A Behavioral Economic Analysis of Payday Lending Regulation in Canada

by

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Abstract
Payday lending regulation in Canada assumes that if borrowers are provided the statistical determinants of a prospective loan, they will make efficient borrowing decisions. This paper argues this disclosure framework is misguided. Specifically, it rests on the notion that consumer-decision makers are inherently rational actors. However, behavioral economics helps demonstrate that most borrowing decisions are guided by cognitive biases that cloud people’s ability to make informed decisions. In turn, payday borrowers routinely incur unexpected additional costs, often resulting in financial paralysis. Moreover, payday lenders, keenly aware of consumer psychology, design and package their loan products to exploit these biases. Accordingly, this paper suggests that Canadian policymakers adopt a correlative strategy, namely, applying mandated disclosure regimes that employ cognitive biases to counteract others. These measures would make the potential consequences of payday loan related overindebtedness more apparent to borrowers, improving the accuracy of their evaluation of the likelihood of the occurrence.
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Chapter 1
Introduction

Carla, a twenty-something single mother of two, depends heavily on her car. She purchased it used after having saved up for the better part of a year. The car has substantially improved her family's mobility and, by extension, the quality of their lives. For instance, it made it possible for Carla to transfer her children, both of whom suffer from learning disabilities, to an alternative program at a school outside their neighborhood's yellow bus network. It also allowed her to secure a job as a delivery woman for a local courier company, which provides considerably better working hours than her previous job working the graveyard shift as a cashier at a 24-hour convenience store.

On a Friday, while driving home, following Carla's last shift of the workweek, the car began to rattle and make uncharacteristic noises. Carla pulled into a nearby garage to have the car inspected. The mechanic informed her that the car's fan belt was broken. He could replace it over the weekend, at a cost of $250, thereby ensuring that Carla would not miss her next shift and could also drive her children to school by the start of the next school week.

Carla has approximately 48 hours to determine how she will cover the cost of the repair. She currently has enough money jointly in her checking and savings account to cover the balance. Covering the cost of the repair with her savings, however, will leave her with very little money, between now and her next paycheck, to cover day-to-day expenses, such as groceries, let alone less foreseeable expenses, such as additional car repairs. In
addition, Carla does not have access to immediate sources of low-cost consumer credit, such as a credit card or line of credit, largely the consequence of an impaired credit history. Walking home from the garage, Carla's attention is caught by the banners plastering the windows of a Money Mart location on Bloor Street in Toronto's west end, advertising low-cost, hassle-free cash advances 'as easy as 1-2-3.' She decides to solicit further information inside the store from a company representative. The representative explains that Money Mart will advance her $300 for 14 days in exchange for a one-time fee of $63, in cash, in as little as an hour. Carla opts to take the loan on the simple assumption that deferring the cost of the car repairs is worth the one-time fee.

The credit transaction Carla has entered into is commonly referred to as a payday loan. Payday loans are small, short-term cash advances offered at very high effective interest rates to borrowers with impaired credit histories, that is borrowers who mainstream financial institutions typically view as a high credit risk.1 Borrowers can generally apply for these loans either in person, at a payday lender's retail location, or over the Internet, on a lender's website.2 To qualify for a typical payday loan, a borrower need only hold an active bank account and demonstrate proof of employment income; an up-to-date bank statement and recent pay stub usually suffice.3 If a prospective borrower satisfies these criteria, lenders will cement the contractual deal by extending a loan on one date in

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2 This latter option is only available in certain Canadian provinces, namely, Alberta, British Columbia, Nova Scotia, Ontario and Saskatchewan.

consideration for a promise – usually collateralized by a postdated check – to repay the loan amount as well as a standard fee – typically in the range of $20 to $25 per $100 borrowed – by the maturity date on the loan, generally two weeks from the date on which the loan was first issued. 4

Payday loans have become something of a lightning rod for criticism. Opponents of payday lending argue that "the terms of a typical payday loan combine to trap cash-strapped consumers in a cycle of debt." 5 More specifically, critics argue that the finance charges levied against borrowers are so excessive that they "immediately [put] an obstacle in the way of the borrower's ability to repay the loan." 6 In turn, a cycle of financial distress is virtually assured, because the core characteristics of the payday loan product – an exorbitant effective interest rate coupled with a limited window for repayment – requires borrowers to allocate a substantial share of their next paycheck to repaying the loan, which "leaves most borrowers inadequate funds for their other obligations, compelling them to take a new payday loan almost immediately." 7 Parrish and King estimate that repeat borrowing accounts for nearly three quarters of the entire volume of payday loans. 8 The authors' tabulation of loan-level data also demonstrates that more than half of these “new loans are taken out at the borrower's first opportunity upon paying a previous loan back," that is within less than one day of repayment. 9

4 Mann and Hawkins, supra note 1 at 863.
6 Ibid.
8 Ibid at 2-3.
9 Ibid at 2.
Another oft-criticized feature of payday loans is the conditions imposed on borrowers who wish to refinance an existing payday loan. In particular, opponents argue that the cost of refinancing drastically exacerbates the extent to which "borrowers get into cycles of chronic borrowing at high interest rates."¹⁰ Unlike conventional consumer credit, borrowers are typically required to repay their payday loans in a single payment, rather than through payments over time.¹¹ Lenders sometimes insert contractual clauses that either expressly disallow installment payments or render them prohibitively expensive by assessing borrowers additional finance charges to process them.¹² Accordingly, when a payday loan reaches maturity, a borrower must either pay the entire balance owing, namely, the principal and related interest, or extend the loan for another term and pay an additional interest charge. These loan renewals, commonly referred to as a "rollovers," impose substantial costs on borrowers, because "the penalty fees and/or the charges associated with [the] new loan increase the borrower's short-term debt load and make the loan increasingly difficult to repay."¹³ For instance, if a borrower rolls over a $300 loan with a $45 fee three times before fully repaying the loan, he or she will pay four $45 fees, or $180, and still owe the $300 principal, thereby ballooning that borrower's debt obligation to $480 within two months of taking out the initial loan (assuming the standard two-week maturity rate applies). Even where rollovers are statutorily prohibited, as is the case in the Province of Ontario, legislation rarely prevents borrowers from carrying loans

¹¹ Etherton supra note 5 at 9.
¹² Ibid at 10.
¹³ Andrew Kitching and Sheena Starky, "Legislative Summary (PRB 05-81E0 Payday Loan Companies in Canada: Determining the Public Interest" Parliamentary Information and Research Service (26 January 2006), online: Parliament of Canada <http://www.publications.gc.ca>. 


from other lenders or from restarting the debt cycle immediately after the existing loan has been paid. In these cases, the borrower will either default on the loan, thereby allowing the lender to exercise its interest in the post-dated check collateralizing the loan, or secure repayment by taking out a loan from a third-party payday lender. All told, opponents of payday lending contend that heavy short-term debt loads often prompt borrowers to rely on extensions of existing or additional payday loans to compensate for their ballooning debt obligations. In turn, payday borrowers habitually find themselves re-borrowing and are thereby ultimately mired in a cycle of debt, "continually paying interest and other charges that quickly exceed the initial value of the loan in order to avoid defaulting." 

In this sense, consumer advocates suggest that payday lending is predatory by design. Not only do high fees, short-term due dates, and single balloon payments work to ensure repeated borrowing and a long-term cycle of debt, but also loans are often packaged in ways that obscure their true costs. Loan terms often include complex interest-rate structures, transaction fees, late penalties and other factors that can make the real cost of an underlying loan difficult for borrowers to readily decipher. Moreover, without an accurate measure of cost it can become difficult for consumers to reliably compare various credit options. Accordingly, most consumer protection laws require lenders to disclose the Annual Percentage Rate of Interest ("APR") for all types of loans. APR

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15 Ibid.
17 Stephanie Ben-Ishai, "Regulating Payday Lenders in Canada: Drawing on American Lessons" (2008) 4 CLPE 3 at 28.
provides a standardized computation of cost that calculates the simple interest rate on an annual basis, taking into account most fees, in addition to the amount of time a borrower has to repay a given loan, while also factoring in the reduction in principal as payments are made over time. In other words, APR provides borrowers with a bottom-line figure that allows for easy comparison-shopping across potential lenders.

Payday lenders are legally obligated to disclose the relevant APR to their borrowers. The extent of this disclosure, however, is often limited. Payday lenders frequently obfuscate their disclosure obligations by discreetly embedding the APR within the fine print of loan documents, their Internet websites or storefront signage, for instance. Rather than clearly state the APR to customers, payday lenders typically advertise the cost of loan products as reflecting a certain amount per $100 borrowed. For instance, lenders might quote a rate of $21 per $100. However, consumer advocates argue that this often gives an undiscerning consumer the impression that a simple interest rate of 21 percent applies to their loan, and thereby reflects his or her true cost of borrowing. In turn, a consumer might view that option as less expensive than a Credit Card Cash Advance advertising an interest rate of 22%. If both rates are clearly expressed in terms of APR, which reflects the simple interest multiplied by the number of times the term goes into one year, then the real cost is much easier to understand. In particular, the terms would starkly favor the option of a cash advance at an APR of 22% as compared to the payday loan, which would carry an APR of 546% (21% times 26 two-week terms). To put the difference in perspective, consider Carla's experience and assume that she not only takes an initial two-week payday loan, but also re-opens that payday loan for an additional two weeks. In terms of dollars, in opting to take out a $300 payday loan to pay for her emergency car
repair at a rate of $21 per $100 borrowed, the real cost borne is $126, which equals 23
*times* more than the cash advance carried for one month, the total cost of which is $5.50.
In this sense, if payday lenders obscure the APR on their loans, borrowers lack "the
necessary information to make an informed judgment regarding whether he or she can
repay the loan or whether there is a more affordable option."\(^\text{19}\)

All told, consumer advocates complain that payday lending "*is per se* a predatory lending
practice."\(^\text{20}\) Predatory lending generally refers to lending practices "that are considered to
be so detrimental to borrowers as to be considered abusive."\(^\text{21}\) Put in terms of economics,
predatory lending constitutes a "welfare reducing provision of credit."\(^\text{22}\) Payday lenders
make households worse off by deceiving them into borrowing more than is optimal,
which, in turn, "reduces household welfare, and may increase default risk."\(^\text{23}\) In
particular, payday lenders "exclusively target vulnerable consumers with low incomes
and insufficient collateral to borrow from a bank."\(^\text{24}\) These low-income, cash-strapped
consumers have few mainstream alternatives, such as savings or credit cards, and
consequently "feel that they have nowhere else to go."\(^\text{25}\) For instance, a survey recently
conducted in the state of Wisconsin reports that the average annual income of payday
borrowers is roughly $19,000 and that upwards of 80 percent of borrowers do not own a


\(^{21}\) Ibid.


\(^{23}\) Ibid at 6.

\(^{24}\) Bellam and Talai *supra* note 1 at 9.

\(^{25}\) Ben-Ishai *supra* note 17 at 5-6.
home. Moreover, the typical borrower is often worried about how they will "get enough cash to pay overdue telephone and electric bills" or in Carla's case, an urgent car repair. Critics charge that payday lenders exploit this vulnerability, which is made easier by the fact that "fringe" borrowers overwhelmingly tend to be less educated than mainstream borrowers and in many cases are also "first-time borrowers (or are rebounding from a failed first foray into credit)." In fact, recently uncovered internal memoranda from a large American payday lender described "minority [groups] with a household income of less than $25,000, a high school or GED education or less, ages ranging from 18-59 years and female heads of household with dependents [...] and welfare recipients" as "fertile markets" for payday lenders.

Policymakers have therefore been deluged, in recent years, by “a flurry of critical proposals” to remedy the alleged problems of the high-cost, short-term credit market. At one end of the spectrum are calls for the outright ban of payday lending practices. The prohibitory model is anchored in the view that payday-lending services are "predatory, usurious, and unconscionable" and, on that basis, justifies denying the flow of sub-prime credit as "in the individual's best interest." However, few jurisdictions have endorsed this regulatory schema. In Canada, for instance, only the provinces of Quebec and Newfoundland and Labrador have effectively barred the practice of payday lending. This

28 Morgan supra note 20 at 2.
30 Francis supra note 1 at 613.
seems to reflect the view that an unqualified prohibition of payday lending transactions is an overly blunt regulatory instrument. Notwithstanding a broadly based moral disapproval of payday lending practices, sub-prime lenders nevertheless provide low-income consumers, many of whom have limited access to traditional banks, with alternative means of credit. Accordingly, Bellam and Talai note, that "shuttering the industry without first providing a feasible alternative to payday loans is a problematic solution, as it is likely to leave an entire class of consumers without access to credit."\(^{32}\) Furthermore, commentators also caution that the wholesale prohibition of the market for subprime consumer credit may unintentionally push an already "vulnerable group [of borrowers] to turn to loan sharks and more criminal lenders."\(^{33}\) According to this view, therefore, any public policy effort to overcome the market failures borne out of payday lending must nonetheless ensure that low-income and, in many instances, high-risk borrowers have sufficient access to credit.

