

***Comments of the Public Interest Advocacy Centre
(PIAC) and the National Anti-Poverty Organization
(NAPO)***

***To the Maximum Total Cost of Borrowing Advisory
Board***



On

***The Consultation on the Maximum Total Cost of
Borrowing on Payday Loans in Ontario***

October 31, 2008

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The following comments are provided by the Public Interest Advocacy Centre (PIAC) and the National Anti-Poverty Organization (NAPO) and are addressed to the Maximum Total Cost of Borrowing Advisory Board of Ontario as part of the consideration period following the passage the Ontario *Payday Loans Act, 2008*.

About PIAC and NAPO

The Public Interest Advocacy Centre is a national non-profit organization devoted to the representation of consumer interests in matters involving public utilities, essential services, and public interest issues of broad application to Canadians. PIAC has developed a strong record of consumer advocacy since its inception in 1976, and is widely recognized as an important and influential voice for ordinary consumers in a variety of marketplace issues. PIAC is governed by a distinguished volunteer Board of Directors from across the country, and is supported by member groups and donors representing hundreds of thousands of Canadians.

The National Anti-Poverty Organization (NAPO) is a non-profit, non-partisan organization working for the eradication of poverty in Canada. NAPO is a member-based organization, with three categories of membership – Regular, Associate and Group. NAPO’s Group members are located across all 13 provinces and territories and include food banks, shelters for the homeless and abused women, legal aid clinics, employment support organizations, and others.

NAPO is governed by a volunteer Board of Directors numbering up to 23 individuals, with seat allocation following a geographic formula for representation from all parts of Canada. A distinguishing feature of NAPO’s leadership is that all of the Board members are people with deep personal experience of poverty.

The Boards of both NAPO and PIAC have approved the following joint submissions.

Questions to be Addressed

1. The Public Interest Advocacy Centre (PIAC) and the National Anti-Poverty Organization (NAPO) (collectively, PIAC/NAPO) make these comments in response to the letter of the Minister of Small Business and Consumer Services of Ontario dated September 23, 2008 soliciting comments on a maximum total cost of borrowing for “payday loans” in Ontario.
2. Comments are to be made to the “Maximum Total Cost of Borrowing Advisory Board” (MTBAB or the Board), an *ad hoc* independent advisory Board reporting to the Minister.
3. These comments follow an oral presentation made by PIAC/NAPO on September 29, 2008 to the MTTBAB and should be considered in conjunction with those oral remarks.
4. It is PIAC/NAPO’s understanding that the following questions are to be answered in responding to the Minister’s request for comment:
 - a. What do you believe should be the maximum total cost of borrowing rate for payday loan agreements in Ontario?
 - b. What empirical data or criteria should be used to determine a maximum total cost of borrowing rate?
 - c. What societal values should be considered in determining a maximum total cost of borrowing rate for payday loan agreements?
 - d. Should there be different upper limits to the total cost of borrowing rate for different classes of borrowers (i.e. borrowers receiving social assistance benefits)? If so, what should that rate be?
 - e. What impact or benefit would a different upper limit have on the behaviour or circumstances of the above classes of borrower
5. In addition, PIAC/NAPO have addressed certain specific questions regarding rates that were raised by the Board in oral presentation.

Rate

What do you believe should be the maximum total cost of borrowing rate for payday loan agreements in Ontario?

6. PIAC/NAPO believe that payday loans are not materially different from other consumer and small business loans in that many of the same factors that a lender must account for are present in both types of loan.¹
7. What is materially different is the different emphasis upon certain of the factors: the lack of traditional “security”, the relatively small amounts loaned and the extremely short formal term of the loan. We deal with each of these differences before turning to an analysis of the loan factors.
8. PIAC/NAPO also note that there have been rate-setting hearings thus far in Manitoba and Nova Scotia. PIAC/NAPO emphasize that the Board should not view the rates set in those provinces as the price floor (or ceiling) for rates in Ontario. That is, the lower rate set in Manitoba may well prove to be too high upon examination of the rate-setting factors described below.²
9. Likewise, PIAC/NAPO caution against the Board setting a very high rate such as that in Nova Scotia in the hopes that such rates will attract competition and somehow lower rates overall. In fact, from our observations and the available evidence (described below) the tendency is for the market quickly to reach the maximum rate and stay there;³ and in fact for a high rate to attract more less efficient and less scrupulous operators to enter the market.
10. Finally, PIAC/NAPO reiterate that while they are participating in this consultation process, that they would prefer an open, transparent and administrative rate-setting process as opposed to the course taken by the Government of Ontario to advise the Cabinet and permit Cabinet to choose a maximum rate of borrowing in Ontario.⁴ As a result, some of PIAC/NAPO’s comments may appear too geared to an administrative rate-setting scenario, however, it is done in hopes that even if the present Board is not an independent administrative body, that it will follow the same principles as one in the rate-setting, as was indicated would be the case in the oral presentation.

