Payday Loans: A Socially Responsible Industry?

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ABSTRACT: We use an ethical framework not before seen in the finance literature to assess the payday loan industry practices. A payday loan is a very high cost, unsecured, short-term personal loan based on one's future pay check. The industry appears on the face of it to exploit vulnerable consumers. We investigate with a view to three outcomes:

1. What practices are most problematic for family financial management?
2. Should this industry be regulated?
3. If it should be regulated, how?

We first provide an historical overview of payday loans. Second, we describe the important characteristics of payday loans and how the industry operates.. Third, using the corporate social responsibility (CSR) framework proposed by Schwartz and Carroll (2003), we analyze the industry critically by examining its practices from an economic, legal, and ethical perspective. Fourth, based on the descriptive evidence and the CSR analysis of the payday loan industry,we draw out the important family financial management issues and conclude that the industry does require government regulation, which has already happened in many jurisdictions. Finally, we provide advice on how the regulations should be designed.

KEYWORDS: payday lending; corporate social responsibility; regulation; usury

While short term loans have been available in one form or another for ages, a formal 'payday loan' industry, as distinct from the banking industry, has only recently begun to emerge around the world since the early 1990s. The industry primarily involves the provision of an unsecured, short-term personal loan based on one's future pay check. While several studies have examined the ethical nature of usury (e.g., Lewison, 1999; Mews and Abraham, 2007), to better examine the nature of this particular new industry we will attempt to discuss whether the industry, as represented by several of its major players in their current practice, has been acting in a socially responsible manner. We use this analysis to answer a dual question. Should the industry be regulated, and if so, should the regulation be such that it is effectively shut down, or permitted to continue under significant restrictions? At the same time, we use the evidence to provide basic advice on what consumers need to know about payday loans for their own protection.

To do so, we first provide an historical overview of payday loans. Second, we define what a payday loan consists of, and provide basic evidence on the operations of the industry. Third, using the corporate social responsibility (CSR) framework proposed by Schwartz and Carroll (2003), we examine its practices from an economic, legal, and ethical perspective. Finally, we conclude our analysis by answering the regulation questions and emphasizing the most important issues for individual consumers.

Historical overview of payday loans

In general, money lending has historically been considered to be ethically problematic. According to one commentator: "Major thinkers throughout history - Plato, Aristotle, Thomas Aquinas, Adam Smith, Karl Marx, and John Maynard Keynes, to name just a few—considered money lending, at least under certain conditions, to be a major vice. Dante, Shakespeare, Dickens, Dostoyevsky, and modern and popular novelists depict moneylenders as villains" (Brook, 2007). Despite Biblical and Islamic laws against usury (leading to the prohibition of usury by the Catholic Church in 1139), society has over time however become much more accepting of charging interest to others. Beginning with European Jewish money lenders and merchant bankers, much of the Christian world began to accept the necessity of charging interest for loans by the late 16th century (see Brook, 2007; Frierson, 1969). Eventually pawn shops, car title lenders, rent-to-own stores, loan sharks, and even banks through overdraft protection, began to fill the demand for small short term loans. More recently, a formal payday loan industry has begun to flourish, with the first payday lender, Check Into Cash, Inc. of Tennessee, opening for business in 1993 (Chin, 2004: 726). By 2007, there were already approximately 25,000 payday lenders in the U.S. extending billions in short-term loans to 15 million people every month (*Wall Street Journal*, 2007). There are now more payday stores in the U.S. than the number of McDonald's restaurants and Starbucks combined (Newsom, 2010). There are approximately 2 million Canadian customers who take out at least one payday loan a year from over 1,400 retail stores across Canada (Canadian Payday Loan Association, 2011a). The volume of loans is now estimated at approximately CDN$2 billion (CBC, 2007). As a recent sign of the industry's emerging legitimacy, several firms in the U.S. are now publicly listed companies, such as Advance America Cash Advance Inc.), QC Holdings, Inc., and Dollar Financial Group, (while Cash Store Financial Services Inc. is a publicly listed Canadian company. Internet payday lending also continues to grow, although no studies on the actual extent of this activity appear to exist. The industry is well-established in the UK and Australia, and appears to be growing in other countries including Mexico, the Caribbean, and Ireland. The industry is also clearly international and multi-national, and in the process of consolidation. Grupo Elektra, a Mexican financial services and consumer electronics retailer with operations in eight countries in Latin America, is in the process of taking over Advance America. Dollar Financial owns Money Mart in Canada (Money Mart is larger than the US operation) and Money Shop in the UK and Ireland.

A Description of the Payday Lending Business[1]

A payday loan is an unsecured, small, short-term personal loan.

- The principal cannot exceed $1,500, although most loans are around $300
- Lenders typically allow loans up to 50 percent of the next pay check, but more often they are between 15 to 30 percent. o
- The term cannot exceed one month, although most loans are for no more than 14 days
- Almost all lenders charge a fixed percentage of the principal, regardless of the number of days the loan is outstanding. For the most typical payday loan, a $15 charge on a loan of $100 over a two week period would represent a nominal percentage rate (APR) of 390% (26 x 15%). The effective annual rate,(EAR) which takes into account compounding, would be 3,685%.
- Payday lenders do not perform credit checks and they do not report to credit information services. The prospective borrower must have an employment record and a bank account on which to write checks. The customer fills in a standard application form and signs it,

[1] The information in this section is drawn from Buckland (2012), Center for Responsible Lending (2009), Ernst & Young (2004), Public Utilities Board of Manitoba (2007-08, 2008), Robinson (2006, 2007) http://www.ukpaydayreviews.com/ and unreported field research by Robinson.

gives the lender a check dated on the next payday for the principal plus all fees and interest, and receives either cash or a direct deposit that s/he can access immediately.

- Borrowers who are not able to repay their loans must either: (1) extend or 'rollover' the loan; (2) pay off the loan but immediately borrow again from the payday lender through a 'back-to-back' transaction; or (3) default, and thereby incur bounced check fees by the payday lender and insufficient fund fees by the borrower's bank while still owing the full amount of the original post-dated check. The critical issue with rollovers and back-to-back loans is the repeated application of the entire fee for each new loan, and the subsequent fees are applied to the total owing, which includes the previous fee(s).

What are the characteristics of the borrowers?

