jurisdiction over local property matters. The federal government, however, retains rights to regulate crime, including criminal interest rates. Nevertheless, significant harmonization has taken place between the states with regard to financial matters under the Commercial Code system, described below.

As in Canada, payday lenders in Australia at first avoided direct regulation. The *Consumer Credit Code*, which otherwise exhaustively regulates consumer loans, and applies across the Australian states and territories, exempted loans with terms under 62 days. This exemption was originally intended for short-term bridge financing and trade credit agreements. However, this definition neatly coincided with the average term range of payday loans, effectively permitting the industry to grow.

Australian regulators responded rapidly. In the state of Queensland the Minister of Fair Trading assembled a task force to report on payday lenders which had 5 terms of reference:

- Investigate the size of the pay day lending market;
- Investigate the lending practices within the pay day lending market;
- Establish the real cost of pay day loans by reference to an annual percentage rate;
- Identify the types of consumer borrowing money from pay day lenders; and
- Develop options and make recommendations for the regulation of payday lending in Queensland.[38]

The Task Force considered six options: status quo – no regulation; voluntary industry code of conduct; regulation under the *Consumer Credit Code*; licensing; interest rate caps; and outright prohibition.

After a period of consultation with consumer groups, industry leaders and legal professionals, the Task Force settled on amending the *Code*.[39] The amendments "clos[ed] a loop-hole in the *Consumer Credit Code* that allows payday lenders to

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[38] See "Fair Trading", *infra*, next note, at 2.

[39] Queensland, *Pay Day Lending – A Report to the Minister for Fair Trading*, (August 2000) online: Office of Fair Trading homepage <http://www.consumer.qld.gov.au/oft/oftweb.nsf/AllDocs/3A1B0FBCF63EE9FA4A256B4400317450/$File/36.pdf> p.12 [herinafter "Fair Trading"] at pp. 20-30.

operate in an unregulated way."[40] The exemption from the Code for loans under 62 days was limited to loans where fees and charges do not exceed 5% of the value of the loan and the interest rate charged is under 24%.[41] Since these interest rates and charges are not reflective of those charged by the payday loan industry, the effect of the amendment is that all payday loan transactions now are subject to the code.

The *Code* provides consumer protection to consumers who borrow money, requiring that:

- lenders fully and frankly disclose the terms of the loan before the consumer signing the loan contract. This includes the fees and charges payable, the interest rate, the amount of the repayments, the term of the loan and whether security is required;
- loan contracts be in writing;
- lenders provide the consumer with a copy of the loan;
- lenders properly account for repayments made;
- lenders ensure that the borrower can repay the loan without substantial hardship;
- restrict the types of security that can be demanded; and
- prevent a lender from taking court or recovery action against a borrower without first contacting the borrower and providing the borrower an opportunity to make good any arrears or default.[42]

The Queensland version of the *Code* was proposed for acceptance by all of the states, as is the procedure with amending the *Code*. However, certain omissions in the Queensland proposals, especially the absence of an interest rate cap, attracted the attention of other state regulators.

STATE INTEREST RATE CAPS

In an unusual state-to-state divergence, payday lending is presently regulated differently depending on the state. The state of New South Wales[43] has

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[40] Queensland, Office of Fair Trading, press release, "Payday Lending Amendments", online: Office of Fair Trading homepage <http://www.consumer.qld.gov.au/OFT/OFTWeb.nsf/Web+Pages/60A1543C7C3E5DEB4A256B44001B7FBA?OpenDocument> [hereinafter "Queensland Press Release"].

[41] *Consumer Credit (Queensland) Act*, 1994, s.7.1, online: <http://www.legislation.qld.gov.au/LEGISLTN/CURRENT/C/ConsuCredit_Qld_A94_01A_.pdf>

[42] Queensland Press Release, supra note 24.

[43] NSW eagerly adopted the changes to the Code months before the rest of Australia. "Normally changes to the Uniform Consumer Credit Code come into force throughout Australia simultaneously after being passed through the Queensland Parliament. Due to delays caused by the Queensland election, [NSW Fair Trading Minister] was not prepared to wait for…the reforms. However, the NSW bill will be repealed when the Queensland legislation is passed." New South Wales, Department of Fair Trading, press release, "Payday Lender Law Introduced into Parliament", (11 April 2001), online: http://www.fairtrading.nsw.gov.au/secondarymenus/aboutnswfairtrading/20010411paydaylenderlawintroducedintoparliament.html. However, the NSW regulation capping interest rates has not, however, been

incorporated an interest rate cap into the *Code* through regulations,[44] as has the state of Victoria,[45] and the Australian Capital Territory. Interestingly, the Task Force recommended NSW and Victoria remove this limit[46] as it threatens to undermine the sustainability of the payday lending industry in these states. To date there has been no indication that these rate caps will be lifted nor have there been any prosecutions under the cap. In addition, it appears payday lenders are continuing to operate in NSW and Victoria despite rate caps.

Dispute Resolution Mechanisms

The *Code* is heavily reliant on the actions of borrowers to regulate the payday loan industry. It is an offence to contravene the requirements of the *Code* and the Minister of Fair Trade can sue credit providers, independently or on behalf of consumers.[47] However, the resources of the government are limited. Only the most extreme violations attract the attention of the Minister, leaving most borrowers to their own devices. Since a "contract is not illegal, void or unenforceable because of a contravention of this *Code*"[48] the potential recovery for the average borrower is not great. In fact, the *Code* expressly limits damages to the amount of interest paid by the borrower and any damages arising from the contract.[49] The vast majority of borrowers could at best expect a judgment of $200 (Aus.) if not less;[50] an amount that is generally not worth pursuing. Therefore, in the absence ministerial intervention, payday lender regulation probably is not effectively enforced under the current amendments to the Code.

Fortunately, the NSW version of the *Code* confers the jurisdiction to hear disputes upon both the courts and the new Consumer, Trader & Tenancy Tribunal (CTTT).[51] The role of the CTTT is to provide an independent, low-cost and accessible dispute resolution forum to the people of NSW who are parties in consumer or tenancy disputes.[52]

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repealed, and in fact has been re-enacted under a new regulation: *Consumer Credit (New South Wales) Special Provisions Regulation 2002,* NSW Reg. 2002-583, ss. 7-10, replacing the *Consumer Credit (New South Wales) Special Provisions Regulation 1996*. The regulation of interest rates is required by the *Consumer Credit (New South Wales) Act 1995*, s. 11.

[44] *Consumer Credit (New South Wales) Special Provisions Regulation 2002* NSW Reg. 2002-583, s. 7.

[45] Victoria's interest rate limit is also 48% APR, although this appears to stem from another statute than the Consumer Credit Code.

[46] Fair Trading, *supra*, at 32.

[47] *Consumer Credit (Queensland) Act, supra*, at s.110-111.

[48] *Consumer Credit (Queensland) Act, supra,* at s. 170.

[49] *Consumer Credit (Queensland) Act, supra*, at s. 103.

[50] Unless there were an interest rate cap, as in NSW. In this case, the amount of interest above the allowable interest rate is recoverable, making the action more worthwhile to the borrower. See for example: *Moore* v. *Fast Access Finance*, [2002] NSWCTTT 591 (23 December 2002) at ¶32 (available via AUSTLII website: http://www.austlii.org).

[51] *Consumer Credit (NSW) Act,* 1995, s. 8, online: <http://www.austlii.edu.au/au/legis/nsw/consol_act/ccswa1995346/>.

[52] Consumer, Trader & Tenancy Tribunal (CTTT) homepage, online: <http://www.fairtrading.nsw.gov.au/secondarymenus/cttt.html>.

Borrowers can avail themselves of the CTTT services for a relatively low cost. All applications under the *Code* are heard for $62.53 (Aus.) and there is no fee for applications regarding charges on the grounds of hardship or postponements of enforcement proceedings.[54] In addition, the CTTT has the prerogative to waive application fees where it "considers that there are special reasons for so doing".[55] In disputes of not more than $10,000, the tribunal will only award costs in exceptional circumstances.[56] The services of the CTTT are inexpensive and accessible. Applications can be made at over 100 locations throughout NSW, by post, fax or email.

The level of formality in CTTT hearings benefits consumers in the payday loan industry. Generally, tribunals are not bound to the rules of evidence and are required to act with as little formality as possible; without regard to technicalities.[57] To further correct the imbalance of power and lower costs, parties to disputes of not more than $10,000 are not entitled to representation by a legal practitioner in the absence of an exceptional circumstance.[58]

However, to date there has been no recourse to the tribunal by payday borrowers. Perhaps this may be due to recovery being limited to illegal fees and interest. Interestingly, the Queensland Office of Fair Trading states in consumer information documents that a lender breaching the *Code* (in Queensland) may be ordered to forgo repayment of, or refund, the principal of any loans with illegal fees, interest or terms.[59] This does not seem supported by the *Code* (in Queensland), and there appear to be no cases by the Queensland courts or Queensland Small Claims Tribunal making such an order.[60]

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[53] *Consumer, Trader and Tenancy Tribunal Regulation,* New South Wales, *2002,* s.11.1 (d) 1. (ii), online: <http://www.pco.nsw.gov.au/extracts/02/2002-79.pdf>.

[54] *Consumer, Trader and Tenancy Tribunal Regulation, supra,* s. 11.1 (d) (iii).

[55] *Consumer, Trader and Tenancy Tribunal Regulation, supra,* s. 12.

[56] *Consumer, Trader and Tenancy Tribunal Regulation, supra,* s. 21.

[57] New South Wales, "Introducing the new CTTT", Pamphlet, (February 2002), online: <http://www.fairtrading.nsw.gov.au/pdfs/secondarymenus/cttt/ctttdl.pdf>.

[58] *Consumer, Trader and Tenancy Tribunal Act,* New South Wales, 2001, s 36, online: <http://www.austlii.edu.au/au/legis/nsw/consol_act/ctatta2001361/>.

[59] http://www.consumer.qld.gov.au/OFT/OFTWeb.nsf/AllDocs/F4A7C8A2096BA7284A256C8E00286515/$File/Payday%20lending.pdf

[60] The OFT may be relying upon s. 114 of the Code which reads:

> **114 Civil effect of other contraventions**
>
> (1) If a credit provider contravenes a requirement of or made under this Code (other than one for which a civil effect is specifically provided by Division 1 or by any other provision of this Code), the Court **may order the credit provider to make restitution or pay compensation to any person** affected by the contravention and, in that event, may make any consequential order it considers appropriate in the circumstances. [Emphasis added.]

This provision is not clear as to what "restitution" might be nor the limit of any compensation. Again, it may be one must wait for judicial interpretation of whether the principal can be recovered or refunded.

RECENT DEVELOPMENTS – COMPARISON RATES

The *Consumer Credit (Queensland) Amendment Act 2002* has inserted into the *Consumer Credit Code* a new Part 9A, which provides for the mandatory disclosure of “comparison rates”. Comparison rates are required:

- in advertisements for fixed term credit which feature an annual percentage rate, and
- in comparison rate schedules which are to be made available to consumers.

In effect, the comparison rates are a formula, based upon nominal annual interest rates, which also take into account repayment periods and other factors not usually considered in the calculation of an Annual Percentage Rate. The comparison rates regulation requires the lender to provide copies of sample rate charts with typical loan costs. Loan costs must be expressed as a “comparison rate” to all consumers prior to completing a loan, either by making them available at the lender’s physical storefront or displayed on a screen when accessing loans electronically or through the Internet.

Comparison rates are, in effect, a very sophisticated form of cost of credit disclosure intended to make comparison of different credit products more possible. The comparison rates are accompanied by warnings as to the possible limitations of their usefulness. For example, comparison rates do not include charges that are unascertainable due to reliance upon future events, and comparison rates may not reflect other benefits of taking a loan with a particular provider, such as service perks or reductions on other products. Whether this advance in the sophistication of “truth in lending” regulation will aid borrowers should be closely monitored.

