

The Cost of Providing Payday Loans in a US Multiline Operator Environment

A study prepared on behalf of the
Financial Service Centers of America

September 2009

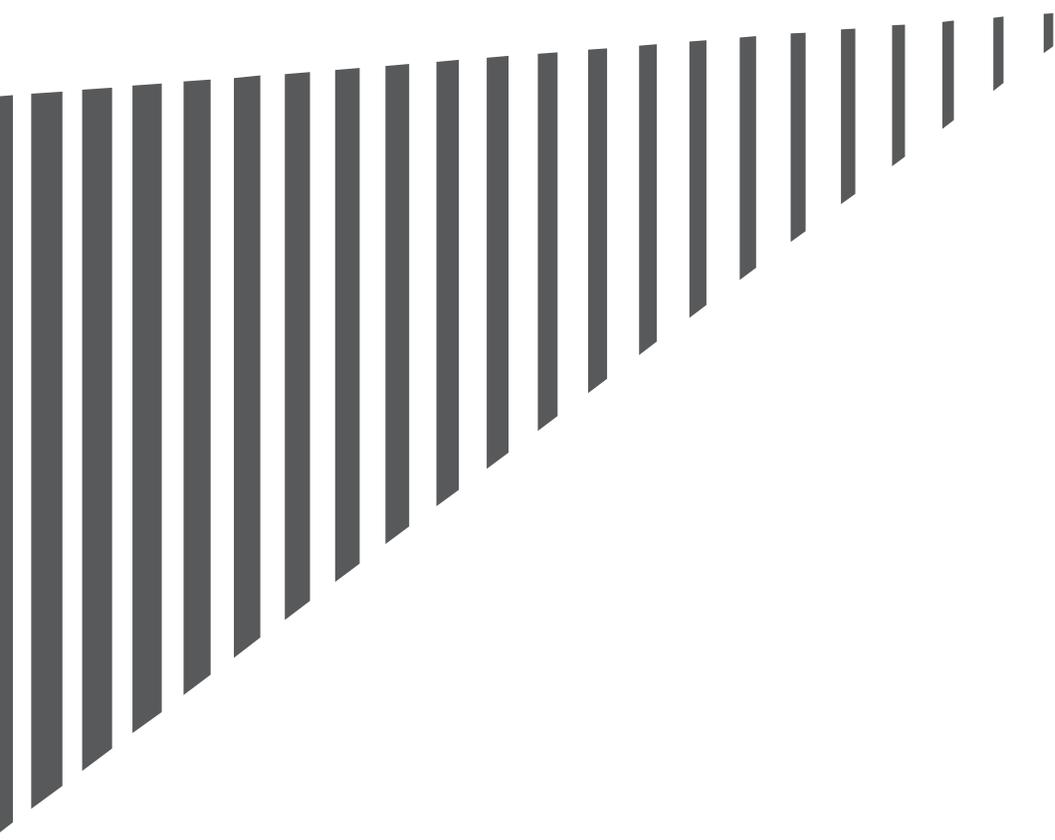


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I. Executive Summary

Ernst & Young LLP (“Ernst & Young”) was engaged by Financial Service Centers of America, Inc. (“FiSCA” or “Client”) to perform a survey to determine the cost of the current Payday Advance product (“PDA”) to multiline financial service center providers (operators offering additional services such as check cashing, money remittance and electronic bill payment). The current PDA product is a short term credit product offered pursuant to state law in approximately thirty-five states. Ernst & Young found that the average PDA offered by survey respondents was \$379.

Ernst & Young’s findings, based on the responses to the survey, establish:

Table 1 Revenue, cost and pre-tax profit for the average PDA of the E&Y survey

PDA revenue, cost and profit (pre-tax basis)		
	Store-Weighted Average	
	per \$100 loan	per \$379 loan
Revenue	\$ 15.26	\$ 57.85
Operating Cost	\$ 9.41	\$ 35.65
Cost of Loan Capital	\$ 0.07	\$ 0.27
Cost of Supplementary Capital	\$ 0.67	\$ 2.54
Bad Debt cost	\$ 3.74	\$ 14.17
Loan Cost	\$ 13.89	\$ 52.63
Profit (pre-tax)	\$ 1.37	\$ 5.22

- Of the companies operating 2,687 locations that responded to the survey, revenue per \$100 of PDA principal loaned equaled \$15.26.
- The store-weighted average cost¹ to PDA providers per \$100 of principal loaned equaled \$13.89.²
- On a pre-tax (and pre-interest) basis, PDA providers earned a store-weighted average profit equal to \$1.37³ per \$100 of loan principal issued.
- The store-weighted average cost per \$100 loan includes a bad debt cost of \$3.74 and operating costs of \$9.41.

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- **On an average PDA of \$379, providers realize a store-weighted average pre-tax profit of \$5.22.**
- **Survey respondents represent an estimated twenty-seven percent of multiline industry locations.**

The results of this study are presented on a per \$100 PDA basis as is consistent with state regulations (e.g., Alaska, Illinois, Michigan and Oklahoma) and independent studies (e.g., Morgan (2007) and Morgan and Strain (2007)).

FiSCA estimates that there are approximately 10,000 multiline PDA locations throughout the US. Ernst & Young prepared a detailed questionnaire that was electronically submitted (via FiSCA management) to all FiSCA member companies to gather financial information at the company level. Based on the responses, Ernst & Young analyzed information for 2,687 locations (or an estimated 27 percent of the industry locations). The respondents ranged from one company with one location up to one company with approximately 1700 locations (or “stores”). As is the case with most weighted averages, the size of the company is often used as the weight. Ernst & Young’s results weight each of the responding companies’ financials by the number of locations associated with each company.

Ernst & Young extracted the relevant financial survey information into a model to calculate the cost, by major component, of providing PDAs. Ernst & Young included in the cost base the following categories: operating costs (e.g., rent, utilities, insurance, salaries and benefits), bad debt cost, cost of loan capital and supplementary capital.

Because the surveyed companies were multiline operators, Ernst & Young used a widely recognized cost allocation method – costs were allocated based on relative revenues associated with PDA revenues vis-à-vis other types of revenues (e.g., check cashing) – to estimate the costs associated to PDA.⁴ As the PDA is a core service line among the surveyed locations – it generated approximately 51 percent of their total revenue – Ernst & Young deemed this cost allocation approach reasonable.

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To understand the nature of the corporate overhead (and management fees) of the large companies, Ernst & Young conducted interviews with the upper-level management of responding companies to seek further clarification of these charges. More specifically, Ernst & Young conducted interviews with the management of large companies in the survey, representing 96 percent of the corporate overhead expenses from the survey data. Companies confirmed to Ernst & Young that the corporate overhead represented properly allocated charges (i.e., costs directly attributable to the PDA business), including for example, executive compensation, services that would be provided by third parties absent central headquarter (e.g., collection, call centers, IT, general counsel, and human relations) and regional headquarter expenses. Ernst & Young also evaluated Officers' Salaries when reported as a stand alone expense item (most often for smaller companies) and also found no adjustments were warranted relative to the existence of potential profit elements.

