

Consumer Protection in the Payday Lending Sector

Ministry of Government Services
Policy and Consumer Protection Services Division

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Introduction

This discussion paper invites comments and suggestions on whether further measures are needed to protect consumers of payday loans and to promote fair market practices by payday lenders.

Concerns have been raised about the cost of a payday loan and the practices of payday lenders. A payday loan is a small advance of money for a short period. When all fees and expenses are added to the nominal interest rate, the effective annual rate of interest can be high. For a typical payday loan of \$300 for 14 days, the annualized cost of borrowing can appear in excess of 400 per cent. Section 347 of the *Criminal Code* establishes an effective annual rate of interest exceeding 60 per cent as a criminal rate of interest. Payday lenders claim that they cannot offer payday loans profitably at interest rates of 60 per cent or less and would be forced to stop offering the service if the *Criminal Code of Canada* upper limit of 60 per cent were enforced.

The payday lending sector characterizes payday loans as a simple financial service product that addresses a temporary or emergency credit need that usually cannot be met by traditional financial institutions. They further maintain that the current market pricing of the loans is in keeping with inherent risks of such loans and applicable operating costs. Moreover, they claim that the fees for payday loans are less costly to consumers than available alternatives such as bounced cheque fees and late fees associated with credit cards and utility payments.

In Canada, governments have been assessing options to deal with payday lending for several years through the Consumer Measures Committee (CMC), a federal-provincial-territorial intergovernmental working group that seeks national approaches to consumer protection issues. Ontario's preference is for a harmonized national approach to regulation and interest rate setting, with a federal lead on rate setting to create a national standard for the industry.

The federal government recently passed Bill C-26, adding section 347.1 to the *Criminal Code*. Section 347.1 defines a payday loan and will exempt payday lenders from criminal interest rate provisions if the loan is made in a designated province. A province could request designation provided it has legislative measures that protect recipients of payday loans and limits the total cost of borrowing. As a result, each province will need to determine whether it wants to seek designation so that payday lenders in its jurisdiction would be exempt from the *Criminal Code* provisions governing criminal rates of interest.

Feedback received from this discussion paper will be used to evaluate the need for additional measures to protect consumers of payday loans and whether Ontario should seek designation under the *Criminal Code* and limit the total cost of borrowing for payday loans. It is the ministry's goal that any options for reform will achieve the following objectives:

- Provide appropriate consumer protection for those who use payday loans
- Promote fair market practices by payday lenders
- Ensure a responsive and effective legal framework to govern payday lending
- Promote compliance with the law

Through this consultation, the Ministry of Government Services is looking for comments on whether additional measures are needed to protect consumers who use payday loans and on the elements of the regulatory and legal framework. . The ministry kindly requests your input, views and feedback on the issues outlined below.

The ministry has provided some background material and some questions for consideration. **Respondents are not restricted to consideration of only the questions listed below.** Please feel free to share any viewpoints and other perspectives that you feel are appropriate.

Please respond by July 6, 2007 electronically or in writing, to:

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Payday Loans and the Industry

Payday lending is a relatively new product and is most frequently offered in a suite of “alternative” financial services along with cheque cashing, bill payments, and wire transfers, generally provided at a single location.

A payday loan is a small, unsecured loan made to the borrower in exchange for a post-dated cheque or pre-authorized debit. Lenders typically require the borrower to prove three months continuous employment, produce a recent utility bill in their name to establish address, and have an active chequing account. There is no credit check or specific test applied to determine the borrower’s ability to repay.

Although the principal amount of a payday loan varies, the norm in Canada is a maximum advance of 50 per cent of the borrower’s pay for their regular pay period. The average loan in Canada is approximately \$300 with a term of 10 days to two weeks. The borrower is required to provide a post-dated cheque or pre-authorized debit for the principal amount and all interest and fees. The cheque is to be cashed by the lender on the borrower’s next payday.

