The effects of usury ceilings

Donna Vandenbrink

Regulations designed to prevent usury, or the taking of "excessive" interest, have been debated from the time of Moses. Today, as a result of a prolonged period of high inflation, record interest rates, and sluggish economic growth, the usury ceilings in effect in many states are the center of controversy. Are the critics of these usury ceilings simply speaking out of self-interest when they argue that interest rate ceilings work to consumers' disadvantage by restricting credit flows and distorting financial markets? Do usury ceilings protect consumers from abusive lending practices and enable them to obtain loans at reasonable rates, as their advocates claim?

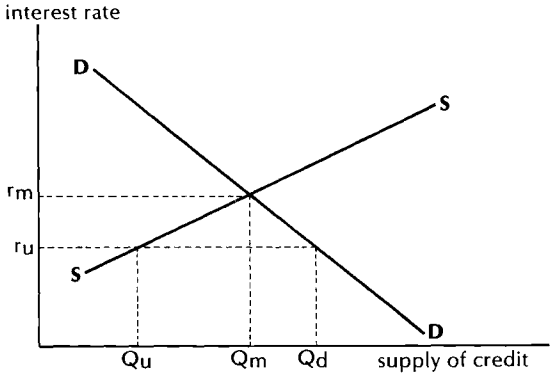
Recent legislation, at both the federal and state levels, has been in the direction of relaxing interest rate controls. The 1980 Depository Institutions Deregulation and Monetary Control Act overrode state interest ceilings on some categories of loans, and additional federal action may be forthcoming. At the same time, many state legislatures have revised their usury statutes. In large part, these recent changes in usury regulation have been in response to the current economic situation. But is deregulation of usury ceilings desirable? And if it is desirable, should it be left to the states or is it best accomplished by federal preemption? This article surveys the economic research on usury ceilings in order to help answer these questions.

Usury ceilings in a competitive market: the theoretical arguments

In economic theory, the credit market is viewed like any other market.[1] There are buyers (borrowers) and sellers (lenders) of credit; the price of credit is the interest rate. The credit market is easily represented in a conventional supply and demand diagram (see figure). The demand curve indicates the amount of credit borrowers are willing to purchase at various prices (interest rates). The supply curve indicates how lenders' marginal cost of funds varies with the amount of credit supplied and, thus, the amount of credit they are willing to grant at various interest rates, assuming the market is competitive. According to theory, borrowers and lenders will eventually establish an equilibrium in the market at a price which just balances the supply and demand for credit. We can call this price the market rate of interest. Such a rate is shown as r_m.

Usury laws stipulate a maximum rate of interest which lenders may legally charge. When a usury law is introduced, it may alter the way in which both price and quantity are determined in the credit market. Exactly what happens depends on the level of the usury ceiling relative to the market rate. When the legal ceiling is above the market rate of interest (r_m), the law has no effect at all. The

The effects of a binding usury ceiling



[1]For a simple theoretical treatment of usury ceilings see Chapter 9 in James Van Horne [25]. For a more advanced discussion see Rudolph C. Blitz and Millard F. Long [2].

market forces of supply and demand are unconstrained by the usury ceiling, and the equilibrium price and quantity of credit are unchanged. However, when the legal ceiling is below r_m, the regulation does affect the market outcome. Such a usury ceiling, like the rate r_u in the figure, is said to be binding or effective.[2] A binding ceiling obviously alters the price of credit—the ceiling rate becomes the rate of interest charged. Therefore, if the market rate r_m were considered too high, a usury ceiling of r_u would lower the rate of interest for those borrowers who were able to obtain credit.

However, establishing a lower-than-market interest rate by means of a usury ceiling will also bring about a decrease in the quantity of credit supplied. Given lenders' costs (as reflected in the supply curve shown in the figure), the most credit which they will provide when the interest rate is held down to r_u is Q_u. Therefore, the binding usury ceiling will lead to a reduction from Q_m to Q_u in the amount of credit supplied. Furthermore, in contrast to the situation in the unregulated market, this amount of credit will not satisfy all those who are willing to borrow at the ceiling price. The usury ceiling creates a situation of excess demand with borrowers seeking an amount of credit, Q_d, that exceeds the amount supplied by lenders, Q_u. Borrowers are prevented by the ceiling from bidding to obtain more credit and lenders will not provide any more credit at the legal maximum interest rate. Thus, at the legal ceiling price the reduced amount of credit must be rationed among borrowers by some means other than price.

The important implication of this straightforward supply-demand analysis is that usury laws can succeed in holding interest rates below their market levels only at the expense of reducing the supply of credit to borrowers.