¹ Please see Appendix 1, Professor Laurence Booth, “Thoughts on Interest Rate Limits on Loans”, a note prepared for PIAC, September 2008. Hereafter, “Booth”.

² See *infra*, fn 13, rates for state payday loans in the U.S. Many states cap small loans at 36% (or even 28%) annual interest, including some that previously had permitted triple-digit payday loan rates.

³ See Colorado Report, *infra*, at p. 5: “In 1997, 95.38% of DDLA [payday] loans were written (contracted) at the maximum amount permitted ...”.

⁴ Please see PIAC and NAPO’s Comments to the Standing Committee on General Government on Bill 48, filed 30 May 2008, pp. 5-6.

Criteria for Rate

What empirical data or criteria should be used to determine a maximum total cost of borrowing rate?

Rate Cap Regulation and Consumer Protection

11. When deciding what criteria should inform the payday loan rate calculation, the Committee should first consider the regulatory rate-setting model it is seeking to emulate. In deciding this, the Board must keep in mind that it is setting a rate cap. There is considerable law and administrative practice surrounding the setting of rate caps, and PIAC/NAPO have been deeply involved in setting rate caps in telecommunications, gas and other utilities.
12. In PIAC/NAPO's experience, a rate of return model typically results in better prices for consumers. Rate of return regulation was designed to emulate the results that a competitive market would achieve in public utility monopoly markets (such as telephone or natural gas distribution). Rates under rate of return regulation are designed in terms of company earnings (neither excessive nor inadequate to attract capital) and consumer rates (which must be "just and reasonable").
13. PIAC/NAPO are aware that the market for payday loans is a competitive market. However, PIAC/NAPO submit that, whatever rate-setting model is selected, it is appropriate, given the nature of the market and the vulnerable nature of the borrowers, for the Board to consider what rate is "just and reasonable" to borrowers. PIAC/NAPO also note that even in "price cap" style regulation (as opposed to rate of return) that several regulatory regimes (such as telecom) have continued to require that rates be "just and reasonable" even under a price cap.⁵
14. Price cap regulation is designed for price regulation that nonetheless encourages productivity gains at the industry level. In essence, a formula for determining the price cap is set by the regulator. This formula includes factors for inflation and productivity gains, among others. The price cap formula functions such that companies that make efficiency gains in their operation are able to retain the earnings without having such efficiency returns lower rates during the price cap, all the while being insulated from losing profit from efficiency gains that result from inflation.

⁵ See *Telecommunications Act*, S.C. 1993, c. 38, subs. 27(1): "Every rate charged by a Canadian carrier for a telecommunications service shall be just and reasonable."

15. PIAC/NAPO have, over the years, reminded regulators of the following principles that are fundamental in price cap regulation to protect consumers and which have direct bearing in the present rate-setting exercise.

General Consumer Principles for Price Cap Setting

- The price cap regime should treat shareholders and ratepayers alike in terms of risk and reward.
 - Industry-wide productivity gains should be passed through to ratepayers; only those productivity gains in excess of industry-wide norms should accrue to shareholders.
 - Industry-wide profit levels are an important measure of the reasonableness of the price cap index.
16. In addition, the Board should note the real possibility that payday lenders use payday loans as a profit-centre in their overall business and may propose a rate that they state that they “require” to operate at (present, high) profit levels. Part of the payday lenders’ proposed payday loan rate therefore may include cross-subsidies to other less profitable activities such as cheque cashing, rent-to-own, money orders and transfers, etc. Price cap regulation generally avoids this conundrum by requiring “baskets” of services that are related have their own individual price caps. Although the Board is not setting rates for other payday lender services than deferred payment (payday) loans, PIAC/NAPO submit that in order to avoid such cross-subsidy and an unfair payday loan rate, that the Board should at least notionally consider payday loans as a separate sub-basket with a separate (notional) rate cap from other payday loan company services.
17. PIAC/NAPO therefore would recommend that the Board consider a rate cap formula that accounts for inflation, a productivity offset and a limited exogenous adjustment feature, together with a quality of service/market behaviour adjustment:

The Proposed Payday Loan Price Cap Formula

$$PCI = I - X \pm Z - Q$$

18. The price cap is expressed as an index (PCI), which is the maximum amount by which the loan prices in question (in aggregate) can rise. This index is adjusted annually, to account for changes in the inflation rate.
19. The basic price cap formula involves three variables: inflation (I), the productivity offset (X) and the exogenous factor (Z). Other variables, such as a quality of service adjustment (Q), can be added.

