THE SCHOOL OF PUBLIC POLICY

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CAPSTONE PROJECT

Financial Literacy within Payday Lending Legislation

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Payday loans have become one alternative credit product that many of these borrowers have substituted to fill their credit needs. A recent report from the Financial Consumer Agency of Canada, (FCAC), indicated that 45% of all respondents used a payday loan to pay for an unexpected expense such as a car repair, and 41% of respondents used a payday loan for an expected expense such as paying for an overdue utility bill.[3] Additionally the FCAC report indicated that 43% of respondents did not understand that a payday loan is more expensive than alternative forms of credit.[4]

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[1] Ebner, "Payday Lenders Squeezed by New Regulations."
[2] Davis and Kim, "Explaining Changes in the US Credit Card Market: Lenders Are Using More Information."
[3] Financial Consumer Agency of Canada, "Payday Loans: Market Trends."
[4] Ibid.

The net benefit of payday loans has mixed results in academic research, with many indicating that the current regulatory structure of payday loans has led to negative outcomes for many borrowers within the industry.[5]

Legislation in Canada has traditionally looked at lowering the price ceiling for payday loans or limiting the amount of a loan that a borrower can obtain, yet this has had little positive effect and has likely caused additional credit rationing behaviours by lenders.[6] Recently, suggestions have been brought forth to focus on improving financial literacy among borrowers so they can make more well informed decisions.[7]

To counter some of the gaps in consumer financial literacy some provinces have implemented mandatory financial literacy material handouts to assist borrowers to gain a better understanding of budgeting, credit and overall financial health. Alberta and New Brunswick are the most advanced in their requirements, mandating financial literacy informational material be provided in addition to contact information for credit counselling services for all borrowers.[89] Manitoba has mandated that contact information for credit counselling services be provided to all borrowers, but has not required any form of financial literacy information material be provided.[10] Finally, Ontario has mandated that a portion of the licensing fees paid by payday lending institutions be used to fund the Ontario

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[5] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis."
[6] Ibid
[7] Momentum.org, "The Real Cost of Payday Lending."
[8] Province of Alberta, Fair Trading Act.
[9] Financial and Consumer Services Commission, Payday Loans Licensing and Ongoing Obligations.
[10] Province of Manitoba, Payday Loans Regulation Règlement sur les prêts de dépannage.

Payday Lending Education Fund, but do not have any provisions within the legislation as to what the fund is intended or required to provide.[11]

The academic literature has fundamentally suggested that financial literacy is most improved through customized, one-on-one training interactions. However, very little effort has been put forward to investigate the effectiveness of financial literacy handout information, and for good reason. It can be difficult to ascertain the retention abilities of the general public from complicated financial handouts. Most survey data analysis is unavailable to properly assess or address these concerns.

Payday lending legislation is complicated and heavily influenced by political actors. It is unlikely that regulation focused solely on improving financial literacy outcomes through payday lending regulation will be successful given the research available, however, more data collection and analysis may provide some additional insight into the validity of such efforts.

[11] Province of Ontario, Payday Loans Act.

INTRODUCTION

Payday loans are becoming a larger part of the Canadian credit industry. The most recent report from the Canadian Consumer Finance Association (formally the Canadian Payday Loans Association) indicated that in 2014 there were 4.47 million loans made worth $2.19 billion dollars, which is almost double the number of loans and value from 2010.[12] In the past 30 years, information gathering techniques about borrower credit history have improved in the credit industry.[13] Some have suggested that this has caused many low income or high-risk borrowers to become displaced or pushed out of traditional credit markets.

Payday loans have become one alternative credit product that many of these borrowers have substituted to fill their credit needs. A recent report from the Financial Consumer Agency of Canada, (FCAC), indicated that 45% of all respondents used a payday loan to pay for an unexpected expense such as a car repair, and 41% of respondents used a payday loan for an expected expense such as paying for an overdue utility bill.[14] Additionally the FCAC report indicated that 43% of respondents did not understand that a payday loan is more expensive than alternative forms of credit.[15]

[12] Ebner, "Payday Lenders Squeezed by New Regulations."
[13] Davis and Kim, "Explaining Changes in the US Credit Card Market: Lenders Are Using More Information."
[14] Financial Consumer Agency of Canada, "Payday Loans: Market Trends."
[15] Ibid.

The net benefit of payday loans has mixed results in academic research, with many indicating that the current regulatory structure of payday loans has led to negative outcomes for many borrowers within the industry.[16]

The reasons for use of a payday loan can be simplified into two main categories. The first reason is that borrowers simply do not have enough savings available to handle a personal financial shock.[17] This can be something as simple as a necessary car repair required to maintain employment, or as dire and complex as requiring additional funds in order to prevent eviction or foreclosure. Secondly, a borrower may be forced to use a payday loan from a lack of alternative forms of credit. Not all consumers have access to a credit card or other forms of lending vehicles. These reasons can be exacerbated by the financial education, family structure, age or a variety of other variables of the payday loan borrower.

Legislation in Canada has traditionally looked at lowering the price ceiling for payday loans or limiting the amount of a loan that a borrower can obtain, yet this has had little positive effect and has likely caused additional credit rationing behaviours by lenders.[18] Recently, suggestions have been made that focus on improving financial literacy among borrowers so they can make more well-informed decisions.[19]

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[16] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis."
[17] Stegman, "Payday Lending."
[18] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis."
[19] Momentum.org, "The Real Cost of Payday Lending."

To counter some of the gaps in consumer financial literacy some provinces have implemented mandatory financial literacy material handouts to assist borrowers to gain a better understanding of budgeting, credit and overall financial health. Alberta and New Brunswick are the most advanced in their requirements, mandating financial literacy informational material be provided in addition to contact information for credit counselling services for all borrowers.[20], [21] Manitoba has mandated that contact information for credit counselling services be provided to all borrowers, but has not required any form of financial literacy information material be provided.[22] Finally, Ontario has mandated that a portion of the licensing fees paid by payday lending institutions be used to fund the Ontario Payday Lending Education Fund, but do not have any provisions within the legislation as to what the fund is intended or required to provide.[23]

Ultimately the question becomes whether specifically legislating financial literacy material or education is an effective way to assist with increasing the net benefit of the payday loans industry or if legislation should be focused in other areas.

This paper looks to analyze the current legislative environment surrounding payday loans and how legislation focused on financial literacy is being implemented. The paper first outlines the history of payday lending legislation and regulation within Canada. Then the paper highlights how this legislation has impacted the market structure of payday loans and allowed for economies of scale to form. The paper looks at the financial literacy

[20] Province of Alberta, Fair Trading Act.
[21] Financial and Consumer Services Commission, Payday Loans Licensing and Ongoing Obligations.
[22] Province of Manitoba, Payday Loans Regulation Règlement sur les prêts de dépannage.
[23] Province of Ontario, Payday Loans Act.

literature and how this has been applied to payday lending legislation. Finally, the paper outlines where the current legislation is lacking and outlines where legislation should improve in the future.