Payday lending emerged in Canada in the early 1990s and has since grown rapidly. Current estimates place the industry at 1,300 to 1,400 storefronts nationally with almost half that number operating in Ontario. Two major players, each of which has almost 400 locations, dominate the Canadian industry.

While the industry has grown quickly over the past decade, it remains a small player in the financial services sector. The total industry is estimated to issue approximately \$2 billion in loans annually. At the storefront level, the average location would lend approximately \$1.5 million and make 5,000 individual loans a year (based on an average loan of \$300). This translates to an average of 16 loans per day and would require less than \$100,000 in total loan capital.

Other short-term loans or loan substitutes available to consumers are typically less expensive with modest monthly or annual charges. At major banks, overdraft protection might bear a \$5 charge in the month that the account holder is overdrawn and interest of approximately 20 per cent per annum until the amount is repaid. Personal lines of credit are less expensive and are based upon the borrower’s credit standing. The most expensive is a credit card advance with borrowing costs generally between 24 and 30 per cent.

Federal Government Context

The federal government has constitutional jurisdiction over “interest”. Under section 347 of the *Criminal Code*, it is an offence to receive interest at a criminal rate which is defined as an effective annual interest rate that exceeds 60 per cent. The establishment of a criminal usury rate was intended for use in prosecution of loan sharks and did not anticipate payday lending or a variety of other short-term financing arrangements that may exceed annual rates of 60 per cent. As a result, prosecution, which requires the consent of the provincial Attorney General, has been pursued infrequently.

Federal Bill C-26, “An Act to Amend the Criminal Code”, defines a payday loan as an advance of money in exchange for a post-dated cheque, a pre-authorized debit or a

future payment of a similar nature. It does not include any guarantee, overdraft protection or security on property and does not include an advance through a margin loan, pawn broking, a line of credit or a credit card.

Under Bill C-26, the federal government will exempt a payday lender from criminal interest rate provisions if:

- a. the loan is for \$1,500 or less and the term of the agreement is for 62 days or less,
- b. the lender is licensed or otherwise specifically authorized under the laws of a province to enter into the loan agreement, and
- c. the province is designated by the federal government.

A province could be designated if it:

- a. requests to be designated,
- b. has legislative measures that protect recipients of payday loans, and
- c. provides for limits on the total cost of borrowing under payday loan agreements.

Should a province decide not to request “designation”, the prohibition against charging a criminal rate of interest on a loan under Section 347 of the *Criminal Code* would continue to apply to all relevant transactions in the province.

The payday loan exemption would not apply to loans made by federally regulated financial institutions, such as banks and trust companies. These institutions would still be subject to the prohibitions against receiving a criminal rate of interest. However, payday loans made by provincially-regulated financial institutions in a designated province would not be subject to the Criminal Code provisions regarding criminal rates of interest.

Ontario’s Current Framework

The *Consumer Protection Act, 2002* (CPA 2002) provides much of the statutory framework for Ontario to protect consumers and borrowers.

The CPA 2002 defines cost of borrowing as all amounts that a borrower is required to repay as a condition of entering into a credit agreement other than the principal amount (certain voluntary charges may be excluded such as insurance for chattels used to secure a loan). The total of all charges must be disclosed as an annual percentage rate (APR), making certain that consumers understand all charges associated with their loan. These requirements reflect the federal-provincial-territorial harmonized cost of borrowing disclosure rules that were created through a process of public consultation and intergovernmental negotiation.

Section 17 of the CPA 2002 prohibits unfair practices and section 15 provides that it is an unfair practice to make an unconscionable representation. In determining whether a representation is unconscionable, it may be taken into account that the person making the representation knows or ought to know that there is no reasonable probability of payment of the obligation in full by the consumer.

The *Wages Act, 1990*, provides further protection. Payday lenders are prohibited from taking wage assignments under Subsection 7 (7), which states that an assignment of wages to secure payment of a debt is invalid, subject to the exception in subsection 7 (8). If a payday lender were to represent to consumers that wage assignments are valid, it would be contrary to the *Wages Act* and may be considered a false, misleading or deceptive representation under the CPA 2002.

