20 December 2022

Guidance Note 2 – Interest rate policy and anti-usury regulations

This guidance note[1] is based on the reported experience of central banks as regards their country framework for interest rate policy and anti-usury regulations. It covers:

- *The general framework for setting interest rates;*
- *A short discussion of public authorities' consumer protection objectives;*
- *Selected countries' experience with regulations to prevent excessive interest rates; and*
- *The challenges posed by interest rate regulations.*

1. General framework for setting interest rates

The general picture reported by IFC members is that business **interest rates are typically directly determined by market forces** and indirectly influenced by the policy rates set by central banks. In the euro area, for instance, the interest rate policy is conducted by the Governing Council of the European Central Bank (ECB) for all the country members of the Eurosystem. Another example is the Philippines, where the central bank follows a market-oriented approach for its interest rate policy since the mid-1980s.

Such a market-oriented framework for interest rate setting is often considered as the best way to promote economic activity and the contribution of finance to development. In practice, this means that authorities are not deciding on a specific interest rate that economic agents would be obliged to use for their investment and saving operations. In particular, **credit institutions are usually free to fix themselves the level of the interest rates** attached to the deposits and loans of their customers.

There are however **exceptions** to this general picture. For instance, authorities can decide on the levels of interest rates granted for deposits made in public saving institutions. Moreover, loans with specific lending rates can be granted by public or quasi-public institutions for facilitating the financing of selected categories of economic agents (eg students), sectors (eg agriculture) or classes (eg small and medium-size enterprises (SMEs)). Lastly, specific measures can be put in place for preventing excessive costs for those accessing financial products and services; this relates in particular to anti-usury regulations.

[1] This analysis produced by the IFC Secretariat (Bruno.Tissot@bis.org; IFC.Secretariat@bis.org) does not necessarily reflect the views of the BIS or IFC members and the various institutions mentioned in this note.

2. Consumer protection objectives

A key policy objective behind the development of interest rate regulations is to protect economic agents, especially when they have not a good understanding of the financial risks they may face in their saving and investment operations. These issues can have a significant financial stability dimension, as highlighted during the Great Financial Crisis of 2007-09 and, more recently, during the Covid-19 pandemic.[2] Yet consumer protection objectives have to be balanced with the other goals of public authorities, namely, to ensure sound competition in the financial industry and more generally support economic and financial development.

Properly regulated financial instruments are essential to meet households' needs and contribute to their financial well-being. But these products may be complex and, when used by economic agents with limited financial literacy and awareness, lead to **substantial risks especially for the most vulnerable types of households (as well as small firms)**.[3] This can in particular arise when the provision of financial services is characterised by a limited understanding of the terms and conditions involved, imperfect price disclosure, or misleading conduct by the lenders (eg unfair lending practices).[4] Authorities across the world have therefore adopted several types of measure to protect savers and borrowers from such risks and also promote their access to "sound" finance.

Specific policy attention has been put in this general context on the credit instruments offered to investors and especially on their prices – that is, on the interest rates to be supported by borrowers that, if they were excessive, could be detrimental for their financial positions. This refers to the so-called usury rates, ie when the lender is charging a very high interest rate that is deemed unreasonable. To avoid this situation, public institutions are tasked in some countries to set a maximum interest rate for credit products. Theses caps can depend on a variety of factors, such as the currency of the loan considered, its potential indexation on inflation, its maturity or its size. The measures in place can be permanent or limited in time to cope with specific crisis situations like during the Covid-19 pandemic. A financial institution will be allegedly committed usury if it is granting a loan at an interest rate exceeding the relevant cap and will typically be prosecuted by the judiciary authorities of the country.

3. Selected countries' experience with regulations to prevent excessive interest rates

History is full of examples of the setting of usury caps on interest rates put in place against creditors. According to a recent estimate, the GDP-weighted global usury ceiling had been well above 5% from the end of the 14th century to the late 1800s, despite a substantial decline over the

2 In Europe, for instance, Spanish agencies have been looking into excessive pricing behaviour in sectors affected by the Covid-19 crisis and started investigations into anticompetitive practices in the area of financial lending: cf OECD (2019): "Exploitative pricing in the time of COVID-19", 26 May. Turning to the Philippines, the central bank set an interest rate ceiling on all credit card transactions in November 2020 (subject to a regular review) to ensure borrowers, particularly small firms, were not charged exorbitant interest rates and finance charges at the height of the pandemic.

3 For a recent reference to usury lending to firms in China and the impact of interest rates charged above the legal ceiling, see OECD (2017): Economic Surveys China, March.