The effect of usury ceilings on the quantity of credit supplied: the evidence

Potential borrowers would surely find it less than desirable if binding interest rate ceilings did have the predicted effect on the supply of credit. In order to test this predicted relationship and to measure its importance, investigators have examined a number of different credit markets.

Because commercial loans are usually exempt from state usury ceilings, there have not been many studies of the effects of usury ceilings on commercial lending. In one of the few such studies, Robert Keleher of the Federal Reserve Bank of Atlanta [9] determined that banks in Tennessee extended fewer commercial loans the further market interest rates rose above the state's 10 percent usury ceiling.[3]

More widely studied has been the mortgage market, where binding usury ceilings also have been found to have very restrictive effects on credit supplies. The Federal Reserve Bank of Minneapolis [3, 20] analyzed Minnesota's experience with an 8 percent usury ceiling on conventional home mortgages. In this case, the usury ceiling had a significant impact on the composition of mortgage credit even though the total volume of mortgage lending apparently was unaffected. The Minneapolis study found that when market rates climbed to between 9 and 10 percent in 1973-74, home financing in Minnesota shifted substantially from conventional mortgages that were subject to the ceiling to FHA or VA loans that were exempt from the ceiling. About 40 percent of all new mortgage loans issued in the state in late 1974 were FHA-insured, almost double the usual share, and conventional mortgages were virtually unavailable in the Twin Cities.

More formal analyses of the effect of

[2]What has happened in many states over the last decade is that for various economic reasons market interest rates have risen above what were initially nonbinding statutory ceilings. While the ceilings always existed, only recently have they begun to impinge on the market.

[3]The exceptions were loans to nondurable and durable manufacturing and loans to service industries. Keleher speculates that these loans were not adversely affected by the ceiling because of previous commitments, strong customer relationships, and nonprice rationing.

usury ceilings on the supply of mortgage credit were carried out by James Ostas [16], Philip Robins [19], and James McNulty [12]. Ostas and Robins approached the issue indirectly, looking at the impact of ceilings on home building rather than on mortgage lending. Ostas estimated that the number of authorized housing permits fell by 11 to 19 percent for every one percentage point that the market rate was above the usury ceiling. Robins found that for each percentage point by which market rates exceeded usury limits, single-family housing construction was reduced by 16 percent. Looking directly at mortgage lending, McNulty found that usury ceilings have an impact on the supply of credit even before the average market rate hits the ceiling. He estimated that as the average market rate rose from a point below, but still close to the ceiling, mortgage lending was lowered 7.5 to 12.5 percent for each 1 percentage point rise in the market rate relative to the ceiling.[4]

Usury ceilings appear to have some adverse effect on the supply of consumer credit as well. In a technical study for the National Commission on Consumer Finance (NCCF), Robert Shay [21] found that state usury ceilings had a small but statistically significant negative effect on the number of consumer loans extended. Each 1 percentage point decrease in the usury ceiling on small loans was associated with 18 fewer loans per 10,000 families.[5] In addition, Shay found that lower rate ceilings were associated with fewer new auto loans. However, he found no significant effect on the supply of credit to purchase other consumer goods (mobile homes, boats, aircraft, and recreational vehicles).

The Credit Research Center (CRC) at Purdue University has conducted several studies of usury ceilings and consumer credit. In one such study, Johnson and Sullivan [8] found that a 1977 change in Massachusetts law which lowered the usury ceiling on small loans was an important factor in the 12.5 percent drop in the amount of such loans outstanding in that state between 1975 and 1979.

In another study for the CRC, Richard Peterson [17] compared urban consumer credit markets in Arkansas, which had a 10 percent comprehensive usury ceiling, with similar credit markets in Illinois, Wisconsin, and Louisiana, which had less restrictive ceilings. Although he found that residents of Arkansas obtained as much (or more) credit overall as consumers in the other states studied, he also found that consumers in Arkansas obtained significantly less *cash* credit and more point-of-sale credit (retail credit and credit cards) than their counterparts in the states with less restrictive ceilings. Here, as in the Minnesota mortgage market, the usury ceiling apparently did not reduce the total supply of credit, but it did cause consumers to substitute one type of credit for another—and, importantly, the change in the mix of credit favored lenders rather than consumers. Merchants and dealers who issue point-of-sale credit can compensate for the reduced profitability of their credit operations by raising prices on the goods they sell.

Noninterest credit conditions: usury ceilings and credit rationing

Altogether, the empirical research on the effects of usury ceilings largely substantiates the argument that binding usury ceilings lead to a reduction in the amount of credit provided by lenders. But credit transactions involve a number of terms other than the interest rate. Usury ceilings determine the price that lenders can charge, but they do not constrain the other conditions that lenders may choose to offer. Faced with a bind usury ceiling, lenders may be expected alter these noninterest conditions in orde

[4]Despite finding this impact on the number of loans extended, McNulty did not find that Georgia's ceiling had a significant impact on housing construction. McNulty believed this was because Georgia's ceiling was only moderately, and briefly, restrictive during the period under study.