Inflation Measure

20. This measure should reflect as accurately as possible the inflation applicable to the services whose prices are being capped. The lower the inflation measure, the lower the price cap index, and hence, rates to consumers. This measure is adjusted annually.

Productivity Offset

21. This "X-Factor" should reflect as accurately as possible the productivity gains (i.e., efficiency improvements) that the company can be expected to achieve under competitive market conditions, for the capped services. The larger the offset, the lower the price cap and hence, rates to consumers. This figure is set for the entire price cap period.

Exogenous Factor

22. This "Z-Factor" allows for an adjustment to the price cap index in the event of external forces uniquely applicable to the payday loans industry, which significantly affect the companies' costs after the price cap has been set. It is important to limit such adjustments to those cost impacts which are truly beyond the control of the company, and which do not affect other industries likewise. Adjustments due to exogenous factors are rare. Crucially, PIAC/NAPO insist that costs related to losses from class actions alleging violation of the criminal interest rate be excluded from consideration as an exogenous factor. The rationale for this exclusion is that the modification of the *Criminal Code* to include new section 347.1 provides payday lenders with a complete legal regime for offering high cost payday loans but it does not insulate these companies from past actions before the law was passed nor does such a legal payday loans regime legitimize or render unforeseeable and unfair any allegations of criminal interest activity.

Quality of Service Factor

23. Some regulators include in the price cap formula a "Q-Factor", in order to counter the potentially adverse effect of strong cost-cutting incentives on service quality. Typically, service quality will be measured against established standards. If it falls below the standards, then an adjustment can be made via the Q-Factor, to effectively penalize the company.
24. Given the nature of payday loans and the tendency of payday lenders to over-aggressively attempt to collect delinquent accounts and otherwise to deal with consumers in a non-transparent manner, PIAC/NAPO consider it crucial for the Board to include a "Q-Factor". The Q-Factor would measure complaints against the company in question on a number of prohibited grounds under the

payday loans and other Ontario consumer protection and truth-in-lending legislation. Examples would be violations related to offering rollovers, illegal collection efforts (threats), failure to provide documentation and failure to state APR of the loan.

25. PIAC/NAPO note that the Q-Factor is consonant with the Province's duty to ensure, under the *Criminal Code* section 347.1(3) that "the province has legislative measures that protect recipients of payday loans and that provide for limits on the total cost of borrowing under the agreements." A Q-Factor likely would be a particularly effective measure in ensuring there is an effective, enforceable limit on payday loans and while protecting consumers.
26. Note that the Board will, under the above price cap formula, have to recommend to the Minister that the Minister require payday lenders to provide accurate details of loan origination (if necessary, on a confidential basis) to determine the industry-wide productivity rate.

Surpluses

27. If in any year, a price cap formula would result in a surplus (which normally would mean a refund to utility customers) PIAC/NAPO propose that the surplus be directed to the Ontario Payday Lending Education Fund (more on the Fund is stated below).

Criteria for Determining the Base Rate

28. PIAC/NAPO note that the criteria for determining the base rate allowed for payday loans relies heavily upon the manner in which payday loans are characterized as opposed to more traditional consumer loans, such as credit cards and lines of credit. Some of the similarities and differences are outlined below, before turning to the actual elements of the potential formula for determining the rate.
29. Booth's criteria (see Appendix 1) then usefully can be discussed as an aspect of how to calculate the base rate that then is adjusted for inflation, productivity, exogenous adjustment and quality of service/market behaviour, as described above.

Security

30. Traditional banking makes a clear distinction between loans that are "secured" by either real or physical property or a lien on intangible property such as income streams or by the personal guarantee of a guarantor. Traditional banking deems secured loans as less risky as the creditor can realize on some

other assets in the case of default. The creditor thus charges a lower interest rate for better-secured loans and a higher rate for worse secured loans, even going so far as to refuse to lend when there is no security or surety.

31. Consumer loans without traditional security, such as lines of credit and credit cards, are usually given at a higher rate, if loans are made at all. It is the reluctance of mainstream banks to lend in these circumstances to certain “uncreditworthy” persons that payday loans have seized upon to structure their loans.⁶
32. Logic would therefore indicate that payday loans should carry a higher rate of interest than secured consumer loans, which they indeed do. However, to believe that payday loans are not effectively secured is to miss the key to the profitability of payday lending.
33. Payday lenders in fact do have a reliable source of “security” in payday loans. This is the personal cheque or pre-authorized debit that they hold that is due for presentment on the day the borrower is paid or is to receive a social assistance benefit.
34. Payday loans are also known as “deferred presentment” or “deferred deposit” loans, as payday lenders hold a personal cheque from the borrower dated for presentment on the very day that the borrower is paid or receives benefits.
35. Payday lenders use this cheque as very effective “security” for the payday loan by cashing the deferred payment cheque on the day the borrower is paid or receives benefits, almost always “scooping” the loan repayment out of the account prior to other creditors presenting other cheques, debits and bill payments.
36. Payday lenders have thus “mortgaged” the borrower’s ability to pay other creditors and paid themselves first.⁷ As a result, the payday lenders, with a post-dated personal cheque, in fact have highly effective security (as long as the borrower remains employed or receives social assistance or other benefits).
37. It is therefore false for payday lenders to claim that their loans are wholly unsecured and that for this reason alone their lending rate should command a premium.

