The Supply-side of Payday Lending in Manitoba: 
Response to Interveners’ Reports

For Rebuttal of Submissions Relating to the Regulation of Payday Loan Fees 
For the Manitoba Public Utility Board Hearing November 2007

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By

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Executive Summary

This report examines four key aspects of the supply-side of the payday lending market in Manitoba that are raised in several reports of interveners to the Manitoba Public Utilities Board (PUB) hearing to cap the fees charged by payday lenders. These are key issues in conceptualizing the market and thus important to consider carefully. The way in which a market is conceptualized is very important as it will frame discussion and debate. Carefully considering the assumptions that are made about the market can more effectively ensure that the PUB process is well informed.

The four key issues identified in other intervener reports regarding the supply-side of the Manitoba payday loan market include: the competitiveness of the market, the costs of payday lenders, the current and future existence of substitutes and the impact of rate caps on the market. In several cases we draw on neoclassical economic theory to assist in defining controversial terms.

Is the market for payday lending in Manitoba competitive? Before one agrees or disagrees it is important to define what is meant by competitive. We argue that the market for payday lenders is far from the neoclassical economic model of perfect competition. In fact there is evidence that it is oligopolistic, that there are entry barriers (that have not been effective because of a lack of price competition), that the product is homogenous but that there is limited price competition and that some firms are earning profits higher than industry standards.

A second issue arising from intervener reports deals with how representative the Deloitte report’s (Deloitte, 2007) results are for the payday loan industry in Manitoba. We find that the sample selection by Deloitte was too small and too narrow to draw conclusions from it for the industry. The sample included only four firms (for complete cost data and five for cost data except bad debt expenses) and excluded the large firms. Thus we conclude that the estimated cost to provide a payday loan of $26.87 per $100 is likely well above the Manitoba average.

The next issue identified in the intervener reports deals with the issue of substitutes for payday loans. Rentcash explicitly argues that “payday advance outlets fill a niche in the market that banks or credit unions either cannot or will not fill” (Rentcash, Section 2.41.) and other reports implicitly assume that payday loans have few significant substitutes. By substitute we mean a product that buyers consider to be interchangeable with payday loans. If there are no payday loan substitutes then buyers are solely reliant on payday lenders for these products. If, on the other hand, there are substitutes from both fringe bank and mainstream bank sources, then consumers are not solely reliant on payday lenders. We find that pawn loans, rent-to-own contracts from fringe banks and credit lines and cards from mainstream banks are comparable products for many consumers.

Moreover, some banks and credit unions are developing new products that are even closer in character to the payday loan. For instance, Vancity Credit Union in Vancouver has developed ‘My Best Interest’ which shares many of the same characteristics of payday loans except for the fees.
A final issue raised here has to do with how some interveners have characterized the consequences of a rate cap. Some interveners argue that any rate cap will have a negative consequence on the industry. Others argue that a rate cap will be advantageous to the industry as long as it is not too low. We find that the likely consequences for a rate cap is a market that is similarly structured as today (i.e., oligopolistic), with similar access to capital, with outlets continuing to serve small towns with sufficient volume of business, with firms facing slightly higher costs to address regulation in order to ensure consumers are protected and with roughly equivalent levels of convenience for consumers.
1) How Well Does the Payday Loan Market in Manitoba Function?
A key issue raised by interveners has to do with how well the payday loan market is currently functioning. Some interveners have argued that the payday loan market is not functioning ideally leading to the need for government regulation. The Coalition has made this argument most strongly but the CPLA has supported this argument in some ways (e.g., in advocating a fee cap). Some interveners, on the other hand, have argued that the payday loan market is currently functioning well. This argument is most forcefully made by Clinton and Rentcash. Gould and the CPLA also argue the market is functioning well but also see some problems.

First, several interveners argue that the market is functioning well because it is competitive: “The payday loan market is competitive… (Gould, p.8-9).” Clinton concludes his report by arguing, “The [payday loan] industry is open and competitive… (Clinton, 2007, p.15).” These interveners argue that the appropriate way to describe the market is competitive. But what is meant by a competitive market? Several points identified by the interveners are discussed and examined with reference to neoclassical economic theory (Table 1).

a) Number & size of firms
The industry is said to be competitive because there are many firms. For instance Gould states, “The payday loan market is competitive with many payday loan companies providing service. In some locations in Winnipeg several companies may compete for business on the same block (Gould, 2007, p.8-9).” Clinton similarly argues, “Payday lending is a small industry…with many firms (Clinton, 2007, p.13).” These reports identify a large number of firms in a market as characteristic of competition.

Neoclassical economic theory argues that one feature of a perfectly competitive market is a large number of firms, none of which have a major share of the market. These firms cannot affect the outcome in the market, they cannot dictate the price for their product but can only respond to the price signal by determining their output level. It is the perfectly competitive market for which there is theoretical grounds to conclude that the market outcome is mutually advantageous to consumers and producers and government intervention is not required. However, if a few firms control the majority of the market even, if there are many firms, then this market is not perfectly competitive but imperfectly competitive. Exactly what type of market imperfection cannot be determined without more information about the character of the market.

In the case of payday lending in Manitoba it was found that 62 percent of the outlets were held by Money Mart and Rentcash. It may be that if these two firms’ business volumes are greater than other firms, that these two firms control an even greater share of the market share in terms of sales. This suggests the payday loan market is imperfectly competitive and most likely oligopolistic. An oligopolistic market is characterized by domination of the market by a few large firms, entry barriers associated with such things as economies of scale (and scope) and advertising. Additionally, market outcome is uncertain as oligopolies behave in strategic ways that may foster product innovation or
may protect market share.  