[5]Shay also found a positive but insignificant relationship between the dollar volume of loan extensions and usury ceilings. If the average size of each loan were to rise while the number of loans fell, the usury ceiling might not affect the total dollar volume of loans extended.

achieve a higher effective return on the smaller amount of credit they will offer. For example, by such means as strengthening loan terms, adjusting borrower-screening criteria, or increasing noninterest fees and charges, lenders may be able to skirt the impact of usury ceilings on their overall profitability. It is important to consider how these strategies affect the borrowing public.

As pointed out above, under binding usury ceilings borrowers demand more credit than lenders are willing to provide. This requires lenders to rely on nonprice means to allocate credit among potential borrowers. Many of the strategies lenders are likely to follow in this situation can be expected to concentrate the impact of usury ceilings on certain borrowers. For example, making loan terms more stringent reallocates credit away from those who are unable to afford larger down payments or the larger monthly payments necessitated by shorter maturities and higher minimum loan size. Determining credit-worthiness according to individual borrower characteristics rations credit away from high-risk consumers who might be willing to pay higher-than-ceiling rates. Finally, adding noninterest charges eliminates from the market those for whom these extra costs are too great.

By encouraging these lending practices, usury ceilings may fail to give consumers the protection and benefits which they were intended to provide. For example, usury laws may work against the goal of ensuring that credit is available to small, inexperienced borrowers. When lenders ration credit by some means other than price, small borrowers, low-income borrowers, and high-risk borrowers are likely to find it more difficult to obtain credit. Prime borrowers, on the other hand, may obtain even more credit than they would have at normal market interest rates. Furthermore, when lenders institute noninterest charges to compensate for interest rate ceilings, they effectively raise the cost of credit for the successful borrower. This means that, while a ceiling may reduce the explicit price of credit (the interest rate), it may not result in lower overall costs of borrowing even for those able to obtain loans. The noninterest charges also make it more complicated for customers to comprehend the total cost of borrowing and make it more difficult to make well-informed credit decisions.

These lending practices and their undesirable consequences may exist in the absence of interest rate ceilings. However, some empirical studies have found that the extent to which these devices are used is influenced by the restrictiveness of usury laws. Several studies have established that loan terms do become less favorable to borrowers when usury ceilings become more restrictive. For example, the Minneapolis Federal Reserve Bank [3, 20] found that during one period when Minnesota's ceiling on mortgage loans was binding, the average maturity of conventional mortgages in the Minneapolis-St. Paul SMSA fell significantly. The same study found that required down payments increased much more sharply in the Twin Cities compared with SMSAs not subject to binding usury ceilings. Similarly, according to the New York State Banking Department [10], down payment requirements increased and maximum maturities decreased during the 1974 credit crunch when market interest rates rose above New York's 8.5 percent ceiling on mortgage loans.

Phaup and Hinton [18] actually measured the magnitudes of the changes in noninterest mortgage terms due to New York's usury ceiling. Using data on new mortgage lending for single-family dwellings in Schenectady, New York for 1961 through 1976, they estimated that for each 1 percentage point the market rate rose above the usury ceiling, there was a 4 percent shortening of mortgage maturities and an 8 percent decline in loan-to-value ratios.[6]

Peterson's study [17] indicated that usury ceilings have similar impacts on noninterest loan terms in the consumer credit market.

[6]Ostas also found mortgage down payments were larger and maturities shorter, the more binding the usury ceiling. The maturity effect, however, was not statistically significant.

This study found that maturities of auto loans in Arkansas were shorter than in states with less restrictive usury laws. In addition, the average minimum size for personal loans at commercial banks and credit unions was 2.5 times larger in Arkansas than in other states covered by the study. Peterson found that Arkansas lenders charged higher fees for mortgage credit investigations and appraisal than did lenders in other states with less restrictive interest rate ceilings. Arkansas residents also paid higher charges for checking accounts and overdrafts. (Moreover, retailers faced bigger discounts and less desirable terms when selling their retail credit contracts to other creditors.)

