

The Cost of Usury

Robert Mayer¹

A RESPONSE TO Matt Zwolinski (2013), “Are Usurious? Another New Argument For the Prohibition of High Interest Loans?”, *Bus Ethics J Rev* 1(4): 22–27.

ABSTRACT

When states deregulate the price of payday loans, most consumers will pay more for emergency cash than when a moderate usury cap is imposed. But advocates of price deregulation, including Matt Zwolinski, fail to discuss the distributive effects of their favored policy or to explain why most borrowers should pay more than is necessary for a cash advance. The objections Zwolinski raises against my argument for imposing a usury ceiling in this market miss the mark because they do not justify the increased cost consumers must bear when the price of a payday loan is allowed to float.

THE STRONGEST ARGUMENTS never dodge the tough questions. But in my experience the advocates of deregulated pricing in the market for payday loans always do. They won’t acknowledge this inconvenient fact: that when state governments deregulate the price of payday credit, most consumers will pay a lot more for a cash advance than when legislatures adopt the type of moderate price cap I defend in my paper “When and Why Usury Should Be Prohibited” (Mayer 2012). A compelling justification for price deregulation should explain why it is desirable for most borrowers, who are already cash-strapped, to pay more than they have to for quick cash. But I’ve never come across an advocate of deregulated pricing who would own up to this fact or was

¹ Loyola University Chicago. Email: rmayer@luc.edu

even aware of it. They don't see that they have their work cut out for them. They have to defend the product that costs considerably more than a feasible alternative.

Matt Zwolinski's (2013) critique of my paper is no exception to this rule. He does not explain why it is beneficial for most borrowers in a deregulated market to pay what I show is an inflated cost. His defense of deregulated pricing is even more vulnerable than the libertarian argument by Labat and Block (2011) that I tried to refute in my paper.

Usury caps that bind lower the price of credit in the legal market. If the cap is very low, whole credit products will be eliminated. Moderate price caps, by contrast, serve to cheapen the cost of credit for those who qualify. How is this effect of government intervention achieved? By forcing lenders to select their customers more carefully. To turn a profit, creditors must reduce the amount of debt that is unrecoverable when borrowers default. In any lending operation, the good debts cover the bad. But when government caps the price of credit, lenders are prevented from boosting the fee they could charge to the solvent debtors to cover these losses. Their only real option is to lend more cautiously. They will have to prefer applicants who seem more likely to pay back their debts. The riskiest prospects will be denied credit.

When stated in this way, it isn't difficult to predict what sorts of populations might be receptive to binding usury caps. People with higher credit scores, more affluent populations, savers, the risk-averse, and established incumbents all stand to gain from the imposition of a moderate usury ceiling. These people will pay less for credit because they will not be saddled with the burden of covering the risky bets lenders might like to make when pricing is deregulated. The situation of these more credit-worthy populations is improved – at least in the short run – while the situation of the riskier populations is worsened.

Now, in most credit markets it isn't actually beneficial, all things considered, to tilt in the direction of the more solvent groups. They will gain less than they think because the resulting credit exclusion has undesirable consequences. Growth will be hampered, inequality might increase, and the prohibition could spawn a pernicious black market. There are plenty of econometric studies that show usury limits

in markets for mortgages, commercial loans, and so forth are welfare-reducing. In these credit markets deregulated pricing is preferable. Part of the reason is that these products tend to be priced for risk. Applicants with lower credit scores will be charged a risk premium, which eases the burden on more solvent debtors. The latter won't feel cheated by deregulated pricing because the interest rate they pay will be less than the rate paid by people with poorer credit.

Now consider the market for payday loans. It is the most expensive legal credit market there is. If it functioned like the market for toothbrushes (Zwolinski's example), there would be no justification for imposing a price cap. But when it is deregulated, the market for payday credit operates in a distinctive way. There is no risk-pricing. All borrowers pay the same fee, regardless of their credit score. This isn't because the lenders cannot distinguish between the better and the worse risks. Most do use scoring tools designed specifically for the subprime population they serve. These programs are not omniscient, but there is evidence that these methodologies can calculate the probability of default with much greater accuracy than a standard FICO score (Agarwal, et al 2009). There is also evidence that, when prices are capped at a moderate level, the bulk of payday borrowers who are charged the premium price in a deregulated market are not rationed out of this market when the fee is reduced through government action (Avery 2011). The price can be cut by one-third (from \$22 to \$15 for every \$100 of credit) without reducing the volume of lending. As a result, most payday borrowers gain from imposing the price cap. They get the credit they seek at a lower cost. By forcing the lenders to choose their customers more carefully, the usury statute saves most applicants for this type of credit a lot of money.