HISTORY OF PAYDAY LENDING LEGISLATION

Non-traditional loans first came to Canada in the early 1900's. Their earliest recorded form was a process called "salary buying", which was a process where a borrower would use their future salary as collateral to obtain a high interest loan, typically through a loan shark or criminal enterprise.[24] Salary buying was one of the earliest tools that a loan shark would use in order to ensure repayment of their loan. Salary buying also took the form of a discounted loan in exchange for a future paycheque.[25]

Salary buying continued until 1950 when the Government of Canada passed the *Small Loans Act*.[26] This act advised what was considered to be reasonable terms for small and non-traditional loans. However, there were large concerns surrounding this Act as it did not set a firm restriction on the interest rates that could be charged for the initial loan. Additionally, it only regulated loans that were below $300. At the time, $300 was considered to be a relatively large loan; however, the Act did not account for inflation and became obsolete quickly.[27]

The motivation for the Small Loans Act was less focused around ensuring that borrowers were not being taken advantage of, but rather to limit the interaction of loan sharks and criminal organizations with borrowers. The collection tactics of loan sharks were abhorrent and resulted in physical harm for borrowers who could not pay back in

[24] "Calls Salary Buying Vicious Loan Fraud."
[25] Birkhead, "Collection Tactics of Illegal Lenders."
[26] Bogert, "The Future of Small Loan Legislation."
[27] Ibid

time. Enforcement of the Act was a struggle and did not fully come into effect until the mid-1970's.[28]

In 1980 the Government of Canada repealed the *Small Loans Act* and amended the Criminal Code of Canada to include s. 305.1.[29] The repeal and amendment indicated that the Government understood the shortcomings of the Act and its inability to prosecute known criminal enterprises that utilized usurious loans.[30] The amendment set a maximum rate of annual interest of 60% and set clear penalties for any individual or organization that entered into an illegal agreement with a borrower. [31]

This change in law dramatically decreased the number of loan sharks and illegal lending organizations in Canada.[32] Unfortunately for high risk borrowers, they no longer had the same access to credit under this new legislation. The market adjusted to their demand for immediate cash and the service of cheque cashing became increasingly popular. In a 1986 academic journal article, which investigated factors in selecting a banking institution, as many as 41% of low income individuals had reported to using a cheque cashing service in the previous 12 months.[33]

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[28] Department of Justice, "Loan-Sharking - A Typology of Profit-Driven Crimes."
[29] The Criminal Code was amended again in 1989 which moved s. 305.1 to s.347. This amendment offered up additional definitions of illegal lending practices but no major shifts in policy took place.
[30] Antle, "A Practical Guide to Section 347 of the Criminal Code - Criminal Rates of Interest."
[31] Criminal Code, RSC 1985, c C-46.
[32] Department of Justice, "Loan-Sharking - A Typology of Profit-Driven Crimes."
[33] Laroche, Rosenblatt, and Manning, "Services Used and Factors Considered Important in Selecting a Bank: An Investigation across Diverse Demographic Segments."

The process of cheque cashing involves having a personal postdated cheque cashed for an upfront fee. Based on the high risks associated with cashing personal postdated cheques, the market naturally limited the amount that a person could cash. For many individuals with limited access to credit, the average maximum of $150 was not enough to provide them with the necessary flexibility they demanded.[34]

Paycheques became the preferred alternative to personal postdated cheques in order to allow borrowers to gain access to additional funds. They were seen as more stable and less risky than a personal postdated cheque.[35] Payday lending operations started to open across Canada in the mid 1990's. Many of them offered personal postdated cheque cashing services, but advertised payday loans as the cheaper alternative.[36]

The main difference between the two services was that a payday loan did not require an upfront fee, nor did it limit the amount allowed to be borrowed. The reality was that payday loans were even more expensive than cheque cashing services.[37] The administrative fees that were charged on payday loans exceeded the annual rate of interest outlined by the criminal code.

By the mid 2000's the Federal Government debated whether to include administration fees in the definition of illegal interest rates. The ambiguous interpretation of s.347 of the Criminal Code made it difficult to include payday loans initially, as the loans

[34] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis."
[35] Stegman, "Payday Lending."
[36] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis."
[37] Stegman, "Payday Lending."

were not defined to have an interest rate.[38]

In 2006, Bill C-26 was introduced to amend s.347 of the Criminal Code and set limitations on how a payday lending institution could operate within Canada.[39] The Bill defined a payday loan as "An advancement of money in exchange for a post-dated cheque, a pre-authorized debit or a future payment of a similar nature but not for any guarantee, suretyship (form of insurance), overdraft protection, or security on property and not through a margin loan, pawn broking, a line of credit or credit card."[40]

Instead of implementing strict legislation on the administration fees that a payday lending institution could charge, Bill C-26 limited the amount that could be borrowed to a maximum of $1,500, and a repayment period limit of 62 days. The Bill also allowed each province the autonomy to individually legislate and regulate the payday lending industry that would best suit their population.

Manitoba passed *Payday Loans Regulation, Man Reg 99/2007* as an amendment to *The Consumer Protection Act* in 2007. They were the first province to pass payday lending legislation after Bill C-26 received royal assent in Federal Parliament. The initial version of the legislation focused primarily on clear communication of the costs associated with the loan as well as limited restrictions that would be placed on the lending institution. The legislation set requirements for signage and advertisement of payday loans within the Province, as well as ensuring that the interest rates associated with the loan did not exceed

[38] Antle, "A Practical Guide to Section 347 of the Criminal Code - Criminal Rates of Interest."
[39] Kitching, Starky, and Bergevin, "Bill C-26: An Act to Amend the Criminal Code (Criminal Interest Rate) Law and Government Division Legislative Summary LS-541E."
[40] Ibid

the Federal usury rates for the initial loan.[41]

Alberta has been one of the more innovative provinces with passing payday lending legislation. They did not pass personalized legislation for payday lending services until 2009. They amended the *Fair Trading Act* to include specific provisions regarding payday lending operations. Like other provincial legislation Alberta's approach was to set limitations surrounding known pitfalls with the usage of payday loans. The Act set clear guidelines for prohibited practices including: discounting the principal amount of the loan, allowing a rollover loan, requiring payment before the borrower would receive their paycheque, making unauthorized withdrawals from the borrowers account, and charging any additional fee beyond what was outlined in the payday loan agreement. They set a loan term interest rate limit of 23% on the principal amount that could be borrowed, and a maximum borrowing amount of 50% of the borrower's pay. In the interest of protecting the borrowers further, the Act put restrictions on how the payday lending institution could contact the borrower for late payment and made any form of verbal, written, or physical harassment illegal.[42]

Advocacy groups became increasingly interested in the shortcomings of the Alberta legislation after it passed. Momentum Community Economic Development Society (hereafter referred to as Momentum) became one of the leading groups to lobby the Alberta government to revise the legislation. In 2014, Momentum published a report outlining the shortcomings of the 2009 legislation. They highlighted the inconsistencies in

[41] Province of Manitoba, Payday Loans Regulation Règlement sur les prêts de dépannage.
[42] "Payday Loans Regulation, Alta Reg 157/2009."

the rollover restriction, citing that "for every new customer; fifteen return or rollover loans are issued."[43] A rollover loan is a loan that is issued to cover the remaining amount of the existing loan.

Momentum pointed out that even though this process was illegal, there were no provisions to stop a borrower from paying off the original loan in full, and then taking out a subsequent loan to cover their other expenses. Envronics Research Group conducted a 2012 survey that indicated that 55% of payday loan users were using the loan service to cover regular anticipated expenses, but many of that 55% percent were repeat loan users.[44]

In addition to cutting interest rates on loans to make them less expensive, Momentum suggested stretching out the due date of the loan. They suggested that this allowed borrowers to effectively save and pay back the loan, while maintaining their weekly expenses.

In 2016 Alberta passed *An Act to End Predatory Lending*, which also amended the *Fair Trade Act*.[45] The 2016 Act implemented four major changes to the previous legislation. First, it forced all payday lending institutions that operate within Alberta to register their business with the provincial government and provide the government with annual borrowing data of their customers.[46] The data collection allowed the government to measure real changes in borrower's trends based on legislative changes.