⁶ Stephanie Ben-Ishai, “Regulating Payday Lenders in Canada: Drawing on American Lessons”, CPLE Research Paper 16/2008, Vol. 04, No. 03 (2008) (Toronto: Osgoode Hall Law School), at p. 36. Online SSRN at: <http://ssrn.com/abstractid=1128147>

⁷ See Brian T. Melzer, “The Real Costs of Credit Access: Evidence from the Payday Lending Market” (Chicago: University of Chicago Graduate School of Business, December 6, 2007) at p. 30. Online: http://www.rhsmith.umd.edu/finance/pdfs_docs/seminarspring08/RealCosts_Melzer.pdf

38. Industry figures bear out the effectiveness of personal cheque security. Dollar Financial Corp. is based in the U.S. and does some of its payday lending there and some in the U.K. However, at least one-third of its business is done in Canada under the name Money Mart, the largest Canadian payday lender.⁸ DFC's latest "Form 10K" filing with the Security and Exchange Commission of the U.S. indicates that only 11.8% of loans were "gross charge offs" (that is, roughly speaking, defaults). This level, while higher than some secured loan portfolios, is not significantly higher than some secured loan portfolios and is on par with certain credit card loan portfolios.⁹
39. Although further detailed below, the other factor to keep in mind is that rate for 'net charge offs' for payday loans is in fact much lower than the rate for "gross charge offs" due to recovery of some of the outstanding loan amounts after default through collection and other efforts.

Loan Amounts and Term

40. On average, according to payday lenders, payday loans are for amounts in the \$350-450 range.¹⁰ These are typically to be repaid within 8-14 days,¹¹ at the borrower's next payday or date on which the borrower receives social assistance or other benefits.
41. While these small amounts and short term would appear to make the calculation of the rate required to make the loans (given origination costs – See Booth, Appendix 1) much higher than standard loans, the Board should keep in mind that payday borrowers typically take several loans a year, effectively extending the term.
42. Figures from regulators of payday lending in North Carolina and Colorado in the U.S. show that more than half and up to two-thirds of payday loan borrowers are in the 12+ loans a year bracket in those states.
43. For example, the regulator in the State of Colorado reported to the legislature in a report in 2007 (for the years 2000-2006) that:

- Study-to-date, nearly half of the total annual DDLA [deferred deposit, i.e., payday] loan volume is attributable to consumers who transacted

⁸ The Dollar Financial Corp. 10K Form for 6/30/2008 indicates that about 1/3 of its stores are located in Canada, however, Canadian company loan originations accounted for more than U.S. and U.K. company loan originations combined. Online:

<http://www.sec.gov/Archives/edgar/data/1271625/000089322008002500/w66715e10vk.htm>

⁹ Canadian Tire's branded credit card write-off is 5.76% (Source: 2007 Annual Report from SEDAR), online: www.sedar.com at p. 34.

¹⁰ See The Cash Store, Annual Report 2007, at p. 24 from SEDAR. Note the DFG 10K form indicates average Canadian payday loans at \$445 (at p. 25).

¹¹ See North Carolina figures, NC Report, *infra*, at p. 3, Table III(B) which indicates 62.96% of payday loans were for terms of 8-14 days in that state in that period.

sixteen-or-more loans with the same lender during the previous twelve months. Consumers who borrow twelve-or-more times a year account for nearly two-thirds of the typical DDLA licensee's unit volume.¹²
[Emphasis added.]

44. The earlier (1997-2000) North Carolina figures are consistent with the distribution of payday loan borrowers tending to repeat loans and show over half of payday loans are made to borrowers who take six or more payday loans in a year.¹³
45. The Board should note that while the demographics of the Ontario market and these states may be somewhat different, that the loan product offered is not materially different and it can thus be expected that Ontario borrowers would be repeat borrowers in large numbers.¹⁴
46. The Board also should note that most repeat loans are either “rolled over” (loan extension with principal intact and repayment of interest and charges only) – which is illegal under the *Payday Loans Act, 2008* subs. 35(1) but may well be occurring in any case¹⁵ – or are given back-to-back (that is, a new loan origination is given the same day or very shortly thereafter—which is apparently permitted under subs. 35(1)(b) of the *Act*). Either method lengthens the term of the loan if it is considered to effectively be one loan.
47. Given the likelihood of a large number of repeat loans, the shorter formal term and small amounts of the loan on their face are not to be used without adjustment in a mechanical rate formula such as that in Appendix 1 – Booth.