RECENT DEVELOPMENTS – FURTHER REGULATORY REFORM OF PAYDAY LENDING

The inclusion of payday lending in the *Consumer Credit Code* is not the final regulatory step to be undertaken in Australia. Recently, the Office of Fair Trading and the Ministerial Council on Consumer Affairs have released "Fringe Credit Providers – Discussion Paper" calling for comments by 10 October 2003.[61] The discussion paper in particular concentrates on payday lending regulation. Its goal is "further reform" to address such areas of concern as:

- the refusal by some fringe credit providers to disclose annual percentage rates to assist borrowers in understanding the true cost of loans and to make comparisons with products of other credit providers;
- the imposition of fees that translate to exorbitant rates of interest;
- fringe credit providers taking security over essential household items; and
- fringe credit providers insistence on and use of direct debit authorities.[62]

Regarding APRs, for those lenders charging a flat fee for a payday loan, the Discussion Paper concludes the *Consumer Credit Code* is not clear that this fee that is to be treated as interest (unlike under s. 347 of the Canadian *Criminal Code*). (APRs must, however, be revealed under the *Code* for loans with a clear interest component.)[63] Although this oversight is perhaps less important now given the development of the comparison rates sheets, it is one which the Discussion Paper suggests should be clarified to force payday lenders to reveal an APR.

Regarding interest rate caps, the Discussion Paper notes payday lenders in some states are applying the avoidance technique of replacing high interest charges with up front fees to achieve a higher effective rate of interest.[64] This is not possible in NSW, where all fees must be included in the calculation of APRs and comparison rates.[65] The Discussion Paper takes the position that all fees should be included in APR calculation to counter such avoidance schemes. However, the Discussion Paper concludes that a "national interest rate cap is not supported" and that states will be free to implement or lift interest rate caps as they see fit.[66]

Most ominously, the Discussion Paper concludes there is a major problem with payday lenders requiring direct debit authority from a borrower's bank account as

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[61] See full Discussion Paper at: http://www.consumer.gov.au/html/download/fringe_discussion_paper.pdf

[62] Discussion Paper, p. 2.

[63] See *Consumer Credit Code*, s. 15(C).

[64] Discussion Paper, pp. 42-43.

[65] *Consumer Credit (New South Wales) Act 1995*, s. 11(1A) and *Consumer Credit (New South Wales) Special Provisions Regulation 2002,* NSW Reg. 2002-583, s. 8.

[66] Discussion Paper, p. 43.

a condition of the loan application.[67] This is known as "pre-authorized payment" in Canada. It basically allows the lender to make an electronic request for payment from the borrower's account according to the terms of the agreement. Problems identified by the Australian regulator include continuing to debit an account after the loan has been repaid and debiting an incorrect amount. The Discussion Paper proposes to tackle this problem through greater disclosure to be required by the *Code*, namely:

- the credit provider would be required to disclose the following in writing:
  - the consumer can cancel a direct debit authority at any time by contacting their bank;
  - the consumer can lodge a complaint with their bank if there has been an unauthorised debit (for example, accessing the account on days not specified on the authority or for amounts not specified on the authority); and
  - the consumer can contact the Australian Banking Industry Ombudsman . . . for assistance in resolving complaints regarding unauthorised debits.

This "disclosure" approach appears inadequate in Canada, especially for payday lenders operating largely through websites as opposed to storefronts. These "virtual payday lenders" often now require a direct debit authority (DDA) to get a loan (online). Unfortunately, if there are insufficient funds at the time of transfer, the financial institution will charge an NSF fee (as may the lender). However, unlike a dishonoured cheque, with a direct debit authority the lender may try to re-perform the withdrawal several times a week or even several times in one day – each time incurring for the borrower an NSF fee from his or her financial institution (typically $25 in Canada). Either this type of abuse requires an outright ban on taking DDAs by payday lenders, or limits on withdrawal attempts such as only 2 permissible attempts, with time between attempts (perhaps 2 days) and a requirement to contact a borrower about possible problems with payment. At the least, the borrower must have the option of paying in another fashion (by a physical cheque, by cash, or by Internet post-dated authority).[68]

Overall, the Australian Discussion Paper has proposed only modest amendments which will better regulate the industry but which do not tackle it in the wholehearted manner of South Africa's MFRC.

Australia's approach, coming as it does from a federal country similar to Canada, gives us a possible preview of legislation in this country. However, even in the more centralized Australian situation, with its *Consumer Credit Code*, it is worth

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[67] Discussion Paper, pp. 30-32.

[68] Internet banking with post-dated payment dates selected by the user, for example from Royal Bank, will attempt to pay from an account 3 times on the day appointed for payment. However, the bank will apply NO CHARGE if there are insufficient funds and since the direction is from the customer to the bank (not the payday lender) additional attempts to debit the account cannot be made without customer authorization.

noting that the problem of variation between states on key aspects such as interest rate caps can still occur. We should expect a similar divergence of provincial opinions on interest rates if the provinces are left to decide the matter themselves.

U.S. Experience

The United States has become a regulatory battleground for proponents and opponents of payday lending. Regulation of these lenders is largely a matter of state jurisdiction (with the important exception of Federal paramountcy under national banking legislation). As noted in Report 1, state usury laws are largely being repealed at the behest of payday lender lobbies.[69] There is a great variety of response to the repeal of state usury laws, however, most jurisdictions have imposed at the least licensing, and in certain states, more or less direct regulatory control. Differences in the legal culture between Canada and the United States make a direct comparison of the legal frameworks for regulation difficult; however, the policy challenges faced in these regulating jurisdictions hold lessons for Canadian regulators.

Recently, California, Virginia and Alabama have passed comprehensive regulatory laws controlling payday lending.[70] Several states have had extensive experience regulating the industry already, and none more so than North Carolina.

NORTH CAROLINA – TRYING TO (RE-)REGULATE

Payday lending is presently illegal again in North Carolina, being a violation of state usury law.[71] However, until August 31, 2001, payday lending was legalized and substantially regulated by a law which "sunset" on that date.[72] This law had allowed fees of up to 15% on small loans, which were limited to $300. It also provided for a maximum term to maturity of 31 days and a prohibition of rollovers.[73]

During the nearly 4 years during which the industry was regulated,[74] North Carolina's Commissioner of Banks took an active role in disciplining the industry and in documenting its practices. What occurred in North Carolina was an experiment and provided lessons for further study.

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[69] *Ibid.*

[70] Source: National Conference of State Legislatures, online: http://www.ncsl.org/programs/banking/paydaylend-intro.htm#legislation , accessed August 19, 2003.

[71] P. Skillern, "Small Loans, Big Buck$: An Analysis of the Payday Lending Industry in North Carolina" (Durham, N.C.: Community Reinvestment Association of North Carolina, 2002), online: http://www.cra-nc.org/small%20loans%20big%20bucks.pdf) at p. 1.

[72] M. Stegman and R. Faris, "Payday Lending: A Business Model that Encourages Chronic Borrowing" (2003) 17 Economic Development Quarterly 8 at 9. Also available online: http://www.kenaninstitute.unc.edu/Centers/CCC/CCC_Publications_Presentations/PaydayChronicEDQ.pdf

[73] N.C. Gen. Stat. § 53-275 et seq.

[74] In 1997, the NC Legislature enacted N.C.G.S. § 53-281 to licence and legalize payday lending.

One result of North Carolina's industry regulation was the showing that payday lending did not flee the state, and that short-term credit continued to be offered to borrowers in the state after regulation.[75] There was an explosive growth in licensees and locations.[76] There was also a substantial year over year growth of payday loans and fees.[77]

The Commissioner also made some important empirical findings. The Commissioner found 72% + of loans were for 14 days or less.[78] Two-thirds were for $201-$300 ($300 being the maximum). Most borrowers took out loans frequently during a year.[79] (The study figures did not include data on whether any loans were back-to-back, or whether borrowers simply sought out multiple simultaneous loans from different lenders to pay off other payday loans.)[80] In addition, there was a hard core group that were effectively using payday loans as "revolving credit". These hardcore borrowers used payday loans 19 or more times a year, accounting for fully 14% of borrowers.[81]

In effect, the N.C. Commissioner's figures support the payday lending opponents' claims that payday lending is not targeted to occasional use but rather to "chronic borrowing".[82] The Commissioner also discovered considerable industry resistance to regulation by the law, [83] and numerous breaches of it,[84] even by licensed lenders. The Commissioner made a number of recommendations to strengthen the law aimed at providing borrowers more credit disclosure, limiting lenders' ability to threaten a criminal bad-cheque prosecution and providing the Commissioner with more enforcement power.

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[75] See REPORT OF THE COMMISSIONER OF BANKS TO THE NORTH CAROLINA GENERAL ASSEMBLY ON THE SUBJECT OF PAYDAY LENDING (February 22, 2001), online: http://www.banking.state.nc.us/reports/ccfinal.pdf (the "2001 Report") and 2000 ANNUAL REPORT OF CHECK CASHING BUSINESSES LICENSED UNDER ARTICLE 22 OF CHAPTER 53 OF THE NORTH CAROLINA GENERAL STATUTES - FACT SHEET (online: http://www.banking.state.nc.us/cc/cccon00.pdf), (the "2000 Report"). Note as well that confusingly, the 2001 Report uses 1999 and prior data, while the 2000 Report provides 2000 data.

[76] 2001 Report, Table IIIE, notes a growth from 71 to 242 licensees and 307 to 1204 branches from late 1997 to 2000. Licensee figures included those offering cheque cashing only, payday loans only, or both.

[77] 2000 Report (with 2000 data) indicated $123 million in fees on in 2000 compared to $96 million in 1999 (2001 Report, with 1999 data) and face value of cheques increasing from $649.5 million to 834.7 million.

[78] 2001 Report, Table IIIB.

[79] Table IIIF of the Report shows figures ranging from 9% of borrowers (2 loans) down to 2% of borrowers (18 times), with only 13.2% using payday loans only once in a year.

[80] Annual Report, 2001, p. 5.

[81] In 1999 (See 2001 Report. 2000 figures (from 200 Report) are similar).

[82] See M. Stegman and R. Faris, "Payday Lending: A Business Model that Encourages Chronic Borrowing", *supra*, note 57.

[83] As is apparent from the 2001 Annual Report, the licensees were not required to provide information on their loans to the Commissioner, nor to cooperate with the Office's investigations of complaints.

[84] There were a total of 8911 violations of the law found by the Commissioner, totaling $550,249.20 in unauthorized charges during the life of the N.C. law. (Report, Table IIA).

As noted, on August 31, 2001, legislators allowed the law to sunset, effectively making payday lending illegal once more.[85] Although the Commissioner of Banks has attempted to halt payday lending in the state, this has not happened. Larger payday lenders simply partnered with national banks, effectively allowing them to operate in N.C. under the protection of the federal Bank Act (known by payday lending opponents as "rent-a-bank"). The Commissioner of Banks responded by bringing injunction proceedings in the state court system against one rent-a-bank payday lender, seeking to halt the payday lender's agency arrangement with the bank.[86] The payday lender promptly issued its own injunction proceedings in federal District Court seeking to halt the Commissioner's lawsuit, on the basis of federal paramountcy of the banking legislation.[87]

With this backdrop, two bills are presently before the N.C. General Assembly seeking to reintroduce payday lending regulation.[88] The new Bill that is most likely to pass has these features:

- requires state licensing;
- requires a written agreement; payday lending deemed a loan;
- re-imposes the 15% limit on fees (but this time capping the fees at $40 on any loan instead of $45 on $300 in the past);
- imposes a warning against relying upon payday loans as a revolving or long-term credit solution;
- gives a right of rescission within the next business day;
- imposes all federal *Truth in Lending Act* requirements on state payday loans (including statement of the APR as required by Reserve Board Regulation Z);
- imposes restrictions on provisions in aid of litigation or collection such as hold harmless clauses, confession of judgment clauses, mandatory arbitration clauses (except as permitted by the American Arbitration Association), waiver of borrower claims or defences;
- prohibits waiver of the N.C. law itself;
- prohibits lending to borrowers with outstanding payday loans in amount of $300 aggregated, or who have 3 outstanding loans (lenders are expected to use a "subprime credit reporting service" to check this and the borrower must certify there are no other outstanding loans above this limit);

[85] Memo from Hal D. Lingerfelt, Commissioner of Banks to the Industry, dated August 30, 2001. Online: http://www.banking.state.nc.us/reports/payday31.pdf

[86] N.C. v. Ace Cash Express Inc. Complaint online: http://www.banking.state.nc.us/cc/nccompl.pdf

[87] Goleta National Bank and Ace Cash Express Inc. v. Lingerfelt and Cooper Complaint online: http://www.banking.state.nc.us/cc/goleta.pdf

[88] House Bill 1005, "An Act to Authorize and Regulate Deferred Deposit Loans by Providing Consumer Protections and Disclosures" (Barnhart, et al.) and House Bill 1213 "An Act to Regulated Deferred Deposit Transactions and to Provide Additional Consumer Disclosures and Protections" (Culpepper/Grady). Both online at: http://www.ncleg.net Both bills have extensive provisions and protections in addition to the regime which existed prior to the previous law's sunset. Bill 1213 has advanced to the Senate and appears likely to become law.