Table 1. Key Characteristics of Payday Loan Market Identified in Interveners’ Reports

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Perfect Competition</th>
<th>Imperfect Competition e.g., Oligopoly</th>
<th>Payday lending in Manitoba or Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Number &amp; size of firms</td>
<td>Many firms &amp; each has small share market</td>
<td>A few large firms control large share of market</td>
<td>Two firms hold 62% of the outlets identified in Manitoba</td>
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<tr>
<td>2. Entry &amp; exit</td>
<td>None</td>
<td>-Economies of scale and scope</td>
<td>-Economies and scale and scope</td>
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<tr>
<td></td>
<td></td>
<td>-Firm created: e.g., advertising</td>
<td>-Money Mart advertisement</td>
</tr>
<tr>
<td>3. Product pricing</td>
<td>Homogenous product with one price</td>
<td>Differentiated; e.g., via brand proliferation</td>
<td>-Homogenous product with several prices</td>
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<td></td>
<td></td>
<td></td>
<td>-Other financial services available: cheque-cashing, money wiring, etc.</td>
</tr>
<tr>
<td>4. Informed consumers</td>
<td>-Voluntary</td>
<td>Advertising and differentiation affect consumer decision-making</td>
<td>-Disproportionately vulnerable consumers</td>
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<td></td>
<td>-Consumers understand the product and its prices</td>
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<td>-Fees not uniformly fairly disclosed</td>
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<td></td>
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<td>-Short-term loan converted to medium term loan</td>
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<tr>
<td>5. Profit level</td>
<td>Receives a ‘normal’ which includes a return to capital</td>
<td>Ranges from ‘normal’ to ‘super-normal’</td>
<td>Data from Ernst &amp; Young LLP (2004) report found high profit for some payday lenders</td>
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b) Entry and exit barriers
Some interveners argue the payday loan market is competitive, in part, because new firms can easily enter the market. Clinton argues that entry and exit barriers are low and that

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1 Further analysis of the competitive nature of the payday loan industry in Manitoba can be found in section 2c.
2 A principles of economics textbook in discussing perfect competition explains this point by stating, “consumers know the nature of the product being sold and the prices charged by each firm” (Ragan & Lipsey, 2005, p.206).
this allows for new companies to enter the market to enhance competition (Clinton, 2007, p.10). If entry into the payday lending market is relatively easy then if there are large profits to be had new firms will enter. The neoclassical economic theory finds that as new firms enter, prices are kept low or bid down in order to reduce supernormal profits to normal profit level.

What are barriers to enter? They include economies of scale (and scope) and barriers that are created by the firms. Economies of scale exist when larger firms face lower per unit costs. This means that larger firms are more efficient than smaller firms. Larger firms may be more efficient because they can spread out fixed costs over a larger volume of operations. Firm-created barriers are obstacles the firm has erected that prevent other firms from entering the market. An example of this type of barrier is advertising. By engaging in heavy advertising, a firm can generate a level of consumer loyalty towards its particular brand. New entrants would need to engage in a similar type of advertising in order to persuade them to buy their product so that the advertising becomes a barrier to enter.

Are there barriers to entry in the payday loan market? There is evidence that there are both economies of scale (and scope) and advertising barriers in the payday lending market. What is the evidence of this? First, Money Mart and Rentcash control a large share of outlets in Manitoba. If there are economies of scale and scope in the market then these players should be enjoying them. Second the Ernst & Young LLP (2004, p.31) report found that larger payday loan firms enjoy lower costs to provide payday loans in comparison to smaller firms. This demonstrates economies of scale in the industry. In addition, Ernst and Young LLP (2004) found that multi-service providers (providing services in addition to payday loans like cheque-cashing, money wiring, bill payment, etc.) faced lower costs than single-line providers. So the largest firms in Manitoba likely enjoy efficiencies that smaller firms do not. If successful, Money Mart’s advertising may have added another barrier to entry.

The results suggest that there are barriers to entry in the payday lending market. These barriers include economies of scale (and scope) as well as firm-generated barriers like advertising. However, since there has not been competition between payday lenders on price, these barriers have not been constraining for firms. Without price competition firms can generate a normal profit in the market even with higher per unit costs.

c) Product pricing
Some interveners argued that payday loan pricing in Manitoba is consistent with a competitive market. Clinton argues, “Payday loan critics contend that the existence of a wide range of charges across the industry means that there is little competition. This is a non sequitur, as the degree of competition, or of monopoly for the matter, has no bearing on the dispersion of prices. A spread of prices of more than 20 percent at different outlets, for consumer items that are more or less the same, is the norm rather than the exception, and show no tendency to decline over time, despite improvement in information technology (Baye et al. 2004). Indeed, price dispersion on this scale is so pervasive that
Baye et al. conclude that is the natural state of competitive market (Clinton, p.7).”

However, a characteristic of a perfectly competitive market is that there is one price for the product that firms cannot set or affect. Firms simply respond to the price by setting their output level. Clinton argues that a 20 percent spread in prices across outlets is the norm in retail products. It is not clear how he established 20 percent as the normal level of price dispersion: is it based on a homogenous good or a good that is differentiated? Also, it is unclear if he is referring to price differences across outlets or across firms. Without this information it is hard to accept the 20 percent figure as the norm. Nevertheless, in research completed for the PUB process it was found that the lump sum fees across 8 Winnipeg firms offering a $250 loan ranged from $44 to $109 (Buckland et al., 2007, p.8). This represents a 40.0 percent price spread, which is double what Clinton claims is the ‘normal’ level of price spread.

In general the evidence suggests that payday loans in Manitoba are a homogenous product that is offered at a range of prices. Payday lenders generally offer other financial services including cheque-cashing, money wiring and bill payment.

d) Consumer knowledge of the product

It is argued by some interveners that payday loan clients are average Canadians in terms of income and other characteristics (Clinton, 2007, p.5, Pollara, 2007). Moreover, it is claimed by some interveners that consumers are well informed about payday loans and their fees. For instance, Clinton claims that “The payday loan market in Manitoba looks like more retail markets in all key respects. It has at least reasonably informed consumers” (Clinton, p.3).

For a perfectly competitive market to function well, consumers must voluntarily engage in the market. For consumers to voluntarily engage in the market exchange they must understand the nature of the exchange including the product characteristics and fees. The consumer needs to know about the product rules and fees before it is purchased. Then the consumer must have at least the option to engage in the exchange or not. Ideally the consumer would have other options as well.