II. Scope of the Study

A. Scope

FiSCA engaged Ernst & Young to prepare an independent study on the costs of providing PDAs, as offered in a multiline (operators offering additional core services such as check cashing, money remittance, electronic bill payment) environment. FiSCA intends to use the results of Ernst & Young's study, along with other information, to evaluate the cost structure of multiline operators in regards to potential regulatory changes to the PDA.

B. Caveats and limitations

The results of this report are based on data Ernst & Young collected from twelve survey participants (i.e., companies) and are determined by the assumptions and calculations detailed in Section V of the study. This report is intended principally as an assessment of Payday lenders' costs as well as revenues and profits. This report does not constitute an "endorsement" of a particular product by Ernst & Young, but rather it provides cost and related estimates to enable further study by interested parties on this product.

Ernst & Young did not analyze the trends over time in the costs of providing PDAs, nor did Ernst & Young attempt to quantify the impact of future regulatory changes or changes in the economic environment on the costs. The economic analysis is based on cross-sectional data and the results are reflective of the results of the twelve surveyed companies and representative of each of their fiscal year 2008 results. Results are representative of the survey respondents' results and may not be necessarily representative of the entire industry.

III. Industry Analysis

A. The PDA

The PDA is an unsecured short-term loan for a relatively small amount of money provided by a non-traditional lender. The process works as follows:⁵ A borrower completes a simple application for a loan and typically is required to provide supporting documentation, including proof of regular income, a personal checking account and identification. If approved, a borrower reads and signs an agreement containing disclosures – including those required by the Truth in Lending Act – and writes a post-dated personal check, usually coinciding with the borrower’s next payday, for the amount of the advance plus a fee. Then the lender immediately advances the borrower funds, but holds the check until the agreed upon date.

B. Industry overview

In 2008 there were approximately 22,000 financial service centers (locations) across the US as estimated by FiSCA. Out of the 22,000 locations, an estimated 10,000 were multiline operators who offered a combination of the following services: PDA lending, check cashing, title loans, installment loans, money transfers, money orders, utility bill payment, prepaid debit cards, prepaid phone cards, lottery and miscellaneous other services. Of the remaining 12,000 locations, it is estimated that roughly 8,000 provided exclusively PDA services, while 4,000 offered primarily check cashing services.

Table 2 Company distribution by size

FiSCA member companies	
% of companies with over 100 locations	2.1%
% of companies with no more than 100 locations	97.9%

Source: FiSCA

During 2008, Payday lenders in the US extended 120 million PDAs with a total value of \$42.1 billion (Stephens Inc. (2009))⁶. The fees (revenue) associated with these advances amounted to \$7.3 billion, of which \$1.51 billion corresponded to revenue of

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public mono and multiline companies (Stephens Inc. (2009)). Consequently, in 2008, the size of the average PDA was estimated by Stephens (for the entire industry) to be approximately \$351 and the average fee per \$100 loan amounted to \$17.34. This average fee is consistent with those reported by Morgan (2007)⁷ for PDA locations across 37 US cities: the mean fee per \$100 loan was \$17.10, while the median was \$16.80.

IV. E&Y survey: Design, Data Collected and Sample Characteristics

The purpose of this study is to assess the cost to only multiline operators of providing PDAs. Ernst & Young's analysis and results rely on a survey conducted among FiSCA member companies during March and April 2009. Ernst & Young requested respondents to provide information for the most recently available fiscal year, which was in all cases 2008.

A. Survey design and structure

The Ernst & Young survey ("E&Y survey") had 29 questions and covered the following categories:

- ▶ Company structure and business mix (e.g., legal structure of the company, whether the company operates as a direct lender or as a broker, services offered, number of locations, states where the company offers PDAs and total number of employees);
- ▶ Owners' compensation (including number of owners receiving compensation and hours worked by each them);
- ▶ Financial statement information (e.g., breakdown of revenue and transaction volume by line of service, store-level expenses, corporate expenses and balance sheet information);
- ▶ Financing and sources of capital (e.g., information on type of debt held by the company and its cost);
- ▶ PDA activity (including average initial term, and number and volume of loans issued in the most recent fiscal year);
- ▶ Unrecoverable debts (e.g., number and volume of loans defaulted and defaulted loans that were never collected); and,
- ▶ PDA fee structure.

The E&Y survey is presented in Appendix A.

B. Data collection and extraction

FiSCA distributed the E&Y survey electronically to all its members in mid-March. Ernst & Young received a number of surveys that represented roughly 2,813 locations

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(responses were submitted directly to Ernst & Young and not through FiSCA). Ernst & Young classified the surveys, according to the quality of their data, into three groups: the first group (or 82 percent of the companies) had complete information to be included in the analysis; surveys in the second group missed essential information like the dollar volume of PDAs; and, in the third group were surveys that lacked essential and other information (e.g., unrecoverable debts). Ernst & Young contacted companies in the second group, and requested information including the Payday transaction volume (in dollars). The second group accounted for 16 percent of the survey respondents. Eighty-one percent of the companies in this group were able to furnish Ernst & Young with the Payday transaction volume information. One particular reason the remaining respondents were unable to provide this information is because their system does not differentiate between loan types. The companies in the third group (or 2 percent of the total) provided very limited information and thus their responses were deemed unusable. Therefore, the analysis is based on information collected for 2,687 locations. Although follow-up interviews were conducted with respondents to confirm or revisit responses which were unclear, the information obtained was not audited nor subject to other verification procedures by Ernst & Young.

Respondents received the survey in an Excel file. Respondents filled out the survey electronically and returned the results to Ernst & Young. To process these surveys systematically, Ernst & Young created custom scripts using Visual Basic for Application (“VBA”) software. The end user would use the familiar interface of Microsoft Excel – this standard software enables automatic data collection and processing to take place in the background. A “beta” (or sample) version of the survey and related process were also tested with individual FiSCA members before the formal release of the survey.

C. Sample characteristics

As described above, the respondents who provided usable surveys represented 2,687 locations, or 27 percent of the estimated 10,000 multiline locations offering PDAs throughout the country. The locations of the respondents are distributed in over 82 percent of the states that allow PDA services. These locations derived \$459 million in

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revenue from PDA. The average size of the loan issued was \$379, which is similar to the reported industry average of \$351.⁸

V. Methodology and Results

In this section Ernst & Young details the methodology employed in estimating the cost for an average location in the survey of providing a \$100 PDA. Secondly, profitability results are also derived.

A. Classification of costs

Ernst & Young classified the costs of providing PDAs into four categories:

- ▶ Fixed and variable operating costs
- ▶ Cost of loan capital
- ▶ Cost of supplementary capital
- ▶ Bad debt costs

1. Fixed and variable operating costs

Ernst & Young segregated the operating costs from other cost categories related to the cost of capital. Ernst & Young collected detailed information on the operating costs that were broadly classified in the survey as either location (store) expenses or corporate expenses. Because understanding the nature of the costs associated to providing PDAs is a relevant aspect of the study, Ernst & Young categorized operating costs as fixed (and therefore subject to an allocation process), variable or hybrid (i.e., partially subject to an allocation process).

