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Consumer Debt and Usury: A New Rationale For Usury

Robin A. Morris*

I. INTRODUCTION

Usury is society's oldest continuous form of commercial regulation. It controls a multiplicity of individual transactions, each of relatively small significance. For example, the American Banker's Association estimates that there are about 5,300 credit card transactions per minute at \$40.00 per transaction.¹ The aggregate of these transactions is of major significance to society itself in promoting economic development and controlling the negative consequences of debt.

Consumer debt in our society has reached levels never dreamed of in our early industrial economy² and interest rates have risen to levels that would have shocked the conscience even a generation ago.³ Those high rates have been implicated in the recession of 1980, the deepest downturn since the Great Depression of the 1930's, and prompted the Federal Reserve system to control the supply of money in an effort to avoid disaster.⁴ Controlling money supply was the preferred choice of intervention as the Federal Reserve system deregulated interest rates to let them rise and fall in response to money supply.⁵

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1. *The MacNeil/Lehrer News Hour: House of Cards* (WNET/Thirteen television broadcast, Jan. 15, 1987) [hereinafter *House of Cards*] (statement by Bob Carlile, senior vice president of Trustcorp, Inc., for the American Bankers Association).

2. See *infra* note 54.

3. See *infra* note 35.

4. Bennett, *Can the Fed Penetrate Economy's Interest-Rate Insulation?*, *Int'l Herald Tribune*, Oct. 6, 1987, at 11, col. 5.

5. *Id.*

This article examines usury as a macroeconomic tool accommodating individual appetites for consumer indebtedness and society's need for economic development. Usury laws are not simply the means of protecting individuals from indebtedness, or of protecting the individual consumer's interest, but they are also a "means of economic policy employed . . . in fighting inflation."⁶ This second application of usury, as a macroeconomic tool, and not simply a microeconomic tool, is the most important use of usury in our post-industrial economy, particularly as we struggle with the problems of developed economies, declining employment prospects, high consumer demand for products and services and widespread, convenient credit opportunities. While much criticism has been directed at usury laws as an anticompetitive form of consumer protection, this article argues that even assuming anticompetitive effects exist, they are not dispositive of the merits of usury. In addition, this paper urges reconsideration of usury laws as a means of protecting society from the negative effects of enormous consumer indebtedness.

II. USURY AS A MACROECONOMIC TOOL

The macroeconomic purpose of usury laws can be seen in the way in which ancient societies began imposing regulation on lenders before written history.⁷ The laws of ancient societies were structured to protect the community, as well as its individual members from the destabilizing effects of indebtedness such as debt servitude and debt oppression. For example, the Old Testament provisions containing the Mosaic law on usury forbade charging any interest on loans to

6. N. REICH & H. MICKLITZ, CONSUMER LEGISLATION IN THE EC COUNTRIES 153 (1980). "These rules [usury laws] do not so much serve the consumer's interests, but are means of economic policy employed by the government, especially in fighting inflation. In some respects, these rules may even be detrimental to the consumer in so far as he will not get credit in order to effect his purchase decisions." *Id.*

7. The one exception was ancient Greece. Prior to the appointment of the benevolent dictator, Solon, and the implementation of his credit reforms, there was no limit either on interest rates or on what might be pledged as collateral in any Greek city states. W. SMITH, A HISTORY OF GREECE 90-91 (Boston 1855). Historical accounts reveal that Solon reformed Athenian credit laws in order to defuse the social and moral crisis which had arisen in Athens because of the widespread enslavement for debt. *Id.* at 91-94. By the time Solon was appointed, the enslavement of debtors and their extensive use as agricultural workers on their former lands had come to such a crisis that rebellion by the poor was imminent and debts could no longer be enforced without fear of violence. *Id.* Solon began his reformation by passing a "disburdening ordinance" which made repayment easier by devaluing Greek money. I.V. DURUY, HISTORY OF GREECE AND OF THE GREEK PEOPLE 531 (1890). Solon also canceled all contracts in which the debtor had pledged his body or that of his family as collateral and prohibited such collateral in future loans. Much like modern bankruptcy, these measures freed the debtor but left many creditors unable to collect their obligations. The devaluation of Greek money gave creditors some relief. *Id.* at 96-97. Finally, perhaps as added creditor relief, all limits were once more removed from interest rates. S. HOMER, A HISTORY OF INTEREST RATES 34 (2d ed. 1977).

tribal members but did not forbid lending for profit to outsiders.⁸

The macroeconomic function of usury, maximizing group welfare by preventing destabilizing indebtedness, was much easier to apply when outside groups could be used for purposes of capital development and growth. While the homogenous tribal or religious community insulated itself from the vicissitudes of debt slavery and other forms of oppression, it maintained profitable levels of commercial lending with other out-groups.⁹ With the revival of trade and commerce after the plague years of the 14th century, and the increasingly heterogenous character of communities, the tension between the need for economic development and the desire to insulate society from the instability of excessive debt became more difficult to accommodate and balance in one society. Early Christians, for example, incorporated Old Testament law against usury into their faith. Christianity was more ethnically diverse than Judaism as it embraced new ethnic groups formerly excluded from the Hebrew tribe. In such a pluralistic community it became more difficult to apply the Mosaic laws against usury, especially since Christian theologians in the Middle Ages were confronted by the acute need to develop trade and to restore the vigor of the economy of post-plague Europe.¹⁰ Complete prohibition of lending for profit would have impeded economic recovery in the Middle Ages. Christian theologians began to apply a scholarly "gloss" to the Old Testament law to accommodate the needs of trade and development while still attempting to control lenders on moral grounds. The "scholastic"¹¹ interpretations of usury law allowed Christians to lend for profit to Christians and non-Christians alike so long as the interest charged did not shock the conscience.¹²

8. The Mosaic law against usury is found in *Exodus* 22:25; *Leviticus* 25:36-37; *Deuteronomy* 23:19-20; *Ezekial* 18:8, 10-13, 17; and *Nehemiah* 5:6-13.

9. For example, Rome had different usury laws for the Italian states and for its colonies. See S. HOMER, *supra* note 7, at 48-52.

10. For a time in medieval Europe, Jewish pawn shops which charged high interest rates were tolerated as a necessary evil. As trade revived following the Dark Ages, those pawn shops were unable to meet the increased demand for credit. *Interest Rates and the Law: A History of Usury*, 1981 ARIZ. ST. L.J. 61, 72-77. Christian entrepreneurs were needed to provide capital to fill the void. In order for these Christian businessmen to lend without sinning, theologians developed investment schemes such as the triple contract and the sale of annuities to circumvent Christian religious restrictions on charging interest. *Id.*

11. See generally J. NOONAN, *A SCHOLASTIC ANALYSIS OF USURY* (1957) (examining the charging of interest from the catholic viewpoint).

12. The common law of unconscionability derives from this church doctrine. In the absence of an applicable legal standard, the common law of unconscionability for-

In American society, while we continue to have usury laws, they have been greatly undermined by accommodating the business world's need for capital to grow and expand. This has been compounded by the view of usury as a form of microeconomic governmental interference justified only by paternalism. The tension between economic development and usury laws in American society is evidenced by the numerous statutory and judicial exemptions in state usury laws to accommodate businesses that depend upon consumer credit for their viability.¹³ Indeed, most modern societies have retained usury laws despite this tension between economic growth and fears about the dangers of excessive personal indebtedness despite the fact that debt slavery and most of the other cruel aspects of debt oppression have been outlawed. While the relationship between consumer debt and economic development is apparent and has been understood since the 14th century revival of trade, it is no longer clear whether usury has any legitimate protective application in societies without debt slavery. While it probably served to moderate the political and social unrest caused by widespread debt oppression in

bade interest rates that shocked the conscience. As an alternative to usury it has been suggested that a statutory version of the common law standard of unconscionability be adopted. Under this proposal, the parties may agree to any interest rate, but courts would be able to declare any loan transaction unconscionable where the interest rate is excessive and the loan, taken as a whole, is harsh and unconscionable. See Comment, *An Ounce of Discretion for A Pound of Flesh: A Suggested Reform for Usury Laws*, 65 YALE L.J. 105 (1955). This form of case-by-case standard setting, in lieu of the much more transparent and objective standards of most usury ceilings, is highly expensive to enforce.

13. A recent example of a major statutory exemption from state usury laws to accommodate the economic needs of a credit-dependent industry is the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501, 94 Stat. 161-63 (codified as amended in note to 12 U.S.C.A. § 1735f-7 (1980)) [hereinafter DIDMCA]. This federal act preempted state usury ceilings on many first home mortgage loans permitting those rates to rise in order to give relief to home builders and related industries. "The Committee believes that this limited modification in state usury laws . . . is needed to facilitate a national housing policy and the functioning of a national secondary market in mortgage lending." S. REP. NO. 368, 96th Cong., 1st Sess. 19 (1979).

