

A Cost-Benefit Analysis of the Arkansas Usury Law and Its Effects On Arkansas Residents and Institutions

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Interest rates have proven to play a pivotal role in this country's economic welfare. Because of this, the Arkansas usury law is a major issue for Arkansas residents. They can be affected by the state's usury law anytime that they need to borrow funds from a financial institution, including the acquisition of credit cards. The proposed research plan includes obtaining information supporting both sides of the usury law issue, evaluating that information, and conducting a cost-benefit analysis of the Arkansas usury law. The research plan will also include analyzing the effects of the usury law on different financial classes of Arkansas residents as well as the effects on Arkansas banks. In addition, a group of suggestions will be compiled hypothesizing what, if any, changes in the state's usury law would be beneficial for Arkansas residents and banks.

UsurY is defined as charging a price for credit that exceeds the limits set by law—this is concrete and easy to interpret. “What is the lawful rate of interest?” or “What should it be?” are much more abstract questions with no simple or definite answers. The research provided will define and explain the usury law in the state of Arkansas beginning with its history in the Arkansas constitution.

The purpose of this research is to analyze Arkansas' usury law according to what costs and benefits that it offers to all Arkansas consumers, and to examine the effects of the usury limits on lending institutions. The research will also compare Arkansas usury regulation to that of neighboring states and address any reaching effects that those differences may present to Arkansas citizens and institutions. Also, the research will address credit cards and the significance that the usury law has on these holdings. In addition, the research will show that methods of avoiding usury limits do exist in the form of payday lenders and other fringe banking establishments. Finally, a section of analysis and conclusions will be presented to the reader.

Section I—The Constitution[\[i\]](#)

Arkansas is the only state that sets its usury limits in the constitution, yet usury has been a heated subject throughout the state's existence. Arkansas has had a total of five constitutions in its history. The first, in 1836, gained the state admittance to the union, and the next three were written within a ten-year period around the civil war. The fifth and current constitution was established in 1874. Three other constitutions have been proposed by constitutional conventions in 1918, 1970, and 1980, but they were all rejected by Arkansas voters.

The 1874 constitution set the usury limit at ten percent because at the time that was a very high ceiling. This was not changed until Amendment 60 imposed the current interest rate regulations.

The 1970 constitutional convention proposed changes to the usury limits. The usury law was the single greatest debated topic during the convention partly due to the problems associated with the fact that the prime rate was at 8.5 percent, and the usury limit was capped at ten. After failed motions both to change the usury law and to leave it unchanged, the delegates could reach no consensus. The topic was finally abandoned due to some alleged bribes by Arkansas bankers, but the constitution failed anyway.

There were other attempts to change the ten percent usury cap in 1974 and 1980, but both proposed amendments put the power to change the interest rate in the hands of the Arkansas legislature, and both amendments failed.

The usury limitation was finally changed on November 2, 1982, by Amendment 60, the Interest Rate Control Amendment. The current regulations can be found in the constitution of the state of Arkansas, Article 19, Section 13. The current legislation states that "the maximum rate of interest on any contract entered into shall not exceed five percent per annum above the Federal Reserve Discount Rate at the time of the contract." The constitution goes on to specify that consumer loans, loans for personal use, cannot exceed 17 percent per year regardless of the discount rate. The constitution also addresses penalties for usury. All usurious contracts are void and the party paying the excess interest is entitled to recover twice the amount of unlawful interest paid. These things combined make Arkansas' constitutional provisions among the strictest sets of usury guidelines in the United States.

Section II—The Cost-Benefit Analysis

Benefits. The Arkansas usury law guarantees that any consumer borrowing from a bank that is housed in the state is guaranteed a fair and reasonable rate of interest on all general loans. This benefits every citizen who is approved for a loan because it guarantees that the consumer will not pay interest above the designated rate, which is the Federal Reserve Discount Rate plus five percent. The benefit is the apparent protection from unfair interest rates, and it has been enough to persuade citizens to vote down the last two attempts to change the usury law (1988 and 1990). In 1990, more than 65 percent of voters voted against an amendment to raise the lawful rate of interest. [\[ii\]](#)

A second benefit of the legislation is that consumers who are not well informed do not have to worry about being taken advantage of by their lender, for there are legal repercussions for violating the usury limits. There is not a lot of negotiation; the rate charged is within a narrow window of that five percent cap.

