VIEWPOINTS

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Payday Lending: Does Regulation Depend on Which Party Holds Power?

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When a borrower receives a so-called "payday loan," he or she writes a check that is postdated to the next payday or signs over permission for the lender to make an electronic withdrawal of the amount borrowed, plus fees, on that day. Converting these fees into interest rates yield very high rates, reaching levels often considered outrageous or unethical. Indeed, in states where payday lenders are permitted to operate, the typical rate on a $300 payday loan, when annualized, can easily exceed several hundred percent. And individuals collectively spend $9 billion annually on payday loan fees.

Many critics allege that payday lenders set up shop in specific neighborhoods expressly to engage in predatory lending to ethnic minorities or low-income and less-educated people. Lenders do not perform an analysis of whether a borrower can afford the loan. Rather, they automatically gain access to funds from the borrower's bank account the day the loan is due.

The organization representing the industry, the Community Financial Services Association of America, has said that a payday loan would have to roll over every two weeks for a full year to reach the highest rates, and that "state laws and industry best practices simply do not allow this to happen." However, a Pew Research Center study found that the small minority of borrowers who regularly roll over their loans account for the majority of payday lenders' profits. The association also notes that its members are filling a market niche since commercial banks and credit unions do not sufficiently reach out to these potential customers, either due to their own decisions or their regulators' policies. In the absence of payday loans, the industry argues, borrowers would fall prey to loan sharks and riskier forms of credit, such as auto title loans. These often carry even higher interest rates and may involve the forfeiture of one's car, potentially impairing the borrower's ability to earn income.

In an attempt to address both sides of the issue, the federal Consumer Financial Protection Bureau (CFPB) proposed for comment new rules in March 2015. While recognizing the need for affordable credit, including payday loans, the CFPB expressed concern about the "long-term debt traps" found in short-term credit products. The rules would require that payday lenders verify borrowers' ability to afford the debt and offer repayment options in some cases.

When industry practices generate such high-profile controversy that the state or federal government intervenes, politicians are sure to join the fray. After all, they too have the power to legislate industry behavior. When it comes to regulating business, people tend to expect decision-making to follow party affiliation, with Democrats and Republicans on opposite sides of the fence. In reference to payday lenders, many would expect Democrat-controlled states to impose more restrictions on the industry, perhaps even ban it, while Republican-controlled states might support loosening regulations and even allowing payday lenders to enter the financial marketplace nationwide.

Given the heightened focus on the two parties during the presidential campaign and the controversy surrounding the payday lending industry, it seems appropriate to examine the validity of these assumptions. We can begin to draw a picture of the situation by noting the states in which one party controls both the governorship and legislature and whether the practice is legal or banned. (Most states held elections in November 2014.)

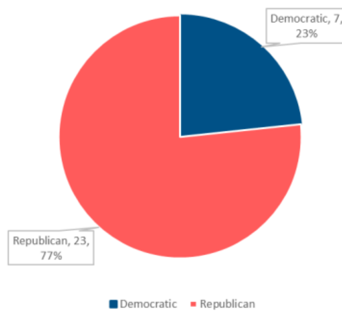
We find that one party controls both the governorship and legislature in 30 states, with Republicans dominating, 23-7. It seems reasonable to assume that in these states, the party in power can determine the degree of regulatory stringency imposed on payday lenders, though in states where control recently changed, the issue may not yet have been addressed. As shown in Figure 1, five of those states (not including the District of Columbia) have prohibited payday lending. And in four of these five, Republicans are in control. Democrats hold sway in only one state, which may surprise some observers. (Note that 10 states and the District of Columbia ban payday lending, while 40 states do not.)