¹² See Administrator of the Colorado Uniform Consumer Credit Code (UCCC), “Payday Lending Demographic and Statistical Information –July 2000 through December 2006 –Summary Information from the Ongoing UCCC Study of Colorado’s Payday Loan Industry and Consumers” (Denver, Co., U.S.A.: March 8th, 2007) at p. 9 (Colorado Report). Online:

<http://www.ago.state.co.us/UCCC/AnnualRpt/ddlasummary2007.pdf>

¹³ See Office of the Commissioner of Banks, REPORT OF THE COMMISSIONER OF BANKS TO THE NORTH CAROLINA GENERAL ASSEMBLY ON THE SUBJECT OF PAYDAY LENDING (Atlanta, Georgia, U.S.A.), FEBRUARY 22, 2001, at p. 6. (NC Report). Online:

<http://www.nccob.org/NR/rdonlyres/2A95D7DA-75C0-49F3-B896-CAC45D947727/0/CheckCashersReporttoGenAssembly.pdf>

¹⁴ The Board may also wish to review the various U.S. state maximum rate caps. All maximum state rates are posted at the Consumer Federation of America’s payday loan website: www.paydayloaninfo.org, click on “State Information”. The Board may also wish to view the Consumers Union/CFA/NCLC payday loans “Scorecard” to see what a \$250 payday loan costs in each state (online:

http://www.consumerfed.org/pdfs/small_loan_scorecard_08.pdf). That link is on the homepage at the website. The legal documentation (contracts) report is also accessible at that site. Finally, the Board may be assisted by the National Consumer Law Center’s Summary of State Laws, online:

http://www.consumerlaw.org/issues/payday_loans/content/NCLC_SUMMARY.pdf

¹⁵ See Stephanie Ben-Ishai, “Regulating Payday Lenders in Canada: Drawing on American Lessons”, *supra*, note 6, at pp. 27-28.

48. The Board thus may also anticipate lower origination costs given that often the loan will be to the same borrower, at the same location for the same amount.¹⁶
49. The Board also can rightly demand a decrease in rate due to productivity gains in computerizing and otherwise streamlining the handling of (especially repeat) payday loans.

Rate for “Average” Borrowers

50. This discussion leads PIAC/NAPO to a final statement about the proposed maximum rate for an “average” payday loan should be in Ontario.
51. PIAC/NAPO are in agreement that ACORN Canada’s proposed recommendation of up to \$10 origination fee plus up to 60% EAR interest plus up to 5% of the principal amount of the loan is the maximum that could possibly be tolerated by Ontario payday loan borrowers. However, PIAC/NAPO suggest to the Board that this rate could very likely be much lower, given the explanation of the other factors above, such as the low relative default rate and tendency of borrowers to take multiple loans.
52. PIAC/NAPO therefore suggest that, at the very upper limit, the ACORN limit should be applied, however, the Ontario government should adjust the rate frequently based upon extensive loan reporting to the Ministry. PIAC/NAPO would expect that the evidence will suggest the rate could indeed be moved much lower.

Default Rate

53. During PIAC/NAPO’s oral presentation to the Board, the issue of a special rate upon default was raised. This question was answered in Manitoba by requiring a special lower rate be applied upon default.

¹⁶ For example, DFG lauds its computerized loan origination and repayment systems in its 10K filing in these terms:

We continue to enhance our point-of-sale transaction processing system, which is composed of a networked hardware and software package with integrated database and reporting capabilities. The point-of-sale system provides our stores with instantaneous customer information, thereby reducing transaction time and improving the efficiency of our credit-verification process. Also, we have deployed an enhanced centralized loan-management and collections system that provides improved customer service processing and management of loan transactions. The loan-management system and collections system uses integrated automated clearinghouse payment and returns processing, which facilitates faster notification of returns and faster clearing of funds as well as utilizing fax server document-processing technology, which has the effect of reducing both processing and loan-closing times. The point-of-sale system, together with the enhanced loan-management and collections systems, has improved our ability to offer new products and services and our customer service.

54. In the opinion of PIAC/NAPO, Ontario's legislation regarding payday loans is different than Manitoba's; Ontario's Payday Loans Act, 2008 prohibits any charge or interest on amounts in "default" in addition to the previously calculated due amount, with the exception of "legal fees" and bank returned cheque fees.
55. Section 33 of the *Payday Loans Act, 2008* makes this clear. It reads:

Restriction on default charges

33. (1) A lender shall not impose against a borrower under a payday loan agreement, and the borrower is not liable to pay, default charges other than,
- (a) reasonable charges in respect of legal costs that the lender incurs in collecting or attempting to collect a required payment by the borrower under the agreement; or
 - (b) reasonable charges reflecting the costs that the lender incurs because a cheque or other instrument of payment given by the borrower under the agreement has been dishonoured.
- 2008, c. 9, s. 33 (1).