The Consumer Protection Branch of the Ontario Ministry of Government Services investigates consumer complaints and enforces Ontario's consumer protection laws and regulations. The ministry receives complaints on a wide variety of consumer issues and records the number of complaints on an industry-by-industry basis. In 2006, the ministry received 10 written complaints about payday lenders.

New Rules Developed

New measures have been developed to ensure that borrowers are made fully aware of the cost of borrowing prior to entering into a payday loan agreement and ensure that there are no charges contained in fine print. These measures will allow borrowers to engage in comparison shopping and encourage rate competition among lenders.

Ontario has developed regulations under the CPA 2002 that would create additional disclosure requirements specifically for payday lenders. The regulations will require all payday lenders in Ontario to display large point of sale disclosure posters detailing the total cost of borrowing for a \$300, 14-day payday loan, expressed as total dollars and as a cost-per-\$100 borrowed. These posters must be visible to the borrower prior to entering into a loan agreement. New regulations will also strengthen point-of-sale contract disclosures such as requiring more prominent details of the payday loan agreement including the total cost of borrowing. In addition borrower would be required to acknowledge details of the loan by signing a standard disclosure box on the front page of the agreement.

These measures are designed to ensure that borrowers are more fully aware of the cost of borrowing before entering into a payday loan agreement and to ensure that essential information is not contained in fine print. These measures would assist consumers in making informed decisions in their best interests.

1. Are additional consumer protections needed?

Stronger CPA 2002 disclosure requirements will better inform many consumers of their total cost of borrowing and should have negligible impact on the cost to the consumer for the product or service in question.

Demographic information collected by Environics and Ipsos-Reid about the users of payday loans in Canada suggests that many borrowers likely do not understand the true cost of the loan (37 per cent believe that the cost is the same or lower than credit card interest). In the U.S., an industry-funded study found that over 40 per cent of borrowers believed their payday loan rates were less than 30 per cent APR, not much more than a credit card rate. In reality, payday loan rates can be many times higher. In addition, over

25 percent of the borrowers surveyed in Canada admitted that they have “no alternative source of borrowing.”

Additional protections beyond disclosure requirements could include measures that control the behaviour of payday lenders. It should be noted that this type of regulatory approach is considerably more expensive and could create a noticeable increase in the cost of doing business for the lender and lead to increased costs for borrowers. Ultimately these costs may be passed on to consumers. The following are examples of additional measures that have been suggested by consumer advocates or considered in other jurisdictions:

1. Rules that limit the amount of money advanced.

Payday lenders do not evaluate the individual borrower’s repayment capacity. This may result in consumers borrowing more than they can reasonably be expected to repay. The practice adopted by the industry to reduce this risk is to limit the amount advanced to a portion of the borrower’s next paycheque (usually 50 per cent).

2. Requirements to better assess a consumer’s ability to repay.

Payday lenders do not try to determine the extent of the borrower’s financial obligations or their ability to repay. Under current practice, borrowers are required to provide proof only of a chequing account, a utility bill that confirms address, and proof of 90 days of employment.

3. A requirement to undertake credit checks.

Payday lenders in Canada do not subject borrowers to a credit review. In the U.S., studies have indicated that while convenience and lack of a credit check make it easy for a consumer to get a payday loan, it may only postpone the borrower’s financial troubles until the loan comes due. Ninety-one per cent of all payday loans are made to borrowers who display a pattern of repeat borrowing, taking five or more payday loans per year. Members of the payday lending industry have stated that the cost of performing credit checks, and many of these other obligations, is expensive and would only increase the cost of borrowing to the consumer.

4. Restrictions on how many payday loans a consumer can take over a period of time.

In the U.S., borrowers typically take a number of loans per year. These may be rollover extensions or back-to-back transactions where the borrower pays a fee to borrow funds to pay a previous loan or extend the term. The original principal owed is never paid down. The borrower’s situation can be made worse by going to more than one lender (1.7 locations on average) preventing lenders from knowing how much other debt the borrower has.