Empirical research has also tended to confirm the expectation that the burden of usury ceilings falls unevenly on the borrowing public. The availability of credit to certain groups of borrowers appears to depend on the restrictiveness of usury ceilings. Peterson, for example, found that cash credit was significantly less available to low-income and high-risk borrowers when usury ceilings were more restrictive. The lowest income group and the three highest risk groups of consumers in Arkansas obtained a larger proportion of their credit from point-of-sale sources than in other states in the study with more liberal interest rate ceilings. In their study of the Schenectady, New York mortgage market, Phaup and Hinton [18] found that lower income areas felt the impact of usury regulations on mortgage lending activity more than other areas. They found that mortgage activity in census tracts of the lowest economic stratum was more sensitive to the usury ceiling and to noninterest credit terms than mortgage lending in tracts characterized by higher economic status. Johnson and Sullivan [8] found that Massachusetts' lowered ceiling had a greater impact on the availability of small regulated loans than of large ones, particularly at small, local finance companies. They concluded that less prosperous consumers who needed and could afford only small loans "were progressively excised from this portion of the legal cash loan market" (p. 14).

The survey data collected by the National Commission on Consumer Finance (NCCF) have been used in several studies of the impact of usury ceilings on consumer credit markets. Greer's [7] analysis showed that differences in finance company rejection rates were closely related to differences in state usury ceilings. The lower were rate ceilings, the higher was the rate of rejection for personal loan applicants. Greer concluded from this study that, with higher allowable interest rates, lenders are more willing to accept risky borrowers and, consequently, binding ceilings make it more difficult for riskier borrowers to obtain credit. Finally, using the same NCCF data, Shay [21] found additional evidence that high-risk borrowers are most affected by usury ceilings. Generally, higher-risk borrowers obtain credit through auto dealers and finance companies rather than banks. The fact that the higher rate ceilings specifically applicable to auto dealers and finance companies were found to be responsible for curtailed credit in the new auto and personal loan markets led Shay to conclude that the burden of the ceilings falls largely on those whose credit standing is weakest.

The broad conclusion that emerges from these empirical studies is that usury ceilings create a climate in which lenders are able to pursue practices unfavorable to some or all borrowers. On balance, usury ceilings appear to be a type of regulation whose benefits to borrowers are extremely questionable. The primary benefit is a lower-than-market interest rate. But, depending on lenders' actions, borrowers may end up facing higher noninterest credit charges and less favorable terms as a result of usury ceilings. Moreover, attached to the lower-interest benefit of usury ceilings is a direct cost to the borrowing public in the form of a reduced supply of credit. Furthermore, it is likely that the cost of restricted credit availability falls disproportionately on high-risk, low-income borrowers—those whom usury ceilings are usually designed to protect.

Thus far, usury ceilings have been discussed in terms of their effect on individual

borrowers. Usury ceilings also affect consumers and the economy in a more general way. This broader impact is a consequence of the particular way in which interest rate regulation has been implemented in the United States.

Diversity of usury ceilings. Since colonial times, the responsibility for regulating interest rates on credit has rested with the states. As credit markets have evolved since that time, states have developed complex sets of statutes which apply to specific types of lenders and specific types of credit, often with different limits depending on the size of the loan. As a result, there is great diversity in the coverage of interest rate ceilings within individual states.[7] Furthermore, there is also great diversity in ceiling rates and coverage across states.

These legal arrangements have important implications for the economic impact of usury ceilings. Lack of uniformity of limits and coverage means that some forms of credit are constrained by ceilings while others are not. Under these circumstances, lenders will want to shift their portfolios into loan categories which are not subject to binding ceilings.[8]

State-imposed usury laws establish interest rate ceilings on credit extended to borrowers within a particular state. But, since credit markets are not confined by state boundaries, lenders may find it more attractive to extend credit across state lines to borrowers in states which offer less constraining usury laws. Thus, interstate differences in limits and coverage will distort the geographic distribution of credit and alter the allocation of funds to credit-sensitive economic activities.

Many of the studies cited previously provide implicit support for the notion that the diversity of usury ceilings among states affects the geographic distribution of credit. Studies comparing loan volumes across states with different usury ceilings suggest also that credit availability varies among states depending on the restrictiveness of their usury ceilings.

A study by the staff of the New York State Banking Department [10] shows somewhat more directly how credit flows away from states with restrictive usury ceilings. The study found that during the period 1966 to 1974, when national mortgage market rates were almost continuously above New York's usury ceiling, savings and loans in New York increased their proportion of out-of-state mortgage holdings from 6.5 percent to over 18 percent. Over the same period, in-state conventional mortgage holdings by these institutions fell from 67 percent of total assets to 47 percent and from 75 percent of total mortgages to 57 percent. Clearly, New York State S&Ls responded to the ceiling which bound in-state conventional mortgage rates by increasing their relative holdings of uncovered loan categories, including out-of-state mortgages.[9]

In the long run, state differentials in usury ceilings may even influence the location of suppliers of credit and of credit-sensitive economic activities. Arkansas, which had a low, comprehensive 10 percent usury ceiling, provides several examples of the locational effects. There are no consumer finance

[7] A 1981 listing by the Financial Institutions Bureau of the Michigan State Department of Commerce contains 25 different loan categories subject to interest rate ceilings imposed by state law. The effective maximum rates ranged from 5 percent on personal loans by individuals for nonbusiness purposes to 36 percent on loans by pawnbrokers. A 1980 survey of Iowa usury laws summarized that state's current interest rate ceilings under 9 categories, with maximum permitted rates ranging from 5 percent (the legal rate) to 36 percent (the maximum rate on the first $500 of a loan by a chattel loan licensee).