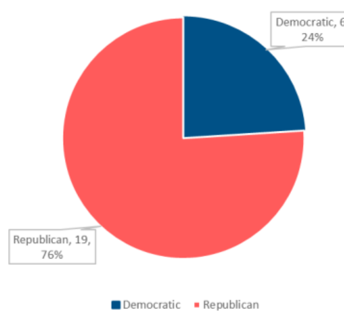
In 19 of the remaining 25 states under single-party control, payday lending is legal, and Republicans hold both the governorship and legislature, while Democrats hold control in six. However, an analysis of the data reveals no significant correlation between the legal status of payday lending and whether states are Democratic or Republican controlled, in part due to the small sample of states governed by Democrats.

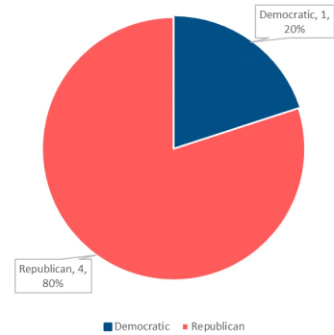
The story changes, however, when one digs deeper to consider who was in charge when payday lending was banned. The practice is prohibited in 10 states, but so far we have looked at the five whose government is controlled by one party.

It turns out that in eight of the 10 states, Democrats were in charge of both the governorship and the legislature when the laws were changed to prohibit payday lenders; Republicans were in charge in one state (neither party was in control in Georgia). This finding may be more consistent with expectations based on perceived differences between the political parties regarding government intervention in the private sector. Furthermore, in both Georgia and North Carolina—where Republicans are now in control—some believe there may be an effort to lift the bans. This too would seem to comport with perceptions of the parties.

