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Submission to

Maximum Interest Rate Inquiry

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[1] Introduction

The Inquiry is required to consider the questions of whether a maximum annual interest rate should be fixed on regulated contracts, and whether other measures should be adopted to reduce the need for consumers to resort to high interest credit contracts. This submission focuses primarily upon the first of those questions, although the second is considered in section 6. The submission proceeds by examining the aims of ceilings in section 2, the role of interest rates in section 3, the resulting causes of high interest rates in section 4, and the implications of ceilings in section 5.

[2] Aims of Interest Rate Ceilings

Interest rate ceilings are typically imposed with the best of intentions, but with undesirable consequences contrary to those intentions. The usual aims of those advocating interest rate ceilings can be summarised as follows:

[a] To prevent exploitation of uninformed or desperate borrowers by unscrupulous lenders.

[b] To provide an offset to an imbalance of market power between providers of finance and individual customers which

enables the former to charge interest rates above those required to generate normal profits.

[c]To promote "equitable" outcomes amongst borrowers - so that all pay a common price or maximum price for a common commodity.

[d]To provide an element of subsidy for deserving borrowers for whom market rates of interest are judged to be too high

[e]To substitute determination of loan interest rates by government fiat in place of market determination, in reflection of a view that market processes do not lead to either an efficient or just outcome.

Implementation of a policy of interest rate ceilings to achieve such aims needs to be analysed on two criteria - the merits of the aims themselves, and the efficacy of ceilings in achieving those aims. To do so, it is important to understand the role of contractual interest rates.

[3]The Role of Contractual Interest Rates

Since lenders must raise deposit (or other investor) funds for onlending to loan customers, a major aggregate determinant of loan interest rates is the cost of deposit/investment funds -

which reflects movements in market interest rates. While lenders can have some influence on the explicit interest cost of funds raised (by for example advertising or providing other services to depositors or investors, or by skilful management of funding needs), this cost of being involved in the business of lending is largely outside the lender's control. Moreover, most attention is typically focused upon the apparent margin of contractual loan interest rates over the cost of funding to the lender.

Contractual interest rates represent the actual gross return received by a lender on a loan contract (and the actual cost to the borrower) only if full repayment occurs according to the schedule of repayments specified in the contract. Where borrowers are slow to repay and force lenders to incur extra costs in obtaining repayment, or default on their obligations, the return is less than that involved in the contract.

The contractual interest rate must thus incorporate (where appropriate) an allowance for default risk. Most importantly, that allowance must reflect the expected default risk from a loan to that particular customer. Any lender who willingly grants loans to all customers at an interest rate which only incorporates allowance for the average default risk, will quickly find themselves with a portfolio of higher than average risk loans and consequent losses. Lenders, to remain commercially viable, must have the flexibility to set

contractual interest rates to reflect estimates of default risk associated with particular customers, and to reject loan applications if the likelihood of default is such that no contractual interest rate can be found at which the loan is commercially justified.

In this respect, consumer lending has many similar elements to insurance (e.g. third party car insurance). It is not possible to predict with certainty which borrower will default, or which driver will have an accident, but differing probabilities can be assigned on the basis of observable characteristics - such as past experience. Just as insurance companies charge different premiums for customers in different risk categories, so lenders need to charge different interest rates (reflecting different risk premiums) for different borrowers.

When explicit fees and charges on loan contracts are disallowed, loan interest rates must also reflect the need for lenders to incorporate a margin for such costs into "interest" receipts. The costs involved here include both costs specific to the loan itself, such as processing and administration, as well as costs involved in general operation of the business. The margin between average loan and funding costs must cover staffing costs, costs of physical equipment and premises, advertising, and provide an adequate return to the lender for equity tied up (and put at risk) in the business. Where different loan (or deposit contracts for that matter) involve

the incurrence of different costs, it is necessary to allow for those differences in the determination of interest rates. Otherwise, the "cross-subsidisation" involved will drive out the "low cost" business which is being charged rates reflecting costs associated with higher cost customers.

[4] Causes of High Contractual Interest Rates

The preceding section enables us to determine what factors can lead to high contractual loan interest rates.

[a] When market interest rates are high, the high cost of funding to lenders must ultimately be passed on to loan customers. In a high inflation environment, market interest rates can easily reach very high nominal levels, without those rates imposing an excessive real burden on lenders paying such rates. (For example, a real interest rate of 5 per cent p.a. when inflation is running at 30 per cent p.a. requires a nominal interest rate of 36.5 per cent p.a.. While the time pattern of repayments can cause a cash flow problem for borrowers under some loan contracts, this is a reflection of an inappropriate contract design rather than of the interest rate per se.)

[b] A second cause of high contractual loan interest rates is that loans are to customers who are categorised as having a high risk of default. Since specific customers who will default cannot be predicted (or if they can they will not

be granted loans), high contractual loan interest rates implicitly contain an appropriate insurance premium which high risk customers must bear.

[c]A third cause of high contractual loan interest rates can be that administration costs etc which must be incorporated into the interest rate are relatively large. This could occur for two main reasons. First, the size of the loan may be relatively small. Since there is a large fixed cost element in loan processing and administration, these costs may far outweigh the funding cost involved in a small loan. Second, if the loan is for a very short time, similar considerations apply. The administration costs cannot be spread over a long period of time if the loan is a short term loan.