Costs. The biggest problem with Arkansas's usury limit is the availability of credit. The legislative protection of the borrower leads to a credit crunch. Lending institutions can only provide credit to those customers who meet the risk guidelines for a loan that charges the legal rate of interest. Banks can not charge a higher rate to provide credit to high-risk customers, so consumers without established credit or with a blemished credit record may have considerable difficulty finding a reasonable source of credit.

Even without the usury limit, there is still some federally imposed limitation on interest rates

because "loan sharking" is illegal, so it can be argued that the usury law does not accomplish the goal of protecting the consumer, but is merely redundant.

Rich versus Poor. The usury law is a moot point for those who are established enough to secure a loan at the prime rate. Low-risk borrowers seem to benefit from usury laws. They are able to attain loans and are never pushed out of the market due to a credit risk. It is an entirely different situation for high-risk borrowers. The poorer consumers do not necessarily see any benefit from a usury law. They are often rejected traditional loans and forced to seek credit from loan sharks or pushed out of the market all together. The availability of credit under usury limits is comparable to a grading scale without the possibility of earning a B, C, or D. The only options are to pass with high marks or to fail.

Lending Institutions. Lending institutions in Arkansas do not fare well from the usury law. They simply cannot lend money in situations that do not meet the company's guidelines. The pool of consumers who are capable of securing a loan at the legal rate of interest is greatly reduced. Competitive pressure is a major issue for Arkansas banks. FDIC General counsel Opinion Number 11, issued in 1998, deals with state banks operating branches in other states and the interest that they can charge^[iii]. In some situations, a bank is allowed to charge the rate of interest in the institution's home state even if it operates a branch within a state with usury laws. Arkansas banks cannot compete with these institutions in higher-risk transactions because of the cap on interest rates.

The most interesting information that I found from interviewing workers in the banking profession deals with how they recover the money lost from high-risk borrowers. Banks do make loans to people who do not qualify for the usury capped interest maximum due to their credit risk. To balance the risk related with loans made to people just outside of the plausible risk area, the banks are forced to charge even the best customers with very near the maximum interest rate allowed by law. Although the usury law seems, at first glance, to benefit those with exceptional credit, they are actually the ones most adversely affected by the law. If banks could charge according to risk, then the rates for the best customers would, possibly, be lower than at present.

Student Survey. As part of my research, I surveyed 100 business students in an Arkansas university. Of those, 23 were enrolled in a graduate program in business administration. The main focus of the survey was to test the students' knowledge of usury laws as a whole and of the specific regulations in the state of Arkansas. The students were asked the question, "What is a usury law?"

Only 23 of those surveyed had any kind of knowledge of the subject. Of those, 7 graduate students had partial knowledge (30 percent of the graduate students surveyed) of usury laws, but only 16 of the undergraduates (20 percent of the undergraduate students surveyed). In addition, only 13 students combined demonstrated substantial knowledge of the subject.

Students were then asked, "What is Arkansas's usury law?" Only four of the business students surveyed were able to answer the question. Two undergraduates and two graduate students were able to explain the Arkansas usury limitations. These results support the assumption that Arkansas residents are not very well informed about the state's usury law and what it is meant to

do. (See Figures 1 & 2.)

Section III—Arkansas Usury Law Versus Neighboring States

Usury limits. Oklahoma limits business loans to 45 percent interest. Louisiana's interest is to be no less than 7 percent and no greater than 14 percent. In Missouri, there is not usury limit. Texas has a set of ceilings for different kinds of loans but no set usury limit. In addition, Mississippi has no usury limits on loans of \$5000 or more, Tennessee's usury rate is 24 percent, and Kansas caps interest at 15 percent^[iv].