Along these lines, some commentators have proposed ostensibly simpler fixes to "slow the treadmill [of debt]," including, "placing modest caps on the interest rates that payday lenders can charge."\(^{34}\) The push for interest rate regulation of payday lending products is typically grounded in the view that "the payday lending and other short-term lending industries are classic failed markets."\(^{35}\) In a perfect market, "competitive forces will

\(^{32}\) Bellam and Talai supra note 1 at 1.

\(^{33}\) Ben-Ishai supra note 17 at 6.


\(^{35}\) Nathalie Martin, "1,000% Interest - Good While Supplies Last: A Study of Payday Loan Practices and Solutions" (2010) 52 *Arizona Law Review* 3 at 607.
eliminate excessive profits." Consider two banks located at the same busy intersection. In an effort to attract consumers, these banks both advertise their respective mortgage rates in their storefront windows for the public to see. This ensures that neither bank "can obtain excessive profits, since the consumers are fully informed" of the banks' prices. Moreover, competition (or antitrust) law prohibits the banks from colluding with one another to set high mortgage prices. Under these circumstances, to remain competitive, the banks "must set prices as low as possible so that they do not lose business to the neighboring [bank], but high enough so that they earn a fair profit" for providing mortgages. As a result, consumers who borrow from either bank obtain their mortgage at an equilibrium rate, namely, the price where supply intersects with demand, "and where neither [bank] is reaping an excessive profit."

In an imperfect market, however, prices do not adjust in lockstep with competition. In the payday lending market, for instance, reformers contend that competitive market forces have not succeeded in bringing the cost of payday loans down to equilibrium prices. Rather, lenders tend to levy "the exact same thing for a loan, typically the largest amount allowed by law." This is made easier by the fact that payday customers tend not to be financially savvy, such that they typically do not understand the cost of their loans and, as a result, are unlikely to comparison shop. Moreover, recent studies suggest that payday borrowers are driven primarily by convenience when choosing a lender. Because competitive market pressures do not condition lending behaviour, payday

37 Ibid.
38 Ibid.
39 Ibid.
40 Martin supra note 35 at 607.
41 Ibid.
lenders are able to charge more than they otherwise could in a perfectly competitive market and, by extension, are able to earn allegedly excessive profits. In charging interest above the market rate, "large numbers of people, usually those who can least afford it, are getting trapped in the humiliating and costly cycle of recurrent debt associated with payday loans." Proponents of reform contend that an absolute interest rate cap can offset this problem. While regulatory intervention may be inappropriate when market forces are working properly, "failed markets create a need for regulation." According to this view, the current payday lending market warrants stricter interest rate regulation, because it appears as though market forces have not driven down prices. Moreover, the only factor seemingly limiting existing rates is the maximum amount allowable under the law. Accordingly, proponents of payday lending reform argue that policymakers should respond to this market failure by lowering existing usury rates in an effort to drive prices down closer to equilibrium, albeit artificially.

It is important to note, however, that enacting new rate ceilings will not necessarily achieve a better result. Market forces do not automatically condition the price levels that regulators deem appropriate. Because legislators rarely make economic decisions with complete information, statutory price caps can in some ways be quite arbitrary. More importantly, in some cases, imperfect knowledge may result in a legislated rate ceiling considerably below that which would operate in an unregulated market. In turn, Cayne and Trebilcock note that "ceilings set below the levels necessary to sustain the efficient

42 Martin supra note 35 at 607.
43 Ibid.
lender will eliminate lender credit from the market place.\textsuperscript{45} For instance, Bertrand and Morse note that the \textit{Military Lending Act} that recently took effect in the United States and imposes a federal usury cap of 36\% APR for payday loans issued to military personnel and their family, as well as a law enacted in the state of Ohio that limits APRs on payday lending to 28\%, do not provide sufficient margins for payday lenders to cover the cost of borrower default.\textsuperscript{46} As a result, the authors suggest that effectively "these legislations eliminate payday lending" for certain demographics.\textsuperscript{47} These drastic legislative measures, however, appear to disregard conditions that are central to the relationship between demand and supply for consumer credit. In particular, demand for subprime credit appears significantly less elastic than its supply, "that is, the imperatives inducing a person to borrow at high rates are more powerful than the forces which impel a person to lend at these rates."\textsuperscript{48} Accordingly Cayne and Trebilcock note "that very serious exclusionary consequences for borrowers would result from the collective withdrawal of lenders from a regulated market place in which they find it uneconomic to operate."\textsuperscript{49} Given the inelasticity that typifies low-income consumers’ demand for credit, loan sharks and other criminal lenders are likely to take advantage of "rate ceilings which eliminate the efficient lender."\textsuperscript{50} By way of example, the authors cite the passage of the \textit{Russell Sage Foundation's Uniform Small Loans Law} in the United States, first enacted in 1907, which responded to concerns that existing usury rates, statutorily enforced throughout the country, had "prevented legitimate lenders from transacting business with high-risk

\textsuperscript{45} Cayne and Trebilcock \textit{supra} note 44 at 414.
\textsuperscript{46} Marianne Bertrand and Adair Morse, "Information Disclosure, Cognitive Biases and Payday Borrowing" (2011) 66 \textit{Journal of Finance} 6 at 1865.
\textsuperscript{47} \textit{Ibid}.
\textsuperscript{48} Cayne and Trebilcock \textit{supra}.
\textsuperscript{49} \textit{Ibid}.
\textsuperscript{50} \textit{Ibid} at 415.
borrowers, with the result that these borrowers began to rely upon illegal lenders to service their needs."\textsuperscript{51}

Moreover, a robust enforcement regime is required for stricter usury limits to have their intended effect. However, efforts to actively enforce statutory interest rate restrictions are not always successful. The Canadian experience, for instance, serves as a cautionary tale. I will address the nuances of the regulatory schema governing the provision of consumer credit throughout Canada, in greater detail, later in this paper. For the present purposes, however, it is worthwhile noting that while s 347 of the \textit{Criminal Code} prohibits lending agreements that set the payment of interest at a criminal rate, defined as anything higher than a 60 percent APR, the provision has never been used to prosecute payday lenders who levy interest charges in excess of the prescribed rate.\textsuperscript{52} Not surprisingly therefore, payday lenders throughout Canada levy interest rate charges in excess of the federal usury limit.\textsuperscript{53} For instance, payday lending rates in Nova Scotia routinely exceed 900\% APR, while interest charges running 700\% APR are equally common in British Columbia.\textsuperscript{54} This is particularly problematic because it leaves borrowers with "the dangerous illusion that there is in fact a federal ceiling on interest rates" when, in fact, "the reality is that the federal usury cap in s 347 of the \textit{Criminal Code} provides little in the way of consumer protection."\textsuperscript{55}

\textsuperscript{51} Cayne and Trebilcock \textit{supra} note 44 at 415; see also Bruce G. Carruthers et al., "Bringing Honest Capital to Poor Borrowers: The Passage of the Uniform Small Loan law, 1907-1930" (2009) \textit{Yale University Economic Growth Center Discussion Paper No. 971}, online: Yale University <http://www.econ.yale.edu>.
\textsuperscript{52} \textit{Criminal Code} R.S.C. 1985, c C-46 s. 347(1) [\textit{Criminal Code}].
\textsuperscript{53} Bellam and Talai \textit{supra} note 1 at 1.
\textsuperscript{54} \textit{Ibid} at 6-7.
\textsuperscript{55} \textit{Ibid} at 14.
Another commonly advocated approach to regulation of the payday lending industry involves improving existing mandated disclosure regimes. Disclosure is the linchpin of consumer protection regulation. Accordingly, most consumer protection regimes impose a "uniform interest-rate disclosure obligation on payday lenders."56 As noted above, however, payday lenders frequently obscure the full extent of a borrower's interest rate obligation by directing their attention towards the cost per $100 borrowed, rather than more instructive characteristics, such as the annual percentage rate. Moreover, Mann and Hawkins note that current disclosure schemes are "also problematic because consumers often get the information too late in the process for it to be useful."57 Most disclosure regimes are limited to requiring the lender to provide the borrower with mandated information, such as the APR, at some point before the contract is signed. As a result, lenders often only disclose this information just before the parties culminate the lending agreement, thereby leaving the borrower with no practical opportunity to comparison-shop.58 Furthermore, Mann and Hawkins also note that there exists a "substantial problem of noncompliance." 59 Recent studies suggest that payday lenders overwhelmingly neglect to comply with mandated interest rate disclosure requirements or routinely disclose them inaccurately.60

Until relatively recently, payday lending was a distinctly American phenomenon. The payday loan industry, at least in its current "storefront" incarnation, began operating in the United States in the early 1980s. The industry has since then experienced meteoric

57 Mann and Hawkins supra at 904.
58 Ibid at 904.
59 Ibid.
60 Ibid at 904-905; Ben-Ishai supra note 17.
growth ballooning from virtually no payday lending stores to more than 25,000 establishments, that is more locations than McDonalds, Wal-Mart, Starbucks and Home Depot combined.61 But payday lending is a relatively new phenomenon in Canada. It emerged in much the same way as it did in the United States, namely, as a fast-growing offshoot of the check-cashing industry that developed "on a large scale when checking accounts had proliferated into the bottom half of the income scale."62 However, the industry only claimed its foothold in Canada's fringe lending market during the past decade. As of 2009, various payday-lending firms now comprise approximately 1,500 storefronts, spread across the country, that collectively generate estimated annual profits in excess of $1 billion.63

As a result, Canada’s regulatory experience with payday lending is a relatively fledgling enterprise. Moreover, in recent years, it has also undergone a number of dramatic reforms. This shift was essentially a response to popular conceptions of payday lending practices as predatory. In other words, existing regulations did not sufficiently curtail the market failures of payday lending and, in turn, vulnerable consumers were regularly co-opted into improvident borrowing arrangements. The country’s new regulatory approach, perhaps somewhat predictably, endorses many of the reforms commonly advocated by proponents of payday lending reform. In turn, the regulatory landscape is made up of a patchwork of outright bans and interest rate caps as well as mandated disclosure obligations. Earlier in this introduction, I outlined some of the pitfalls various

63 Olena Kobzar, “Perils of Governance through Networks: The Case of Regulating Payday Lending in Canada” (2012) 34 Law & Policy 1 at 37; Bellam and Talai supra note 1 at 5; Kitching an Starky supra note 13; Ben-Ishai supra note 17 at 1.
commentators have associated with typical regulatory efforts to correct the market failures of the payday-loan industry. The common theme underlying these criticisms seems to be a sense that, on the one hand, these regulatory interventions are too intrusive; outright bans and interest rate caps, for instance, impede the flow of institutional credit to low-income consumers, thereby pushing them to criminal lenders. On the other hand, disclosure regimes do too little, that is, they are a weak proxy for consumer protection; they tend not only to be easy to avoid, but borrowers also often do not have the requisite financial savvy to comprehend them.

The following discussion suggests that Canada’s regulatory project, much like similar efforts elsewhere in the world, may not achieve its desired results, less as a consequence of regulatory over or under reach and more as a result of the economic narrative that informs it. Neoclassical economics has been the dominant policy paradigm for developments in regulated industries for more than four decades. It is built on a strong assumption that all economic agents are fully rational and thereby make consumer decisions accordingly. This conceptual framework and analytical tool has, therefore, figured prominently in the design of consumer protection regulation. However, this approach to economic policymaking has increasingly been called into doubt by an emerging trend in legal academia, namely, the intersection between law and behavioral economics. Behavioral economics is rooted in the view that “real people exhibit cognitive biases that create systematic departures from the assumption of unbounded rationality.” Proponents of this new analytical approach argue that policy grounded in this worldview is “based on a richer model of individual behavior than the rational actor

64 Francis *supra* note 1 at 614.
model underlying mainstream economic analysis.”\textsuperscript{65} Law and behavioral economic scholars consequently argue that this insight “must be incorporated to generate sound predictions and legal policy.”\textsuperscript{66} Behavioral economics “has attracted widespread attention for its possible relevance particularly to consumer protection regulation.”\textsuperscript{67} As Francis notes, however, very little academic attention has been paid to the “possibility of using behavioral law and economics in analyzing the payday-loan industry.”\textsuperscript{68} Even less thought appears to have been given to the application of this new analytical paradigm to payday lending reform in Canada. Accordingly, the following discussion evaluates existing and proposed regulatory frameworks for Canada’s payday lending industry through the lens of behavioral law and economics.