As was discussed in Serving or Exploiting, certain structural changes have come to bear on low-income Canadians and mainstream banks. Incomes over the last 10-20 years have stagnated at the bottom of the income range of Canadians. What would logically flow from this is a growing demand for more basic banking services including small-sum loans. In addition there has been a decline in bank services such as small-sum loans and there is evidence that mainstream banks have disproportionately closed branches in inner-
city neighborhoods. Thus the demand for small-sum loans has most probably risen but the supply from mainstream sources has dropped. Payday lenders have responded to this market opportunity by entering the market and expanding in number if outlets. Consumers have the option to engage in payday loans or not, and to this extent their market participation is voluntary. However, since banks have pulled out of small-sum loans, consumers do not currently have the option to turn to them for their loan. Thus their participation in the market is voluntary but their options are limited.

Moreover, the mystery shopping reported in *Serving or Exploiting* found that payday loan fees were not generally provided in the form of an APR. Since APRs are not widely available consumers may not be as fully informed. This is because APRs (or some other type of annualized interest rate) allow consumers to compare fees across payday lenders and compare with other type of credit products.

e) Normal profits
Interveners have also argued that the payday loan market is competitive and this is evidenced by the normal profits being earned by the firms. For instance, Clinton argues, “…one finds a wide range of reported earnings across firms. This is consistent with a tendency over time for firms to make normal profits, and for reported earnings to vary in line with management skills (Clinton p.10).” Gould finds that, “[Money Mart’s] profitability has not been excessive (Gould, p.20-21).”

Neoclassical economic theory finds that the firm in a perfectly competitive market earns what are called ‘normal’ profits. This includes returns to pay for all the firm’s costs plus a return on capital that adequately compensates the owners. There are only two publicly traded payday loan companies that provide data on profitability: Money Mart through its US-based parent company Dollar Financial Group and Rentcash. As reported by Gould (p.32), Money Mart net income grew from $18.4 million in 2005 to 29.3 million in 2007. Net profit margin rose from 12.6 percent in 2004 to 13.9 percent in 2007. Net income for Rentcash went from 6.8 million in 2005 to 5.9 million in 2007. Net profit margin dropped from 13.2 percent in 2005 to 7.7 percent in 2007. These declining and lower (compared with Money Mart) figures may partly reflect Rentcash’s decision to discontinue rollovers.

Another source on industry profit is the Ernst and Young LLP (2004) report. It did not disclose profit levels for firms it interviewed but did comment on average data on the payday loan sample and found that as a group, pay-day lenders are “earning returns on equity that are comparable in other segments of the financial industry, a significant proportion of the industry is not making adequate returns (Ernst and Young LLP, 2004, p.44).” In addition Ernst and Young LLP found that 7 of the 19 respondents had an overall business loss for the reporting period (Ernst and Young LLP, 2004, p.44). It was noted that, “Given the return on equity reported in the mainstream financial services sector (Ernst and Young LLP, 2004, p.26) was reported as 18.97%, this suggests that while the average return for the group of pay-day lenders is near 20%, since several firms are losing money, other firms must be making much higher than 20%. This is evidence of some very high profit rates among the most profitable firms (Buckland, 2006, p. 29).”
f) The Market for payday lending is similar to other (retail) markets
Several intervener reports refer to the payday loan market being similar to other (retail) markets: “The payday loan market in Manitoba looks like most retail markets in all key respects. It has at least reasonably informed consumers. There is a differentiated product, a variety of suppliers of varying size, and free entry” (Clinton, p.3). The argument here is that because the payday lending market is similar to other markets and since other markets don’t have special fee caps, then payday lending doesn’t require special fee caps.

This argument is more pragmatic than theoretical. Neoclassical economic theory cannot support this argument since the argument is not rooted in theory. What neoclassical economics can tell us is that if all other markets are imperfect then there is no guarantee that all other markets will lead to the best interests of firms and consumers. So once again, this argument is not sound theoretically.

The other weakness of this argument is that we don’t have sufficient information on the nature of other retail markets to support the conclusion that payday lending is similar to them. In particular, how many retail markets find the two largest firms controlling 62 percent of the outlets? Or, how many other retail markets involve credit, a particular type of service not like groceries or footwear. Credit is different from these other consumer goods because credit is a means to an end of consumption and can lead to the accumulation of debt. Buying tomatoes or runners (in cash) doesn’t add to your liabilities. Getting a $250 payday loan does.
2) Manitoba Payday Lenders’ Costs & the Deloitte Report

A second key issue raised by several intervener reports deals with the underlying costs faced by payday lenders to deliver their loans. Understanding payday lenders’ costs is an important consideration with respect to establishing a rate cap. Without this knowledge it is difficult to know the consequences of particular rate caps for firms, and by extension, payday loan consumers.

a) Context

Submissions to the PUB on behalf of the CPLA (the report by Gould) and on behalf of Rentcash Inc. (the report by Clinton) claim that the market for payday loans is functioning properly and that competition is necessary to ensure that customers are well served in terms of both price and convenience. Both reports rely heavily on evidence provided by Ernst and Young (2004) on the cost of providing a payday loan in Canada and, in the Gould report, on the costs of providing a payday loan in Manitoba by Deloitte (2007).

There is a significant problem with the Deloitte report, however, that is ignored by Gould. There are also important insights into the nature of the market for payday loans that are not discussed in the Clinton and Gould reports.

b) The Limitations of the Deloitte study

The Deloitte study uses the Ernst and Young methodology to update estimates of the costs of payday lending for Manitoba alone. This information would be useful if the Deloitte study had been able to gather cost data from a representative sample of Manitoba payday lenders, but there is clear evidence that they have not. Of the thirteen payday lenders approached by Deloitte, only five responded and only four provided sufficient cost information to estimate the cost of a payday loan using the Ernst and Young methodology. Deloitte makes no attempt to assess whether the sample of payday lenders has characteristics similar to those of the population of payday lending firms currently in business in Manitoba. They do provide evidence on costs by volume of business (p.11), however, which indicate that two of the operations have a payday loan volume between $750,000 and $800,000, a third has volume of about $900,000, and the fourth has volume of about $1.175 million. In particular, without knowing the precise list of respondents, this very small sample very likely misses the large payday lending firms operating in Manitoba. According to the Ernst and Young report, the large payday lending firms had an average loan volume per store in 2004 of $1.85 million, or 57% larger than the largest store in the Deloitte sample. The stores in the Deloitte sample all fall into the “medium” and “small” categories in the Ernst and Young study.

