Thinking faith
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# The scandal of extortion

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As the House of Lords completes its consideration of the Banking Bill, Joe Egerton draws attention to the case for limiting interest on loans by law, made by Keynes and Adam Smith.

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Few of those invoking the authority of Keynes today in debates surrounding interest rate levels seem to have taken the precaution of reading *The General Theory* before seeking to wrap the mantle of his authority around a not infrequently puerile and jejune misrepresentation of his position. As the full text of *The General Theory* is available online,[1] this is shameful. It is also damaging in that it deprives 21st century Britain of the opportunity properly to consider what the most incisive of 20th century economists has to offer us in solving today's problems.

In this article, I focus on one omission from contemporary debate: Keynes's support for Usury Laws. This is to be found in Chapter 23 of *The General Theory*. The chapter is entitled 'Notes on Mercantilism, The Usury Laws, Stamped Money and Theories of Under-Consumption'[2]. The passage on usury is only 780 words in total.[3]

As Keynes notes, theology and economics both have something to say on interest rates; Keynes refers with approval to the Medieval theologians:

> I was brought up to believe that the attitude of the Medieval Church to the rate of interest was inherently absurd, and that the subtle discussions aimed at distinguishing the return on money-loans from the return to active investment were merely Jesuitical attempts to find a practical escape from a foolish theory. But I now read these discussions as an honest intellectual effort to keep separate what the classical theory [of economics] has inextricably confused together, namely, the rate of interest and the marginal efficiency of capital. For it now seems clear that the disquisitions of the schoolmen were directed towards the elucidation of a formula which should allow the schedule of the marginal efficiency of capital to be high, whilst using rule and custom and the moral law to keep down the rate of interest.

These theologians started from the express prohibitions on charging interest in the Torah[4]. St Thomas Aquinas observes that as we are now all brothers and sisters, the prohibition has become universal[5]. Exactly what is prohibited depends on the translation of the Hebrew – but quite clearly exorbitant interest rates are outlawed, as the literal prohibition is against 'biting'.

The Torah is the Law of God in the New as well as the Old Testament: 'For – Amen I tell you – not a single letter, not a single punctuation mark, will pass away from the Torah until it all happens. The whole of Creation will pass away before that!'[6] The parable of the absentee landlord[7] suggests that the Torah is not to be taken as prohibiting all interest – the slave who kept the 10 minae the landlord had given him hidden in his handkerchief is asked 'Why didn't you give my money to a bank, so that on my arrival I could have claimed it with interest?'[8]

The question of what constituted excessive interest occupied the attention of the great medieval theologians – St Anselm, St Thomas, Bl. Duns Scotus, Cajetan[9] and de Soto are among those who devoted effort to elucidating the question. However, despite the massive contribution made by theologians to developing a basis for economics – Hayek regarded the Jesuit theologians of the Salamanca school as having a better claim to be the founders of capitalism than the Calvinists, to whom Weber gave credit – in our modern age we prefer to look to economists for guidance on these matters. So let us look at what two economists of some standing wrote: Keynes and Adam Smith.

Keynes strongly and enthusiastically advocated the restitution of laws limiting the amount of interest that a lender could charge: 'for centuries, indeed for several millenniums, enlightened opinion held for certain and obvious a doctrine which the classical school has repudiated as childish, but which deserves rehabilitation and honour.' Keynes's concern was that without statutory controls, interest rates tended to be too high, and this would cause unnecessarily low levels of economic activity and unnecessarily high unemployment.

Keynes pointed his readers to Adam Smith, who discusses laws against usury. Smith starts by rejecting laws that prohibit interest entirely[10]. But he is opposed to 'the extortion of usury'. He suggests instead that the maximum rate of interest that can be charged should be set by statute law above, but not far above, the rate at which money is lent to borrowers with good security: 'In a country, such as Great Britain, where money is lent to government at three per cent and to private people on good security at four and four and a half per cent, the present legal rate, five per cent, is, perhaps, as proper as any.' [11] One of the main reasons that Smith advances for setting so low a rate is that if interest rates are high, only prodigals borrow – sober individuals likely to use money wisely do not. So Adam Smith's concern is two-fold: first, high interest rates make it impossible to finance low risk investments, and we note that today many small businesses and farmers are making exactly this complaint. Second, at high interest rates prodigals can borrow (because the high rates cover a risk of default). There is a consensus that one of the reasons for our current unhappy situation (I leave open the question as to whether this is a recession or a depression) is that too much was borrowed by families and individuals over the last decade.