The balance of this paper is divided into five parts. Part two provides an overview of the history of payday lending regulation across Canada. Part three provides a basic primer on behavioral economic analysis of the law and juxtaposes this framework against the neo-classical economic model. Part four sets out the pitfalls of Canada’s current regulatory model. In particular, this section highlights its inability to sufficiently account for the cognitive biases that condition borrowing behavior, both among low-income demographic segments as well as across the broader population of consumers. Part five draws on the application of behavioral law and economics to other policy domains in an effort to present some potential solutions for improving the effectiveness of Canada’s regulation of payday lending practices. Part six is the conclusion.

\textsuperscript{66} Francis \textit{supra} note 1 at 614.
\textsuperscript{67} Salinger \textit{supra}.
\textsuperscript{68} Francis \textit{supra}.
Chapter 2
The History of Payday Lending Regulation in Canada

The regulation of payday lending practices in Canada constitutes a decidedly confused experiment in consumer protection. From a historical standpoint, payday lenders are "an industry relatively insulated from regulation either at the federal or provincial level."69 The payday lending industry stormed Canada's financial services market in the early 1990s. Between then and 2007, the chief federal legislation governing their lending practices was s 347 of the Criminal Code. The provision treats receiving a payment of interest in excess of 60 percent per annum as an indictable criminal offence subject to a term of incarceration of not more than five years.70 Payday loans are "almost always in violation of the Criminal Code interest limits."71 However, while a limited few lower court decisions have struck down payday loans for contravening s 347, "rarely (if ever) have such 'respectable' usurers been prosecuted."72 In large part, this reflects the original purpose of the provision, which in adding s. 347 to the Criminal Code in 1980, the federal government declared was "to give police forces across Canada a prosecutorial handle with which to fight loan sharking," rather than buttress consumer protection policy.73

69 Kobzar supra note 63 at 127.
70 Criminal Code, supra note 50.
71 Mary Anne Waldron, "What is to be done with Section 347?" (2003) 38 Can. Bus. L.J. 367 at 368.
Payday lenders are known to charge rates that often exceed the interest reportedly collected by illegal loan sharks.\textsuperscript{74} It appears, however, that charging exorbitant interest rates is not sufficient to trigger scrutiny under s 347. Rather, Parliamentary hearings on Bill C-44, which culminated in the adoption of the criminal rate of interest, seem to imply that the prosecutorial ambit underlying s 347 is limited to lenders that not only charge excessive interest rates, but also "operate surreptitiously [...] and use or threaten to use violent collection methods if the borrower default[s]."\textsuperscript{75} That being said, the anti-usury law contained in s. 347 does not expressly encompass this qualification. For this reason, in \textit{Garland v. Consumers' Gas Co.}, the Supreme Court of Canada opined "that s. 347 is a deeply problematic law" insofar as "some of its terms are most comfortably understood in the narrow context of street-level sharking, while others compel a much broader application," such as to consumer and commercial transactions.\textsuperscript{76} Accordingly, in its holding, the Court effectively urged Parliament to take the required remedial action to clarify the underlying premise for the provision.\textsuperscript{77}

The Supreme Court decision in \textit{Garland} added to mounting public pressure to improve the regulatory scheme governing the rapidly growing payday lending industry. In turn, Parliament addressed the question of how to effectively regulate payday-lending practices by passing Bill C-26, which came into force after receiving Royal Assent in the spring 2007. Rather than reframe the language of s 347 in such a way that it could readily invite prosecutorial scrutiny of payday lenders charging in excess of the proscribed interest rate ceiling, "Bill C-26 contemplated a quite different solution to the problem of their reputed

\begin{footnotes}
\item[74] Chin \textit{supra} note 26 at 729; Bellam and Talai \textit{supra} note 1 at 8.
\item[75] Ziegel \textit{supra} note 72 at 395.
\item[76] [1998] 3 SCR 112 at 52.
\item[77] \textit{Ibid.}
\end{footnotes}
excessive charges.”⁷⁸ Under the new regulatory framework, the federal government retained a 60 percent interest rate cap as the country’s designated usury limit. The new scheme did, however, change the regulatory landscape in a number of important respects. Firstly, the Bill statutorily defined payday loans as "an advancement of money in exchange for a post-dated cheque, a preauthorized debit or a future payment of a similar nature but not for any guarantee, suretyship, overdraft protection or security and not through a margin loan, pawnbroking, a line of credit of a credit card."⁷⁹ Secondly, the new legislative framework allowed "for provincial regulation of the area, if the province exercises its option to regulate under the new s. 347.1(3)."⁸⁰ More specifically, under s. 347.1(3), provinces can opt into a federally-defined regulatory scheme, which gives consenting provinces the authority to act as industry regulators provided they implement "a licensing or other type of authorization system for lenders, the establishment of limits on the total cost of borrowing, and a framework of protections for consumers."⁸¹ The basic components generally include: (a) interest rate caps; (b) cancellation protection; (c) mandated disclosure; (d) rollover prohibitions; (e) licensing; and, (f) consumer remedies.⁸² Where provinces are designated as having satisfactorily assumed this regulatory burden, Bill C-46 specifically exempts payday loans under $1500 and for less than 62 days from scrutiny under the Criminal Code, provided the issuing lender is licensed under the applicable statutory regime of their host province. Since the Criminal Code was amended to allow Provinces to regulate the payday loan industry, every

⁷⁸ Kobzar supra note 63 at 34.
⁷⁹ Criminal Code supra note 50 at s 347.1(2) and (3).
⁸⁰ Ben-Ishai supra note 17 at 11.
⁸¹ Ibid at 12.
⁸² Ibid at 12-13.
province and territory, other than Quebec and Newfoundland\textsuperscript{83}, have opted in to the new regulatory scheme and adopted the requisite enabling legislation to set up their own regulatory regimes.\textsuperscript{84}

As mentioned, Bill C-26 effectively delegates jurisdictional responsibility for payday loans to the provinces. While the amendment requires consenting provinces to commit to certain regulatory thresholds, namely, consumer protection legislation that includes limits on the overall cost of borrowing, it nonetheless leaves the provinces with significant legislative discretion in how they do this. As a result, despite the fact that most provinces share similar legislative frameworks, the extent and scope of their respective regulations often differ widely from one another. For instance, all provincial regimes prohibit straightforward loan rollovers. The extent of this restriction, however, has historically varied between jurisdictions. Ontario first enacted provincial legislation dealing specifically with the provision of payday loans in 2008. Prior to enacting the \textit{Payday Loans Act, 2008}, payday lenders operating in Ontario were regulated primarily under existing provincial consumer protection legislation, which incidentally prohibited rollover loans. However, lenders could easily skirt the rollover prohibition by issuing back-to-back or concurrent loans. While back-to-back loans did not technically qualify as rollovers, they nonetheless engendered similar \textit{sequela}, namely, over-indebtedness resulting from ballooning interest charges that left the principal untouched.\textsuperscript{85}

\textsuperscript{83} Both provinces effectively prohibit the provision of payday loans outright, albeit in different ways. For instance, Quebec statutorily limits interest on all loans to 30\% APR, while Newfoundland has opted not legislate on the matter, thereby leaving the federal usury cap of 60\% APR in place. Because payday lenders ostensibly cannot operate with these interest rate limitations in place, payday loans are \textit{de facto} illegal in both provinces.

\textsuperscript{84} Kobzar \textit{supra} note 63 at 34-35.

\textsuperscript{85} Ben-Ishai \textit{supra} note 17 at 28.
As another illustration, most provincial regimes cap the cost of borrowing. In Ontario, for instance, provincial law caps the cost of borrowing at 21 dollars per 100 dollars advanced.\textsuperscript{86} However, the governing legislation does not expressly bar additional fees from being applied to the loan.\textsuperscript{87} As a result, payday loan companies commonly issue loans through a debit card, which borrowers can only access once an activation fee is paid.\textsuperscript{88} In turn, when this fee is pooled with the interest charges already accruing to the borrower, "the resulting APR easily exceed both the federal and advertised provincial usury caps."\textsuperscript{89}

More importantly, under the current regime of federally sponsored provincial regulation, all participating jurisdictions allow for annual percentage rates far in excess of the federal usury limit. Under the current regulatory framework, legislation prescribes the maximum allowable interest rate that lenders can charge borrowers on a 12-day loan cycle. However, when these simple interest rates are calculated in terms of APR, the resulting percentages skyrocket past the federal usury limit. For instance, Nova Scotia permits a simple interest rate of 25 percent, which translates to 760 percent APR\textsuperscript{90}; British Columbia permits 23 percent or 700 percent APR\textsuperscript{91}; Alberta permits 23 percent or 700

\textsuperscript{86} Payday Loans Act, 2008, SO 2008, c 9, s 23.

\textsuperscript{87} Bellam and Talai supra note 1 at 7.

\textsuperscript{88} "Payday lenders skirt loan charge limits" CBC News (14 June 2011), online: <http://www.cbc.ca>.

\textsuperscript{89} Ibid; Bellam and Talai supra.

\textsuperscript{90} In the Matter of the Consumer Protection Act, 2011 NSUARB 22 (Nova Scotia Utility and Review Board) at 114.

\textsuperscript{91} BC Reg 57/2009, s. 14.
percent APR; Manitoba permits 17 percent interest or 517 percent APR; and Saskatchewan permits 23 percent interest or 700 percent APR.

At first glance, these simple interest rates appear substantially lower than the federal usury limit and, in a sense, they also accurately reflect the borrowing costs associated with a standard two-week payday loan. However, a rate ceiling predicated on a 12-day loan cycle tends to disregard the circumstances of the average payday loan consumer. As mentioned earlier, an overwhelming majority of these consumers are repeat borrowers. According to some estimates, "for every loan to a new customer, payday lenders make 15 loans to repeat customers on average across the country." A recent consumer survey conducted in Toronto by the Association of Community Organizations for Reform Now (ACORN) indicated that nearly half of all payday loan borrowers take out six or more payday loans a year. To put these consumer habits in perspective, another study found that if a Toronto-based borrower "pursued back-to-back loans for one year (26 loans) on a principal amount of $300 [they] would pay roughly $60 in interest every two weeks […] over $1,560 in interest (520% APR) for a $300 loan." Altogether, attempts to limit the cost of borrowing through caps grounded in a simple rate of interest allow lenders to significantly distort the real costs borne by most borrowers.