By definition, a fixed cost is a cost that is not directly determined by the volume of transactions of a PDA company. Examples of fixed costs include rent, utilities, security, insurance and corporate overhead. Some of these costs are fixed by contract and have specific duration (e.g., occupancy costs).

Variable costs are costs that change in proportion with the volume of PDAs issued. For example, an operator facing a higher than average volume of loans issued will pay more for bank service charges.

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Ernst & Young identified a third category of costs (labeled “hybrid” costs) that can be classified either as fixed or variable costs. These costs are largely labor costs (salaries and benefits). They may or may not be affected by changes in the volume of PDAs. A location requires a minimum number of employees to operate the store and to this extent salaries may be considered a fixed cost. The location also has the alternative to hire an employee by the hour or to increase the number of full-time employees during busy seasons (i.e., during periods of higher loan advance volumes). In such a case, the labor costs would be considered variable. Staffing needs could also change over time in response to changes in the volume of business; therefore in the long run salaries could be viewed as variable, while in the short run they would tend to be fixed. Because Ernst & Young could not gather more detailed information related to the staffing decisions of the companies, Ernst & Young determined, for the purpose of the analysis, to treat salaries and benefits as hybrid costs.

The distinction between fixed and variable costs matters when studying the difference between the average and the marginal cost of providing PDA services. Multiline operators offer check cashing, money transfers, installment loans, utility bill payment and other services in addition to PDA. If PDA is an ancillary service, then the marginal cost of providing this service may be lower than the average cost. Upon review of the data, Ernst & Young determined that all of the companies that responded to the survey provided PDA services, which generated on average 51 percent of the total revenue of an average location. Consequently, Ernst & Young concluded that for the surveyed companies, PDA was a core service and the *operating* costs associated with this service were not marginal.

Ernst & Young requested respondents to provide, if available, their own estimates of operating costs associated to the PDA. A total of 25 percent of respondents were able to provide their own estimates. If a respondent could not provide that information, Ernst & Young apportioned the cost of providing PDAs using the percentage revenue derived from this activity as an allocation key. This is a standard allocation methodology used in other fields of regulatory economics (e.g., transfer pricing). Of those 25 percent of

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respondents that provided their own estimates, approximately 8.3 percent only provided payday lending figures and therefore an allocation key could not be built, another 8.3 percent of respondents provided estimates that were similar to the estimates that would have been provided by the allocation key, and the remaining 8.3 percent of respondents provided estimates that allocated a smaller portion of the costs than the allocation key.

For a given operating expense “*i*” the allocation was performed as follows:

$$\text{PaydayLoan Expense}_i = \text{Expense}_i * \frac{(\text{PaydayLoan Revenue})}{\text{Total Revenue}}$$

For example, for a company that derived 45 percent of its revenue from PDA and had a rent expense of \$100 during the year, Ernst & Young would allocate \$45 (i.e., 45 percent multiplied by \$100) as rent expense associated to PDA services. Notice that this allocation was used only for operating expenses, and not for other expenses like bad debts of loan cost or capital.

To measure the costs consistently across different companies, Ernst & Young performed the following adjustments:

Goodwill amortization: Goodwill is characterized as the residual between the price of a business and the fair market value of all the identifiable assets. Goodwill captures, among others, the value of a brand, reputation and client lists. Goodwill is not recognized until the business is sold to another entity. After the sale, goodwill is recognized and any amount attributed to it becomes a cost of the business. However, upon review of the survey data, Ernst & Young determined that goodwill amortization costs were immaterial (i.e., they accounted for 0.26 percent of total cost).

Provision for loan losses and doubtful accounts: Ernst & Young analysts observed a wide variation in the methods used by respondents to account for bad debts. Some companies write off bad debts after fixed intervals of time, while others write off bad

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debts at the end of the year or after exhausting all possibilities of collection. To treat bad debts consistently across respondents, Ernst & Young removed the provision for loan losses from the operating cost calculation and performed an estimation of bad debts consistently for all respondents. The treatment and estimation of bad debt costs is described in the Methodology Section 3 of this study.

Interest: Interest costs are not considered as an operating cost nor bad debt cost. Costs associated to long term debts are included in the cost of capital, and therefore have been removed from the operating costs to avoid double counting the costs.

Taxes: The results are presented on a “before-income-tax” basis.

Franchise expenses: Some of the companies in the sample have franchise operators. Franchisors provide services to franchisees including advertising and head office services. The survey data was provided on a company basis rather than on a location basis. Therefore the surveyed companies that are franchisors have provided their franchisor expenses on an aggregate basis and the data regarding the costs for each of their franchisees is unknown. Ernst & Young included franchise payments incurred by surveyed franchisees in their cost base, as these expenses are necessary for their operations. Eight percent of the surveyed companies were franchisees. Their franchise fees represented less than 0.1 percent of the total fixed costs of the surveyed companies.

Payment to affiliated companies: Some large companies may have a corporate office that provides centralized services to affiliates as a means to efficiently leverage certain types of “shared” services. Such services can include, among others, legal services, accounting, insurance, payroll and collection. To the extent that a location would be willing to hire a third party for the provision of these services, these costs should be treated as such. These types of services, when provided by an affiliate, are charged out as “corporate expenses/overhead”. However, corporate expenses could potentially also

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include management fees that may or may not be a form of profit distribution, rather than an actual cost associated with the provision of PDA services.

Seventeen percent of the survey responding companies accounted for 96 percent of the “Corporate Overhead Expenses”. To understand and test the nature of the corporate overhead (and management fees) of the large companies, Ernst & Young conducted interviews with management of such surveyed enterprises (and requested cost ledger data) to seek further clarification of these charges. Companies represented to Ernst & Young that the great majority of costs comprising the corporate overhead were costs directly attributable to the PDA business, including functional costs such as “IT”, executive compensation, health insurance, and property insurance. More specifically, Ernst & Young determined (based on interviews and review of data from follow-up interviews) that the corporate overhead expenses were largely comprised of two types of expenses, headquarter expenses and regional expenses. The headquarter expenses tended to be cost categories – such as legal or information technology – that were centralized for cost efficiency purposes. They included costs for items such as IT, general counsel, government relations, and human resources. In addition, a centralized collection center was also a corporate overhead expense for particular companies. The regional expenses tend to be operational in nature, (e.g., management and staff in a regional office). To validate the type of expenses included in the corporate overhead, Ernst & Young randomly selected a company – from the survey set of respondents having these types of costs – and requested the ledger of the expenses. Ernst & Young removed from the corporate overhead costs any items that represented potential profit distribution. For example, one company included in its corporate overhead a payment to outside investors, which Ernst & Young excluded from the cost base in the analysis.