- a mandatory repayment plan where a borrower informs the lender before maturity of an inability to pay. The repayment plan provides four equal installments to retire the debt spread over the borrowers next 4 paydays (at least 14 days apart). There are other restrictions and requirements on borrowers and lenders under a mandatory repayment plan;
- prohibits certain practices such as taking security, requiring multiple checks, selling credit insurance, tied-selling, threatening criminal process to collect, cooperating with the Commissioner, failing to record borrower activity and positive outcomes to the credit reporting agencies, failing to cooperate with the Commissioner regarding complaints.

There are $10,000 fines per occurrence available to the Commissioner. Borrowers may also bring civil actions. However, a notable omission is that there is no restriction on rollovers.

Consumers in North Carolina must therefore be content with a regime which will ensure basic truth in lending principles, curtail the worst collection excesses and provides a possibility of time to pay (provided they notify the lender prior to default). The results under the new regulation will be intriguing to follow, particularly if the removal of the prohibition on rollovers leads to increasing consumer debt-spirals and bankruptcies.

Lessons may be learned from the North Carolina experience. Legislators should not acquiesce to industry calls to “sunset” hard-earned regulation. Any reintroduction of legislation will likely be weaker and will most certainly attract the full force of industry lobbying. Another lesson is that regulation will allow government to keep clear figures on payday lending volumes and profitability. This information is extremely valuable in gauging the effectiveness of regulation but is unavailable when not in place. Finally, North Carolina’s experience proved that regulation will not scare the payday loan industry out of the market. Payday lenders, as all other businesses, can survive and compete under regulation.

PENNSYLVANIA – ANATOMY OF AN INDUSTRY BILL

Home of Dollar Financial Group Inc. and DFG Holdings Inc. (corporate parents of Money Mart), Pennsylvania is in the midst of a struggle between opponents and proponents of an industry-sponsored payday lending bill.[89] Pennsylvania still has a usury law, the Consumer Discount Company Act,[90] which caps annual interest rates on small loans at 23.75%. Under this Act, almost all payday lending is illegal. [91]

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[89] “Pennsylvania Payday Loan Forum Presentation”, by Jean Ann Fox, Director of Consumer Protection, Consumer Federation of America , September 9, 2003, Harrisburg, PA, a response to House Bill 2348 (Pennsylvania), available from CFA. (“Fox Presentation”). The bill is House Bill 1808, online: http://www2.legis.state.pa.us/WU01/LI/BI/BT/2003/0/HB1808P2348.pdf

[90] 7 P. S. §§ 6201—6219.

[91] Fox Presentation, p. 2.

Nonetheless, payday lenders have been very active in the state until lately under rent-a-bank arrangements with national banks. However, payday lenders are now “feeling the heat” as national banks are confronted by federal regulators looking to outlaw the practice.[92] As a result, the only banks left supporting the payday loan industry in states like Pennsylvania are other state banks which take direction from the Federal Deposit Insurance Corporation (FDIC). This is a somewhat tenuous position, as the FDIC has recently released guidelines for bank inspectors on payday lending similar to those of other federal national bank regulators.[93] Hence the industry’s felt need for “legalization” of payday lending at the state level in Pennsylvania.

Pennsylvania is one of only fifteen remaining states with usury caps, making the result in Pennsylvania a bellwether for the remaining 14 “illegal” states. The Pennsylvania industry bill is “typical” of the legislation being prepared for these states, says industry foe Jean Ann Fox:

> A typical industry bill caps rates at over 450% for two week loans, permits continuous loan flipping, and invokes bad check laws if loans aren’t repaid. Their model may include provisions that sound consumer friendly but don’t do much, such as a right to cancel and return the loan proceeds within 24 hours. Colorado has such a provision in its law and reported that in 2002 less than 1% of customers were able to take advantage of the right to cancel. It is much more likely that consumers won’t be able to repay the full amount on their next payday, much less return the cash the next day.[94]

Pennsylvania’s bill sets its rate at $17.50 per $100 (APR of over 450% on a two-week loan) on loans up to $1000 and 30 days. It requires public posting of “finance charges“. It requires a written loan agreement containing a statement of the APR and all other federal Truth in Lending Act requirements. Criminal prosecution for bad cheque cashing is prohibited, however, and there is a one-day right of rescission. Rollovers are limited to one. When rolling over, however, an additional finance charge of “$0.175 per $1” (*i.e.*, $17.50 per $100) is permitted. Back-to-back transactions are specifically allowed and there is no prohibition on taking out multiple loans from different lenders.

Although this bill is perhaps more open with disclosure of cost of credit than some other industry-sponsored bills, it is extremely generous on the financial aspects of the transaction (Florida’s rate is $10 on $100). Typical borrowers

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92 *Ibid.*

93 See http://www.fdic.gov/regulations/safety/payday/index.html. The Guidelines do not prohibit “rent-a-bank’ arrangements, however, the FDIC counsels: extra capital reserves; vigilance regarding adequate allowance for loan losses; caution against overlending and rollovers; respect for *Truth in Lending Act* requirements including APR statement and warns of “reputation risks” in partnering with payday lenders.

94 *Ibid.*, pp. 3-4.

may not be able to fully use the financial insight that such disclosure should provide (for reasons of lack of choice, failure of the market to provide competitive prices or the borrowers own ‘bounded rationality”). However, borrowers will face difficulties where it counts most – high interest rates.

NEW YORK STATE – FIGHTING RENT-A-BANK LENDERS

Enforcing the law is in vogue in New York state now, due largely to the efforts of Attorney General Eliott Spitzer.
New York has a 16% civil usury cap and a 25% criminal usury cap. Nonetheless, payday lenders operate in the state by partnering with state-chartered FDIC-regulated banks that export other state interest rate limits (for example Delaware’s, that has no limit). This is known as “rent-a-bank” payday lending.

In September 2003, Spitzer filed a lawsuit against two Pennsylvania-based payday lenders and the payday lending state-chartered County Bank of Rehoboth Beach, Delaware for violating the state’s usury limits with the rent-a-bank arrangement.[95] The lawsuit is a direct attack on the rent-a-bank structure. It will test whether exported interest rates will be permitted when the reality of the transaction is that the payday lenders make the loan. At present, these lenders operate under the cover of a formal transaction between the borrower and the bank, where the bank immediately assigns the debt to the payday lender. The New York action has the potential to halt all such rent-a-bank arrangements. Should it be successful, it will greatly increase the efforts of payday lenders in the U.S. states to replace usury laws with payday lending-authorizing laws.

FLORIDA – KEEPING AN EYE ON BORROWERS

Florida has passed a payday lending law, the *Deferred Presentment Act*, in 2001 (effective October 31, 2001). The Florida Act’s innovation is that it not only prohibits rollovers (or back-to-back loans within 24 hours) but has also outlawed simultaneous payday loans.[96] The state was able to do this as it added a requirement to create “a [single] statewide database for use by all licensed providers to capture and track deferred presentment transactions”, which went into effect in February 2002.[97] The prohibition of simultaneous loans of course requires a system to track such loans, which is available to all lenders. The legislation has also mandated the creation of such a database.

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[95] See Press Release: “New York Sues to Stop Illegal Payday Lending Scheme” (New York, NY: September 24, 2003). Online: http://www.oag.state.ny.us/press/2003/sep/sep24a_03.html

[96] The legislation also contains an innovative provision where “[t]he customer may extend the term of the agreement for an additional 60 days after the original termination date without any additional charge provided the customer makes an appointment with a counseling agency within 7 days after the end of the deferment period. The customer must complete the counseling within the 60 day grace period, and comply with the repayment plan established by the counseling agency”: Deferred Presentment Program 2002 Annual Program Report to the Legislature, State of Florida Department of Banking and Finance (online: http://www.veritecs.com/Annualreport.pdf) at 4.

[97] *Ibid.*, at 3.

The Florida law requires a credit check be performed for each state-regulated loan (at a maximum $5 "verification fee"),[98] while rent-a-banks are free not to check the credit histories of borrowers. The official "payday loan credit bureau" is Veritec Solutions LLC. Its stated goal is to become a facility to discourage overlending by regulated lenders. Rollovers and simultaneous loans by providers are effectively prohibited by payday lenders' required use of the system.[99]

However, some serious questions about this approach arise. First, as in all credit reporting, issues of consumer privacy are raised. However, the major difficulty is that this form of regulatory control of simultaneous loans requires the adoption of a paternalistic approach to payday borrowers – they are simply not trusted to avoid overuse of payday loans by borrowing from several lenders simultaneously. In effect, there is state-mandated surveillance of borrowers in the subprime market, which is not required for mainstream borrowers.

The effectiveness of the database also may be threatened by unregulated "rent-a-bank" lenders. Unregulated rent-a-bank lenders as noted do not abide by the credit database requirement. In doing so, they have no access to the credit-risk information the database provides, meaning they may make worse loans (but at a higher rate).[100] While this may be positive for those good credit risk payday borrowers, it is perhaps driving poorer risk borrowers to rent-a-banks still operating in the state, at high levels of interest.[101]

In addition, despite the extensive legislation in Florida, rent-a-bank payday lending is still active in the state, meaning those payday lenders regulated by Florida's state law are competing with unregulated rent-a-bank lenders.[102] This is not to say, however, that the Florida-regulated lenders are in risk of demise. Rather, what has occurred is an odd "skimming" of the best payday loan clients from the market by the regulated payday lenders. The higher-risk clients with poorer chances of repayment are being picked up by the rent-a-bank lenders with their higher interest rates.[103]

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[98] The cost of credit checks are generally passed on to consumers, however, one chain in Florida is already competing on this price leverage by advertising no fees for the government-required check.

[99] The Florida Annual Report at 12 notes that although not eliminated, there has been an 82.6% reduction in persons with 2 or more outstanding loans since the database requirement was implemented.

[100] Annual Report Commentary, 2003 Veritec Solutions LLC (online: http://www.veritecs.com/AnnualReportCommentary.pdf) at 10. This report suggests payday lenders in OTHER states may not have as many performing loans as regulated Florida lenders, however, there seems no reason why unregulated lenders IN Florida would not also suffer the higher industry average of "charge-offs" (unrecoverable loans).

[101] Much like the difficulties encountered in South Africa with unlicensed lenders until recent legislation permitting the MFRC to regulate unlicensed lenders. See above.

[102] *Ibid.*, at 5.

[103] It is also worth noting that Florida actively pursued rent-a-bank payday lender Ace Cash Express, which settled the action by agreeing to become licensed under the Florida law. Although the January 2003 settlement was coincidental with an order of the Office of the Comptroller of Currency to stop operating in

What can be learned from the Florida model is that regulation should probably stop short of attempting to control borrowers from reckless simultaneous use of payday loans from various lenders. Such control can only be achieved through an intrusive database of payday loan monitoring. It may also unintentionally drain the beneficial effects of regulation from the poorest borrowers, if there is any chance of competition from unregulated lenders.

