Lowering the Cost of Borrowing for Payday Loans in Ontario

RESPONSE FROM CARDUS TO MINISTRY OF GOVERNMENT AND CONSUMER SERVICES

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In the Fall of 2015, Cardus published a significant research study on payday lending in Canada. Our report, "Banking on the Margins," addresses many of the questions asked by the Ministry below and this response is informed by that report, which is attached, alongside conversations that have been conducted prior to and following the publication of this report.

First, we commend the government for studying this important issue, and for its considered, thoughtful approach to reforming payday lending in Ontario. Payday lending, with its benefits and drawbacks, raises questions that have no easy answers. It is fraught with complexity and, given the lack of clear data, poses considerable challenges to a government wishing to make laws that provide the public legal framework for a just lending market.

Second, we recommend that the government expand its payday lending reform efforts beyond an exclusive focus on interest rates. As we note in our report: "a standalone policy, interest rate regulation, regardless of the level of restrictiveness, does little to help consumers and can do unintended harm" (41).

A change in the interest rate without any additional changes to loan terms or repayment terms is likely to have a negligible effect on the well-being of consumers. It is the short-term nature of payday loans that puts the heaviest pressure on borrowers. The current average term of a payday loan in Ontario is 10 days, and it is the requirement to repay both the principal and interest at once that does the most damage to consumers. As we note, this "effectively moves the burden of illiquidity from one pay period to the next" (33) and moves the cash-flow challenged consumer into a position where they run the risk of terminal dependency on small loans.

The savings that will be achieved by a reduction in the interest rate from 21 percent to either 19 percent, 17 percent or 15 percent are significant, but do not address the underlying – and more important – issue of cash flow shortages for borrowers. We pointed out that the key driver of payday loan usage is cash flow shortage (18-21). Any policy that does not address that core issue is unlikely to make significant positive change for borrowers and could result in reducing access to credit by way of store closures.

Cardus conducted an analysis of the profitability of two major Canadian lenders – National Money Mart, and the now defunct Cash Store Financial – based on the most recent publicly available financial statements of both firms. We attach an interactive spreadsheet to this submission which shows the impact of interest rate changes on the profitability of these firms. Within the limitations provided in tab two of our spreadsheet, our analysis suggests that modest changes in interest rates are potentially feasible, but that National Money Mart's income before taxes (a five year average of 8.5 percent) indicates limited room for business vitality if the firm continues to operate as currently structured.

Further, given that the major firms in this industry operate nationally, Ontario's proposed changes need to consider the impact of regulatory changes in other jurisdictions on the overall viability of payday lenders in Canada. Alberta's Bill 15, An Act to End Predatory Lending, introduced in May of this year, will need to be considered alongside Ontario's changes. Assuming that Alberta's proposed interest rate reduction to 15 percent is in place, a reduction in Ontario to 17 percent would place the biggest player in this industry on the edge of unprofitability, while 15 percent would make the firm unprofitable if it maintains its current structure. We suggest that if the government wishes to focus exclusively on interest rate reductions it should not reduce rates lower than 17 percent.

It is possible that such changes would force the industry to re-evaluate its current business structure. But, as we note, the bulk of the costs of providing payday loans (approximately 75 percent) are the result of the costs of overhead, including physical infrastructure and staff. If this is put against behavioural studies of payday loan borrowers – many of whom consider the physical presence of lenders an important reason for transacting with them – it's possible that the ability of firms to adopt different cost structures is limited. It is possible, however, that regulatory changes will force firms to adopt different

models and especially moving to models that reduce physical infrastructure like online lending. This has both challenges and benefits. It both opens the potential for an increase in gray or black market online lenders (28), but also for innovative disruptors like MOGO and other financial tech companies to grow their market share (46-47).

While it is not possible (given the lack of data) to estimate the impact that significant reductions might have on how often people borrow from payday lenders, it is important to note that lowering costs has the potential of increasing use among a subset of users, especially the approximately 13 percent of payday loan users who take loans for discretionary purposes. As noted above, without a change in the repayment structure of payday loans, the savings of reduced interest rates are unlikely to have a significant effect on the leading problem with payday lending: repeat loans. Its effect will be limited

Restrictive interest rate regulation alone "does not remove any of consumers' previously existing barriers to higher-tiered credit products" and a significant loss of lenders that might come as a result of increased losses, can "force consumers to find potentially inferior alternatives to address their need for small-dollar liquidity relief" (41). Studies suggest that a lack of access to small-dollar credit can increase bankruptcies, increase illegal lending (including lending by organized crime), and increase the substitution of more expensive means of accessing small dollar credit (42).

The question of whether there are any particular reasons why Ontario's business environment requires a higher interest rate than other provinces is difficult to address. Estimates would have to account for the effects of a wide variety of variables, including the number of customers in a given market, the cost of such things as utility rates, rental rates, wage costs, and payroll taxes in various markets, and other factors which contribute to the cost of lending for payday lenders.

Interest rate regulation on its own will have limited effect on the payday lending market in Ontario and its efficacy in helping borrowers achieve better financial outcomes is significantly limited. A better approach would be to introduce a two-pronged strategy for reforming the market: movement towards reducing the cash-flow "shock" of the current payday lending market by mandating longer terms for borrowers to repay (though this might require federal/provincial cooperation to alter the upper loan term limit of 62 days) (43-45) and significant and sustained support for alternatives offered by financial institutions and their civil society partners (45-48). While the former can provide the framework, it is only the latter that will actually rebuild a better, more enabling, credit market.

Again, on behalf of Cardus we'd like to commend the government for its attention to this important issue, and we look forward to working with you to help build a better, enabling credit market in Ontario.

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