- The borrowers are predominantly lower class, lower income, living in poorer neighbourhoods, often in areas where banks have reduced their services and closed branches;
- The borrowers are frequent repeat customers. In Canada, the lenders report one new customer for every 15 repeat customers. In the US, the average customer borrows nine times a year.
- They do not have access to ordinary bank credit mechanisms – credit cards, lines of credit, overdraft protection.

All of the references outside of the industry claim that families using payday loans are likely to be caught in a debt trap. They must continue to borrow just to repay the previous loan. Common sense alone tells us that if a low income family has trouble making ends meet, giving up 15 – 30% or more of the next paycheck to repay a loan, plus the fees, will often be impossible. (King *et al.*, 2006: 2)estimate that the typical payday borrower pays back $793 for a

$325 loan. If a US low income earner earning $25,000 per year takes the average nine loans per year for $300 each time and pays a fee of 15%, his annual cost is $405, or 1.6% of his gross income. While this seems very modest for a middle class professional, it is a heavy expense for someone of lesser means.

How is the payday lending business organized?[2]

This sub-topic could take a book and we have room for only a sketch of the most important factors:

- A payday loan store is a very small business. Annual loan volume in Canada ranges from CD$ 300,000 to 7,000,000, but few stores lend more than $3million and the average in Canada appears to be less than $1million. The average loan volume per store appears to be lower in the US. Fees in Canada range from 15 – 25%, for a gross annual revenue of $45,000 to $1.4 million, but the average store appears to gross around $200,000 p.a. Fee in the US are capped at 15% in many states and we have not observed any place where the rate is commonly more than 19%. The average store makes about 10 loans per day and few would make more than 30 loans per day.
- Operating costs of opening the door every day – wages, rent, utilities, etc.—make up the great majority of costs, 70-80% on average.
- Capital required is tiny relative to operating costs, because the loans turn over so quickly and the premises are always rented.
- Loan losses are much higher than bank loan losses, but they are relatively stable.
- The key success factor is quickly obtaining enough volume of business to cover the operating costs, which are largely fixed in the short term.

[2] This section draws on Ernst & Young (2005), Robinson (2006, 2007, 2008), Manitoba Public Utilities Board (2007-08).

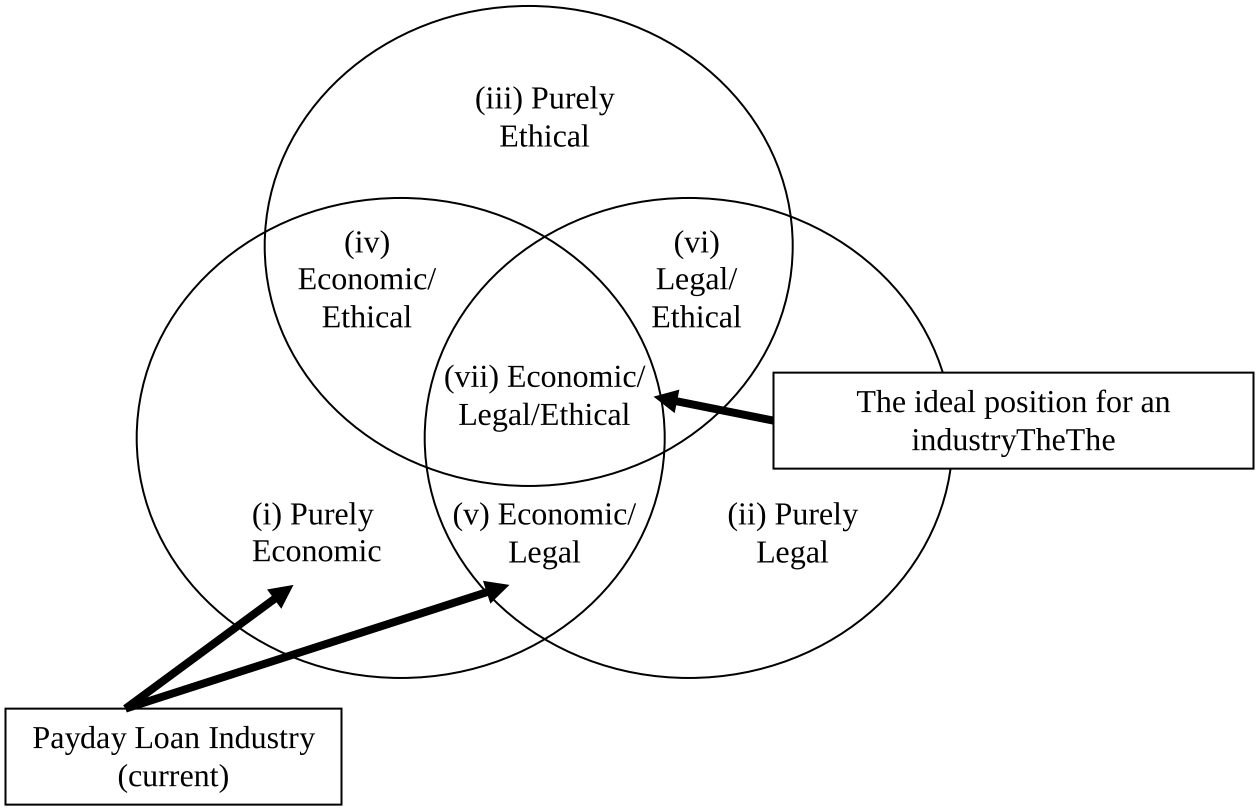
- Canada has three large chains that account for well over half the volume of loans in the country and probably closer to 80%. There are also many smaller chains and single owner-operated stores. The market is more dispersed in the US, Australia and the UK, but there are also large chains in those countries.
- The large chains in Canada have been growing right up to the end of 2011 but smaller chain and independent store numbers are declining. The total number of stores seems to be growing in the UK and stable in the US and Australia.
- No reliable evidence exists on the loan volume over the internet and through cell phones.
- Two business models exist. Most companies lend directly to the customer. A few of the chains claim that they act as brokers between a third party lender and the customer, and hence their charges are not interest.

