# Payday Loans: A Financial Product with Broader Implications for Vulnerable Consumers

Written Submission to the Nova Scotia Utility and Review Board Hearing Regarding Payday Loans

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#### Introduction

The goal of this submission is to present an overview of the critical social and economic factors that are especially relevant and in the public interest to consider when making the decisions about payday loan costs that are before the Nova Scotia Utility and Review Board. This submission forefronts factors that the Board needs to consider from the perspective of consumers. It summarizes the most recent and relevant research evidence about who borrows from payday lenders, and what other credit options are available for these consumers. It highlights the issues that need to be considered in order to fairly balance the interests of consumers against the cost to do business and the risks of payday lenders. Finally, it underlines the importance, as well as the difficulties, of developing policy in this area that protects the consumers, reasonably regulates the industry and takes into account what is in the best interest of the public, and thus balances the benefits and costs to society as a whole.

The lack of a consumer representative intervening at the public hearings raises a concern about how adequately consumer issues can be addressed at the hearings. This is an especially critical concern for the decisions that are before the Board because, as is shown, the costs of these loans will disproportionately affect the most vulnerable (asset-and income-poor) consumers who have few if any other options to fill the needs that are being filled by a payday loan.

# Cost of Borrowing: How high should it be?

There is no consensus in the research about exactly how to determine what payday loans should cost for the borrower; how high should the interest rate be and what other fees should be charged by payday lenders? How does one decide what is too high? We are answering this question mainly from the perspective of the consumer, in recognition that this is a power relationship that is an imbalanced one –the balance of power going to the lenders.

On the face of it, from the perspective of consumers, the fees charged by payday lenders are too high if we take traditional services from a mainstream bank as the comparative. The closest comparative, in terms of what is available to consumers, is bank account overdraft, or cash advance from credit cards. Certainly, the fees for these services are lower than those for payday loans. Even if we were to accept this as a fair comparative, which it is arguably, the other question that is raised is whether the higher fees are in-line with the quality or quantity of the services offered, as well as whether these alternative credit options are accessible by the average payday loan clientele and thus whether consumers in practice could choose the option that would cost them less.

Payday lenders themselves would argue against the bank comparative because banks do not offer the same service –short-term, unsecured loans. Payday lenders justify the higher fees by suggesting that their costs are higher and they are in a business that comes at a higher risk because they do not do a credit check and the loan is unsecured. Higher fees are said to also partly reflect the higher costs of providing a large volume of small transactions. In addition, they point out that they offer a service that is worthy of higher

fees because of the convenience offered to the consumer (open late hours, open Saturdays, quick transaction, immediate funds released), and based on the satisfaction rating of consumers. (For a critical examination of supply-side issues and evidence that runs counter to these arguments for the high costs, see Jerry Buckland, Chris Robinson, Wayne Simpson & Marilyn Brennan's rebuttal and response to interveners' reports October 31, 2007; see also Wayne Simpson's analysis of the competitiveness of payday lenders (2007); In summary, among other claims, they argue that the costs are not as high as is suggested, and that the payday lender market itself is not adequately competitive).

While these supply-side issues are important to consider, these need to be balanced by a full consideration of how high the costs should be from the perspective of the borrower, as well as the broader social consequences of overly high costs. In order to do so, it is important to consider who the borrower is and whether they do have other credit options available. In other words, if we accept the argument that payday lenders are responding to demand and that their fees should be high to reflect the important gap that they are filling; we still need to ask why the gap exists, who is using the service, and what implications there are for the average borrower. Are borrowers making an informed choice to use a service with such high fees or should the fee better reflect the need to protect a consumer who has few if any options?