The advocates of deregulated pricing never acknowledge this result but it is the inconvenient fact that must be confronted. In states where the fees for payday loans are deregulated, most consumers will pay more than they have to for this product. The question is why that is beneficial.

One cannot say the welfare effects of deregulated pricing are beneficial because this has not been established empirically. There are only a handful of studies that try to estimate the welfare effects of payday lending, but they reach opposite conclusions and each is methodologically problematic. None has demonstrated that society gains

(or loses) when the price of a \$100 payday loan is \$22 instead of \$15. Trying to isolate the effect of that kind of difference through macro-economic analysis is all but impossible.

Labat and Block (2011) defend deregulated pricing for payday loans by positing that a usury cap will create a pernicious black market. The minority of applicants who are rationed out of the legal market when the government imposes a price ceiling, they claim, will be driven to the loan sharks, who allegedly charge more and treat their customers more abusively than any payday lender would. In my article I devoted a number of pages to testing this hypothesis and I showed that the supposition is largely baseless. My argument there summarized a book I wrote on this topic (Mayer 2010). The loan-shark thesis is mostly myth, at least as it applies to the market for payday loans. It isn't a compelling reason to require the more solvent borrowers in this market to pay the inflated fee that advocates of deregulated pricing want to impose on them.

Turn now to Matt Zwolinski's critique of my argument. He does not challenge my claim that when prices are deregulated the more solvent majority cross-subsidizes the least credit-worthy minority. He also does not try to refute my claims about the black market. All Zwolinski (2013: 24–26) says is that the market for payday credit seems sufficiently competitive to him and that the rate of profit for the industry is normal. He ignores completely the distributive effects of different price regimes, which is the main focus of my paper. Zwolinski is effectively saying that most consumers should have to pay more for their payday loans than is necessary because in a free market the lenders have to compete against each other and they do not make windfall profits. But I doubt that consumers who could be serviced when the fee is capped at \$15 will think these are compelling reasons why they should have to pay \$22 (or \$25 or even \$30) for every \$100 they borrow when prices are deregulated.

The question about whether the rate of profit in this industry is high or low is beside the point, I think. Even industries with razor-thin profit margins can be intensely exploitative. Consider the thousands of garment sweatshops that operate in the state where Zwolinski resides. The contractors barely turn a profit and, for that very reason, are driven to break the law and sweat their workers. In the case of payday

lending, I am sure the lenders make more money when the fee they can charge is \$22 rather than \$15. But the crucial point is that they can still earn a decent return when the fee is \$15. Experience demonstrates this. The price cap I defend is not meant to put the industry out of business. Instead, it forces the lenders to make their profit by selecting their customers more carefully. Unless the government compels them to do so, they have no financial incentive to ease the burden on their more solvent debtors.

The question about whether payday lending is sufficiently competitive in the absence of government intervention only enters my argument for price regulation when I try to explain why the lenders don't do what you'd expect them to do if the market was fully competitive. The evidence shows that they could service many customers profitably when the fee is \$15 but none of them actually charges such a low fee where prices are deregulated. I account for the fact by drawing on the literature that argues competition in the market for payday loans is defective (Mayer 2012: 7–8). Nothing Zwolinski says better accounts for the fact I am trying to explain. The phone survey he conducted was enterprising, but Zwolinski doesn't mention that a price cap operates in California. All the prices charged there converge on the cap. What happens in a regulated state won't tell us much about the behavior of lenders where the market is free, which is what we want to know.

The argument I've made in defense of the price cap for payday loans would never have occurred to me if I hadn't gotten a payday loan myself. I live in one of the states where prices aren't regulated and I paid 50% more for my cash advance than somebody ten miles away in a neighboring state where payday loans are more tightly regulated. It made me wonder why. Since I belong to the more credit-worthy majority of payday loan consumers, I wanted to state our case for lower prices. This population shouldn't have to cover all of the bad bets payday lenders make when they are permitted to charge what the market will bear. These businesses should cater to the borrowers who are more likely to pay back their debts. Since they will not do that when the market is free, government ought to compel them to do so by capping the price of this expensive product. The interests of the more solvent borrowers should be preferred. These wage-earners

should be spared as much as possible from carrying the burden the debtors with the worst credit impose when the price of a payday loan is allowed to float.

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