Corporate social responsibility assessment of the payday loan industry

One of our principal questions in this paper is whether the payday loan industry should be regulated, and we use a corporate social responsibility framework. Possibly the most dominant CSR theoretical framework available to use in analyzing business activities is that proposed by Archie Carroll (1979). Carroll states as follows: "The social responsibility of business encompasses the *economic, legal, ethical,* and *discretionary* [later termed philanthropic] expectations that society has of organizations at a given point in time". (1979: 500, emphasis added). Carroll (1991) later portrayed the obligations in the form of a "CSR Pyramid" with economic and legal obligations forming the base of the pyramid (i.e., required by society), followed by ethical obligations (i.e., merely expected by society) and philanthropic obligations (i.e., merely desired by society). Carroll's CSR construct has been incorporated by numerous other theorists (Wartick and Cochran 1985; Wood 1991; Swanson 1995, 1999). In addition, Carroll's CSR framework has been developed into an empirical instrument to measure CSR "orientations" (Aupperle 1984; Aupperle, Carroll, and Hatfield, 1985) of various professional groups and industries (e.g., Burton and Hegarty 1999; Ibrahim and Angelidis 1993, 1994. 1995; Mallott 1993; O'Neill, Saunders, and McCarthy 1989; Pinkston and Carroll 1996; Sheth and Babiak, 2010; Smith, Wokutch, Harrington, and Dennis, 2001; Spencer and Butler, 1987).

Based on theoretical and empirical concerns raied over the application of each of the four domains, Schwartz and Carroll (2003) proposed the "Three Domain Model of CSR" which rejects philanthropy as an explicit obligation of a public firm (other than when it is supported by the economic and/or ethical domains). More detailed criteria for those attempting to apply the legal and ethical domains are also provided, rendering the theoretical framework potentially more amenable to judging or critiquing a particular firm or industry. As a result, the application of Schwartz and Carroll's (2003) CSR theoretical framework to assessing an industry would take CSR assessment beyond other studies which tend to use much more narrow or restrictive criteria (e.g., based on their social or environmental initiatives), for example the pharmaceutical industry (Lee and Kohler, 2010), the oil and gas industry (Frynas, 2010), or the international banking industry (Scholtens, 2009). The following diagram shows a visual representation of the three domain framework.

The Three Domain Model of Corporate Social Responsibility and the Payday Loan Industry



We believe the payday loan industry operates primarily in the economic domain and is partly, but not wholly, in the legal domain, but is not ethical.

Economic domain

While some scholars might reject the economic domain as part of CSR, most would include it as possibly representing the fundamental obligation of firms (Carroll, 1999; Friedman, 1970) and should therefore be included as part of any CSR assessment. According to Schwartz and Carroll (2003: 508), for the purposes of their three domain CSR model, the economic domain captures:

> …those activities which are intended to have either a direct or indirect positive economic impact on the corporation in question. The positive impact is based on two distinct but related criteria: (i) the maximization of profits; and/or (ii) the maximization of share value. Any activity that is pursued with improving profits and/or share value in mind is deemed to be economically motivated.

Assessment: Like virtually all businesses, there is no question that the payday loan industry operates within the economic domain. According to Butler and Park (2006: 119): "[Since] the industry debuted just over a decade ago [it] has since experienced tremendous market growth." While this growth has slowed or perhaps stopped in terms of the total number of stores in the countries where it first arose, Canada and the US, some of the largest chains continue to expand and purchase others. In Canada, Cash Store Financial, Money Mart and Cash Money, the three largest chains, are considerably larger in 2012 than they were in 2006. For example, Cash Money had 71 outlets in 2006 (Robinson, 2006) and has 131 in April 2012.[3] The summary

[3] Manual count of stores listed at http://www.cashmoney.ca/store-locator/region/241.aspx?city=%20&zip=, accessed April 10, 2012.

financial results in Table 1 show that the four largest firms in Canada and the US are large and very profitable (2010 results for Cash America, 2011 for the others).

Table 1

Summary Financial Results of the Largest Payday Lenders in Canada and the US

	Revenue (000)	Total Assets (000)	Net Income (000)	Return on Equity
Advance America	$625.9	$431.6	$67.6	25.8%
Cash America	1293.3	1427.2	115.5	15.6
Cash Store Financial	136.6	121.8	9.0	10.6
Dollar Financial	788.4	1662.8	65.8	20.4

Legal domain

Schwartz and Carroll (2003: 509-510) define their legal category of CSR as follows:

> [The legal domain]…pertains to the business firm's responsiveness to legal expectations mandated by and expected by society in the form of federal, state, and local jurisdictions, or through legal principles as developed in case law…*restrictive* compliance [with the law] occurs when a corporation is legally compelled to do something that it would not otherwise want to do…*opportunistic* compliance [occurs when]…a corporation…actively seek[s] out and take[s] advantage of loopholes in the legislation to be able to engage in certain activities. In such cases one typically finds that the corporation is abiding by the letter of the law but not the spirit of the law...Activities would fall outside of the legal domain when they take place despite: (i) an awareness of non-compliance with the law; [or] (ii) an awareness of actual or potential civil negligence...

Assessment: In terms of the payday loan industry, although in many respects one might argue that its actions tend to fall within the legal domain (i.e., as restrictive or opportunistic compliance), the industry (as represented by several of its major players) in several jurisdictions appears to clearly fall outside of the legal domain.

In the United States for example, there are a number of states that have enforced bans against payday lending. These states include: Arizona, Arkansas, Colorado, Connecticut, Georgia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Vermont and West Virginia (AFFIL, 2011). Other states simply cap the interest rate at 36 percent or less for small loans (King *et al.*, 2006: 4). In addition, the U.S. government has promulgated legislation enacting a 36 percent annual rate cap for consumer loans made to military families (King *et al.*, 2006: 13). Rather than simply comply with the law however, several payday lenders appear to either evade the law, fight back in the courts, or engage in extensive lobbying efforts to change the law in the industry's favor. For example, in 2008 Global Payday Loan was fined $234,000 by the Illinois Department of Financial and Professional Regulation for exceeding the $15.50 per $100 limit on fees for payday loans (Illinois Government, 2007). In another case, the payday loan industry in New Mexico sued and a judge issued a preliminary injunction on a state law that said borrowers could only renew payday loans twice (Watkins, 2006).