An example of a judicially created exemption to benefit retailers of consumer goods is the "time-price" fiction, an exemption particularly important to retailers of "big ticket" consumer goods. The time-price fiction allows retailers to establish two prices—a cash price and a time price—but holds that the difference between the two will not be considered interest, thereby exempting these prices from usury laws. THE NATIONAL COMMISSION ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 93 (1972) [hereinafter COMMISSION REPORT]. Retailers selling on "time" were thus exempted from state usury ceilings on interest. This exemption greatly facilitated the growth of retail "sale" credit from merchants. *Id.* See also *Morris v. Capitol Furniture and Appliance Co.*, 280 A.2d 775, (D.C. 1971); *Hare v. Gen. Contract Purchase Corp.*, 220 Ark. 601, 249 S.W.2d 973 (1952). Judicial decisions have also virtually exempted credit card issuers from state usury. See *infra* note 20. Lenders frequently criticize usury as an anticompetitive interference with their businesses. Even if this criticism is true, it is not dispositive of government and society's interest in regulating debt.

ancient civilizations, it remains to be seen whether usury has come to serve any important social objective in our time¹⁴ or whether it is outmoded and unjustifiable as microeconomic paternalism.

We are in the midst of an antiregulatory trend in public administration,¹⁵ and in that spirit usury has been uniformly criticized in law review literature as anticompetitive and amounting to the unnecessary regulation of lenders.¹⁶ Meanwhile, courts and legislatures are in the process of disassembling most usury regimes on a piecemeal bases.¹⁷ Before the criticism of usury becomes overwhelming, usury should be reconsidered to examine its purpose and relevance to modern economic lives. Although it does depress competition, anticompetitive effects are not dispositive of the possible merits of usury.

14. See S. BREYER, REGULATION AND ITS REFORM 34-35 (1982).

15. The movement to deregulate industries in favor of "free market" forces has resulted in the repeal of regulatory laws in many areas. See, e.g., Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779 (1984) (deregulating some of the cable communications industry); Bus Regulatory Reform Act of 1982, Pub. L. No. 97-261, 96 Stat. 1102 (1982) (deregulating buses to facilitate competition with other public transportation, especially cut-rate airlines); DIDMCA, *supra* note 13 (deregulating a variety of federal lending institutions and exempting them from state usury laws); Motor Carriers Act of 1980, Pub. L. No. 96-296, 94 Stat. 793 (1980) (deregulating most of the interstate freight hauling industry that had formally operated under price and entry controls); Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895 (1980) (deregulating rates in the railroad industry); Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (1978) (deregulating the airline industry).

16. For articles discussing the anticompetitive effect of the regulation of lenders, see COMMISSION REPORT, *supra* note 13, at ch. 6 and 7; Benfield, *Money Mortgages, and Migraine—The Usury Headache*, 19 CASE W. RES. L. REV. 819 (1968); Boyes & Roberts, *Economic Effects of Usury Laws in Arizona*, 1981 ARIZ. ST. L.J. 35; Curran, *Legislative Controls As A Response To Consumer-Credit Problems*, 8 B.C. INDUS. & COM. L. REV. 409 (1967); Felsenfeld, *Consumer Interest Rates: A Public Learning Process*, 23 BUS. LAW. 931 (1968); High, *Consumer Credit Regulation In Texas—A Rejoinder By An Economist*, 50 TEX. L. REV. 463 (1972); Johnson, *Regulation of Finance Charges on Consumer Installment Credit*, 66 MICH. L. REV. 81 (1967); Jordan & Warren, *A Proposed Uniform Code For Consumer Credit*, 8 B.C. INDUS. & COM. L. REV. 441 (1967); Jordan & Warren, *The Uniform Consumer Credit Code*, 68 COLUM. L. REV. 387 (1968); Kawaja, *The Case Against Regulating Consumer Credit Charges*, 5 AM. BUS. L.J. 319 (1967); Kipke, *Consumer Credit Regulation: A Credit-Oriented Viewpoint*, 68 COLUM. L. REV. 445 (1968); Lynch, *Consumer Credit at Ten Percent Simple: The Arkansas Case*, 1968 U. ILL. L.F. 592; Shay, *The Uniform Consumer Credit Code: An Economist's View*, 54 CORNELL L. REV. 491 (1972); Warren, *Consumer Credit Law: Rates, Costs, and Benefits*, 27 STAN. L. REV. 951 (1975); Comment, *Interest Rate and the Law: A History of Usury*, 1981 ARIZ. ST. L.J. 61; Comment, *Should Usury Statutes Be Used To Solve The Installment Sales "Problem"?*, 5 B.C. INDUS. & COM. L. REV. 389 (1964); *An Empirical Study of the Arkansas Usury Law: "With Friends Like That . . ."*, 1968 U. ILL. L.F. 544; Comment, *Usury Legislation—Its Effects on the Economy and a Proposal for Reform*, 33 VAND. L. REV. 199 (1980).

17. See *supra* note 13.

Usury may still be a good way for society to moderate competing interests in the use of credit and the accumulation of debt in society.

Jeremy Bentham's paper on usury published in 1787¹⁸ articulated the philosophy of modern critics of usury and accounts for the ambivalence of modern nations' attitudes to usury laws. While most developed nations still have usury laws,¹⁹ they are riddled with exemptions to benefit a trade or industry.²⁰ Bentham and the mercantilists favored the rapid economic development of their society and they discounted the potential for instability due to indebtedness based on the theory that individuals exercise free choice and negotiate their own best interests. The aggregate of individual choices was also considered the best proxy for society's best interests. In his letters on *Defence [sic] of Usury*, Bentham wrote:

No man of ripe years and sound mind, acting freely, and with his eyes open, ought to be hindered, with a view to his advantage, from making such a bargain, in the way of obtaining money, as he thinks fit: nor (what is a necessary consequence) anybody hindered from supplying him, upon any terms he thinks proper to accede to.²¹

Bentham's "free" market theory of usury has influenced the modern view of usury in ways that make it profoundly different from that of ancient societies. Bentham's assertion implies an idealized bargaining dialogue between borrower and lender. The lender is presumed to bargain for his or her own self interest to charge the highest rates the traffic will bear and to "puff" or even mislead the buyer. This conduct is to be offset or limited by the borrower's comparison shopping, questioning, and negotiating. This bargaining dialogue will yield the "fair price," i.e., the price and amount of credit that is in the individuals' and society's best interests. This normative dialogue presumes equal aptitude, intelligence, information, and vigor on the parts of both borrower and lender. To the extent that these presumptions about borrowers and lenders and their interaction are untrue, the unregulated market is not "free" and does not yield the results postulated by free market theorists, including Bentham. Two widely different philosophies of intervention developed around this view of society. One was committed to a model of temporary legal

18. J. BENTHAM, *Defense of Usury*, in 3 THE WORKS OF JEREMY BENTHAM 3-29 (J. Bowring ed. 1962).

19. Usury laws remain on the books of all the member countries of the European Economic Community and most Islamic states. See generally DIGEST OF COMMERCIAL LAWS OF THE WORLD (1987) (discussing the commercial practices of individual countries).

20. For example, federal decisions beginning in 1975 virtually exempted the credit card industry from state usury laws giving a major boost to the expansion of consumer credit. The line of federal decisions allowing banks to "export" higher interest rates from state to state, taking the highest rate allowed began with *United Missouri Bank of Kansas City v. Danforth*, 394 F. Supp. 774 (W.D. Mo. 1975) and culminated with *Marquette Nat'l Bank of Minneapolis v. First Omaha Serv. Corp.*, 439 U.S. 299 (1978).

21. J. BENTHAM, *supra* note 18, at 3.

intervention in the market—intervention designed to improve the performance of market participants or market-perfecting strategies.²² Others believed the problems lay beyond the market, in the inherent nature of men and women themselves, thus favoring more permanent forms of intervention, such as standard setting.²³

What is most remarkable about the impact of Bentham's market model of interest rates is that it changed the focus of policy discussions about usury to his view that the purpose of usury is to regulate a myriad of microeconomic transactions involving countless individuals, not to regulate indebtedness in society as a whole. Viewed as microeconomic regulation of individual lenders and borrowers, it is difficult to calculate the benefits of usury. However, viewed as a tool for managing the total amount of credit in society, usury may still be an important macroeconomic tool for moderating negative consequences of widespread indebtedness in modern, post-industrial society even as it was in ancient society.