# Borrower Profile: Who borrows money from payday lender services?

Stereotypes of both payday borrowers and lenders abound. Borrowers are often portrayed as low income earners, maybe with lower than average education and literacy skills, without other financial options either because banks had moved out of their neighborhoods and there was a geographic barrier, or because they had credit difficulties and maybe no bank account or any other credit options. Borrowers are sometimes thought to be using these loans in one-off emergency situations, but more often are thought to be using them when they run out of money to pay for monthly expenses and thus become repeat users. Views of payday lenders include an impression of them as predators and exploitative—located in poorer neighborhoods and getting people trapped in a cycle of debt because of exorbitant and unjustified fees. There is, also, a general impression that consumers were not protected, but at the mercy of payday lenders. These impressions—of both borrowers and lenders-might be considered generalizations based on oversimplifications. It is important to delve below the surface and ensure that portrayals are fair, but more importantly accurate and based on evidence.

There is a lot of research that has been done in the United States on pay day loan borrowers (see for example, Elliehausen, 2006). There has been no research done in Nova Scotia, but some research done on consumers in other provinces as well as research on the industry as a whole (for overviews, see for examples, Kitching & Starky, 2006; Lott & Grant, 2002). There have also been national surveys that included borrowers from Nova Scotia in their sample. The two most recent national surveys (Ipso-Reid, 2005; Statistics Canada, 2005) are the most relevant and reliable data sources because they are national. The national snapshot is important because the research has shown that there are stark differences amongst the provinces, with a concentration of payday lenders out west,

for example. This means that the more specific surveys and analysis of experiences in the other provinces might not be as translatable.

The **Survey of Financial Security** (Statistics Canada, 2005) is the most recent national survey of payday borrowers in Canada. The survey findings show that the consumers of payday loan services are generally among the poorest and most financially vulnerable Canadians. It sheds further light on who borrows through payday loans. Indicators of past and current financial difficulties uncovered by this survey suggest that families who use these loans have few or no other options (Pyper, 2007). The details of these indicators and other details about borrowers from this survey include:

- Young families (head of household 15 to 24) were three times more likely to have used payday loans than those aged 35 to 44, after controlling for other family characteristics.
- Low-income families (living below the Low-Income Cut Off) were fully twice as likely as those living above LICO to have used payday loans—4.6% compared with 2.3%.
- Over half of families who used payday loans were in the lowest 20% of net worth, and nearly 8 in 10 were in the bottom 40%.
- 7 in 10 families who used payday loans were renters (only 37% of none users were renters).
- Families with little savings or no credit cards were significantly more likely to have used payday loans. Those without credit cards were 2 to 3 times as likely, and those without savings of at least 500\$ were 2.6 times as likely to have used payday loans.
- Families behind in bill or loan payments were more than four times as likely to have used payday loans.
- Four in 10 families who borrowed money through payday loans had spending that exceeded income, substantially more than families who had not used payday loans.
- Almost half of families who used payday loans reported that they had no other option.
- Payday loan borrowers tend to be less educated; 21% had no high school and only 11% had university compared to the general population of which 11% have no high school and 25% have university.

There is a very important caveat to this evidence and all survey evidence that seeks to offer a snapshot of these borrowers: these surveys likely under-report usage by lower-income, lower-literate people and especially those with financial difficulties. Therefore, some of these figures may be under-estimated. It is important to note that data are not available on ethnic make-up of payday lending clients in Canada, which would be an important gap to fill given that African Americans are disproportionately represented amongst borrowers of payday loans in the US (see for example, Squires & O'Connor, 2001).

If we were to revisit the stereotypes discussed above, most of the generalizations are rather accurate. In summary, as is echoed in other research, payday loan borrowers tend to have incomes lower than average national family income, to have very little savings in their bank account and have more trouble 'making ends meet.' They also tend to have more trouble accessing other sources of credit (Buckland, Carter, Simpson, Friesen & Osborne, 2007). There is also evidence that these services are not used as one-

off emergencies, the survey conducted by Ipso-Reid for the **Financial Consumer Agency of Canada** (Ipso-Reid, 2005) provides more insight into the usage as follows:

- Almost one-quarter report using these services monthly.
- 52% using payday loans at least monthly had incomes under \$30,000, compared to 32% of other payday loan consumers
- Almost half of those who had used these non-bank financial services thought the interest rates charged were not higher than those of financial institutions or just didn't know (Createc, 2006).