Many firms in the U.S., if not in direct violation of the law, appear to engage in opportunistic compliance with the law. One might suggest that such behaviour is acting contrary to the 'spirit' of the law, if not the letter of the law. According to the Center for Responsible Lending: "By far the most pervasive method payday lenders have used to circumvent state lending laws is…known as ‘rent-a-bank’. Under this arrangement, large payday lending companies typically partner with very small banks located in states with lenient lending laws. The payday lenders claim that their association with the partner bank allows them to preempt state law and make payday loans in states where they would other wise be illegal” (King *et al.*, 2006: 4). As one example, Advance America, the leading U.S. payday lender in terms of the number of stores, "…allied with an out-of-state bank in 2002 to evade limits that some states imposed on the industry’s excesses” (Karger, 2005, p. 7). Other U.S. firms use innovative ways of charging additional fees, and by not calling such fees interest: “Some payday lenders…disguise their loans as other products in order to continue illegal lending practices” (King *et al.*, 2006: 4). According to the Center for Responsible Lending (2006: 5), over the years: “the industry has proved remarkably adept at making minor changes in the business model to skirt each attempt by lawmakers to put an end to the abusive practice.”

In some states, the fee cap is set at $15 per $100 of loan, but the legislation was not explicitly worded to require that the fee be charged when the loan is repaid. In those states, payday lenders “discount” the loans. A loan of $100 yields only $85 cash, with the fee charged at the start of the loan, for an effective charge of $15/$85, or 17.5% of the loan principal. In Canada, up to at least 2007, Cash Store Financial advertised widely that it charged 20% of principal as a broker fee for finding a third party lender, who was never openly identified, and the same claim appeared in its annual reports. In reality, Cash Store Financial was discounting its loans and the fee was 25% of the principal. On top of that, the customer had still to pay interest at an effective annual rate of 59% and a fee to have the value after the deduction of the fees loaded on to a debit card, because, ironically, Cash Store Financial did not dispense any cash. To top it all, Cash Store Financial charged first time borrowers $6 for the debit card that the now much-diminished principal was loaded onto. In all, the fee for a first time borrower of an average loan was 31% of the principal. In Canada, the allowable rate of interest is governed by section 347 of the Criminal Code, which is a federal statute. Until 2006, the maximum rate was 60% per annum. Money Mart and Cash Store Financial attempted to create the illusion that their loans met this limit by using complex fee schedules, only a small part of the fee being called interest. The Cash Store's method has already been described. Money Mart charged much lower fees, but they were still far above 60% per annum. The interest rate was 59% EAR, but a substantial check cashing fee was added to the repayment check left by the customer and so the average Money Mart fee for a two week loan was 19% of the principal. The definition of "interest" in section 347 is very broad and appears to include all of these fees, but none of the provincial Attorneys General ever laid criminal charges. One possibility is that the governments recognized a legitimate need for such small loans, and were reluctant to use the big 'club' of criminal prosecution, which would certainly close down payday lending altogether. The industry could thus argue that since usury laws were not being enforced, it was legally acceptable to charge excessive rates.

In 2006 the federal government amended section 347 to allow the provinces to regulate payday loans and allow higher rates of interest, provided the loans were less than $1500 and outstanding no more than 30 days. Subsequently, most provinces did regulate both the fees and other aspects of the loans, disallowing rollovers and setting rate caps as a percentage of the principal ranging from 17% in Manitoba to 31% in Nova Scotia. The province of Quebec had already enacted legislation limiting all loans to a maximum effective annual rate of 36%, which ended payday lending in the province, since no payday lender could come close to covering costs at that rate.

The legislation that regulates payday lending in the majority of U.S. states does give firms the legal right to provide payday loans, usually with a rate cap of 15% of principal. A number of US states have effectively banned payday lending by limiting all loans to an effective annual rate that is too low for payday lenders to operate, usually 36% p.a. A few states allow payday loans without any fee regulation.

In terms of acting contrary to civil law (often based on non-compliance with statute law), class action lawsuits launched in Canada were originally settled or vigorously defended by payday loan firms (Quik Payday Loan, 2006). One Canadian provincial judge held in a civil class action suit in 2006 that a payday loan company was in fact violating Canada's *Criminal Code* (Kilroy, 2006). The Supreme Court Justice of British Columbia ruled that late fees and processing fees charged by the small payday loan company, was in fact interest. She also found that the company was charging an interest rate above 60 percent, in violation of Canada's *Criminal Code.* It is yet to be seen if this case will pave the way for other successful class action lawsuits against payday loan firms in Canada. In one case, MoneyMart settled a class action lawsuit in Ontario for $120 million in 2009 (MoneyMart, 2009). The notes to the 2011 Dollar Financial Group financial statements discuss a number of different lawsuits brought by consumers in Canada and California, some of them settled out of court, others still in progress.

While overall one can suggest that the payday loan industry in general is technically operating within the legal domain under ‘opportunistic compliance’, many firms appear to be close to breaking or bending the law (i.e., a violation of the ‘spirit’ of the law), while others fall outside of the legal domain due to their apparent readiness to violate legislation or face the prospect of civil litigation rather than modify their practices.

Ethical domain

According to Schwartz and Carroll (2003: 511), the ethical domain of their three domain CSR model refers to the ethical responsibilities of business as expected by the general population and relevant stakeholders, and includes three general ethical standards: (a) conventional; (b) consequentialist; and (c) deontological. According to Schwartz and Carroll (2003: 513), activities would fall outside of the ethical domain when they are: “(i) amoral in nature (i.e., with an unawareness or indifference to the morality of the action); (ii) take place despite an awareness that the action conflicts with certain moral principles (i.e., are unethical); or (iii) are only intended to produce a net benefit for the corporation and not for the affected stakeholders (i.e., are only supported by egoism).”

(a) *Conventional standard*: For the purposes of their model, Schwartz and Carroll define the standard of conventions as (2003: 512): “…those standards or norms which have been accepted by the organization, the industry, the profession, or society as necessary for the proper functioning of business.” They indicate that (2003: 512): “…reference should be made to formal codes of conduct or ethics (e.g., organizational, industrial, professional, or international) to establish whether a company is acting ethically according to the conventional standard." In this sense, the conventional standard is based on the moral standard of cultural relativism, i.e., determining whether one's actions are in conformance with the views of the majority of a particular reference point (e.g., industry or society) (see Velasquez, 2006: 19).