Figure 1: Legal Status of Payday Lending and Political Party in Control



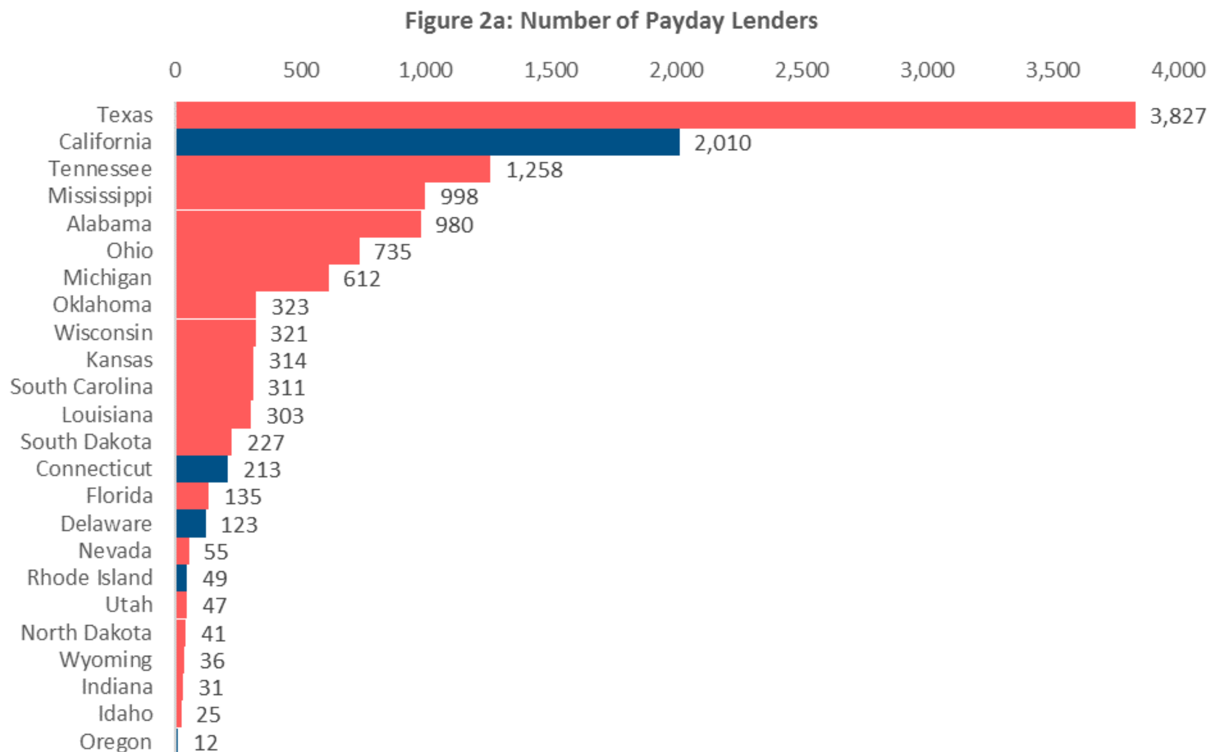


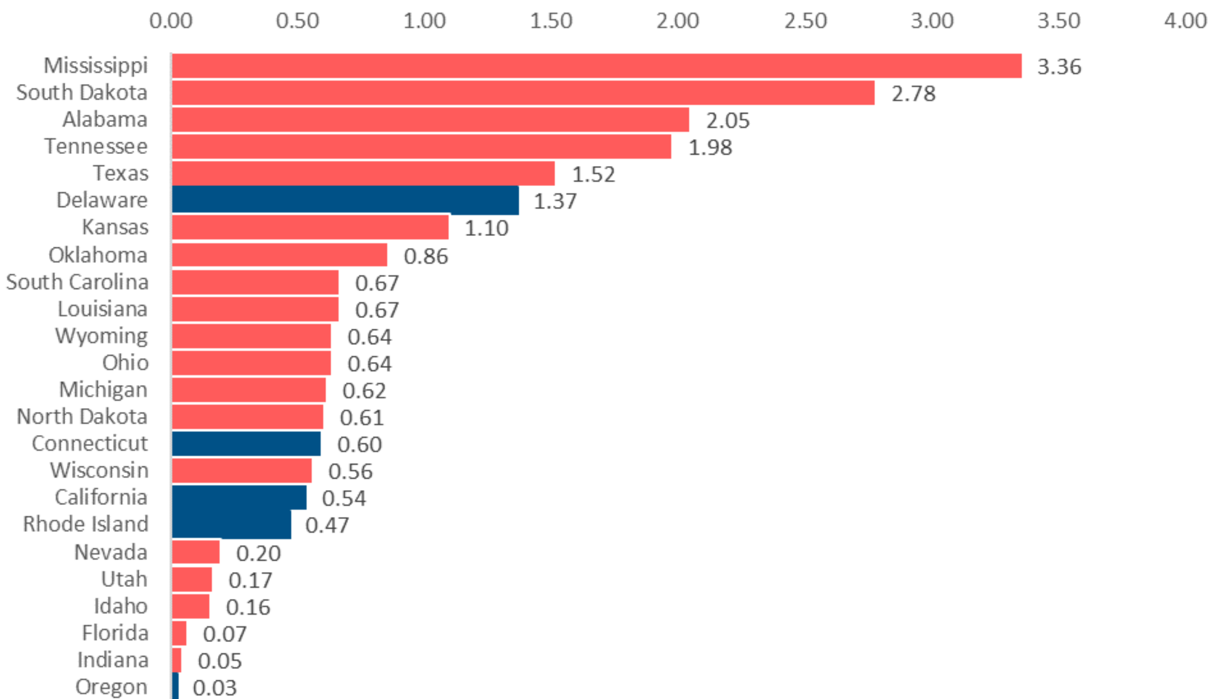


Source: Milken Institute.

Figures 2a and 2b rank the 25 Democratic- and Republican-controlled states by the number of payday lenders and the number of payday lenders per 10,000 population (no data exist on the number of firms for Hawaii). Note that the Democratic (blue) states don't all fall at the bottom in either figure. Conversely, the Republican (red) states don't all rank near the top. It is important to note that we find no significant correlations between the number of payday lenders, or the number of payday lenders per 10,000 population, and whether Democrats or Republicans are in control (in part because of the small number of blue states).