The devolution of authority over the payday loan industry has, therefore, received repeated criticism both among academic policy analysts and consumer watchdogs. In

92 Alta Reg 157/2009, s. 7.
93 The Consumer Protection Act, CCSM, c C200, s 151.1(1); Man Reg 50/2010 s 2.2(1)-(2).
94 An Act respective Payday Loan Agreements, Payday Lenders and Borrowers, 2007, c P-4.3, s. 23 (1); Sask Reg RRS P-4.3 Reg 1, s. 14(1).
96 Ibid.
97 Ben-Ishai supra note 17 at 28.
particular, commentators note that ceding control over payday loan companies to the provinces has resulted in "a hodgepodge of regulations with no overarching national standards."\textsuperscript{98} Along similar lines, critics also point out that Parliament promulgated the federal-to-provincial shift in jurisdictional responsibility over the payday lending industry as a way to incentivize better enforcement on the part of provincial officials who until that point had not adequately enforced the existing federal usury law. Under the old regime, the federal government argued that it had not been able to proceed with criminal charges against payday lenders for otherwise blatant contraventions of the federal usury prohibition, because "s. 347 of the \textit{Criminal Code} is unusual in that it requires the consent of the provincial Attorney-General in order to prosecute an offence under it."\textsuperscript{99} Provincial officials apparently refused to grant this authority under the guise that prosecutions would "drive away payday loan companies, leaving consumers to the mercy of loan sharks."\textsuperscript{100} Accordingly, Parliament opted to shift the burden to the provinces by putting the regulatory ball in their courts. However, Kobzar argues that the provinces' historical reluctance to sign off on prosecutions notwithstanding blatant violations of the federal usury limit "should inspire little confidence in any provincially-devised and enforced regulatory scheme for payday loans."\textsuperscript{101}

Accordingly, proponents of reforming Canada's current regulatory framework governing the provision of payday loans argue that the federal-provincial devolution of authority should be replaced with an overarching federal scheme grounded in a fixed usury rate ceiling coupled with uniform disclosure requirements. Provincial regulation currently

\textsuperscript{98} Kobzar \textit{supra} note 63 at 35.
\textsuperscript{99} \textit{Ibid} at 40.
\textsuperscript{100} \textit{Ibid}.
\textsuperscript{101} \textit{Ibid} at 35.
"requires disclosure in the form of posted warnings and information in agreements about the cost of credit and the high cost of the loans." 102 The current framework for disclosure requires that lenders disclose the cost of a loan in terms of a dollar amount, for example, $25 for $100 borrowed for one week, totaling $125 for one week. The provinces also require lenders to post both the total cost "clearly at the front of the store or on the counter in a similar fashion to the way that banks post the daily exchange rate" as well as a notice that the loans are intended to be short-term. 103 According to Ben-Ishai, however, the key is not whether disclosure made in terms of dollar cost per $100 borrowed or articulated as an annual percentage rate more accurately conveys the total cost of borrowing, but rather whether the way this information is provided is easy for the borrower to understand and compare among different lenders. In the absence of a mandated uniform disclosure template, however, payday lenders can provide this information in ways that satisfy their statutory disclosure burden without easing the asymmetries of information that challenge the consumer's ability to make informed borrowing decisions. 104

102 Ben-Ishai supra note 17 at 29.
103 Ibid.
104 It is worthwhile noting that the regulation of payday lending in Canada is roughly the same as in comparable jurisdictions. For instance, Australia's new regulatory regime adopts similar interventions. The key features of the Consumer Credit Legislation Amendment (Enhancements) Act 2012 include an interest rate ceiling, various limitations on ancillary fees and other charges, restrictions on rollovers and on borrowers entering into multiple loans. Along similar lines, the United Kingdom recently announced new payday lending regulations, which include caps on the cost of payday loans, limits on rollovers, and a requirement that lenders undertake affordability assessments before issuing loans as well as a rule that advertisements for payday loans include warnings that alert prospective borrowers about the potential financial risks associated with payday loans. While each country approaches the regulation of payday loans somewhat differently from one another, they nonetheless all involve “intervening in the market for payday loans to prescribe the terms on which those loans can be made available to borrowers.” More specifically, they tend to rest on some combination of interest rate caps, limitations on repeat borrowing, and mandated disclosure requirements. See Paul Ali, Cosima McRae and Ian Ramsay, “Payday Lending Regulation and Borrower Vulnerability in the United Kingdom and Australia (Forthcoming 2014).
More importantly, as the rest of this paper sets out, the “potential of disclosure as a regulatory tool” may itself be a flawed exercise in consumer protection insofar as research on bounded rationality increasingly suggests, “that consumers do not always act in the rational way that underlies the rationale for disclosure.”\(^\text{105}\)

\(^{105}\) Ben-Ishai supra note 17 at 29.
Chapter 3
Behavioral Economics, Bounded Rationality and the Consumer

To recap, the regulatory framework outlined above aims to correct the failures of the market for delivery of high-interest emergency loans. More specifically, competitive forces have not sufficiently conditioned the relationship between supply and demand, such that the cost of borrowing remains considerably higher than it otherwise would in a more perfect market. Demand for credit is also markedly inelastic. These conditions join together to create a perfect storm for low-income borrowers.

Mainstream banks tend to view the low-income borrowing segment as a high credit risk. Many of these borrowers have impaired credit histories or insufficient assets to collateralize their borrowing habits. As a result, mainstream banks have strategically "segment[ed] the financial services market such that low-income people face sub-prime lenders and fringe banks while middle and upper-income people face mainstream bank financial services supply."\(^{106}\) The market's segmentation constrains consumer choice for low-income borrowers by restricting their access to mainstream sources of credit, such as credit cards and lines of credit. This leaves them in a precarious position. Industry regulators closely monitor the behavior of mainstream banks, whereas they pay comparatively little attention to fringe financial institutions.\(^{107}\) Because low-income borrowers cannot easily meet their spontaneous needs for credit within the protective

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107 Ibid at 21.
confines of mainstream financial service institutions, they must gravitate to whoever is willing to lend to them, whether or not that lender is subject to regulatory scrutiny. This makes low-income borrowers an essentially captive audience for predatory lenders. Payday lenders take advantage of these conditions, for example, by marketing their loans as short-term emergency sources of credit while packaging them in such a way that borrowers seeking a ‘quick fix’ find themselves mired in a cycle of debt that inevitably leads to greater financial distress than would otherwise have been the case had they opted against the loan.

Regulatory efforts to correct this market failure are more often than not grounded in neoclassical economic theory. Viewed through this analytical lens all consumers of payday lending services are targets for industry exploitation, not because of some comparative socio-economic disadvantage, but more as a consequence of certain imperfections that burden the market for fringe lending products. The most important consequence of these market imperfections is that payday borrowers pay too much for the product.108

Neo-classical economic theory contends "that people make rational decisions to maximize their 'satisfaction' including decisions about what type, and what size of credit to use."109 As rational economic actors, consumers will only use payday loan products if it is consistent with their personal or household goals. However, the market's imperfections create structural barriers to this exercise. Payday lenders routinely conceal the real cost of their products, which ensures they have better information than prospective borrowers. This creates an imbalance of bargaining power that significantly

108 Buckland et al., supra note 105 at 17.
109 Ibid at 20.
disadvantages the borrower. In particular, this asymmetry of information invariably hinders his or her ability to make an informed decision regarding the loan. It induces prospective borrowers into thinking they are paying less than they are for payday loans. Because borrowers are misinformed about the real cost of these loans, they have no discernable way to anticipate whether carrying these liabilities is likely to push them into a debt cycle. If the lender had accurately conveyed all the relevant information with which to make a decision, borrowers would avoid loans with unfavorable terms and conditions, particularly those that give rise to potentially prohibitive costs. In other words, this theory contends that information asymmetries explain the anomalous borrowing habits that alarm policymakers.

Neo-classical economics argues that government intervention in consumer contracts is generally unwarranted. This anti-regulation presumption is set aside, however, when consumer misperception distorts the free market, for example, when it results in the adverse selection of loan products. Under these circumstances, neo-classical economics believes that “disclosure mandates should be one of the main regulatory responses to the problem of consumer misperception.”\(^\text{110}\) In particular, disclosure mandates “target imperfect information and misperception with respect to product attributes.”\(^\text{111}\)

In order to tackle the adverse selection of payday loan products, therefore, regulators should ensure that borrowers have a complete picture of their real cost. Hence, mandating disclosure requirements obliging lenders to both accurately as well as


\(^{\text{111}}\) \textit{Ibid.}
conspicuously disclose this information should suffice in correcting the welfare costs commonly associated with payday lending products. Symmetry of information would force lenders to charge only a competitive market price, which is the maximum amount borrowers would be willing to pay taking into account what the lender requires to sustain a profitable business. In other words, perfect information is the solution to the ills of payday lending.

The Canadian experience, however, suggests that disclosure is not a sufficient proxy for a perfect market. Rather, it appears to confirm the insights into consumer credit decision-making provided by behavioral law and economics. Behavioral science argues that real people are boundedly rational. In contradistinction to the rational actor model that underpins neoclassical expectations of human economic behavior, the work of Tversky and Kahneman, for example, demonstrates that cognitive biases habitually motivate human judgment and choice.\textsuperscript{112} This cognitive predisposition means that actual judgments often systematically depart from "unbiased forecasts" and resulting decisions thereby tend to differ from those anticipated by neoclassical theory.\textsuperscript{113} In this sense, behavioral science arguably sketches "a more realistic conception of human behavior."\textsuperscript{114} It also implies that the standard assumptions of traditional law and economics are sometimes false. Accordingly, behavioral law and economics applies "traditional economic tools, enhanced by a better understanding of human behavior" in a

\textsuperscript{112} See Amos Tversky and Daniel Kahneman “Judgment under Uncertainty: Heuristics and Biases” (1974) 185 Science 4157.


\textsuperscript{114} Ibid at 1545.
corresponding effort to "offer[] a host of novel prescriptions regarding how to make the legal system work better."\textsuperscript{115}

The development of behavioral economic analysis of law equips academic policy analysts with better analytical tools for prescribing public policy. In particular, it provides a compelling alternative to the prevailing approach to economic policy analysis, namely neo-classical economic theory, which many examples of existing regulated activity demonstrate, often fails to produce sound policy prescriptions. For example, traditional economic reasoning views punitive damages favorably, because they are a private alternative to public regulatory intervention. The purpose of punitive damages is to supplement compensatory awards that provide insufficient deterrence of socially undesirable private behavior.\textsuperscript{116} However, neo-classical economic theory also recommends that punitive damages should be awarded only if "an injurer has a significant chance of escaping liability for the harm he caused."\textsuperscript{117} In other words, the utility of punitive damages lies in the fact that while some "injured parties do not detect and seek compensation for all injuries," society nevertheless has an interest in deterring the behavior that caused those harms. Therefore, in order for punitive damage awards to succeed in reaching optimal deterrence, courts should instruct juries to "estimate the likelihood that the defendant might have escaped having to pay for the harm for which he

\textsuperscript{115} Jolls et al. \textit{supra} note 113 at 1546 and 1547.
or she should be responsible" and award punitive damages that reflect the probability of non-detection.\footnote{118}{Polinsky and Shavell supra note 117 at 957.}

Sunstein et al. note, however that "psychological work on punishment has suggested that when thinking about punishment, people's ideas diverge from what would be expected from an optimal deterrence approach."\footnote{119}{Cass R. Sunstein et al., Punitive Damages: How Juries Decide (Chicago: University of Chicago Press, 2002) at 134.} For instance, real people have difficulty mapping the probability of non-detection onto an unbounded scale of dollars.\footnote{120}{Sunstein et al. supra note 116 at 4.}

Moreover, a juror’s sense of moral outrage over a given tortfeasor’s actions often disproportionately informs their calculation of punitive damages. In turn, these behavioral tendencies often produce arbitrary and erratic judgments that undermine the neo-classical economic basis for punitive damages. Accordingly, Sunstein et al. note that “if the basic problem is that people’s moral judgments are not the proper basis for punitive awards,” but jurors lack sufficient behavioral constraint to set aside their moral outrage when rendering awards, then perhaps an expert administrative body would provide the requisite rationality, even if it is a bureaucratic alternative.\footnote{121}{Ibid at 10.}

economic analysis of law has developed, only recently has it made a foray into consumer credit regulation.

In *Seduction by Contract*, Oren Bar-Gill, an expert on the law and economics of contracts and contracting, argues that consumer contracts are a function of the interaction between market forces and behavioral psychology. The author argues that consumers are imperfectly rational, namely, their decisions tend to be partially motivated by bias and misperception. In particular, consumers are psychologically predisposed to shortsightedness and over-optimism. These cognitive biases instinctively draw consumers to products and services that offer short-term benefits, notwithstanding their potential long-term costs. These mistakes are also systematic and predictable, which further motivates sellers to actively engage with them. More specifically, sellers design their “products, contracts and pricing schemes to maximize not the *true* (net) benefit from their product, but the (net) benefit *as perceived by the imperfectly rational consumer.*”

In other words, sellers conceal the true costs of a given product or service in complex contracts, which makes them “appear more attractive than they really are.” According to Bar-Gill, this result is a market failure, because it suggests that many consumer transactions are not economically efficient; that is only the seller is made better off.