Assessment: There is evidence both for and against the claim that the industry is acting in accordance with the conventional standard. Society does not appear at this point to have raised any major objection to the practices taking place, and as indicated above most governments, while increasingly regulating the practice, have not made payday loans illegal. The significant number of users of payday loan services (e.g., millions of users in the U.S. and Canada) also suggests that the service is considered to be not only morally acceptable, but highly desirable, if not necessary.

There is evidence however that the industry is not living up to the conventional standard. The carefully-planned avoidance of the letter of the law as recorded in the previous section shows that even the modest accepted standards are not always met. Many consumers have recognized after the fact that their particular contracts were unfair, as evidenced by the civil suits, some of them now settled out of court.

The U.S. Financial Service Centers of America (FiSCA) has a *Code of Conduct* (FiSCA, 2007) which addresses such issues as: marketing and advertising; operations; documentation; pricing and consumer charges; consumer's right to rescind; consumer education; collection practices; invoking the criminal process; and extensions (FiSCA, 2011a). The Canadian Payday Loan Association (CPLA) has developed its own *Code of Best Business Practices* (Canadian Payday

Loan Association, 2011d) for its members, addressing issues such as: collection practices; confidentiality; credit counselling; collateral; right to rescind; and rollovers (i.e., all the debt including fees are rolled over into a new loan). The CPLA has gone even further by establishing an "Office of the Ethics and Integrity Commissioner."Some individual firms have even established their own codes of conduct or ethics, such as Advance America (2006) and Cash Store Financial Inc. (2011). What has not been clearly established however is whether these codes are fully being met by industry players (see Butler and Park, 2006: 120-123). Unless these codes are actually being met, the industry would not be meeting the conventional standard.

(b) Consequentialist standard: According to Schwartz and Carroll (2003: 512), the consequentialist standard "…focuses on ends or consequences" and "…suggests that "…the morally right thing to do is to promote the good of persons." An action is considered ethical according to utilitarianism (i.e., one particular type of consequentialism) "…when it promotes the good of society, or more specifically, when the action is intended to produce the greatest net benefit (or lowest net cost) to society when compared to all of the other alternatives (2003: 512)."

Assessment: The application of this standard to the payday loan industry highlights some of the more difficult aspects of the ethical analysis. The benefits of the industry to society can be identified in terms of the number of users of the service, and the short term alleviation of hardship that easier and quicker access to funds can provide. Many customers would potentially not be able to obtain short term credit but for the payday loan industry. Howard Karger, in his book *Shortchanged*: *Life and Debt in the Fringe Economy* (2005), summarizes the situation for many people using the payday loan industry. According to Karger's research (2005: 4), people simply "…can't wait for checks to clear" and "live hand-to mouth" meaning that "…waiting a week or more for a check to clear the banking system means not having food on the table." In other cases, people live in "…a cash economy, and many of the small shops where they buy food, clothing, and other necessities accept only cash. Checks are viewed sceptically and generally are not accepted" (2005: 4). Many people "…do not trust banks, and don't feel welcome there" (2005: 4). Others are also "…reluctant to write checks for fear of bounced-check fees from banks and merchants (2005: 4). According to the CEO of Advance America, "Contrary to [the Center for Responsible Lending's] spin, responsible use of the payday product provides consumers firm footing to overcome unexpected financial circumstances…Millions of consumers avoid excessive credit card late fees and interest, skyrocketing NSF fees, and other punitive measures for missed payments by utilizing our products. Customers have also successfully used payday advances to deal with thousands of unexpected expenses ranging from family illnesses to natural disasters" (Advance America, 2006).

In addition, there are other benefits to payday loans as well. One customer survey of over 500 payday loan users by the Canadian Payday Loan Association in 2007 found that 51% used payday loans because they were "quick and easy", 18% because of the more convenient locations, while 15% had no other alternative source of financing (Polara, 2007). One third of respondents indicated they needed the payday loan for emergency cash to pay for necessities. Beyond the benefits to users, those working in the industry itself certainly benefit, including shareholders/owners, employees, and suppliers. Governments (and thereby society) also derive the benefit of the tax revenue that is generated from the industry as well.

The difficulty in the analysis arises with respect to calculating the potential long-term hardship that may occur to users of payday loans and their families. While users of the payday loan service clearly derive a short term benefit, it is not at all clear whether they are digging themselves into some sort of debt trap, which due to the onerous interest charges, only generates greater long-term hardship. For example, one study sponsored by the Canadian Payday Loan Association found that while 78% of respondents paid back all of the loans they received in the past on time, the remainder (22%) did not (Polara, 2007). According to Butler and Park (2006: 121): "…consumers can easily become trapped in a web of accumulated loans and finance charges that can ultimately lead to grave debt or bankruptcy." As a result, the ultimate social costs include: "…bad credit ratings, lower savings rates, less home ownership, bankruptcies, an increase in the number of people depending on welfare, and the costs of preventing and deterring criminal behavior" (Butler and Park, 2006: 123). The industry claim that the purpose of payday loans is to meet unexpected emergencies is belied by the previously quoted statistics that show that most customers take out many loans a year. The business model requires a lot of repeat business. Ernst & Young (2004) estimated that it costs 2.7 times as much to process a first-time customer as it does to process a repeat customer.

According to the Center for Responsible Lending, predatory payday lending (i.e., imposing unfair loan terms on borrowers) "…costs American families $4.2 billion per year in excessive fees" (King *et al.*, 2006: 2). The Center also estimates that those states in the U.S. that ban payday lending "…save their citizens an estimated $1.4 billion in predatory payday lending fees every year" (King *et al.*, 2006: 2). The industry allegedly collects 90 percent of its revenue from borrowers who are not able to pay off their loans when due, as opposed to one-time users dealing with short-term financial emergencies (King *et al.*, 2006: 2). We have already shown with a reasonable example that a repeat lender will pay a material portion of his or her income due to dependence on payday loans.