Bentham was the first modern philosopher to openly embrace the use of credit as a tool for economic development and as such articulated the economic needs of society struggling to amass capital and to improve the quality of life. Entrepreneurs needed the economic freedom to accumulate capital for investment, even at great risk. Bentham's declaration gave them a platform from which the economic agenda could be openly addressed for the first time since church laws on usury had overshadowed secular economic life following the Dark Ages. As discussed,²⁴ these church usury rules appear to have been concerned with the group more than individuals, but they had begun

22. Market perfecting strategies are those which perfect the ideal dialogue between sellers and buyers by helping buyers to negotiate more effectively or to compare shop more easily. A market perfecting solution is intervention designed to improve the performance of market participants, not merely to set a specific standard committed to self-perpetuation. However, market perfecting strategies focus responsibility on consumers and avoid issues of commercial standards of conduct. See Beales, Craswell & Salop, *The Efficient Regulation of Consumer Information*, 24 J. L. & ECON. 491, 503-05 (1981) [hereinafter Beales]. See also *infra* note 38. Because market perfecting strategies are less restrictive forms of intervention, they appeal to the current political ideology which favors deregulation of many industries. See *supra* note 15 and accompanying text. They also contemplate some acceptable level of consumer injury since information will not reach all consumers who need it. Usury laws which set the interest rates lenders may charge are a traditional form of regulation and price and entry controls. Critics of usury laws maintain that the free market is the best way to structure debtor-creditor relationships and have focused their criticism on anticompetitive effects of this traditional form of regulation. See Wallace, *The Uses of Usury: Low Rate Ceilings Reexamined*, 56 B.U.L. REV. 451, 452 (1976).

23. See *infra* notes 69-95 and accompanying text.

24. See *supra* notes 8-12 and accompanying text.

to lose their moral force and clear purpose when the economic needs of development began to accelerate, especially as debt slavery and oppression began to disappear.

Bentham's philosophy gave lenders a declaration of independence. Usury directly regulates the lender's freedom to charge whatever interest rates he can get for his or her money. But legal regulations are appropriate to limit lender freedom when society or certain individuals may be harmed. Lenders' freedom to cause harm is controlled through market-perfecting strategies or through more permanent regulation. The principle difficulty with usury regulation today is, however, the difficulty in finding consensus about what is a harmful level of indebtedness, and whether harmful indebtedness is the product of different value systems (*not* a reason to regulate behavior in a democratic, pluralistic society) or the product of temptation, ignorance, or aberration.²⁵

Bentham's critique changed the view of usury in one further way. After Bentham, even proponents of usury tended to defend its merits on the basis of the individual borrower's need for protection. Since then, usury is rarely considered a tool for addressing the widespread effects of indebtedness. Because usury laws are so hard to rationalize on the level of most individual borrowing, its application to a larger scale of the problem has been lost in discussion.

III. USURY AS CONSUMER PROTECTION

To the extent that usury prescribes the rate of interest lenders may charge borrowers, usury paternalistically substitutes government judgment for that of the parties to the transaction, displacing the market dialogue by eliminating bargaining at least on that term. Viewed on a larger scale, however, usury has another important market effect: its effect on the supply of credit. Usury is a mechanism for controlling the amount of credit in society. By controlling lender incentive to lend by limiting profits from lending, usury laws counterbalance forces increasing the supply of credit. As such, it is a proxy for society's interest in controlling the amount of credit more than society's interest in controlling lender profit.

A. *Paternalism for the Incapacitated Borrower*

Beyond the larger social interest at stake, the paternalism of usury serves a compelling interest in the case of at least one type of borrower, the incapacitated borrower. Where incapacitation affects the borrower's ability to participate in the marketplace effectively, pater-

25. Gelfand, *Authority and Autonomy: The State, The Individual and The Family*, 33 U. MIAMI L. REV. 125, 156-57 (1978). See also Wallace, *supra* note 22, at 474.

nalism remains a compelling reason for structuring lender-borrower relationships according to an objective standard. Although paternalism in legal regulation is no longer considered a compelling rationale for regulation,²⁶ protecting the vulnerable is the traditional consumer protection rationale.²⁷ Incapacitated borrowers are susceptible to making mistakes in bargaining transactions, for which they must bear the consequences. Based on the belief that incapacitated borrowers will make irrational decisions about credit, or will be unable to evaluate information or will misestimate risks attendant on the credit transaction, government substitution of judgment is a direct appeal to public moral values, limiting the degree to which vulnerability can be used against the borrower. These are moral values which are themselves important, even apart from efficiency concerns.²⁸

There are a number of different kinds of incapacity affecting borrowers, especially modern borrowers. One type of phenomenon that will cause the borrower to be unable to evaluate information is "bounded rationality," a limitation on the ability of any human being to process many pieces of information. Any typical credit transaction involves many considerations along with the applicable interest rate—things which may be related to the cost of credit. Depending on the product or services being purchased on credit, the transaction can become very complicated in the number of terms to be negotiated and their interrelationship. Because of complications inherent in any credit purchase, borrower search, shopping and bargaining strategies tend to reflect self-imposed limitations on information, limiting consumer ability to bargain on all terms using all relevant information. Consumer researchers have identified the following consumer information strategies that may cause consumers to depart significantly from the normative market dialogue of Bentham:

First, . . . [consumers] will . . . use more readily available and vivid information . . . [such as] personal selling and point of purchase information [but ignoring more accurate written disclosures]. Second, consumers will process information in the form in which it is displayed [making uniformity of terminology essential to facilitate accurate comparison shopping]. . . . Third, consumers, when searching for new producers of information, will refer initially to previous experience. . . . Fourth, . . . [consumers] are poor statisticians and

26. See generally S. BREYER, *supra* note 14.

27. See *Federal Pre-empting State Usury Laws*, 37 BUS. L. 747, 783 (1982) [hereinafter *Pre-emption Laws*].

28. See Ramsay, *Framework for Regulation of the Consumer Marketplace*, 8 J. CONSUMER POL'Y, 353 (1985) (discussing the need for governmental intervention in the marketplace to protect consumer economic interests).

tend to put too much weight on small [or biased] data samples. . . . Fifth, . . . [consumers] tend to ignore small probability events [like unpleasant occurrences]. . . . Finally, . . . consumer search tends to be limited to a small number of alternatives even though a large number are available.²⁹

Another modern phenomenon that leads to irrational decisions about the use of credit is a compulsive disorder called credit binging or credit abuse. This disorder is growing among well-educated, upwardly mobile young adults who use credit to subsidize a standard of living to which they are accustomed or to which they aspire, but which their current income will not support. The credit abuser uses the pleasure of purchasing goods to overcome feelings of boredom, anxiety, anger, fear, or loneliness. This compulsive behavior has prompted the formation of self-help groups, and has attracted public attention in the media.³⁰ This disorder incapacitates more borrowers than the traditional types of incapacity such as mental illness, senility, and occasional illiteracy.

Protection of the vulnerable is one of the oldest motivations for consumer protection.³¹ Legitimate exercise of paternalistic power recognizes that information is of no use to an illiterate or mentally incompetent person. In order to protect these persons from the consequences of their own actions, a civilized society imposes limits on the ability of others to take advantage of such handicaps. Usury laws which regulate the lender-borrower relationships limit the ability of lenders to take advantage of borrowers who are handicapped in ways that prevent borrowers from fully participating in the bargaining phase of an extension of credit. Usury laws do this by setting objective standards of conduct for lenders.³² Many of the borrowers assisted by this paternalism might also benefit from a market perfecting strategy like consumer information,³³ but many borrowers who make irrational decisions will not be able to benefit from a mar-

29. *Id.* at 364-65.

30. See, e.g., Bennett, *Now, The Age of Fast-Buck Banking*, N.Y. Times, Dec. 14, 1986, § 3, at 1, col. 1; Hudson, *I Don't Need All The Credit*, NEWSWEEK, July 14, 1986, at 9; *Shopping Addiction: Abused Substance is Money*, The Times-Picayune, June 16, 1986, at 20, col. 1.

31. See *infra* note 34.

32. Unlike mandatory information disclosure requirements, standard setting shifts responsibilities from buyer to seller. See Cave, *Market Models and Consumer Protection*, 8 J. CONSUMER POL'Y, 335, 345-48 (1985).

33. Government can provide consumers with information by mandatory disclosure requirements like ingredient labeling or by dissemination of educational materials. The Federal Trade Commission has invested more of its resources over the last eight years in consumer education by publishing booklets and pamphlets which a consumer can order, usually free, on a variety of topics from shopping through the mail to home mortgages. These pamphlets are written in plain language and advertised in public service announcements in the media. The most obvious flaw in this stratagem is accessibility of the information to illiterate consumers or to consumers who did not learn of its availability. There are other major flaws with this educational strategy. See Beales, *supra* note 22, at 531.

ket perfecting strategy that refocuses responsibility for mistakes in the bargaining process on them.

Paternalism is a legitimate restraint on lender conduct in order to protect vulnerable people; therefore, usury should not be discarded in its entirety as inappropriately paternalistic. Before policy-makers commit themselves to a choice that excludes limits on interest rates, they should obtain more empirical data on the numbers of borrowers who may be affected by an inability to negotiate credit in their own best interests. These people are incapacitated in terms of the normative model of consumer behavior. Lender marketing and negotiating behavior with respect to these people is the most important factor to control in avoiding problematic debt situations with these borrowers. Usury laws provide objective, self-executing controls on lender behavior. It is important to know how many people are most dependent on lender behavior rather than other factors in making the decision to accept and use credit.