[8] For example, according to an article in *Business Week*, March 22, 1982, finance companies are switching emphasis from consumer lending to commercial lending in part because commercial loans are generally exempt from usury regulation while consumer loan charges are not.

[9] Savings banks and state-chartered commercial banks did not exhibit the same large, steady increase in the proportion of out-of-state mortgage holdings. However, New York State savings banks already held almost one-half of their mortgages on out-of-state properties. Furthermore, in-state conventional mortgages, those subject to the ceiling, comprised very small proportions of the total assets of savings banks (approximately 12 percent) and commercial banks (approximately 2 percent) compared with S&Ls.

How ceilings vary among Seventh District states

	First mortgage	New auto loan	Bank credit card	Unsecured personal instalment loan*
Illinois	No limit by state law	No limit	No limit	No limit
Indiana	No limit by state law	←	21% or { 36% on unpaid balance to $540 18% on unpaid balance to $1,800 → 15% on unpaid balance over $1,800	
Iowa	No limit by state law	21%	18% on unpaid balance to $500 15% on remainder	31% of unpaid balance to $150 24% of unpaid balance to $300 18% of unpaid balance to $700 12% of unpaid balance to $2,000
Michigan	No limit due to federal override	16.5%	18%	18% or { 31% of unpaid balance to $500 13% of unpaid balance to $3,000
Wisconsin	No limit by state law	Greater of 18% or 6-month T-bill rate + 6%	18% or no limit when 2-year T-bill rate remains above 15% for 5 consecutive Thursdays**	Greater of 23% or rate on 2-year or 6-month T-note + 6%

*Rate limits often vary by type of lender. Limits shown are highest permitted for any lender. Under the 1980 Monetary Control Act, banks, S&Ls, and credit unions may charge the greater of the Federal Reserve discount rate plus 1 percent or the highest rate permitted any state lender for the type of loan in question.

**The operative limit has been 18% since the law became effective November 1, 1981.

companies located in Arkansas and that state has a much larger number of pawnbrokers than Illinois, Wisconsin, or Louisiana, which have more lenient ceilings on consumer credit. In addition, a survey of merchants in the adjacent cities of Texarkana, Texas and Texarkana, Arkansas [1] revealed that there were many more automobile, furniture, and appliance dealers on the Texas side of the border than on the Arkansas side. Furthermore, 84 percent of the merchants interviewed indicated that Arkansas' usury ceiling had been an important factor in their decision to locate in Texas.

Differences in state usury regulations also were cited in recent decisions to relocate the credit card operations of Citibank, First National Bank of Maryland, Philadelphia National Bank, and the First National Bank of Chicago.[10] In addition, banks in Seattle and Detroit are reported to be considering relocating credit card operations to other states because of usury limits.[11]

The macroeconomic impacts of usury ceilings. When usury ceilings make it unattractive to make loans in a particular state, the adverse impact of the ceilings falls most heavily on the credit-sensitive sectors of the state's economy. The health of a state's residential construction industry, for example, can be seriously affected by its usury regulations. As Ostas and Robins showed, housing starts and permits are sensitive to ceilings on mortgage rates. Furthermore, the New York State Banking Department concluded that New York's restrictive usury ceiling contributed to the depressed condition of the housing market in that state during the late 1960s and early 1970s.

Similarly, there is evidence that restrictive usury ceilings on automobile loans and

[10]See *Wall Street Journal*, December 5 and 15, 1981 and *The American Banker*, September 30 and October 30, 1981. The ability of banks to take advantage of interstate differences in ceilings on credit card lending derives from a 1978 Supreme Court ruling. In Marquette National Bank v. First of Omaha Service Corporation, the Court determined that national banks may charge out-of-state credit customers the rate permitted by the law of the bank's home state. See *Federal Reserve Bulletin*, vol. 67 (February 1981), p. 181 fn. The same option does not apply to department stores, gasoline companies, or other issuers of retail or sellers' credit cards.