Effects. It is quite evident that Arkansas has a much more strict usury law than most of its neighboring states. This puts exceptional stress on Arkansas banks near less regulated states. For example, in Texarkana, Arkansas, the Texas banks can offer more flexible credit package. This persuades money to leave Arkansas and leaves Arkansas banks unable to compete and keep money in the state.

Section IV—Credit Cards

Credit card rulings. In 1978, the Supreme court ruled that it is legal for national banks to export higher rated credit cards to states with usury laws well below the card's designated rate of interest. The credit card issue is legally bound to the regulations of the state where the operation is located (*Marquette v. 1st Omaha Services*). Since 1987, retailers can create 'credit-card' banks for their department store cards to export department store cards at a higher interest rate.

A credit-educator and author of *The Ultimate Credit Handbook*, Gerri Detweiler explained the effect that this ruling has on the state of Arkansas:

“It's been a real problem for state legislators because what happens is that they try to institute a law that applies to businesses in their states and those companies will move out of state to sideswipe the law but still send credit cards to people who live in that state. ^[v]”

Student Survey. The second part of my survey of 100 business students dealt with credit cards. Out of 100 students, 73 possessed credit cards, but only five (seven percent) had credit cards from an Arkansas bank. This leaves a large segment of the market untouched by Arkansas banks because of their inability to charge higher rates of interest. The survey results support the view that the usury law is restraining Arkansas banks.

One of the banks that I researched said that issuing credit cards was a huge mistake because they were unable to charge a high enough interest rate to recover the costs associated with administering credit cards.

Section V—Getting Away With Usury, What the Usury Law Fails to Do

Payday advance loans. Although the usury law is designed and expected to protect consumers, it does not cover all of the bases. The payday loan industry (also known as check

cashers, paycheck lenders, and dozens of other related names) has gained a reputation for indisputably high interest rates that seem to qualify as blatant usury. Yet in most states (even those with usury laws) these institutions slip through the cracks. Even though Arkansas has one of the most restrictive caps on small loan interest rates, there is no specific 'check casher law.' Nineteen states have adopted legislation that in some way regulates payday loans. The absence of this kind of law and lack of specific restrictions allows these 'check advance loan' operators to exist and prosper in Arkansas.

The check cashing industry, on the other hand, feels that it is providing a vital service for its customers. Check cashers do not find it fair to list a two week loan in terms of annual percentage rates. They compare payday advance loans to a taxi cab saying, "it is cost-effective for short distances, but probably not the best way to travel from New York to San Francisco."

Explanation of the table. I chose to survey a group of payday lenders to see what the terms were and how Arkansas compared to other states in respect to the fees that these establishments charged. I simply asked each business what the fee on a \$100 check would be, how long they would keep the check, and if they would roll the check over if I was unable to pay the fee at the end of the period. I used an article that had compiled similar surveys from different civic and community organization in several states—both with and without usury laws[\[vi\]](#). (The table is located at the end of this report.) Even though Arkansas' *usury* law is among the strictest in the nation, some of the fees ranked among the highest! In Hot Springs and Little Rock, for example, the establishments that I contacted all charged a \$22.22 fee on a \$100 loan for a two-week period. That converts to an Annual Percentage Rate of over 500 percent. Referring back to the definition of usury—exceeding the interest limits set by law or society—this appears to abuse the limits that society has placed.

Rent-to-own establishments. State limits on retail interest rates do not apply to rent-to-own establishments because the customers can bring their merchandise back at anytime without the obligation to finish paying for the item. When renting to own, no debt is technically incurred, so the establishment is immune to usury laws since they deal with loans. Also rent-to-own leases are contracted for very short periods like a week or a month, and they are not regulated by the Consumer Leasing Act. This leaves rent-to-own establishments setting any rate that people are willing to pay.

