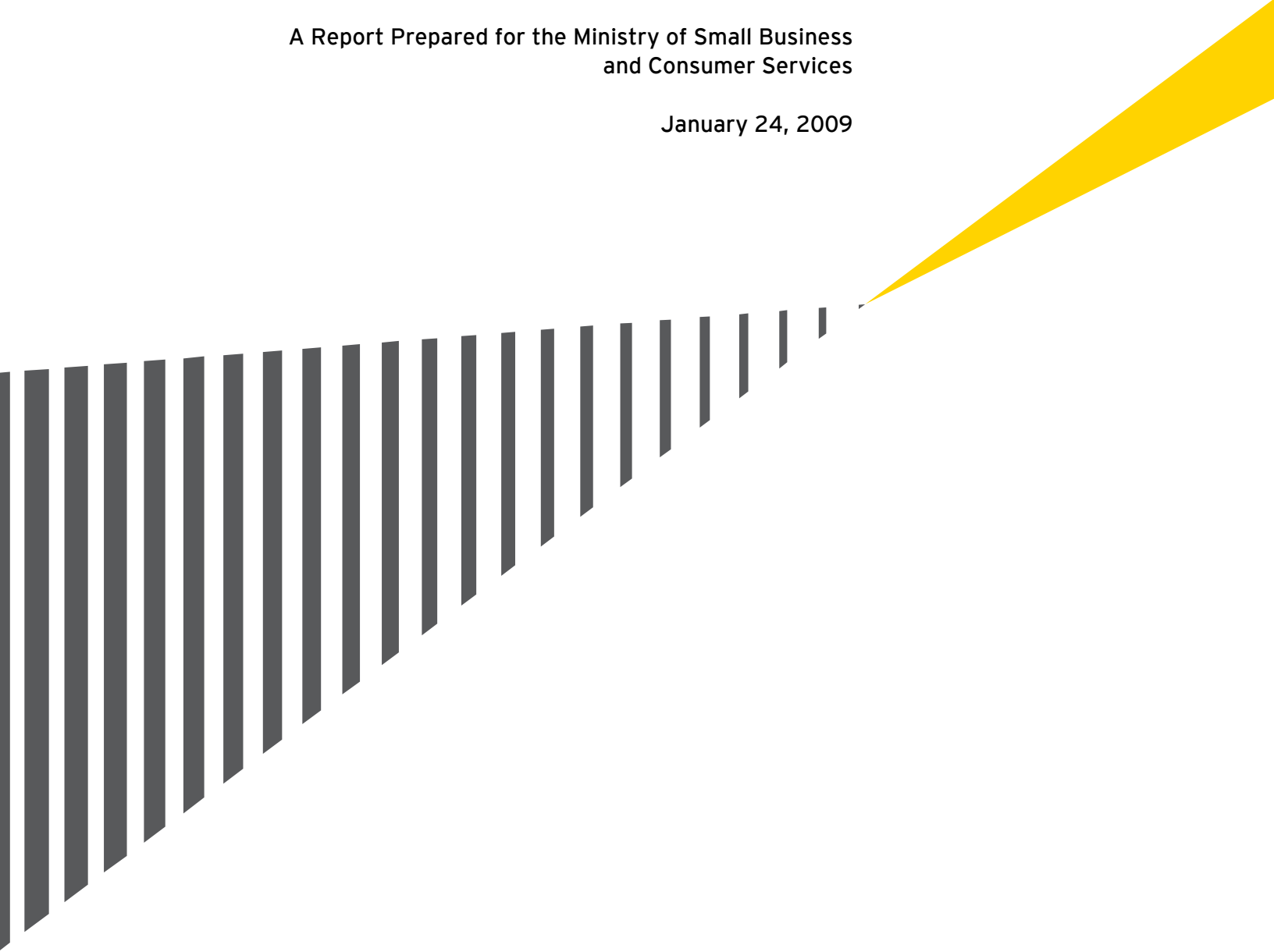


# The Cost of Providing Payday Loans in Ontario

A Report Prepared for the Ministry of Small Business  
and Consumer Services

January 24, 2009



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This report is intended solely for the information and use of the Ontario Ministry of Small Business and Consumer Services (“Ministry”) and the Maximum Total Cost of Borrowing Advisory Board (“Board”) and is not intended to be and should not be used by anyone other than these specified parties. Ernst & Young therefore assumes no responsibility to any user of the report other than the Ministry and the Board. Any other persons who choose to rely on our report do so entirely at their own risk.

## 1. Executive Summary

In connection with the *Payday Loans Act, 2008* that recently received Royal Assent in the Province of Ontario, the Ministry of Small Business and Consumer Services ("Ministry") established the Maximum Total Cost of Borrowing Advisory Board ("Board") for the purpose of advising the Ministry on the upper limit for the rate of borrowing that businesses in the industry should be allowed to charge their clients. The Board has received input from a number of industry stakeholders and other interested parties. The Ministry has engaged Ernst & Young LLP ("Ernst & Young") to independently collect financial information from a sample of payday lenders related to the cost structure of their businesses and to use this information to calculate the cost of providing payday loans in Ontario based on an agreed methodology. The Board and the Ministry will use this report, in conjunction with other information available to them, to determine the borrowing limit rate.

The methodology used by Ernst & Young to collect and analyze payday lending cost information is similar to that used for and by other parties. A detailed questionnaire was prepared and after contacting approximately 100 companies which provide payday loans in Ontario, a total of 11 completed surveys were received of which 9 contained sufficient detail to allow for inclusion in the findings. While the surveys that were received were not subject to audit procedures, unclear or incomplete data was clarified through follow-up discussions held with each of the respondents. We further note that the calculations presented in this report are based solely on the data provided by payday lenders who participated in the survey and are not statistically representative of the entire payday loan industry in Ontario. Had other participants completed the survey, the calculations would have varied.

Once the data for each respondent was obtained and clarification received for any missing or unclear information, the relevant financial information was input into a financial model for the purpose of calculating the cost, by major cost component, of providing payday loans. As requested by and agreed with the Ministry, the model for this report is based on the model used in *The Cost of Providing Payday Loans in Canada*, which was prepared by Ernst & Young in 2004 for the Canadian Association of Community Financial Service Providers (now the Canadian Payday Loan Association), and any significant variations from this model are described in our report.

Based on the information received, Ernst & Young has calculated an unweighted average cost of \$22.07 and a weighted average of \$21.50 per \$100 of payday loans. It is important to note that these costs are based on historical financial information and therefore do not reflect any new costs that may be incurred to achieve and maintain regulatory compliance, or any changes to their cost structure as a result of recent changes in the economic environment. The results are also impacted by the assumptions inherent in the model and the use of other assumptions would result in different cost calculations. Our report contains additional details as how these amounts were calculated and provides cost calculations and assumptions that were incorporated into the major cost components: operating costs, costs of capital, and bad debts.

## 2. Introduction

### 2.1 Background

Ernst & Young LLP (“Ernst & Young”) was commissioned by the Ontario Ministry of Small Business and Consumer Services (“Ministry”) to prepare an independent and objective report on the costs of providing payday loans in the province of Ontario. The Ministry intends to use Ernst & Young’s results to support its understanding of the payday loan industry’s cost structure. In addition, the Maximum Total Cost of Borrowing Advisory Board (“Board”) will consider the contents of the report, along with other information and submissions it has received, in forming a recommendation on an appropriate upper limit for the total cost of borrowing with respect to payday loans in Ontario.