[11]See *The American Banker*, May 6, 1982.

other forms of consumer credit can affect the level of consumer purchases and retail trade. The survey of merchants in Texarkana, Arkansas, and Texarkana, Texas [1] revealed that approximately 38 percent of credit sales among merchants on the Texas side of the border were to customers from Arkansas. This substantial out-of-state shopping, which is presumably due to the 10 percent usury ceiling in Arkansas, represents a significant loss of potential business revenues for Arkansas-based retailers. Furthermore, as the authors of the study concluded, it represents a loss of jobs and local tax revenues.

A state's usury ceiling is likely to have far-reaching consequences for the state's real economy. Its effects can be expected to show up first in the level of credit-financed expenditures and eventually in levels of state employment and income. A study by Richard Gustely and Harry L. Johnson, described by Harold Nathan [14], used an econometric model of Tennessee to examine the impact of that state's comprehensive 10 percent usury ceiling. According to Nathan, the authors found that Tennessee's economy grew faster than the national economy except at times when market interest rates exceeded the state usury ceiling. The ceiling was estimated to have cost the state annually between 1974 and 1976 $150 million in output, $80 million in retail sales, and 7,000 jobs. This study indicates how restrictive usury ceilings may deprive a state of the credit needed to keep its economy expanding. All residents of the state are affected, not only those borrowers who find credit difficult to obtain.

Usury ceilings and competition

As the foregoing discussion has shown, the impacts of usury ceilings extend well beyond simply holding a lid on interest rates. The adverse effects on the economy as a whole may even be sufficient to outweigh the benefit to those who are able to borrow at below-market interest rates. However, a common argument is that without usury laws borrowers would be forced to pay exorbitant interest rates, or at least rates that were unreasonable in relation to the cost of supplying credit. Thus, evaluation of usury laws is not complete without a consideration of the consequences of not having usury ceilings.

According to economic theory, a competitive market is sufficient to prevent lenders from exercising power over pricing or earning more than a normal return. The price established in a competitive market reflects suppliers' costs of providing the given amount of the good. To be sure, removing a binding usury ceiling will result in higher interest rates. However, if credit markets are competitive, the resulting market rate of interest will not exceed lenders' cost of providing credit. It is when competition is absent that consumers may face unreasonable interest rates. Thus, the consequences of not having usury ceilings depend importantly on the competitiveness of credit markets. Indeed, the absence of competition is the only clearly defensible theoretical reason for imposing a usury ceiling.

We might argue that U.S. credit markets today are fairly competitive. Many types of institutions—banks, finance companies, credit unions, thrift institutions, and retailers—make up the supply side of the credit market and frequently offer credit in closely substitutable forms. Moreover, in many (but not all) local market areas, consumers can choose among several lenders of any particular institutional type. However, competition in credit markets may be hampered by the fact that lending institutions have become specialized according to the types of credit they offer and/or the types of borrowers they serve. In the area of personal consumer credit, for example, banks and other depository institutions primarily offer cash credit to lower risk borrowers while finance companies specialize in servicing higher risk customers. Thus, the question of whether credit markets are sufficiently competitive to protect consumers from unreasonable interest charges is one which must be answered empirically. Unfortunately, studies of the extent of competition in credit markets do not provide a definitive answer to

the question.

Smith [22] concluded from a study of the structure of rates on personal loans at commercial banks that there is a considerable degree of interbank competition for the more profitable type of loans, but that this does not extend to the small high-risk loan where the social problems of credit regulation are most acute (p. 524). He also found evidence of interinstitutional competition in the influence of consumer finance companies on bank loan rates and portfolio composition. On the other hand, Geer's analysis of the NCCF data on personal loan rates [5] did not allow him to conclude firmly that finance companies and commercial banks compete vigorously.

The NCCF Report provided some evidence of the existence of competition in its findings regarding the pattern of interest rates across states. The Commission's 50-state survey revealed that rates on auto loans and unsecured loans at banks clustered within a rather narrow range (the market rate?) regardless of state usury ceilings.[12] Also, average observed interest rates for these loans were in the same range even in states with no ceiling at all.[13] In contrast, in the finance company loan market, the Commission noticed a much closer correspondence between observed rates and the state usury ceilings.

The conflicting findings of these few studies illustrate the difficulty in reaching a definitive conclusion about the extent of competition in credit markets. The studies described here suggest that competitive behavior may vary considerably among different segments of the credit market. Rates on finance company personal loans, for example, appear to be set less competitively than rates on auto loans or personal loans extended by banks. Another factor which makes an overall assessment of competition difficult stems from the potentially great differences in local market conditions. Lending institutions located in urban areas may face much greater competitive pressures than lenders in smaller cities or towns.