The research and especially the survey findings provide some insight into the borrower – who is vulnerable in many senses: young, poor families, struggling to make ends meet, with few other options, and often with a limited "financial literacy," as well as lower educational levels. While these factors about the borrowers are important to consider, it is equally important to consider the context in which consumers are making informed choices.

# Going beyond individual risks and responsibility: Financial insecurity and other issues

On the one hand, given what we have outlined regarding borrowers, payday lenders could be commended for offering a service to consumers who appear to have few or no other options. On the other hand, without other options payday lenders may have captured a vulnerable consumer and thus the high costs of this product can have serious negative implications. First, consumer reliance on these businesses can be self-reinforcing because these loans don't allow the client to save money, or to repair or build a credit rating (Buckland, Carter, Simpson, Friesen & Osborne, 2007). Yet, consumers are receiving a more *limited set of services* than what is offered by a bank or credit union at much higher fees. The market is *bifurcating* more than it is expanding choices; in other words, some consumers are being streamed into alternatives like payday lenders, not using them to supplement other options available in banks or credit unions. The major concern with these businesses is that once consumers use their services they get caught in the debt cycle. At the very least, since more borrowers are low-income people this kind of business is more likely to reinforce poverty. These concerns are reinforced when we take into consideration broader structural changes in the economy and the context in which consumers are using payday loans.

This is a critical time to ensure that more Nova Scotians are improving their financial capability and financial security. Instead, there is an increase in financial insecurity and the financial capability of Canadians is in question. Recent research indicates that those vulnerable to getting caught in the debt cycle and needing to rely on these types of services is on the rise as people's income (with the exception of those at the high end of the pay scale) continues to stagnate or/and become unpredictable (Buckland, Carter, Simpson, Friesen & Osborne, 2007, 2007). We know there is an increase in precarious employment –employment that is nonstandard, with very few benefits, fewer hours, and little permanency. We know there is an increase in the working poor – the number of families that have two-income earners and are not able to make ends meet. Vulnerability also increases with the unpredictability of future expenses such as heating oil or other

such expenses. Canadians have a growing debt load while also having less in household savings (Policy Research Initiative & FCAC, 2006). This is a very precarious situation: 49% of Canadians report being always just one or two missed paycheques away from being poor (CCPA, 2007). All of these structural changes are likely to increase the number of Nova Scotians relying on payday lenders, and to make it more difficult to break the debt cycle.

While the notion of a debt cycle suggests that consumer protection in the area of payday lenders is a problem largely for the poor minority, structural changes to the economy have made a substantially larger proportion of the population vulnerable to falling into poverty. The current situation in the US underscores the importance of protecting consumer interests with respect to "high-risk" loans, that if too many borrowers are trapped in a cycle of debt from which they are unable to escape, this can have serious spillover effects in the economy as a whole. In this context, it is troubling that Canadians are bearing more responsibility and more risks for their financial well-being with a shifting away from government responsibility (Policy Research Initiative & FCAC, 2006). It is more important than ever that credit consumers' interests be protected.

#### Recommendations

#### **Borrower Fees and Costs:**

- Our key recommendations are based on the notion that "a just and reasonable rate for a payday lender to charge is a rate that allows an efficient lender to recover costs and earn a reasonable profit, but not earn an excess profit" (Robinson, 2007).
- Default fees should reflect the payday lender's costs and also penalize the consumer to a reasonable extent.
- Renewal and extension fees need to be as low as is feasible, as these are of particular concern for trapping consumers.
- We suggest that the Board consider recommendations for specific numbers that have been presented to the Manitoba Utilities Board by Dr Chris Robinson (2007). This recommendations were as follows:
  - o Payday loan: 17% on \$250, 12% on next \$250, 10% on the rest
  - o + \$10 fee only for first-time borrower
  - Replacement loan: \$10 + 1% per week.
  - o Default fees: \$20 + NSF cost
  - o Alternative for initial payday loan is 16% of entire loan

