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Review Of "Loan Sharks: The Birth Of Predatory Lending" By C. R. Geisst

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G Financial Economics

Loan Sharks: The Birth of Predatory Lending. By Charles R. Geisst. Washington, DC: Brookings Institution Press, 2017. Pp. ix, 261. $26.00, cloth. ISBN 978–0–8157–2900–6, cloth; 978–0–8157–2901–3, e-book. *JEL 2017–1012*

The title of this book, *Loan Sharks: The Birth of Predatory Lending*, is misleading. Most people would expect a history of the early years of consumer finance, in which unlicensed high-cost lenders dominated. That is indeed part of the book. But the book is more accurately described as a somewhat haphazard, popular account of major developments in US financial history from 1890 through 1935. The theme that the author, Charles R. Geisst, hopes will unite the topics is "loan sharking," which he defines broadly to mean high-cost lending, whether for consumer finance, mortgage loans, or stock market speculation.

The first two chapters discuss consumer finance and farm mortgages, as well as sundry other topics, from about 1890 through 1920. In that era, several states maintained a 6 percent ceiling on annual interest rates. As Geisst recognizes, "Even at double the legal rate, legitimate lenders would find it difficult to make small loans due to the administrative costs and work involved" (p. 81). In fact, banks of that era did not provide consumer loans; this gap was filled by unlicensed lenders, such as the salary buyers and pawnbrokers common in urban areas. Salary buyers were the illegal "payday lenders" of the time, providing workers with advances on their salaries at interest rates of 10–20 percent per month. Geisst does not explain the economic rationale for such high rates in competitive markets. As the era progressed, some states passed laws allowing annual interest rates over 6 percent on consumer loans. This permitted philanthropists, religious groups, and others to form mutual loan societies, credit unions, industrial banks, and remedial loan organizations to provide consumer credit on terms more favorable than those of the illegal lenders. In the case of Midwestern farm mortgages, local lenders often originated them and sold them to Northeastern insurance companies. Interest rates on these loans were about 2 percentage points higher than those for farm mortgages in the Northeast, a gap Geisst attributes to "loan sharking." His economic rationale is muddled: ". . . it would be expected that the presence of so many competing lenders would have forced loan sharks out of business. But in reality, all lenders, legitimate and otherwise, wanted to be in the high-interest lending business" (p. 29). As Geisst explains, in 1916, Congress passed the Federal Farm Loan Act, which created federal land banks to support agricultural credit markets. Other topics covered in these chapters include: the greenback exceptions clause; restrictions on foreign ownership of land; speculation on commodities at the Chicago Board of Trade; the absence of a federal income tax; the Panic of 1893; the rise of layaway credit for consumer purchases; the Panic of 1907 and birth of the Federal Reserve System; the Pujo Committee hearings on "money trusts"; and stock market speculation and state Blue Sky laws.

Chapter 3 covers the period from about 1920 through 1927. In this era, the Russell Sage Foundation pushed states to adopt a Uniform Small Loan Law (USLL) allowing annualized interest rates of 36 percent. It argued this was necessary for the development of a legal small-loan market. Geisst (p. 232) views this rate as excessive, writing, ". . . the rates allowed under the USLL hardly were fair or just. It is difficult to imagine a borrower realistically being able to repay debts when the legal borrowing rate ranged from 30–40 percent per year." Nevertheless, many states enacted versions of the USLL and licensed, for-profit consumer finance companies opened. The chapter also reviews the Florida land boom, the high failure rate of small state-chartered banks, the spread of mortgage-based securities and commercial real estate financing in New York City, concerns about German reparation payments, the McFadden Act of 1927, and the rise of the call loan market for stock market speculation.

Chapters 4 and 5 cover the lead up to, and aftermath of, the Great Depression. In the late 1920s, many households carried heavy debt burdens. In some states, there were efforts to set more restrictive usury ceilings than permitted under the USLL since, "…most had come to realize that lending small amounts at 36 percent interest was no bargain for the borrower" (p. 155). Chapter 4 reviews the late-1920s debate over proper Federal Reserve policy in response

to rising debt levels and stock market fervor. As Geisst notes, nonfinancial firms actively lent in the booming call loan market. Chapter 5 provides a familiar recounting of the government's response to the financial disruptions of the Great Depression. These include the creation of Federal Home Loan Banks to buy performing mortgages from savings banks, the Home Owners' Loan Corporation to purchase delinquent mortgages from banks, the Federal Housing Administration, and the Reconstruction Finance Corporation. Chapter 5 also discusses the Pecora hearings, the Glass–Steagall Act, reforming the Fed to create the open market committee and a unified discount rate, and Regulation Q.

In a postscript, Geisst (p. 235) argues in favor of usury laws but, "No single fixed rate is (or was) agreeable as a usury ceiling, and that casts a long shadow over the intellectual basis of usury ceilings because critics maintain that any rate is arbitrary and political." Geisst (p. 236) proposes that, rather than a fixed interest-rate ceiling, usury laws should set a limit on the spread over some benchmark interest rate to ". . . allow lending rates to adjust to market conditions while still protecting borrowers from the vagaries of the market."

The book has several weaknesses. It tries to cover too many topics in just 236 pages and, necessarily, many are treated very superficially. There is no coherent framework that links the various topics. There are no tables or graphs to show trends or put data points in perspective. Despite this, readers certainly won't miss one or two key themes, e.g., consumers often pay very high interest rates for closed-ended small loans, but readers will wonder why the greenback exclusion clause is relevant. For those who would like a more engaging and focused account of consumer credit over much of the same period covered by Geisst, I recommend *Financing the American Dream* by Lendol Calder (1999).

Economists will be frustrated that the book lacks any serious discussion of the factors that create variation in interest rates at a point in time. High-cost loans can be explained by large risk-screening and monitoring costs relative to the size of the loan, risks of loan losses, lenders' market power, borrowers' ignorance, etc. Geisst mentions some of these factors, but it is always in passing with no serious analysis. A good counterexample is Kenneth A. Snowden's (2013) history of the mortgage market at the turn of the twentieth century. He attributes higher farm mortgage rates in the Midwest to high information and monitoring costs faced by people in the capital-abundant Northeast who saw loan opportunities in other regions of the country. This makes more sense than vague charges of "loan sharking". Similarly, Geisst includes no serious analysis of the advantages and disadvantages of his proposal to revise usury laws to set limits on spreads over interest rate benchmarks.

References

Calder, Lendol. 1999. *Financing the American Dream: A Cultural History of Consumer Credit.* Princeton and Oxford: Princeton University Press.

Snowden, Kenneth A. 2013. "Mortgage Banking in the United States, 1870–1940." Research Institute for Housing America Special Report.

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H Public Economics

The Economics of Tax Policy. Edited By Alan J. Auerbach and Kent Smetters. Oxford and New York: Oxford University Press, 2017. Pp. x, 390. ISBN 978–0–19–061972–5, cloth.

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As the editors of this volume observe in their opening chapter, major changes have occurred, in both the US economy and in what researchers know about the effects of taxes, since the last major federal tax reform, the Tax Reform Act of 1986. This book provides background information on a wide array of tax topics and proposes relevant, research-based reforms. Each chapter covers a separate aspect of the federal tax code and is authored by an expert from that field of research. Together, the chapters are stunning in their breadth, exploring everything from environmental taxation, to capital gains and estate taxation, to tax compliance. A thoughtful discussion by another leading scholar in each field follows each chapter. These discussions provide additional perspective on each of the topics.

The chapters generally begin with a background section covering both the history and the intended purpose of the current design of the