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Loan interest caps take credit away from the poor

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This week the California state Senate will debate Assembly Bill 539, a bill that would make half of consumer loans between $2,500 and $10,000 made in the state illegal. The bill's aim is to lower the cost of consumer credit, but history shows that interest-rate caps like the one AB539 would institute only work to reduce the supply of loans, especially to the most vulnerable.

The Golden State already has one of the most draconian payday loan laws in the Union: Borrowers may borrow at most $300 ($255 once fees are discounted) and they cannot roll over the loan at the end of its term. Loans between $300 and $2,500 may only happen under a special-purpose pilot program which in 2017 attracted a mere 16 participating lenders. As a result, there are fewer loans made under $2,500 than between $2,500 and $4,999. Furthermore, 57 percent of people who apply for credit under the pilot program are rejected.

The more than 2 million (17.6 percent of) California households who, according to the Federal Deposit Insurance Corporation, currently lack access to bank credit face very limited options for short-term borrowing. AB539 would only make the problem worse, by capping the annual interest rate on loans between $2,500 and $10,000 at 36 percent plus the Fed interest rate target, currently 2.4 percent.

California isn't alone in looking to further restrict the interest rates that lenders can charge. According to the World Bank, as many as 30 countries have either introduced or tightened up usury laws – which ban lending above a certain rate of interest – since 2011. Such caps are among the oldest financial regulations, featuring in the Old Testament and in the writings of Aristotle. Most Western countries had tight interest-rate caps, rarely above 10 percent per annum, until the mid-19th century.

Yet, the economic evidence consistently shows that interest-rate caps are harmful. They make it harder to approve applicants for credit, because some borrowers' lack of collateral and high default risk make lending to them under the cap unprofitable.

Like other price controls, usury caps cause credit demand to exceed supply. Remember the pictures of long lines at gas stations during the 1970s oil crises, when government restricted the price of gas? Interest-rate caps would similarly lead to more people wanting credit than was available, giving lenders the ability to favor their friends and to allocate credit based on irrelevant factors or personal traits.

Indeed, usury caps are always hardest on the poorest. When making a loan, the lender wants guarantees that it will collect on the funds borrowed. Wealthier people can pledge their assets as collateral, while those lacking property or a long credit record can only compete by bidding a higher rate. But a usury cap takes away this ability to compete, invariably causing lenders to approve the well-established over the marginalized. The poor must then go without or turn to irregular – sometimes criminal – operators, who typically lend on more disadvantageous terms. Indeed, when politicians such as Robert Kennedy pushed to relax usury laws in the 1960s, one of their chief goals was to drive the loan sharks out of business.

AB539 would make $1.4 billion worth of consumer loans illegal. Proponents of the law say lower-cost lenders stand ready to plug the credit gap that will result – but if they can lend profitably below the 36 percent cap, why are they not already doing so? The profile of the typical short-term borrower – with a low credit score, a short credit history, and a need for immediate access to liquidity – also suggests cheaper credit options would be unavailable. Even if they are available, approval may take longer than the cash-constrained applicant can wait.

The lenders affected by the bill claim that their under-36 percent competitors require borrowers to buy add-ons, such as credit insurance, that allow them to raise the cost of credit while remaining below the statutory cap. Borrowers, of course, care about the total cost of a loan, not whether it takes the form of an interest charge or an insurance premium.

What is almost certain is that the cap will reduce competition in the California market for consumer loans. This is rarely a desirable consequence of public policy, since it is vigorous competition that spurs lenders to offer products consumers want at prices that reflect the cost of providing them.

The usury caps of old are coming back with a vengeance. Those who care about the welfare of the worst-off, in California and elsewhere, should not cheer.

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