Moreover, the assumption that an unregulated market is *not* paternalistic is not a logical corollary. An unregulated market is potentially as paternalistic as a regulated market.³⁴ Lenders, as the more powerful, unified, and cohesive force, will certainly substitute their judgment for that of incapacitated borrowers who are unable to exercise judgment in the bargaining process in their own best interests. Governmental paternalism is preferable to lender domination of the vulnerable because government judgment is more consistent with established public policy and public moral values concerning the limits on freedom to take advantage of vulnerable people.

Society has a clear interest in limiting exploitation as an exploitative society is in danger of instability by its exploited members. Society also has an interest in both debt and credit as they promote economic development and affect employment, savings, and a host of other factors connected with domestic stability. The structure of lender-borrower relationships should protect society's interest in in-

34. An unregulated but imperfect market could be dominated by lender preferences. If lenders substitute their judgment for borrowers', the market is no less paternalistic than if government substitutes its judgment for borrowers'. See *Pre-emption Laws*, *supra* note 27, at 778-80 (statement by George Wallace). This article is a collection of comments made by members of a distinguished panel during a program by the American Bar Association Committee on Consumer Financial Services at the 1981 ABA Annual Meeting in New Orleans, Louisiana. The comments were edited for publication by the program moderator William M. Burke. The panelists included Beth L. Climo, Counsel to the Senate Banking Committee, Peter D. Schellie of Washington D.C., and George J. Wallace, formerly a professor of law at Rutgers University.

debtedness and credit. The question of whether the unregulated market is the best way to structure these relationships is of current importance as lenders seek more freedom from regulation in an era of increased competition and seek to market more credit³⁵ to a population squeezed by diminishing employment opportunities and diminishing standards of living.³⁶

Ancient societies with strict usury laws were not concerned with modern concepts of individual entitlements, individual freedom or individual protection but were focusing on balancing relationships within their tribes, groups, or towns. These societies seemed more concerned about the destabilizing effects of widespread personal indebtedness such as slavery, impoverished and homeless families, revolution and riot, as oppression threatened the poor too much.

Modern societies ignore this focus on stable relationships and mitigation of the negative effects of oppression probably because those negative effects are harder to see since legal slavery has disappeared in most modernized nations. Yet, even in modern nations, debt has been associated with riots and civil unrest.³⁷ Instead, modern societies are more concerned about the need for economic development which usury laws seem to impede because of the limitations they impose on competitive conduct.

The tension between these policy concerns, economic development and protection from destabilization, continues in American society today, mainly in terms of the debate over who should structure the relationship between lenders and borrowers, the government or an idealized "free market." Indeed, the constituency pressing for the ab-

35. The Arab oil embargo of 1968 forced interest rates higher throughout the economy, blurring traditional market segmentation between banks, small loan companies and credit card issuers. For the first time, these lenders all began to compete with one another for the same customers. See Bennett, *supra* note 30, at 8, col. 2.

36. Redesign of full-time employment into part-time employment, growth of part-time and part-year work, and the spread of wage freezes and wage reductions from one industry to another foreshadow a decline in annual salaries and decline in the average American standard of living. See generally BLUESTONE & HARRISON, *THE GREAT AMERICAN JOB MACHINE: THE PROLIFERATION OF LOW WAGE EMPLOYMENT IN THE U.S. ECONOMY* (1986) (concluding that the decline in high-wage manufacturing employment and the expansion in low-wage retail trade employment may leave America without a middle class with middle-level incomes). This forecast is particularly ominous for highly leveraged borrowers who depend on steady employment and stable or rising salaries for repayment of debt and who also use debt as a way of supplementing their living standard and participating in the advertised, material culture.

The projected effects of usury ceilings would impact most on "marginal" borrowers whose income level, employment tenure, duration of residency and previous credit record are minimal qualifications. Usury limits would counteract the expansion of credit for more marginally qualified borrowers. Canner & Fergus, *The Economic Effects of Proposed Ceilings on Credit Card Interest Rates*, 72 Fed. Res. Bull. 1, 7 (1987) [hereinafter Canner].

37. See generally D. CAPLOVITZ, *THE POOR PAY MORE* (1969) (examining consumer practices and their effect on low-income families).

olition of usury laws in both state and federal legislatures is composed of lenders and businesses dependent upon consumer credit for profitability.³⁸ They, like Bentham, are obviously much more concerned with the role consumer debt plays in economic development and growth than with the potential for injury from widespread indebtedness and an oversupply of credit.

B. Society's Interest in Debt: Development and Stability

American society has had usury laws since its days as a colony of England and the states still retain these laws, as does nearly every other nation with whom America trades. State legislatures have historically had exclusive jurisdiction over usury laws in the United States apart from preemptive federal legislation.³⁹ States have retained sovereignty because they feel that they know what is best for their communities in terms of growth and potential for oppression.⁴⁰ Federal legislation has mainly exempted certain nationally unified and cohesive industries from state laws restricting their trade. The Depository Institutions Deregulation and Monetary Control Act of 1980,⁴¹ for example, preempted state usury ceilings on most first home mortgages to give relief to home builders and industries dependent on home building. The senate report on the Act states: "The Committee believes that this limited modification in state usury laws will enhance the stability and viability of our Nation's financial system and is needed to facilitate a national housing policy and the functioning of a national secondary market in mortgage lending."⁴² While the federal legislature has invoked its preemption powers generally to weaken state usury regimes, several state legislatures have expanded their usury regimes to reach credit card interest rates. As bank profits on credit cards soar⁴³ and consumer debt load reaches its highest point in history,⁴⁴ some states like Connecticut have lowered

38. *Pre-emption Laws*, *supra* note 27, at 782 (statement by Beth Climo).

39. *See supra* note 13.

40. *See Pre-emption Laws*, *supra* note 27, at 795-97 (statement by George Wallace).

41. *See DIDMCA*, *supra* note 13.

42. S. REP. NO. 368, 96th Cong., 1st Sess. 19 (1979).

43. In 1986, bank profits for credit cards will be around \$5 billion dollars. Luke, *High Rates Can't Be Justified*, *Los Angeles Group Says*, *Am. Banker*, Jan. 9, 1987, at 6, col. 3.

44. Consumer debt was 19% of income in 1986. Barmash, *Consumer Spending Lull Seen: Debt Burden, Buying Power Cause Concern*, *N.Y. Times*, Dec. 8, 1986 at D1, col. 6. Sandra Shaber, Vice President of Chase Econometrics, stated that the debt burden is "worth considering, of course, but it won't lead to a recession." *Id.* at D10, col. 2. Similarly, Robert Genetski, an economist, stated that the debt, by itself, is not really

the ceiling on permissible credit card interest rates.⁴⁵ The debate over who should structure the relationships between lenders and borrowers is louder than ever.

The debate is also over who best reflects society's interest in debt and credit, the marketplace or the legislature.⁴⁶ The remainder of this article argues that society's interest in indebtedness also includes related areas such as society's interest in savings, employment, and the quality of life as these relate to social stability. Lenders and borrowers, in our modern post-industrial economies, share a dangerous incentive to oversupply the market with credit which is antithetical and unresponsive to society's broader interests in stability. In addition to the relationship between economic development and credit, society's interest also includes the relationship between diminishing standards of living, credit, and employment prospects in a deindustrializing economy. Thus, society's interest exceeds economic development alone, but also includes the dangers of social instability in an era of diminishing employment and an economy highly dependent on employment to finance widespread personal debt. The greatest

significant. *The MacNeil/Lehrer News Hour: Off Balance* (WNET/Thirteen television broadcast, Oct. 20, 1986) [hereinafter *Off Balance*].

45. In most places where banks are free to set their own credit card interest rates, there are no plans to reduce the interest rates currently charged. Despite a drop in the prime lending rate from 13% to 10.5% in less than a year, the bankers' profit motive does not permit a reduction in the credit card rates. *The Wall St. J.*, Mar. 7, 1985 at 1, col. 5. Some declines have been documented, but they remain the exception rather than the rule. There have been a few voluntary reductions to attract new customers and to head off pressure for lower rates from consumer groups. See *N.Y. Times*, Oct. 9, 1985, § 4, at 1, col. 6 (Manufacturers Hanover Corporation drops to 17.8% from 19.8%). See also *The Wall St. J.*, May 22, 1986 at 1, col. 5 (Home Savings of America in Los Angeles dropped its rate to 16% from 20.4%; Central Bank in San Francisco dropped to 17.76% from 19.8% and the Society for Savings in Hartford, Conn., dropped to 13.9% from 14.9%).

Additionally, regulators in a few places have strengthened or enacted credit card usury laws that will force banks to lower the rates. *The Wall St. J.*, Mar. 7, 1985, at 1, col. 5. As an example, a Connecticut law lowered the maximum interest rate on credit card loans to 15% effective June 4, 1986. *CONN. GEN. STAT. ANN.* tit. 42 § 133c (West 1987). Within two months some Connecticut banks had gone even lower to 10.9% interest on credit cards.