This report includes a summary of data obtained through a survey of Ontario payday lenders (“payday lenders”, “respondents”) and the results of our calculations based on that data. The report is not intended as a commentary on the appropriate maximum total cost of borrowing or as an assessment of payday lenders’ costs, operations, or risk management practices, nor does it provide audit or any other form of assurance on the cost data. This report is intended solely for the information and use of the Ministry and the Board and is not intended to be and should not be used by any other party or for any purpose other than those specified above.

Ernst & Young prepared a report in October 2004 (“2004 Report”) entitled “The Cost of Providing Payday Loans in Canada” commissioned by the Canadian Payday Loan Association (“CPLA”, formerly the Canadian Association of Community Financial Service Providers). We understand that the applicability of the methodology developed by Ernst & Young for the 2004 Report has been discussed with the Board by a number of third parties in connection with the data collection process carried out by the Board. Consequently, the methodology and procedures utilized in this report are based on the 2004 Report except where noted.

#### Payday Loans

A payday loan is an unsecured short-term loan for a relatively small sum of money provided by a non-traditional lender. Statistics from the Canadian payday loan industry suggest that the average payday loan is valued at around \$280 and is extended for a period of 10 days.<sup>1</sup> In order to qualify for a payday loan, the borrower generally requires personal identification, a bank account, and proof of a regular income. The lender will typically lend up to a specified percentage of a customer’s net pay for a typical period of 1-14 days, ending on the borrower’s next payday. The borrower provides the payday lender with a post-dated cheque or authorizes a direct withdrawal for the value of the loan plus any interest or fees charged.

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<sup>1</sup> Canadian Payday Loan Association, *What is a payday loan?*, <http://www.cpla-acps.ca/english/aboutloans.php>

## 2.2 Scope and Limitations of This Report

The purpose of this report is to provide the Ministry and the Board with an independent and objective analysis on the cost to provide payday loans in Ontario. This report is intended to present a calculation of the range of costs to provide payday loans in the province of Ontario based on a sample of providers, rather than a precise, statistical analysis of the industry's cost structure. As with any study of this nature, this report is subject to the scope and limitations outlined below and should not be used by the Ministry and Board as the sole source of information relative to the cost of payday loans.

### Temporal Scope

This report is the result of work conducted from November 2008 to January 2009. The survey data is based on payday loans disbursed and related financial results for the most recent fiscal year for which a respondent had such information available, which was typically 2007 or 2008. As the survey only requested respondents to provide information for the most recently available, single fiscal year, the scope of this report does not include an analysis of trends over time in the costs to provide payday loans nor does it attempt to project future costs which may be impacted by regulatory changes or changes in the economic environment. For example, it is not known the extent to which the payday loan industry's revenue and cost structure will change as a result of compliance with the recently enacted *Payday Loans Act, 2008 [Ontario]*. The calculations are also impacted by the assumptions inherent in the model (as described more fully in section 3) and the use of other assumptions would result in different cost calculations.

### Sample Size

Ernst & Young identified and attempted to contact approximately 100 businesses with payday lending operations in the province of Ontario. 46 lenders agreed to receive a copy of the questionnaire developed by Ernst & Young and 11 responses were received, although two surveys lacked certain information that necessitated their exclusion from our calculations. The nine respondents who provided usable information operate a total of 67 stores representing approximately 9 to 9.5% of the estimated 700 to 750 storefronts operating in Ontario (as indicated by the Ministry).

Calculations presented in this report are based solely on the data provided by payday lenders who participated in the survey and are not statistically representative of the entire payday loan industry in Ontario. In some instances, our calculations are based on a sample size of less than nine, as some respondents may have provided responses that, while largely complete, lacked certain details that resulted in their exclusion from certain calculations. Had other participants completed the survey, the calculations would have varied.

We recognize that our sample size is relatively small, particularly in comparison to previously completed studies of the industry. Many of the companies we contacted indicated that the timing of the study around the end of the year made it difficult for them to participate in the survey. In addition, concerns were expressed about contributing confidential information. As a result, we were unable to obtain responses from any companies beyond the 11 indicated above.

### Data Quality

This report and the related analysis are based on data provided by payday lenders through an independent survey developed and conducted by Ernst & Young which, as agreed with the Ministry, was based on the methodology used for the 2004 Report. Respondents were asked to use actual financial statements for their most recent fiscal year to respond to the survey questions, and to provide a copy of their financial statements with their completed questionnaire. Because each business collects data and reports results in different ways, many of the respondents were unable to complete the questionnaire in full based entirely on data from their financial statements. Although follow-up discussions were held with respondents to fill in missing information and to confirm or revisit responses which were unclear, the information obtained was not audited or subject to other verification procedures.

## 3. Methodology

### 3.1 Segregation of Costs

Based on the methodology from the 2004 Ernst & Young report, the cost of payday loans is segregated into four components. These are:

1. Fixed and variable operating costs
2. Cost of loan capital
3. Cost of supplementary capital
4. Bad debt costs

#### 3.1.1 Fixed and Variable Operating Costs

For purposes of calculating the total cost incurred by payday loan companies for the provision of payday loans, information on fixed and variable operating costs was grouped together and segregated from the costs of capital and bad debt costs. While the segregation of fixed and variable operating costs is not required for the model used to calculate the total cost, the fixed and variable components have been summarized for the purpose of this report.

**Fixed costs** are assumed to be those that are incurred by a payday loan company but are not directly tied to the volume of transactions: occupancy costs (rent, utilities), depreciation, advertising, head office expenses, security, etc. Many fixed costs are non-discretionary and fixed by contract for a specific period of time (e.g., occupancy costs). Other fixed costs, such as advertising, are more discretionary, but are not directly tied to the volume of business.

**Variable costs** are assumed to be for the purpose of this report those for which the amount of the cost incurred has a direct relationship with the volume of payday loans issued by a lender. For example, an increase in the volume of transactions would be expected to lead directly to a proportionate increase in banking transaction charges.

The distinction between fixed and variable expenses is often dependent on the magnitude of services and in some instances, not clearly distinct. Salary and benefits are a good example of an expense item which is not easily classified as either a fixed or variable cost. For example:

- Some payday loan providers may pay employees on an hourly basis with flexible schedules that allow the employer to increase or decrease staffing levels based on the volume of loans being issued. This would appear to be a cost that would be described as variable. However, it should be recognized that a storefront operation may be required to have minimum staffing levels in order to be open throughout the business day, even if the volume of business at certain times of the day does not justify that level of staffing. As a result, there is also a fixed component to this type of staffing arrangement.
- Another business may have fixed work hours for its staff and pay employees a fixed annual salary. This at first glance would appear to be a fixed cost structure. However, in this situation, it is reasonable to expect that the volume of business at a location could increase or decrease to such an extent that a change in the staffing level would be made and the payroll cost would change. While this introduces a variable component to the cost, it would be expected to move once certain loan volume thresholds are achieved, and therefore does not have a direct relationship to loan volumes.