Moreover, Bar-Gill notes that neoclassical economic assumptions regarding the capacity of seller competition to “increase efficiency and protect consumers” are misplaced in the

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126 *Ibid* at 2.
127 *Ibid*.
128 *Ibid*.
context of behavioral market failures.\textsuperscript{129} Rather, under these conditions, competitive forces oblige “sellers to exploit the biases and misperceptions of their customers,” because an altruistic seller will necessarily lose business to the “low-road seller who offers what the consumer mistakenly believes to be the best contract.”\textsuperscript{130}

Bar-Gill has detailed this dynamic in a case study of consumer credit products.\textsuperscript{131} In this study he demonstrates that credit card issuers shape their contracts and pricing schemes “around consumers’ systematic deviations from perfect rationality.”\textsuperscript{132} For instance, consumers habitually underestimate the extent of future borrowing. This reflects the average consumer’s tendency to misjudge self-control problems coupled with an optimism bias “that might lead consumers to underestimate the likelihood of contingencies bearing economic hardship,” (i.e. the probability of losing their job or the difficulty they will face finding a new one) that are likely to prompt excess borrowing in addition to factors as mundane as the borrower’s own forgetfulness. Accordingly, credit card contracts offer features that cater directly to a consumer’s behavioral impulses in providing immediate benefits such as low introductory interest rates and frequent flyer points, as well as zero annual and per-transactions fees that appear alongside high long-term interest rates and large over-limit fees in addition to significant cost penalties for late payment.\textsuperscript{133} In this sense, the credit card contract is “a tool designed to exploit consumers’ underestimation bias.”\textsuperscript{134}

\begin{footnotesize}
\begin{itemize}
  \item[129] Bar-Gill superscript note 125 at 2.
  \item[130] Ibid.
  \item[132] Ibid at 1373.
  \item[133] Ibid at 1376.
  \item[134] Ibid at 1377.
\end{itemize}
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contractual fine print, contributes to staggering levels of credit card borrowing, which “renders the consumer more vulnerable to financial hardships.” In crafting a policy response to the welfare costs associated with excessive consumer borrowing, therefore, Bar-Gill and others insist that regulators take better stock of consumers’ limited will power and imperfect rationality.

Despite Bar-Gill’s insights into the relationship between consumer psychology and the manner in which lenders orient the consumer credit market, few researchers have expressly applied behavioral economic analysis to payday lending more generally, let alone considered it in the Canadian policy context. Bar-Gill and Elizabeth Warren, an active consumer protection advocate, however, have noted, that “payday loans provide another example of a credit product that can impose substantial costs on imperfectly informed and imperfectly rational borrowers.”

135 Bar-Gill supra note 131 at 1378.
Bar-Gill applied behavioral economic analysis in an effort to better explain the staggering levels of credit card borrowing in the United States. As mentioned above, Bar-Gill suggests that consumers exhibit a cognitive predisposition that he refers to as ‘underestimation bias’, which undermines their capacity to make sound *ex ante* judgments of future borrowing. Underestimation bias is effectively a composite of the following psychological susceptibilities: imperfect self-control, over-optimism and hyperbolic discounting. Policymakers often regard credit cards and payday loans as distinct forms of consumer credit. While credit card and payday loan contracts may bear different features and determinants, they are nonetheless both vehicles for accumulating substantial liabilities. Moreover, in both cases, policymakers have questioned the wisdom and caution of borrowers and lenders alike in generating economically significant amounts of consumer debt. Accordingly, the cognitive biases used to better understand the habits and preferences of prime borrowers may provide a useful framework when conducting a similar inquiry regarding the behavior of their subprime counterparts.

1 Imperfect Self-Control

Real people often display bounded willpower, which “refers to the fact that human beings often take actions that they know to be in conflict with their own long-term interests.”\(^\text{137}\)

\(^{137}\) Jolls et al. *supra* note 108 at 1479.
This psychological impediment explains why so many people have trouble committing to a diet or have difficulty quitting smoking. These self-control problems can also help explain consumer-borrowing decisions. More specifically, according to Bar-Gill and others, imperfect self-control is a major reason why most consumers habitually underestimate their future borrowing. Consumers assume they have sufficient willpower to resist the temptation to finance consumption with debt. Lenders are keenly aware of this consumer psychology and so they design contracts that exploit borrower self-control problems by tempting “consumers to borrow more in the short term than they would prefer in the long run.” Open-ended loans, such as credit cards or lines of credit, open the proverbial door to these problems of self-control. Close-ended loans, such as a typical bank loan, determine the amount borrowed up-front. Under these circumstances, self-control is not at issue, because the loan provides the borrower with no ex post facto discretion regarding the extent of his or her liability. In this sense, a close-ended loan serves as a commitment device, which enables “the consumer to constrain her future self by pre-committing to a maximum amount of debt.” Conversely, credit cards are not equipped with the same default; that is, they leave the extent of the borrower’s liability open or capped with an upper-limit. While the consumer may plan beforehand to limit their borrowing to a pre-determined amount, he or she is not “contractually bound to that intention, so her willpower will be tested continually.”

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138 Francis supra note 1 at 627.
139 Bar-Gill supra note 131 at 1397.
140 Francis supra at 628.
141 Bar-Gill supra.
142 Ibid.
143 Francis supra.
At the outset, payday loans appear more closely aligned with traditional bank loans, because the amount of the debt and related term are similarly determined upfront.\textsuperscript{144} Francis notes that for practical purposes, however, payday loans are more analogous to open-ended loans insofar as consumers can effectively roll them over indefinitely.\textsuperscript{145} In other words, when the original term matures, a payday borrower can shift present costs into the future by extending the loan over an additional term. In this sense, rollovers are a “temptation similar to the one credit-card users face when they decide whether to pay off their entire balance or to pay only the minimum payment.”\textsuperscript{146} The rollover option changes the nature of a payday loan by essentially rendering it a “fixed-principle loan with an open-ended term.”\textsuperscript{147}

The availability of rollovers heightens a borrower’s exposure to imperfect self-control and can lead to certain consumer mistakes.\textsuperscript{148} On the one hand, consider borrowers who are \textit{unaware} they exhibit bounded willpower. These borrowers take out a payday loan as a one-time solution to a temporary shortfall in liquidity. They calculate that the related fees are a relatively small price to pay to meet an immediate expense. They are also aware of the costs of rolling over a loan, but they believe their loan is “one of the 10% of loans that do not lead to repeat borrowing.”\textsuperscript{149} However, this confidence masks the fact that borrowers consistently underestimate their future borrowing, “since when the future comes they may not be able to resist the temptation to extend the loan for two more weeks and incur the additional unexpected cost of the rollovers, which were not

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\textsuperscript{144} Francis \textit{supra} note 1 at 628; Creola Johnson, “Payday Loans: Shrewd Business or Predatory Lending?” (2002) 87 \textit{Minn. L. Rev.} 99 at 64-69.
\textsuperscript{145} Francis \textit{supra}.
\textsuperscript{146} \textit{Ibid.}
\textsuperscript{147} \textit{Ibid.}
\textsuperscript{148} \textit{Ibid.}
\end{flushleft}
calculated as part of the initial loan.”¹⁵⁰ On the other hand, consider borrowers who are 
aware they exhibit bounded willpower. These borrowers may mistakenly view a payday 
loan no differently than a typical bank loan, namely, as a close-ended transaction. 
Moreover, this feature may appeal to these borrowers, because it offers a “deliberate 
device” which protects against self-control problems, “just as a dieter might place a lock 
on the refrigerator.”¹⁵¹ For instance, White recounts the story of a payday borrower who 
opted for a payday loan in lieu of a credit card offer, because the “repayment system of 
the payday loan, in her mind at least, precluded runaway debt.”¹⁵² When payday rolls 
around, however, they are presented with the option of deferring their costs to another 
loan cycle. Under these circumstances, they quickly “discover that their borrowing is not 
as constrained as they had anticipated,” because while they were aware they exhibited 
bounded willpower, they did not expect that it would be challenged.¹⁵³ Accordingly, 
these borrowers “will also have underestimated their future borrowing.”¹⁵⁴ 

Canadian provinces that have opted to regulate intra-provincial payday loan products, 
under the new federal policy model, all ostensibly prohibit the extension of an 
outstanding payday loan for a fee or the advance of a new payday loan to pay off an 
existing payday loan. At the outset, this gives the impression that the imperfect self-
control bias is not an issue in the context of the Canadian payday lending market. As 
mentioned above, however, until very recently payday lenders operating in certain 
jurisdictions were able to skirt this obligation by packaging extensions as back-to-back or 

¹⁵⁰ Francis supra note 1 at 628-629. 
¹⁵¹ White supra note 149 at 162. 
¹⁵² Ibid. 
¹⁵³ Francis supra at 629. 
¹⁵⁴ Ibid.
concurrent loans as opposed to straightforward rollovers. Even now that most permutations of fee-based loan extensions are prohibited, enforcement is not always sufficiently robust to ensure compliance. Moreover, save for inconvenience, very little appears to prevent a borrower from taking out a loan from a third party payday lender to defer the costs of an existing loan. Notwithstanding even an assiduously enforced rollover prohibition, the availability of this option means that only consumers who are aware of their imperfect self-control are shielded from repeat borrowing. Conversely, consumers who are entirely unaware of their cognitive predisposition remain vulnerable to the over-indebtedness associated with repeated payday borrowing, because the original loan effectively remains open ended.

2 Optimism Bias

Jolls et al. note that a “common feature of human behavior is overoptimism.”\textsuperscript{155} In short, most people operate their day-to-day lives under the mistaken belief that bad events are far less likely to happen to them than to others.\textsuperscript{156} Put another way, “people are often unrealistically optimistic about the probability that bad things will happen to them.”\textsuperscript{157} Vast swaths of empirical research support this insight into human behavior. It appears that nearly everyone believes they are significantly less likely than others to experience hardships. For instance, most consumers believe that they are less likely than their counterparts to suffer the harms commonly associated with the products they use,

\textsuperscript{155} Jolls et al. \textit{supra} note 108 at 1524.
\textsuperscript{156} \textit{Ibid.}
including car accidents and adverse health outcomes.\textsuperscript{158} One case study found that “while smokers do not underestimate statistical risks faced by the population of smokers, they nonetheless believe that their personal risk is less than that of the average smoker.”\textsuperscript{159} The phenomenon of risk underestimation has also found anecdotal support in surveys of college undergraduates, who when polled anonymously at the start of a university course, both consistently and overwhelmingly predict they will score above the final average grade in the course. As Jolls aptly points out, however, “these beliefs cannot all be correct; if everyone were below (or above) average, then the average would be lower (or higher).”\textsuperscript{160}

Unrealistic optimism or overoptimism can have profound implications for public policy. For instance, policy efforts to improve the quality of our air, land and water, are often “characterized by a belief that government must compel the market to behave environmentally.”\textsuperscript{161} Accordingly, governments develop systems of pollution control, which generally include regulatory prescriptions that oblige private economic actors to take necessary precautions to protect the environment coupled with a strong enforcement mechanism to secure compliance with the regulatory system. There appears to be broad consensus among policymakers that high penalties – including but not limited to substantial monetary penalties, the revocation and suspension of firm operating licenses, and so on – are required ingredients of this regulatory mix, because they not only punish wrongdoing and avoid a recurrence, but more importantly they deter others from


\textsuperscript{159} Ibid.

\textsuperscript{160} Jolls supra note 152 at 1659.

committing similar offences.\textsuperscript{162} However, if prospective polluters consistently underestimate their likelihood of being sanctioned, then it seems unlikely that a penalty-based regulatory regime, even if robustly enforced, will have the desired deterrent effect. In this sense, sound policy must somehow account for this systematic error in human judgment.

Accordingly, a thorough consumer protection policy should have a strong appreciation for the fact that “many consumers exhibit overoptimism, which contributes to overall underestimation of future borrowing.”\textsuperscript{163} In the context of payday lending, for example, optimism bias contributes to the underestimation of borrowing in the following ways. Most borrowers believe they are less likely to rollover their payday loan than the average borrower.\textsuperscript{164} As mentioned earlier, borrowers often find it difficult to avoid deferring the present costs of repayment when tempted with an extension, such as a rollover. Therefore, optimism bias can cloud a prospective borrower’s \textit{ex ante} judgment regarding the actual risk of repeat borrowing and his or her related exposure to over-indebtedness.

Unrealistic optimism causes borrowers to underestimate future borrowing in other ways as well. In particular, it hinders their capacity to accurately project future expenses, because most people discount the probability they will face urgent medical bills or car-repair expenses, for instance.\textsuperscript{165} As a result, consumer-borrowing decisions regarding the size and cost of a given payday loan, tend to be informed only by present-day liquidity constraints. This can often leave very little room to absorb costs that might arise in

\textsuperscript{163} Francis \textit{supra} note 1 at 629.
\textsuperscript{164} \textit{Ibid}.
\textsuperscript{165} \textit{Ibid}. 