[d]Finally high contractual loan rates could reflect a situation in which a lender has excessive market power, and can charge rates which generate above normal profits.

[5]Consequences of Interest Rate Ceilings

The preceding section indicates that high contractual loan interest rates can, in a competitive market, be explained by the need for participants to obtain a normal rate of return on capital. However, where a lack of competition exists, there can exist situations where "excessive" contractual rates occur.

Since there is significant competition in the market for consumer credit in Australia, we proceed by examining the consequences of interest rate ceilings in a competitive environment.

[a]Exclusion of customers.

When ceilings are prescribed, those customers for whom a "fair" interest rate (reflecting administration costs and allowance for default risk) exceeds the ceiling, will not obtain loans from regulated lenders. Those whom the ceilings are intended to protect are not helped.

[b]Innovations to avoid ceilings.

A major determinant of financial innovation has been the existence of regulations which prevent two parties from entering a mutually desired contract. New financial instruments and financing techniques develop to achieve the same outcome in a different legal structure not subject to the controls. While occasionally such innovations may prove to be independently durable, most rely on their ability to sidestep regulation to justify their higher costs and sustain their existence. From society's perspective, the artificial development of such inefficient financing practices is to be avoided.

[c]Development of alternative unregulated markets.

Typically, the needs of unsatisfied customers will be met by others not subject to the regulations which prevent regulated lenders from accommodating those customers. That may simply involve other "respectable" lenders gradually taking over the business of the constrained institutions. Since the constrained institutions presumably have some expertise in servicing that market, society loses through the diversion of the activity to a less efficient market. An alternative consequence is that borrowers turn to lenders who are less "respectable", and who operate outside the normal legal and consumer protection boundaries. This is clearly an undesirable outcome.

[d] Loan size limitations and secondary financing costs

When lenders are constrained from charging an appropriate default risk premium, one response is to attempt to accommodate the customer by investigating ways of reducing default risk. Obtaining some degree of collateral or guarantee is one option, while another is to reduce the size of loan to be granted. Similarly, when ceilings lead to subsidisation of borrowers (as occurred under restrictions on Savings Bank housing loan interest rates), loans are rationed, both in terms of size and in terms of other criteria for eligibility. Such rationing forces borrowers to resort to secondary finance to obtain the desired loan size - and this will typically be from an

unregulated source of finance which charges much higher loan rates. Overall, the cost of the joint finance is unlikely to be less than if the whole funding had been available in the absence of the ceiling.

An alternative undesired response of "over lending" can also occur. Where the ceiling prevents viable lending because of a small loan size or term, institutions may impose minimum loan size and/or term criteria. Borrowers are then required to take out a larger loan than desired. While this might simply provide an efficient method of countering the regulation, it can lead to over-borrowing by customers with undesired consequences.

How do the objectives of interest rate ceilings listed in section 2 stand up against these apparent problems.

[a]They may increase exposure of uninformed or desperate borrowers to unscrupulous lenders.

[b]When they lead to regulated lenders not providing finance to particular borrowers, the illness of market power imbalance is cured, but the medicine kills the patient. Moreover, resort by unsatisfied borrowers to alternative unregulated sources of finance simply changes the locus of the power imbalance.

[c]Equitable treatment of borrowers is not achieved by trying to enforce a common or similar interest rate upon all contracts. Loans to different borrowers are not the same commodity. They are all different, and the appropriate charges differ. Equitable treatment is better achieved by ensuring that all have access to finance on terms which, as a result of competition, appropriately reflect the costs of lending.

[d]Subsidisation of deserving borrowers will not occur when ceilings are in place. They will simply be excluded from access to regulated finance.

[e]Governments have shown no superior ability relative to market forces to determine the appropriate interest rate for particular types of loans. While suggestions have been made that the ceilings currently being suggested are unlikely to have much impact, by virtue of their height, the existence of a ceiling invites political interference with the level - at less political cost than de novo imposition of a ceiling.

[6]Alternatives

[1]Where concern exists over inappropriate treatment of particular borrowers, access to credit tribunals, banking ombudsmen, etc., provides an avenue for resolution of

these concerns.

[2]If concern exists over inadequate discrimination between customers on risk grounds, or inappropriate assessment of customer default risk, attention should be paid to development of better credit rating information.

[3]If it is felt that private financial institutions err on the side of caution in determining default risk premiums, government provision of consumer loan insurance could be considered.

[4]If deserving borrowers or those in need of emergency funding are not appropriately accommodated by private financiers, mechanisms for provision of direct government subsidy or access to emergency funding could be investigated.

[5]If there is concern about borrowers being insufficiently informed, it is appropriate that full information about borrowing costs be made available and incorporated in contracts. While there are merits in expressing all up costs in the form of an annual percentage borrowing cost, to enable ease of comparison, this does not imply that the contract should not allow for separate identification of components of that cost. The borrower is, for example, better informed if told that the 40% p.a. borrowing cost arises from a 20% p.a. explicit interest cost plus

establishment and administration fees of \$200.

[6]If there is concern that there is insufficient competition in the market for consumer loans, enabling lenders to exploit monopolistic power and charge excessive interest rates, policymakers' attention needs to be directed towards policies which ensure adequate competition.

7. Conclusion

There is nothing to recommend the imposition of a maximum annual percentage rate on consumer loan contracts. The aims behind such a policy are either misguided, or are better served by other available measures.