46. This debate on market versus state regulation was typified by an exchange between Martha R. Seger, Governor on the Federal Reserve Board, and Senator Christopher Dodd at hearings on bills legislating a federal cap on credit card interest rates. Ms. Seger testified to the Federal Reserve Board's belief that credit is most fairly and efficiently allocated where there are no regulatory constraints, and if there are legal ceilings imposed upon credit card interest rates, then state law should set them. *Credit Card Disclosure Acts: Hearings on S. 241, S. 242, S. 616, and S. 647 Before the Subcomm. on Consumer Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 79-80 (1987) [hereinafter *Hearings*] (statement of Martha R. Seger, Governor of the Federal Reserve Board). Senator Dodd questioned the consistency of that approach with the decision in *Marquette Nat'l Bank at Minneapolis v. First Omaha Serv. Corp.*, 439 U.S. 299 (1978), which undermined state usury ceilings by allowing federal banks to "export" interest rates. *Hearings* at 93. Ms. Seger did not see any inconsistency. *Id.* at 93-94, 99-101.

probability of social dislocation would be in the event of recession because the economic matrix of widespread indebtedness, an oversupply of available credit and diminished employment income, would cause many more borrowers, their families, and, indirectly, lenders to suffer default in a recession. Further, the market behavior of lenders and borrowers both tend to contribute to this vulnerability by oversupplying the market with credit and increasing the dependency on high quality employment that will not be there in the future.

IV. CREDIT AND THE THREAT OF RECESSION

Rohatyn: "[T]he most serious issues . . . are not the sort of theoretical arguments about budgetary deficits, but the notion that excessive borrowing kills you in the last analysis.

.....

I was brought up to believe that excessive borrowing was bad for you."

McNeil: "[W]hat is bad about that? . . . Americans in their private lives borrow more money than any other people on earth."

Rohatyn: "[I]t's also not very good for Americans to do it. . . . We've crushed the private sector with debt. We're buying companies with borrowed money which forces us to break them up and reduce employment. We're doing some things that are very, very risky, and I think we're taking risks beyond anything that's rational."

.....

McNeil: "What is the specific risk or peril that you see? . . ."

Rohatyn: "[What are we going to look like if] we go into a recession . . . ?"⁴⁷

A. Unemployment and Consumer Debt

During recession, employment diminishes and salaries tend to decline, a trend that is already part of our long term economic prognosis. Even apart from a recession, the trend toward redesign of full time employment into part-time work, growth of part-time and seasonal work and the spread of wage freezes and wage reductions from one industry to another, foreshadow a decline in annual salaries and decline in the average American standard of living.⁴⁸ Meanwhile, recent studies report that consumers, most of whom depend upon

47. *Off Balance*, *supra* note 44 (statement by Felix Rohatyn, a senior partner in the New York banking firm of Lazard-Frère). See also *Credit Card Interest Rate Ceiling and Disclosure: Hearings on H.R. 78, H.R. 244, H.R. 515, H.R. 1086, and H.R. 1584 Before the Subcomm. on Consumer Affairs and Coinage of the House Comm. on Banking, Finance and Urban Affairs*, 100th Cong., 1st Sess. 86 (1987) (statement of Jerry Cosentino, Treasurer, State of Illinois) ("[L]ooming on the horizon is the third American deficit, the Consumer Deficit that joins the already enormous Federal and Trade deficits that individually and collectively pose an ominous threat to the American economy").

48. See *supra* note 36.

steady employment and rising income levels for repayment of debt, have undertaken the highest debt load in American history⁴⁹ with fewer savings than ever to meet emergencies, or even temporary interruptions in cash flow.

Modern borrowers (and thus modern lenders) need employment income in rising amounts to avoid default. This relationship between employment and default was demonstrated in 1974 by David Caplovitz's seminal econometric study, *Consumers in Trouble: A Study of Debtors in Default*.⁵⁰ Loss of employment was the most prevalent reason for borrower default on their obligations to repay credit.⁵¹ Most of the other reasons for default were also related to income interruptions or diminution of income such as illness of the worker or a working family member.⁵² These income interruptions together with "voluntary overextensions" left borrowers unable to meet payment obligations as they become due.⁵³ As our consumer debt grows, American borrowers (individually and American lenders in the aggregate) become more dependent on continued employment. With consumer debt approaching one trillion dollars,⁵⁴ unemployment and underemployment pose the real danger to society that large numbers of borrowers will default on credit obligations even apart from some event which could trigger a recession.

While default does not reduce modern debtors or their families to slavery, the event can be devastating to individuals and their families, as well as costly to society in quantifiable and nonquantifiable ways.

49. See *supra* note 44.

50. D. CAPLOVITZ, *CONSUMERS IN TROUBLE: A STUDY OF DEBTORS IN DEFAULT* (1974).

51. *Id.* at 57.

52. *Id.*

53. *Id.* at 53. A recent econometric study of "problematic debt situations" in the Netherlands tends to reconfirm this portion of Caplovitz's findings about reasons for consumer default. In this Dutch econometric study, debtors with significantly leveraged debt to income were finally forced to take measures to cope with the consequences of individual indebtedness when reduction or loss of income occurred. Dessart & Kuylen, *The Nature, Extent, Causes and Consequences of Problematic Debt Situations*, 9 J. CONSUMER POL'Y, 311, 325-28 (1986) [hereinafter Dessart]. The study also examined statistical factors leading up to this denouement which contributed to excessive leveraging of individual income. *Id.* These results are discussed *infra* notes 67-68 and accompanying text. This study presents several obvious problems in terms of its validity for American policy decisions, since the Netherlands is a much more centrally controlled economy. Nevertheless, it represents the most recent attempt to examine the foundations for such policy decisions in a non-anecdotal, statistically valid study. The Caplovitz study in 1974 is the only attempt to examine causes of consumer default in the United States and must be updated before legitimate, responsible decisions on consumer welfare and usury can be taken.

54. Between 1950 and 1972 consumer installment debt rose from \$21.5 billion to \$137.2 billion. COMMISSION REPORT, *supra* note 13, at 5. By the end of 1981, consumer installment debt had reached \$333.4 billion. 49 Fed. Reg. 7,741 (1984) (to be codified at 16 C.F.R. § 444). By the end of June, 1986, total consumer installment debt had reached \$567.4 billion. 72 Fed. Res. Bull. app. at 40 (Oct. 1986).

Psychological injury to defaulted debtors and their families was first explored by Professor Wallace in 1973.⁵⁵ He found that both the defaulted debtor and his or her family suffer loss of self-esteem, financial instability, increased stress, and dislocation of family life as a result of default on credit.⁵⁶ The psychological leverage applied in debt collection can cause personal guilt, social censure, marital stress, worry about possible job loss, lost productivity at work, and painful family reorientations due to diminished income.⁵⁷ The impact of problematic debt on individuals and their families was studied more recently by a team of researchers in the Netherlands. Their survey of Dutch nationals revealed that the consequences of problematic debt include social isolation, psychological stress, depression, sleeplessness, aggression, tension in personal relationships and other psychosomatic complaints.⁵⁸

Moreover, modern borrowers who lose their jobs, homes, or see their family life deteriorate under the pressure of default may become the homeless, rootless, and transient unemployed, and sometimes even the mentally ill and unemployable in American society. Recent surveys show that many of America's homeless were once American workers, taxpayers, and homeowners.⁵⁹

Quantifiable costs of default to society as a whole include not only these costs of wasted human lives, but also the costs of collection efforts before default occurs (paid by all borrowers to some extent), and costs of maintaining bankruptcy courts after default occurs, un-

55. See Wallace, *supra* note 22, at 473; Wallace, *The Logic of Consumer Credit Reform*, 82 YALE L.J. 461, 471-72 (1973).

56. Wallace, *supra* note 22, at 473.

57. *Id.* For an anecdotal account of family life with a high risk borrower, see the recent biographical and autobiographical sketches of spy novelist, John Le Carre in the N.Y. Times, Mar. 16, 1986, (Magazine), at 40 and J. LE CARRE, A PERFECT SPY (1986).

58. The consequences [of problematic debt] . . . must also be seen in dynamic perspective. . . . Borrowers also become more and more "socially" isolated, on the one hand because of a reluctance to talk about their own situation for reasons of pride and embarrassment, and on the other hand because the financial needs which a social life involves can no longer be satisfied. It is obvious that this will often be accompanied by increasing psychological stress. In this respect, the whole range of depressive symptoms (sleeplessness, anxiety, aggression, etc. is encountered. If this type of phenomenon occurs, the sufferer becomes less and less able to cope with the still deteriorating financial situation. At the final stage, serious tensions occur in personal relationships as well as all kinds of complaints of a psychosomatic nature.

Dessart, *supra* note 53, at 328.