Figure 2: Number of Payday Lenders in States Controlled by One Party



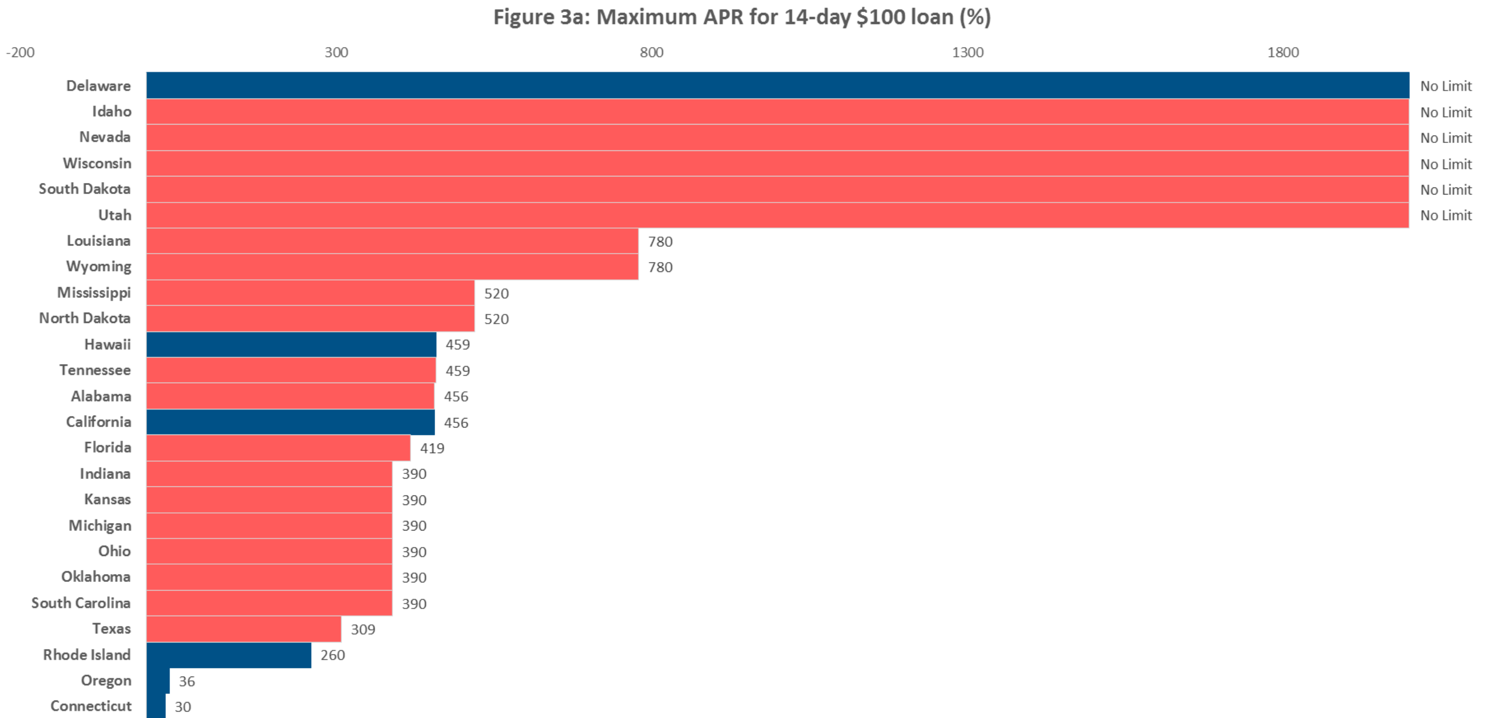


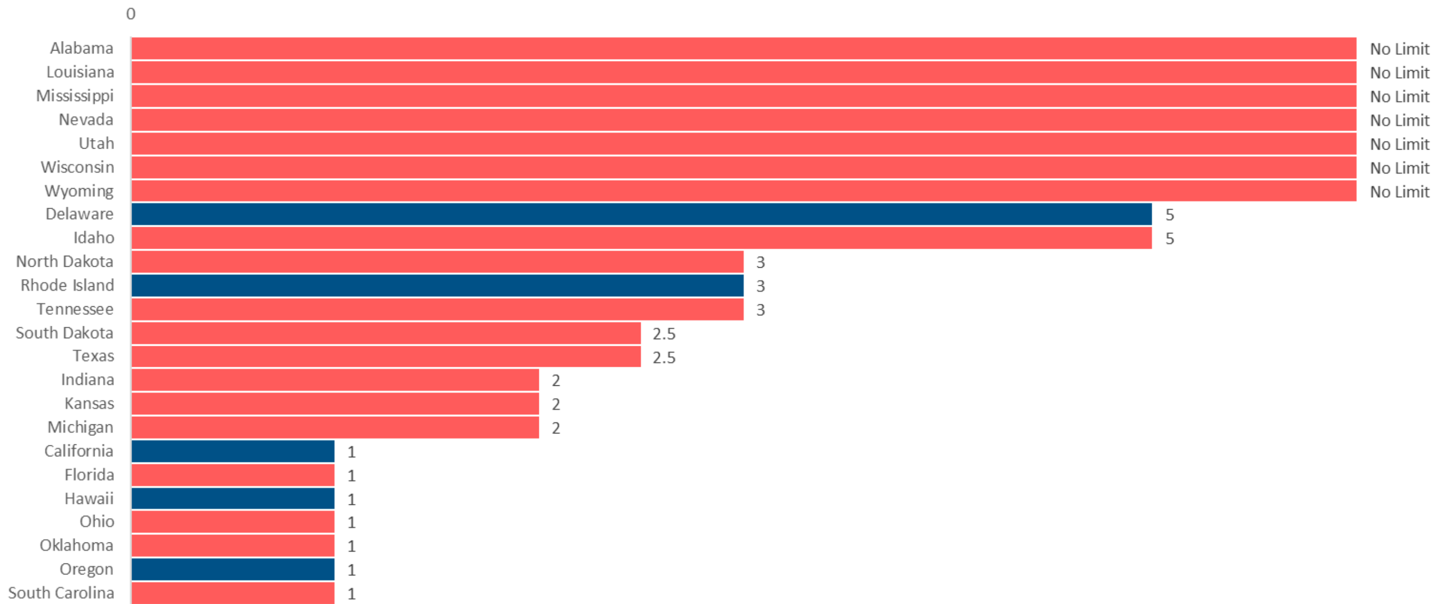
Source: Milken Institute.