5. Provisions to create fairer “rollover” borrowing requirements.

If the borrower finds that they are unable to repay the amount owed when the loan term expires, they may take a “rollover” loan. The consumer borrows the original principal amount plus the fees they owe. In effect, they are borrowing to pay the fees from their previous loan and incurring a new set of fees in the process. This is a particularly dangerous practice for borrowers and may lead to a rapid escalation of their debt load.

The Ontario government would like to know what you think. Which, if any, of the above consumer protection measures should be considered ? Why? Are there other consumer safeguards that should be studied?

2. Should Ontario consider a licensing regime for payday lenders?

Regulating an industry could entail oversight of their business practices for compliance with a series of specific and general legal requirements such as those referred to in the preceding section. Licensing is an additional tool which can be used to establish and enforce specific eligibility, operational, and reporting requirements for businesses or individuals engaged in business.

Ontario licenses participants in many industries including: gaming and alcohol, auto dealers and salespeople, funeral directors, travel agents, and real estate brokers and real estate agents. The licence fees collected from the licensees are used to offset the costs of training, public education, inspection and enforcement measures.

If Ontario were to design a licensing regime, what elements should it include in order to meet regulatory objectives? For example, under a licensing regime Ontario could implement a variety of provisions to require that payday lenders comply with:

1. Eligibility and personal disclosure requirements to be licensed including personal financial statements and background checks.
2. Requirement that senior officers of a corporate entity, significant shareholders, managers, and owners in the case of sole proprietorships, be included in licence applications.
3. Training and education requirements for management and personnel.
4. Standards of conduct/code of ethics.
5. Record keeping requirements.
6. Reporting requirements.
7. Disciplinary actions and penalties.

A licensing regime would also provide Ontario with the ability to revoke the licences of non-compliant lenders preventing them from carrying on business as a payday lender. Consumers will benefit by knowing that as licensed payday lenders, the businesses that they are dealing with are required to follow specific rules and are subject to inspection and penalties for non-compliance.

A licensing approach must be equitable and require a similar burden of accountability from the lender regardless of the business model. In the interest of fairness and consumer protection, the sole proprietor of a single storefront and the president of a publicly traded corporation should be subject to the same standard.

It should be noted that a licensing framework is costly and usually requires the establishment of some administrative mechanism to oversee the industry. Ontario could govern payday lending under a number of different bodies. This could include an administrative decision maker with ministry staff to inspect and monitor compliance or a Delegated Administrative Authority model where an arm's-length agency administers the

statute and legal framework for the government. Caution must be exercised so that the cost of regulation does not add significantly to the cost of payday loans and lead borrowers into the hands of illegitimate lenders.

The payday lending industry in Ontario, with 600–700 outlets, is smaller than would normally be regulated by a dedicated special purpose agency. Ontario could follow the example of Saskatchewan, which proposes to keep costs down by licensing payday lenders under an existing regulatory infrastructure.

The Ontario government would like to know what you think. Is a licensing or other authorization regime necessary? If so, what licensing provisions would you recommend?

3. If Ontario were to seek designation, what would be an appropriate mechanism to establish limits on the total cost of borrowing?

If Ontario were to seek Federal designation, it would be required to place limits on the total cost of borrowing for payday loans. At present, Ontario does not limit the cost of borrowing for any loan product and does not have an existing process or mechanism to do so.

Manitoba and Nova Scotia are considering a rate-setting mechanism through their public utility commissions or boards. These are semi-autonomous bodies that are not under direct provincial control. They would engage in a hearing process and invite various stakeholders to make submissions and offer information that provides the basis for the board to establish rates. Other provinces are considering whether or not to set maximum rates directly as opposed to using a public board/process.

Many jurisdictions in the United States have set maximum payday loan rates. The average rate cap ranges from \$15 to \$17 per \$100 borrowed. It is important to note that research on U.S. payday loan rates indicates that in those jurisdictions with rate caps, over 90 per cent of loans are made at the maximum rate. It is fair to say that the maximum rate has become the only rate.