59. See Collin, *Homelessness: A Post-Industrial Society Faces a Legislative Dilemma*, 20 AKRON L. REV. 409, 413 (1987). See also M. HOPE & J. YOUNG, FACES OF HOMELESSNESS (1986).

derwritten by tax dollars. Lesser quantifiable social costs would include the diminished productivity of workers in the workplace when they are in debt trouble⁶⁰ and the long term effect on our country of becoming a nation of debtors, many of whom are perpetually overleveraged by debt. Finally, the pressure of dramatic increases in consumer defaults upon bank portfolios and profitability cannot be blithely ignored. It is impossible to quantify the effect of such a stressful condition on public moral values such as honesty, thrift, self-reliance, and institutions like the family. Because these costs are not quantifiable, they do not translate readily into a cost benefit analysis⁶¹ and are easily ignored.⁶² These costs do exist, however, and ought to concern our society as much as they concerned ancient civilizations.

60. No empirical study has been done linking debt collection pressure to worker productivity but employers are sensitive to this relationship. If an employer learns of an employee's debt problems, the employee may lose promotions, pay raises, and even his or her job. Many employers lose their faith in a defaulting employee's motivation, productivity, sense of responsibility, honesty, and trustworthiness. See 49 Fed. Reg. 7,758 (1984). Because of this suspicion, courts have found that an employer has a legitimate interest in knowing about an employee's debt problems. See *Voneye v. Turner*, 240 S.W.2d 588, 590 (Ky. Ct. App. 1951). *But cf.* Consumer Credit Protection Act, 15 U.S.C. § 1674(a) (1982); ILL. ANN. STAT. ch. 48, para. 39.11, § 10 (Smith-Hurd 1986) (statutes which prohibit discharge of an employee whose wages are being garnished).

61. The main attraction of cost benefit analysis is that it appears to offer a relatively value-free approach and quantitative answers to policy questions. When input is not quantifiable, it may be excluded from consideration, making conclusions suspect. Another shortcoming of cost benefit analysis occurs when equity concerns override the economic calculus. An example from the consumer protection area is regulation designed to protect the vulnerable. See Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983); Ramsay, *supra* note 28, at 357-58.

62. Banks, credit unions, small loan companies, retailers, and other industries are much better organized and their impact on policy making is much greater than that of consumers and borrowers. Borrower concerns are diffused across many different products and service markets. Trebilcock, *Winners and Losers in the Modern Regulatory System: Must the Consumer Always Lose?*, 13 OSGOODE HALL L.J. 619, 620-22 (1975). Reliance on traditional cost benefit analysis tends to weight the interests of the lending constituency more heavily because of their articulate and organized representation. See Ramsay, *supra* note 28, at 357-58. See also Diver, *supra* note 61, at 99, 101.

The receipt of accurate signals about the social costs and benefits is a necessary, but not sufficient, condition for optimal precision of rules.

.....

One cannot, however, logically equate the intensity of the response to a policy decision with the magnitude of the costs and benefits generated by the decision. The costs of sending signals of equivalent intensity may not be the same for each of the interests affected. The most vociferous lobby need not have the highest stake in the outcome; it may simply have the lowest organization costs.

Id.

The major risk of this underrepresentation of borrower interests is that usury is viewed in light of its competitive focus. Legislators have lost some perspective in their pursuit of competition and ignored circumstances where regulation of competition might be to the long term advantage of society and consumers. See Reich, *Toward a New Consumer Protection*, 128 U. PA. L. REV. 1, 14-15 (1979).

B. *The Crisis of Credit*

Today, institutional pressures to increase consumer debt outweigh borrower incentive to refrain from indebtedness. Lenders, pushed by new competition from any business that has enough market power to raise and lend money, are under enormous pressure to sell credit and expand their portion of consumer debt in order to maintain profits.⁶³ Market segmentation between lenders had protected profitability for many years.⁶⁴ Banks were the most selective lenders charging lower rates to their customers than small loan companies which served different borrowers at higher rates permitted by law. Deregulation and new competition have fostered an intense competition between these lenders resulting in more credit being made available to more borrowers than ever before. This increased competition has caused an expansion of the pool of available consumer credit and may be the single most influential factor leading to problematic debt in our society today. Under deregulation, banks marketing credit have extended more credit in the form of credit cards to consumers than ever before.⁶⁵ Lenders granting credit to borrowers in record numbers and at record rates may have overwhelmed rational, information-seeking behavior of borrowers.⁶⁶ Borrowers often fail to consider important credit characteristics such as term and rates, assuming that if they can obtain credit in the judgment of the lender, they must be able to afford the repayments. This abdication in the normative borrower dialogue makes the granting of credit by lenders the single most important contributing factor to problematic debt.⁶⁷

63. Under prodding from Senator Shelby, Ms. Seger, Governor on the Federal Reserve Board, admitted that the most profitable part of banking operations for many, if not most, banks today is the credit card operation. *Hearings, supra* note 46, at 98. When market rates of interest dropped in 1984 and 1985, profits on credit cards went up. *Id.* at 94 (statement by Ms. Seger).

64. *See supra* note 35.

65. *See Hearings, supra* note 46, at 127-38 (testimony of James B. Wiesler, Senior Vice Chairman, Bank of America, representing Visa).

66. *See supra* note 54.

67. This hypothesis was tested in the survey of Dutch nationals. Dessart, *supra* note 53. The empirical data for their country proved that:

[T]he most important explanatory factor for the origin of a problematic debt situation is institutional, namely the granting of credit to borrowers who already have one or more outstanding credits, either in the form of a second or third credit or in the form of a transfer of credit [e.g., a consolidation loan]. . . . [S]ome restraint in the granting of additional credit to borrowers who have already taken out one or more credits is to be recommended.

Id. at 331. The average American family currently possesses 9.6 credit cards. *House of Cards, supra* note 1 (statement by Bob Carlile).

Restraint on lender extensions of credit becomes very important to controlling the amount of credit available and used by borrowers in this climate. However, there is little market incentive for lenders in our era of deregulation to reduce extensions of credit—particularly credit card credit. Moreover, solutions to rising debt and its problems should not necessarily be predicated on the rational, information-seeking model of consumer behavior in this climate.⁶⁸

These influences are magnified by market imperfections discussed below, such as inadequate information, lack of choices, and convenience, which add to the oversupply of consumer credit and overleveraging of consumers in the market as consumers borrow more than they want to borrow and use more credit than they need to use. Decision-making by lending institutions illustrates how lenders can exploit an imperfect market, not perfect it, when market imperfections are based on consumers who do not, or cannot, fully participate in the market dialogue.

Usury laws are a self-executing way of controlling the overall supply of credit. The remainder of this article explores forces contributing to oversupply of credit and reconsiders usury as a tool limiting the aggregate amount of consumer credit in society—an important tool in protecting modern society from the effects of deindustrialization moderating economic growth in favor of social stability.

V. AN OVERABUNDANCE OF CREDIT: MARKET FAILURES AND OVERSUPPLY

Usury laws benefit four groups of consumer borrowers,⁶⁹ each of whom does not, or cannot, participate fully in the marketplace. Their failure to participate in the market causes a market failure which, in each case discussed below, causes them to borrow more credit than they want or need. This superabundance of credit con-

68. Once again, the findings of the Dutch survey are relevant and troublesome for our information based strategy of handling consumer credit problems. The Dutch survey found that the relationship between knowledge of institutions extending credit and the terms and forms of credit did not bear a simple relationship to the likelihood of problematic indebtedness. Instead, they found a curvilinear relationship between these two facts, *i.e.*, “[b]orrowers with a very high or very low level of knowledge of credit affairs have a low probability of experiencing financial problems. . . . Most problems occur among borrowers with a moderate knowledge. They overestimate their knowledge [and], therefore do not ask for more information and as a result make the wrong decisions.” Dessart, *supra* note 53, at 332 (emphasis added). Those with very little actual knowledge who recognize this are cautious because they recognize their limits, like borrowers who are very knowledgeable. *Id.* at 323. Ironically, borrowers with the greatest chance of improvident borrowing will also be the most difficult to reach with information based solutions since “they overestimate their knowledge and will therefore less readily appreciate the usefulness of obtaining information.” *Id.* at 332.

69. See Wallace, *supra* note 22, at 475.

tributes to a staggering internal consumer debt. Usury affects lender behavior by diminishing the amount of credit available.

Usury laws benefit uninformed borrowers who borrow more credit than they want because they do not fully understand the risks.⁷⁰ Usury laws also benefit the incapacitated borrowers who borrow more credit than they want because they do not understand the risks. Usury laws also benefit high risk borrowers who borrow more than they may want or need because they have no choices. Finally, usury laws benefit credit card borrowers who borrow more credit than they want or need because they choose convenience instead of the process of bargaining and shopping for each extension of credit. Usury laws do not benefit the cash-paying consumer⁷¹ or the low risk borrower who has alternative sources of low rate credit and access to adequate information.