Duty of loan broker

- (2) No loan broker shall facilitate a contravention of subsection (1). 2008, c. 9, s. 33 (2).

56. The "reasonable charges in respect of legal costs that the lender incurs in collecting or attempting to collect a required payment by the borrower under the agreement" should be limited to those costs actually incurred for hiring a lawyer. There is no other plain meaning of "legal costs" and any attempt to expand that wording to include collection agents or costs of collection (other than when using a lawyer) is not supported by the wording of the section.
57. Likewise, "reasonable charges reflecting the costs that the lender incurs because a cheque or other instrument of payment given by the borrower under the agreement has been dishonoured" can only relate to bank fees for cheques returned for insufficient funds. Any attempt to widen this concept to allow any collection fees or additional interest upon "default" would run contrary to the clear wording "because a cheque . . . has been dishonoured" which ties the "costs" directly to the dishonouring of the cheque.
58. As a result, PIAC/NAPO suggest to the Board that it has no jurisdiction to, and legally cannot, recommend a default rate or indeed any further charge upon default of the payday loan besides that allowed under s. 33 of the *Act*.

Classes of Borrowers

Should there be different upper limits to the total cost of borrowing rate for different classes of borrowers (i.e. borrowers receiving social assistance benefits)? If so, what should that rate be?

59. The issue of special rates for classes of borrowers is controversial amongst civil society and poverty advocates. PIAC and NAPO diverge somewhat on this point in their submissions.
60. Effectively, the Board indicated it wished to have particular submissions on the following possible different classes of borrowers with the expectation that those consulted would recommend different rates for these classes of persons:
 - social assistance recipients;
 - those borrowing amounts based on a large proportion of their paycheques (for example, 30% and higher of paycheques or benefit statements); and
 - other possible classes of borrowers.

Social Assistance Recipients

61. The National Anti-Poverty Organization supports a separate, lower rate for social assistance benefits recipients than the rate for borrowers who base their loan upon employment income. NAPO would prefer that no interest or other fees (besides a minor loan origination charge of \$5) apply to loans based on social assistance payments, given the obvious financial need of people in such circumstances. However, NAPO realizes that this may cause lenders to refuse to lend to this group and so submits that an appropriate fee for those persons using social benefits to obtain payday loans would be, at most, a \$5 flat origination fee plus 3% of the loan principal, no matter the length of the loan.
62. Such an origination fee plus 3% of principal yields the following APR¹⁷ on a 7-day, 10-day and 14-day loan for \$250:

¹⁷ Annual Percentage Rate, calculated in this manner (courtesy of ACORN):

$$\text{APR} = m \times (1 + i_m)$$

where:

m = the number of periods in the year

i_m = the interest rate for the period.

For a 365 day year, the 7 day loan is 52.14 periods a year, the 10 day loan 36.5 periods a year and the 14 day loan is 26.07 a year. Please note that as per the conclusion in PIAC's second report on payday lending, we do not calculate "effective annual rate" (EAR) of interest as it is confusing and APR provides a

Loan Amount	Term (days)	Rate (\$5+3%)	APR
\$250	7	5+4.50=9.50	314.4%
\$250	10	5+4.50=9.50	220.1%
\$250	14	5+4.50=9.50	157.2%

63. As the Board may note, to those persons receiving social assistance, the prospect of paying at least double or up to five times the current criminal interest rate on other standard loans (60%) already is burdensome to them. However, in NAPO’s opinion, the rate thus proposed would not lead inexorably to a cycle of debt for borrowers receiving social assistance but rather may in some cases be manageable for persons receiving social assistance.
64. NAPO also notes that the prospect of default on these loans actually is lower than those based upon employment income as generally social assistance benefits, once granted, continue and are not generally reduced, and further that government cheques have a near-zero prospect of non-payment. This fact alone justifies a lower rate for payday loans based upon social assistance benefits.
65. PIAC has some concerns that a special social assistance rate can be used by payday loan companies to justify a higher rate for the bulk of payday borrowers who will inevitably cross-subsidize these social assistance recipient borrowers. PIAC also is concerned that payday lenders simply will instruct borrowers who are using social assistance benefits to seek out a relative or friend who is employed to lend to instead, so that the payday lender can avoid the lower mandated rate for persons receiving social assistance benefits.
66. However, PIAC suggests that the Board can avoid this problem, while keeping a special lower social assistance rate by firstly, keeping the “regular” payday loan rate low and close to the social assistance rate, and secondly, by treating the social assistance rate and the employment income rate for payday loans as separate “baskets” in price cap parlance.
67. Regarding keeping the two rates as separate sub-baskets, PIAC notes that having two such sub-basket constraints would require the Board to instruct the Ministry to require payday lenders to report the “inputs” to their loan businesses separately and otherwise separate the two lines of business for reporting. Only in this way could the appropriate price cap adjustments be made for each sub-basket and the danger of cross-subsidization avoided.

sufficient estimate of interest and is portable to other common interest estimates such as those mandated for credit card interest rate reporting.