Since the Deloitte sample is not representative of the population of payday lenders operating in Manitoba, it cannot be used to assess the current costs of loans among payday lenders in this province as the Gould report (p.20) attempts to do.

Gould states that the Deloitte report “provides a current cost estimate of $26.87 for small payday loan companies in Manitoba and indicates that the costs for these companies have increased since the E&Y Report was published.” Since the Deloitte sample is not representative of the industry neither is this figure representative. E&Y report an average

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5 The fifth respondent did not provide vital information on bad debt costs (Deloitte, p.8) and had to be excluded from all calculations involving bad debt costs, including total costs.
cost for small ($100) payday loans among their sample of lenders of $20.66, which includes costs of $20.79 for medium-sized lenders (average store loan volume of $1.15 million) and $22.88 for small lenders (average store volume of $640,000). Regardless of which figure we choose the implied cost increase for 2004 to 2007 from the Deloitte sample is substantially above inflation: 30% for the full E&Y sample and the sample of medium-sized stores and 17% for small stores in the E&Y sample, compared with a general inflation rate of 6.5% during this period. It is more likely the case that the differences in costs between the Deloitte and Ernst & Young studies represent dramatic differences in the stores included in each sample, or store heterogeneity in statistical terms, especially differences in the size of store by volume of loan business. Without an analysis of changes in the costs of a loan on a store-by-store basis, which is not available from either Ernst & Young or Deloitte or a combination of the surveys, there is no reason to assume that costs have increased more than the rate of general inflation. In fact, if the volume of business has increased at payday lending establishments, costs may well have fallen, as the Ernst & Young results suggest. This leads us to the important lesson of the Ernst & Young study.

c) Lessons from the Ernst & Young study

The Gould report makes clear the economies of scale associated with payday lending in the Ernst & Young study: The cost of a $100 payday loan varies from $22.88 for the companies with small loan volume ($636,000 per store on average) to $16.93 for the companies with large loan volume ($1,854,000 per store on average). These are the unweighted averages of all stores in each category; since the larger stores do most of the loans, the average cost for all stores weighted by loan volume produces a mean loan cost of only $15.69 compared to an unweighted cost for all stores of $20.66. This means that about 50% of loans in 2004 cost $15.69 or less, predominantly at stores with larger loan volume, as the average cost per store of a payday loan in the Ernst & Young study varies substantially from $10 to more than $30 (E&Y, p.17).

Although the Gould and Clinton reports argue that the payday lending market is competitive, it is difficult to square this assessment with the apparent differences in loan costs by store volume. Compare this volatility with the retail gasoline market, where prices vary little across stations in a local market like Winnipeg for a product that is about as homogeneous as payday loans. As discussed in section 1, if there were effective price competition in payday lending, the small stores would be unable to compete because their costs are too high. If the low-cost stores competed on price, they could drive the high-cost stores from the market either by forcing the high-cost stores to provide loans below cost or by attracting customers to the cheaper loans at low-cost lenders. Because there is no effective price competition, the small stores are able to remain in business. And because there is no effective price competition, we can expect competition to arise in other, non-price areas: store hours, wait times, assessment of borrower default risk, etc.

The wide variation in loan costs per store and the implicit economies of scale in the provision of payday loans suggest that regulation (or price competition) would drive some, typically smaller volume, stores out of business while leaving a sufficient number

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of medium to large stores to continue to compete on both price and non-price aspects of payday loan provision. A price of $20 for a $100 loan, for example, would exceed the costs for about half the firms in the Ernst & Young study (p.17), leaving roughly half the firms viable at that price.

Moreover, the business lost by the smaller firms leaving the market would very likely accrue to the medium and large firms, enabling further economies of scale and still lower loan costs. Lower prices may also increase loan volume, in the absence of any other changes in the market. Higher loan volumes and lower costs to firms that remain in the market once prices are regulated would permit profit margins to remain healthy.
3) Substitutes for Payday Loans
A third key issue arising from intervener reports has to do with the assumption that payday loans operate in a market in which there are no substitutes. Rentcash makes this claim explicitly: “Payday advance outlets fill a niche in the market that banks or credit unions either cannot or will not fill due to the unique nature of the product and the increased risk associated with loaning small, unsecured amounts to a large and varied client base.” (Rentcash, Section 2.4.1) Yet there are existing substitutes at mainstream banks that include overdraft protection, credit cards and lines.7 Moreover, there is evidence that mainstream banks and credit unions are developing more directly substitutable products.

a) Substitutes and Market Structure
The payday loan industry is advocating that a ‘free’ competitive environment among its participants is in the best interest of its clients. It argues for a rate cap that is sufficiently high enough to allow smaller companies to remain viable and offer competition in the market. The position taken is that without this service uniquely offered by payday lenders, consumers will suffer and resort to more dangerous, perhaps illegal alternatives. However, intervener reports do not seem to consider an alternative scenario. For example, interveners do not consider a market where traditional financial institutions undertake a more active role in this market.

Arguably, this limits the scope of the debate and presumes that the only suppliers to consider are fringe banks. More lenient caps favoring smaller payday loan operators, portrayed by the industry as the only viable competition for the larger and more dominant operators, are based on a narrowly defined market of suppliers. We argue for a broader conceptualization on the basis that more sustainable alternatives through fully regulated, full service mainstream institutions have not been fully considered. Substitute products or adaptations offered through nationally chartered banks and provincially regulated credit unions must be factored into the debate. Allowing for the possibility of re-entry by conventional institutions shifts the debate from one that assumes competition is limited to that which exists between small, private operators with high cost structures and two large, publicly traded companies, to one that involves more balanced competition among large, efficient suppliers of financial services.

b) Potential for Market Re-entry by Mainstream Financial Institutions
While payday lenders are growing in presence and use by Canadian and American consumers, some banks and credit unions are responding. Overdraft protection, credit cards, personal lines of credit and small loans are convenient, economical services typically provided by mainstream banks to address short-term credit needs. The material submitted by Buckland et al.8 and the attached report from Mr. Bob Whitelaw (Appendix 1) shows that credit unions in particular have demonstrated interest by developing new

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7 Fringe bank substitutes include pawn loans and rent-to-own contracts
services that come close to competing with payday loans. Mr. Whitelaw observed that,

The most current information indicates approximately 1,400 of the 9,000 credit unions throughout the United States now offer some form of small short-term loan to members at interest rates between 12% and 18% annual percentage rate (APR). Research demonstrates that an increasing number of credit unions are responding to the requirements by members for small cash loans for a few days before their payday.