70. There is no general agreement on what information is useful to consumers in a credit transaction or even whether consumers can effectively process all the data relevant to a credit decision. Ramsay, *supra* note 28, at 364-65. Empirical studies confirm that consumers do not always shop for the price of credit, particularly when credit is primarily a matter of convenience not necessity. They may instead shop for low monthly payments or some other credit term. *Pre-emption Laws, supra* note 27, at 779-80 (statement by George Wallace). Regulation to remedy inadequate information may seek to improve the market's own provision of information that may be too expensive for borrowers to produce initially. See S. BREYER, *supra* note 14, at 27; Ramsay, *supra* note 28, at 359. Information regulation may also expand the consumer's ability to process complex information. This is the consumer education function of providing additional information to consumers. See S. BREYER, *supra* note 14, at 28; Ramsey, *supra* note 28, at 359. See also *supra* note 33. Even though the imperfect information rationale has been another fundamental rationale for consumer protection (in addition to paternalism) it is not clear that information remedies can successfully assist the consumer to evaluate all important characteristics of products or services. *Pre-emption Laws, supra* note 27, 779-80 (statement by George Wallace). Thus, regulation to remedy inadequate information is most effective to improve the market's own provision of information that may be too expensive for borrowers to produce initially. See S. BREYER, *supra* note 14, at 27; Ramsay, *supra* note 28, at 359.

71. Indirectly, however, cash paying customers may subsidize credit customers and thus be negatively impacted by low usury ceilings, especially if usury ceilings are set near or below prevailing market rates. Subsidization can occur when merchants of goods or services sold on credit (sale credit) raise the price of those goods or services to compensate for costs of extending credit to some but not all of their customers. By making the charge for credit part of business overhead costs, cash paying customers subsidize part of the cost of extending credit. Theoretically, the interest charged to borrowers is meant to compensate the lender for the cost of extending credit. When the lender is also the seller of goods, the lender/seller can use profits from the sale of the goods to recoup the additional cost of credit. While this kind of subsidization is very hard to detect and is not illegal, it contributes to the supply of credit to more marginal borrowers and oversupply of credit in our economy.

A. *Information and Market Failure*

An informational failure may cause borrowers to misestimate the true cost of credit. This can occur when the market does not produce all the information borrowers would willingly pay for, as distinguished from the incapacity to use information discussed below. The provision of additional information will help these borrowers to correctly appraise the true cost of credit, thus helping these borrowers to bargain more effectively. Information-based remedies, including government provision of information, aim at improving the bargaining process as a market-perfecting strategy. Market-perfecting strategies, however, place ultimate responsibility once more on the borrower for mistakes in the bargaining process,⁷² instead of imposing standards of conduct on lenders in the way that tort law usually does. Moreover, information remedies tend to favor borrowers with more education. When borrowers do not use information, it clearly cannot serve a beneficial purpose. Although the relationship between information and market behavior should be a simple one,⁷³ research into consumer behavior must caution against assumptions that consumers actually use information in a normative, rational way. Information assists those who can use it because they are educated enough to understand it and those who appreciate their lack of knowledge and their need for information. People with moderate to high levels of education who fail to correctly identify their own lack of knowledge will not use information effectively,⁷⁴ a problem which affected nearly forty-two percent of the borrowers with debt problems in one study.⁷⁵ Clearly, this kind of data must affect our disclosure-oriented solutions to consumer debt, and this type of study should be repeated in this country to determine its validity in our economy. Nevertheless, restraints that are necessary to trim dangerous credit consumption in our society may not be assumed to derive sufficiently from information directed at borrowers if a significant number of borrowers do not recognize their need for information and therefore do not use it.

Usury laws, by contrast, set a standard which is presumed to reflect the true cost of credit, eliminating the need for bargaining. Usury laws impose responsibility for the bargaining stage on lenders who must comply with the legal standard instead of relying on consumer bargaining to correct the market exchange between lender

72. See Beales, *supra* note 22, at 503.

73. See generally Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979) (stating that market models which explain market behavior are of little use to lawyers, judges, and legislators because of their mathematical complexity).

74. Dessart, *supra* note 53, at 332.

75. *Id.*

and borrower. In the absence of objective legal standards, uninformed borrowers tend to borrow more credit than they would want if they understood its true cost. By setting an objective standard, usury laws bring the amount of credit borrowed closer to true consumer preferences by reducing lender incentives to supply credit and thereby reducing overall supply.

Incapacitation may also cause the borrower to misestimate risks in the credit bargaining process. Providing information will not help borrowers who are unable to participate in the bargaining process because these borrowers cannot be empowered to bargain more effectively. Market-perfecting strategies which refocus responsibility for mistakes in bargaining on these borrowers will not remedy the market failure caused by incapacitation of these borrowers.

B. Usury Laws as a Substitute for Adequate Information

Standard-setting focused on lenders is the only way to protect these borrowers from the consequences of their own vulnerability in the bargaining process. Usury laws are one type of standard-setting rule society can impose for the protection of its members. Because usury laws employ an objective measurement, unlike other tortious standards of conduct, the transaction costs⁷⁶ of policing the market are relatively lower and fall on society as a whole, rather than the class of incapacitated borrowers who are least able to absorb such costs. Less intrusive methods of policing the market for abuses are the tort doctrines of unconscionability⁷⁷ and the statutory tort of consumer unfairness,⁷⁸ but these standards rely on judicial intervention

76. Transaction costs are costs of bargaining, including search and information costs, bargaining and decision costs, and policing and enforcement costs. These costs do not show on a balance sheet and may be ignored by traditional cost benefit analysis (see *supra* note 61) but nonetheless affect the way goods and services are allocated and delivered. See Ramsay, *supra* note 28, at 355; see also R. POSNER, *ECONOMIC ANALYSIS OF LAW* 30 (2nd ed. 1977) (transaction costs are the cost of effecting a transfer of rights). Transaction costs can perpetuate externalities in several ways including imposing expenses on communication with affected people, some of whom may systematically underestimate the true value of relief from the problem caused by their underrepresentation. See generally Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

77. See *supra* note 12.

78. Consumer unfairness is a modern concept first codified in the Federal Trade Commission Act of 1914 [hereinafter FTC Act]. 15 U.S.C. §§ 41-51 (1982) (original version at ch. 311, § 1, 38 Stat. 717 (1914)). The FTC Act specifically forbade unfair and deceptive acts and practices, leaving the Commission definitional jurisdiction of both terms, "unfairness" and "deception." *Id.* § 45, 38 Stat. at 719. While deception had a common law derivation, unfairness had none. In 1980, the Commission issued a letter

for definition and, as such, are expensive for the injured plaintiff to enforce. This transaction cost makes less objective standards ineffective in policing high volume transactions, each of relatively small individual significance.

Absent objective legal standards, incapacitated borrowers also borrow more credit than they want or need because in the absence of a meaningful expression of the consumer preference, merchant and lender preferences dictate the amount and price of credit to the incapacitated borrower. Theoretically, usury standards set at a normative rate bring the available supply of credit to a level closer to true consumer preferences by reducing supplies and lender incentives to provide credit. While reducing the supply of credit may deprive some incapacitated persons of credit, part of the borrowing by the incapacitated is prompted only by temptation, ignorance, or aberration (not just differing values). Usury standards limit lending which also has potential for taking advantage of this vulnerability, a paternalistic goal, perhaps, but a legitimate use of paternalism.⁷⁹

High risk borrowers also fail to participate in the bargaining process for credit for a different reason: The lack of alternative sources of low cost credit. They also tend to borrow more credit than they want or need because of this failure. High risk borrowers are those who have a high probability of defaulting on a loan or credit sale, generally because of their marginal ability to repay credit (and not usually because of unwillingness to pay).⁸⁰ High risk borrowers characteristically have high debt loads, virtually no savings, and they may also have marginal, seasonal, or unstable employment. Because they are high risk, these borrowers are unlikely to have alternative sources willing to extend them credit at a lower cost. Therefore, their ability to bargain and comparison shop is severely limited. The normative bargaining dialogue presumes the availability of alternative sources of credit.

Information may be useful to these borrowers if it informs them of the presence and location of alternative sources of lower cost credit. This kind of information may help these borrowers participate in the bargaining process more fully and effectively if the market has alternatives for them. If the market does not have alternative sources, however, information is relatively unimportant to them. Again, in-

to the Consumer Subcommittee of the Senate Committee on Commerce, Science, and Transportation, explaining the meaning of consumer unfairness. They listed three elements of consumer unfairness: (1) consumer injury; (2) violation of an established public policy; and (3) unethical or unscrupulous conduct. Despite the unwieldiness of this term, many states have followed the FTC Act and included consumer unfairness in their state consumer protection laws. 5 Trade Reg. Rep. ¶ 50,421 (CCH).

79. See *supra* note 25.

80. See *supra* note 68.

formation strategy favors the educated borrower and disfavors the less mobile or educated borrower, like the elderly and the poor.