Percentage of Pay/Benefits

68. The question also arises regarding a special rate for borrowers who borrow above a certain set percentage of their paycheque or social assistance benefits. For example, in Manitoba, the Public Utilities Board there set a rate of 15% of principal where a borrower exceeded 30% of his or her salary (that is, 15% of value received from \$501 to \$1000; 6% of principal for loans from \$1001 to \$1500) in place of 17% of principal on the first \$500 loaned.¹⁸
69. PIAC/NAPO generally do not support a special rate for borrowing above a pre-defined threshold of pay or benefits. Rather, PIAC/NAPO support an amendment to the legislation to invalidate any loan that is based on an amount in excess of 30% of a borrower's pay or benefits.
70. If the Minister cannot incorporate such a prohibition in the regulations under the *Payday Loans Act, 2008*, nor amend the Act itself, then PIAC/NAPO support a rate that is equivalent to their suggested social assistance rate for loans in excess of 30% of employment income for those relying upon employment income to ground a payday loan (that is, 3% of principal on the amount above 30%).
71. For those on social assistance, the maximum rate above 30% of their benefits should be 1% of principal on the amount above 30%. Given the vulnerability of this latter borrower group and the nature of the assets they are in effect pledging, this rate is intended to discourage lending above the 30% threshold, but not to make it completely unavailable to a borrower who needed this higher amount.

Other Classes of Borrowers

72. PIAC/NAPO do not support other rate classes.

¹⁸ Manitoba Public Utilities Board, Order 39/08, April 4, 2008.

Societal Considerations in Setting the Rate

What societal values should be considered in determining a maximum total cost of borrowing rate for payday loan agreements?

73. It is important to clarify that even though some studies conducted by research firms under contract by the payday industry, and PIAC's own reports, have found that not all users of cheque-cashing and payday loans are the poor in the sense of living close to the poverty line, those users are in fact in the lower income bracket are rather marginal users. A large majority of payday services users have in common the characteristic of facing temporary financial scarcity or instability.
74. The very business case of the payday industry is based on the reality that an increasing number of constituents and households live from paycheque to paycheque and, facing a sudden need for extra cash, cannot wait until their next payday:

“Our core customer group are working and middle class consumers who are often underbanked and underserved by traditional financial institutions. These customers rely on their current income to cover immediate living expenses and cannot wait for cheques to clear through the commercial banking system”.¹⁹
75. Likewise, users who have wider financial options are unlikely to resort to these services. In a market without users with damaged credit histories and where basic banking services are widely available to the largest number of consumers there would not be business case for payday lending, or, at best, it would remain a marginal lending service. In a market populated by consumers with robust or at least resilient financial capability, the use of a payday loan would certainly not be a rational choice, even in extreme cases. Instead, payday users who usually “have other options” only resort to payday lenders because they have “maxed out” those other options. They are, however, ultimately, in the same vulnerable position as those who live from paycheque to paycheque. For all of them, a payday loan is the last avenue to resort when in financial need, and is indeed, the costliest form of credit in existence at the retail level.
76. PIAC and especially NAPO are concerned that not enough is known about whether payday loans can lead some consumers into poverty and whether payday loans lead to personal bankruptcies. PIAC/NAPO again urge this

¹⁹ Dollar Financial Corp., *Annual Report to the SEC Form 10-K*, Filed September 11, 2007, online: <http://www.sec.gov/Archives/edgar/data/1271625/000089322007003121/w39492e10vk.htm> at p. 6.

Board and the Ontario government to compile as detailed information as possible from the lenders as a condition of their licence so that researchers can investigate whether the social cost of payday loans outweigh their perceived benefits in achieving temporary personal financing.

77. To this end, PIAC/NAPO recommend that the Board recommend that the Ontario Payday Lending Education Fund, created under the Act, be used to support research into the social effects of payday lending.
78. Section 67 establishes as purposes of the Fund:
 - (a) to promote the education of persons respecting the rights and obligations of persons and entities under this Act and respecting financial planning, where the education is done through the use of publications, training, advertising, and similar initiatives, including by making grants and transfer payments; and
 - (b) to achieve other objectives that are consistent with the purposes of this Act and that are prescribed by the Minister. [Emphasis added.]
79. PIAC/NAPO submit that the Minister is well within his powers to direct that part of the fund be spent on such research.