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relation to future adverse events thus inducing “economic hardships that lead people to borrow more,” such as getting fired.\footnote{Francis supra note 1 at 629.} Furthermore, this condition is actually exacerbated when individuals “perceive that they have some degree of control over whether or not the negative event will occur,” which as mentioned earlier, is a common symptom among payday borrowers.\footnote{Ibid at 629-630.} In particular, payday-loan borrowers sometimes exhibit unrealistic optimism regarding “the likelihood that they will have fewer expenses and more money in two weeks and, even more, that they will have the self-control to repay the loan on its maturity date.”\footnote{Ibid at 630.} Therefore, policy efforts aimed at redressing the increasingly staggering levels of payday loan debt must necessarily account for the frequency with which unrealistic projections of future self and circumstance inform borrower decision-making.

3 Hyperbolic Discounting

Hyperbolic discounting (or present-biased preference) is another source of “weakness of the will” that can help further explain why so many consumers end up borrowing more than they had initially anticipated.\footnote{Bar-Gill supra note 126 at 1398.} Neoclassical economic models of consumer behavior assume a constant discount. In other words, traditional economic analysis argues that “the difference between the attractiveness or aversiveness of a reward or punishment today versus tomorrow is the same as the difference between a year from now and a year and one day from now.”\footnote{Jolls et al. supra note 108 at 1539.} However, there is considerable evidence to
the contrary, namely, that real people exhibit sharply declining discount rates. In terms of economics, Bar-Gill explains the phenomenon as follows. Hyperbolic discounters systematically discount costs and benefits that will materialize in the near future, but apply smaller additional discounts for costs and benefits that seem further away. In other words, people exhibit extreme impatience for short run rewards, but this preference declines steadily over time. This inter-temporal inconsistency of preferences effectively means that “one’s present desires for the future are at odds with one’s future desires for the future.”

This cognitive tendency directly informs consumer-borrowing patterns. Because hyperbolic discounters are generally unaware of their “present-biased time preferences” they rarely take stock of the ways in which this conditions their borrowing habits. In particular, present bias heightens consumer desire for instant gratification, which can often result in problems restricting spending. More importantly, when confronted with a shortfall in liquidity, consumers often rely on credit to fuel their present consumption desires, which in turn often leads to increased borrowing.

Consider the application of this behavioral pattern to a consumer debating whether or not to sign up for a new credit card. For many consumers this decision rests on a balance between the utility of having greater access to credit and their concomitant exposure to greater indebtedness. Therefore, at the outset, point X in time, the consumer evaluates the

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171 Jolls et al. supra note 108 at 1539
172 Bar-Gill note 126 at 1399.
173 Jolls et al. supra.
175 Meier and Sprenger supra note 169 at 194.
likelihood he or she will borrow on the card at point Y in the future. The consumer “weighs the future benefit from a credit card purchase [at Y] against the more distant [Z] cost of debt repayment, including payment of interest charges.”

Taking for granted an *ex ante* appreciation that there are substantial costs of borrowing on his or her credit card, the consumer concludes that their preference at X is not to borrow at Y. In light of this preference, the consumer moves forward from X under the assumption that he or she will not borrow at Y, which, in turn, induces the consumer to take out the new credit card. The consumer is later confronted with an actual borrowing decision at Y; that is “now [Y] is the present and [Z] is the near future.” Assuming the consumer is a hyperbolic discounter, they will heavily discount the costs of Z from Y. In other words, “even if the future [Z] cost of borrowing is substantially higher than the present Y benefits, the consumer, [at Y], may decide to borrow on her credit card.”

According to Bar-Gill, this reversal in preference (i.e. the preference at X not to borrow developing into a preference and decision to borrow at Y) “is an immediate implication of hyperbolic discounting.”

Hyperbolic discounting is also helpful in describing how and why consumers frequently underestimate the total cost of an initial payday-loan transaction. The consumer is typically confronted with an unanticipated expense. The payday lender offers the consumer a $300 loan in exchange for a $75 fee payable in two weeks. The consumer has a choice between paying $300 today and $375 in two weeks. If the consumer heavily

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176 Bar-Gill note 126 at 1399.
177 Ibid.
178 Ibid.
179 Ibid at 1400.
180 Francis *supra* note 1 at 630.
discounts the value of a future surplus of $75 in relation to a present-day surplus of $300 with a deferred cost of $75, then he or she is likely to pay the high fee in exchange for the loan. According to Francis, the underlying problem is that even if the borrower demonstrates a strong *ex ante* preference for repaying the loan in two weeks, he or she is likely to change their mind.\textsuperscript{181} In other words, this preference is likely to reverse when the loan matures. More specifically, when the two weeks expires, the borrower is confronted with a new present or “today.”\textsuperscript{182} If their tendency to discount future rewards still applies, then they will yet again “prefer paying a high fee later over paying anything now.”\textsuperscript{183} In this sense, the preference for short-run rewards over long-run costs often results in “poor predictions of their future credit decisions.”\textsuperscript{184}

\textsuperscript{181} Francis *supra* note 1 at 630.
\textsuperscript{182} Ibid.
\textsuperscript{183} Ibid at 630-631.
\textsuperscript{184} Ibid at 631.
Chapter 5  
A Behavioral Approach to Regulation

With these behavioral insights in hand, a clear pattern emerges. Cognitive biases often induce consumers to make misguided borrowing decisions. They also help explain increasingly high levels of payday loan debt despite their prohibitive costs and detrimental consequences for long-term financial health. Problems controlling spending and borrowing, unrealistic projections of personal exposure to future adverse events as well as a tendency to discount future costs in favor of present benefits, can make it difficult for consumers to accurately and reliably project the potential cost burden of a payday loan. By nature, payday loans are a last resort; that is their high transaction costs make sense only in the context of an emergency shortfall in liquidity. In other words, consumers should presumably avoid them except when there is little other option available to deal with an emergency. The cognitive shortfalls mentioned above, however, can cloud this critical insight with the result that consumers lose sight of the underlying basis for payday loans, namely dire financial straits. Moreover, these behavioral traits are a particular challenge for low-income consumers, who wrestle simultaneously with often very limited access to mainstream sources of credit. These factors also create very favorable market conditions for payday lenders. In particular, as mentioned earlier, it allows them to design and package their loan products in ways that exploit the cognitive fallibilities of already distressed borrowers.

Knee-jerk regulatory solutions to the problem of payday borrower over-indebtedness generally involve some combination of absolute interest rate caps and mandated disclosure. More extreme proposals have called for the outright ban of payday loan
products. Previous sections of this paper have stressed the inherent weaknesses of these approaches. On the one hand, bans and caps both acknowledge as well as respond to low-income consumers who struggle to make rational borrowing decisions. However, these regulatory efforts not only come at the expense of consumer freedom of choice, but sometimes also jeopardize the broader safety of low-income consumers. As mentioned earlier, this consumer demographic frequently exhibits markedly inelastic demand for credit. This tendency sometimes prompts them to seek out alternative sources of credit, such as violent criminal lenders, when legitimate lenders are either forced out by wholesale bans or abandon marketplaces restricted by overly stringent caps. On the other hand, mandated disclosure regimes tend to be grounded in the standard neo-classical economic assumption that consumers are rational actors and that market failures, such as information asymmetries, are the principal culprits for the pitfalls of the payday lending industry.

Behavioral economic analysis, however, suggests that consumers are imperfectly rationale. While this shortfall often causes consumers to make suboptimal borrowing decisions, behavioral economic analysis offers a middle ground between the grim expectations of consumer behavior that define overtly paternalistic regulatory solutions, such as bans and caps, and the decidedly more optimistic projections of consumer decision-making that frame regulation informed by a standard rational actor calculus, such as crude mandated disclosure regimes. In particular, behavioral economic theory posits that while bounded rationality and self-control often prompt people to make "ill-informed" decisions, it is nevertheless possible to "steer people's choices in welfare-
promoting directions without eliminating freedom of choice."\(^{185}\) While people's choices may be conditioned by certain cognitive predispositions, the possible directions these choices can take can also be circumscribed through regulation. More specifically, regulation determines the possible starting points from which these cognitive predispositions can influence the direction of individual behaviour. Short of resorting to prohibition, regulation cannot completely sever the influence of cognitive bias on individual decision-making. However, wherever possible, policymakers should design legal rules or starting points that preserve freedom of choice, but provide the infrastructure that allows individuals to fully exercise that autonomy, while simultaneously pointing them in the direction of those choices that policymakers view as decidedly welfare-promoting.\(^ {186}\)

Take for example the growing problem of obesity in Canada. Alarmingly high obesity rates are increasingly linked to various chronic diseases, such as hypertension and Type 2 diabetes.\(^ {187}\) The economic cost to Canada's public health system for treating these diseases was roughly $7.1 billion in 2011.\(^ {188}\) Obesity in Canada is hence a significant public policy issue. High obesity rates are also increasingly attributable to excessive sugar intake.\(^ {189}\) In other words, the dietary preferences of some consumers produce unhealthy outcomes, the burden for which is felt not only by those individuals, but also

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\(^{186}\) Ibid.


\(^{188}\) Public Health Agency of Canada, Obesity in Canada: A Joint Report from the Public Health Agency of Canada and the Canadian Institute for Health Information (Ottawa: Public Health Agency of Canada, 2011).

\(^{189}\) Johnson et al. supra note 183.
by Canada's public health system as a whole. Outside of Canada, the public policy response to this challenge has ranged from sin or excise taxes on unhealthy foods and beverages to their wholesale prohibition, such as former New York Mayor Michael Bloomberg's now infamous effort to ban the sale of mega sized sugary soft drinks. However, these overtly paternalistic regulatory efforts often produce unintended adverse consequences, notwithstanding the best intentions of policymakers to discourage unhealthy behaviour. Sin taxes on unhealthy foods, for instance, tend to be regressive; that is, they fall disproportionately on consumers at the lower end of the income distribution. The basis for sin taxes is the notion that higher prices necessarily disrupt marketplace decisions to consume high-calorie drinks, for example. However, lower-calorie drinks are not necessarily less costly than their high-calorie counterparts. As a result, the impact of raising prices to stifle obesity rates, which are widely dispersed and affect all population groups\(^{190}\), is borne more substantially by poorer consumers. It assumes further that potential substitute drinks not captured by the excise, such as orange juice, contain less sugar. Most importantly, sin tax proponents also appear to assume that individuals are inherently incapable of making healthy consumption decisions for themselves. However, this ignores viable alternatives to paternalism, such as the recent efforts of the federal government of Canada to implement changes to food labeling in order to help consumers better understand the health implications of the foods they consume. The recently proposed changes to the nutrition facts and ingredient labels on packaged food includes a requirement that food manufacturers "clearly state on nutrition labels the amount of sugar they have added to products" in addition to "suggested serving

\(^{190}\) J. Slater et al., "Socio-demographic and geographic analysis of overweight and obesity in Canadian adults using the Canadian Community Healthy Survey" (2009) 30 Chronic Diseases in Canada 1 at 12.
sizes that reflect what people actually eat, and make the calorie count more prominent. Not only does this strategy allow consumers to easily compare sugar content among different brands, but in providing a standardized suggested serving size consumers are in a sense forced to juxtapose their eating habits against a healthy benchmark. As Sunstein notes, this type of disclosure is more likely to prove effective, because it avoids abstract statements regarding what constitutes healthy eating in favor of transmitting information that is "concrete, straightforward, simple, meaningful, timely and salient" while also "clearly identify[ing] the steps that might be taken to obtain the relevant goal" – namely avoiding overconsumption of sugar – by indicating the requisite serving size associated with a healthy intake. In other words, the disclosure is behaviorally informed.

Along similar lines, in order to address the concerns commonly attributed to payday lending, such as borrower over indebtedness, while simultaneously avoiding the drawbacks of regulation that either assumes too little or too much of consumers, the resulting policy framework must take stock of the behavioral predispositions at the heart of the problem. These insights better place policymakers to design regulatory frameworks that equip consumers with the necessary tools to overcome their inherent cognitive predispositions that impede arriving at informed borrowing decisions. Along this line of reasoning, policymakers might consider the following regulatory proposals.

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193 Ibid at 8.
Disclosure is the “least controversial mode of legal intervention” with which to regulate predatory lending. Disclosure regimes are “predicated upon the notion that if consumers are provided sufficient information about loan products, including for example, annual percentage rate, finance charges, payments schedules, settlement costs and the like, they will have the information necessary to shop competitively for loans.”

