

COMMENTARY

In Defense of Usury

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Charge 80% per year on a loan in the U.S. and you're called a usurer. Charge 80% per year on a loan in Latin America or Africa and you can be a poverty-alleviation charity.

Which is the right label? Outrage over usury is based on a fundamental belief that credit at high rates does borrowers more harm than good. This belief now holds sway among policy makers world-wide, who seek to curb consumer lending at "excessive" interest rates. Prescriptions include the interest-rate caps imposed recently by state and federal governments in the U.S., Japan and South Africa. Several U.S. states are considering additional measures, including outright bans on payday lending.

But the result of interest-rate caps is often less access to credit. Advocates for restricting access correctly note that poorer consumers (and for that matter just about everybody else) have decision-making limitations that are exploited in the market. Examples include impulsive spending, and underestimating the cost of borrowing and the benefits of long-run investing.

But even consumers making flawed decisions may be better off when they can borrow from regulated financial institutions at "excessive" rates.

Our organization, Innovations for Poverty Action, tested this proposition. We worked with a successful finance company in South Africa to randomly choose some just-below-the-normal-approval-bar applicants to receive a four-month installment loan. The lender charged its normal rate: 200% APR. The remaining, just-below-the-normal-approval-bar applicants (the "control group") were rejected in line with the lender's normal credit policy.

We then tracked both groups over the next six to 27 months, measuring their well-being based on a range of economic, social, health and mental health measures. Applicants who were randomly approved for a loan had higher incomes, less hunger, better credit scores and more positive outlooks than their control group counterparts - even after paying the high interest rate. Though they had higher than normal default rates, the borderline loans were also profitable for the lender.

The new borrowers did report higher stress and depression levels than the control group. But overall, the borderline loans objectively did more good than harm. Our findings are striking because governments that restrict credit access do so on the premise that consumers make themselves worse off by borrowing at high rates.

How can it be that consumers get preyed upon in the market, yet still end up better off? One possibility is that returns to borrowing swamp the cost of consumer mistakes. Rolling over payday loans repeatedly might cost you big bucks; but it can turn out to be a good deal if you need the initial loan to fix your car, hold on to your job and avoid losing even bigger bucks in after-tax earnings.

Another possibility: The alternative to being gouged by a financial institution is being gouged more expensively by an unregulated lender.

So what should policy makers, advocates, and practitioners do? Don't restrict access or competition. Do equip consumers with the financial survival skills they need to succeed in the marketplace. How can we do right by consumers in financial markets? Social science offers two key lessons so far.

First, product features and product presentation affect consumer decision-making. We know this from both developed and developing countries. There is no "neutral" way to present financial choices to consumers; products and their presentations should be designed to guide folks to the choices that suit them best. Better loan-disclosure laws, for example, might help make sure borrowers are fully aware of the terms of their commitments. Opt-out (instead of opt-in) payroll savings plans could help employees accumulate savings.

Second, we owe it to consumers to consider the evidence, and demand more of it, before swinging the pendulum away from access to credit. This means more scientific evaluations, using gold-standard randomized methodologies such as the one described above.

Firms can and already do integrate testing into their day-to-day operations. But much remains to be learned about how to make finance work best for lower-income and poor people. What mixture of products and services maximizes impact, and also delivers institutional growth and sustainability? Which marketing and presentation of products deepen outreach, and help target those who will benefit the most? It is both good business and good policy to have concrete, reliable answers to such questions.

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