California – New Law, Better Protections – Regulatory Nirvana?

California has passed a new law regulating payday lending, which will come into effect March 1, 2004.[104] This law "legalizes" payday lending by exempting payday lending from state usury laws.

California's law gives complete regulatory oversight to the Commissioner of Corporations. The law limits payday loans to $300 for up to thirty-one days. Fees are limited to 15% of the face value of the borrower's cheque. Disclosure of fees must be expressed as an Annual Percentage Rate. In addition, each contract must set out a chart with APRs for each $100 increment at 14 and 30 day terms. Rollovers are prohibited. Loan extensions are permitted but no extra fee may be charged. Taking of collateral is prohibited. Lender recovery clauses such as confession of judgment clauses are prohibited. Bad cheques cannot be referred to criminal authorities. NSF fees are limited to $15. Both the Attorney General and any borrower may bring an action for non-compliance with the Act. The borrower may seek triple damages and costs. Borrowers have access to a 1-800 complaint line.

Lenders must be licensed, and fees from licensing fund programs designed to educate the public regarding payday loans and to fund enforcement actions. Lenders must not only keep adequate records, but report on the volume of loans to the Commissioner on a yearly basis. The report must also detail average APRs, average loan amounts, average length of loans, value of returned cheques, recovery on returned cheques and net charge-offs of returned cheques. The Commissioner has jurisdiction to regulate both licensed and unlicensed payday lenders. The Commissioner must publicly report on lenders and may recommend changes to fees, lengths of loans, and even if "implementation of an installment loan product in lieu of a deferred deposit transaction" would be preferable.[105]

Is this the nirvana of payday lending regulation? It certainly appears to be a complete code, aimed at all weaknesses identified thus far in regulatory regimes

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this manner, the possibility exists that ACE also noted the poorer performance of those unregulated lenders not accessing the Veritec database and decided to accept regulation.

[104] Senate Bill 898, Statutes of California, 2002, c. 777. See http://www.leginfo.ca.gov/statute.html and enter "777" in chapter search box and "2002" in year box for full text.

[105] See s. 23057.

(such as South Africa's inability to regulate unlicensed lenders) and to include all positive provisions (such as North Carolina's statistics and reporting).

Unfortunately, all of this well-thought out regulation is in danger of being preempted by federal rules proposed by the Office of the Comptroller of Currency. This leads one to speculate: did California scare the industry into lobbying the federal government to pre-empt this proactive legislation?

U.S. FEDERAL BANK REGULATORS AND PAYDAY LOANS

U.S. federally-regulated banks have partnered with payday lenders to offer payday loans in all state jurisdiction where usury limits are in place, or even in certain cases to avoid the strictures of state payday lending statutes. Federal bank regulators include the Federal Reserve (the Fed), the Office of Thrift Supervision (OTS), the Office of the Comptroller of Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). All of these regulators have, over the last 10 years, had their hands in payday lending oversight due to federal bank involvement and the permitted "export" of state interest rates under the *Marquette* decision of the U.S. Supreme Court.[106]

Anti-payday lending advocates such as the Consumers Federation of America soon brought intense pressure to bear on these regulators to halt rent-a-bank arrangements. The Fed initially tolerated rent-a-bank arrangements between federally-chartered banks, then changed its position abruptly by refusing to permit Eagle National Bank to partner with Dollar Financial Group Inc. (Money Mart's corporate parent) in the U.S. in 2001. The OTS followed this lead.

The OCC appeared to follow this position as well, but now is considering amending its rules to "gut" rules state payday lending limits.[107]

However, it is presently the FDIC that is the real problem, according to the CFA and others,[108] as FDIC allows state-chartered banks to export interest rates for the benefit of out-of-state payday lenders (see above description of this process in New York state).

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[106] FDIC's *Guidelines on Payday Lending* state of the *Marquette* decision: "The authority of national banks to export favorable interest rates on loans to borrowers residing in other states was recognized by the U.S. Supreme Court in *Marquette National Bank of Minneapolis* v. *First Omaha Service Corp.* , 439 U.S. 299 (1978), in the context of section 85 of the *National Bank Act*. That authority was subsequently extended to credit unions, savings associations, state nonmember banks and insured foreign branches in the DIDMCA to provide competitive lending equality with national banks."

[107] Consumers Union has actively attacked the OCC's proposed rule as it "would prevent most state laws from applying to nationally-chartered banks. . . . Nearly every state consumer protection law that applies to banks is threatened by this proposed rule." The proposed rule is found at: http://www.occ.treas.gov/fr/fedregister/68fr46119.pdf

[108] See "FDIC Failure to Halt Rent-a-Bank Payday Lending Undermines Benefits of 'Banking' the Unbanked", Statement by Jean Ann Fox, Director of Consumer Protection, Consumer Federation of America, November 5, 2003. Online: http://www.ncrc.org/PressReleases/StatementFDICForum.pdf

Many lessons can be learned from the U.S. regulatory experience. Firstly, it is very likely that some banks or other financial institutions will be drawn to partner with high margin payday lenders. Secondly, in such agency relationships, banks and payday lenders will seek out legal rules on a national level to thwart regulation at a state or provincial level. Third, is that the highly politicized regulators of banking services may not be trusted to come to principled decisions on payday lending. Such regimes must be controlled locally at provincial (state) level or the risk is run that any legislation will be ineffective. Local level regulation is not as divorced from actual payday borrowers and their concerns; and the provincial regulators are less beholden to banks and other financial institutions, which often are federally-regulated. Bank regulators concerns are limited more to bank liquidity and viability than social policy – as evidenced by the FDIC's *Guidelines on Payday Lending*.[109]

U.S. *Community Reinvestment Act* Requirements

The legal landscape on American banking was, during the 1990s, greatly redrawn by the *Community Reinvestment Act* (CRA):

> The CRA requires all banks and thrifts to serve the credit needs of the communities in which they are chartered. Under the CRA law, [. . .] lenders have not only an "obligation" to meet the credit needs of the

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[109] For example, this distinction becomes clear in the Guidelines discussion of rollovers, which rather than flatly prohibiting them, rather cautions the banks to exercise good "risk management" in taking them:

> *Renewals/Rewrites*
> The *Retail Classification Policy* establishes guidelines for extensions, deferrals, renewals, or rewrites of closed-end accounts. Despite the short-term nature of payday loans, borrowers that request an extension, deferral, renewal, or rewrite should exhibit a renewed willingness and ability to repay the loan. Examiners should ensure that institutions adopt and adhere to the *Retail Classification Policy* standards that control the use of extensions, deferrals, renewals, or rewrites of payday loans. Under the *Retail Classification Policy*, institutions' standards should:
> - Limit the number and frequency of extensions, deferrals, renewals, and rewrites;
> - Prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer; and
> - Ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained.
>
> In addition to the above items, institutions should also:
> - Establish appropriate "cooling off" or waiting periods between the time a payday loan is repaid and another application is made;
> - Establish the maximum number of loans per customer that are allowed within one calendar year or other designated time period; and
> - Provide that no more than one payday loan is outstanding with the bank at a time to any one borrower.

> communities in which they are chartered, but rather have a "continuing and affirmative obligation" to meet those needs.[110]

Section 804 of the CRA, for example, requires the FDIC to assess CRA performance. FDIC's report must include a lender's record of serving low- and moderate-income communities. However, to date, few FDIC banks have been failed on this assessment, despite sponsoring payday loans in rent-a-bank arrangements.

This position has been roundly criticized by the National Community Reinvestment Coalition, a group dedicated to enforcement of the CRA and promotion of affordable financial services to mid- and low-income Americans. In addition, the Consumer Federation of America has criticized the FDIC's enforcement record and has called on the FDIC to use upcoming assessments to take the position that payday lending is *per se* a violation of the CRA.[111] FDIC has to this point emphasized those portions of its Guidelines on Payday Loans,[112] which do not take this position but rather caution banks to not overexpose themselves to payday loans and to have adequate reserves and other safeguards in place.

Although the outcome of this struggle is unclear, it is worthwhile noting that in Canada there is no equivalent to the CRA. Canadian bank regulators, therefore, lack even this sort of legal leverage to deny banks access to the payday lending market should they choose to enter it through a similar rent-a-bank (agency) relationship with payday lenders.

Present Canadian (Provincial) Regulation of Payday Lending

Five provinces presently have some form of licensing or registration requirement for payday lenders: New Brunswick, Newfoundland, Nova Scotia, Quebec and Saskatchewan.[113] Saskatchewan's Act is relatively new and discussed in more detail below. New Brunswick's Act is presently being replaced by a new, tougher act. Quebec's *Consumer Protection Act* has been interpreted by court decisions

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[110] Remarks of John Taylor, President and CEO National Community Reinvestment Coalition, November 5, 2003: "FDIC Regulatory Failure Contributes to Crisis of Predatory Lending and the Unbanked" available online: http://www.ncrc.org.

[111] See "Venture Bank FDIC's Payday Test Case?" *American Banker*, November 18, 2003.

[112] FDIC, "Guidelines For Payday Lending" online: http://www.fdic.gov/regulations/safety/payday/index.html

[113] New Brunswick *Cost of Credit Disclosure Act* RSNB 1973 c. C28 ss.1-13, 25-29 (to be repealed and replaced by *Cost of Credit Disclosure Act*, S.N.B. 2002, c. C-28.3, Part II, ss. 6-15 (assented to June 7, 2002, to come into force upon proclamation (unproclaimed)); Newfoundland, *Consumer Protection Act* RSN 1990 c. C31 ss. 1-15, 23-31; Nova Scotia *Consumer Protection Act* RSNS 1989 c.92 ss 1-16, 29-33; Quebec *Consumer Protection Act* RSQ c. P-40.1 ss 321-338 and Saskatchewan *Trust and Loan Corporations Act, 1997*,S.S. 1997, c. 2.22, Part III, ss. 16-34.

to place an effective 40% APR limit on all loans in the province.[114] The remainder of the provinces do not even try to register the payday lenders as lenders. In effect, therefore, payday lenders in Canada generally are unregulated as financial institutions or lenders *per se*.

As noted by Ramsay, the scant existing legislation which is applicable to payday lending is built upon an "integrity and financial probity" premise.[115] It prescribes registration with a regulator that requires payment of regular fees for registration and some showing of financial stability. Licensing conditions are usually limited to these requirements but regulators may review licences for breaches of the applicable legislation. Legislation such as Newfoundland and Labrador's has such substantive credit requirements as revelation of APRs, a right of prepayment without penalty, disclosure of the elements making up a total cost of credit, provision of that credit statement to the borrower, and limits on advertising. The borrower is not required to pay amounts charged which exceed the required statement of the cost of borrowing.

Further licensing conditions specifically targeting the payday lending industry or payday lending practices have not been created. In effect, present consumer protection legislation only places some minor limits on entry into the market, and places upon that lender minor disclosure requirements, on the premise that informed consumers will use the disclosure to make rational decisions regarding the cost of, and use of, payday loans. As Ramsay has indicated, faith in such rational decision-making may be misplaced. At the least, one can note that these acts are dated and do not address serious issues in payday lending such as rollovers and interest rate caps. Present regulation is, therefore, simply inadequate.

VALUE OF THE LICENSING APPROACH

Ramsay details several advantages to a licensing approach to the AFS, including exclusion of worst-offenders, making up for information failure of borrowers, monitoring of lenders practices, etc. However, he also notes that licensing is not a panacea and cites considerable costs associated with a licensed market. He also notes the limitations of a licensing system. Licensing regimes are often less flexible than true regulatory regimes since control over the licensee is effected by threat of revocation or restriction of the licence. Courts have developed significant administrative law safeguards (and complications) that make such revocation difficult and costly for a regulator. A true regulatory regime, however, can target particular problems (e.g. unfair trading) without threatening the heavy-handed sanction of licence revocation, but rather a wide range of disciplinary action.