Without a more detailed understanding of each respondent's business structure, we are not able to definitively categorize salary and benefits as either a fixed or variable operating cost when summarizing results across all respondents, and it is likely that for most payday loan businesses, we would observe both fixed and variable characteristics. For the purpose of providing a break-down of fixed and variable costs as a percentage of total costs in section 4.2, we have categorized salary and benefits as a "hybrid" cost: an expense which is primarily fixed but may be tied to loan volumes at certain thresholds.

This distinction between fixed and variable costs, while not essential in calculating total costs of providing payday loans, is also important when considering differences between mono-line and multi-line operators. Mono-line operators are only in business to provide payday loans; as such, all fixed and variable costs get allocated to their only business activity of payday lending. Multi-line operators offer services in addition to payday loans such as cheque cashing, money transfers/orders, tax preparation, etc. For multi-line operators, it is not easy to determine which of their business lines are incremental/marginal services and how fixed costs should be allocated among different lines of business.

If a multi-line provider was able to provide an allocation of expenses that relates exclusively to their payday loan business, or a reasonable method of allocating expenses, that allocation was used. If a multi-line provider's payday lending business constituted more than 95% of its total revenue, all expenses were deemed attributable to payday lending on the assumption that the other line(s) of business are ancillary to payday lending and, if the business discontinued its other service line(s), the operating expense structure for the company would not likely change.

If a multi-line provider was unable to provide a specific allocation for expenses, an allocation was made based on the share of total revenue earned from the payday loan segment. The default allocation was based on the following calculation:

$$\text{Payday Loan Expense}_i = \text{Expense}_i \times \frac{(\text{Payday loan fees} + \text{Payday loan interest})}{\text{Total Revenues}}$$

In the above expression, *Payday Loan Expense<sub>i</sub>* is the amount of individual expense item *i* that is related to the provision of payday loans, and *Expense<sub>i</sub>* is the total amount of individual expense item *i*. This assumes that if payday loans account for *x%* of a company's revenues, then *x%* of its operating costs, such as salaries, would also be related to the provision of payday loans. This allocation was used for costs other than the cost of capital and bad debts. This allocation method assumes that the company's profit margin on payday loans is the same as that for other lines of business. As noted earlier, it was used only if alternative methods were not available. This allocation is based on expenses adjusted to remove any costs that do not reflect the cost of providing payday loans, such as management fees to affiliated entities. These and other such adjustments are described in the following section.

### Adjustments for Special Categories of Costs

For model consistency in measurement of costs across different operators, several adjustments have been made for special categories of costs such as inter-company transactions, goodwill, and franchise issues.

#### (i) Goodwill amortization expense

Goodwill is defined as the residual between the price of a business and the fair market value of all the identifiable assets. It represents such things as brand name, reputation and clientele that the vendor has established during his or her operation of the business prior to selling the business. It would not be recognized as a cost where the business is continued in the legal entity where it was started. However, when the business is sold to another person, goodwill gets crystallized and any amount attributable to it

becomes a legitimate cost of doing business. For the purpose of this report, amortization of goodwill is recognized as a legitimate cost, except where goodwill is attributable to transactions between entities within a group of related corporations.

*(ii) Provision for loan losses and doubtful accounts*

The survey responses indicated that there are significant variations in the method used by respondents to account for bad debts. Some respondents write off bad debts after a fixed interval such as 30, 60, or 90 days. Other respondents only write off bad debts at year end or only write off a bad debt after all reasonable efforts to collect the debt have been exhausted, sometimes as long as three years after the date of default. Therefore, costs related to bad debts have been removed from the calculation of operating costs and are instead calculated based on a consistent method under the category of bad debt costs. This is discussed in more detail in section 3.1.3.

*(iii) Interest*

Costs related to interest on long term debts are included under the cost of capital and have therefore been removed from the calculation of operating costs. This is discussed in more detail in section 3.1.2.

*(iv) Taxes*

Amounts charged for taxes were deducted from total costs so that results are presented on a “before-income-tax” basis.

*(v) Franchise expenses*

Some of the larger operators have franchise operations. These operators incur costs to support their franchise operations such as advertising and other head office functions. The model distinguishes corporate store costs from franchise support costs, since the latter would not reflect the underlying cost of providing payday loans from their corporate stores. If the respondent is a franchisee of one of the larger operators, its costs include amortization of the franchise fee and annual franchise royalty payments. For the franchisee, these are components of the costs of the payday loan business and have therefore been included in the calculation of total cost to provide payday loans. If a respondent provided costs on a system-wide basis (summing costs for all stores), expenses directly related to franchising are treated as an inter-company expense and have been excluded.

*(vi) Payments to affiliated companies*

Payday loan companies sometimes operate their business through a group of affiliated companies where inter-company transactions and management fees flow between related companies. For example, a payday store operation may acquire labour services, leasing of property and other services from an affiliated entity. The entity could charge the operating company its cost plus a mark-up.

Payday management fees to affiliated companies or the parent company may represent a form of profit distribution or the actual cost of the services provided by the parent, or a combination of both.

For the purposes of our calculations, to the extent these services provided to related entities would be charged for by a third party service provider, they have been included in the cost base of providing payday loans. On the other hand, if the fees charged to the operator were a form of profit distribution, then they have been excluded from the cost base.

*(vii) Payments to owners*

Information was gathered on payments to proprietors, partners, shareholders, and spouses and other family members of the proprietors, partners and significant shareholders. The survey also requested supporting information such as the number of employees on the payroll as well as the typical amount of time owners spend working on the business in a typical week. As a result, certain payments were included in the calculation of operating costs for payday lending and others were not, depending on whether the payments based on the data provided were a cost of services rendered.

*(viii) Non-recurring expenses*

Respondents were also asked to identify non-recurring or unusual expenses that were incurred outside the normal course of business and do not reflect costs that should be allocated to payday lending. Where necessary, operating costs have been adjusted to account for these non-recurring expenses.

### **3.1.2 Costs of Loan and Supplementary Capital**

The cost of loan and supplementary capital is the actual or opportunity cost of funds to the lender. These costs include the cost of capital for the amount lent to the customer, the cost of carrying fixed assets, and the cost of carrying the cash reserves necessary to ensure that money is available when the customer requests a loan.

Some payday lenders borrow the funds required for loan and supplementary capital. An appropriate interest rate for this capital must be determined. Many payday lenders use equity and retained earnings to provide payday loans. A suitable rate of return on equity must be assumed to reflect the opportunity cost of using that capital for payday lending, instead of for some other economic activity, in order to provide an accurate cost of providing a loan. It is important to note that equity investors take on more risk and therefore must be compensated with a higher rate of return than for the borrowed capital.

In the methodology adopted for the 2004 Report, the costs of capital and bad debts relate to the dollar volume of loans and advances, and not to the fees/revenues earned from them. As a result, a different allocation methodology was used for these. In particular, a measure of annual percent cost of funds, akin to a measure of annual interest rate on borrowed funds, was calculated. It is a blended rate, reflecting the reasonable borrowing costs plus an assumed amount for the opportunity cost of the equity capital of the operator. Similarly, the aggregate bad debt costs for a given year are expressed as a percent of the total volume of loans granted during the year.