[43] Momentum.org, "The Real Cost of Payday Lending."
[44] Envronics Research Group, "Payday Loans Users Study - Alberta."
[45] "An Act to End Predatory Lending, SA 2016, c E-9.5."
[46] Ibid

Second, Alberta restricted interest rates on payday loans to 15% of the principal amount, up to a maximum of 60% of annual interest.[47] This provision provided borrowers with protection in case they fell into a debt cycle trap.

Third, Alberta required payment schedules to be stretched to three pay-periods. Borrowers were no longer required to pay back the entire loan at the time of their next paycheque, but could pay it off over three paycheques.[48]

Finally, the Alberta legislation forced payday lending institutions to provide financial literacy material and information to all potential borrowers prior to entering into a payday loan.[49] Alberta became the first province to require in-depth financial literacy material to be issued to every borrower at the time of the loan.

Prior to Alberta's 2016 legislation, Manitoba and Ontario were the only provinces that included minimal financial literacy requirements within their payday lending legislation. Manitoba required a phone number of a credit counselling service be provided at the time of the loan and Ontario required all payday lending firms pay into a province-wide education fund. The Ontario Payday Lending Education Fund outlined that a portion of the licensing fees obtained by the province must go towards advertising campaigns designated towards improving financial literacy and enhancing consumer understanding of credit terms.[50]

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[47] Ibid
[48] Ibid
[49] Ibid
[50] Payday Loans Act, 2008: Ontario Payday Lending Education Fund Corporation.

In practice, Alberta's latest legislation attempts to provide potential payday loan borrowers with significantly more support. In a 2017 academic working paper, it was found that an individual is as much as 25% more likely to use a payday loan if they have been refused a credit card.[51] Providing individuals with financial literacy information prior to entering into the payday loan agreement will likely reduce that percentage.

However, the most significant change is the requirement to share borrowing data with the government. Most survey data are unreliable as to why a person uses a payday loan. There is incentive for individuals to misrepresent their reasoning. Forcing the payday lending institutions to share borrowing data permits the government to understand the effects of changing legislation.

There are concerns that tightening the restrictions on interest rates may lead to a decrease in the overall supply of loans being available to borrowers.[52] The 2009 Alberta legislation prevented payday lending institutions from demanding a credit check prior to approval for the loan, but the information they were allowed to ask for such as bank statements and employment records gave the lending institutions enough information to decide how restrictive they wanted to be towards their borrowers.[53]

Automatic stretching of payment schedules is also a concern. Assuming borrowers of payday loans are rational, the extension of payment schedules will allow them to budget to pay back the loan and they will be better off. If borrowers are not rational, this can lead

[51] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis."
[52] Ibid
[53] "Payday Loans Regulation, Alta Reg 157/2009."

to an increase in poor spending habits and make the borrowers worse off than with the shorter payment schedule.

Currently there are no officially proposed changes or opposition to Alberta's legislation. The Canadian Consumer Finance Association, (CCFA), (formally the Canadian Payday Loan Association) has not drafted any official counter arguments to the current legislation since it passed. However, a recent report has indicated that the changes in payday lending regulation did not have a positive effect on access to traditional lending options.

From December 2016 until May 2017, the CCFA reported that 80% of individuals surveyed who applied for a small, short-term financing option through a credit union were denied.[54] The indication of this report is that the cost of obtaining a traditional loan has not changed, yet the cost of obtaining a payday loan has decreased. The report suggests that demand for payday loans will increase due to the recent legislation changes. Changes to the current legislation are also not expected until the results of the data collection start to come through. Alberta will have access to payday lending borrowing data at the end of 2018, which will include 2017 and 2018 data. Other provinces have spoken of changes to their payday lending legislation, specifically Nova Scotia and Newfoundland (who does not have provincial legislation currently). However, they are waiting to hear from the results of Alberta's change prior to pushing for change.

[54] Canadian Consumer Finance Association, "Alberta: Small Sum Loan Study."

Making payday loans completely illegal is one proposal that has been presented by various governments and advocacy groups.[55] The issue with complete illegalization is that many individuals have no credit alternatives, and the benefits of having no access to credit are ambiguous.[56]

[55] Talai, "A Behavioral Economic Analysis of Payday Lending Regulation in Canada."
[56] Melzer, "The Real Costs of Credit Access: Evidence from the Payday Lending Market*."

MARKET POWER AND SCALE ECONOMIES THROUGH LEGISLATION

Very little academic research focuses on the market structure of payday loans and how scale economies have formed. Stegman and Faris created an initial equation that represented the basic structure of how profits are accumulated within the payday loans market.[57] However, their work did little to address the formation of scale economies and focused more on how profits could be increased within the market. Flannery and Samolyk investigated the formation of market power and drew on empirical evidence surrounding two nation-wide firms within the United States and their financial performance over the 2001-2006 period.[58] They found that scale economies tend to form within payday loan stores based on the length of time that a firm has been in operation. The longer the store has been in operation the larger profits became. They suggest that this occurred due to the increase in repeat loan customers for that store, as well as an increase in customer information available to the firms.

Factors of Market Power within Credit Markets

Traditional market power can be determined in various ways but refers to the ability of a firm to price its product above the level that would prevail in a homogenous market with high levels of competition. The Lerner Index is one method of determining market power. It measures the difference in market price from the firm's marginal cost. The difficulty in

[57] Stegman and Faris, "Payday Lending: A Business Model That Encourages Chronic Borrowing."
[58] Flannery and Samolyk, "Scale Economies at Payday Loan Stores."

utilizing the Lerner Index as a method of market power determination in a real-world situation is that it can be difficult to determine the true marginal cost of the firm.

Church and Ware claim that "the ability for a firm to profitably raise price above marginal cost depends on the extent to which consumers can substitute to other suppliers."[59] In other words, if substitutes are available for consumers, the market power of the firm is diminished, and prices become more in line with marginal cost.

Credit ratings are determined by the evaluation of credit risk of a prospective borrower and their ability to pay back the debt. Credit markets are inherently reliant on information gathering techniques to determine credit ratings of borrowers.

The riskiness of a borrower and the potential loan is traditionally determined through a process of credit checks in both the United States and Canada. An individual's credit score is usually a prime determining factor to the credit worthiness and riskiness of the potential borrower. Davis and Kim reviewed the credit information gathering techniques of the US credit card market from the 1980's and found that risk pooling has become less evident as information gathering technology has improved.[60]

Credit interest rates have moved from a pooling equilibrium to a separating equilibrium due to these factors. This has pushed many borrowers out of the market entirely based on a more dynamic risk profile that can be determined. Specifically, younger and lower income individuals are the main borrowing groups that are affected by this

[59] Church and Ware, *Industrial Organization: A Strategic Approach*.
[60] Davis and Kim, "Explaining Changes in the US Credit Card Market: Lenders Are Using More Information."

change. The number of rejections of credit cards has dramatically increased over this time. Davis and Kim suggest that the lack of reasonable alternatives for these borrowing groups is likely a prime factor for the increase in payday loan usage.

Unlike most other markets, borrowers within credit markets can be faced with barriers to entry based on their credit risk profile. This can hamper the capability for an individual to gain access to substitutes and forces them into markets with potentially higher instances of market power.

The list of effective substitutes is narrowed to a few credit vehicles available in North America. A recent report from the Atlantic Provinces Economic Council claims that the payday loans market suffers from a restricted availability of inferior substitutes.[61] The report claims that many substitutes have high barriers to entry and are not available for the average payday loan customer.