Owner compensation: Ernst & Young asked respondents to provide detail on owners’ compensation to investigate whether these payments (if excessively high) could represent profit distribution. Ernst & Young requested information including the total amount of salaries, bonuses and other compensation received by owners, the number of owners actually receiving any compensation, and the number of hours spent by each

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of them on the business in a typical week. From correspondence with the respondents, Ernst & Young confirmed that the owners' compensation is included in the salaries and benefits reported as store expenses. Furthermore, for the companies that provided this information it was confirmed that the reported salaries and benefits represented actual expenses and did not include elements of profit distribution. In addition, owners' compensation (as reported by 50 percent of the respondents) represents less than 0.5 percent of the salaries and benefits costs incurred by all the surveyed companies. As discussed previously, the information obtained from the survey data was not audited nor subject to other verification procedures. Ernst & Young contacted companies that had over 25 locations and did not report owners compensation. It was determined that these companies either did not employ owners, or were owned by an independent third party.

Non-recurring expenses: Ernst & Young asked respondents to identify non-recurring expenses that should not be allocated to the PDA business. Costs in this category included items such as location closing expenses. Ernst & Young excluded these costs from the calculations.

2. Cost of loan and supplementary capital

The cost of loan and supplementary (e.g., cash reserves) capital is defined as the opportunity cost of funds to the lender. These costs are comprised of the cost of capital for the value of the loan, the cost of carrying fixed assets, and the cost of carrying cash reserves necessary to ensure that money is available when the customer requests a loan.

The funds required for loan and supplementary capital are borrowed by certain Payday lenders. To capture the cost of borrowing, Ernst & Young must determine an interest rate on this capital. Other Payday lenders use equity and retained earnings to provide PDAs. A suitable rate of return on equity should reflect the opportunity cost of using that capital for PDA, instead of using it on the next best (investment) alternative. To estimate an appropriate return on equity and the representative rate on corporate

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borrowing for the surveyed companies, Ernst & Young accessed Bloomberg to obtain publicly available data on the cost of equity of five multiline operators listed in the table below (see Table 3). Ernst & Young selected the median value of the range (i.e., 12 percent) as an appropriate (market determined) return on equity of the surveyed companies.

Table 3 Cost of equity and debt (interest rate percent) for major multiline Payday loan operators

Major Multiline Payday Loan Operators	Cost of Equity	Cost of Debt
Cash America (CSH)	12.40%	2.32%
EZCORP, Inc. (EZPW)	11%	2.19%
Dollar Financial (DLLR)	15.03%	2.22%
First Cash Financial Services (FCFS)	9.87%	2.30%
Rent-A-Center (RCII)	12.56%	6.78%
Median	12.40%	2.30%

Source: Bloomberg

Cost of loan capital: Ernst & Young then calculated the cost of loan capital by multiplying the dollar value of the loans by the weighted average rate of the cost of capital (“WACC”). This weighted average rate is computed by the interest rate paid on corporate debt and the rate of return on equity in the business. The shareholders would expect to receive a reasonable rate of return on their equity (shareholder equity plus retained earnings) to cover the opportunity cost of providing these funds to the business. Accordingly, Ernst & Young used a benchmark to build the WACC for each company in the survey. More specifically, Ernst & Young used the median interest rate on equity (as disclosed by Bloomberg) from a sample of five public multiline operators, and similarly, Ernst & Young used the median interest rate on debt from the five operators. For a given company, Ernst & Young weighted the interest rates on equity and debt by the relative proportion of equity and long-term debt used to finance its business. Ernst & Young obtained the debt and equity amounts from the balance sheet information requested in the survey (capital stock, retained earnings and long term debt).

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For a given company, Ernst & Young calculated the rate of cost of capital as follows:

$$WACC = \left(\frac{\text{debt}}{\text{total corporate capital}} * i \right) + \left(\frac{\text{shareholder equity} + \text{retained earnings}}{\text{total corporate capital}} * r \right)$$

for i = interest rate on company debt (2%)

r = opportunity cost of equity (12%)

$\text{total corporate capital} = \text{debt} + \text{shareholder equity} + \text{retained earnings}$

Ernst & Young estimated the total cost of loan capital as follows:

$$\text{cost of loan capital} = \text{volume of loans}(\$) * WACC * \frac{\text{average maturity of good loans}}{365}$$

Cost of supplementary capital: A location requires cash balances and fixed assets to support its PDA activity. Therefore, a location needs funds for the principal amount of the loan as well as cash on hand for the loan business, and fixed assets.

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

3. Bad debt cost

Ernst & Young was unable to identify a standard approach for defining a 'bad debt' for PDA. Some lenders designate a debt as "bad" at the time it is in default, (e.g., when the borrower's check is returned). Others may carry these loans as "returned checks" for up to two years. For purposes of this study, Ernst & Young defined a bad debt as a debt that is never collected. More specifically, respondents provided the total value of defaulted PDAs and the total value of defaulted PDAs collected. The difference between these two values represents the bad debt for PDAs. This method of calculating the bad debt is preferred over a revenue allocation of the provision for loan losses because the provision for loan losses represents both bad debts and the company's estimate of future bad debt.

B. Cost per \$100 loan

This section details the results of the cost analysis based on the data of the E&Y survey. The section is organized as follows. The first part of the section contains the estimates of the cost per \$100 loan and details the multiple components of such cost. The second part describes the cost structure of a multiline location offering the PDA based on the survey results. Summary statistics of the E&Y survey locations are presented below.

Table 4 Survey loan statistics - Total and per store average

	Total <i>(All Respondents)</i>	Per Store <i>(store-weighted average)</i>
Number of stores	2,687	
Dollar volume of loans issued in the most recent fiscal year	3,149,428,780	1,172,099
Number of loans issued in most recent fiscal year	8,309,693	3,093
Average loan size	379	379
Total value of loans defaulted	337,916,864	125,760
Defaulted loans as a percentage of total loans (before recoveries)	10.73%	10.73%
Total value of defaulted loans collected	223,384,245	83,135
Collected loans as a percentage of defaulted loans	66.11%	66.11%
Defaulted loans that were never collected	114,532,619	42,625
Bad debts as a percentage of total loans issued (after recoveries)	3.64%	3.64%

Using the methodology presented in the previous section and following FiSCA leadership direction, Ernst & Young calculated the store-weighted average cost per \$100 loan using the number of locations owned by the surveyed companies as weights. Although other weighting approaches could be undertaken, the FiSCA leadership team believes that the store-weighted approach is the most relevant. Accordingly, Ernst & Young has been directed to use the store weighted approach for compilation purposes.