Conclusion

80. PIAC/NAPO therefore submit to the MTCAB that the maximum payday loan rate for Ontario borrowers basing a payday loan upon employment income to be up to \$10 origination fee plus up to 60% EAR interest plus up to 5% of the principal amount of the loan. For those persons basing it upon social assistance benefits, the rate should be a \$5 flat origination fee plus 3% of the loan principal.
81. For both classes of borrowers, when 30% of regular employment income or social assistance benefit is exceeded by the total payday loan, the excess should be charged only at the rate of 3% of principal for those relying upon employment income and 1% of principal for those relying upon social assistance benefits.

Appendix 1

Thoughts on Interest Rate Limits on Loans

Professor Laurence Booth²⁰

The interest rate on a loan is what financial economists call a *promised* rate, since the borrower promises to pay that amount and the lender does not normally get anything more than the promised rate and can get a lot less in the event of default.

To determine this promised rate consider the following situation. A lender evaluates a loan and estimates that there is a 25% chance of default when they will get nothing and a 75% chance that they will be paid in full. If they can get 10% on a government note then for a one year loan to break-even they would indicate

$$1.1 = 0.75 * (1 + R) + 0.25 * 0$$

$$R = \frac{1.1}{0.75} - 1$$

$$R = 46.6\%$$

What this says is to get the same 10% as can be earned on a government bond from this default risky loan, where there is a 25% chance of default and getting nothing, the lender has to charge a promised rate of 46.6%.

It is important here to note that the lender is simply “breaking even” and expects to get the same 10% as is guaranteed from the government bond. In this sense the 46.6% rate is not usurious, but simply reflects the risk of default and getting nothing. As the default rate goes up the promised rate increases rapidly since from the above equation you are dividing by the risk of getting repaid and this number is getting smaller. This is why promised rates on risky loans quickly get close to usurious interest rates.

There are several qualifications to the above. The most obvious is that the lender wants more than the government bond rate, that the lender may want compensation for the illiquidity of the loan as well as the higher documentation cost of verifying the credit risk of the applicant. Plus the default rate obviously may not be 25%, but will vary across applicants. To generate this straight forward extension we can write the above equation as

$$(1 + r + \delta)L + X = (1 - \pi)L(1 + R) + \pi \text{Recover}$$

where r is the base risk-free government rate, δ covers the extra risk or liquidity premium required from the borrower, L is the amount of the loan, X is the set up costs to cover the processing and credit evaluation, π is the probability of default and recover indicates that the lender may recover something from the borrower.

²⁰ Professor, Rotman School of Management, University of Toronto, 150 St. George Street, 416-978-6311.

For example, if the loan is for \$1000, the set up costs are \$20, the government bond rate is 10% and the lender wants a 5% risk or liquidity premium then the lender wants the following on a one year loan:

$$(1 + r + \delta)L + X = (1 + 0.1 + 0.05) * 1000 + \$20 = \$1,170$$

If there is a 10% default risk and the lender only expects to recover 50 cents on the dollar, then in default the lender expects to get \$50, which is a 10% probability of getting \$500. This means that the promised rate of return, ie., the interest rate on a risky loan, has to be

$$\frac{(1 + r + \delta)L + X - \pi R_{\text{recover}}}{(1 - \pi)L} - 1$$

Or with our numbers

$$R = \frac{\$1,170 - 50}{0.9 * 1,000} - 1 = 24.4\%$$

To determine a fair lending rate for pay day loans the required information would include an estimate of all of the above factors, it would be very useful to get historic information on:

- The typical loan size (L)
- Default rates (π)
- Recovery rates (Recover)
- The profitability of pay day lending in terms of the institution this will give an idea of the risk and liquidity premiums (δ)
- The set up costs, that is how much time and background checking goes into each loan since the profitability of the loan has to go towards recovering the institutions operating as well as financial costs (X).
- The length of time or maturity of the loan, which in the example was assumed to be one year but in practise would be much shorter.

This data would be needed across significant periods of time and geographic regions, since defaults tend to be clustered around economic slowdowns and specific areas where there is higher unemployment.

Without the above data it is difficult to work out whether a pay day loan limit should be 30%, 40% or higher. Note that you can buy sovereign loans with promised rates of as high as 70-80%, the only problem is that the country is not paying interest. The fact is that there are always some risky individuals, countries or companies that will promise anything to get their hands on money, with no intention of repaying the loan.

Additional data on credit card debt from retail institutions, such as the Bay or Sears or the car companies could also be useful serving as a base for the rate and also to examine their rates and other charges. Finally, note that how the promised rate is expressed can alter the true or effective interest rate.

*** End of Document ***