A credit card is one of the primary forms of substitution of a payday loan. They are highly dependent on the potential borrower's credit history and income variables. In addition to the individual's history and propensity to pay, aggregates are utilized within the credit market to determine risk levels for similar borrowers.[62] Additionally the ability for a borrower to gain access to a credit card can be disrupted by historical payment issues.[63]

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[61] Poschmann, "An Assessment of Payday Lending: Markets and Regulatory Responses About the Atlantic Provinces Economic Council An Assessment of Payday Lending: Markets and Regulatory Responses."
[62] Davis and Kim, "Explaining Changes in the US Credit Card Market: Lenders Are Using More Information."
[63] Agarwal, Skiba, and Tobacman, "Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles?"

Low-income borrowers are significantly more affected in their ability to obtain credit through historical payment habits than individuals in higher income groups. Alternative to credit cards, overdraft protection is the second largest substitute for payday loans. Utilizing the relationship with a traditional bank, borrowers may be able to achieve additional protections from overspending or emergency fund requirements.

Melzer and Morgan analyzed the impact on overdraft protection with the presence of payday loans within various states in the US. They found that banks and credit unions reduce overdraft credit limits and prices when payday credit is prohibited. This suggests that depositories respond to payday loan bans by taking less risk, bouncing cheques they would have otherwise covered. Unfortunately for low income individuals, overdraft protection is ultimately reserved for higher income individuals or individuals with various banking products.[64][65]

Many payday loan users are unable to acquire more than a basic bank account within Canada and thus would be unable to qualify for overdraft protection.[66] One recent substitute that has become available for borrowers is a "cash crunch loan" offered by various credit unions throughout Canada.[67] These loans are designed to be a direct substitute for payday loans. In the Province of Alberta, the payment schedule mimics that

[64] Poschmann, "An Assessment of Payday Lending: Markets and Regulatory Responses About the Atlantic Provinces Economic Council An Assessment of Payday Lending: Markets and Regulatory Responses."
[65] Momentum.org, "The Real Cost of Payday Lending."
[66] Talai, "A Behavioral Economic Analysis of Payday Lending Regulation in Canada."
[67] They are defined as a "Cash crunch loan" within Alberta. Similar types of loans are available in Nova Scotia, Prince Edward Island and Ontario, but are a variation of a personal loan.

of a payday loan and can be paid back over three pay periods. However, a large difference between these loans offered through credit unions is that a credit check can still be completed on the borrower prior to issuing the loan. A recent report from the Canadian Consumer Finance Association found that 80% of potential borrowers were declined a cash crunch loan in Alberta.[68]

When traditional lending substitutions for payday loans are not available, borrowers turn to non-traditional or even illegal options. The 2005 Survey of Financial Security found that 6% of sample Canadians would turn to a family member to borrow money for an unexpected expense of $500[69] Similar findings were found with the Canadian Financial Capability survey conducted in 2008 and 2014[70] These numbers are likely inflated slightly as all provinces require a payday loan user to have access to a bank account.[71]

The Canadian Bankers Association found in a recent 2017 report that as many as 400,000 Canadians do not have access to a bank account.[72] The report does not state why these individuals do not have bank accounts, but factors such as poor advertisement of free or low-cost banking accounts as well as transaction restrictions are claimed to be contributing factors.[73]

[68] Canadian Consumer Finance Association, "Alberta: Small Sum Loan Study."
[69] Pyper, "Perspectives on Labour and Income - Payday Loans."
[70] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis."
[71] Ibid.
[72] "Canadian Bankers Association: Banks and Consumers 2017 Report."
[73] Daniel, "Recent Changes to Canada's Financial Sector Legislation."

Finally, borrowers that are unable to access credit through family or traditional lending vehicles may turn to illegal loansharking lenders. Data could not be found for Canada specifically on the prevalence of loansharking in the current market, but the United States has an average 300 cases of illegal loansharking reported each year.[74]

Formation of Scale Economies within Payday loans

Flannery and Samolyk initially cited an industry report made by Stephens Inc., which "estimated a new payday store requiring an initial investment of $30,000 would generate more than $258,000 in operating cash flow in its first five years of operation, implying an annual pretax return of approximately 170 percent."[75] This should be an indication that the market would be ripe for new entry and borrowing fees would be forced down due to competition. Instead they found that the age of the store was directly related to the profitability of the operation. "[Their] analysis confirms that payday loan stores operate with sizable fixed costs and scale economies; profitability requires a healthy level of loan activity."[76] They found a strong relationship between store age, loan volume and store performance. New stores tended to incur losses or at best break even, where mature stores (four years or older) were quite profitable. Default losses are the largest component of operating expenses that contribute to store profitability.

[74] Mayer, "Loan Sharks, Interest Rate Caps, and Deregulation."
[75] Flannery and Samolyk, "Scale Economies at Payday Loan Stores."
[76] Ibid.

Stegman and Faris initially estimated the two dimensions of firm profitability through cross-sectional regressions of data collected by the Commissioner of Banks in North Carolina and developed the following formula.[77]

$$P_i = a_0 + a_1(N_i) + a_2(C_i) + a_3(\%Repeat_i) + \beta Z_i + \tilde{\varepsilon}_i$$

Where: P_i = firm *i*'s profits per store; alternately revenues (loan fees plus returned check fees) per outlet or "modified gross income" (MGI) per outlet;

N_i = the number of outlets operated by firm *i*;

C_i = the number of customers per outlet at firm *i*;

$\%Repeat_i$ = the percentage of firm *i*'s customers who borrow at least monthly;

Z_i = a vector of other control variables.

Flannery and Samolyk criticize this specification as it does not account for the disentanglement of influence of repeat business from the influence of greater loan activity.[78]

Instead they conducted a new survey of two national lenders (that account for approximately 27% of the industry). The survey looked to collect data on store-level costs

[77] Stegman and Faris, "Payday Lending: A Business Model That Encourages Chronic Borrowing."
[78] Flannery and Samolyk, "Scale Economies at Payday Loan Stores."

and revenues. They categorized the stores into three age groups. New stores were those that had been operating for less than a full year, young stores had been open between one to four years, and mature stores had been operating for at least 4 years. They conducted three specifications that outlined operating costs, credit losses and store profits. All three regressions were log linear and accounted for all variables in the Stegman and Faris specification.