What can be stated definitively, however, is that from the point of view of protecting borrowers from unreasonable interest charges, competition is desirable, and the more the better. To the extent that competitive pressures arise from the presence and ready entry of many firms into the market, consumers are best served by policies that foster these conditions in credit markets.[14]

There is some evidence that usury ceilings, rather than fostering these conditions, tend to restrict competition in some parts of the credit market. The NCCF found, for example, a strong inverse relationship between statewide finance company concentration ratios and the average level of legal rate ceilings on personal loans. (Higher concentration ratios are usually associated with lower levels of competition.) The relationship was even stronger within the group of states having low rate ceilings. The finding that lending firms tend to be more highly concentrated in states with lower rate ceilings can be attributed to several factors. First, low usury ceilings drive inefficient firms out of the market, thereby increasing concentration [6, p. 1377]. In addition, low usury ceilings create barriers to entry making it difficult for new firms to compete during the start-up phase [15, p. 137].

[12]Of course, it could simply be that the state usury ceilings were above the optimum price for an oligopolistic competitor. Even if that were the case, however, the situation indicates that the rate oligopolist lenders establish is below what most legislatures consider usurious.

[13]In addition, an investigation by the Federal Reserve Bank of St. Louis revealed that mortgage rates in the Chicago, Minneapolis, and Pittsburgh SMSAs did not rise to state ceilings when these usury limits were allowed to float. See Lovati and Gilbert [11].

[14]The literature on the structure of banking markets has established that firm entry and concentration have highly significant, although quantitatively small, effects on competitive pricing behavior. See Stephen Rhoades, *Structure-Performance Studies in Banking: A Summary and Evaluation*, Staff Economic Studies 92 (Board of Governors of the Federal Reserve System, 1977); Harvey Rosenblum, "A Cost-Benefit Analysis of the Bank Holding company Act of 1956," *Proceedings of a Conference on Bank Structure and Competition* (Federal Reserve Bank of Chicago, 1978); and George Benston, "The Optimal Banking Structure: Theory and Evidence," *Journal of Bank Research*, vol. 3 (Winter 1973), pp. 220-37.

Rate ceilings may impede competition in various other ways. The NCCF argued that different rate ceilings for different types of consumer lenders tend to segment the market artificially and restrict interinstitutional competition [15, p. 147 and 5, p.60]. A recent study by Sullivan for the CRC [23] supports this argument. She found that the extent of competition between banks and finance companies for consumer loans depended on whether the two types of lenders operated under the same or different rate ceilings. In a local personal loan market in Illinois, which differentiates ceilings by type of institution, borrowers from banks had significantly different risk characteristics than borrowers from finance companies. Such segmentation was not found in a comparable local loan market in Louisiana where all lenders are treated equally.

Another difficulty with usury ceilings, suggested by Shay's findings, is that rate ceilings may offer convenient focal points for setting rates higher than they might otherwise be set, when lenders already have some power to set prices [21, p. 457]. Finally, the Treasury Department's Interagency Task Force on Thrift Institutions [24] recently argued that very low usury ceilings discourage thrift institutions from adding consumer loans to their portfolios and from actively competing with finance companies by offering consumer loans. According to all of these arguments, the removal or easing of usury ceilings would tend to make credit markets more competitive.

Knowledgeable, informed borrowers also foster competition in credit markets. When consumers do not know or cannot compare rates being charged by various lenders, each lender has more scope to charge whatever rate he chooses. Thus, a high level of borrower awareness can place a natural constraint on interest rates, in lieu of the external constraint of a usury ceiling. Indeed, as the NCCF pointed out, "Not all consumers need be aware of the APR [annual percentage rate] or shop for credit to bring about effective price competition. A significant marginal group of consumers who are aware and do shop is sufficient to 'police' the market" [15, p. 175].

It is difficult to say exactly what the size of that group needs to be, but the Commission suggested that one-third to one-half of all borrowers is certainly sufficient. By this criterion, today's consumers seem to exert a rather effective pressure on lenders. A 1977 Consumer Credit Survey sponsored by the Board of Governors of the Federal Reserve System [4] classified 65 percent of consumers as aware of APRs on revolving credit. The awareness level on bank credit cards was 71 percent, and on closed-end credit it was 55 percent.

Consumer awareness levels were not always this high. Surveys comparable to the 1977 one were conducted in 1970 and 1969. Only 38 percent of credit users were found to be aware of APRs on closed-end credit in 1970 and only 15 percent in 1969.[15] Awareness levels on retail revolving credit and bank credit cards were only 35 and 27 percent, respectively, in the 1969 survey, although they stood at 56 and 63 percent by 1970.

