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The truth, but not always the whole truth in Lending Laws

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Abstract

Both microcredit and sub-prime loans are loans to poor consumers, often in small amounts leading to high interest rates. These high interest rates charged by banks have raised the question whether the poor, often illiterate or with limited literacy, understand the amount of interests they are going to pay. For this many countries have enacted truth in lending laws.

The paper surveys them in a number of developed and developing countries. It finds that the whole truth, the Effective Annual rate based on the actuarial method, is never revealed on the plea that it would be too complicated. There remain excluded areas which seem to be uncovered and approximations which could amount to white lies. But the degree of truth is evolving in each country in order to move to greater truth, while penalties for not complying with the truth standards are different and consequently not always incentive to banks.

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Introduction

The growth of microfinance has pointed to the inclusion of the poor in the economy (Armendariz & Morduch, 2005; Ashta, 2009 forthcoming). For this, it is better to lend money to them rather than give them donations (except for the poorest of the poor) because such lending makes them responsible (Yunus, 2003). This logic and enabling regulation has led banks to lend to the poor. This includes markets like the sub-prime in the United States and microcredit borrowers in poorer countries.

In both cases, the lack of earning power coupled with the lack of collateral leads to higher risk that banks might not want to assume. To compensate for higher risk, banks charge high interest rates. Moreover, the small size of loans to the poor relative to the rich leads to high transaction costs, which increase tremendously the total cost of the credit. In other words, the fixed cost is inversely related to the size of the loan because of the fixed administrative costs charged by the bank in order to grant the credit. As a consequence, the disclosure of global effective interest rates is much more important when the credit amount granted is small, since this charge is proportionally heavier in the operation's global cost.

To permit charging higher interest rates to accommodate small borrowing, many countries abolished wholly or partly their usury laws (Attuel-Mendes & Ashta, 2008). The USA has abolished at a federal level, while individual States may still have usury laws. The UK never introduced these laws. France has modified these laws to permit high interest rates for firms. In Algeria, interest rates were also gradually deregulated, starting with Instruction 07-95 in 1995, which eliminated the usury rate, but which entitled the Bank of Algeria to set a maximum bank margin, which in turn was abolished in 2001 (CGAP, 2006). There is no usury rate legislation in Morocco: The Moroccan Banking Act gives a total freedom about interest rates, except for abuses in variable rate credits. All these examples indicate that to encourage lending to the poor, enabling legislation was introduced.

These two factors (high interest rates charged by banks and high total cost of credit) in a permissive institutional framework raised the question whether the consumers and the poor, often illiterate or with limited literacy, understood the amount of interest and the rates they were going to pay. For this many countries enacted truth in