For mature stores, they found that the cost function indicated that payday loan stores operated with substantial scale economies. "A one percent increase in the number of loans originated raises operating costs (measured net of loan losses and collection costs) only 0.128 percent, holding the number of customers constant."[79]

They also found that operating costs rise with the number of customers served (elasticity of 0.346) indicating that it is costlier to serve a broader customer base holding everything else constant. "If a store increases loans and customers by the same proportion (keeping the average number of loans per customer constant), store operating costs increase by 0.474 percent. In other words, it is cheaper for store to make additional loans to existing customers than to add loans by attracting new customers."[80]

They found similar results in calculating store profits. "Holding constant the number of customers, a one percent increase in the number of loans increases store operating income by 0.665 percent."[81]

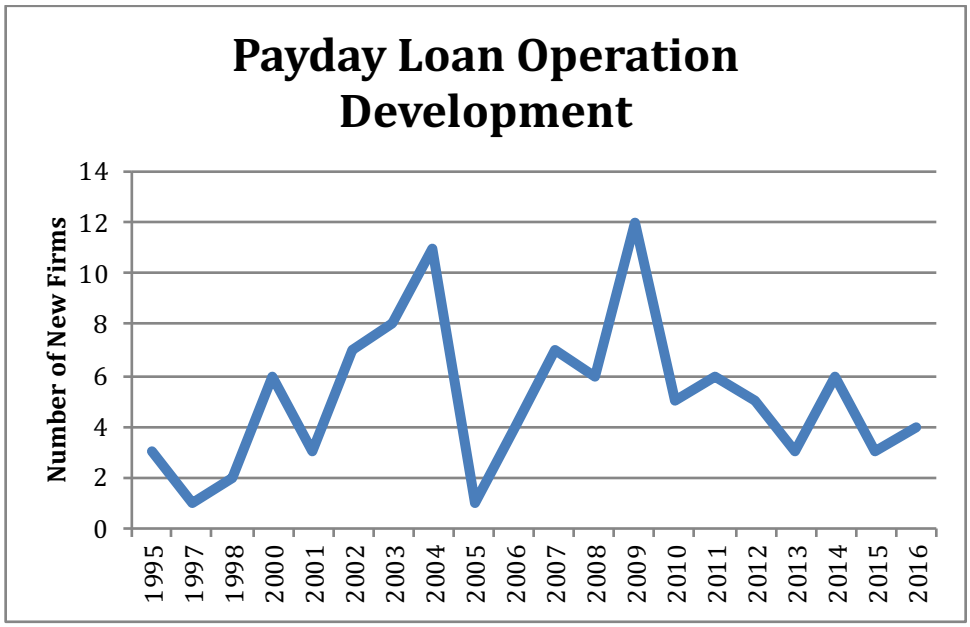
[79] Ibid.
[80] Ibid.
[81] Ibid.

For young stores they found that increasing the number of customers and loans results in increasing losses for the store (elasticity of -0.278). Their conclusion is that a young store will accept net operating losses for the purpose of establishing a customer base with high customer knowledge. The more information they can gather of their customer base, the more educated firms can be in extending payday loans. Therefore, they can shrink their customer base but increase profitability through credit rationing.

Application in Canadian Market

The development of the Canadian payday loans market has been heavily influenced by legislative changes among provinces. The market has seen a significant shift in the number of firms in operation in the last 20 years.

Figure 1: Progression of Payday Lending Operations Within Canada (Gross annual additions)



Source: Personally collected data from provincial business registries.

From the period of 1995 to 2004 no explicit legislation existed within the Canadian market pertaining to payday lending operations. Usury laws were thought to apply which would allow payday loan firms to charge a maximum interest rate of 60 percent annually.[82] Payday lending operations challenged this by citing "hoteling usage" and the products' use of an administrative fee instead of interest rate.

Hoteling is a concept that essentially means that the product is meant to be used for short term situations and the price would not reflect that of a long-term alternative, similar to hotel room pricing compared to apartment rental pricing. Ambiguous legislation in the Canadian Criminal Code also allowed for the administrative fee usage to skirt past interest rate restrictions.[83]

During this period, the market facilitated a rapid expansion in the number of firms to offer payday loan services. 49 distinct firms entered into the market. Of those 49, Money Mart was the only one to establish itself as the largest firm with the greatest geographical reach. Money Mart set up operations in 8 of 10 provinces during this time. The Newfoundland, Nova Scotia, and Ontario markets were entered through acquisition of an existing firm.[84]

[82] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis."
[83] Antle, "A Practical Guide to Section 347 of the Criminal Code - Criminal Rates of Interest."
[84] C&C Payday Plus in Newfoundland, National Payday in Ontario and The Money Pro$ in Newfoundland.

In 2005 the Federal Government announced that they would be proposing legislation that would regulate payday loan operations within Canada.[85] Prior to the introduction of Bill C-26, speculation over the extent to which the government would regulate the market dramatically decreased the number of entrants into the market. Only 16 new firms entered into the market during that time, almost entirely comprised of smaller firms and non-national brands (such as Money in Your Pocket, Ready cash, Pay2day, Payday Inc.) 10 of those firms no longer exist. Money Mart later acquired 8 of the failing firms and entered into every province except for Prince Edward Island. Bill C-26 ended up being less restrictive than originally anticipated, but allowed each province the autonomy to write individual legislation.

From 2007 to 2009, almost all provinces had implemented payday lending legislation and regulation. However, most of the legislation was focused on the practices of lenders with physical storefronts as well as measures to protect potential borrowers from being unfairly discriminated against. This led to the rise of online payday lending firms.

Of the 28 new firms that entered the market, 11 were online lending only. Though the exact reasoning as to why such a high percentage of new entrants were online only is unknown, it is likely that their entrance was motivated by the ability to circumvent provincial regulation, particularly with relation to fee caps, percentage of income borrowing restrictions and mandated signage requirements.[86] Additionally, online firms

[85] Kitching, Starky, and Bergevin, "Bill C-26: An Act to Amend the Criminal Code (Criminal Interest Rate) Law and Government Division Legislative Summary LS-541E."
[86] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis."

have significantly lower cost of operations as they have much lower labour costs, as well as a lack of rental or physical capital costs associated with storefront operation.

One of the largest areas of legislation that impacts the structure of payday lending markets within Canada is the restriction placed by provinces on what information can be requested when applying for a payday loan. All provinces prohibit payday lending operations from running formal credit checks on potential borrowers. Their reasoning is that it can signal to more traditional lending operations that a borrower's use of a payday loan will make them significantly riskier and would unfairly reject them from gaining traditional forms of credit.[87] The standard practice of information gathering by payday loans as allowed by legislation is to ask for proof of income and a bank statement. The requirement of a bank statement is designed to prevent a borrower from taking on multiple payday loans simultaneously. Manitoba is the most restrictive in this manner and prohibits payday lending operations from asking for banking information other than simply a bank account number that will be used for the deposit and withdrawal of funds.[88]

From 2010 to 2016, 39 new firms entered the market, 20 of which were online only. A second firm, Cash Money, started to emerge as a national lending brand with storefronts located in almost every province. Difficulties in tracking closures of firms through provincial Registry data, eliminated the possibility of determining how many operations were affected by either competition from online lenders or economies of scale that resulted in closure. However, between 2016 and2018 the number of physical locations have

[87] Ibid.
[88] Ibid.

dramatically dropped in Canada. According to the Canadian Consumer Financial Association (formally the Canadian Payday Lending Association) the number of physical stores dropped from approximately 1,400 at the start of 2016 to 961 at the end of 2017.[89]

[89] "Canadian Consumer Finance Association – We Represent the Majority of Licensed Payday Lenders in Canada."

CHARACTERISTICS OF PAYDAY LOAN BORROWERS

Reasons for accessing a payday loan may differ across all users. The academic literature has indicated that payday loan borrowers enter into the market for a variety of different reasons, but can be simplified into two main categories. The first reason is that borrowers simply do not have enough savings available to handle a personal financial shock.[90] A recent survey by the Financial Consumer Agency of Canada indicated that 45% of all payday loan borrowers surveyed entered into the market for an unexpected, necessary expense such as a necessary car repair. 41% of respondents of the same survey indicated that their decision to use a payday loan was due to an expected and necessary expense, such as rent, a utility bill or a mortgage payment. Secondly, a borrower may be forced to use a payday loan from a lack of alternative forms of credit. The same FCAC survey indicated that the methods of paying back the payday loan ranged from taking out a secondary payday loan, to borrowing from friends and family or selling a personal item to raise the income. Often a borrower may turn to a payday loan if they had been refused a credit card or alternative form of credit, but it is plausible that a borrower would choose a payday loan due to a lack of understanding of the relative costs.

