AOC and Sanders' credit card interest rate cap would be disastrous

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Back in the early 1900s, Progressives helped drive loan sharks out of business by lobbying to lift state usury caps. Those caps had barred lenders from charging interest above 6% to 10% a year, forcing low-income Americans to seek credit in the illegal market. Now, Representative Alexandria Ocasio-Cortez and Senator Bernie Sanders want to bring back a similar usury law that would cap annual credit card interest rates at 15%.

The ostensible aim of their proposal is laudable: to make credit more affordable for American households at a time when they carry a collective balance of $870 billion, with an average credit-card APR of 17.73%. But the consequences of a cap would be disastrous, removing access to credit for millions of low- and moderate-income households and forcing them to rely on family members, tighten their belts or seek higher-cost forms of credit.

Ocasio-Cortez and Sanders wonder why banks charge double-digit interest if they can borrow funds at 2.5%, the rate at which banks lend to each other.

But that is a misleading comparison. First, 2.5% is the rate banks pay on very short-term borrowing, which is less risky and therefore cheaper than longer-term consumer credit. Second, the business of banking is expensive. Banks spend time and resources screening borrowers to assess their creditworthiness. They invest in physical and virtual facilities to ensure the safety of customer funds and their personal information, online and offline. Banks also employ hundreds of thousands of staff to help customers find the products they need, understand the terms of each product, and service mortgages, small-business loans and credit-card debt.

The ever-increasing number of regulatory mandates hasn't helped lower the cost of providing banking services either. The financial industry is one of America's most regulated sectors, with more than 27,000 new regulations added to the books since 2010. That regulatory accumulation goes some way to explain why the cost of financial intermediation hasn't really gone down since 1960. It also explains why, despite all the talk about banker greed, the post-crisis return on equity for most banks remains comparably low at 10% to 12% — and concerningly low for the smallest banks, at 7.5%.

Ocasio-Cortez and Sanders seem to assume that whatever is bad for the banks will be good for consumers. But the evidence from previous interventions suggests otherwise.

After the financial crisis, legislators passed the Durbin Amendment, which capped the fees that banks could charge businesses for using debit cards in an attempt to lower consumer costs. But it hasn't been successful. Banks have replaced their debit fee income with new fees on bank accounts and by requiring higher minimum balances. While businesses saw their debit card payment costs decline, they didn't pass on those savings to consumers. What's more, many consumers had to switch from debit to credit cards, and up to a million of them may have become unbanked due to the Durbin Amendment, according to a study by my colleague Todd Zywicki at George Mason University.

With more than 8 million American households lacking a bank account and another 24 million without access to much consumer credit, it would be a reckless gamble to remove the few options many low-income Americans currently have by making it unprofitable to lend to them.

The 15% cap would also apply to payday loans — a short-term alternative overwhelmingly used by people who simply have nowhere else to turn because their credit scores are very poor and they have high outstanding debts.

Ocasio-Cortez and Sanders call payday lenders "loan sharks" to imply they abuse their customers. While annualized interest rates on payday loans look very high, one must keep in mind that the term of these loans is short, typically two weeks. Furthermore, payday loans are better than illegal alternatives that can result in higher rates or even criminal behavior. Yet, a 15% cap would make it impossible for most of these credit-constrained Americans to get credit through payday loans or other means.

Rather than curtail the few ways in which many low-income families can gain some financial security today, Ocasio-Cortez and Sanders should think about how technology can increase access to payments and credit for underserved consumers. For example, the use of mobile money accounts has expanded at breakneck pace in Africa and Asia — leapfrogging physical bank branches and cards. Now that most Americans own a cell phone, mobile accounts offer a promising way to bring the unbanked into the financial system.

Ocasio-Cortez and Sanders have a lower-tech solution in mind, though. They want the postal service to offer lending products to customers. But they haven't explained how post offices could quickly gain the skills and technology needed for properly advising, underwriting and monitoring consumers. It's not like public banking has been a great success elsewhere. For example, in Spain, publicly owned banks were at the epicenter of the financial crisis because politicians pushed them to lend to home buyers who couldn't afford their mortgages when the market turned.

Banks retreated from the market for small-dollar loans after regulators in 2013 issued guidance pressuring them to do so. Encouraging banks to resume lending to the underserved is a more promising solution than a new government monopoly in the form of postal banking.

Ocasio-Cortez and Sanders call their bill the "Loan Shark Prevention Act," but the historical evidence suggests that the measures the bill contains will only help real loan sharks flourish. Usury caps simply don't work.

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