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[114] Quebec *Consumer Protection Act* RSQ c. P-40.1 s. 8. Judicial decisions referenced in C. Masse, *Loi sur la protection du consommateur – analyses et commentaires* (Cowansville: Les Éditions Yvon Blais, 1999), pp. 142 et seq.

[115] Ramsay Report, p. 33.

However, licensing of payday lenders, in addition to a complete regulatory code, has been attempted in several U.S. jurisdictions and has succeeded in avoiding several avoidance practices. Colorado has recently used its licensing requirements to exclude a lender who flaunted the state's prohibition on rollovers.[116] Licensing requirements have successfully been used to shut out and fine online payday lenders from Nevada making loans over the Internet to Kansas residents.[117] Licensing should also guard against "disguised" payday loan transactions such as phone service that is offered without any actual connection, or sale-leaseback arrangements which give a cash advance (loan) which then must be re-paid.[118]

SASKATCHEWAN

The Saskatchewan *Trust and Loan Corporations Act, 1997* is an example of an act passed to consolidate control over the entire financial services industry within a province. Payday lenders are captured by the act's definition of the term "financing corporation", which includes "a body corporate that does not accept deposits and that . . . carries on the business of lending money".[119] The act solves the problem of the complexity of regulating all financial services by simply permitting the Superintendent of Financial Institutions wide discretion to specify particular licensing requirements for each category of applicant, and indeed, for each individual applicant. Saskatchewan has, under this act, specified fairly strict substantive credit requirements on payday lender applicants, including prohibiting rollovers, and specifying interest rate caps, as well as requiring the more standard procedural protections such as true cost of credit disclosure.

Interestingly, the regulation of payday lenders in Saskatchewan has not decreased the number of applicants or their locations and has not, it seems, resulted in a restriction of credit to low-income borrowers. The Saskatchewan model therefore may be an adequate model for smaller provinces short of a full-blown, industry-specific regulation. However, such a system would appear unwieldy, and perhaps arbitrary, in high volume provinces such as Ontario and British Columbia.

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[116] See "Americash shut down" Denver Business Journal, 17 November 2003. Online: http://denver.bizjournals.com/denver/stories/2003/11/17/daily16.html

[117] "State orders two online lenders to stop doing business", Wichita Eagle, 13 November 2003.

[118] See Press Release: "Disguised payday loans mushroom in Texas, victimizing borrowers who face exorbitant interest rates, threat of criminal penalties", Consumers Union, February 25, 1999. Online: http://www.consumersunion.org/finance/paydaysw299.htm

[119] The definition also includes: "has as its primary business the granting of revolving credit; or . . . is one of a class of businesses prescribed in the regulations as a financing corporation". The regulator therefore has a wide discretion in concluding a business is a financing corporation and it would appear to cover all sorts of payday lenders, as well as pawn shops, rent-to-own and car and home equity loaning businesses.

PENDING PROVINCIAL COST OF CREDIT DISCLOSURE STATUTES

Adding to the mix of provincial legislation is a model act concluded by the Consumer Measures Committee creating a harmonized cost of credit disclosure law drafting template.[120] As noted in Report 1, provinces including B.C., Québec, Ontario and Alberta have pledged to enact this type of legislation but are now allowing the bills to remain unproclaimed, ostensibly to await full overhaul of the regulation of financial services in the province (B.C. and Québec) or simply to await the drafting of regulations (Ontario).

The model cost of credit (COC) disclosure law is basically “Truth In Lending” legislation. However, it applies to open and closed credit (with the exception of credit cards). It requires lenders to include the APR, and sets out a method of calculation.[121] Like s. 347 of the *Criminal Code*, the COC model law expansively defines “interest” to include generally <u>all fees and charges</u>, including mandatory loan insurance. Only charges which are beyond the control of the lender, or which are truly difficult to calculate at the time of the loan are exempt from the interest definition. The COC model law also requires disclosure statements clearly indicating all charges and repayment terms be provided to the borrower at or before entering into the loan (that is, disclosure may be made in the loan application). Also, the COC model law allows a borrower to prepay a loan, or a portion thereof, without penalty (lenders are still permitted to charge a prorated portion of the interest to the date of repayment). In addition, default charges are not permitted, except for NSF cheques and legal costs surrounding collection. Finally, restrictions are placed on advertising: where a loan advertisement refers to rates of interest, fees or amounts loaned, this triggers a requirement to include a representative loan with all costs, and the APR calculated. All of these required elements must be conspicuous and prominent.

Although these new requirements tackle many of the issues around information failure and cost of credit, they generally are “procedural” and do not address such substantive questions as rollovers and rescission. In other words, even were s. 347 amended, the COC model law may not be adequate to tackle whole payday lending problem.

As noted, some provinces appear to be delaying implementation of the COC model law in hopes of harmonizing with larger reforms of financial services industries. However, since these larger undertakings are truly complex regulatory matters that could take years to implement, it makes more sense in the short term to adopt the COC model law now, perhaps in conjunction with the reform of s. 347. However, this should not end the matter, and more intensive regulation is indicated.

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[120] “Agreement for Harmonization of Cost of Credit Disclosure Laws in Canada Drafting Template” Consumer Measures Committee (June 1, 1998) online: http://strategis.ic.gc.ca/pics/ca/cmcccdl.pdf

[121] See Appendix 2 for the various methods of calculation of APR.

Barriers to Provincial Regulation of Payday Loans

Three realities seem to be slowing provincial efforts to modernize regulation in this sector: first, of course, is the federal prohibition on usury found in s. 347 of the *Criminal Code*. In B.C. for example, provincial regulators were first to face the growth of payday lending in Canada but were reticent to regulate an "illegal" industry, no matter how prevalent. The second reality is a lack of resources in the consumer protection branches of government. The third involves ambitious efforts to try to bring all provincial and federal regulation of the financial sector together, with the inherent delays in such a large process.[122]

The first reason, s. 347, is the greatest barrier to regulation and the one that must be removed first. However, the manner of doing this will have a profound impact upon the shape of provincial regulation of the industry and it should not be undertaken lightly. Below is an examination of the amendment of s. 347 of the *Criminal Code* to exempt payday lending from the Canadian criminal usury law.

Reform of s. 347 *Criminal Code*

The present stumbling block to regulating payday loans is the criminal interest rate offence in s. 347 of the *Criminal Code*. The provincial governments will not seek to regulate an area defined by the federal *Criminal Code* as illegal. [123] In addition, at least some provinces are reticent to raise the issue of regulation of interest rates, which is a thorny constitutional question. (Regulation of interest rates *per se* is probably a matter competent only to the federal government, or, at best, a concurrent jurisdiction with the provinces).[124]

As a result, the Consumer Measures Committee has recently been tasked with investigating the regulation of the AFS market and payday lending in particular. The CMC is presently considering the basic requirements of the regulation of small, short-term loans. To do so, it will likely consider amendment or repeal of s. 347 of the *Criminal Code*, as the possible illegal nature of these loans adds a level of complexity to the greater policy questions of these loans' usefulness for, and abusiveness to, borrowers.

The initial question is how far a simple amendment to the *Criminal Code* could go in regulating the industry. Certainly, it would be possible to exempt small, short-term loans, perhaps up to $500 and due under 30 days, from the ambit of s. 347. This exemption, as in South Africa, could effectively "legalize" the practice of

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[122] Source, Interview with Reg Faubert, Chair of Consumer Measures Committee investigating payday lending B.C. (August 1, 2003). For example, B.C. withdrew the *Consumer Cost of Credit Act* in order to aid in the overhaul of parallel consumer financial regulation. Québec is doing the same at present.

[123] Interview with Reg Faubert, *supra*.

[124] P. Hogg, *Constitutional Law of Canada*, 2nd ed. (Toronto: Carswell, 1985) at pp. 478-9, but see M-A Waldron, *The Law of Interest in Canada* (Toronto: Carswell, 2001) at pp. 18-28. See Appendix 4 for the text of s. 347 of the *Criminal Code* and s. 91(19) of the *Constitution Act, 1867*.

payday lending. However, given the federal government's limited jurisdiction over criminal law and interest rates regarding this industry, the exemption section would have to be carefully crafted and not overly ambitious to avoid provincial constitutional jurisdiction over matters of property and civil rights. A precedent for the legislation would be the former *Small Loans Act*.

The amendment could stop there, however, it is possible that the federal jurisdiction over interest rates could be used to in effect legislate a rate cap. A harder question would be whether this jurisdiction could be stretched to the point of prohibiting rollovers. Finally, the question of the enforcement of s. 347 could possibly also be addressed by a possible amendment.

Rate Caps - Tax Rebate Discounting Act Model

Tax discount rebating has been used since the 1970s under a formula that in effect caps interest rates.[125] Under the *Tax Rebate Discounting Act* (TRDA) the allowable rate is 15% on the first $300 of a loan and 5% above that amount. This approach, and the figures, seem to suggest a clear precedent in how to cap payday loan rates under an amendment to s. 347. This rate cap also is in line with those U.S. jurisdictions that have a rate cap (e.g. Virginia, etc.).

However, this rate should not be accepted at face value with respect to payday loans without some additional investigation.

First, this rate structure may represent a raise in prices for Money Mart, although it will probably result in a significant lowering of other payday lender rates. At present, Money Mart's fees (widely seen as lowest in the industry) on a 10-day loan of $300, are: "stated interest" (i.e., the 59% allowed under s. 347, calculated at $0.89 per $100 per week - Being $1.27 per 10 days per hundred dollars. 3 x 1.27 = $3.81.): $3.81 + 4.99% of the $303.81 "advanced" = $15.16 plus $12.99 per item cheque cashing fee. Total: $331.96. APR = 389% (Note we are assuming a court would conclude the cheque cashing fee was indeed "interest"). Now, if the TRDA model is applied, the total is $45 on $300 for 10 days, being $13.04 more, with an APR of 547.5%. The potential rise in price of Money Mart's loans is about 4% under the TRDA model.[126] This seems unnecessary, as Money Mart is presently "in the black" at their present rates.[127]

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[125] Tax rebate discounting has been legalized as an exception to s. 347 of the *Criminal Code* since 1978. The federal *Tax Rebate Discounting Act* (TRDA) defines tax rebate discounting and provides for minimal registration of tax rebate discounters with Canada Customs and Revenue Agency. Tax rebate discounters are not otherwise regulated (federally or provincially), not even to the point of licensing requirements for integrity or financial probity. Tax rebate discounters are, however, subject to Revenue Canada audits.

[126] Of course, Money Mart may use lower prices as a way to retain or build market share, and not raise prices to the new ceiling. However, it must be noted that Money Mart makes less per transaction than other payday lenders due to its pricing structure, so an eventual price raise is not unlikely.

[127] Money Mart's U.S. corporate parent Dollar Financial Group Inc.'s SEC Form 10-K filing for fiscal 2003 notes at p. 25: "The increase in total revenues resulted primarily from an increase of $11.7 million [U.S.], or 16.8%, in consumer lending revenues. **The increase in consumer lending revenues was**

On the other hand, it appears that the TRDA model rate would be a significant *decrease* in compensation for several payday lenders. In effect, it would truly be a cap for most lenders.[128] On this basis, therefore, regulators will have to make a choice of whether to gain an overall price reduction for most lenders or authorize a slight increase for the market leader.[129] However, obtaining such a cap on rates, even though it may leave some room for increase in some lenders, is probably a price worth paying for overall consumer savings across the payday loans industry in Canada.

Second, the 15% cap also may have the perverse effect of legitimizing that cost, as borrowers perceive it to be a fair rate, when in reality the amount may be far in excess of what these loans really cost to provide. At this point, it is unclear what is a “fair” price to be paid for small, short-term loans. More research is required, although hard figures on the cost of administering these loans, if used either to justify the higher “TRDA model” amount, or to argue against a rate cap, should be produced by the industry before legislators agree to these proposed rates.