The reason for a lack of savings can generally be divided into three subcategories. First, many payday loan users are considered to be of low or moderate income and might not have the ability to save. Their income may be stretched across all expenses such that a small change in their personal finances can have a severe negative effect. Second, their poor saving habits may be attributed to poor financial literacy. The inability to properly budget

[90] Stegman, "Payday Lending."

or understand the differences in interest rates can lead borrowers to make poor choices with relation to their personal finances.[91] Finally, their lack of savings may be attributed to myopic time preferences, where the borrowers will increase spending in the current period regardless of the future negative consequences.[92]

The second main reason for a borrower to choose a payday loan is a lack of alternative sources of credit. Most borrowers will not choose a payday loan as their first source of credit. Instead, they will seek out all other forms of credit that are accessible to them until a payday loan simply becomes the only available option.[93] This does not mean that they cannot be approved for any other form of credit; in many cases, the speed or convenience of the payday loan is what drives them into the market as other substitute options have larger transaction costs associated with time and effort. Payday loans can be approved within minutes, from the comfort of the borrower's home in many cases. Additionally, the rejection rate of payday loans is very small. As long as the borrower does not have a current loan from the payday lending institution and has some form of income, they are generally approved.[94]

The Buyer-Behaviour Model

[91] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis"
[92] Jones and Mahajan, "Time-Inconsistency and Saving: Experimental Evidence From Low-Income Tax Filers."
[93] Kluska, "Effects of Government Legislation and Regulation of Payday Loans in Canada: An Economic Analysis"
[94] Melzer, "The Real Costs of Credit Access: Evidence from the Payday Lending Market*."

Most economic analysis of consumer behaviour is based on the outcome of utility optimization decisions. This process takes into consideration factors such as education, income, age, prices, and some combination of other consumer demographic characteristics. This process is often highly efficient and effective in determining optimal outcomes, but often deal little with the actual decision-making process that occurs with many consumers, especially if consumers are not rational in their actions.

Instead, many researchers have used a cognitive model of consumer decision process called the Buyer-Behaviour Model – also called the Dirichlet model. The Buyer-Behaviour model is often used to describe how frequently-bought branded consumer products are purchased when the market is stationary and unsegmented. "It models simultaneously the counts of the number of purchases of each brand (or product) over a period of time, so that it describes purchase frequency and brand choice at the same time."[95] The model views the consumer's decision as a process occurring over several stages: Problem recognition, internal and external search for information, choice and outcome evaluation. These stages relate to internal feedback occurring throughout the process. Consumers may pause at each stage of the purchase decision, simplify the information gathered, use heuristics, take shortcuts, or proceed immediately to the purchase of the item.[96]

The model establishes that consumers of payday loans will seek out loans essentially out of a necessity (the problem recognition stage) and obtain information to

[95] Bassi, "The Dirichlet Model: Analysis of a Market and Comparison of Estimation Procedures."
[96] Elliehausen, "An Analysis of of Consumers' Use of Payday Loans."

guide them along the decision-making process. Information processing is where complications can arise for consumers based on their personal demographic characteristics. Information processing is the component of the decision-making process that holds the basic facilities for thinking and directing behavior. Things like previous experiences, criteria for evaluating alternative options and preconceived attitudes towards alternatives are all major factors in the information processing component. In other words, payday loan borrowers may be pushed into the market based on a poor experience they, a friend or family member had with a more traditional bank. That experience may create a preconceived attitude towards alternatives that lowers the value or trust associated with the substitute, regardless of cost. Comprehension is also a large necessary component to proper information processing. If the consumer cannot comprehend the details associated with the borrowing or purchasing decision, they can end up with a suboptimal outcome or product.

This model is important to the discussion of regulation and educational enhancement of payday lending borrowers as it indicates the necessity to focus on characteristics outside of traditional educational parameters. In the recent FCAC study, less than half of respondents (43%) understood that a payday loan is more expensive than an outstanding balance or cash advance on a credit card. Major factors that drove individuals to payday loans were characteristics such as convenience, and easy of use. Additionally, when asked how respondents were able to pay back the payday loan, 42% of respondents indicated that they used an alternative source of credit or savings. This raises questions

about why the borrowers would choose to enter the payday loans market to begin with if they had access to alternatives.[97]

Changing Consumer Behaviour

Researchers have attempted to quantify the amount of incentive it would take to transition a myopic time preference individual into a more rational acting consumer. Mahajan and Jones conducted a natural experiment by incentivizing New York state tax filers to create a budget associated with tax returns and follow through with the planned savings.[98] They presented a sample of tax filers the option to create a budget and save their tax refunds in an approved, liquid, savings vehicle. If they agreed, they would receive an incentive bonus beyond that of the regular savings interest offered. A second group of tax filers were offered a greater incentive if they produced a budget and agreed to put their tax return funds into a binded, illiquid savings vehicle. Borrowers in the first group had the option to opt out of the savings vehicle once they had received their tax returns where the second group could not. The results of the experiment concluded that the average annual discount rate is 164% among low-income earners. This means that low-income earners within the sample needed to be provided 164% rate of return in order to justify committing their earnings to a binded, illiquid savings program, otherwise they would rather have the opportunity to spend that income.

[97] Financial Consumer Agency of Canada, "Payday Loans: Market Trends."
[98] Jones and Mahajan, "Time-Inconsistency and Saving: Experimental Evidence From Low-Income Tax Filers."

Decisions to save at the sub-optimal level also appear to not just be relegated to individuals of low-income status. A recent survey by Forum Research Inc. indicated that 46% of Canadians had little to no emergency savings established – meaning less than one month's worth of expenses.[99] The survey indicated that this was consistent across all age groups and income levels – though there was a lower percentage of poor savers at the high end of the age and income levels. The sample size of Forum Research Inc. report is small and not likely a highly robust representation of all of Canada, yet, it does raise questions about the most effective ways to resolve financial instability and increase better financial decisions. Paying people to save is likely the most effective way, yet only 65.2% of Canadian households are contributing to either an RRSP or a TSFA savings vehicle.[100] However, offering a interest rate of 164% in order to properly capture low-income individuals within a savings incentive plan is unlikely to be feasible.

[99] Bozinoff, "More than Half Are Concerned About Prime Increase."
[100] Canadian Press, "65% of Canadians Are Saving for Retirement, Census Shows."

FINANCIAL LITERACY

What is financial Literacy?

Payday loans have become an increasingly complex service. The need for layered policy options to better regulate the payday lending industry has become more of a necessity than in previous years. Many advocacy groups have called for the outright banning of the service believing a more paternalistic approach is required.[101] Academic research has indicated that the outright banning of the service has ambiguous impacts on low and moderate-income groups.[102]

Others have called for a tightening of interest rates to better protect borrowers from abhorrently high interest rates and costs. This avenue is seen to be a catch-all option as it allows for the cost of loans to decrease to the borrower. However, the reduction in price caps can lead to a credit tightening process that can exclude those that are the most vulnerable. Instead, financial literacy and education programs are an alternative approach

[101] "ACORN Policy Position: Fair Banking."
[102] Taken from Melzer 2011 "Two studies detect negative effects: (Skiba and Tobacman 2008) find greater rates of chapter 13 bankruptcy filings among payday borrowers, and (Carrell and Zinman 2008) find declines in job performance and readiness among Air Force personnel stationed near payday lenders. Three studies find benefits of payday loan availability: (Morse 2011) finds lower foreclosures following natural disasters; (Morgan and Strain 2008) find lower rates of bounced checks in Georgia and North Carolina before payday loan bans; and (Zinman 2010) identifies deterioration in subjective assessments of financial well-being after Oregon restricts payday lending. In a field experiment in south Africa, (Karlan and Zinman 2010) also find that improved credit access increases rates of employment and improves food security."

that might help to minimize the potential negative impacts that payday loans are said to cause.