In setting a maximum total cost of borrowing for payday loans, Ontario would need to strike a balance between ensuring that consumers are not charged unacceptably high rates and permitting lenders to charge rates that are fair. If Ontario moves to establish maximum payday loan rates, there are a number of options available. For example:

- Saskatchewan has proposed to establish maximum payday loan rates in regulation to be made under its draft *Payday Loan Act* based on broad consultation with stakeholder groups led directly by the government.
- Ontario could undertake a public hearing process that uses an arm's-length body similar to a public utilities board to receive testimony from industry members and public interest groups to establish maximum rates.

- The province could establish a maximum rate in regulation as a starting point that would be reviewed at a fixed future date (perhaps two years) when lender operating data is available to establish lender rates of return. The starting point could be benchmarked on rates established in other jurisdictions. A regular periodic review of the rate could then be established to reflect market trends.

The Ontario government would like to know what you think. If Ontario were to establish a maximum rate for payday loans, what type of process should be used? What other methods could be used to fairly establish maximum rates?

4. Should Ontario seek designation under Federal Bill C-26?

Under the terms of Federal Bill C-26, the requirements for designation to regulate the payday lending industry are a licensing or other type of authorization system for lenders, the establishment of limits on the total cost of borrowing, and a framework of protections for consumers. Licensing and setting limits on cost of borrowing may, in combination with other consumer protection measures, provide very powerful tools to control the activity of payday lenders and ensure fair and ethical treatment of consumers. There is little information about the effect of regulation on payday lending available from Canadian sources.

The Canadian industry is new and has not been subject to the length of study or depth of examination that it has in the United States. As a result, Canadian regulators often seek to learn from the experience of U.S. regulators.

Approximately 50 per cent of U.S. states have chosen to regulate payday lenders directly to advance consumer protection. Various regulatory models and rate setting practices have been implemented across the country, yet criticism of the industry remains strong.

The variety of actions taken in the U.S. range from outright bans to the implementation of regulatory regimes similar to that required under Bill C-26 and there is little consistent evidence to prove that consumers have benefited. Currently, lawmakers in Arkansas, South Carolina, Oregon, Washington, Rhode Island, New Mexico and Indiana are considering tightening the rules on payday lenders. Payday lenders are also trying to overturn a recent payday loan ban imposed by Georgia. North Carolina banned payday lending in 2001 after a five-year experiment of tightly regulating these cash-advance stores.

While Bill C-26 has passed, it is unlikely that each province/territory will respond with the same measures. Various provinces have proposed different models for payday industry regulation and rate setting. Some jurisdictions, such as Quebec, will not license lenders whose loans exceed an annual rate of 35 per cent. There are no payday lenders legally operating in Quebec. Manitoba and Nova Scotia have amended their consumer protection acts to permit a full regulatory regime.

If Ontario, or any other province, chooses not to apply for designation, Section 347 of the *Criminal Code of Canada* would continue to apply in those jurisdictions.

The Ontario government would like to know what you think. Should Ontario seek designation under Bill C-26?

We Want Your Feedback

The Ministry of Government Services invites your comments on the issues raised in this paper and any additional comments related to the regulation of payday lenders in Ontario. The Ministry thanks you for the time and effort you have invested in this process. As consumers, members of the business community, social policy groups and academics, your input, advice, views and suggestions are important to ensuring that appropriate measures are taken to protect consumers and business alike.

Please submit comments by July 6, 2007 through any of the following ways:

Writing: Ministry of Government Services
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This is a public review

All materials or comments received from organizations may be used and disclosed by the ministry to assist in evaluating and revising existing legislation and related regulations. This may involve disclosing materials, comments, or summaries of them, to other interested parties during and after the public comment period.

An individual who provides materials or comments and who indicates an affiliation with an organization will be considered to have submitted those comments or materials on behalf of the organization so identified.

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