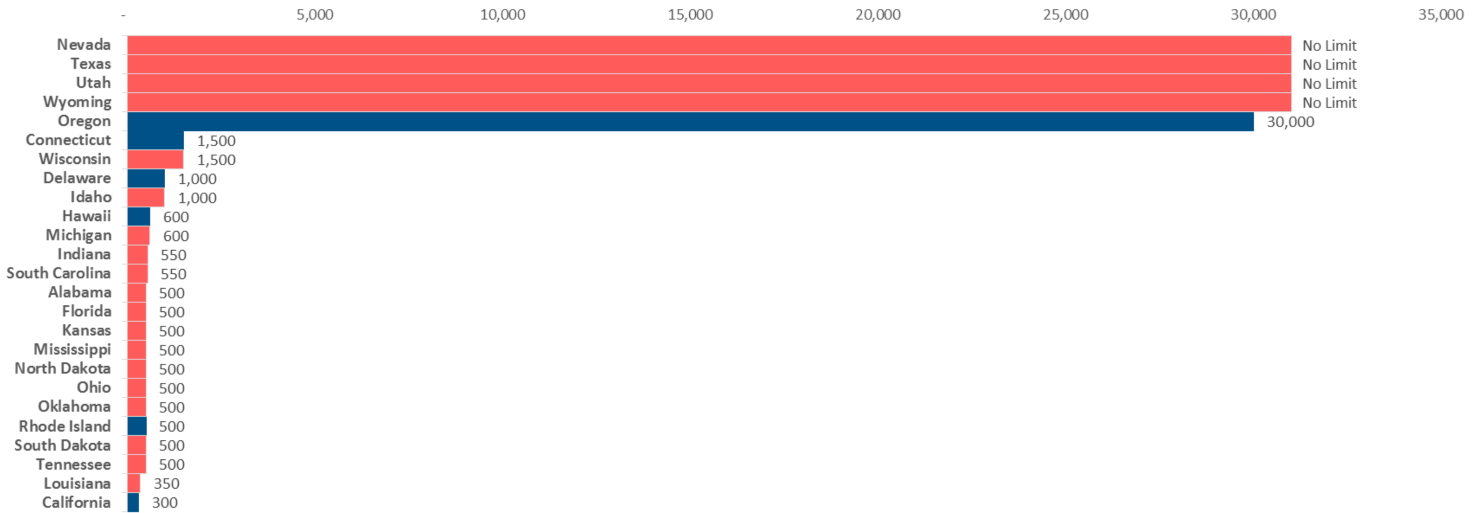
In the 25 states that are under the control of one party and where payday lending is legal, regulations target four primary areas: (1) the maximum annualized percentage rate (APR) for a 14-day $100 loan (2) a maximum loan amount (3) a maximum number of outstanding loans at one time, and (4) a maximum number of rollovers or renewals of loans. The stringency of the regulation varies fairly widely across states. (For more information on regulatory data, see James R. Barth, Jitka Hilliard, John S. Jahera, Jr., and Yanfei Sun, "Do State Regulations Affect Payday Lender Concentration?" forthcoming in "Regulating Consumer Credit," a special issue of the *Journal of Economics and Business*.)