The development of payday-loan like overdraft programs that many community banks and credit unions have begun to offer in the US has caught the interest of its Canadian counterparts. Several credit unions have taken the lead in developing some of these products. For example,

- Assiniboine Credit Union offers a secured credit card to credit-constrained consumers. A customer unable to obtain a credit card is eligible to apply. If approved, the customer would deposit funds into a secure account and the amount secured would determine the credit limit on the card.

- Vancity Credit Union offers a secured credit card similar to Assiniboine Credit Union. In addition they are in the process of developing a product that responds to the growing demand for payday loans but is not a payday loan. The ‘My Best Interest’ (MBI) loan product, currently in pilot mode, uses a straight fee based on dollar amount, which when annualized is between 18 and 30 percent. The repayment period is 6 months, rather than the two week period associated with payday loans; thought to be too short a period leading to rollovers and repeat borrowing. It also incorporates delivery features designed to speed service through easy access and non-intrusive application procedures.  

In his report on payday loan alternatives among mainstream banks and credit unions Mr. Whitelaw (Appendix 1) noted,

- “Today other credit unions are conducting active and ongoing studies and developing business cases to introduce small short-term loans to their members. While the development work is underway at this time senior management of other credit unions are discussing the business opportunities with their boards.”

- “The work largely involves fact-finding, analysis on costs and processes, consumer market opportunities, development of business cases, and design of operating procedures and templates. Earlier this year the Credit Union Central of Ontario (CUCO) held a series of seminars prior to the annual general meeting. Among the most popular seminars, both in terms of attendance and active and engaged questions, was the session headed “Small Loans- Big Profits”.”

9See also the response to CPLA/Coalition 1- 59.
In the case of under-served or disadvantaged neighborhoods, collaborative efforts of mainstream banks, financial support organizations and community groups provide a form of indirect re-entry.10

The initial retreat of mainstream financial institutions left a void in the small, unsecured loan market that payday lenders were willing to fill. But sole reliance on payday loan operators as suppliers to this market carries with it the potential to distance borrowers from full service providers of credit, savings, transaction and insurance products essential to managing a financially sound household. By offering a tailored payday loan facsimile with a built in savings component, banks and credit unions have an opportunity to use their scale and reach to serve a portion of this market. Availability of product may be enough to tie prospective borrowers to their own financial institution should the need arise. The opportunity to establish or re-establish a productive banking relationship may prevent more Canadians from looking outside of fully regulated, financial institutions for services that meet their needs.

If payday loans are deemed a necessary component of the financial services industry, then it is fitting that banks and credit unions return to the market to serve some portion of this need. The evidence suggests renewed interest by some institutions, credit unions in particular, to assume a larger role in meeting the basic needs of low to modest income and financially vulnerable consumers. Innovative product solutions offered through mainstream financial institutions may eventually weaken the hold that payday loan operators have on the market. Consumers who depend on small sum, short-term credit to stretch resources may look forward to more choice, lower cost and a chance to build just enough savings to curb the debt cycle.

c) Implications for Regulation
Banks and credit unions have a strong role to play in terms of early intervention and to anchor more firmly those clients who may be at risk of moving outside of the mainstream. They represent real and desirable competition as suppliers of financial services with a capacity for innovation. They also represent the potential for more balanced competition among large, efficient producers who are in the best position to offer lower rates and a broader range of product appealing to different segments of the market. This scenario not only mitigates the fear that consumers will be driven to more dangerous alternatives in the absence of competition provided by smaller, less efficient operators, but allows for the strong likelihood that they will be better and more effectively served.

10See Buckland et al. (2007), p. 25.
4) The Impact of Rate Caps on the Payday Loan Market

A final key issue raised by industry interveners relates to the impact of rate caps on the market. First the industry seems to be divided over the principle of rate caps. The CPLA has called for a cap to be set at $20 per $100 loaned. In a supplementary document to the CPLA submission, Gould (2007, p.24) recommends the cap be set between $20 and $23 per $100 loaned. However, in a supplementary document to the Rentcash submission, Clinton comes out strongly against the rate cap in principle and finds that, “the case for payday loan fee regulation of any kind is open to question…(emphasis in original) (Clinton, 2007, p.11).” Clinton describes regulation of this type as “heavy-handed” (p.13) and he concludes his report by arguing that there is no case for “radical government intervention (p.15).”

While some payday loan firms/associations in the industry are divided over the principle of a rate cap, several interveners to this process appear to be in agreement that the cap should not be too low. Interveners have voiced a range of concerns related to a low rate cap ranging from how it affects competition, limits access to capital, hits remote locations, adds to costs, hurts consumers and is arbitrary.

Contrary to Clinton’s claims, given that the payday loan market is not perfectly competitive, government intervention in general and rate caps in particular may be an effective way to promote consumer and producer welfare. The characteristics of the payday loan market –the concentration in the Manitoba market, the existence of some entry barriers, the spread in payday loan prices, the lack of accessible consumer information at the store level, the high level of profits by some payday lenders, and considering important structural changes in the Canadian economy (low-end income stagnation and declining bank services for certain neighborhoods and needs)– suggest that the principled argument against government intervention in general and fee caps in particular is not strongly supported.