Financial literacy in a general sense lacks a consistent definition within the academic literature, which makes it a difficult goal to strive for in a policy framework. Prior to 2007, financial literacy was not a common term within Canada. It originated in the United Kingdom and refers to the skills and knowledge necessary to manage finances.[103] However, this definition has been argued to be ill-equipped to highlight the societal struggles that individuals may face outside of management of their finances.[104]

The Financial Consumer Agency of Canada defined financial literacy as having the knowledge, skills and confidence to make responsible financial decisions.[105] More recent research has expanded on this definition and claims that financial literacy is a form of fundamental comprehension and understanding of financial products. It is a necessary component of understanding for any individual to function within today's economy and society. Yet, it is not a static form of understanding and education like that of general or numeric literacy. In other words, the ability to understand basic arithmetic or have basic reading and writing skills do not directly translate into financial literacy skills.[106]

These definitions may appear to be similar in nature but the slight differences in intent and definition has led to large negative impacts for Canadians, even with the presence of financial literacy programs. A recent analysis by Jennifer Robson from Carlton

[103] Murray, "Financial Literacy : Policy Approaches for Low-Income Albertans."
[104] Robson, "The Case for Financial Literacy."
[105] Murray, "Financial Literacy : Policy Approaches for Low-Income Albertans."
[106] Robson, "The Case for Financial Literacy."

University has found that "40% of the Canadian Adult population lacks, and is projected to continue to lack, the basic and essential skills needed to function in today's economy and society."[107] She claims in her findings that most financial literacy programs and professionals contain a large barrier to entry that requires a certain underlying comprehension of numeric and general literacy, or a greater financial capacity than what the most vulnerable groups can access in order to improve their financial capabilities.[108]

Additionally, she found that most financial literacy information can be inaccurate for most vulnerable groups as their circumstances can be drastically different from the average Canadian, or the advice offered is simply not relatable to their situation. She claims that most financial information will recommend a 30% or higher savings rate from income to help offset any future shocks to their personal finances. This may be an obtainable goal for the average Canadian, but for low-income, vulnerable communities, this simply cannot apply as many are forced to live paycheque to paycheque or cannot make ends meet as they are reliant on government transfers to survive.

The lack of relatability can cause many of the people within the vulnerable group to disengage with financial literacy material as it does not directly apply to them, or the amount that they could save appears to have little effect on their overall financial welfare.[109]

[107] Ibid.
[108] Ibid.
[109] Ibid.

Large components of the research indicate that financial literacy has both an educational component, as well as a psychological one. There is evidence that supports a correlation between higher education attainments and better financial outcomes, but many of the studies suggest that higher income could hide poor financial literacy decisions.[110] This idea is not new and is one that is commonly investigated by behavioral economists as well as psychologists.

The psychological aspect of financial literacy relates to the level of integration between what an individual knows they should do, and how they actually behave. Irrational behavior results when an individual's "stated preference" is different from their "revealed preference". Stated preference is a concept where individuals (primarily survey respondents) will state a specific set of preferences that they might have. Revealed preference is a determination of an individual's preferences based on their actions.[111]

With respect to payday loans, individuals with low financial understanding can experience dire consequences from using a payday loan. The Financial Consumer agency of Canada conducted a survey of payday loan borrowers in 2016 and found various outcomes that outline the need for financial literacy attention in the payday loan policy area. In their report, they found that respondents had poor understanding of the costs associated with payday loans, similar substitutes that were available to them, and how to budget effectively in order to pay back the loan.[112]

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[110] Murray, "Financial Literacy: A Conceptual Review"; Mason and Wilson, "Conceptualising Financial Literacy."
[111] Church and Ware, *Industrial Organization: A Strategic Approach*.
[112] Financial Consumer Agency of Canada, "Payday Loans: Market Trends."

How to improve financial literacy?

Since it is difficult to obtain universal agreement on the definition of financial literacy, the task of improving it also becomes more difficult. There are many suggestions offered throughout academic research, however, the approach tends to split into two main directions.

First, the common suggestion is to focus more efforts on improving numerical and general literacy techniques. Murray (2010) and Mason and Wilson (2000) are the most aggressive in this suggestion, pointing to the empirical evidence showing large positive correlations between education attainment and financial outcomes. Critics have suggested that higher income achieved from the education is more likely to hide poor financial literacy, but Murray explains that the overall outcome is improved from education attainment which is an easier goal to attain.[113] Similar findings were found by McKay (2011) in an analysis of the Canadian Financial Capability Survey and Atkinson et al. (2006) in a UK survey analysis.[114]

The second approach recommended is to separate financial literacy as a completely separate educational skill and focus more programs on the development of financial literacy at all stages of educational attainment. Forté (2014) suggests that introducing

[113] Murray, "Financial Literacy: A Conceptual Review."
[114] McKay, "Understanding Financial Capability in Canada: Analysis of the Canadian Financial Capability Survey"; Atkinson et al., "Levels of Financial Capability in the UK: Results of a Baseline Survey."

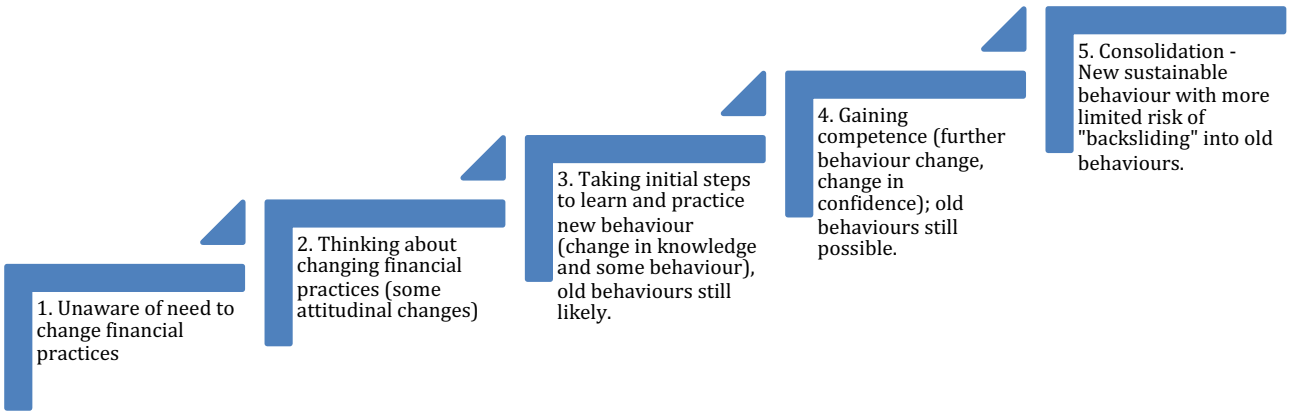
financial literacy education classes within the K-12 education system that enhance specific financial literacy skills would be the best way to improve overall financial outcomes. Classes should include topics such as how to make a budget, how sales tax works, prioritizing necessities, and more.[115] Momentum also supports this decision with their findings in a 2014 analysis of how they were best able to improve financial literacy outcomes through educational programs.[116]

As for how to improve financial literacy outcomes for the current adult population, many researchers have supported the five-step program created and outlined by Angela Lyons in 2006. She utilized the stages of change with addiction counselling and modified it to fit financial literacy, describe various states of awareness and action, as adults move from being unaware of any need to change their financial behaviour, becoming motivated to change, then practicing change, and finally forming new and lasting financial habits.