4 For an overview of these issues in the area of short-term consumer lending, see OECD (2019): "Short-Term Consumer Credit: provision, regulatory coverage and policy responses".

period.[5] In the United Kingdom, in particular, lending at interest was effectively illegal before the middle of the 16th century. In 1545, a legal maximum interest was fixed, and any amount in excess of the maximum was usury. The maximum rate was applied to all transactions, and usury laws were still in force up to the middle of the 19th century.[6] This practice of setting a legal maximum on interest rates was followed by most western nations including the United States.[7]

Certainly, the more recent trend observed at the global level has been a **general decline in the practice of setting-up usury caps for interest rates**, especially among advanced economies in the context of greater financial liberalisation. As a result, the related laws have been abolished in several places, following the example of the United Kingdom after the mid-1800s. In Norway, for instance, mortgage rates were subject to usury regulations that were removed at the end of the 19th century.[8] In the United States, an important development was the Depository Institutions Deregulation and Monetary Control Act of 1980, which phased out restrictions on interest rates for depository institutions (with in particular the removal of the deposits' caps put in place at the time of the Great Depression). Since the 1980s, market interest rates in the Philippines are no more subject to any ceiling prescribed under the usury law that had been enacted at the beginning of the 20th century.

Yet there are still **a number of regulations in place across the world that set a maximum limit to market interest rates**. [9] In the United States, for instance, usury is regulated and enforced primarily by state usury laws, including the rate of interest determined to be usurious. Accordingly, caps set at the state level typically request parties to contract for interest on a loan at a rate not exceeding a specific percentage. There are often different rules and exceptions depending on the loan quantity, the type of individual, the entity making the loan, and the type of loan.[10] Generally, loans subject to such laws include those with a non-bank financial company (meaning that "normal" bank loans are not in scope), higher education student loans, payday loans.

A number of other advanced economies have also kept specific interest rate regulations. In **France**, the usury rate is defined as the legally maximum interest rate that financial institutions can charge when making a loan and aims at protecting borrowers. The Bank of France is responsible for calculating and publishing quarterly usury rates (with the methodology defined by legal documents) together with the average rates observed for a list of various types of loans.[11] Similarly,

5 See Paul Schmelzing (2020): "Eight centuries of global real interest rates, R-G, and the 'suprasecular' decline, 1311-2018", online appendix to *Bank of England Staff Working Paper* no 845, January.

6 See UK contribution to *BIS Papers* no 127 (2022): "Historical monetary and financial statistics for policymakers: towards a unified framework".

7 For an historical background on the US situation, see National Consumer Law Center (2021): "Why cap interest rates at 36%?", August.

8 See Norway contribution to BIS Papers no 127 (cf footnote 5).

9 For a stock-taking of the number of countries capping interest rates for loans and the various forms used, see Maimbo, S M and C A Henriquez Gallegos (2014): "Interest rate caps around the world: still popular, but a blunt instrument", *Policy Research Working Paper*, no 7070, World Bank Group, Washington, DC, October.

10 For a recent US study, see Elliehausen, G, S Hannon and T Miller (2021): "A new look at the effects of the interest rate ceiling in Arkansas", *Finance and Economics Discussion Series*, no 2021-045, Washington: Board of Governors of the Federal Reserve System.

11 Cf the related information published by the Bank of France for the third quarter of 2022. The usury rate is basically calculated as the average interest rates observed over the preceding quarter augmented by one third.

the **Banco de Portugal** calculates and publishes quarterly the maximum interest rates in force for each type of consumer credit; the rates constitute the maximum limits on the charges that can be contracted in relation to personal credit, car loans, revolving credit and credit overruns. This regime has been in force since 2010 and applies to consumer credit agreements that fall under a specific legislation.

Turning to emerging market economies, one illustrative example is **Chile**. Several versions of interest rate caps on credit products have been in place since 1929. Under the current legislation there is a set of twelve caps on different types of loans, depending on the currency, indexation, maturity, and loan size. These rates are determined and supervised by the Financial Market Commission, the Chilean financial market supervisor which is independent from the central bank. These interest rates are called *Conventional Maximal Rate* ("Tasa Maxima Convencional", or "TMC") and are published on a monthly basis.[12]

Lastly, in those countries that do not have specific policy regulation to cap loans' interest rates, there is often the **possibility of litigation** when lenders offer interest rates considered to be excessively high compared to prevailing market rates. In practice, judiciary authorities would be in charge of verifying that a loan agreement can be related to predatory lending and qualified as illegal. Interest rates above a certain level would also be considered as "usurious" by court rulings depending on circumstances.