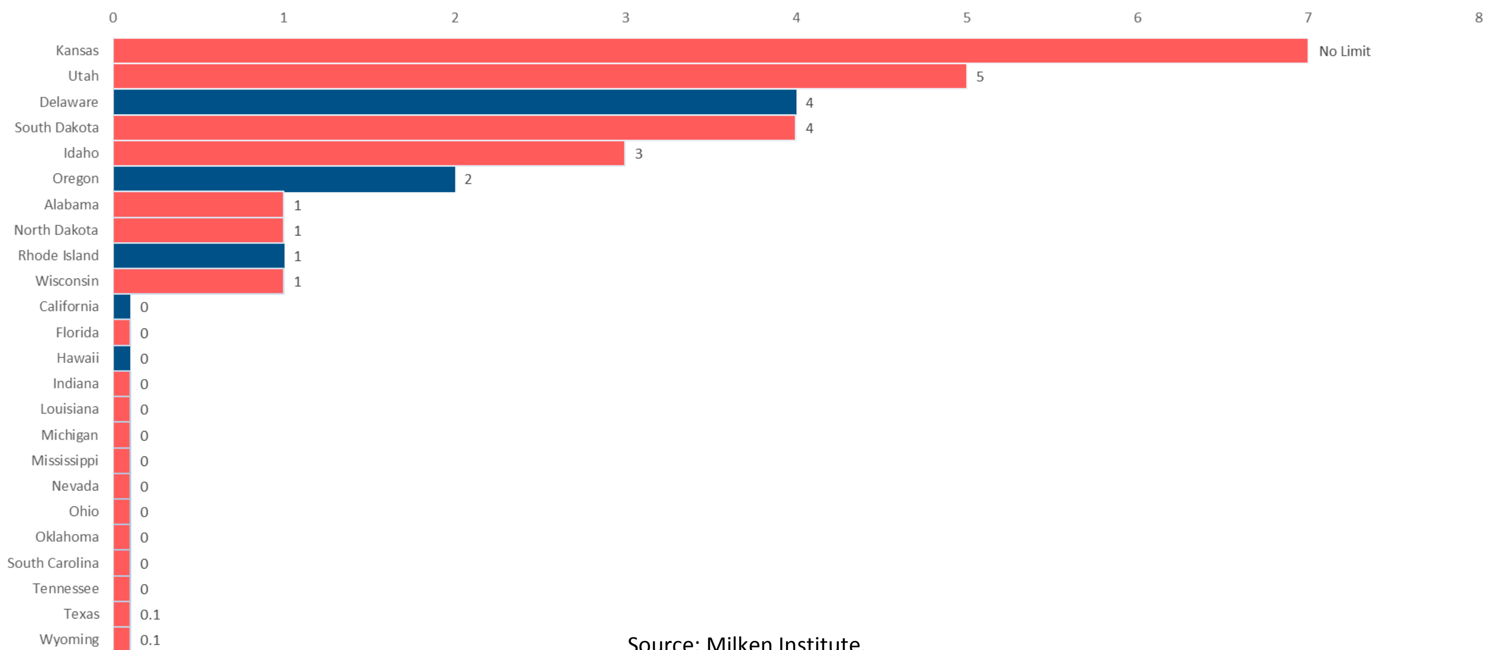
Figures 3a. through 3d. show the states ranked according to the leniency of their payday loan regulations (information is available for Hawaii, but not for Connecticut in 3b. and 3d.). Clearly, the most stringent states are not always Democratic-controlled, and the most lenient are not always Republican-controlled. In fact, no particular order is apparent in the distribution of blue and red states among the regulated areas. As a result, we find no significant correlations between regulatory stringency or leniency and the political party in control.