Additionally, as discussed in section 3, payday loans have important substitute products such as pawn loan, cheque-cashing service, overdraft protection, credit line and card, etc.

a) Some less efficient/small firms will exit & other firms can’t enter

A key concern expressed by some interveners is that a low fee cap will lead some firms to exit the industry and that this process will stifle competition. For instance, Gould argues, “Unlike the corrections that may take place with regulatory lag in the public utility case, there is no correction for the payday loan companies with a cost structure above that assumed in the Board’s decision. They will not be able to operate in Manitoba” (Gould, p.10). Clinton similarly argues, “The unintended side effects of aggressive fee controls include…less competition on service as well as price, less responsiveness to differentiated customer demands, and less opportunity for small firms to survive or enter the market” (Clinton, p.2).
This argument is based on some key assumptions:
- First, it assumes, supported by data from the Ernst and Young LLP (2004) report, that payday loan firms face different cost levels and that economies of scale and scope lead larger firms to enjoy lower per unit costs than smaller firms. If rate caps are set at a level based on the most efficient producer then small firms would not be able to profit and would exit the industry.

- Second, it assumes that the departure of firms from the market will lessen competition. This is a more problematic assumption. The reason is that at present the market in Manitoba is dominated by a few large firms. These firms enjoy economies of scale and can erect other entry barriers through advertising. These firms pursue interdependent strategies intended to maintain or increase their market share and or profit. The small firms that operate in an oligopolistic market have limited power. Since their costs are much higher than the leading firms they cannot compete with them on price.

The consequence of small firms exiting the industry due to a low rate cap is not likely a lessening of competition: the market will move from one oligopolistic structure to another oligopolistic structure. While oligopoly is arguably not an ideal market structure, carefully regulated oligopoly is perhaps the best option. Moreover, setting the rate cap too high could lead to a situation where firms previously charging a lower fee could raise their fees. One study in the US found that in states where rate caps, they become the market price even for firms that charged lower fees prior to the rate cap: “a number of studies …strongly suggest state rate caps determine the typical payday loan fee” (Ernst, Faris & King, 2007, p.3).

Additionally, some payday loan firms are anticipating opportunities to expand under a new regulatory environment. In a conference presentation Rentcash CEO Gordon Reykdal commented on the consequences of payday loan regulations including rate caps and rollover bans, “We anticipate volume gains on the onset of the regulation and again as I mentioned the 45% of the smaller operators that will not be able to sustain the ban on the rollovers, nor if there is any rate caps that we believe there is a potential for us to increase our market share (Reykdal, 2007).” In its report to the PUB, 310$Loan reported that Money Mart announced its plan to open 75-100 new outlets in Canada as a result of new government regulations and that another big U.S. payday lender, Advance America plans to open outlets in Canada soon (Smyth and Slee, 2007, p.12).

b) Access to capital will decline
Some payday loan firms use a brokerage model whereby they act as a broker to connect payday loan clients to a lender. Rentcash is one such payday loan company as they act as broker for Assistive Financial Corporation, the creditor. In his report for Assistive Financial, Schiffner argues that capital available for payday lending is limited. This is because there are few people able to act as shareholders and investors in a company like Assistive Financial. According to Schiffner this is because,
“Unlike many other lenders within the financial industry, Assistive Financial Corp. recognizes the risks that underlie payday loans, and the company is able to identify shareholders and investors who are willing to advance capital. However, these shareholders and investors are a very small group and form a tiny proportion of all available lending capital (Schiffner, 2007, p.5).”

Schiffner argues that an excessively low rate cap could reduce returns and that would reduce the pool of funds available for payday lending that could ultimately, “diminish the number of companies to which potential borrowers might apply, impact competition among constituents in the present marketplace, and discourage new players from entering into the industry (Schiffner, 2007, p.7).”

This is an interesting argument. However, it is equally plausible that a rate cap that allows the most efficient firms to operate will work to the advantage of the investors. If inefficient firms exit the market this would allow the large firms to expand their operations. This could lead to higher returns for these firms and attract more capital for investment.

c) The impact of rates on small or isolated markets
A concern expressed by several interveners is that low rate caps would particularly hurt small or isolated markets currently served by payday lenders. It is argued that these markets presently have low payday loan volumes so that they cannot support an efficient high-volume outlet. The argument is that these firms maintain their viability by charging higher fees to cover their higher per unit costs. A low rate cap may drive them out of business and leave the town with fewer or no payday lenders.

There are two points to consider on this issue. First, since a large part of the payday lenders costs are fixed operating costs, it is possible that a payday lender in a small town may face some advantages in terms of cost. In a small town rent and wages may be lower than in a city. A second point to consider is that at a high enough fee level the consumer’s net benefits from a payday loan become negative, i.e., the benefits are outweighed by the costs.

d) Regulation brings additional costs to production
Some interveners have made the point that government regulation involves a cost to the firm. They are required to engage with regulators, collect and provide data to regulators and this all adds to their costs. Clinton argues that the “[a]pplication of the public utilities model of regulation would involve, at best, minor social welfare benefits, offset by heavy costs of application and compliance (Clinton, 2007, p.13).”

While regulation will impose costs to firms, government and consumers, the lack of regulation also involves costs born by all these actors. Payday lending in Manitoba is characterized by a number of things that arguably justify regulation including,

- Payday lending is an expensive product that is used disproportionately by
Canadians with lower than average incomes that make it the subject of what Mayer calls sufficiency exploitation
- Payday lending can involve rollovers and repeat loans, which Mayer argues is associated with relative advantage exploitation
- Payday lending in Manitoba is likely an oligopolistic market dominated by Money Mart and Rentcash

e) Hurt consumers by lessening convenience
Some interveners argue that a low rate cap will drive some firms out of the market and this will reduce the number of outlets left in the market. Consumers will be left with fewer and less convenient options. Clinton argues these “adverse side effects” of a low rate cap include “erosion in quality of service through longer lines and waiting time, through loss of convenient offices, and through shorter open hours (Clinton, 2007, p.11).” This argument assumes that at present consumers are well served and that after the implementation of rate caps that the number of outlets will decline. Given the argument in Serving or Exploiting that some payday lending clients are experiencing some sort of sufficiency or relative advantage exploitation it is not clear that all payday loan customers are presently well served. Moreover, rate caps will not necessarily reduce the number of outlets if firms enjoying economies of scale expand their outlets into areas exited by small firms.

f) Arbitrary choice
A final critique one intervener has made of the rate capping process is that it does not follow from public utility regulation and will therefore involve an arbitrary decision. Clinton argued, “The obstacles to applying this [public utility regulation] model to payday lending are forbidding. The product is inherently differentiated, with respect to office location, ancillary products, open hours, brand identity, and so on; and there are many providers. To calculate efficient unit costs, the PUB would have to make an arbitrary choice among the existing firms (Clinton, 2007, p.12).” While public utility regulation is intent on establishing rates that allow the one public utility to cover its costs, Clinton is arguing that this same logic cannot be applied to a market with more than one firm. Which firm’s costs need to be covered - all the firms or a sub-set of the firms?