While an overall assessment of the net benefit to society is therefore problematic, one can make the case that if a long-term perspective is taken, the industry is not currently generating a net benefit to society, and would need to reduce fees (while still maintaining reasonable profitability) before this would more clearly take place. In an era of 2% inflation, the return on equity numbers in Table 1 are evidence of excess profits. Robinson (2006) and Robinson's testimony in Public Utilities Board of Manitoba (2007-08) provide explicit, detailed numerical analysis showing that fees much lower than those charged in Manitoba at the time would allow efficient payday lenders to earn a fair rate of return. According to the U.S. Federal Trade Commission, payday loans are simply a type of "costly cash" (Foreman, 2006). Several questions remain however such as: Would society be better off if the industry ceased to exist? As an alternative, will other financial institutions (e.g., banks, credit unions, etc.) ever be willing to fill the need for payday lenders? Are payday lenders operating in the most efficient fashion by charging excessive rates, or could they survive and even prosper while reducing the rates they charge to a more reasonable level? If not, would it be better if an even bigger underground lending industry (e.g., mafia) began to flourish, also charging excessive rates, being completely unregulated, and with no tax revenue going into the government's coffers? Would more severe repercussions take place for those customers failing to pay their debts? According to the payday loan industry, their profits are reasonable (when loan risks and fixed store costs are taken into account) when compared to other financial institutions and thus it would be difficult to reduce fees to a lower level (see Skiba and Tobacman, 2007). In response, some would suggest however that even the mafia would never charge interest rates comparable to those charged by the payday loan industry. One Canadian politician has stated that the payday loan industry is worse than loan sharks, and "…charge interest rates that would [even] make Tony Soprano blush" (Rupert, 2005: E5). Although the mafia is always advanced as the straw man in this argument, we have never seen a scrap of evidence that this would happen, or that it has happened in jurisdictions that have banned payday lending.

This component of the analysis (e.g., the payday loan industry versus other alternatives) suggests that it may be better if the industry continues to exist, but only if certain practices are modified (e.g., payment terms are more restricted and enforced). Butler and Park tend to agree (2006: 135): "Payday lender's pursuits of profits at the expense of the social good may result in short-term net gain to the payday lending industry, but it does so by harming consumers." As a result, they recommend that payday lenders "…should lower interest rates to a level that keeps lenders in business while protecting consumers from bankruptcy (2006: 134)." Only after such changes take place would the overall greatest net good for society be realized.

(c) Deontological standard: The deontological standard, as opposed to focusing on consequences, is defined by Schwartz and Carroll (2003: 512-513) as embodying those activities which reflect a consideration of one's duty or obligation. This category embraces moral rights, justice, religious doctrine, Kant's categorical imperative, and core values such as trustworthiness

(i.e., honesty, integrity, reliability, loyalty); responsibility (i.e., accountability); caring (i.e., avoid unnecessary harm); and citizenship (i.e., assist the community).

Assessment: There appear to be many *deontological* concerns with respect to the activities of the payday loan industry.

Kant/Exploitation: The payday loan industry may be seen as exploiting a vulnerable population, and thereby in violation of philosopher Immanuel Kant's categorical imperative. Kant argued that one should treat people as "ends" in themselves (i.e., having intrinsic worth as a free rational human being) rather than merely as a "means" to an end. In other words, one should not treat others only as a means to advance one's own or the firm's self-interest (e.g., profits), or be able to exploit, manipulate, or take advantage of others, even for the greater good. Kant states: "Act in such a way that you treat humanity, whether in your own person or in the person of any other, always at the same time as an end and never merely as a means to an end" (Kant, 1964: 96).

For example, the ease with which lower income families can become caught in the 'debt trap' created knowingly by payday loan firms, suggests that they are not being treated with respect, but merely as a means to higher profits. According to Butler and Park (2006: 120): "…payday lenders target clients who are vulnerable because of their low income or lack of financial knowledge." Buckland (2012) reports extensive research on financial exclusion in Canada that shows the same behaviour on the part of "fringe banks," who are primarily payday lenders and check cashers.

Two groups in particular that have been identified as being targeted by the payday loan industry are U.S. military personnel and the African-American community. According to a U.S. Department of Defence Report (2006: 4): "Predatory lending practices are prevalent and target military personnel, either through proximity and prevalence around military installations, or through the use of affinity marketing techniques, particularly on-line." According to the Center for Responsible Lending (2005a: 1), active-duty military personnel were three times more likely than civilians to have taken out a payday loan with one in five active-duty military personnel being payday borrowers in 2005. Predatory payday lending was estimated to cost military families over $80 million in abusive fees every year. According to the Department of Defence, payday lending is one of the top ten key issues impacting the quality of life of U.S. soldiers (Center for Responsible Lending, 2005b). In addition, African American neighborhoods are allegedly being specifically targeted, with such neighborhoods having three times as many stores per capita as white neighborhoods (King *et al.*, 2005), and with payday loans "…now specifically threatening students of historically Black colleges and universities" (Center for Responsible Lending, 2005c: 1). The pattern of location of fringe banks in Canada lacks the racial aspect, but very clearly matches the poorest inner city districts of Canadian cities (Buckland, 2012).

As a final measure of disrespecting others, any firm that engages in "rollover" practices, referred to as the industry's "most dangerous feature" (see Butler and Park, 2006: 122), or uses threats and phone calls to the employers of delinquent debtors, may be seen as taking advantage of or exploiting the misfortune of certain members of society.

Justice/Fairness: While there is extensive academic debate over what justice or fairness should consist of, one approach used by Snyder (2010) in his analysis of payday loans is based on two types of fairness: (i) 'micro' fairness; and (ii) 'macro' fairness. Snyder rejects micro fairness as "there is considerable competition between payday lenders in the US", meaning that the payday loan industry is not able to extend "…unfair terms to its customers [relative to] what they could expect from a hypothetical fair market" (2010: 203). Snyder does believe however that payday lenders are engaged in macro unfairness, in that payday lenders are taking advantage of systemic racism that has prevented many minority borrowers from less expensive banking services (2010: 203). We disagree with Snyder's conclusion that the micro fairness condition is met. Customers of payday lenders are often unable to do the extra travelling required to go from a poor neighbourhood with no banks but lots of payday lenders to a neighbourhood with mainstream banks. Furthermore, the evidence is unequivocal in Canada that prior to regulation, the payday lenders did not compete on price, because there were vastly different pricing schemes, with Money Mart averaging 19% of principal and Cash Store Financial at the other end of the scale averaging 29% of principal. As further evidence, prior to regulation coming into effect in Ontario, Money Mart used its complex interest plus cheque cashing fee plus another fee to charge customers, leading to the average rate of 19% we have already stated. Robinson (2006) established clearly that Money Mart was profitable, and Money Mart has since expanded its number of stores even as regulation has supposedly reduced fees. However, Ontario's fee cap is 21%, and Money Mart immediately raised its fees and abandoned its previous fee schedule. At the same time Cash Money, the third largest lender, raised its fee from 20% to 21% in Ontario.