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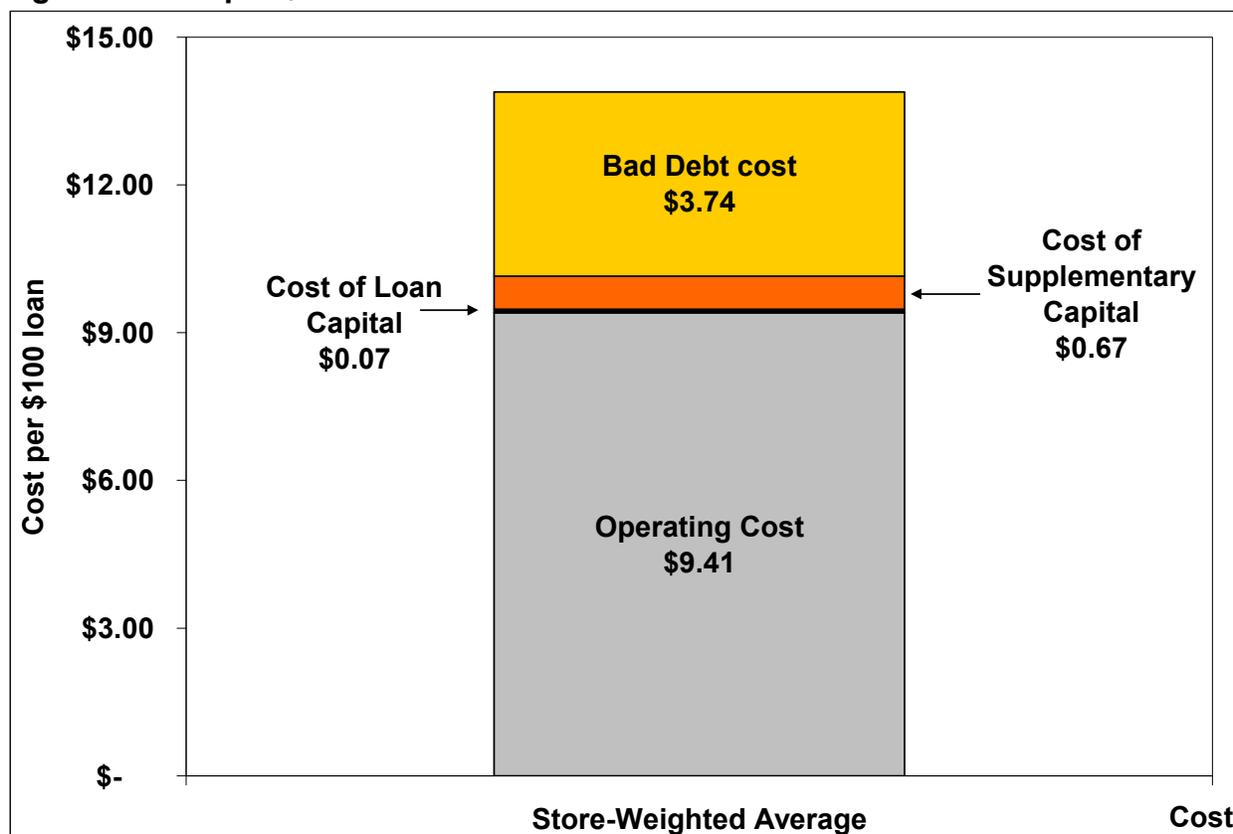
The table below depicts the cost of providing a \$100 PDA.

Table 5 Cost per \$100 PDA

	Store-Weighted Average
Total Operating Cost	\$ 9.41
Total Cost of Loan Capital	\$ 0.07
Total Cost Supplementary Capital	\$ 0.67
Total Bad Debt Cost	\$ 3.74
Total Cost	\$ 13.89

The store-weighted average cost of providing a PDA for the Ernst & Young surveyed companies is \$13.89 per \$100 loan during fiscal year 2008. As depicted above, operating costs are by far the largest cost component, representing over 67 percent of total costs. The cost of loan and supplementary capital are the smallest components of the total cost, accounting for approximately 6 percent, while bad debt costs accounts for the remaining 27 percent.

Figure 1 Cost per \$100 loan



In the survey the store-weighted average operating cost (among responding companies) per \$100 loan equaled \$9.41. The store-weighted average cost of loan capital equaled \$0.07; and, the store-weighted average cost of supplementary capital equaled \$0.67 per \$100 loaned. The store-weighted average bad debt costs equaled \$3.74 per \$100 loaned. The store-weighted average total cost per \$100 loan equaled \$13.89.

After estimating the cost of providing a \$100 PDA, Ernst & Young analyzed the cost structure of multiline operators offering PDAs. Table 6 below provides detail on the costs for an average multiline location, stated as a percentage of total costs. These percentages are based on store-weighted average calculations for each expense item across surveyed companies. Operating costs have been categorized into three types: fixed costs (those which are not directly related to loan volumes), variable costs (those

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which are directly related to loan volumes), and “hybrid” costs (those which generally behave like fixed costs but may be related to loan volumes at certain thresholds).

Table 6 Breakdown of costs of providing PDAs (as a percentage of total costs)

	Store-Weighted Average
Fixed Operating Cost	
Rent	11.33%
Utilities	2.92%
Insurance	0.29%
Security	1.64%
Advertising	2.66%
Depreciation and amortization	4.66%
Corporate overhead	14.04%
Payments to affiliated companies	1.05%
Total fixed operating cost	38.58%
"Hybrid" operating cost	
Salaries and benefits	25.81%
Incentive plan expense	0.58%
Total hybrid operating cost	26.39%
Variable operating cost	
Bank service charges other than interest on loans and Credit checks	1.54%
Total Variable operating cost	1.54%
Total operating cost	66.51%
Cost of loan capital (fixed)	0.41%
Cost of supplementary capital (fixed)	3.41%
Bad debt cost (variable)	29.67%
Total Cost	100.00%

Fixed operating costs represent 39 percent of the total costs associated with PDA activities for an average multiline location in the E&Y survey. Within operating fixed costs, corporate overhead expense is the largest cost item accounting for 14 percent of total costs. Another large item is rent, which accounts for 11 percent of total costs. As previously discussed, corporate overhead expenses include costs directly attributable to the PDA business that do not result from operating a location, but from the overall operation of the company (corporate office). These costs include executive compensation, a range of services that would be provided by third parties to the

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locations absent central headquarter (for example, collection, call centers, IT, general counsel and human relations) and, regional headquarter. Ernst & Young conducted interviews with management of companies that contributed to 96 percent of the total overhead expenses of the survey. As discussed previously, the vast majority of these costs do appear to be actual operating costs (i.e., as noted in one of the interviews if these services – and associated costs – provided by corporate were not provided, then the operating entity would need to procure the ‘service’ from a third party provider or otherwise incur the necessary cost “in house”).

Salaries and benefits account for 26 percent of the total costs associated to PDA. Therefore, fixed and hybrid costs account for the majority of location operating expenses.

Bad debts are sizeable and constitute a large portion of the cost of providing Payday lending services in a multiline environment. The store-weighted average bad debt accounted for 30 percent of the total costs associated to PDA.

For the surveyed companies, bad debts (actually written-off) as a percentage of total loan volume ranged from 0.1 percent to 6 percent. The store-weighted average bad debts as a percentage of total loan volume equaled 4 percent. Defaulted loans (before recoveries and/or formal write off to Bad debt expense) as a percentage of total loan volume ranged from 1 percent to 42 percent. The store-weighted average of defaulted loans a percentage of total loan volume equaled 11 percent.