Lyons suggests this model may be useful for describing how financial literacy programs work, but it has proven difficult to apply as a model for program design or evaluation.[117] Figure 2 outlines the suggested stages of Lyons' model.

[115] Forté, "Sociocultural Issues in Adult Financial Education."
[116] Momentum.org, "The Real Cost of Payday Lending."
[117] Lyons et al., "Are We Making the Grade? A National Overview of Financial Education and Program Evaluation."

Figure 2: The Lyons Model of Changing Poor Financial Behaviours



The Lyons model is suggested to be an effective model to assist irrational individuals in the advancement of changing unhealthy financial behaviours, but lacks structure for rational individuals. It also lacks practical support functions and misses on describing what specific actions need to be taken to improve financial behaviours. Robson suggests the utilization of the Kempson et al. model to identify which steps are needed for an enhanced focus.[118]

[118] Robson, "The Case for Financial Literacy."

Figure 3: Kempson et al. Model for Improving Financial Literacy

Each step within the Kempson et al model includes three sub categories of understanding, motivation and confidence, and in practice. Understanding is referring to outlining all the elements of the step so that individuals on the path towards improved financial literacy have an ability to understand what steps are particularly required for them to meet the expectations of that step.

For example, in the "Making Ends Meet" section, "Understanding" would include things like budgeting plans and outlining what monthly purchase items are "needs" instead of "wants". "Motivation and Confidence" is a step that identifies what psychological steps are required in order to keep individuals motivated and instilled with confidence in order to keep on task and improve success rates.

In the "Choosing Products" section, having community support programs to keep the individuals motivated to stay true to the plan they personally established helps to ensure that backsliding happens much less frequently.

Finally, the "In Practice" step suggests that all the material learned works best when it is customized to the individual person with relevant real-world examples, and that is presented by an organization or individual who is deemed trustworthy by the participant of the program.[119]

How does the legislation align with the academic suggestions?

Currently within Canada, no legislation is present within the payday loans area to enhance financial literacy and awareness in the manner suggested by the research. The closest is the Ontario Payday Lending Education Fund; however, this fund lacks the necessary finances in order to be effective in improving these outcomes in the ways suggested. The fund collects funding as a portion of licensing fees within the province. The annual licensing fee is $440 for a home office location and $990 for each branch location, yet only 35% of the licensing fee goes towards the Education Fund.[120] Since there are only 961 branch locations recorded within all of Canada as of 2017, if you assumed they were all located within Ontario, the most that the province would receive in funds would be less than $1 million annually. Since only 35% of the funds collected go towards the Education Fund, the

[119] Kempson, Collard, and Moore, "Measuring Financial Capability: An Exploratory Study."
[120] "Business Applications, Licences and Permits | Ontario.Ca."

maximum contribution would be only $350,000 annually. The reality is that the 961 branch locations are spread across Canada, rather than just Ontario, and as a result, the Education Fund collects a significantly smaller portion of income than $350,000. This limits any type of financial awareness and education programs to small advertising campaigns with little to no personalization based on the client of the payday lending store.

Based on the research that is available, however, the current structure of financial literacy enhancement through informational handouts is insufficient. Though counterfactual information is lacking to sever a causal improvement between information handouts and financial literacy improvements, enough information and research is available to indicate that course of action is insufficient in improving financial outcomes.

Improvements within traditional educational programs will likely increase some positive outcomes as suggested by Murray (2010), Mason and Wilson (2000) and Forté (2014). However, research conducted by Robson (2012) and Elliehousen (2009) have indicated that an enhanced, customized, one-on-one training environment will render the best results. These improvements are unlikely to come specifically from within payday lending legislation, however, there is opportunity to develop an educational initative through funding procured in similar fashion as the Ontario Payday Lending Education Fund. The revenue share would have to dramatically increase, however, that is likely the best course of action to improve financial literacy outcomes specifically related to payday loans.

There may be value in creating targeted informational and educational campaigns designed to improve outcomes within demographic groups most likely to use payday loan

services – young individuals with families in need of credit to maintain daily household life. Such a campaign would specifically provide assistance with the financial literacy outcomes of future generations as the personal experiences of their family may dictate their own personal financial outcomes.[121] Additionally, an educational campaign directed at low-moderate income, young families would benefit governmental social program expenditures as families that are more likely to use a payday loan are more likely to use a government social program.[122] If personal outcomes are improved for these families, the reliance on social programs may decrease and overall expenditures could fall for provincial governments.

[121] Elliehausen, "An Analysis of of Consumers' Use of Payday Loans."
[122] Ibid.

CONCLUSION

The research reviewed suggests personalized education programs for adults based on their individual circumstances as the most effective way to improve financial literacy. Other suggestions include increasing efforts within traditional educational systems and programs to increase financial literacy capacity for youth before they are faced directly with decisions that required an increased financial understanding.

Personalized education programs are far more expensive than legislation that simply requires the handout of a pamphlet or the provision of contact information for credit counseling services. However, no research has been presented that the counterfactual to these programs would not have some level of effectiveness. There is no evidence that suggests that financial literacy handouts cannot and do not improve financial outcomes for individuals. This is due to the lack of data that exists about users of payday loan services in Canada, as well as the difficulty in establishing a natural experiment to properly test the effectiveness of literacy programs. Stated preference survey data would be unreliable as many survey respondents would overstate their personal understanding of the material.[123]

According to the academic research on the topic, the financial literacy components of provincial legislation are limited in their scope. Without the proper pairings of other educational programs, the opportunity cost associated with the current financial literacy handout requirements are large.

[123] Mason and Wilson, "Conceptualising Financial Literacy."

Based on the research available, implementing legislative and policy changes solely against payday lenders is unlikely to achieve the desired target of improved financial outcomes. Many researchers have stated the most effective methods of improving financial literacy outcomes is within personalized, one-on-one approaches. Utilizing a legislative stop-gap method of financial literacy information handouts is unlikely to be successful and thus creates large opportunity costs, diverting attention and legislative efforts away from more practical and efficient ways of achieving the goal.

As stated previously, rational borrowers already understand the costs associated with the loans and thus are making a conscious decision based on what is the best course of action for them. Irrational borrowers are likely to borrow and use the credit available to them regardless of the consequences.

Evidence has also been presented to illustrate that payday loans have some value within the market. The improvements in overdraft protection as well as the increased access to credit can provide some positive effects to rational borrowers at the margin. Irrational borrowers will still be harmed by the high cost of borrowing, and the potential to fall into a debt cycle trap, but enhancing legislation to protect those borrowers does not appear to be a pareto improvement.

The payday loans market is a complex evolving market and legislation continues to struggle to keep up with the evolution. Evidence is strong that legislation and regulation is required, but flexibility within the legislation appears to be the best course of action.

Legislation should continue to focus on enhancing data collection and sharing techniques so that more surveys and research can be empirically based and outcomes of

specific aspects of the legislation more effectively measured. Provinces can develop "best practices" legislation and regulations by comparing data measuring the outcomes of various legislative differences among the provinces, or following legislative changes in a particular province.

Continuing efforts to develop financial literacy may be the most helpful in overall improvement of borrower well-being in the long-term. Future study is required of the market as data becomes more readily available in the next few years.

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