Despite the low rate set by the Monetary Policy Committee, interest rates charged to individuals, families and businesses are very much higher – the margin over the minimum lending rate has widened. Over the past six months I have seen offers of loans at interest rates of up to 40% by respected high street names as well as institutions apparently authorised by the FSA. Some of the offers in December were pitched as offering a way of paying for a family Christmas. They would certainly guarantee fasting in Lent. Small businessmen and farmers are being told by banks that they can take out loans at double figure rates. I have just been advising one company on a letter to a leading bank that charged £300 for one month's interest and 'fees' on an overdraft of £15,200 – the interest element was £182; but the 'fees' – including a recurring monthly £75 – seem simply to be disguised usury.

We also have a well-publicised problem over mortgages. First time buyers have for many years been able to borrow at less than 2% over base rates. Today the gap is wider – a respected mortgage broker's view is that a first time buyer would be charged 4% or more over base rates and face penalties on early redemption.

A Usury Law would apply a statutory limit to the amount of interest that can be charged on loans and thus directly address the problems caused by high interest rates by forcing them down

What shape might such a system take?

First, the Law should apply only to mortgages and loans to individuals and families (personal finance and credit cards) and businesses, to cover working capital or low risk investment (e.g. in a new low cost heating system). It should not apply to investment in developments which have a significant risk. To provide finance for such projects, borrowers should look for equity finance, or agree an arrangement whereby an investor receives a share of any profits that might be made from a commercial venture. That should ensure that a Usury Law does not stifle enterprise and investment. Transitional arrangements are necessary to allow existing high risk commercial loans to be rearranged. The Usury Law would focus on lending to individuals, families and low risk businesses.

Smith's 5% would translate today into 4% over today's Bank of England rate. However today's rate is exceptionally low; but given the damage to the economy, it is reasonable to expect this rate to remain low for years. So 5% is not a bad starting point – with a possible addition of 1% to cover the costs of servicing a loan account.

There are arguments for setting different statutory limits depending on the purpose or type of lending, although there would need to be a 'general limit' that applied to all lending not covered by a specific limit. There might, for instance, be a limit of 1% over base rate on mortgages on homes occupied by their owners or let out, subject to a minimum level of 3.5% and maximum of 5%. If lenders were simultaneously released from any requirement that forces them to cut interest below this figure then this should enable a lender to pay about 2 to 2.5% to savers in respect of mortgages.

There should obviously be a limit on interest rates on unsecured lending, for instance overdrafts, personal loans and credit cards. Adam Smith, who as we have noted, thought 5% was appropriate, took the view that a limit of 10% would have the undesirable effect of encouraging borrowing only by prodigals. There certainly has been a good deal of lending for consumption at much higher than 10%. If banks were limited in what they could charge, they would be unwilling to take the risks they have done to gain easy lending for current consumption.

There is of course a question as to what to do with existing personal loans, especially credit cards. According to such programmes as the BBC's *Money Box*, the rates charged by a number of lenders have increased quite substantially – a figure of 8% has been mentioned for some lenders. The lenders will doubtless say that this reflects the risk of default. We should take this seriously. Medieval theologians did allow that interest could be charged to cover loss. However, it is not clear that this condition would permit increasing interest rates, as has happened recently, and charging more on today's borrowers to cover yesterday's defaulters. In any case, is the risk of loss enough to justify interest rates currently above 15%? Are nearly 10% of borrowers defaulting? And would the default figures not drop sharply if interest rates were cut? Plainly pushing up interest rates increases the risk of default. I doubt if the theologians would sign off today's interest rates. And they certainly will depress demand – so Keynes would be unsympathetic to what is going on today.

My own view is that a 6% limit should be imposed – 5% interest (as suggested by Adam Smith) plus 1% for the facility. However as credit card operators are forced to cut the interest they charge they should be allowed to increase minimum monthly payments on those still in employment who could afford this. The effect would be a shaking off of debt for the borrowers and a reduction in risk for the lenders. Even if many borrowers could only afford the present or even lower minimum payments – and we do not know how many borrowers are under serious pressure, but it is realistic to assume that by the end of the year well over two million will be – the medium term effect would be to take a lot of pressure off many families. If a borrower repaid 2.5% a month, and interest were limited to 0.5% a month, then a large loan would be nearly paid off in three years. Not all borrowers could afford that much, but with interest rates limited to 5%; those able to pay as little as 1% would see a quite rapid fall in indebtedness and the lenders would see a significant fall in their exposure to risk.