This argument seems to assume that the PUB has only one method by which it can establish rate caps, and that one method is based on public utility regulation. However, it is not clear why rate capping must be rooted in public utility regulation. If there is evidence that a market is not operating effectively and the government seeks to improve its effectiveness there are other reasons and methods that can be used. For instance, governments in many countries set minimum wages. Minimum wages are established to ensure that workers receive a basic standard of living. The fact that payday loan APRs are universally above the Criminal Rate of Interest suggests that payday loan markets are not functioning effectively. This has generated pressure in Manitoba for government to intervene in the market.
The Manitoba PUB has experience in setting a rate cap in a market that is not a public utility. In 2006 the PUB established a rate cap for cashing government cheques.
References Cited


Smyth, Andrew and Nathan Slee. 2007. “Evidence pertaining to public hearings before the Manitoba Public Utility Board to determine maximum allowable charges and fees for payday loans,” report presented by 310$Loan, Surrey BC.
Appendix 1

Excerpt From
Credit Union Alternatives
to
Payday Loans
Fact-finding & Issue Identification

10/26/2007
Whitelaw Public Policy Research and Consulting
R.A (Bob) Whitelaw B.A (Hons), M.A.
Alternative Credit Union Developments in the United States

The most current information indicates approximately 1,400 of the 9,000 credit unions throughout the United States now offer some form of small short-term loan to members at interest rates between 12% and 18% annual percentage rate (APR). Research demonstrates that an increasing number of credit unions are responding to the requirements by members for small cash loans for a few days before their payday. The U.S. National Credit Union Foundation estimates the use of payday loans by credit union members is between seven and 15 percent.11

As a response to the increasing number of payday stores, 22,00012 according to recent reports, credit union introduced loan products that mirrored the convenience and accessibility of the loans, combined with the absence of credit checks at rates substantially lower than payday store combined interest rates and fees. 13

Credit unions throughout the United States are discovering that their deposit taking status combined with their employee knowledge, systems and infrastructure provides a cost-effective opportunity to offer small short-term loans to members between paydays at interest rates from 12 percent to 18 percent. These credit union programs reflect the convenience and immediate accessibility of the “payday” loans including the absence of credit reports checks. Introduction of the small short-term loan product only requires minor modifications to the existing open-end unsecured loans.14

The general approach by U.S. credit unions is to use their own liquidity or in-house deposits to support their small short-term loan programs. Capital from deposit taking ensures available loan funds at costs between zero percent and three percent.

11 National Credit Union Foundation. REAL Solutions Report, Washington D.C.
12 Stephens Inc. Investment Bankers September 2005
13 State legislation and regulations dealing with payday loans generally have set fees representing combined interest rates and associated administrative charges at $15.00 to $20.00 per $100.00. This is equivalent to 400 percent to 650 percent (APR). Source: Regulated state tables of permissible fees pursuant to state statutes - Community Financial Services Association (2005).
14 Examples of such models can be found in the final section of this report.
which are traditionally provided as loans at rates between five percent and eight percent. According to the U.S. credit union reports, the profitable returns result from the opportunity to loan the funds through the small short-term loans at 12 percent to 18 percent. Philip E. Greer, Senior Vice President Loan Administration at the North Carolina State Employees Credit Union says the Salary Advance Loan program (SALO) offered by his credit union contributes to the bottom line and member’s well-being.

Mr. Greer advised this consultant:

The loan is merely a modification of our existing open end “line of credit” as we already had systems and software in place to support this type of lending. The application process was simple, needing only an abbreviated application with the member’s name, address, social security number, and place of employment, as well as a recent paycheque stub verifying that the paycheque is on direct deposit at SECU. The members qualify for a loan as long as they are not currently under bankruptcy and as long as they have not previously caused a loss to the Credit Union.

The maximum amount that can be outstanding on the loan is $500, and the loan is to be repaid on the member’s next payday by an internal automated transfer from the deposit account to the loan. The interest rate is 12 percent, which is 1.25 percent above the normal unsecured loan rate for SECU.

The following user statistics are provided by the North Carolina State Employee Credit union. The preliminary fact-finding and analysis conducted by the

15 Letter and detailed attachments provided directly to this consultant dated October 16, 2006 as a follow-up to telephone fact-finding telephone discussions. The Program started in 2001 offering members a chequing account linked to a revolving line of credit. The NCSECU charges 12% or $5.00 for a $500, 30 day loan. It requires borrowers to save five percent of any money borrowed and place it in a savings account. After the first 18 months, this program generated more than $6 million in cumulative savings.
consultant in his private practice is showing early comparable results for some Canadian credit unions. The confidentiality requirements with current clients do not allow disclosure at this time; however two current samples from a Canadian credit union are included in the chart. Further detailed study is proceeding.

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<th>Age Groups of Member using the SALO Loan Product</th>
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<td>26-35 34%</td>
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<td>36-45 29%</td>
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<th>Canadian example</th>
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<th>Beacon Scores for SALO users</th>
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<td>Over 620 10%</td>
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<tr>
<td>560-619 21%</td>
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<tr>
<td>500-559 38%</td>
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<td>Under 500 26%</td>
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<td>No score 5%</td>
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<th>Canadian data under development. Initial</th>
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Work is also underway to determine the impact of a poor credit on the ability to obtain traditional credit products. The Beacon score is used to indicate the individual’s credit worthiness and risk factors on the ability to repay a loan. At the same time many credit granters are now using the Bankruptcy Navigator Index (BNI) measurement which is designed to predict the potential of an individual going bankrupt within the next three years. A low Beacon score of less than 550 on a scale of 750 and a high BNI factor of 3 on a scale of 1 to 3 generally results in a declined loan request.