#### **Cost of Loan Capital Calculation**

The cost of loan capital is determined by multiplying the dollar value of loans by the weighted average rate of the cost of capital. This weighted average rate is determined by the interest rate paid on corporate debt and the rate of return on equity in the business. For equity (shareholder equity<sup>2</sup> plus retained earnings) it is assumed that the shareholders must also receive a reasonable rate of return to cover their opportunity cost of providing funds to the business. Data provided by the questionnaire respondents was not sufficient to calculate the interest rate being paid by the payday loan providers. Similarly, there is no standard expected rate of return on equity for the payday loan industry. As such, assumptions have been used in order to determine a reasonable weighted average cost of capital ("WACC"). These assumptions are discussed in section 3.3. This report includes a sensitivity analysis to

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<sup>2</sup> Note: While most respondents recorded shareholder loans with no stated terms as liabilities on their balance sheet, these have been treated as equity for the purpose of calculating the imputed cost of capital.

allow for the consideration of the impact of alternative assumptions for the interest rate paid on corporate debt and the rate of return on equity in the business (refer to section 4.3).

For the purpose of calculating the cost of loan capital, the two rates are weighted by the relative proportion of long-term debt and equity used to finance the business. These amounts are determined from balance sheet information (capital stock, retained earnings, and long-term debt of each respondent). The calculation is as follows:

$i$  = assumed interest rate on company debt  
 $r$  = opportunity cost of equity  
Total corporate capital = debt + shareholder equity + retained earnings

$$\text{imputed annual rate of cost of capital} = \left( \frac{\text{debt}}{\text{total corporate capital}} \times i \right) + \left( \frac{\text{shareholder equity + retained earnings}}{\text{total corporate capital}} \times r \right)$$

The study estimates the total cost of loan capital as follows:

$$\begin{aligned} & \text{Actual value of loans granted} \\ & \quad \text{multiplied by} \\ & \text{Weighted average annual opportunity cost of capital} \\ & \quad \text{multiplied by} \\ & \text{Average maturity of 'good' loans} \div 365 \\ & \quad \text{equals} \\ & \text{Cost of loan capital} \end{aligned}$$

### Cost of Supplementary Capital Calculation

Cash balances and fixed assets are required to support the payday loan business. Capital required for payday loans, therefore, includes not only the principal amount of the funds lent, but also the cash on hand needed for the loan business, and fixed assets. The calculation above relates to the cost of capital for only the principal amount of the loans.

The cost for the supplementary capital (i.e., cash balances and fixed assets) is calculated by multiplying the portion of supplementary capital allocated to payday lending (based on percent of total revenue) by the weighted average return on capital calculated above.

### Cost of Capital as a Fixed Cost

The amount of capital required to operate a payday loan business is not expected to fluctuate on a daily or weekly basis proportionate to changes in volumes of loans outstanding. As a result, the cost of capital is considered to be a fixed cost for the purpose of providing a break-down of fixed and variable costs as a percentage of total costs in section 4.2.

### 3.1.3 Bad Debt Costs

There is no standard approach to defining “bad debt” in the payday lending sector. Some lenders designate a debt as “bad” at the moment it is in default, e.g., when the borrower’s cheque is returned. Other lenders carry these loans as “NSF loans” or “returned cheques” for up to two years. For the purposes of this study, bad debts are defined as debts that are never recovered, as opposed to simply those loans that are in default. This is a variation from the 2004 Report method which defined bad debts as those not recovered after 90 days. The reason for this is that a number of respondents indicated that they are able to collect a significant portion of default accounts after 90 days.

The cost of the bad debts has to be recovered from the loans that get paid. A bank will typically incorporate the expected risk of bad debts in the interest rate that it charges on its loans. The risk premium is generally in the form of an adjustment to the rate, rather than a fixed dollar amount in addition to the interest charge. Implicit in this adjustment is the assumption that the bigger the loan amount, the larger would be the loss from a given expected risk of bad debts.

Following this practice, bad debt costs are allocated to performing loans as a fixed percentage of the principal amount of the loans. They are not allocated to performing loans as a fixed dollar amount per loan, regardless of its size.

Overall, the bad debt costs per payday loan are calculated as follows:

Total bad debt costs =

1. the principal amount of bad debts
2. the cost of carrying the debt for the period of the loan plus an assumed average of 90 days (after which, the bad debt is treated as being written off)
3. the operating costs allocated to the bad debts
4. the supplementary capital costs allocated to the bad debt

The total of these costs is expressed as a percent of good loans. The bad debt cost for a loan is then calculated as follows:

$$\frac{\text{total bad debt costs in a year}}{\text{total loans granted during the year minus bad debts}} \times \text{value of loan}$$

This calculation distributes the cost of bad debt (i.e., defaulted loans not recovered) across the “good loans” because revenues from good loans (not all loans) must cover off the cost of the bad debt. It should be noted that the operating costs and supplementary capital costs that relate to bad debt are not captured in the operating cost and supplementary cost items in the methodology, i.e., these amounts are not double counted – they are counted only once, under the bad debt item.

#### Adjustments for Payday Loan Brokers

If a payday loan provider operates as a broker, where the financing of the loans comes from a third party financial institution, the operator may not incur any costs related to loan capital or bad debts as the third party financier typically assumes all or a portion of the risk of loan defaults. While a broker’s operating costs are comparable to that of a primary lender, its capital structure is fundamentally different. Since the broker does not have detailed information on the capital structure of the third party financier, any payday loan providers operating as a broker have been excluded from the calculation of average cost of capital, the average cost of supplementary capital, and the average bad debt cost for the purpose of this report.

### **Bad Debt as a Variable Cost**

For the purpose of providing a break-down of fixed and variable costs as a percentage of total costs in section 4.2, the cost of loan capital is categorized as a variable cost. All other things being equal, bad debt costs are expected to increase or decrease in direct proportion with changes in loan volumes, assuming there are no changes to borrowing terms, economic conditions, or other factors that could influence the cost.

### **3.1.4 Costs to Provide Loans to First-Time and Repeat Customers**

The 2004 Report attempted to estimate the costs for originating loans for first-time customers under the assumption that the time and effort required to serve an existing customer with a subsequent loan will not be as time-intensive as for a first-time customer. The information requested from the respondents to support this assumption was highly variable. As such, in the 2004 Report, the ratio of time taken for first-time loans to repeat or rollover loans was standardized across all participating payday loan providers by using the average for all respondents instead of each provider's own ratio.

In the most recent survey, respondents had no formal observations with respect to the costs to issue loans to first time borrowers. Many of the respondents did not answer the survey question on the difference in time between servicing first-time and repeat borrowers because they do not formally track this information. Those that did respond to the question did not provide us with a sufficient sample by which to make a reasonable estimation of the difference in costs to provide loans to first-time borrowers versus repeat borrowers. At least two respondents indicated that there is no material difference in terms of time and effort to provide a loan to a repeat customer versus a first-time customer, particularly when there have been several months or years between borrowing. Some respondents also indicated that they spend more time with repeat customers to better assess the borrower's need for and/or ability to repay subsequent loans. As such, this report excludes any estimation of the difference in costs to originate loans for first time customers.