A prohibition of usury would spell disaster for the loan sharks. A number of firms have speculated on buying up debts, especially where the borrower is in difficulty. They then seek to recover their 'investment' from borrowers. There have been media reports that such firms have threatened legal proceedings to seize family homes – I have seen a case myself. Again we do not know how many cases there are. If the proposed Usury Law limited interest chargeable, and if the government can provide an effective system of support for those unable to pay mortgage interest owing to unemployment or temporary loss of income, then most families would be able to at least keep up interest payments. Some of the firms that have bought up mortgage and other loan books might be in difficulty themselves if borrowers were able to meet their obligations once interest rates had been cut. Our hearts need not bleed for the vultures of the financial service sector.

There will of course be a howl of protest from lenders. The chief executive of the British Bankers Association, will proclaim the end of civilisation as we know it. The banks will tell everyone that they cannot possibly afford to lend at these rates. Taken as a proposition for a well-functioning banking system, this is absurd. 6.0% should allow banks to pay depositors 3.5% and possibly more. 3.5% in present conditions should be enough to attract domestic deposits. That leaves a margin of 1.5% to provide for operating costs, cover losses and provide some profit to a bank. The limit on rates on mortgages could, as suggested above, be lower, but mortgages are lower risk and easier to administer. A margin of 1 per cent (assuming costs for arranging a mortgage are recovered) should be sufficient for a competent and efficient mortgage lender to make a good profit.

If the proposed limits do expose further problems with bank balance sheets, then charging in excess of the suggested limits involves making borrowers pay not for the cost of what they have borrowed but for remedying the damage that the management of banks has inflicted. Some banks may well have got themselves into the position where they have to charge usurious interest rates. In other words, the costs of cleaning up the banking system are falling on those least able to afford them, or preventing the supply of funds to low risk businesses at a rate which reflects the risk of loss. I do not think that a medieval theologian would regard making borrowers pay for mistakes as proper, and Keynes and Smith both regard charging high interest rates as damaging; one to aggregate demand, the other to prudent and sensible investment. A Usury Law will stop this abuse. More may then have to be done to sort out the mess the bankers have got themselves into. But at least the process will be transparent and the costs need not fall where they will cause most social and economic damage.

Legitimate concerns should obviously be addressed. Lenders are certainly entitled to expect that they do receive the interest they will be entitled to which means, for instance, effective measures by the government to support those whose incomes have fallen and are unable to meet mortgage interest payments. The government has already announced some measures to help. It may be necessary to increase housing benefit. It also means that lenders should be able easily to exercise their legal right to ask a court to order an employer to make a deduction from the earnings of those who can but won't pay.

Of course following Keynes and Smith and restricting the level of interest that can be charged on loans runs some risks. But the present anarchy is an abomination. And, if Keynes is correct, high charges will prove lethal to economic recovery.

The Banking Bill offers an immediate opportunity to show that the voice that thundered on Sinai had a message highly relevant today.

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[1] At http://www.marxists.org/reference/subject/economics/keynes/general-theory/; at the time of writing, the first reference generated by a Google search for Keynes General Theory.

[2] Mr Anatole Kaletsky of *The Times* (Jan 8 2009) appears to have taken up the main point of Keynes's comments on "stamped money" – Keynes in this section reproduces a proposal for taxing holdings of notes as well as reviewing (with some sympathy) the idea of taxing savings generally.

[3] It is Section V at http://www.marxists.org/reference/subject/economics/keynes/general-theory/ch23.htm

[4] There are of course also strong prohibitions in the Quran.

[5] The discussion is in Summa Theologiae, IIa IIae Q78: http://www.ccel.org/ccel/aquinas/summa.SS_Q78.html

[6] Matthew 5:18 as translated by Nicholas King SJ (publisher: Kevin Mayhew)

[7] Luke 19:11-27

[8] Luke 19:23

[9] Cajetan was singled out by Leo XIII in *Aeterni Patris* as the scholastic par excellence. It should be noted that whilst St Thomas objected to usury, he expressly and carefully distinguished this from transactions involving property. In any event, the Summa is radically unfinished, that is to say its method (bringing the strongest arguments for and against a proposition into contention) is such that it is always possible that a conclusion can be revised or even reversed by a new argument.

[10] Wealth of Nations, II.iv.13. (Page 356 in the 1976 Oxford edition)

[11] Ibid,II.iv.14, page 357