In this sense, mandated disclosure is the normative preference of neoclassical economics and policymakers alike, because it allows consumers to compare products “relatively quickly and with few or no transaction costs.” In the context of subprime lending, however, the “theoretical premises of disclosure regulation seem quaint and utterly insufficient.” The various cognitive biases exhibited by borrowers suggest that disclosure regimes that merely enforce the conspicuous disclosure of statistical information, such as interest rates, simply do not go far enough. In other words, these disclosures “may remedy imperfect information, but they cannot remedy imperfect rationality.” As Bar-Gill points out, “if a consumer believes that she will not borrow on her card, she will not mind the high interest rate, no matter how large the font.” In this sense, the Ontario Payday Loans Act, 2008, which requires lenders to unambiguously disclose the total costs of borrowing, for example, by displaying posters in-store that set out in 144 point font the maximum allowable cost per $100 borrowed, are not sufficient

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195 Painter Jr. supra at 95-96.
197 Ibid.
198 Ibid.
199 Ibid.
200 Ibid.
tools for borrowers to make an informed individualized borrowing decision.\textsuperscript{201} Rather, if the problem is that consumers routinely underestimate their future borrowing, an effective mandated disclosure regime must find ways to warn of the dangers inherent in a payday loan contract that better resonate with prospective borrowers. In other words, effective disclosure must “cure the underestimation bias.”\textsuperscript{202}

Jolls and Sunstein therefore suggest that policymakers respond to instances where bounded rationality prompts suboptimal social outcomes by attempting to “debias through law by steering people in more rational directions.”\textsuperscript{203} ‘Debiasing through law’ essentially involves using certain cognitive biases to counteract others. To offset the impact of optimism bias on consumer-borrowing habits, for instance, policymakers might develop regulation that implements the availability heuristic. The technical definition of a heuristic is “a simple procedure that helps find adequate, though often imperfect, answers to difficult questions.”\textsuperscript{204} Individuals commonly employ heuristics when making judgments in situations of uncertainty.\textsuperscript{205} The availability heuristic refers to the tendency of people to overestimate the plausibility of a particular development on the basis of knowledge or information that readily comes to mind.\textsuperscript{206} For example, people might “assess the risk of heart attack among middle-aged people by recalling such occurrences among one’s acquaintances.”\textsuperscript{207} In other words, events that conjure vivid mental images “will be more available when individuals make decisions and thus disproportionately

\begin{flushleft}
\textsuperscript{201} See Payday Loans Act, 2008, S.O. 2008, c. 9, s 14.
\textsuperscript{202} Bar-Gill supra note 126 at 1421.
\textsuperscript{205} Tversky and Kahneman supra note 109 at 1124.
\textsuperscript{206} Ibid.
\textsuperscript{207} Ibid.
\end{flushleft}
Therefore, according to Jolls and Sunstein, “because making an occurrence available to individuals will increase their estimates of the likelihood of the occurrence, availability is a promising strategy for debiasing those who suffer from excessive optimism.”

As Francis notes, Health Canada’s requirement that cigarette packages bear full-color warnings that feature graphic images, which include a diseased tongue and a child wearing an oxygen mask, are an attempt to use the availability heuristic to combat the incidence of smoking.

Accordingly, Francis suggests that utilizing this debiasing mechanism can help frustrate the underestimation bias, the arguably principal catalyst for repeat borrowing and related over-indebtedness among low-income consumers of payday loan products. In particular, she suggests that policymakers adopt what she refers to as a “specific narrative disclosure.”

This disclosure model accentuates the potential costs and losses related to payday loan products, by providing prospective borrowers with a “vivid narrative of a borrower who has fallen into the debt trap” coupled with frequency statistics regarding repeat borrowing rates. Francis provides the following examples of such narratives, adjusted for the existing Canadian regulatory context:

Jamie Johnson received a two-week payday loan of $300. Her next paycheck did not go as far as expected, so [after repaying her loan she took out a second two-week loan] for another $45 fee. Four months later, Jamie [realized she had paid $360 in fees, because of her decision to take out the first loan];

And,

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208 Jolls and Sunstein supra note 189 at 210.
209 Francis supra note 1 at 634-635.
210 Ibid at 636.
9 out of 10 payday loans are issued to borrowers with 5 or more payday loans a year.

Francis notes that these disclosures serve two interrelated purposes. Firstly, they provide a potential borrower with a personal narrative that breaks down the costs of a payday loan in an easily digestible way. Secondly, the vivid illustration of those costs makes them “more available to consumers in a way that will counteract their underestimation of future borrowing.”211 In other words, “a few lines relating the actual experience of another payday-loan customer and the costs that he or she incurred will help customers understand the real costs of the loan, even if they cannot grasp the complexity of the APR.”212

Bar-Gill also recommends individualizing the information disclosed to consumers. This might involve requiring lenders to remind the consumer of their past borrowing habits. This information would be more difficult for consumers to dismiss “as an abstract statistic that does not apply to [them].”213 In turn, this disclosure could help hyperbolic discounters as well as borrowers who exercise imperfect self-control better predict their future borrowing. For example, if policymakers require lenders to inform prospective borrowers of the total number of payday loans they received in the past year, then borrowers would better appreciate the broader cost ramifications of the loan.214 Another application of individualized disclosure might involve lenders informing borrowers of the total dollar amount in payday loan fees they paid in the previous year. According to

211 Francis supra note 1 at 637.
212 Ibid.
213 Bar-Gill supra note 126 at 1422.
214 Ibid; Francis supra at 637-638.
Francis, by outlining the costs accumulated by the borrower, “these disclosures become more salient, and the loss more apparent.”

An obvious challenge for policymakers contemplating "psychologically-guided information disclosure" is to determine how, when and where the narratives outlined above should be communicated to borrowers. As Sunstein and Thaler note, "it is hopelessly inadequate to say that when people lack relevant information, the best response is to provide it." Rather, any such effort must account both for how individuals process information as well as the ways in which the delivery of information can influence that process. Policymakers generally better succeed at drawing a marketplace's attention to certain features of a product, for example, when those features are salient to consumers, whereas consumers seem to under react to information that is not salient. The salience of information depends heavily on its presentation; that is, "the behavioral consequences of otherwise identical information depend on how it is framed." Initiatives that rely principally on disclosure to achieve a given policy goal must, therefore, be particularly “attentive to the importance of salience.” For example, binge drinking results, at least in part, from the relative ease with which consumers can access low-cost alcoholic beverages. Accordingly, sin taxes are sometimes applied as an economic tool with which to curb excessive alcohol consumption. Sunstein notes, however, that the efficacy of these taxes varies

215 Francis supra note 1 at 638.
218 Ibid at 1182-1183.
219 Sunstein supra note 187 at 15.
220 Sunstein and Thaler supra at 1182.
221 Ibid.
significantly depending on the moment at which the added cost is introduced to prospective buyers. More specifically, sin taxes clearly identified in the posted price of alcoholic beverages have a decidedly more downward sloping effect on alcohol consumption than when they are applied at the register.\textsuperscript{222} In this sense, it appears that there are not only substantive, but also structural pre-conditions to salient information disclosure. Accordingly, successful efforts to debias payday borrower overoptimism through psychologically-guided disclosure, for example, may rest further on delivering that information at a point in the loan process that resonates with prospective borrowers.\textsuperscript{223}

In developing a methodology for this intervention it is useful to briefly consider the experience of payday lending from the borrower's perspective. Bertrand and Morse capture that experience in the following account:

The loan process begins when the customer approaches a counter or window where a customer service representative (CSR) works and requests a new loan or a refinancing of an existing loan. The customer provides the lenders with a physical copy of her latest bank statement and paycheck stub, and the CSR verifies and updates the employer, income, banking, and personal coordinate information. The CSR takes a few minutes to review the bank account information via a subscriber service and to enter the loan request and borrower information into the system. The company software processes the application and determines whether and how much can be loaned to the customer. (No subjective input enters the loan acceptance process, and local staff cannot influence loan acceptance.) If a loan is offered, the customer signs forms that disclose the terms of the loan and convey the information mandated by state laws, including the APR. The CSR puts the cash and a copy of the paperwork inside a standard size (4 x 9 inch) company envelope and writes the payment due date and amount due on the calendar printed on the outside of the envelope.

\textsuperscript{222} Sunstein and Thaler \textit{supra} note 217 at 1182.
\textsuperscript{223} Bertrand and Morse \textit{supra} note 212 at 1865.
From a behavioral perspective, the substantive quality of the information presented here is clearly problematic. The chronology also highlights an important structural barrier, namely the timing of the disclosure. The alcohol consumption tax outlined above suggests that consumers tend to under react to information disclosed toward the end of a transaction. From a behavioral standpoint it appears that consumers are already "psychologically committed to the deal at this point." In other words, the salience of information disclosures diminishes the further a consumer moves along the transactional timeline. In the context of payday loans, Edwards notes that this condition is exacerbated further by "high-pressure tactics from salespeople who discourage consumers from walking away from a deal at the point of consummation and the burdens of further credit shopping." Therefore, the design of behavioral information disclosures must resolve this timing and coordination issue.

Presumably the most effective solution is to move the consumer's initial interaction with these disclosures closer to the outset of the loan process. However, this begs a number of important questions. Firstly, at what precise moment in the chronology outlined above should specific narrative disclosures be presented to consumers shopping for payday loans? Secondly, even if the relevant timing issue is resolved, how can regulators ensure that prospective borrowers actively engage with those narratives? Along similar lines, how can regulators ensure that consumer service representatives do not actively interfere with this process?

225 Ibid.
In a recent field experiment, Bertrand and Morse tested possible alternatives to the traditional payday loan process outlined above by altering it in two significant ways.\footnote{Bertrand and Morse supra note 215 at 1868 ff.} Firstly, at the front end of the loan process, prospective borrowers were asked to complete a short survey upon submitting their application and related support materials. The survey asked borrowers to identify the expenses motivating the loan application, whether they intended to use the loan for something other than an emergency, to anticipate their capacity to absorb the cost of repaying the loan, and to describe their broader spending behavior.\footnote{Ibid at 1869.} This information was used to capture a profile of the average payday borrower. Secondly, at the back end of the loan process, the regular cash envelopes, which generally indicate the payment due date in addition to the amount due, were replaced with custom envelopes printed with three different information treatments.\footnote{Ibid at 1871.} The first treatment juxtaposed the median annual interest rate of payday loans (443\%) against the median rates of other types of loans, such as installment car loans (18\%), credit cards (16\%), and subprime mortgages (10\%).\footnote{Ibid at 1872.} The second treatment indicated the cost in fees of borrowing $300 - assuming a fee of $15 per $100 borrowed - over two weeks ($45), one month ($90), two months ($180), and three months ($270) respectively.\footnote{Ibid.} The treatment also provided a comparison of these costs against borrowing the same sum on a credit card with a standard interest rate ($2.50, $5.00, $10.00, and $15 respectively).\footnote{Ibid.} The third treatment provided information regarding the frequency with which payday borrowers renew their loans. The treatment
envelope explained that "Out of 10 typical people taking out a new payday loan... 2 1/2 people will pay it back without renewing, 2 people will renew 1 or 2 times, 1 1/2 people will renew 3 or 4 times, 4 people will renew 5 or more times."²³²

Bertrand and Morse suggest that each treatment framed the cost of payday loans in ways that are easier for borrowers to internalize than current mandated disclosures.²³³ By incorporating "behavioural principles from psychology and economics," the treatments armed borrowers with the requisite cognitive infrastructure to de-bias the mental lapses often attributed to payday borrowing mistakes, such as repeat borrowing. For instance, the APR information treatment "makes salient the stark difference in annual rates compared to APRs with which [borrowers] are more familiar."²³⁴ Along similar lines, the dollar information treatment not only provides a dollar-for-dollar comparison to another financial product "that helps borrowers assess the fundamental value of payday borrowing," but also extends that comparison over time. In turn, the treatment encourages borrowers to take a longer-term view of the cost of a payday loan, which "may partly undo borrowers' tendency to apply too narrow a decision frame."²³⁵ The refinancing information treatment conveys, in simple language, the frequency with which average borrowers refinance their payday loans, which may help debias borrowers "overconfident about their ability to repay a loan quickly or about their future income and expense levels."²³⁶