## 3.2 Data Collection Procedures

The cost analysis is based on a survey of payday loan providers operating in the province of Ontario who were willing to participate in this study. A copy of the survey questionnaire is provided in Appendix B. The questionnaire is materially similar to the questionnaire from the 2004 Report and reflects the data and information requirements necessary to conduct the calculations based on the cost quantification methodology outlined above.

Ernst & Young attempted to contact approximately 100 payday lenders operating in the province of Ontario. 46 lenders agreed to receive a copy of the questionnaire and we received a total of 11 responses. Ernst & Young conducted follow-up calls with the respondents to solicit additional information, and to confirm or clarify responses. Of the 11 received, two responses lacked key information and were therefore excluded from our calculations. One response was deemed usable with the exception of balance sheet and revenue data which the respondent was unwilling to provide. This respondent's results have been excluded from summary calculations which rely on balance sheet and revenue data, but have been included where other data was deemed usable.

The nine respondents represent 67 payday storefronts and almost \$31 million of payday loan transactions in 2007/2008.

Table 1 provides loan statistics for all payday loan providers that participated in the survey.

**Table 1**  
**Survey Loan Statistics - Total and Per Store Average**

	<b>Total (All Respondents)</b>	<b>Per Store (Simple Average)</b>
Number of stores	67	
Dollar volume of loans issued in the most recent fiscal year	\$30,615,745	\$456,951
Number of loans issued in most recent fiscal year	100,667	1,502
Average loan size	\$304.13	\$304.13
Dollar value of loans that went into default	\$2,578,633	\$38,487
Defaulted loans as a percentage of total loans (before recoveries)	8.4%	8.4%
Defaulted loans ultimately collected	\$1,613,610	\$24,084
Collected loans as a percentage of defaulted loans	62.6%	62.6%
Defaulted loans that were never collected	\$965,023	\$14,403
Bad debts as a percentage of total loans issued (after recoveries)	3.2%	3.2%

### 3.3 Key Assumptions

This section identifies additional adjustments that were made to the data to better reflect costs associated with payday lending.

#### 1. Extra Cash

In determining the amount of supplementary capital used by the firm for payday loan purposes, an adjustment was made in order to avoid including cash that may have been held at year-end for other business purposes. Generally, the cash held by the company was allocated between different lines of business according to the revenues from each line. Some businesses, however, were holding large amounts of cash at year-end, perhaps to fund expected expansion, or to meet upcoming liabilities.

To account for this, the amount of cash for payday loan purposes was taken to be the maximum of:

- a) the cash as allocated by revenues, and
- b) 1/26th of the total payday loan volume in the year, reflecting the assumption that cash balances do not exceed the total value of loans granted in a given two-week period.

#### 2. Imputed Cost of Capital (Debt and Equity)

The cost of capital is composed of two parts:

- a) the interest costs of debt, and
- b) the return on equity.

Consistent with other studies on the costs to provide payday loans, this survey did not collect sufficient information to calculate an average interest cost for corporate debt or the opportunity cost of equity. However, as indicated by the sensitivity analysis in section 4.3, these assumptions have a relatively minor impact on the overall costs of providing payday loans. The reason for this is that operating costs are by far the largest costs faced by payday loan providers, while the cost of capital is relatively small.

As agreed with the Ministry, to be consistent with the 2004 Report, the cost of capital has been calculated using a corporate debt interest rate of 7% and a rate of return on equity of 15%. We recognize that borrowing costs and the costs of raising capital have been subject to significant shifts in recent months due to the economic environment. While it is not clear if a payday loan business could obtain new corporate debt at this rate or raise equity offering this rate of return, we have attempted to address this issue through the sensitivity analysis in section 4.3.

#### 3. Other Adjustments

The calculation of the cost of carrying supplementary capital (fixed assets and cash reserves) is complicated by data limitations. The data received reflect year-end balances of these amounts, not average daily or monthly balances. Fixed assets will change for a business over a year as depreciation will reduce the value of fixed assets, and new investment will increase the value of fixed assets, especially where the business is expanding.

On balance, it is likely that the calculation overestimates the cost of carrying supplementary capital. Because this cost is a relatively small part of a payday loan provider's overall costs, the impact is expected to be marginal.

## 4. Key Findings

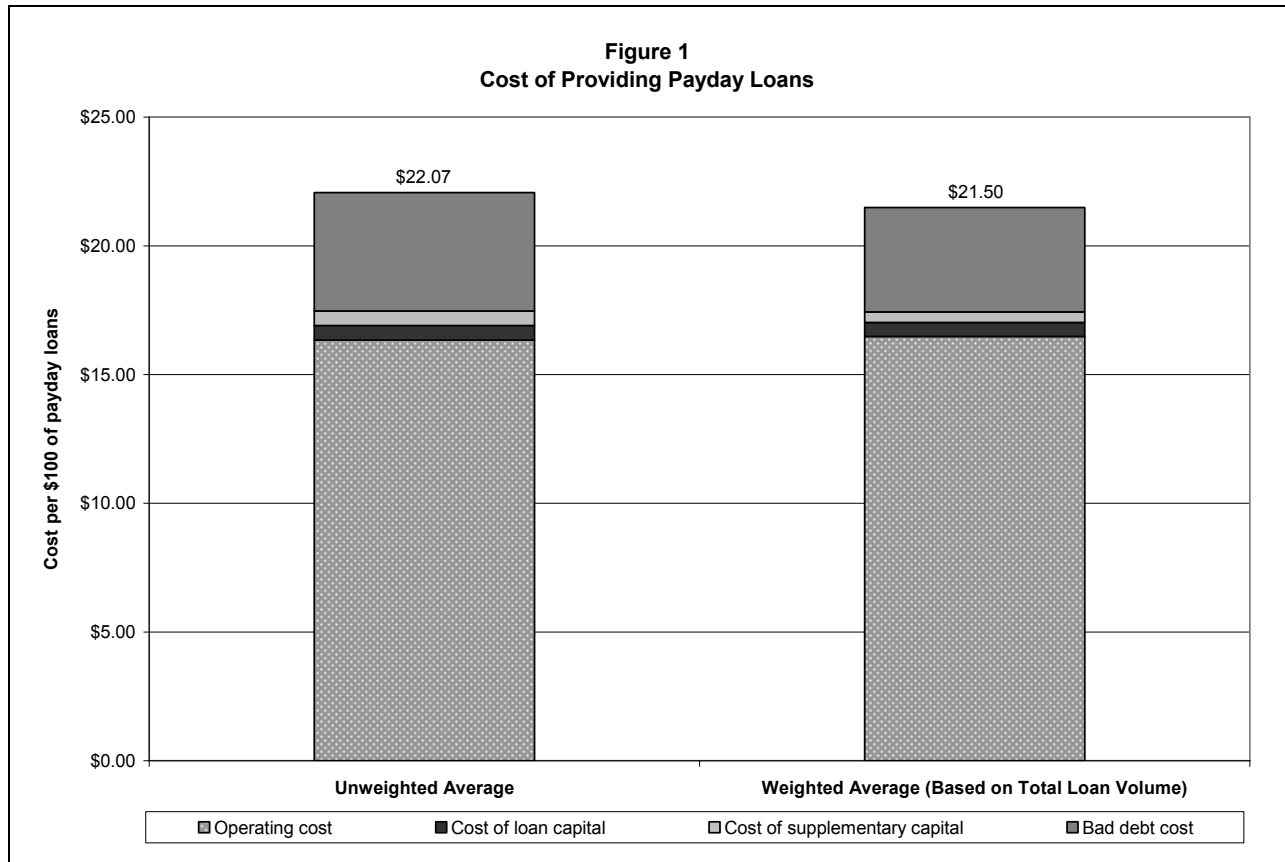
### 4.1 Cost of Providing Payday Loans

Table 2 provides the total cost of providing payday loans, disaggregated by individual cost components stated as a cost per \$100 loaned, as calculated from the usable survey results. To determine the weighted average, weights were assigned on the basis of their relative share in the total volume of payday loans within the sample.