Table 7 Defaulted loans before recoveries and bad debt principal as a percent of total volume of Payday loans

	Store-Weighted Average
Defaulted loans as a percentage of total loans (before recoveries)	10.73%
Bad debts as a percentage of total loans (after recoveries)	3.64%

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Ernst & Young estimated the PDA revenue and costs of a typical location in the E&Y survey. The results are presented in Table 8.

Table 8 Volume, revenue and costs of an average E&Y survey respondent store

Representative Respondent Store	Store-Weighted Average
Annual Loan Volume per Store (\$)	1,172,099
Annual Loan Volume per Store (#)	3,093
Pro Forma payday loan revenue per store	170,805
Rent	
Rent	16,280
Utilities	4,193
Insurance	411
Security	2,352
Advertising	3,819
Depreciation and amortization	6,698
Corporate overhead	20,171
Payments to affiliated companies	1,507
Total fixed operating cost	55,431
Salaries and benefits	
Salaries and benefits	37,093
Incentive plan expense	829
Total hybrid operating cost	37,922
Bank service charges other than interest on loans and Credit checks	
Bank service charges other than interest on loans and Credit checks	2,213
Total Variable operating cost	2,213
Total Operating Cost	95,566
Cost of loan capital (fixed)	590
Cost of supplementary capital (fixed)	4,904
Bad debt cost (variable)	42,625
Total Cost	143,685
Profit	27,120

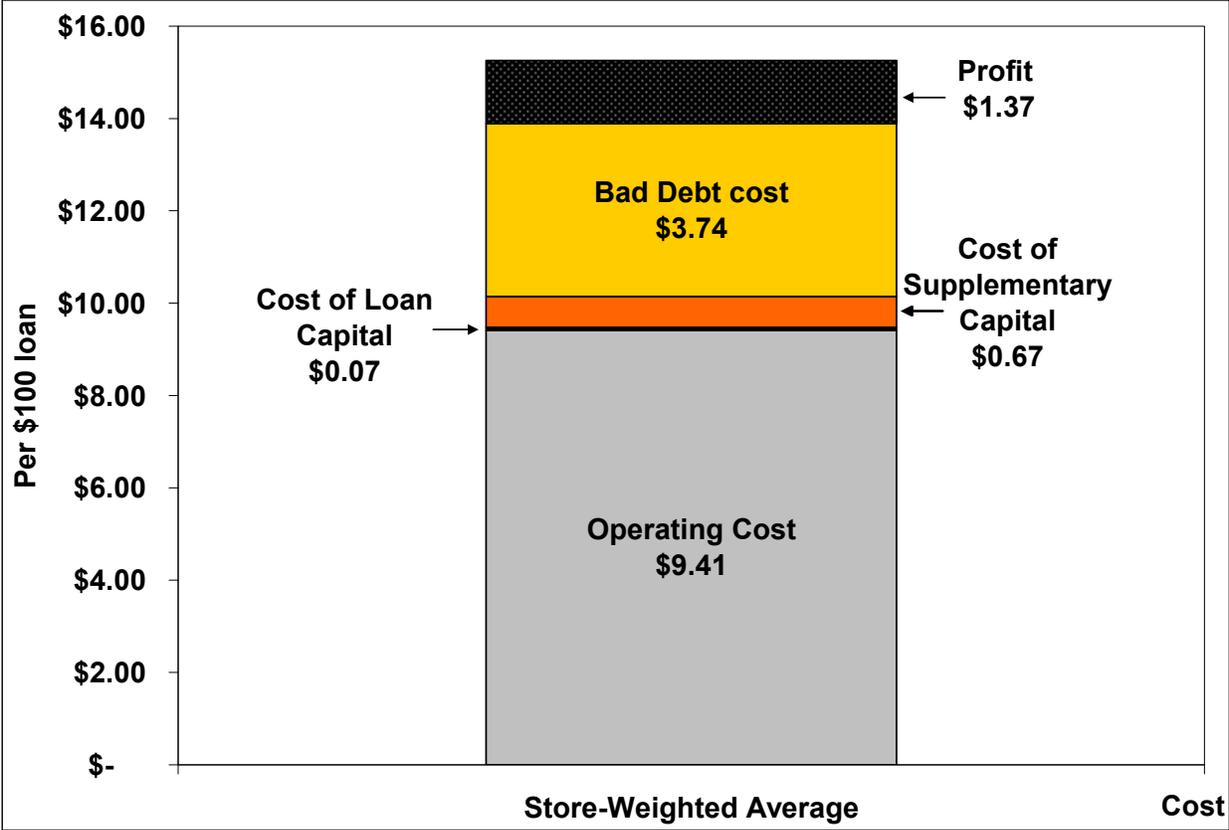
C. Profitability of PDA

Although the focus of the Ernst & Young study is to analyze the costs of providing PDAs in a multiline environment, Ernst & Young was able to perform calculations regarding the profitability of the PDA per \$100 and at the location level.

Companies in the E&Y survey earned a store-weighted average revenue equal to \$15.26 per \$100 PDA. Note these numbers involve no allocations because survey

respondents reported PDA revenue directly and thus are extracted directly from the survey. On a pre-tax basis, the average multiline operator in the survey earned a profit⁹ equal to \$1.37 (store-weighted average) per \$100 PDA.

Figure 2 Profitability per \$100 loan of the average E&Y survey respondent store



To assess the level of profitability on a \$100 PDA for the surveyed companies, Ernst & Young used two profit level indicators (on a pre-tax basis): Markup on Total Costs (MOTC) and Profit Margin. Ernst & Young calculated the MOTC as the ratio of profit¹⁰ to costs (including operating costs and bad debt costs (calculated as the difference between the total value of defaulted PDAs and the total value of defaulted PDAs collected)). The profit margin was the ratio of profit to revenue. The store-weighted average MOTC was equal to 16 percent and the store-weighted average pre-tax profit margin was equal to 14 percent.

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Because the average loan size in the E&Y survey equaled \$379, Ernst & Young calculated (on a pre-tax basis) the revenue, cost and profit for such loan. The following table summarizes the results.

Table 9 Revenue, cost and pre-tax profit for the average PDA of the E&Y survey respondent store

PDA revenue, cost and profit (pre-tax basis)			
	Store-Weighted Average		
	per \$100 loan		per \$379 loan
Revenue	\$	15.26	\$ 57.85
Operating Cost	\$	9.41	\$ 35.65
Cost of Loan Capital	\$	0.07	\$ 0.27
Cost of Supplementary Capital	\$	0.67	\$ 2.54
Bad Debt cost	\$	3.74	\$ 14.17
Loan Cost	\$	13.89	\$ 52.63
Profit (pre-tax)	\$	1.37	\$ 5.22

VI. Conclusions

FiSCA engaged Ernst & Young to prepare an independent and objective study on the costs of providing PDAs, as offered in a multiline (operators offering additional core services such as check cashing, money remittance, electronic bill payment) environment.