Figure 3: Regulatory Stringency in States Controlled by One Party







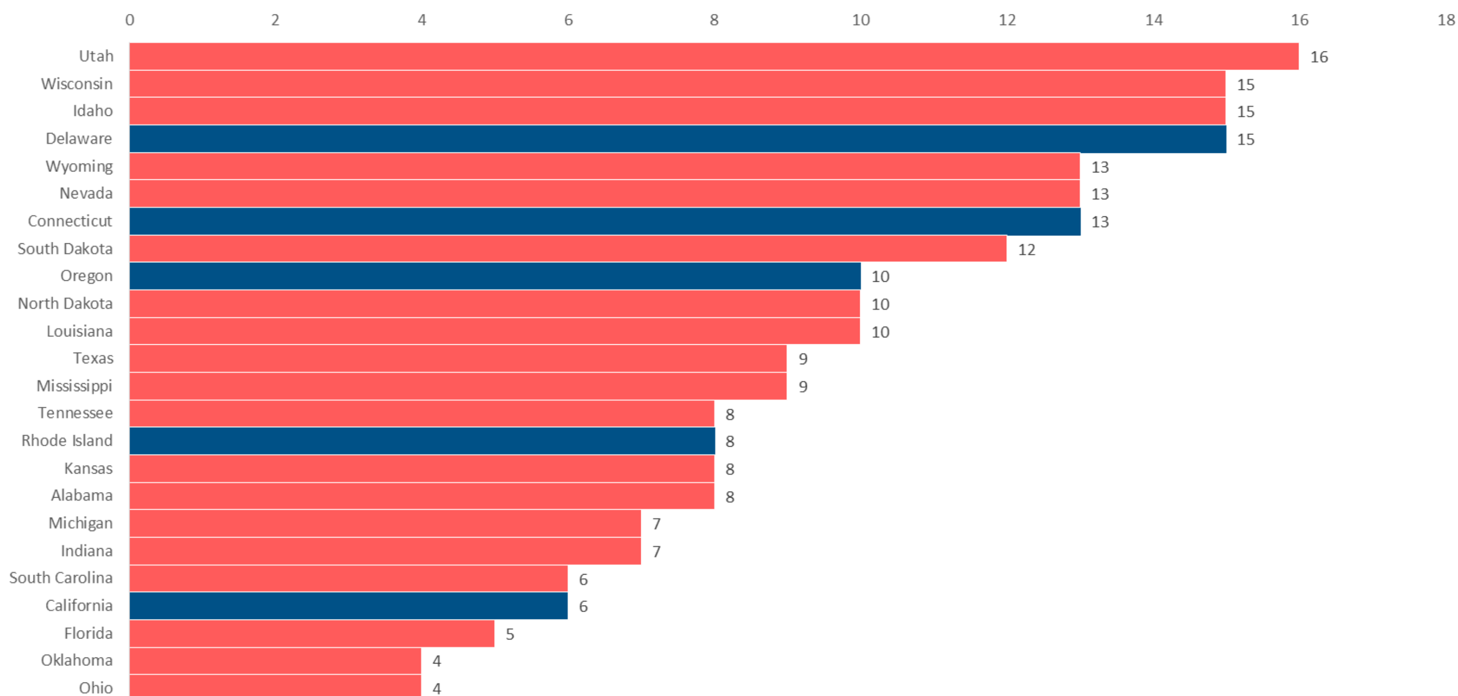


Source: Milken Institute.

Instead of examining each regulation, we built an index based on those four. (For information on the construction of the index, see James R. Barth, Jitka Hilliard, John S. Jahera, Jr., and Yanfei Sun, "Do State Regulations Affect Payday Lender Concentration?" forthcoming in "Regulating Consumer Credit," a special issue of the *Journal of Economics and Business*.)

Figure 4 shows whether states are led by Democrats or Republicans as well as the value of the index, with higher values indicating more lenient regulations. Once again, one can't conclude that Democratic states have the most lenient regulations or the converse for those under Republican control. As found previously, there is no significant correlation between the regulatory index and political party leadership, although again the small number of Democrat-controlled states partly drives this finding.

Figure 4: Overall Regulatory Stringency and Political Party Control



Source: Milken Institute.

To the extent that the parties are open to varied approaches to dealing with payday lending, it is at least possible that they can learn by looking at what is happening across the United States. Where some states (for example, Montana and New Hampshire) enacted low interest rate limits—in the range of 36 percent APR, for example—payday loan stores have disappeared altogether. But surprisingly, when states enact moderate interest rate limits—as happened in Colorado and Oregon—credit continues to be readily available to consumers.

Also, states such as Wisconsin, Missouri, and Texas—which allow lenders to charge very high interest rates, up to three to four times higher than in the lowest-cost states, or operate without rate limits—have the most payday loan firms and locations. Thus competition doesn't appear to bring prices down.

The payday loan industry maintains that there's good reason its loan rates are so high: These small operators spend up to two-thirds of their revenue to run their stores and they must pass that cost on to customers.

Banks and credit unions don't have this problem. They've already built out their branches and diversified their services. In fact, the top four banks in the U.S. have more locations than all payday lenders combined. They also don't need to spend heavily on customer acquisition.

This is why the CFPB has been identifying processes by which banks and credit unions can enter the short-term loan market as less-expensive alternatives. The agency's proposal is likely to shift the market

toward installment loans with smaller payments and make the process less costly for traditional lenders to provide loans that would otherwise be unprofitable.

The CFPB framework would allow loans that limit monthly installment payments to an affordable 5 percent of a borrower's monthly income and limit loan terms to six months. Banks could make these loans successfully because underwriting requirements would also be streamlined to reduce their cost. (However, if federal regulators such as the Office of the Comptroller of the Currency require banks to conduct full underwriting, then lending a few hundred dollars for a few months might be so expensive that banks would have to charge rates similar to those of payday lenders).

If banks are permitted to use the CFPB's streamlined procedures, the Pew Research Center estimates they could offer loans profitably at one-sixth the fees of payday lenders. That would put a remarkable amount of money back in the pockets of working Americans.

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