## Terms and conditions of loans: issue of disclosure

We echo the recommendations made by Buckland, Friesen and Osborne, 2008 as follows: Terms and conditions of payday loans should be simplified and made readily available verbally and in written formats to potential customers in a clear and comprehensive manner. This should include:

- Full disclosure of all requirements to qualify and details of each. *Note:* this should be kept to a minimum and should *not* include a Social Insurance number. Recommended requirements: must be 18 years or older, blank cheque(s) or sign a direct withdrawal form, bank account, recent paystub(s), 2 pieces of identification

(one with photo), current bank statement, number and type of references and their contact info, type of employment information.

- The minimum and maximum amount of loan one may be eligible to borrow.
- The optional fees and services should be clearly stated as such.
- The repayment deadline should be clearly stated at the outset
- A full, simple explanation of charges incurred and options available if payment is not possible, with specifics detailing when each step occurs, and exactly how much any additional fees incurred would be.

## Other recommendations:

- While borrowers need to have a bank account in order to be eligible for these loans and thus are not unbanked, they are considered to be underbanked (Buckland, Carter, Simpson, Friesen & Osborne, 2007). Mainstream banks and credit unions need to develop and market comparative products especially for low-income earners. Payday lenders are fulfilling a consumer demand that needs to be filled in other ways so that consumers have alternatives and real choices. We realize that this is not in the power of the UARB, but we recommend that this provincial government regulate and/or support banks or credit unions and community organizations in efforts to provide better access to basic banking for the most vulnerable consumers.
- We also recognize that the federal government has a role to play as well. It needs to ensure that the *financial services market is competitive and benefiting Canadians*. Competition needs to be operating at various levels including between mainstream banks, credit unions and payday lenders as well as similar financial institutions. This competition needs to be fair competition ensuring that consumers are served appropriately by geography (rural, poorer neighborhoods). There is some evidence that payday lenders operate rather oligopolistically with a few major firms influencing the market (Simpson, 2007).
- As part of improving informed choice, governments along with community organizations need to provide *financial education*.

# Conclusion

The Nova Scotia government should be commended for the work that it has done already related to this issue via amendments to the Consumer Protection Act. The regulations outlined in the governmental discussion paper also address many of the problems and concerns that have been raised about payday lenders. When making decisions before them, the UARB must consider the fact that "while the welfare of some consumers is no doubt improved because of access to payday loans, other consumers are likely using these services because there are so few options" (Buckland, Carter, Simpson, Friesen & Osborne, 2007).

We believe that the government has an opportunity to do more to protect the vulnerable consumer, and that this idea must be forefront in any efforts to ensure financial consumer protection. These issues would also need to be addressed in a poverty reduction strategy for Nova Scotia that seeks to promote financial inclusion and consider how to help those who have financial difficulties including bad credit, and difficulty paying bills. To this end, the Nova Scotia government could for example, raise social assistance rates and reform social assistance so that savings, financial inclusion and independence are

encouraged. In other words, we must work to create an environment that enables the financial capability of more Nova Scotians, that is an environment that would ensure that all Nova Scotians "develop the skills and confidence to be aware of financial opportunities, to know where to go for help, to make informed choices, and to take effective action to improve their financial well-being" (Policy Research Initiative & Financial Consumer Agency of Canada, 2006). Creating such an enabling environment and not furthering financial exclusion is in the public interest.

#### **About the Author**

Christine Saulnier has a PhD in political science from York University. She is the Director of the Canadian Centre for Policy Alternatives-Nova Scotia, which is a nonpartisan, independent organization that produces research on issues of social and economic justice.

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