There may be a greater concern with procedural unfairness which might apply more broadly with respect to all payday lenders and borrowers. For example, there seems to be an unequal relationship of power and knowledge of payday lenders relative to their customers (e.g., ignorance and lack of informed consent), leading to a potentially unfair advantage in the transactions that take place. Most of the customers are the working poor, who may not realize how expensive the transactions really are. The degree of procedural unfairness appears to be of even greater concern for internet payday loans. The Consumer Federation of America has warned consumers that contracts from internet payday lenders "include a range of one-sided terms" including: agreements not to participate in class action lawsuits, mandatory arbitration clauses, and agreements not to file for bankruptcy. In other cases, some lenders are requiring their applicants to agree to keep their bank accounts open until loans are repaid or ask for 'voluntary' wage assignments even in state jurisdictions where assigning wages is against the law (Longley, 2011).

In response, the industry can argue that the rates they charge are fair, as customers clearly need the product and are willing to pay the fees. The branches are often open during more convenient hours than banks, in better locations, also helping to justify the higher fees. According to this argument, it is the responsibility of the client to exercise self-control, not the industry. In addition, the unequal relationship may be balanced with the risks taken by the industry with respect to bad debts, supporting the fairness of the excessive rates being charged.

Transparency/Deception: There are also a number of issues with respect to the extent to which transparency, disclosure, and honesty is taking place within the industry. Without full knowledge, customers may not be giving their consent on a fully informed basis to the transaction. Research suggests that full transparency is not taking place. According to one study: "…only 37 percent of [U.S.] lenders quoted an accurate Annual Percentage Rate even though the federal *Truth In Lending Act* requires it" (Foreman, 2006). Customers clearly have the right to full information and disclosure. The Center for Responsible Lending (2005b) suggests that "Rather than help borrowers through financial challenges, *as they are marketed to do*, payday loans block and destroy access to good credit options. They trap borrowers in high-cost loans, drain their income, damage their credit, and often worsen their financial situation" [emphasis added]. The Cash Store Financial practice of discounting loans and adding fees for debit cards was unquestionably an evasion of transparent disclosure. A considerable benefit to some consumers would be credit repair. If the payday lenders reported to the credit bureaus, those customers who did repay their loans on time could start to improve their credit scores and qualify for cheaper mainstream bank lending and credit cards, but the payday lenders are not part of the credit reporting system.

In response, the industry could argue that it is not at all clear whether the use of the payday loan service would discontinue if the rates of total interest being charged were more fully and clearly disclosed, similar to the use of other products despite disclosure. For example, while most purchasers (including low income purchasers) of lottery tickets generally understand the miniscule odds of winning, they still continue to purchase tickets. Even greater efforts to disclose or even emphasize the low odds of winning would probably not affect lottery ticket sales. Similarly, while new users of cigarettes are now fully informed of the addictive properties and health risks of nicotine, they still begin to smoke despite being aware of these risks (as opposed to current smokers who might be physically addicted to the use of the product) (Hammond et al., 2007). Payday loan firms can argue that at the end of the day, customers know exactly how much ‘extra’ they have to pay for the loan since they write the actual amount on their post-dated cheques. This would remain the case even though customers may not understand that the extra fees translate into an exhorbitant interest rate. On this basis, full and complete disclosure may not be relevant or necessary. On the other hand, North Carolina (2007) found that banning payday loans was highly beneficial to the groups that the industry claims want such loans. North Carolina was the first state to ban payday lending, in 2001.

Although counter-arguments exist, our analysis suggests that the payday loan industry falls outside of the ethical domain. In terms of the conventional standard, while there are multitudes of users, the industry may not even be living up to its own codes of ethics. With respect to the consequentialist standard, the industry’s current practices appear to be creating greater long-term harm than net benefit to society, primarily due to the excessive rates being charged. With respect to the deontological standard, the industry appears to be in violation of Kantianism (i.e., exploitation), transparency, and even possibly justice/fairness as well.

Advice for Consumers

The most important financial planning advice regarding payday loans is simply to not use them, ever. They are extremely expensive and they lead to debt traps. The lender may not be honest with you about the terms.

If a consumer is to take a payday loan, the evidence shows clearly what the most important caveats are:

1. Make sure you know all the costs involved. Watch out for a lender who discounts the loan.

2. Shop around to see if there are better rates elsewhere. The lenders do not compete on price, but they do not all charge the same rate.
3. Take as little as you can manage, because the repayment comes on the next payday and you will have to reduce spending considerably to meet it.
4. Read the fine print to see what the true cost is.
5. Never go to a lender who will require you to roll over an existing loan for the full fee the second time if you cannot repay it on the due date. You must choose a lender who will not charge you additional fees beyond a reasonable interest rate for extending the loan. Most jurisdictions now ban rollover fees beyond a reasonable interest rate, but rollovers are still allowed in some jurisdictions, and lenders may also break the law in this respect.

The Regulation Issue

We believe that the evidence presented and our analysis of it using the CSR model makes a firm case that governments should be regulating this industry. We find that the industry is not operating in the ethical domain and has at times operated outside the legal domain as well. Furthermore, in the legal domain it has a long history of opportunistic compliance that has often violated the spirit of whatever laws and regulations existed. Payday loans are very expensive, and they do lead consumers into debt traps. Despite the industry claims that it exists to provide occasional emergency financing, the evidence shows clearly that most customers are frequent repeat borrowers, which will very often force them into a debt trap.