Third, another sobering fact is that no company presently offering tax discount rebate services charges less than the 15% cap. It may well arise in the payday loans market that every provider under this model charges the maximum. Also in the “limit-related” vein, under the previous federal *Small Loans Act*, lenders would typically only lend up to the first rate step. That is, were the $300/15% rate adopted, it is possible lenders would refuse to lend more than $300, forcing a borrower requiring $500 to pay the top rate from two lenders.[130] Such market failures are possible in the payday loans industry under this model.[131]

Fourth, tax rebates and payday loans are fundamentally different, despite initial similarities. Tax rebates are money that is a once-a-year “windfall” for most consumers, not a regular income payment. It may be appropriate to allow borrowers to discount an irregular, windfall payment once a year at a high APR; it

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primarily as a result of $7.8 million [U.S.], or 34.2%, increase in revenues in Canada resulting from higher lending volumes and increased finance charges . . .” [emphasis added.] Note that this increase does not necessarily represent increased profit.

[128] Most payday lenders besides Money Mart are assiduous in NOT posting their rates. However, two leading payday lenders charge $20 or $25 “fee” per hundred dollars loaned. On a 10 day loan for $300 at $25 per hundred, this is a $75 charge, $30 more than the TRDA model and a 912.5% APR.

[129] Of course, Money Mart may not raise prices, in order to maintain competitive advantage.

[130] Recall Money Mart’s policy to lend only 30% of the net pay of each borrower. While this would be a positive feature to control debt-spirals if it were a stand-alone requirement, in conjunction with a TRDA-type rate of 15%/5% on the first $300, the effect is to require all borrowers netting about $900 per paycheck after taxes (i.e., those earning about $31,000 a year or less before taxes) to take loans at the 15% rate. In order to benefit from the 5% rate for amounts over $300, a borrower would have to be earning over $40,000 a year before taxes. This higher income group is not representative of payday loan borrowers.

[131] Money Mart disputes this claim, stating instead that companies would lend at the lower rate for the remainder of the loan, in order to keep the entire loan business.

may be quite another to permit that same high APR to be applied to regular income payment discounting.

Fifth, the TRDA model, by itself, cannot be complete regulation, as it only modifies the *Criminal Code* illegal interest provision. For constitutional reasons, there may be a limit to the extent of federal jurisdiction over the area under the federal government's interest rate power.[132] As a result, the TRDA model alone fails to address many other legitimate concerns with payday loans. Provinces should take on the industry-specific regulation of payday lending as a consequence of decriminalizing interest rates. We suggest provincial regulators remain seized of the payday loan file to consider such regulation, in accordance with this report's regulatory suggestions, well into the near future.

Sixth, the TRDA model, by itself, obscures the larger reasons why payday loans exist, namely the failure of banks and mainstream financial institutions to serve everyone equally. There is anecdotal evidence the people with good credit are driven to payday loans because of racism or sexism in banking institutions.[133] The TRDA model has no mechanism to address this. There are those who will not deal with banks because the hours are inconvenient or tellers are not sensitive to the needs of the poor. Addressing poor coverage of the AFS by mainstream financial institutions is a matter which will not be addressed by, and even may be somewhat obscured by, this model. As a result, possibly the FCAC should oversee and raise these important larger issues.

Finally, the TRDA model, being a simple amendment to the *Criminal Code* likely cannot <u>require</u> the statement of an APR. APRs are the only method whereby consumers can compare credit costs across financial products, such as credit card advances or debt restructuring. The *CMC Model Cost of Credit Disclosure Act* does, however, address the APR problem at the provincial level. There should be some method of encouraging the provinces to enact the model legislation as a key element of minimal payday lending legislation.

ENFORCEMENT IMPROVEMENTS

Amending s. 347 provides the opportunity to facilitate prosecutions of criminal interest rate violations in the AFS. There appears to be no good reason for the requirement of an actuary's certificate to calculate the effective annual interest rate under the present section. Likewise, there is no reason for the requirement of provincial Attorney-General permission to prosecute.

However, even were these changes made, it would not include any actual increase in any other enforcement mechanism or any new undertaking to enforce the s. 347; there would be no dedicated regulator monitoring the activities of lenders who do not follow s. 347. Some more aggressive provincial financial

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[132] As noted, much of the area would appear to be, at best, shared jurisdiction with the provinces.

[133] Winnipeg Inner-city Research Alliance report.

services regulators might refer prosecutions to Crown attorneys, but this seems unlikely. Other jurisdictions (several U.S. states, South Africa, and the Australian states) do not have evidentiary requirements of actuarial certificates and Attorney-General fiats and still do not generally prosecute their usury offences against the AFS.

Conclusions Respecting Amendment of s. 347 Criminal Code

Nevertheless, despite the shortcomings of the criminal usury law amendment as proposed, it appears a necessary first step in providing the open field in which provincial regulators can act to regulate the industry and protect consumers. However, we caution that removal of the criminal interest rate provision for payday loans must be paired with extensive regulation. PIAC supports the amendment of s. 347 if the provinces seriously consider further, complete regulation of the payday loans industry. We turn now to our recommendations for the shape of that possible provincial payday lending regulation.

Entry of Mainstream Financial Institutions; Community Banking Options

Long-term, even after provincial regulation, the only real prospect of lower payday loan rates for consumers is entry into the market by banks and other mainstream financial institutions, or the development of community-based financial services centres.

Rent-a-Bank in Canada?

South Africa has shown that proper regulation of the market can encourage this form of market “deepening”. However, Canadian financial services culture and reticence into moving into this market may slow this development. In addition, there is a danger in federal financial institutions’ participation in the market. First, the “rent-a-bank” phenomenon is probably a legal possibility in Canada.[134] Such an “agency relationship” could develop if payday lenders seek to avoid new restrictive provincial regulatory regimes. The FCAC should be tasked with tracking the development of mainstream federal financial institution entry into this market to ensure that the groundwork is not laid for Canadian rent-a-bank payday lending.

Community Banking Service Centres

The Winnipeg Inner-city Research Alliance Report has laid out a convincing model of community banking service centres that can provide short-term loans. Further research in this area should be encouraged, as recommended in the WIRA report. Encouraging are Royal Bank’s “Cash & Save” outlets (now two) in

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[134] Based upon federal jurisdiction over interest rates and banking, including the federal *Bank Act*. and s. 2 of the federal *Interest Act* (which allows any rate of interest – subject only to other federal enactments such as s. 347 of the *Criminal Code*).

Toronto. Also encouraging are steps towards low cost loans that are being taken by progressive credit unions across Canada. FCAC should assist consumer groups with encouraging financial institutions to offer low cost loan alternatives to low-income customers.

PIAC and other consumer advocacy groups should closely monitor the payday loan and larger AFS industries and government regulatory response in the time of transition from an unregulated to a regulated market. In short, low and middle-income working Canadians should not be left, for the foreseeable future, alone with only payday loans as a source of small, short-term credit.

Conclusions and Recommendations

Regulation of the payday lending industry, and indeed the entire AFS, is urgently required. The payday lending industry is a fact and does fill a need for credit to a portion of the population. However, with the unlicensed growth of the payday lending industry have come questionable practices and abuses. Simply removing the interest rate cap will not curb these abuses. Regulation should be extensive at the provincial level and include a number of consumer protections.

Minimum Consumer Protection Elements of Regulatory Scheme

Regulation of payday lending is urgently required. It should be a "complete" system, ideally modeled on the South African experience, but should at the least include extensive consumer protection provisions such as those in the California legislation.[135] Minimal regulatory requirements should include the following:

Licensing of Operators

- Licensing reverses present low entry and exit costs that encourage poor quality lenders, poor practices, avoidance of regulation (such as it is);
- Licensing can provide data for analysis of the industry, allowing better refined regulation.
- Mandatory provincial licensing of payday lenders could also include the following requirements on lenders, such as:
  - Fines or licence refusal or revocation for breaches of requirements;
  - minimum operating capital;
  - presence in jurisdiction (to avoid unlicensed Internet lending);
  - publication of complaints history;
  - revelation of corporate structure and governance (transparency)

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[135] See Senate Bill 898, Statutes of California, 2002, c. 777. See http://www.leginfo.ca.gov/statute.html and enter "777" in chapter search box and "2002" in year box for full text.

- regular, detailed reporting of transactions to regulator
- record retention

Regulator Powers

- To be effective, a dedicated regulator, or at least a separate commissioner or department of the relevant provincial financial markets regulator is required;
- Regulator must have jurisdiction over all payday lenders, licensed or unlicensed;
- Prosecute those acting as lenders who are not complying with registration requirements (a provincial offence);
- Manage consumer complaints mechanism (toll-free 1-800 number);
- Renew, suspend, cancel, and grant licences;
- Power to fine offenders;
- Require transaction data from lenders;
- Educate borrowers about cost of credit and payday loans in particular;
- Report on industry each year to provincial legislature;
- Suggest changes to regulatory scheme to legislators.
- Provincial and federal regulators should meet to review the state of payday lending and suggest further regulation at least once every 5 years.

Cost of Credit Disclosure

- All fees and charges must be clearly detailed in writing in contracts and advertising and promotional materials;
- Provide loan application and loan agreement before completion of application/transaction; allow customer to have copy of completed application/loan transaction
- Standardized loan documentation should be produced by the regulator with regulatory requirements;
- Reference to Consumer complaints mechanism on documents
- Fees and charges may not be excluded from definition or calculation of interest (NSF fees may be excluded);

Annual Percentage Rate (APR)

- Annual Percentage Rate (APR) of interest on loans is a crucial measure for consumers.
- It must be calculated for all loans and displayed on loan documentation.
- Typical APRs for standard loan increments and standard loan terms should be available in chart form for borrowers.
- The APR:
    - allows consumers to compare costs of credit across the board of financial options;
    - is the standard legal description of interest rate calculation measure used in most provincial and federal legislation

- shows total cost of all fees and charges (only place where all of these "interest" costs are totaled up);
- could be better explained to the public (see Appendix 1) and why it is important (this could be undertaken by the FCAC);
- While it may be true that most customers of payday lenders "just want to know how much the loan will cost in dollars", it does no harm to require the publication of the APR and should the customer want to compare APRs it will be available;
- should increase competition that truly lowers rates between payday lenders (rather than leaving borrowers to compare fees, which can be confusing and have no real relation to reduction in cost of the credit).

Interest Rate Caps

- Interest rate caps are required to protect consumers from excessive industry fees;
- The proposed rate of 15% on the first $300 is high; consideration should be made to lowering it; industry must justify this level of return by demonstrating and defending costs and profitability;
- Limit on amount of loan to 25% of borrower's net income from next paycheque

Limits on Specific Charges and Fees

- Allowable NSF fees should be limited to a modest amount, representing the real cost of administration;
- Electronic NSF charges must be limited to one attempt to collect;[136]
- Lender-specific identification card charges must be modest and not become a revenue source.
- No default or delinquency charges.
- Interest may not accrue after a default.
- No "broker" or "agency" fees permitted.

No Rollovers, Extensions, Back-to-Back Loans

- Rollovers must be prohibited. Loan extensions (for a further fee) and back-to-back loans without a cooling off period must likewise be prohibited. Payday

[136] Problems with electronic access to bank accounts and payroll deductions will only increase with regard to payday loans. Direct Debit Authorities (DDAs) represent a huge potential problem in Canada – many online payday lenders now require DDA to get a loan. Such DDAs are open to far more abuse than NSF fees (most financial institutions permit 3 tries to debit an account in a week or even more, charging $25 insufficient funds fees each time). Addressing DDA abuse either requires disclosure (as is done in Australia) or an outright ban on repeat tries to debit an account (or strict limits such as only 2 tries 2 days apart after contacting the borrower). Borrowers in addition should have the option of paying another way: by physical cheque; in person with cash; or by Internet banking authorized payment. Electronic banking pre-authorized payments do not incur charges if there are insufficient funds available, as it is the bank trying to pay a bill on your account, not a creditor with a debit authorization.

loans must be limited to industry-stated rationale that they are an "occasional" loan and not long-term source of credit.