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²³² Bertrand and Morse supra note 215 at 1872.
²³³ Ibid at 1866
²³⁴ Ibid at 1871.
²³⁵ Ibid at 1873.
²³⁶ Ibid.
Bertrand and Morse implemented these treatments through one of the largest payday lending companies operating in the United States, which gave them "access to all the customers entering 77 stores spanning 11 states over a period of 2 weeks."\textsuperscript{237} The participating lender later provided the authors "with administrative data on all transactions the participating borrowers engaged in with the lender before and after [their] intervention."\textsuperscript{238} The authors found that individuals who interacted with the various information treatments were 5.9\% less likely to borrow from the lender in the pay cycles following the intervention, which translated to an 11\% decline relative to their control group.\textsuperscript{239} Bertrand and Morse concede that, at first glance, this reduction in numbers may seem like a disappointing result, particularly for those who believe that payday borrowing is inherently irrational.\textsuperscript{240} Regardless, the field experiment provides concrete empirical data that disclosure, which is "inspired by, and responds to, cognitive biases or limitations that surround the payday borrowing decision" has the capacity to influence consumers calculating whether to take out a payday loan, as compared to more traditional regulatory approaches. All told, the field trial suggests:

That getting consumers to think more broadly about the decision to take up a payday loan - by stressing how the fees accompanying a given loan add up over time, by presenting comparative cost information to increase evaluability, or to a lesser degree, by disclosing information on the typical repayment profile of payday borrowers - results in a reduction in the amount of payday borrowing.\textsuperscript{241}

Bertrand and Morse's field experiment is encouraging in a further respect as well. The underlying focus of their research concerned the influence of behaviorally informed

\begin{footnotesize}
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\item \textsuperscript{237} Bertrand and Morse \textit{supra} note 215 at 1867.
\item \textsuperscript{238} \textit{Ibid.}
\item \textsuperscript{239} \textit{Ibid.}
\item \textsuperscript{240} \textit{Ibid.} at 1889.
\item \textsuperscript{241} \textit{Ibid.} at 1867.
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information disclosure on future borrowing as opposed to its impact on a consumer's initial calculus to borrow. In turn, they measured whether psychology-guided disclosure presented to borrowers on the back-end of a payday lending transaction can debias the cognitive shortfalls that often contribute to irrational future borrowing. Their results demonstrate an arguably significant statistical relationship between behavioral approaches to information disclosure and borrower decision-making. However, the broader debate surrounding the payday lending industry concerns the influence of cognitive bias on a consumer's capacity to accurately reflect on cost before entering into an initial loan. Given the diminishing returns of information disclosed to consumers as they approach the back-end of a transaction, policymakers might nonetheless consider applying at the outset of the loan process, information treatments similar to those employed in Bertrand and Morse's field trial, the specific narrative disclosures outlined by Francis or the individualized disclosures proposed by Bar-Gill.

Certain skeptics contend, however, "that disclosure regimes - be they as sophisticated as possible - do not offer a sufficient solution to the problems posed by irrational consumption." This view essentially instructs that disclosure, whether or not informed by insights from behavioral economics, is not sufficient to empower otherwise boundedly rational consumers to “walk away from a bad deal and keep on searching for a better one.” These critics do not deny that cognitive biases can lead to mistakes in market behavior, but rather view disclosure as a misguided tool with which to correct the resulting market failures. Teichman posits that the difficulties consumers face evaluating

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243 Ibid at 56.
complex financial products are so profound, that “direct regulation, including the prohibition of certain practices, may be the only way to provide appropriate protections.” He posits further that behaviorally-informed disclosure regimes may not only be an ineffective alternative to direct regulation, but may also unwittingly produce a regulatory false-positive, namely a sense that policymakers have taken the necessary corrective action, when, in fact, more intrusive regulation is necessary.

Epstein also agrees that reformers should tread cautiously in translating behavioral findings into concrete regulatory actions, albeit for different reasons. Disclosure regimes are politically popular as much for their ostensible capacity to correct behavioral losses while preserving freedom of choice as they are for doing so cheaply; that is, behavioral economics posits that "most of the implementation costs are borne by the regulated parties." However, Epstein has misgivings about these alleged benefits. In particular, he doubts that behavioral disclosure regimes constitute a cheap regulatory fix. Rather, he suggests, "legislation and regulation always cost money." Consumer responses to government regulation are rarely universal. While behavioral disclosure regimes may be simpler than existing approaches and work effectively on some consumers, many others lack the “skills that will enable them to make use of the information they are provided with," such as basic linguistic and arithmetic

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244 Teichman supra note 238 at 58.
245 Ibid at 58-59.
247 Teichman supra at 58.
248 Ibid.
249 Epstein supra at 88.
aptitudes.\textsuperscript{250} Epstein suggests that an effective behavioral disclosure regime, therefore, would likely need to address this shortfall, possibly by relying on ancillary public education programs, which are almost certain to prove expensive.\textsuperscript{251} According to Epstein, however, behavioral economics tends to overlook these costs. In the process, it leaves policymakers with a misguided understanding that regulating behavioral losses involves only modest public spending, when, in fact, the underlying cost burden is liable to prove considerably more expensive. In turn, Epstein worries that policymakers may regulate behavioral market failures without the benefit of a sound cost-benefit calculus, the linchpin of rational law reform.\textsuperscript{252} Accordingly, Epstein suggests that policymakers avoid falling down this regulatory rabbit hole by "invest[ing] reform dollars in other projects, relying on market forces to keep the size of the admitted behavioral losses in check."\textsuperscript{253}

Empirical data may be required to blunt these criticisms. Put another way, policymakers hoping to incorporate behavioral insights into their regulatory toolkit may need to demonstrate that psychologically-guided disclosure, for example, represents more than good intentions. Accordingly, these policymakers might consider proposing their reforms as 'temporary law'. Temporary laws are essentially "regulations that include an expiration date." Ginsburg et al. argue that making restrictions temporary allows for,

\[\ldots\] a form of political compromise that might decrease the costs of political struggles. Proponents of regulation will accomplish their goal but will, by accepting an expiration date, bear the costs of extension. Opponents of regulation will be less opposed to temporary rules than permanent ones. Furthermore, if the proponents and opponents of regulation have genuine

\textsuperscript{250} Teichman \textit{supra} at 57; Epstein \textit{supra} note 243 at 88.
\textsuperscript{251} Epstein \textit{supra}.
\textsuperscript{252} \textit{Ibid} at 93.
\textsuperscript{253} \textit{Ibid}.
uncertainty about the consequences of a particular intervention, they might welcome the information revealed by the temporary law.\footnote{Ginsburg et al., "Libertarian Paternalism, Path Dependence, and Temporary Law" (2014) 81 University of Chicago Law Review 291 at 297-298.}

In other words, temporary legislation can create space for policymakers to gather information about institutional reforms that would otherwise run into political opposition driven largely by "uncertainty as to what the effects of such a law would be."\footnote{Ibid at 326.} In turn, policymakers can better evaluate whether a proposed reform is more closely aligned with an efficient outcome than the status quo, without having to absorb the fiscal burden and attendant political risks inherent in permanent legislation.\footnote{Ibid at 358-259.} If the premise on which the temporary law is based proves false, then upon its expiry the relevant regulatory framework merely reverts back to the status quo ante.\footnote{Ibid at 297.} Conversely, if the temporary law achieves what it set out to achieve, namely a more efficient outcome than the status quo, then the targeted reform is less likely to face the informational hurdles preventing it from becoming the dominant regulatory device. In this sense, "temporary law works like an experiment."\footnote{Ibid.}

Applied to payday lending reform, a temporary legislative approach to psychologically-guided mandated disclosure may temper the conflict between its libertarian critics and those favoring more intrusive regulation, such as permanent bans. On the one hand, the temporary reform can reveal whether or not psychologically-guided disclosure regimes, in and of themselves, are sufficient to significantly move consumer behavior toward efficient outcomes or whether more intrusive intervention is needed. On the other hand,
as a temporary regulatory exercise it involves no enforcement costs; if the law's effectiveness correspondingly diminishes, then this suggests behavioral disclosure treatments are not necessarily a low-cost stand-alone strategy for addressing behavioral losses, which thereby reinforces the libertarian critique.

Along these lines, policymakers might consider the following modest proposal. In order to submit a payday loan application, prospective borrowers must study a short narrative that conveys, in simple terms, the potential finance costs of a payday loan. As a further pre-condition for loan eligibility, these consumers must also complete a rudimentary questionnaire that involves simply repeating the information gleaned from the narrative. This approach to disclosure ostensibly satisfies many of the behavioral considerations outlined by the literature that has been reviewed in this thesis. Disclosure staged at the outset of the loan process is more likely to register as salient with consumers and the questionnaire ostensibly encourages more active engagement with the relevant information, which may help prospective borrowers to think more long term before proceeding with the loan process. Regulators could also adopt a number of strategies to thwart customer service representatives from interfering with this process. For instance, there might be concern that lenders will encourage their customer service representatives to become sufficiently familiar with the narrative and related questionnaire to be able to hurry prospective borrowers through the loan process by supplying them with the correct answers up front. Above and beyond expressly warning borrowers not to interact with third parties when completing the questionnaire, regulators could also employ multiple narrative disclosures that are not only regularly updated, but also delivered to payday lending outfits in serial numbered pre-sealed envelopes while further requiring borrowers
to reseal their completed questionnaires before submitting them to the lender. Payday lenders could also be required to submit all completed as well as any uncompleted questionnaires to regulators as a condition of maintaining their license. Moreover, this type of intervention does not require regulators to disturb current regulatory measures. Rather, policymakers can implement this type of information disclosure in lockstep with existing requirements, such as the obligation that lenders conspicuously display the dollar amount of their fees in-store. In a sense, this approach is relatively similar to the legal requirement, in Canada, that skill-testing questions, such as a basic arithmetic exercise, be completed as a pre-condition to participating in the contests or give-aways commonly held by department stores and grocery chains.

In sum, it may be useful to reframe disclosure as a debiasing mechanism to counteract the underestimation bias that routinely contributes to excessive borrowing and less as a tool for relaying abstract financial details to consumers who are very unlikely to appreciate them as guideposts for making informed borrowing decisions. In this sense, debiasing disclosures “have the potential to make a significant impact by reducing the welfare costs imposed by repetitive borrowing mistakes.”\textsuperscript{259}

\textsuperscript{259} Francis \textit{supra} note 1 at 638.
Chapter 6
Conclusion

Payday lending regulation in Canada has undergone a dramatic transformation in recent years. Under the previous regime, all lenders were subject to a federal usury rate ceiling. The government did not, however, enforce the federal interest rate cap against payday lenders. As a result, payday lenders were largely unsupervised by federal and provincial regulatory authorities. In turn, they consistently levied interest rate charges well in excess of the federal usury limit. Given the ballooning debt loads of many payday borrowers, the federal government acknowledged that better protection than the regulatory framework provided was needed. The federal government thus opted to delegate authority over the payday loan industry to the provinces. The resulting policy make-up now includes a patchwork of outright bans, limitations on interest rates and mandated disclosure rules. Aside from the prohibitory model adopted by Quebec and Newfoundland, the rest of the provinces appear to have embraced the notion that if borrowers are unambiguously provided with the statistical determinants of a prospective loan, they will make the borrowing decision that best accords with their needs. This paper has argued that this framework of disclosure is fundamentally misguided. In particular, it is grounded in the notion that consumer-decision makers are inherently rational actors. However, increasingly robust insights from behavioral economics demonstrate that the decisions of most borrowers are informed by cognitive biases that cloud their ability to make informed decisions regarding the extent of their debt obligations. In particular, borrowers consistently underestimate the likelihood that they will borrow for longer than the standard two-week loan. In turn, payday borrowers
routinely incur unexpected additional costs that often result in financial paralysis. Moreover, payday lenders are keenly aware of consumer psychology. As a result, they design and package their loan products to respond to the consumer underestimation bias. Accordingly, this paper suggests that Canadian policymakers consider adopting a similar strategy, namely, applying mandated disclosure regimes that involve using certain cognitive biases to counteract others. In particular, these debiasing measures would take aim at borrowers who suffer from excessive optimism by making the potential consequences of payday loan related over-indebtedness more available to them in a corresponding effort to increase their estimates of the likelihood of the occurrence. This task could be accomplished in any number of ways. Debiasing disclosure might involve requiring lenders to present prospective borrowers with vivid narratives of typical payday borrowers in financial distress, not unlike the requirement that cigarette packages bear graphic photos of smokers suffering from tobacco-related illnesses. Regulators might also require lenders to provide borrowers with individualized statistics and information regarding their past borrowing habits, including the number of payday loans issued to them in the previous year in addition to the dollar amount in fees they paid to facilitate those loans. Altogether, the goal is to nudge consumers to better appreciate the real costs of payday loans, so that they can make informed decisions about whether to use them.
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