Pawn shops. Pawn shops provide quick cash to customers without any review of their credit history. Instead of a credit-check, the customer must leave an item (jewelry, electronics, anything valuable) in return for the money. They have the option to buy back the pledged item at a higher price at the end of the term. The major cost is selling something for less than it is worth in order to get quick cash, but the benefit is getting that quick cash immediately without the hassles of a credit check or any short or long term commitment.

Sale-leaseback. Another short term, quick cash establishment is the sale-leaseback business. In this transaction, the company buys a consumer's home appliances and then leases them back to the consumer for a monthly fee.

Effects. These 'fringe' banking institutions take advantage of the consumers. The industry

preys on desperate people who cannot establish the credit to get money from any other source. They often charge rates that convert to an annual percentage rate of 100 percent or much more, so the poorest consumers in Arkansas, and America, are paying the highest interest rates. These businesses are present in states with and without usury laws. There are specific regulations against payday loan providers in some states, but for the most part 'fringe' banking institutions fall through the cracks. It defeats the purpose of Arkansas' usury law--to protect the consumer--if Arkansas citizens are forced to seek alternative and very unfair means of attaining credit.

Section VI—Financial Modernization, Congress Steps In

H.R. 10 transforms into the Financial Modernization Act. In the fall of 1999, The United States Congress passed an act sponsored by Senator Phil Gramm from Texas and titled “An Act to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, and other financial service providers, and for other purposes.[\[vii\]](#)” This bill was originally H.R. 10, the Financial Services Act of 1999, but was sent to the president as S900, the Gramm-Leach-Bliley Act. It became Public Law No: 106-102 on November 11, 1999, and is best known to the press as the Financial Services Modernization Act.

Section 731, of S900 deals with Interest rates and other charges at interstate branches. This section is inserted from the Financial Services Act of 1999. In simplest terms, the provisions in this section allow Arkansas banks to charge interest at the same rate as *any* out-of-state branches that may be operating in the state[\[viii\]](#), so if a Tennessee bank with a 24 percent cap and a Kansas bank with a ceiling at 15 percent are operating in the state of Arkansas, then the Tennessee bank, the Kansas bank, and all Arkansas banks would be able to charge 24 percent. The law deals specifically with banks and does not seem to incorporate in-store credit.

Although federal legislation supercedes state law, and the Financial Modernization Act seems to negate the state's usury law, Arkansas bankers are being cautious. The board of the Arkansas Bankers Association has formed a committee to decide if it should test the legislation by filing suit. Banks plan to wait until the law is interpreted in court before moving to raise interest rates above the current legal maximums. Arkansas banks have been following the Federal Reserve's increases in interest rates. Most bankers are saying that they are waiting to see if the bill will hold up under court scrutiny before they actually push any rates above the usury cap. Lunsford Bridges, president and CEO of Metropolitan National, seems to convey the feeling of most Arkansas bankers. He said, “We won't exceed what the old usury limit would be until there's a court ruling on the language.[\[ix\]](#)”

Section VII—Interpretation

The current usury law. From my research, I have found that the preponderance of the information is against the restraining usury law of the present. Because of the current economic prosperity, the effects of the law may not be overwhelmingly evident, but they are present and very far reaching. The extremely low ceiling eliminates two fundamental principles of business: risk neutralization and the ability to compete.

Businesses survive and prosper by analyzing risk and making the proper decisions to neutralize that risk and make an opportunity profitable. This is the cost-benefit strategy at its best. If the benefits of taking an opportunity outweigh the cost that is associated with that opportunity, then it is worth the business's time to undertake it.

Currently, banks in Arkansas are not able to neutralize high-risk borrowers by using higher interest rates. They must offer rates within five percent of the prime. This usury ceiling eliminates a basic part of the free enterprise system. This is not profitable for the banks, for many of the people, or for the state of Arkansas.