- Rollover limits should apply to individual lenders – they should not seek to prohibit simultaneous application for loans with different lenders.
- Prosecution of rollover violations must be regular and aggressive.
- Penalties for rollover violations must be severe, including license suspension

Advertising

- Advertising must not be deceptive or misleading;
- Must detail typical APR of standard loan amount for typical term in clear and conspicuous type;
- Must detail all applicable fees and charges for loans, as well as other charges such as those for convenience cards.

Education and Awareness Campaigns for Consumers

- FCAC and provincial regulators should undertake campaigns to increase financial literacy of payday borrowers, with specific emphasis on cost of this form of credit and alternative credit sources.
- FCAC and provincial regulators should undertake education and action programs to encourage consumer savings.
- Payday lenders should help fund consumer borrowing education either through license fees or particular education levies.

Other Borrower Rights

- Right of rescission immediately following a loan (cooling-off period). Length should be sufficient for borrowers to exercise the right, taking into account the short duration of payday loans. Close of business on the day following the loan could be a minimum period.
- Right of Prepayment of loan at any time and to pay it down in increments of $5 or more, without any penalty or fee (simple interest only to date of payment, pro-rated)
- If interest rates or fees are floating or variable calculations, the borrower should benefit from the lowest rate.
- Lenders should be prohibited from using information collected during the loan transaction for secondary marketing purposes or for distribution to third parties. Lenders should clearly and conspicuously post privacy policies. Clear, express written consent of borrowers should be provided before lenders may use borrowers' personal information with related entities.

Collection and Litigation Limits

- No assignment of wages

- No security (cars, boats, etc.) or contingent security like holding bank cards and PINs, blank endorsed transfer documents, etc.
- No personal guarantees from third parties
- No interest in land
- No threatening of prosecution for “crime” of bad cheque passing
- Borrowers should have a method of cheaply and expeditiously contesting amounts illegally demanded by lenders, with right of set-off against present debts. This could be a regulator-administered tribunal or small claims court action.
- No private arbitration clauses – disputes should be handled by payday loans dispute tribunal or small claims court and clause must not limit access by borrower to court or tribunal
- Statutory damages should be recoverable to borrowers when lenders violate payday lending requirements in small claims action or payday loans tribunal.

Lender Database

- A payday lending credit-reporting system should be investigated by the regulator.
- This database should not be used to track borrowers for simultaneous loans from different payday lenders.
- Positive payday lending records should be made portable to mainstream credit reporting agencies to allow borrowers to improve their credit rating while taking payday loans.

Appendix 1 - National Money Mart Company Comments on Report 1

INDUSTRY CODE OF CONDUCT

Money Mart noted that Report 1's conclusion that "the industry has no incentive to enter into any kind of self-regulation or voluntary code of conduct" was not accurate with regard to Money Mart, which abides by a set of "Best Business Practices". These "best business practices" include[137]:

- **Full disclosure.** ("a complete, written disclosure including the interest rate, terms, due date, cheque-cashing fees and repayment options")
- **"Consumer Protection"**, which could also be styled "Responsible Lending". (Money Mart claims to "qualif[y] its borrowers, and does not lend more than a borrower can reasonably repay from his/her next pay cheque by limiting the advance amount to a maximum of thirty percent of the borrower's net pay.")
- **No "Rollovers" or Extensions.** ("Money Mart does not renew or extend the due date of an advance beyond the borrower's next payday, nor are consumers allowed to pay off their advance with the proceeds of a new advance.")
- **Reasonable Fees and Best Practices.** (Money Mart "is among the lowest priced payday advance services in Canada" . . . "encourages responsible industry business practices, and does not condone excessive fees or unreasonable business practices" . . . "believes the interests and needs of business should be balanced with adequate protection for consumers, thus allowing a competitive and responsible industry to serve consumer need.")
- **Fair Collection Practices.** (Money Mart "follows fair and reasonable debt-collection practices as outlined by provincial guidelines" . . . "does not charge a higher "returned cheque" fee [than financial institutions do] or any unique default fees on cash advance cheques" . . . "does not accrue or charge interest on an advance after the date of default" . . . "does not utilize an Assignment of Wages or Assignment of Debt; rather every effort is made to work out reasonable repayment schedules with customers who have a debt.")
- **Customer Privacy.** (Money Mart "recognizes the importance of respecting customers' right to privacy, and is committed to protecting the confidentiality of customer information by maintaining high security standards and procedures.")
- **Service Guarantee.** (Could also be styled "Right of Rescission". Money Mart "allows the borrower the right to rescind, at no cost, a Fast Cash Advance™ transaction on or before the close of the following business day.")

[137] The wording of these Best Business Practices has been slightly modified and interspersed with comments. To see the exact wording of Money Mart's Best Business Practices, see http://www.moneymart.ca/).

It must be admitted that several of these Best Business Practices go some way towards addressing the possible abuses of the industry and the interests of consumers. However, like all industry-sponsored codes of conduct, it is vulnerable to spotty enforcement. Money Mart contends its stores adhere to the Code because all loan documentation is standard, and all loans are approved centrally, and that the vast majority of its outlets are corporately owned, not franchised.[138]

In addition, Money Mart claims that there have been discussions among larger operators in the industry regarding forming an association and that this may still occur. However, to date there is no such association. Several other Canadian payday lenders have "best practices" posted on websites.[139] The Community Financial Services Association of America (the U.S. payday lender industry association) already requires members to abide by a "best practices" code.[140]

ANNUAL PERCENTAGE RATE

Money Mart also took issue with Report 1's conclusion that the posting of an Annual Percentage Rate (APR) of interest on all loans should be an integral aspect of cost of credit disclosure. Money Mart made two claims with regard to APRs. First, Money Mart contended that it *does* disclose the cost of borrowing as an APR. In particular, when applying for a loan, Money Mart's "Disclosure of Cost" states:

> Interest is charged on your Fast Cash Advance at an effective annual interest rate equal to 59% or 89 cents per $100 per week.[141]

However, this amount fails to take into account "Money Mart's standard first party cheque-cashing fee of 4.99% of the advance plus $12.99 per item fee" which will become payable if the borrower waits until payday to repay the loan, since all Money Mart loans are due the day before payday. These charges, if considered "interest", may raise the APR to significantly over 60% (the legal rate).[142] These charges may well fall within the definition of interest provided by the Supreme Court of Canada in *Garland*. [143]

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[138] Telephone conversation with legal counsel for Money Mart, September 22, 2003 (Money Mart Counsel conversation).

[139] See, for example, Instaloans Financial Service Centres Ltd. Best Practices (online at http://www.instaloans.net/main/BestPractices.htm.) Rentcash Inc. (operating The Cash Store and Insta-rent outlets) refers to a Best Business Practices document, but does not provide website access. It does have a "Code of Conduct" of a general nature stating among other points "Respect Your Customers" and "Respect the Law".

[140] For details of the code, see the CFSA website: . http://www.cfsa.net/genfo/egeninf.html

[141] EAR = $(1+ .4628 \div 52)^{52} - 1 =$ 58.52667%. (See Appendix A for calculation method).

[142] For example, on a 10-day loan of $300, charges are: "stated interest" (i.e., the 59% allowed under s. 347, calculated at $0.89 per $100 per week): $3.81 + 4.99% of the $303.81 "advanced" = $15.16 plus $12.99 per item cheque cashing fee. Total: $331.96. APR = 389%.

[143] This issue is presently before the courts in the context of the industry class actions described above.

Second, Money Mart contended that however interest charges are calculated, APRs are not an accurate reflection of the cost of credit for small, short-term loans: "it has been recognized that APR is awkward and problematic when applied to small, short-term loans."[144] APR is not awkward and problematic but rather is an approximation of interest costs, which may or may not be a fair approximation depending upon certain factors. One of these factors is the frequency of this sort of transaction. Repeat customers are effectively using payday loans as a revolving credit method, therefore the only method of comparing ongoing credit costs across industries is the industry standard (used for all other loans, mortgages and credit cards), the APR.

NSF FEES

Report 1 also concluded that Money Mart encouraged NSF fees:

> NSF fees are another source of revenue. At 25 dollars these are significant and, once again, Money Mart has specific management systems around ensuring that a certain number of cheques "go NSF". However, the interviewee was unclear as to how Money Mart could manage this directly other than those efforts that were already in place to ensure high item fees. Undoubtedly the practice of discouraging redemption would lead to some NSF fees being charged.

The basis of this information were the comments of a former Money Mart employee. Money Mart took issue with this conclusion, stating:

> Because we provide a responsible lending program by not offering extensions, the program is designed in such a way so that we can deposit the cheque at a time when it has the best opportunity to clear, on the customer's payday. This also benefits the customer. In no way does our program design, our customer communication or employee training intend to or encourage a cheque to be returned NSF. Even if the loan is ultimately collected, dealing with NSF cheques is time-consuming and costly.[145]

Money Mart also stated that it prefers all cheques to clear successfully since Money Mart is charged an NSF fee by its bank, and that administrative costs and staff follow-up time are expended on NSF cheques. Money Mart also claimed "[t]his is the only default and collection fee the customer pays even though the real costs can in fact be much higher. This $25.00 fee is also in line with what banks and retailers charge for returned cheques."

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144 Money Mart Letter, p. 3.

145 Letter from Money Mart President Syd Franchuk to PIAC, dated March 7, 2003.

Money Mart's NSF fees and practice appears consistent with consumer credit practice of larger financial institutions and retailers. In addition, such an approach accords with the most likely business model used by Money Mart to make money, detailed below.

Nonetheless, there may well be some inappropriate profit-taking from NSF fees by other AFS lenders, whose charges are often $50, $75 or even $100.[146] Money Mart compares the entire costs of collection of a bad debt ("default and collection fee") with the administrative costs of dealing with one NSF cheque, because Money Mart's collection policy and standard contract waive recovery of post-default interest.[147] Money Mart is quite likely efficient in keeping costs related solely to NSF cheques down,[148] however, for those loans which stay in default, the NSF fees may well not cover collection costs.

ROLLOVERS

Another point of contention with Report 1 was rollovers. As stated in Money Mart's Best Business Practices, Money Mart claims not to permit rollovers. Money Mart claimed that they were alone in Canada in adhering to this policy, which "represents a very significant distinction between Money Mart and others in the industry."[149] Money Mart claimed to have designed its loans to avoid a "borrower's cycle of debt" by prohibiting rollovers, as well as by not charging interest after default. Money Mart noted that "[b]ecause of Money Mart's prominence in the industry . . . the fact that we do not do rollovers is a significant omission that reads should have been made aware of."

PIAC regrets this omission in Report 1 and agrees it was significant. However, Money Mart does not prohibit back-to-back loans (that is, you may come to borrow a further amount against your next paycheque once the last debt is retired, usually on payday) effectively continuing a borrower's dependence upon this form of high-cost credit. As will be seen, there is some movement among regulators to define back-to-back payday loans as an "effective rollover" by requiring cooling off periods between loans.

EFFECTIVE MONOPOLY

Another Money Mart comment focussed on a claim that it was not an "effective monopoly" in many local markets, and that it had only "40 percent of the market in terms of outlets".[150] This is difficult to verify given that the industry is unregulated and is a fact which in itself supports regulation or at the least a

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146 Ramsay Report, pp. 8, 10 and fn 74.

147 See Money Mart standard "Fast Cash Advance™ Loan Agreement". Online: www.moneymart.ca.

148 See Report 1, pp. 103-4, s. 4.2 "Managing Risk". Legal Counsel for Money Mart disagrees, stating that Money Mart probably loses money on NSF cheques 2003 (Money Mart Counsel conversation).