Ernst & Young prepared a detailed questionnaire that was submitted to FiSCA multiline member companies to gather financial information at the company level. Ernst & Young analyzed information for 2,687 locations representing 27 percent of the multiline PDA locations in the US.

Ernst & Young extracted the relevant financial survey information into a model to calculate the cost, by major component, of providing PDAs. Ernst & Young included in the cost base the following categories: operating costs (e.g., rent, utilities, insurance, salaries and benefits), bad debt cost, cost of loan capital and supplementary capital.

To understand the nature of the corporate overhead (and management fees) of the large companies, Ernst & Young conducted interviews with management to seek further clarification of these charges. Companies confirmed to Ernst & Young that the corporate overhead represented costs directly attributable to the PDA business, including for example, executive compensation, services that would be provided by third parties absent central headquarter (e.g., collection, call centers, IT, general counsel and human relations) and regional headquarter.

Using the financial data collected from the E&Y survey, Ernst & Young's analysis yielded the following results (all numbers are on a pre-tax basis):

- ▶ The store-weighted average revenue equaled \$15.26 per \$100 loan during fiscal year 2008.
- ▶ The store-weighted average cost equaled \$13.89 per \$100 loan during fiscal year 2008. The store-weighted average cost per \$100 loan includes bad debt cost equal

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to \$3.74 and operating costs equal to \$9.41. The remainder of the cost reflects the cost of loan capital and supplementary capital.

- ▶ On a pre-tax basis, the store-weighted average profit¹¹ equaled \$1.37 per \$100 loan issued.
- ▶ The PDA is a core service line among the surveyed locations and it generated approximately 51 percent of their total revenue.

Appendix A: E&Y survey

Ernst & Young LLP

Survey for PayDay Loan Providers

INSTRUCTIONS

Please answer all the questions provided on the following worksheets.
To move between the pages use the 'Back' and 'Next' buttons located at the top of the screen.
Please complete one questionnaire for each Company with operations in the U.S. Please provide financials on a GAAP basis.
For questions relating to payday loan balances, please report the principal balance plus interest and fees.

CONTACT INFORMATION

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

Contact name:

Telephone number:

COMPANY STRUCTURE AND BUSINESS MIX

2. In which state(s) does the company covered in this survey provide payday loans?
Please identify any state that has payday loan and/or check cashing services regulated by adding an asterisk (*) next to it.

- 3a. Please indicate if you are a parent company or a non-parent company. For companies that operate multiple entities under affiliated ownership interest and will be submitting multiple surveys for each such entity, indicate here that this entity is a non-parent; and in 3b. indicate the name of the parent to which it is affiliated so we can appropriately identify affiliated companies.

Parent

Non-parent

- 3b. If applicable, please list the parent company to which you are associated.

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

- Check cashing
 Money transfers
 Collateral/pawn loans
 Title loans
 Installment loans
 Tax preparation/discounting
 Money orders
 Utility bill payment
 Prepaid phone
 Lottery
 Other (please specify below)
 Card services/debit cards

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

	FY 2008	FY 2007	FY 2006
Company-operated stores	[]	[]	[]
Franchised stores*	[]	[]	[]
Total (calculated)	-	-	-

* Only for franchisors during 2008

6. Do you act as a direct lender for payday loans or as a broker for loans provided by a bank or other third party?

- As a direct lender
 As broker

7. What is the legal structure of your business?

- Unincorporated proprietorship
 Incorporated private company
 Limited Liability Company (LLC)
 Partnership (incl. LLP)
 Public company
 Other (please specify below)

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8. How many employees do you have?

Full-time employees

OR

Total full-time equivalents*

Part-time employees

Total (calculated)

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

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

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BUSINESS ACTIVITY AND REVENUE RELATED TO PAYDAY LOANS

For the remainder of this survey, for questions relating to payday loan balances, please report the principal balance plus interest

10. What percentage of total payday loan revenue was derived from online payday loan services?

- 0 to 5% 6 to 10% 11 to 15% 16 to 20% More than 20%

OWNER COMPENSATION

The information in this section is required in order to normalize the profits of the business in the event that the company is using owner's compensation for taxation or other purposes. An individual is defined as an owner if he has least 10% ownership of the company. Please answer questions 11-12 with respect to the following:

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

11a. What is the amount of salaries, bonuses, compensation, etc. paid in total to the individuals listed above?

11b. What would the total amount reported in 11a. been had the individuals not been owners?

12a. How many individuals are included in 11a?

12b. For each one of these individuals provide an estimate of the total cumulative hours spent on the business in a typical week.

FINANCIAL STATEMENT INFORMATION

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

13. Please indicate whether your financial statements are: (check only one)

- Audited Provided to a bank or another lender Neither

14. What is the date of the year-end for your most recent financial statements? (Month) / (Day) / (Year)
 / /

15. Please provide the total revenue and volume for payday lending and all other services for the last three (3) fiscal years. With respect to payday lending, please include revenues related to 3rd party lender interest (if applicable) and fees. If volume figures are not available for a line item please leave it blank.

	FY 2008		FY 2007		FY 2006	
	Revenue	Volume (\$)	Revenue	Volume (\$)	Revenue	Volume (\$)
Interest and fees on payday loans						
Check cashing						
Money transfer						
Collateral / pawn loans						
Title loans						
Installment loans						
Tax preparation / discounting						
Money orders						
Utility bill payment						
Prepaid phone cards						
Lottery						
Card services / debit cards						
All other services (please specify below)						
<input type="text"/>						
<input type="text"/>						
<input type="text"/>						
Total Revenue/Volume	-	-	-	-	-	-

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16. Please provide a break-down of your company's expenses on a GAAP basis for your most recent fiscal year end. Please choose one of the following two methods for the payday lending related expenses only.

- Actuals Estimates

Please note, the last column will automatically populate. When available please provide actuals or estimates. If figures are not available for a line item, please leave it blank and the values within the last column will be used in the analysis.

<u>Store expenses</u>	<u>Total (all service lines)</u>	Percentage revenue attributed to payday lending	
		<u>Payday lending only</u>	<u>Payday lending only</u> <i>(Based on above percentage)</i>
Salaries and benefits			-
Incentive plan expense			-
Security (armored car service, alarm systems, etc.)			-
Rent			-
Utilities			-
Insurance			-
Credit checks			-
Bank service charges other than interest on loans			-
Franchise fees (if any)			-
Advertising			-
Depreciation and amortization			-
Goodwill amortization expense (if any)			-
Provision for loan losses, check losses collection and doubtful accounts			-
Interest			-
Taxes (e.g., income taxes, payroll taxes, state taxes, franchise taxes, etc.)			-
Franchise expenses (i.e. services to franchisees)			-
Other store expenses (please specify below)			-
			-
<u>Corporate expenses</u>			
Corporate overhead expenses			-
Payments to affiliated companies (e.g. management fees, royalties, etc.) in excess of corporate overhead (please specify below)			-
			-
Other corporate or non-recurring expenses (please specify below)			-
			-
Total Expenses (calculated)	-	-	-

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17. Please provide a break-down of your company's assets. For accounts receivable - payday loans, please provide figures for the last three fiscal years. For the remaining line items, please provide figures from your most recent fiscal year end.