The usury law in Arkansas also prevents Arkansas banks from competing with out-of-state banks. Out-of-state banks offer high interest credit cards and loans to Arkansas residents by mail, internet, or phone. Those same offers could be made by Arkansas banks if they were not so tightly restricted by the usury limit. Therefore, Arkansas banks cannot compete in a large segment of the market.

Another problem with the usury law is that it pushes money out of the state of Arkansas. Texarkana is a prime example of the flow of money out of the state due to its unique position and close ties to both the states of Arkansas and Texas. Texas has no set usury limit, and Arkansas has one of the most restrictive in the nation. Texas banks are able to offer more flexible credit packages and to extend credit to more consumers than their Arkansas counterparts. Getting a loan may literally be a matter of walking to the other side of the street. Because of the restrictions, borrowers with risk above the prime level are pushed out of the Arkansas market and over to the Texas side.

The new legislation. The Financial Modernization Act is a very important current issue for Arkansas banks and citizens. If it is interpreted to regulate interest rates, it will supercede the state law and level the playing field for Arkansas banks, although other institutions will be held to the usury limitations. The legislation would allow Arkansas banks to charge the same rate of interest as out-of-state banks operating within the state. This would reinstate to Arkansas banks both the capability to neutralize risk and the ability to compete in the market.

The Financial Modernization Act is a step toward a national banking system, but it is a step that could help Arkansas banks, residents, and the state's economy.

Section VIII—Conclusion

Many people live by the old adage "if it's not broke, don't fix it." Perhaps that is why the majority of Arkansas voters have refused proposed changes to the usury limitations in the past. In any case, the current system of usury restraint is broken for many Arkansas residents.

When a person is forced to pawn his or her belongings or use a check cashing service for necessities, or must sell the title to a car or the ownership of appliances to pay medical bills, and then pay 100 percent or more in interest--something needs to be fixed. On paper, the usury law looks like a law for the people, by the people, to protect the people, but communism looked good on paper, also. When all of the other variables are added, then a low usury cap is neither the most

efficient nor the most practical way of protecting consumers from high interest rates and malicious lenders.

Recent legislation in the form of the Financial Modernization Act is a step in the right direction. It will allow for a competitive market and enable banks to service the needs of more Arkansas residents while reinstating the principles of supply and demand and free enterprise on which our country's economic system was built.

