EXECUTIVE SUMMARY

Canadian Consumer Finance Association: Filling the Gap—Canada's Payday Lenders

At a Glance

- In 2014, the licensed Canadian payday loan industry provided nearly 4.5 million short-term loans to Canadian households, at a total value of $2.2 billion.
- Despite its unfavourable reputation, the licensed payday loans industry provides a necessary service for cash-strapped Canadians.
- Placing inappropriate regulations on the industry may reduce access to credit for the financially vulnerable. Consumer education is advised to protect the financial welfare of borrowers and deter the growth of unregulated lending channels.

The payday loan industry has an unfavourable image with the public, and politicians and the media mainly discuss it in a negative light. Despite its unfavourable reputation, the licensed payday loans industry provides a necessary service for cash-strapped Canadians who lack access to alternate sources of credit in times of need. It also generates a substantial economic footprint for the national economy in the process.

In 2014, the licensed Canadian payday loan industry provided nearly 4.5 million in short-term loans to Canadian households, with a total loan value of $2.2 billion. This activity generated 6,930 full-time equivalent jobs for the Canadian economy, with accompanying total salaries of $273.3 million. Extrapolating the economic footprint of licensed payday lenders since 2014, it is projected that Canada's licensed payday lending industry will issue nearly 6 million loans to households in 2016 at a value of $3 billion.[1] Data from the Bank of Canada[2] indicate that credit issued by the licensed payday loans industry represents 4.2 per cent of the $70 billion in total outstanding household consumer credit (excluding residential mortgages) issued by non-bank institutions in 2016. This makes payday loans an important source of credit for Canadians.[3] Consumer credit includes, but is not limited to, credit card loans, personal lines of credit, automobile loans, and other types of personal loans.

The Conference Board of Canada analyzed data from Statistics Canada's 2014 Canadian Financial Capability Survey (CFCS), which indicated that households that use payday loans only do so infrequently (80 per cent of payday loan customers borrow a maximum of twice

1 Grant Thornton, *Confidential Canada-Wide Member Survey*.

2 All computations, use, and interpretation of these data are entirely those of The Conference Board of Canada. As per the Bank of Canada's definition, non-banks include trust and mortgage loan companies, credit unions and caisses populaires, life insurance companies, non-depository credit intermediaries, and other institutions (e.g., automobile leasing and sales financing companies).

3 Bank of Canada, *Household Credit*.

There is no prototypical payday loan consumer in Canada. Instead, there are two distinct categories with widely divergent needs.

annually).[4] However, research in the United States reveals that access to, and use of, licensed payday loans helps borrowers who use fewer than 10 loans per year to survive financially.[5]

There is no prototypical payday loan consumer in Canada. Instead, there are two distinct categories of clients with widely divergent needs. The first category, "ALICE"—which stands for "asset limited," "income constrained," and "employed"[6]—is a relatively financially vulnerable customer who relies on payday loans to cover the cost of both periodic, unexpected expenses and ongoing necessities. ALICE customers' lack of an established asset base severely restricts access to alternate consumer credit through conventional financial channels. The second type of client is the "ARTI"—"asset rich, temporarily illiquid"[7]—a more economically stable client who uses payday loans as interim financing (often as productive capital) to cover unexpected expenses.

ALICE and ARTI clients both use payday loans due to infrequent, adverse spending shocks. However, ALICE clients have the additional challenge of being among the working poor. This is a characteristic that would be better addressed outside the context of the payday loans industry through community support and social service programs that support labour market skills development, financial literacy, and access to affordable living.

The policies required to address the needs of two such different clients will necessarily diverge. As such, paternalistic or broad market initiatives that may superficially appear to be welfare-enhancing for one or both consumer segments may well have unintended, deleterious effects for at least part of the market. For example, research in the United States shows that the implementation of inappropriate fee ceilings constrains access for all types of customers to short-term consumer credit.

4 All computations, use, and interpretation of these data from the survey are entirely those of The Conference Board of Canada.

5 Wilson and others, *An Experimental Analysis of the Demand for Payday Loans*.

6 United Way, "ALICE: Asset Limited, Income Constrained, Employed."

7 Ibid.

High default rates resulting from lending to a largely subprime consumer base characterize the licensed payday lending business model and fee structure. Furthermore, such policies have the undesirable effect of crowding customers out of relatively safe and regulated markets, and causing some of them to use imperfect payday loan substitutes. Notably, these include illegal online lenders or more expensive, regulated forms of short-term credit such as overdraft fees, late bill payment fees, and service cancelation fees. The welfare losses resulting from inadequate access to safe credit will be felt disproportionately by the most vulnerable consumers, for whom the cost of financial instability is highest.

Provincial legislation governing the licensed payday loans industry in Canada provides considerable safeguards against the exploitation of households. Furthermore, legislated fee ceilings on licensed payday loans appear broadly consistent with the cost structure of the licensed payday loans industry in Canada. This industry is characterized by low market power, cannibalization by illegal online lenders, and a high incidence of bad debt. Nevertheless, there is some risk that licensed payday lending could become uneconomical if aggressive policy changes are implemented surrounding fee caps. Careful analysis of the industry's cost structure in Canada reveals that current legislative maximum fees in some provinces with low interest ceilings, such as Alberta, may not adequately cover the cost of providing payday loans. Policy-makers are urged to exercise caution in lowering provincial maximum fees, and to use judicious, evidence-based approaches to securing the financial welfare of Canadian households.

Analysis of natural experiments in the United States concerning the imposition of inappropriate industry regulations reveals that aggressive attempts to cap loan fees significantly reduces access to consumer credit for those who use licensed payday loans, with resultant welfare losses to households. In addition, other conventional sources of consumer credit are imperfect substitutes for payday loans. As a result, displacement of consumers from legal payday-lending channels can result in spillover of borrowers into unregulated (alternate) lending channels that cause consumers to incur higher debt costs.

Consumer education regarding illegal lenders would be a critical step toward protecting Canadian payday loan borrowers' financial welfare.

Imposing inappropriate regulatory requirements on an industry that is already significantly regulated may only serve to reduce access to credit for a financially vulnerable segment of the population. Instead, a public policy approach favouring consumer education is advised. Specifically, consumer education around distinguishing licensed online payday loan lenders from illegal lenders would be a critical step toward protecting the financial welfare of Canadian payday loan borrowers, and deterring the growth in unscrupulous, unregulated channels. Efforts to increase financial literacy, such as the federal government's current initiative in this area, are also critical to ensure that Canadians are making the best financial decisions possible.

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