**Canadian Credit Union Interests and Initiatives**

In many ways, credit unions provide a variety of small short-term loans today. Skip a payment programs provide the opportunity for credit union members to miss a
payment generally once a year. The principal and interest are moved forward providing the member with the opportunity to use the intended loan payment for other immediate purposes.

Credit unions also report an increase in the number of requests for what are termed “unauthorized overdrafts” whereby a member calls a branch and requests help to allow their cheque to proceed with payment made a day or two later when their pay is deposited. Managers and staff try to help the member who is unable to obtain a line of credit or overdraft protection due to their low credit scores. If the request is denied, the only option is to seek a payday loan to cover the cheque and avoid NSF fees and additional impacts including the possibility of an added note to their credit file.\textsuperscript{16}

Alterna Savings Credit Union, based in Ontario, and representing the combination of the former CS-Coop Credit Union and Metro Credit Union took a lead in 2006 and began a project to examine small short-term loans. The study, a first for Canadian credit unions, was responding to studies that found more than 93 percent of payday loan customers have a chequing account with a credit union or bank.

The project started with the vision to identify the increase in consumer use of small loans before their payday; understand the legislative and regulatory environment and anticipated changes on interest rates and fee structures; and, determine and report on opportunities for Alterna to provide a small short-term loan product.

The objective of the Alterna Convenience Loan Project was to consider a product that is simple and convenient, risk tolerant, socially responsible in terms of costs, and designed to break the payday to payday cycle.\textsuperscript{17}

\textsuperscript{16}Personal in-branch fact-finding interviews conducted by the consultant to determine small short-term loan product demand.
The findings and recommendations of the Phase One fact-finding and analysis work were presented to the Standing Senate Committee on Banking, Trade, and Commerce, March 1, 2007. 18

Today other credit unions are conducting active and ongoing studies and developing business cases to introduce small short-term loans to their members. 19 While that development work is underway at this time senior management of other credit unions are discussing the business opportunities with their boards.

The work largely involves fact-finding, analysis on costs and processes, consumer market opportunities, development of business cases, and design of operating procedures and templates. 20 Earlier this year the Credit Union Central of Ontario (CUCO) held a series of seminars prior to the annual general meeting. Among the most popular seminars, both in terms of attendance and active and engaged questions, was the session headed “Small Loans- Big Profits”. 21

18 Details of the Alterna initiative are found in the evidence presented to the Standing Senate Committee on Banking, Trade, and Commerce – Hearings March 1, 2007.
19 Achieving interest rates of 12 percent to 18 percent as demonstrated by the U.S. models is more difficult, but not impossible, as Canadian credit unions are subject to tax while their U.S. counterparts pay either no tax or nominal tax. I have proposed a Canadian model of 28 percent designed as a starting point to encourage discussions, model development and testing as this benchmark amount is fractionally lower than the current 28.9 percent charged by certain department and hardware store credit cards.
20 Presentation made by the consultant.
21 Public policy and operational design work conducted by the consultant.
U.S. Credit Union Costing, Operating and Delivery Models

What follow are five examples of US credit union costing, operating and delivery models.

MODEL 1
Day Air Credit Union, Dayton Ohio
StretchPay Loan

The loan is designed for established members who need a small dollar loan to carry them over until receiving their next regularly scheduled income cheque.

- $35 annual participation fee
- $250 initial credit limit and minimum advance
- 30 day repayment term
- Members pay 18 percent APR until loan is repaid
- Advances must be paid in full prior to new/additional advances

Notes: Must be a Day Air member in good standing for a minimum of 90 days with no derogatory chequing account history/activity during the past 12 months. Member must be in good standing at the time the loan is applied for and each advance is made. Members must be employed by the same employer for a 6-month period, or be receiving a verifiable fixed income must provide proof of income, and time on job at the time of application. The $35 annual participation fee is to be paid with the first advance each year.

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22Key information points developed by the consultant as part of ongoing review work – Sources include direct contact with listed credit unions and webpage references.
MODEL 2
Northwest Community Credit Union, Ohio
Paycheck Today

The loan is described as low cost alternative to payday loan companies for members who want to affordably get through a rough spot (or escape high-cost lenders once and for all).

And it costs less than bouncing cheques.

- No application fee and a fast answer
- No back-to-back schemes
- $100 to $500 2-week loans
- 14.9 percent APR with autopay
- Ideal for improving personal finances
- Helps people build their credit history
NEW!! Payday Loans

Short on cash? Considering a payday loan? This increasingly popular loan option provides the money you need for unexpected expenses or to get by until your next paycheck, with one catch - you have to be willing to pay a price. A typical 15% fee on money borrowed from a payday lender is often the equivalent of an annual percent rate that could range anywhere from 180% to 780%, depending on the payback period.

We have a better alternative… Central Sunbelt Federal Credit Union is now offering a payday loan to help you pay for those unexpected expenses or just to help you make it until your next paycheck, without being taken advantage of by high-rate payday lenders or check cashing companies. You can get up to a $400.00 loan with an annual percent rate of 18%, that equals up to you paying under $6.00 a month in interest instead of the $80.00 to $90.00 most payday lenders or check cashing companies charge.

Contact us today to learn more about Central Sunbelt’s payday loans.

23 Website information – www.centralsunbeltfcu.org
MODEL 4
Florida Central Credit Union
Small Signature Loan

- Typical range $300 to $600
- 14 percent to 18 percent APR
- Payback over 6 to 12 months
- Membership fee of $5.00
- Minimum balance in account of $50.00 – three month
- Direct deposit of paycheques – use small payroll deduction to build account

MODEL 5
North Side Community Federal Credit Union, Chicago^{24}
Payday Alternative Loan (PAL)
Interest rate at 16.5 percent APR

^{24} Website information – www.northsidecommunityfcu.org/other_loan_products_servic.html