	Cost per \$100 of Payday Loans	
	<u>Unweighted Average</u>	<u>Weighted Average</u>
Operating cost	\$16.35	\$16.48
Cost of loan capital	\$0.56	\$0.55
Cost of supplementary capital	\$0.56	\$0.41
Bad debt cost	<u>\$4.60</u>	<u>\$4.06</u>
<b>Total</b>	<b>\$22.07</b>	<b>\$21.50</b>

The total cost of providing a payday loan for this sample is \$21.50 per \$100 of a payday loan (based on the weighted average). Therefore, for a loan of \$304 with a term of approximately two weeks (the average based on survey results), the total average cost is \$65.36.

As depicted in Figure 1, operating costs are by far the largest cost component, representing approximately three-quarters of total costs. The cost of loan and supplementary capital are the smallest components of the total cost, accounting for between 4 and 5%, while bad debt cost accounts for the remaining 19 to 21%.



Average operating costs have been calculated based on all nine usable survey responses. Values ranged from as low as \$10.87 to as high as \$26.75 per \$100 loaned. Cost of loan capital, cost of supplementary capital, and bad debt costs have been calculated based on seven usable survey responses. Cost of loan capital ranged from \$0.44 to \$0.64 and cost of supplementary capital ranged from \$0.05 to \$0.98 per \$100 loaned. Bad debt costs ranged from as low as \$2.67 to as high as \$10.25 per \$100 loaned.

The total cost per \$100 of payday loans ranged from \$15.57 for the lowest cost provider to \$33.39 for the highest cost provider.

## 4.2 Fixed and Variable Costs

Table 3 provides a break-down of costs to provide payday loans, stated as a percentage of total costs. Costs have been categorized as fixed (those which are not directly tied to loan volumes), variable (those which are directly tied to loan volumes), and “hybrid” (those costs which generally behave like fixed costs but may be tied to loan volumes at certain thresholds) based on the descriptions and assumptions described in Section 3 of this report.

	% of Total Costs	
	<u>Unweighted Average</u>	<u>Weighted Average</u>
Fixed operating cost		
Rent	13.9%	16.8%
Utilities	3.4%	2.4%
Insurance	1.4%	1.5%
Security	0.6%	1.4%
Advertising	3.2%	1.5%
Other <sup>3</sup>	<u>9.8%</u>	<u>9.5%</u>
Total fixed operating cost	32.3%	33.1%
“Hybrid” operating cost		
Salaries and benefits	39.0%	40.8%
Variable operating cost		
Bank charges (including NSF) and credit checks	<u>2.8%</u>	<u>2.8%</u>
Total operating cost	74.1%	76.7%
Cost of loan capital (fixed)	2.5%	2.5%
Cost of supplementary capital (fixed)	2.5%	1.9%
Bad debt cost (variable)	<u>20.8%</u>	<u>18.9%</u>
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>
Total fixed costs	37.4%	37.5%
Total variable costs	23.6%	21.7%
Total “hybrid” costs	<u>39.0%</u>	<u>40.8%</u>
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>

Not all respondents reported operating expenses in the same manner. One respondent included credit checks and collection costs under “other”. While these have been categorized as variable costs for all of

<sup>3</sup> While different for each respondent, generally includes overhead costs such as office expenses, accounting, & legal.

the other respondents, we did not receive sufficient detail to segregate credit checks and collections costs from all other expenses for that respondent. However, the impact is assumed to be immaterial.

Table 4 depicts a pro forma income statement for a composite payday lender. The figures were estimated by applying the cost break-down percentages in Table 3 to the weighted average total for operating and bad debt costs. It is included here for illustrative purposes only.

**Table 4**  
**Pro Forma Income Statement (Based on Weighted Average)**

	<u>Per Store (Weighted Average)</u>
Annual loan volume per store (\$)	\$469,058
Annual loan volume per store (#)	1,467
<b>Pro forma payday loan revenue per store<sup>4</sup></b>	<b>\$119,000</b>
<b>Pro forma expenses per store<sup>5</sup></b>	
Fixed operating cost	
Rent	\$19,500
Utilities	\$3,000
Insurance	\$2,000
Security	\$1,500
Advertising	\$1,500
Other	<u>\$11,000</u>
Total fixed operating cost	\$38,500
"Hybrid" operating cost	
Salaries and benefits	\$47,000
Variable operating cost	
Bank charges (including NSF) and credit checks	<u>\$3,500</u>
Total operating cost	\$89,000
Bad debt cost	<u>\$22,000</u>
<b>Income before cost of capital and income taxes</b>	<b>\$8,000</b>

As depicted in tables 3 and 4, expenses for payday lending are largely fixed or semi-fixed. In general, as the volume of loans increases, the average cost per \$100 loaned decreases. In our sample, the weighted average store issues approximately five loans per day (assuming the store is open 6 days per week). Even if each loan requires a total of 30 minutes to issue, process payments, etc., this means that less than three hours per day are directly attributed to the process of issuing payday loans. However, most payday lenders have operating hours comparable to other retail outlets (some even offering 24 hour service).

<sup>4</sup> Includes loan fees and other revenue related to payday lending (e.g., NSF fees, late charges, etc.)

<sup>5</sup> Portion attributable to payday lending

### 4.3 Sensitivity Analysis on Assumptions About the Cost of Capital

As discussed earlier, the cost of loan capital and supplementary capital is a relatively small component of the total cost to provide payday loans (4 to 5% on average).

In quantifying the cost of loan and supplementary capital, as agreed with the Ministry, a 15% return on equity and a 7% interest rate were applied to the capital structure of each lender. The cost of loan capital and supplementary capital varies directly with the assumed return on equity and interest rate. Many factors impact the return on equity and loan interest and these could vary significantly over time. Therefore, Ernst & Young conducted a sensitivity analysis under different return on equity and interest assumptions to determine what impact these would have on the overall cost of providing payday loans.

Table 5

Sensitivity of Cost of Providing Payday Loans to Variations in the Cost of Capital

Assumed Cost of Capital		Cost per \$100 of Payday Loans	
<u>Equity Capital</u>	<u>Debt Capital (Interest)</u>	<u>Unweighted Average</u>	<u>Weighted Average</u>
15%*	7%*	\$22.07	\$21.50
0%	7%	\$21.01	\$20.44
10%	6%	\$21.68	\$21.13
20%	8%	\$22.45	\$21.85
30%	10%	\$23.21	\$22.56

\* Base case assumptions

Table 5 above illustrates the impact on total cost under different assumptions ranging from 0% to 30% for the opportunity cost of capital and a 6% to 10% interest rate on debt. The difference in total cost between the low cost assumption (0% return on equity and 7% interest) and the high cost assumption (30% return on equity and 10% interest) for this sample is approximately 10% (\$21.01 vs. \$23.21 on an unweighted average basis and \$20.44 vs. \$22.56 on a weighted average basis).