149 Money Mart Letter, p. 2.

150 Money Mart Letter, p. 4.

licensing system. However, it does appear that Money Mart is facing increasing, if often fragmented, competition in many markets.[151]

RATES AND COLLECTION AND OTHER INDUSTRY PRACTICE

Money Mart took issue with being included in a general way with all payday lenders. In particular, it sought to differentiate its business in terms of rates, collection practices, default and other charges, prohibition of rollovers, borrower rights such as a right of rescission (cooling off period) and right of prepayment and compliance with provincial consumer protection, trade practices, credit disclosure and debt collection legislation. Regarding rates, Money Mart set out a chart comparing rates with three major competitors, showing costs of borrowing approximately 2.5 times higher for loans offered by Ontario competitors of Money Mart. Money Mart indicated some competitors may charge default fees, resort to aggressive collection practices, accept rollovers and not offer rights of prepayment or a cooling off period (rescission). Money Mart claimed to follow all provincial laws and be licensed where a licence was required as well citing its National Better Business Bureau membership with a complaint-free record.

There is virtually no independent information on the rates and practices of payday lenders in Canada. As noted above, some payday lenders in Canada do have Best Practices documents posted on their websites. It appears, however, that Money Mart may indeed have the lowest fees and that by abiding by its Best Business Practices would offer borrowers more rights than some competitors.

Granted Money Mart may be an industry leader in Canada and have adopted some consumer-friendly practices, the question remains whether the rest of the market, and indeed even Money Mart, should be brought to a higher level by regulation. It is that question which is explored in the remainder of this report.

[151] Money Mart has provided a list of competitors which shows 5 competitors with 40 or more outlets, 5 with 20 or more outlets, 7 with 10 or more outlets, 14 with 5 or more outlets, and 138 with 4 or fewer locations. This list does not include Internet lenders. This list also does not include those geographic areas where there is not already a Money Mart outlet, so the actual number of lenders may be higher.

Appendix 2 - APR, EAR and Other "Interest"ing Mysteries Revealed

Annual Percentage Rate (APR) Calculation

The "Annual Percentage Rate" or "APR" is an approximate measure of the amount of interest payable on a loan over the term of one year. Calculation of the APR is generally performed under the "nominal method". This is a straight linear function and is expressed like this:

$$\frac{\$\text{ amount of interest charged}}{\$\text{ amount advanced}} \times \frac{\#\text{ days (term of loan)}}{365\text{ (days in a year)}} = \text{APR (\%)}$$

Example: 10 day loan of $300 requiring $345 to repay (15% stated rate for the term).

$$\frac{\$45}{\$300} \times \frac{10}{365} = 547.5\%$$

Effective Annual Rate (EAR) Calculation

However, the Effective Annual Rate (EAR) is a different calculation. The EAR is the method specified for calculation of interest under s. 347 of the *Criminal Code*. The EAR is an exponential function. The EAR reflects compounding of the interest on a daily basis. (This is an attempt to reflect the utility of money in the hands of the lender). The EAR calculation is generally expressed like this:

$(1 + APR/k)^k - 1 = EAR$ ("k" is the number of terms in one year (52.1428571428571 wks/ in 365 day long year)) ("APR" is calculated as above)

Example: Many lenders interest charges are $.89 a week per $100. Why?

$$(1+ ((.89 \div 100) \times 52.1428571428571) \div 52.1428571428571)^{52.1428571428571} - 1$$
$$(1+ (.0089 \div 52.1428571428571))^{52.1428571428571} - 1 = 58.727463981509\%$$

Recall the criminal interest rate in Canada is 60%. Charging $0.90 a week would yield an EAR of 59.549895914949, just under 60%. Even leap years, there are 52.2857142857143 weeks a year, meaning the $0.90 rate would be just under 60% (59.75424463835). Most lenders simply do not want to cut a deal that fine. Rounding up a fraction here and there could lead to criminal charges.

The compounding aspect of EAR calculation may be "unfair" or misleading if a loan is truly occasional or specific, but it becomes a more accurate approximation as borrowing approaches a continuous cycle. Exponential functions are also very sensitive to small changes in time, accounting for seemingly ridiculous rates.

\From an economist's point-of-view, neither APR nor EAR is a "correct" measure of yearly interest rates. They are simply different, valid, calculation methods. It is up to legislators to define legally which method represents an efficacious representation of interest rates for the application of the law.

The CMC draft COC legislation adopts a variant of the EAR calculation.

We would instead suggest the straight-line APR method for payday loan rate calculation of APR. Firstly, it is the accepted present measure of credit cost across credit products in Canada and the U.S., especially with credit card rates. Second, it is a simple calculation to perform. Both industry and borrowers would benefit from an easily understandable, portable approximation of cost of credit.

Appendix 3 - How Payday Loans Really Work

Payday Loan Business Model

One overlooked aspect in the discussion of how to regulate payday lending is how the business of payday lending really works; that is, how do payday lenders make money and how can regulation fit with this business model? Such an approach has probably been overlooked for two reasons, one, assumptions have always been made that payday lenders can pay, that they will survive, no matter the regulation piled upon them. This is contrary to classical neo-economic theory of least intervention required in a market. Also, few people probably know what it is that payday lenders need to stay profitable, in a higher finance sense.

However, on the assumption that a regulatory model that reflects the business model of the regulated might actually be more effective, the following generalizations may aid policymakers.

The key to making payday lending profitable is not high interest rates *per se* but rather the ability to collect a loan. In short, as in all lending, the lender seeks "security" for the loan. Usually this is in the form of an asset that can be seized and resold to cover the loan (mortgage property or other collateral). Payday loans are typically thought of as "unsecured". Although formally unsecured by other collateral, payday lenders have come as close as possible to security for their loans as possible. This is done by taking a (post-dated) cheque for the loan (plus fees, representing interest) due on payday, precisely the day when there is the greatest likelihood the loan could be paid off. Indeed, this is precisely the point taken by Money Mart in its defence regarding NSF fees. Money Mart would prefer not to take NSF fees, but rather cash its cheque. Since the cheque is the first presented on payday, the likelihood of payment is increased to the point of the loan being effectively "secured". Money Mart has created something very close to a security interest, or at the least a first opportunity of access to future wages through the device of the personal cheque. This device is legal, however, it does test the spirit of the law against assignments of future wages.[152]

With a large portfolio of "good debts" such as this, Money Mart and other payday lenders are in fact increasing their asset base. These good loans are therefore available as collateral for corporate borrowing, or a potential product for securitization. Payday lenders make money from good loans, not interest. However, when coupled with high effective interest rates and high volume, payday lenders' returns become very lucrative indeed.[153]

[152] See, for example, Ontario's *Wages Act*, R.S.O. 1990, c. W.1, subs. 7(7). Note that Money Mart specifically does **not** take assignments of wages. Some other payday lenders do.

[153] See "Q2 2003 Cash America International Earnings Conference Call – Final", Fair Disclosure Wire, 07-24-2003. Note the confusion of the analyst regarding the drop in Cash America's Q2 assets – CA had fewer outstanding loans in Q2, that is, borrowers got government cheques and paid off their payday loans.

Implications for Regulation

The implications of this business model affect the correct regulatory approach. It suggests that certain measures intended to help borrowers may not – such as extending repayment terms by statute beyond the next customer payday (often to 30, 35 or even 45 days) will be strongly resisted by the industry, who will either seek to evade the extension or come up with a new method of obtaining "security". However, such insight means that certain measure should be easier for the industry to swallow than at first claimed: interest rate caps, APR posting and prohibitions on irresponsible lending should be accepted, or at least tolerated, since they do not attack the foundation of the loan "security". Prepayment of the loan without penalty is likely, by contrast, not acceptable, as it reduces the outstanding good debt and/or period of repayment.

Appendix 4 – Important Legislation

S. 347 of the Criminal Code

Criminal interest rate
347. (1) Notwithstanding any Act of Parliament, every one who
(*a*) enters into an agreement or arrangement to receive interest at a criminal rate, or
(*b*) receives a payment or partial payment of interest at a criminal rate,
is guilty of
(*c*) an indictable offence and is liable to imprisonment for a term not exceeding five years, or
(*d*) an offence punishable on summary conviction and is liable to a fine not exceeding twenty-five thousand dollars or to imprisonment for a term not exceeding six months or to both.

Definitions
(2) In this section,
"credit advanced" «*capital prêté*»
"credit advanced" means the aggregate of the money and the monetary value of any goods, services or benefits actually advanced or to be advanced under an agreement or arrangement minus the aggregate of any required deposit balance and any fee, fine, penalty, commission and other similar charge or expense directly or indirectly incurred under the original or any collateral agreement or arrangement;
"criminal rate" «*taux criminel*»
"criminal rate" means an effective annual rate of interest calculated in accordance with generally accepted actuarial practices and principles that exceeds sixty per cent on the credit advanced under an agreement or arrangement;
"insurance charge" «*frais d'assurance*»
"insurance charge" means the cost of insuring the risk assumed by the person who advances or is to advance credit under an agreement or arrangement, where the face amount of the insurance does not exceed the credit advanced;
"interest" «*intérêt*»
"interest" means the aggregate of all charges and expenses, whether in the form of a fee, fine, penalty, commission or other similar charge or expense or in any other form, paid or payable for the advancing of credit under an agreement or arrangement, by or on behalf of the person to whom the credit is or is to be advanced, irrespective of the person to whom any such charges and expenses are or are to be paid or payable, but does not include any repayment of credit advanced or any insurance charge, official fee, overdraft charge, required deposit balance or, in the case of a mortgage transaction, any amount required to be paid on account of property taxes;
"official fee" «*taxe officielle*»
"official fee" means a fee required by law to be paid to any governmental authority in connection with perfecting any security under an agreement or arrangement for the advancing of credit;
"overdraft charge" «*frais pour découvert de compte*»
"overdraft charge" means a charge not exceeding five dollars for the creation of or increase in an overdraft, imposed by a credit union or caisse populaire the membership of which is wholly or substantially comprised of natural persons or a deposit taking institution the deposits in which are insured, in whole or in part, by the Canada Deposit Insurance Corporation or guaranteed, in whole or in part, by the Quebec Deposit Insurance Board;
"required deposit balance" «*dépôt de garantie*»
"required deposit balance" means a fixed or an ascertainable amount of the money actually advanced or to be advanced under an agreement or arrangement that is required, as a condition of the agreement or arrangement, to be deposited or invested by or on behalf of the person to whom the advance is or is to be made and that may be available, in the event of his defaulting in any payment, to or for the benefit of the person who advances or is to advance the money.

Presumption
(3) Where a person receives a payment or partial payment of interest at a criminal rate, he shall, in the absence of evidence to the contrary, be deemed to have knowledge of the nature of the payment and that it was received at a criminal rate.

Proof of effective annual rate
(4) In any proceedings under this section, a certificate of a Fellow of the Canadian Institute of Actuaries stating that he has calculated the effective annual rate of interest on any credit advanced under an agreement or arrangement and setting out the calculations and the information on which they are based is, in the absence of evidence to the contrary, proof of the effective annual rate without proof of the signature or official character of the person appearing to have signed the certificate.

Notice
(5) A certificate referred to in subsection (4) shall not be received in evidence unless the party intending to produce it has given to the accused or defendant reasonable notice of that intention together with a copy of the certificate.

Cross-examination with leave
(6) An accused or a defendant against whom a certificate referred to in subsection (4) is produced may, with leave of the court, require the attendance of the actuary for the purposes of cross-examination.

Consent required for proceedings
(7) No proceedings shall be commenced under this section without the consent of the Attorney General.

Application
(8) This section does not apply to any transaction to which the *Tax Rebate Discounting Act* applies.
R.S., 1985, c. C-46, s. 347; 1992, c. 1, s. 60(F).

Federal Constitutional Interest Power - Constitution Act, 1867, s. 91(19)

Legislative Authority of Parliament of Canada
91. It shall be lawful for the Queen, by and with the Advice and Consent of the Senate and House of Commons, to make Laws for the Peace, Order, and good Government of Canada, in relation to all Matters not coming within the Classes of Subjects by this Act assigned exclusively to the Legislatures of the Provinces; and for greater Certainty, but not so as to restrict the Generality of the foregoing Terms of this Section, it is hereby declared that (notwithstanding anything in this Act) the exclusive Legislative Authority of the Parliament of Canada extends to all Matters coming within the Classes of Subjects next hereinafter enumerated; that is to say,

[. . .]

19. Interest.