Usury laws may tend to further limit sources of credit to these borrowers by diminishing supplies of credit.⁸¹ The equity question about usury laws and high risk borrowers is whether this deprivation, in the long term, benefits high risk borrowers by reducing their rates of default and the attendant personal and familial strains, or whether high risk borrowers are more injured by usury by virtue of being deprived of the opportunity to share in the consumption opportunities of the more affluent.⁸²

Statutory and judicially created exemptions have mitigated deprivation of high risk borrowers by permitting higher rates of interest on loans to these borrowers. The failure of usury laws to control the portion of high risk borrowing which may be prompted by temptation, ignorance or aberration, reflects social ambivalence about the rights of persons with differing values to incur debt, even dangerous levels of debt. Particularly in the case of the high risk borrowing, usury laws do not reflect a clear social consensus about whether personal indebtedness is harmful or whether those with differing values have the right to engage in dangerous conduct. Indeed, usury laws, when applied to this market failure, reflect the "divergence of social and private preferences"⁸³ about the dangers of personal indebtedness. In a market dominated by lender preferences because of the borrower's failure to participate in bargaining, once again the tendency will be to borrow more credit or to pay more for it than the borrower actually wants or needs. This tendency to oversupply credit contributes to the danger to society discussed above. To that extent, borrowing by high risk borrowers can be socially harmful. Individually, however, it is very difficult to articulate any reason for depriving these borrowers of credit beyond a paternalistic appeal to moral values of thrift, family, life, etc., which are not clearly undermined by the activities of individual high risk borrowers.

81. A recent study of the effects of ceilings on interest rates conducted for the Federal Reserve Board forecasts that lower income families, families headed by younger people, recent entrants into the job market, people with low levels of education and skills, and other marginal and new credit applicants would be most affected by more stringent standards and enforcement if lenders were not allowed to charge higher rates of interest. Canner, *supra* note 36, at 7. However, this study also notes that 32% of all families would benefit initially from a federally mandated reduction in interest rates. *Id.* at 12.

82. See Wallace, *supra* note 22, at 479.

83. See Diver, *supra* note 61, at 66.

Finally, credit has become much easier and more convenient to borrow by using a credit card rather than the application and approval procedure for each extension of credit. Credit card borrowing called "revolving" or open-end credit⁸⁴ is the most convenient form of borrowing for consumers. It is certainly more convenient than "sale credit" extended by merchants of goods or "loan credit" extended by traditional lending institutions because credit card borrowing does not require a new application for each transaction, nor does it assess interest charges on the full amount of credit made available. Interest is charged only on the amount of credit actually used, even though a larger amount is available to the borrower on demand.

The convenience of credit card borrowing can cause a market failure. As borrowers discover the convenience of credit cards, many of which are offered "pre-approved" through the mail, borrower behavior changes from the normative dialogue with the lender. Credit card borrowers rarely shop for competitive interest rates, and it should not be assumed that this behavior may be modified by the provision of more information.⁸⁵ This failure to comparison shop and trade across lender market segmentation has contributed to persistently high credit card interest rates. The consumer's failure to fully participate in the market results in domination of the credit card marketplace by credit card issuer preferences. Those preferences are to keep rates and profits from these rates high. While credit card borrowers have not effectively organized to counterweight this institutional imperative, public opinion mobilized by media reports of credit card profits at a time of declining interest rates, has forced some credit card issuers to voluntarily lower their rates⁸⁶ which have virtually become exempt from state usury ceilings through a series of federal decisions.⁸⁷

Usury laws could have a significant effect on credit card borrowers by forcing interest rates on this type of credit into some sort of relationship with prevailing market interest rates. Usury laws may deprive some credit card borrowers of credit but as lender incentives diminish, so will supply. Again, we are faced with a policy dilemma

84. "Open-end credit" is defined under the Truth in Lending, Regulation Z, 12 C.F.R. § 226.2(20) (1987) as "credit extended by a creditor under a plan in which: (i) The creditor reasonably contemplates repeated transactions; (ii) The creditor may impose a finance charge from time to time on an outstanding unpaid balance; and (iii) The amount of credit that may be extended to the consumer during the term of the plan (up to any limit set by the creditor) is generally made available to the extent that any outstanding balance is repaid." *See also* *Singer Co. v. Gardner*, 65 N.J. 403, 323 A.2d 457 (1974) (holding that a revolving charge account was "open-ended credit").

85. *See supra* note 68 for a discussion of information on consumers with moderate knowledge and low knowledge of credit institutions and terms.

86. *See supra* note 45.

87. *See supra* note 20.

because usury laws as applied to credit card borrowing do not reflect any clear consensus about whether this indebtedness is harmful or whether those with differing values have the right to engage in as much credit card borrowing as they wish on whatever terms they can negotiate. Although the credit card borrowers' own failure to fully participate in the market may result in their borrowing more credit than they want or need, it is difficult to articulate any reason for depriving these individual borrowers of credit beyond a direct appeal to moral values which are not clearly threatened by this borrowing.

C. Society's Interest in Controlling The Credit Supply

Society's interest lies not necessarily in control of any of these individual consumer transactions, but rather in controlling the aggregate of them. Society's interest is complicated by the fact that debt is necessary for economic growth, but irresponsible growth can lead to social factors which undermine long term stability. Usury laws are a useful and reasonable tool for limiting consumer debt in society's best interest by balancing the need for economic development with the risk of destabilizing effects on society. Uniform and effective usury laws could be an important counterweight to the forces of oversupply. Deregulation⁸⁸ and competition⁸⁹ only contribute to the dangers to society from irresponsible growth. Indeed, the legal criticism of usury as anticompetitive⁹⁰ ignores the broad trends of our present economic condition which have caused the consumer debt to balloon in the last forty years.⁹¹ Anticompetitiveness alone does not mean that usury is mismatched⁹² to its protective task. While economists discount the relationship of consumer debt to recession by noting that consumer debt will not lead to recession,⁹³ there is little doubt that *in* a recession all consumers suffer, overleveraged consumers suffer most, and the more overleveraged our population is, the more our society will suffer. The forces which contribute to the

88. See *supra* note 15.

89. See *supra* note 35.

90. See *supra* note 16.

91. See *supra* note 54.

92. Mismatches between regulatory problems and regulatory solutions occur, according to Professor Breyer, where the regulatory process is particularly likely to cause significant anticompetitive harm, where the rationale for regulation is not compelling, or where less restrictive intervention can obtain the same regulatory objectives. See S. BREYER, *supra* note 14, at 195.

93. See *supra* note 44.

oversupply and overleveraging of consumers in our economy make our population as a whole more vulnerable to hardship.

Usury is a recognized tool of *national* economic policy, not simply the domain of state police power. Modern European nations rely on usury laws⁹⁴ as a tool of national policy, not intended merely for the protection of individual consumers.⁹⁵ As a value moderating the supply of consumer credit in society, national usury laws can moderate the competing interests in indebtedness and offer consumers and society protection in a time of diminished employment or recession which is the major problem of post-industrial development.

VI. CONCLUSION

Data on efficiency of markets should not end the discussion of appropriate legal response to problems. The econometric data about efficiency in credit transactions is only the beginning of complex legal analysis which must also consider long-term social policy issues about what are long term ramifications of massive consumer debt in our post-industrial society. Before deciding to jettison this ancient form of social and economic control on modern theories of efficiency, we must also consider in our public policy, the public moral values at stake, including the intangible costs of family and individual suffering in problematic debt situations and the overall social impact of recession in a deeply indebted society. While these consequences are more difficult to measure than other efficiency costs, responsible public policy demands that they be considered.

Qualitative and statistical data on problematic debt can, and should, be updated for the United States economy, perhaps replicating the Dutch survey previously discussed.⁹⁶ Economic forecasting should include efforts to forecast the effect of deep levels of consumer debt on an economy in recession. Lender influence on consumer borrowing behavior and consumer behavior in response to information must be better researched before responsible policy decisions can be made between disclosure-based remedies or other forms of objective restraints on lender behavior. For example, if the results of the Dutch survey on information and consumer response are accurate for American borrowers, policymakers should seriously reconsider the effects of mandatory disclosures of interest rates and other terms under the Truth in Lending Act and pending its revisions.⁹⁷

Efficiency data is only part of the policy answer to the dilemma of how to accommodate consumer debt and economic growth today.

94. See *supra* note 19.

95. See *supra* note 6.

96. See *supra* note 53.

97. See *supra* notes 46, 47, and 84.

Usury is an old rule representing a choice of controlling debt which may have meaning today. To evaluate the rule in light of efficiency concerns we need to consider at least two other sources of data: (1) sociological, consumer behavior research into the causes and consequences of problem debt among consumer borrowers; and (2) economic forecasting on the effects of recession on a deeply indebted consumer population. Lenders are urging policymakers to make judgments on a very narrow set of facts which reflect short-term efficiency concerns. Such shortsightedness may cause immeasurable injury if adopted blindly in our modern economy.