	FY 2008	FY 2007	FY 2006
Cash			
Accounts receivable - payday loans (principal plus interest and fees)			
Accounts receivable - installment loans			
Accounts receivable - other			
Pre-paids			
Inventory			
Net fixed assets			
Other (please specify below)			
<u>Total assets (calculated)</u>			

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

Accounts payable	
Accrued expenses	
Loans payable short term	
Bank debt short term	
Other payables	
Intercompany liabilities	
Long-term debt	
Shareholder loans	
Other (please specify below)	
<u>Total liabilities (calculated)</u>	

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

Capital stock/paid-in capital		
Retained earnings		
Net income for the year		
Other (please specify below)		
<u>Total equity (calculated)</u>	<u>-</u>	<u>(Total Assets - Total Liability)</u> <u>-</u>

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

Description	Amount
	<u>-</u>

FINANCING/CAPITAL SOURCES

21a. For any debt held by the company (e.g. line of credit, term loans, leases, shareholder loans, available information on ratings for bonds issued, etc.) and other capital sources (e.g. common shares, preferred shares, convertible debt) provided by third parties or affiliates, please describe the source of the funds and the cost including interest rates, fees, dividend payments, etc. If you are a private company, please enter your book value for common and/or preferred stock as listed on the financial statement.

Capital source	Amount	Cost*	Description of terms*
		<i>(e.g. 6%)</i>	<i>(e.g. 6% or prime rate + 1%)</i>

**If the financing cost is a market rate plus an additional interest rate, then input as follows: Cost = [additional interest rate] & Description of terms = [market rate] + [additional interest rate].*

21b. If the company is a public company, please provide an estimate of the Beta.

Beta value

21c. Is the Beta provided above based on pre-tax financials?

Yes No

PRODUCT LINE ACTIVITY

22. What is the average initial term (number of days) for payday loans (i.e., excluding rollovers/extensions and re-writes)?

days

23. Please provide the total number of payday loans issued during your most recent fiscal year.

Number of loans issued

24. Of the total loans in question 23, what is the total number and value of payday loans issued through your internet operations (if applicable)?

Number of loans issued online Total value of loans issued online

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RETURNED CHECKS AND UNRECOVERABLE DEBTS

25a. Of the total loans issued in question 23, what is the total number and value of payday loans that went into default (e.g., check returned NSF or failed pre-authorized debit transaction)?

Number of loans defaulted Total value of loans defaulted

25b. Of the above number of defaulted loans, what is the number and value of loans that were collected, even if just partially collected?

Number of defaulted loans collected Total value of defaulted loans collected

26. What percentage of the defaulted payday loans in question 25 were ultimately recovered/collected?

Within 30 days? % 31 to 60 days? % 61 to 90 days? %

Greater than 90 days? % Never recovered? % Unknown

27. For loans fully recovered within 90 days, on average, how many days do you estimate that it typically takes to collect on defaulted payday loans?

days

28a. For financial accounting purposes, do you write off payday loans in default at the time checks/pre-authorized debits are returned as NSF?

Yes No

28b. If you answered NO to question 31a, how many days after the checks/pre-authorized debits are returned do you write them off as bad debts?

days No policy

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FEE STRUCTURE

29. Please describe the fee structure (per \$100 in payday loans) for each of the following (as applicable). In addition, if the company operates in a state where there is a fee cap for the provision of any of the services listed below, please specify the cap.

	Fee cap		Your rate		Comments
	(Fixed fee)	(Percent)	(Fixed fee)	(Percent)	
Payday loans					
Rollovers/extensions or re-writes					
Default charges including NSF checks					
Interest and other charges on defaulted loans					
Optional insurance charges					
Fees for cashing checks to redeem a payday loan					

ADDITIONAL SPACE

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

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Appendix B: References

Ernst & Young, *The Cost of Providing Payday Loans in Ontario*, January 24, 2009

Krejcie, R. and Morgan, D.W., *Determining Sample Size for Research Activities*, Educational and Psychological Measurement, #30, pp. 607-610, 1970.

Market Research, *Consumer Finance*, March 23, 2009

Morgan, P., *Defining and Detecting Predatory Lending*, Federal Reserve Bank of New York, Staff Report no. 273, January 2007

Morgan, D. P. and Strain, M. R., *Payday Holiday: How Households Fare after Payday Credit Bans*, Federal Reserve Bank of New York - Staff Report no. 309, November 2007

Stephens Inc., *Present and Future of the PDA Industry*, March 5, 2009

Stephens Inc., *Payday Loan Industry Report*, March 27, 2007

End Notes

¹ This cost includes the cost of loan capital and the cost of supplementary capital. These cost items reflect normal return to investors for supplied capital. This calculation has been performed in other studies of the industry. The calculation of “profit” presented in Table 1 takes into account both of these “costs” as well.

² The total loan cost is comprised of bad debt cost, operating cost, cost of loan capital, and cost of supplementary capital.

³ This profit was calculated for a \$100 Payday loan as *revenue minus operating cost minus bad debt cost minus cost of supplementary capital minus cost of loan capital*.

⁴ Ernst & Young requested respondents to provide, if available, their own estimates of costs associated to the PDA product. A total of 25 percent of respondents were able to provide their own estimates. When such information was unavailable, Ernst & Young apportioned total costs of the company (to derive the estimated cost of the PDA product) using the revenue (as a percent of total company revenue) derived from PDA activity as an allocation key. Of those 25 percent of respondents that provided their own estimates, approximately 8 percent only provided payday lending figures and therefore an allocation key could not be built, another 8 percent of respondents provided estimates that were similar to the estimates yielded by the allocation key, and the remaining 8 percent of respondents provided estimates that allocated a smaller portion of their total costs to the PDA product than the allocation key.

⁵ See FiSCA’s website (www.fisca.org).

⁶ Stephens Inc. is a full-service, privately owned investment bank headquartered in Little Rock, Arkansas with offices throughout the US as well as in London. They provide their clients with an array of financial and investment banking services (<http://www.stephens.com/>).

⁷ Morgan, P., Defining and Detecting Predatory Lending, Federal Reserve Bank of New York, Staff Report no. 273, January 2007.

⁸ According to Stephens Inc. (2009) during 2008, Payday lenders in the US extended 120 million PDAs with a total value of \$42.1 billion. Therefore, the average loan size was (\$42.1 billion / 120 million) = \$350.83.

⁹ This profit was calculated for a \$100 Payday loan as *revenue minus operating cost minus bad debt cost minus cost of supplementary capital minus cost of loan capital*.

¹⁰ This profit was calculated for a \$100 Payday loan as *revenue minus operating cost minus bad debt cost*.

¹¹ This profit was calculated for a \$100 PDA as *revenue minus operating cost minus bad debt cost minus cost of supplementary capital minus cost of loan capital*.