One telling example is **Germany**, where there is no specific regulation to prevent usury with regard to interest rates. But, while credit institutions are not obliged to use a specific rate for their business, the German Civil Code (BGB) prohibits usury for loan agreements "contrary to public policy", stating that such a legal transaction is "void".[13] As a thumb rule, and according to past judiciary decisions, a loan agreement would be considered in this case in practice if the benchmark effective interest rate is around twice the average interest rate or (in a period of high interest rates) is exceeding it by a given margin.

4. The challenges posed by interest rate regulations

Central banks' experience has highlighted a number of challenges associated with regulations aiming at putting a specific ceiling on interest rates. Hence the **intended benefits of interest rates regulations, especially in terms of consumer protection, have to be balanced with the potential consequences** in the areas of monetary policy, financial supervision, financial inclusion, and economic development.[14]

- **Monetary policy**: an interest rate cap may affect the effectiveness of the transmission of monetary policy to bank lending and domestic liquidity, by limiting the indirect impact of policy

[12] See a recent example of an announcement related to the maximal interest rates and the relevant documentation on the TMC (in Spanish).

[13] Cf BGB Section 138 (**Legal transaction contrary to public policy; usury**): *"(1) A legal transaction which is contrary to public policy is void. (2) In particular, a legal transaction is void by which a person, by exploiting the predicament, inexperience, lack of sound judgement or considerable weakness of will of another, causes himself or a third party, in exchange for an act of performance, to be promised or granted pecuniary advantages which are clearly disproportionate to the performance."*

[14] For a review of the various consequences of interest rate regulations, see footnote 8 as well as the Philippines' review conducted in 1972 on the implications of the usury law in terms of rigid interest rate policy and capital market distortions; cf National Economic Council (Philippines) (1972): "*Report of the Inter-Agency Committee on the Study of Interest Rates*".

rates on market lending rates. Detailed regulation may also be difficult to determine especially to calibrate an appropriate interest rate cap; for instance it has been recently argued that the set-up of the French usury rate, based on past developments for interest rates, may present excessive lags in case of a rapid evolution in the economic situation and/or financial conditions. These difficulties could be reinforced in case of so-called ripple effects throughout the entire financial system; for example, if a cap set on interest rates would trigger similar requests for constraining the broad range of financial products and services provided by banks, credit card companies, or other credit providers.

- **Supervision**: interest rate regulations can put additional burden to those authorities in charge of supervising the financial industry. Moreover, price transparency can be impaired as credit providers may try to offset the impact of a ceiling by imposing higher non-interest rate fees and charges related to the loan. Without proper supervision and enforcement, regulations on interest rate ceiling could thus be circumvented in an opaque way.
- **Financial inclusion**: interest rate caps may cause credit suppliers to stop lending to certain customers (eg those with high-risk profiles) to prevent losses.[15] Adverse selection effects may thus arise, restricting household access to finance products especially for low-income earners and /or the aged population. This can also lead to the development of informal and illegal lending services with even more prohibitive practices.
- **Economic and financial development**: constrains imposed on market mechanisms for the setting of interest rates could lead to inefficiencies in the intermediation between savers and borrowers and constrain financial deepening. For instance, lending companies could have incentives to maximise profit by imposing the highest possible interest within the ceiling imposed by authorities, disregarding of borrowers' specificities. Moreover, excessive regulations could reduce incentives for financial providers to develop product innovation.

Lastly, interest rate regulations can be a relatively **blunt instrument for dealing with the complex issues posed by the protection of the consumers of financial products and services**. First, there are several measures in the area of consumer protection that central banks can act upon. [16] Second, multiple public policies and institutions are also involved in this area and have to be considered in a comprehensive way. Third, the participation of the private sector can be effective too; in Costa Rica, for instance, the Office of Financial Consumers of the Costa Rican Bank Association is a self-regulatory mechanism established by private banks to address conflicts between financial service providers and consumers. Fourth, an important pillar of consumer proception policies relates to non-regulatory measures, for instance to empower economic agents through information and financial education.[17]

[15] For instance, empirical evidence suggests that higher interest rate caps increase the probability that a loan be funded, especially if its borrower is risky; cf Rigbi, O (2010): "The effects of usury laws: evidence from the online loan market", June.

[16] See for instance the various components taken into consideration by the Central Bank of the Philippines (Bangko Sentral ng Pilipinas) for the regulation of financial consumer protection.

[17] For a recent overview of a national experience in the area of consumer protection, see OECD (2020): "Consumer policy in Costa Rica", February.