One alternative is to ban payday lending altogether. We are unaware of any evidence showing that this choice has caused any harm to consumers in Quebec and the 15 US states plus the District of Columbia that have set rates so low that all payday lending has ceased. North Carolina (2007) claims that its ban was beneficial to consumers. Clearly there is something lost, since a lot people do voluntarily use payday loans. The desirable solution is a lower cost alternative, either through community-based organisations, or administered by the banks and credit unions as socially-responsible choice. Buckland (2012) discusses some initial work in this direction in Canada and elsewhere, but not enough experience exists to conclude that this is feasible or infeasible.

We do not take a position for or against banning payday lending. If it is to be allowed, regulation of payday lending is a moving target because the regulation has changed materially during the time the authors have been engaged in the research and continues to evolve, and the authors have been part of that process.[4] We can use the regulatory experience so far and the evidence we have collected to outline the most important aspects that a government should regulate if it allows payday lending to continue.

Rollovers

The most serious problem with payday loans occurs when a borrower cannot repay the loan and the lender requires the borrower to roll it over (other terms are back-to-back and repeat loans) with the entire fee charged again against the new loan. For example, suppose you borrow $300 at 20% for two weeks, based on 50% of your two week net pay of $600. At the end of two weeks you owe $360, but your finances are no better, you need your entire paycheck just to eat and pay rent, and the lender forces you to rollover the loan for another 20% fee. Now in two weeks you will have to repay $432. At the end of six weeks, you owe $518, which is almost your entire net pay. The debt trap is inescapable. Manitoba (2008) allows only one charge of 5% for an extension of a loan, no matter how long. An alternative method is to allow an unpaid loan to be extended at a more ordinary rate of interest, often 36% per annum, or 3% per month.

[4] Robinson testified extensively at the Manitoba regulatory hearings, as documented in Public Utilities Board of Manitoba, (2007-08). The commissioners requested an earlier draft of this paper and placed it into the evidence.

Manitoba (2008) allows 2.5% per month as a default charge if the loan is not extended, but does not allow it to be compounded. Either format recognises that the borrower should continue to pay for the loan, but the initial high processing cost has been covered by the initial high fee.

Limits on Loan Size

Very few loans are anywhere near the upper limit of $1,500, but even a much lower amount can be unmanageable. The example in the previous section of a loan of 50% of the net pay will be impossible for almost anyone to repay, if the family was already unable to make ends meet on the existing pay. Some US jurisdictions limit the absolute value of the loan to a smaller amount like $500, and others limit the fraction of the net pay that may be loaned to 25 – 30%, which is still hard to meet, but not as bad as 50%. Manitoba (2008) has an unusual method – if the loan is for more than 30% of net pay or is made to someone on social assistance, the fee is limited to 6%, which is too low to induce any payday lender to make the loan.

Limits on the Fees

This part of the regulation is the most complex. All jurisdictions that have regulated have chosen either a single fixed percentage of the principal, or fixed percentages on a sliding scale by loan size, which recognises the fixed cost of processing a loan, regardless of size. Many US states allow a maximum of 15% of principal. Manitoba (2008) has a schedule that allows 17% of the first $500, 15% of the next $500 and 6% on any portion greater than $1000. Most loans are $500 are less and the sliding scales usually do not have any effect, because the loan does not exceed the first break point.

Robinson (2006) shows how to properly fix the fees, by working backwards from the cost structure and a suitable cost of capital to determine sets of fee schedules that allow efficient payday lenders to earn a fair rate of return. The evidence presented in Manitoba (2007-08) using this classic rate regulation method showed that 17% on the first $500 and 15% on the next $500 would allow the efficient lenders to continue to operate. Loans above that size were uncommon and so the rest of the rate schedule had no material effect. The competitive evidence supports the calculations, because in 2012 there continue to be many payday lenders in Manitoba, and in the US the states that have regulated at 15% also continue to have many payday lenders. The evidence in Manitoba (2007-08) showed that US states regulating at 15%, and even some with slightly lower scales for larger loans, continued to have considerable growth in the number of lenders after the regulations were implemented. Accordingly, it seems that a fee cap of 15 – 17% of the principal is the highest that should be used. Other Ontario provinces did not adduce any evidence except industry submissions, and they regulated at rates that are clearly too high: for example, Ontario at 21%, BC at 23% and Nova Scotia at 31% (which rate is higher than any lender in Canada was charging prior to regulation).

Disclosure

The borrowers are quite unsophisticated for the most part. The total cost of the loan should be required up front, before any loan is to be made. Evidence in Manitoba (2007-08) showed that in some cases lenders refused to provide this information unless the borrower first signed a binding loan contract. In addition, the effective rate of interest must be disclosed for the loan. To help borrowers compare, the effective cost of a typical loan should be widely-advertised in the store and on any website. The other terms like default costs and method by which the cash is advanced must also be disclosed. None of these requirements is costly for the lender to implement, and indeed they are the same as we would expect for any loan from any financial institution.

Administration

The standard requirements for regulation apply in this case:

- Every payday lender must be registered with a regulatory agency;
- The regulator must have power to inspect records, determine non-compliance with the law and regulations under it, and levy civil penalties;
- The payday lender must maintain prescribed records;
- The lender must not engage in intimidation of borrowers in default.

Conclusion

We conclude based on our analysis that the payday loan industry appears to be, at present, an example of what Schwartz and Carroll (2003: 513-514) label as an "economic/legal" industry, as it appears to focus only on maximizing profit and shareholder value while usually falling within the legal domain but clearly outside the ethical domain. There are however many payday loan firms as noted above that appear to violate the law or act in ways knowing they can be sued, placing them squarely within Schwartz and Carroll's "purely economic" domain. It may be that over time, as larger financial institutions enter into the payday loan market, the CSR profile of the industry will begin to shift to become more legal and ethical and nature. For example, Wells Fargo in the U.S. currently offers its version of a payday loan, called "Direct Deposit Advance," which charges 120% APR (Wells Fargo, 2011). It's not clear whether the big banks will necessarily act any differently from other payday lenders however. In other cases, non-profit credit unions might enter the market, offering lower interest rates along with financial counselling advice for their customers (e.g., Prospera, 2011).

As a response to our CSR assessment and other evidence, we propose a set of basic regulations, which can already be observed in some jurisdictions. An alternative is to ban payday lending altogether and we take no position for or against, although the evidence certainly seems to provide considerable support for a ban. If there is to be payday lending, consumers must be very wary, and we noted the most important considerations for a family that does take out a payday loan.

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