## 4.4 Bad Debts

While bad debt cost is significant for the payday loan industry, bad debt experience varied significantly across this sample. Table 6 illustrates defaults before recoveries and bad debts (write-offs) after recoveries as a percentage of loan volume for all surveyed payday lenders. Bad debts depicted here are only the principal amount of the loan that is non-recoverable.

Table 6

Defaulted Loans Before Recoveries and Bad Debt Principal as a % of Total Volume of Payday Loans

	<u>Unweighted Average</u>	<u>Weighted Average</u>
Defaulted loans as a percentage of total loans (before recoveries)	7.3%	8.4%
Bad debts as a percentage of total loans (after recoveries)	3.7%	3.2%

The principal amount of bad debt ranged from a low of 0.8% of total loan volume to as high as 7.7% after recoveries. As a point of comparison, Table 7 provides the loan loss provisions (an indicator of bad debt) as a percentage of total loans for each of the five largest Canadian banks.

Table 7

Loan Loss Provisions of Canada's Five Largest Banks (2008 Annual Reports)

	<u>Provision for credit losses as a % of net average loans</u>	
	<u>2007</u>	<u>2008</u>
Bank of Montreal	0.17%	0.60%
Bank of Nova Scotia	0.13%	0.24%
Canadian Imperial Bank of Commerce	0.46%	0.45%
Royal Bank of Canada	0.33%	0.53%
Toronto-Dominion Bank	0.37%	0.54%
<b>Average</b>	<b>0.29%</b>	<b>0.47%</b>

## 4.5 Profit Margins

While the focus of this study was not on the profitability of the respondents, the survey results enabled Ernst & Young to summarize profit margins for payday lenders in the sample. To facilitate comparison with industry data from Statistics Canada, we have calculated the operating profit margin as the ratio of operating profit (revenue minus expenses, excluding interest expense, investment income, non-recurring losses from the write-down of assets, gains or losses realized on the disposal of assets, and income tax expense) to total revenue for payday lending. Table 8 includes the calculated averages for this sample.

**Table 8**  
**Operating Profit Margins for Payday Lenders**

	<u>Unweighted Average</u>	<u>Weighted Average</u>
Average operating profit margin for payday lenders	11.3%	6.9%

Based on the survey results, profit margins ranged from -0.9% to 17.6% after accounting for the total costs to provide payday loans. As a point of comparison, Table 9 includes profit margins for major Canadian industries from roughly the same timeframe as the data collected by the survey.

**Table 9**  
**Operating Profit Margins for Canadian Industries**

	Operating Profit Margin (%)				
	<u>Q1 2007</u>	<u>Q2 2007</u>	<u>Q3 2007</u>	<u>Q4 2007</u>	<u>Average</u>
<b>Total, all industries</b>	8.5	8.7	9.0	8.9	8.8
<b>Total, non-financial industries</b>	6.8	6.7	7.0	7.0	6.9
Real estate and rental and leasing	19.1	19.4	19.8	19.9	19.6
Mining (except oil and gas)	18.0	18.7	18.5	18.4	18.4
Oil and gas extraction and support activities	17.4	17.1	17.2	16.7	17.1
Information and cultural industries	15.4	12.8	15.5	14.4	14.5
Educational, healthcare and social assistance services	13.3	13.4	13.8	14.2	13.7
Transportation and warehousing	8.4	8.7	9.5	9.5	9.0
Utilities	6.1	5.3	6.7	7.4	6.4
Agriculture, forestry, fishing and hunting	7.4	7.4	5.4	4.8	6.3
Manufacturing	6.0	6.0	6.4	6.3	6.2
Administrative and support, waste management and remediation services	5.3	5.5	6.0	5.4	5.6
Professional, scientific and technical services	5.2	5.8	5.4	5.0	5.4
Construction	4.8	4.7	4.8	5.1	4.9
Repair, maintenance and personal services	4.5	4.4	4.6	5.0	4.6
Arts, entertainment and recreation	5.3	3.5	3.5	5.8	4.5
Accommodation and food services	4.6	4.1	4.0	4.2	4.2
Wholesale trade	4.0	4.1	4.1	4.3	4.1
Retail trade	3.7	3.7	3.8	4.0	3.8
<b>Total, finance and insurance industries</b>	24.4	27.0	27.3	26.7	26.4
Non-depository credit intermediation	40.8	42.1	44.5	44.6	43.0
Securities, commodity contracts, and other financial investments and related activities	38.1	39.9	39.6	39.1	39.2
Depository credit intermediation	26.2	25.6	28.2	26.4	26.6
Insurance carriers and related activities	12.4	19.4	16.6	17.0	16.4
Activities related to credit intermediation	15.3	14.5	15.1	14.5	14.9

Source: Statistics Canada, *Quarterly Financial Statistics for Enterprises, Fourth Quarter 2007, vol. 18 no. 04*

## 5. Appendices

### 5.1 Appendix A: References

1. *The Cost of Providing Payday Loans in Canada*, Ernst & Young LLP, October 2004
2. Canadian Payday Loans Association web site, <http://www.cpla-acps.ca/english/home.php>
3. *Quarterly Financial Statistics for Enterprises*, Statistics Canada, March 13, 2008, from <http://www.statcan.gc.ca/bsolc/olc-cel/olc-cel?catno=61-008-X&chprog=1&lang=eng>
4. 2008 Annual Reports
  - BMO Financial Group
  - Canadian Imperial Bank of Commerce (CIBC)
  - Royal Bank of Canada
  - Scotiabank
  - TD Bank Financial Group

## 5.2 Appendix B: Survey of Ontario Payday Loan Providers

### **Instructions**

Please answer all of the questions provided on the following worksheet labelled "Response Sheet."

All data should be stated in relation to operations in Canada and financial information should be stated in Canadian dollars.

In addition to completing the questionnaire, please include a copy of the financial statements for your most recent fiscal year-end.

Please e-mail or fax a copy of the completed survey to the contact listed below by end of day Friday, January 9, 2009.

Should you have any questions regarding the survey, please contact:

XXXXXXXX  
Ernst & Young LLP  
222 Bay Street, P.O. Box 251  
Toronto, ON M5K 1J7

Telephone: XXX-XXX-XXXX  
Fax: XXX-XXX-XXXX

E-mail: XXXXXXXX@ca.ey.com

### **Confidentiality**

We would like to thank you for agreeing to participate in the study of payday loan businesses that Ernst & Young LLP (EY) was engaged to perform on behalf of the Ministry of Small Business and Consumer Services. For the purposes of the study, you (the Company), will be providing us with financial and operational information regarding the Company which we understand is to be considered "Confidential Information". Subject to the exceptions described below, EY agrees to take all reasonable measures to hold such Confidential Information in confidence for a period of three years from the date it receives the same, using a degree of care no less than the degree of care that EY would be reasonably expected to employ for its own similar confidential information.