At least some of the improvement in consumer awareness since 1969 revealed by these surveys is probably attributable to the consumer protection legislation enacted in the late 1960s and 1970s. The Truth-in-Lending Act (Title I of the 1968 Consumer Credit Protection Act) was passed only shortly before the 1969 survey, and its impact seems evident in the 1970 survey results. This association of improved consumer awareness with the passage of Truth-in-Lending suggests that, in the absence of usury ceilings, such legislation could effectively ensure consumers of reasonable interest rates by fostering more intense price competition in the credit market.

Policy action and options

Over the past few years there has been a spate of legislative activity affecting usury

[15]In analyzing the results of the 1970 survey, the NCCF found awareness levels in the "general market"—the market comprised mainly of higher income, more highly educated, white, homeowning borrowers who live in nonpoverty areas and use mostly cash credit—sufficient to police the market. The high-risk market, on the other hand, had disturbingly high levels of unawareness.

regulations at the national and state levels. Probably all of these legislative changes have helped to ease the adverse economic effects of binding usury ceilings during the recent period of high market interest rates. However, the specific policies implemented have differed greatly in the extent of their move toward deregulation; not all have involved completely removing legal price constraints.

For example, some states have acted to raise, but not eliminate, ceilings when they have impinged on credit availability and economic activity. This approach preserves fixed statutory interest rate limits and whatever protection they might afford consumers from outrageously high interest charges. But, if state legislatures intend to avert the negative economic impacts of fixed usury ceilings, they must act deliberately and quickly to adjust ceilings limits in response to changes in market rates—a task made more difficult by the increased volatility of rates in recent years.

A second approach, tying ceiling limits to market interest rates, avoids this problem and at the same time preserves the protection afforded by statutory limits. Some states have instituted legislation to allow ceilings to float, usually by stipulating limits several percentage points above certain specified interest rates—such as Treasury bill yields or the Federal Reserve discount rate—over which neither borrowers nor lenders have control. These usury ceiling limits, then, adjust automatically at frequent intervals to changes in the market interest rate. While floating rate ceilings are designed to be nonbinding with respect to the rates charged on the vast majority of loans, they prevent lenders from charging rates which are out of line with the market.

The difficulty with floating ceilings is in choosing a tie-in formula which will keep the ceiling above the average market rate over time. In a 1979 study of floating ceilings in the mortgage market, the Federal Reserve Bank of St. Louis [11] concluded that ceiling rates set 2.5 percentage points above yields on ten-year U.S. Treasury bonds or 5 percentage points above the discount rate were high enough not to distort the flow of credit to housing. Other floating rate schemes, however, continued to bind mortgage rates and impede housing activity.

Action by state legislatures has not been limited to partial easing of controls, by raising limits or implementing floating ceilings. Many other states have completely eliminated their usury ceilings. These states can and still do regulate lenders in other ways, of course.

In addition to these changes on the state level, the federal government has also acted recently to remove legal constraints on interest rates. The 1980 Monetary Control Act temporarily preempted state usury limits on mortgage loans and on large business and agricultural loans. The same act also overrode state interest ceilings on loans by national and state banks, S&Ls, and credit unions when the state ceiling is below the local Federal Reserve discount rate plus 1 percent. Proposals to extend federal preemption to include consumer credit were considered during the 1981 congressional session.[16]

This move by the federal government to supplant state usury regulations raises an important and difficult issue. From an economic point of view federal action has an advantage over states acting individually. It would impose uniformity on credit markets, eliminating legislatively created differentials in interest rates that artificially distort credit flows among states. (Uniformity could be achieved, of course, whether the federal government imposed its own fixed usury ceiling, instituted floating ceilings, or eliminated ceilings altogether.) From another point of view, however, federal action may not be so desirable. The economic advantage of uniform treatment needs to be weighed against the political implications of the federal government stepping into an area—usury regulation—which has traditionally been under the jurisdiction of the states. Thus, the

[16]A Senate bill was introduced by Senator Lugar and incorporated in S. 1720 by Senator Garn; House bills were sponsored by Representatives John La Falce and William Alexander.

question whether deregulation of usury ceilings should be left to individual states or whether it is best accomplished by federal preemption should not be answered on the basis of economics alone.

Summary

Economic research clearly supports the current legislative moves toward deregulation of usury ceilings. The evidence on the impact of usury ceilings shows that they have not achieved their objectives. According to the empirical studies surveyed, usury ceilings have significantly reduced the availability of credit and created hardships for those who were supposed to be protected. Ceilings have encouraged lenders to use such credit rationing devices as higher down payments, shorter maturities, and higher fees for related noncredit services, which increase the effective interest rate. They have curtailed the amount of credit available to lower income and higher risk borrowers, harming primarily those individuals whom the ceilings are intended to benefit. Finally, the lack of uniformity of usury laws across states has distorted credit flows and economic activity, favoring those states and regions which are less regulated.

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