"Confidential Information" shall not include information which: a) is already in EY's possession at the time of receiving the same from the Company; b) may be published or become available within the public domain otherwise than as a consequence of a breach by EY of its obligation not to disclose any of the Confidential Information; c) is lawfully received by EY from any third party without restriction on disclosure or use; d) is independently developed without any breach of these provisions by EY personnel who have not had access to any of the Confidential Information; e) is generally known or easily ascertainable by non-parties of ordinary skill in the areas covered by the engagement; f) is required to be disclosed by EY by law or by any regulatory authority or due to EY's professional obligations or the Rules of Professional Conduct; or g) is approved in writing by the Company for release or other use by EY according to terms stipulated in such approval.

Unless otherwise authorized by the Company, we will not include the name of the Company in our report to the Ministry of Small Business and Consumer Services. However, the Company acknowledges that EY shall be entitled to include all other Confidential Information about the Company in EY's report to the Ministry of Small Business and Consumer Service, and that EY is not responsible for the use or distribution of the report, including the details of any information contained therein, once the report in draft or final form is delivered to the Ontario Government, its Ministries, or Agencies.

**Contact Information**

1. Please provide the name and telephone number of a contact person in case clarification is required on any responses.

Contact name:   
Telephone number:

**Company Structure and Business Mix**

2. In which province(s) does your company provide payday loans? (check only one)

Ontario only  Our company does not provide payday loans in Ontario  
 Ontario and other provinces

3. In addition to payday loans, what other services are provided by your company? (check all that apply)

Cheque cashing  Instalment loans  
 Money transfers  Card services / debit cards  
 Collateral / pawn loans  Tax preparation / discounting  
 Title loans  Money orders  
 Other (please specify below)

4. How many stores did your company operate at the end of your most recent fiscal year (or the year-end for which you have provided financial statements)?

Company-operated stores   
Franchised stores   
Total (calculated)            0

5. Do you act as the principal for payday loans or as a broker for loans provided by a bank or other third party?

As principal  As broker

6. Are your loans insured for default risk? If so, are they insured by an independent insurer or by an affiliated company? (check only one)

Independent insurer  Affiliated company  Not insured

7. What is the legal structure of your business? (check only one)

Unincorporated proprietorship  Incorporated private company  
 Partnership  Public company  
 Other (please specify below)

8. How many employees do you have?

Full-time employees  OR Total full-time equivalents\*   
Part-time employees   
Total (calculated)            0

*\*Full-time equivalent is the % of time a staff member works represented as a decimal. A full-time person = 1.0, a half-time person = 0.5 and a quarter-time person = 0.25.*

9. Are there any other relevant features of your operations that may affect your cost to provide payday loans? Please describe.

**Owner Compensation**

The information in this section is required in order to normalize the profits of the business in the event that the company is using owner's compensation for taxation or other purposes. Please answer questions 10 - 12 with respect to the following:

- a) Proprietors of the business
- b) Partners in the business
- c) Shareholders
- d) Spouses and other family members of the proprietors, partners and significant shareholders

10. What is the total amount of salary paid to the individuals listed above?

11a. What is the total amount of bonuses / benefits / other compensation paid to the individuals listed above?

11b. Do bonuses paid to these individuals represent compensation or a distribution of profits? (check only one)  Compensation  Distribution of profits

12. Please provide an estimate of the total cumulative hours spent on the business in a typical week by the individuals identified above.  hours

**Financial Statement Information**

Please answer questions 13 - 20 on the basis of the financial statements for your most recent fiscal year-end (or the fiscal year for which you have provided financial statements).

13. Please indicate whether your financial statements are:  Audited  Provided to a bank or another lender  Neither (check only one)

14. What is the date of the year-end for the financial statements you provided?

15. Please provide the total revenue for payday lending and all other services. With respect to payday lending, please include revenues related to 3rd party lender interest and NSF fees (if applicable).		Total for Canadian operations Payday lending <input style="width: 100%; height: 15px;" type="text"/> All other services <input style="width: 100%; height: 15px;" type="text"/> Total revenue (calculated) <u><u>\$0.00</u></u>
--	--	--

16a. Please provide a break-down of your company's expenses. (If you do not account for payday lending separately, please provide your best estimate.)

	Total (all services lines)	Payday lending only
Salaries and benefits	<input type="text"/>	<input type="text"/>
Incentive plan expense	<input type="text"/>	<input type="text"/>
Security (armoured car service, alarm systems, etc.)	<input type="text"/>	<input type="text"/>
Rent	<input type="text"/>	<input type="text"/>
Utilities	<input type="text"/>	<input type="text"/>
Insurance	<input type="text"/>	<input type="text"/>
Credit checks	<input type="text"/>	<input type="text"/>
NSF fees and other bank service charges	<input type="text"/>	<input type="text"/>
Advertising	<input type="text"/>	<input type="text"/>
Depreciation and amortization	<input type="text"/>	<input type="text"/>
Goodwill amortization expense (if any)	<input type="text"/>	<input type="text"/>
Provision for loan losses and doubtful accounts	<input type="text"/>	<input type="text"/>
Interest	<input type="text"/>	<input type="text"/>
Taxes	<input type="text"/>	<input type="text"/>
Franchise expenses (i.e., services to franchisees)	<input type="text"/>	<input type="text"/>
Payments to affiliated companies (e.g., management fees, royalties, etc.) (please specify below)	<input type="text"/>	<input type="text"/>
Other (please specify below)	<input type="text"/>	<input type="text"/>
	<input type="text"/>	<input type="text"/>
	<input type="text"/>	<input type="text"/>
Total expenses (calculated)	<u>\$0.00</u>	<u>\$0.00</u>

16b. Are the expenses listed above for payday lending operations based on actual financial results or estimates? If estimated, please describe the method of estimation.

Actual

Estimated (please describe estimation method below)

17. Please provide a break-down of your company's assets.

Cash	
Accounts receivable - payday loans	
Accounts receivable - other	
Pre-paids	
Inventory	
Net fixed assets	
Other (please specify below)	
Total assets (calculated)	<i>\$0.00</i>

18. Please provide a break-down of your company's liabilities.

Accounts payable	
Salaries payable	
Other payables	
Inter-company liabilities	
Long-term debt	
Shareholder loans	
Other (please specify below)	
Total liabilities (calculated)	<i>\$0.00</i>

19. Please provide a break-down of your company's equity.

Capital stock / paid-in capital	
Retained earnings	
Net income for the year	
Other (please specify below)	
Total equity (calculated)	<i>\$0.00</i>

20. Based on your financial statements for the most recent fiscal year, please describe and list the amounts of any unusual or non-recurring / one-time revenue or expenses incurred.

Description	Amount



**Fee Structure**

30. Please describe the fee structure (per \$100 in payday loans) for each of the following (as applicable):

Payday loans

Rollovers / extensions or re-writes

Default charges including NSF cheques

Interest and other charges on defaulted loans

Optional insurance charges

Fees for cashing cheques to redeem a payday loan

**Additional Space**

Use the space below if you require additional space to provide answers to any of the questions listed above. Please indicate the number of the question to which you are responding.