Figure 1

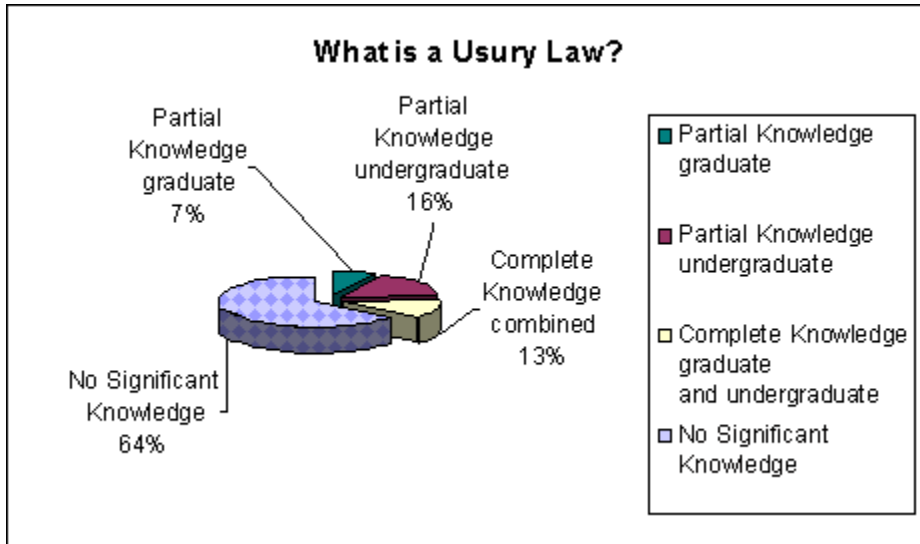


Figure 2

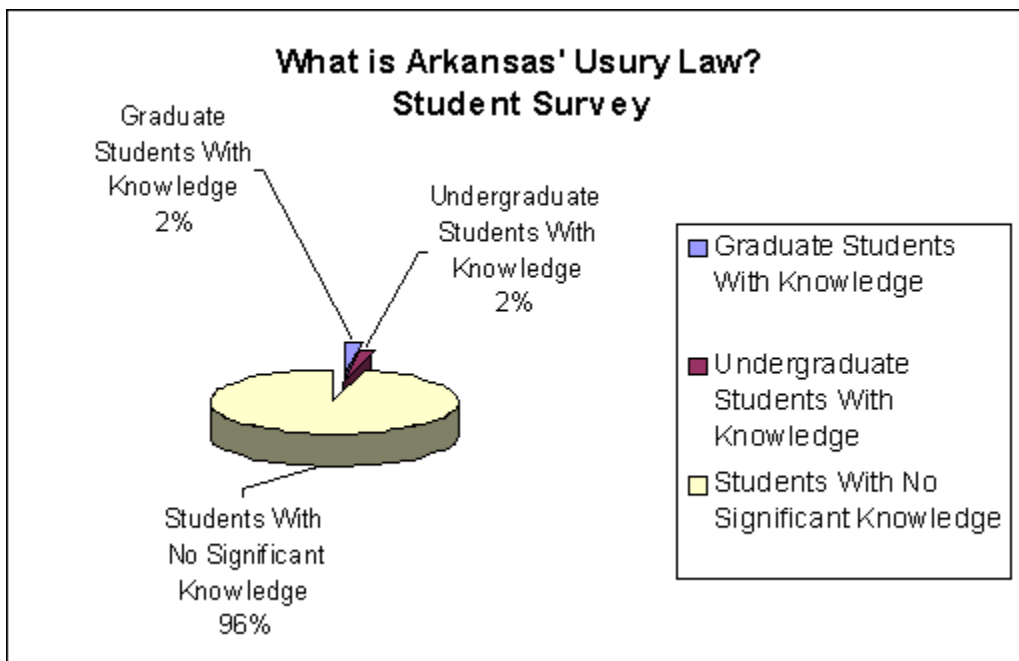


Table 1

Arkansas Payday Loan Survey*					
Feb-00					
Company/City	Maximum Loan	Maximum Term	Fee/\$100	APR/\$100 14 days	Roll-over permitted?
Money Talks Arkadelphia	\$300	next payday	15	391%	yes
Showmethemoney Arkadelphia	\$300 based on pay	next payday/ 2 weeks	15	391%	yes
CheX-2-Cash Arkadelphia/Hot Springs	based on income	next payday	22.22	573%	yes
Chek Mate Hot Springs	up to \$350 according to pay	next payday	22.22	573%	yes
E-Z Cash Hot Springs	\$200	14 days	22.22	573%	yes
American Check Cashers Little Rock/Jacksonville/ North Little Rock/Pine Bluff	300	14 days	22.22	573	yes
Mr. Cash Little Rock	350	30 days	22.22	573	no
Mr. Money Little Rock	350	30 days	22.22	573	no

*This table is based on information given during a telephone survey of the companies listed.

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[iii] Burns, Robert and David Griffiths, “Memphis Regional Outlook, Fourth Quarter 1998:Effects of Mergers on Community Banks,” <http://www.fdic.gov/publish/regout/ro1998q/memphis/region3.html> uploaded April 29, 1999.

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[vii] <http://thomas.loc.gov>

[viii] Collins, Jeffery T. and Miles H. Sonstegaard, "Hey Buddy can ya' spare a dime: Arkansas Usury Laws Revisited," *Arkansas Business & Economic Review*, 32, Fall 1999, pp. 7-10.

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Biographical Sketch

Susan Wesson is a senior finance major from Mena, Arkansas. She has served as president of Phi Beta Lambda and the finance club, and she also participates in Student Government, Rotoract, Heart & Key, Reddie Ambassadors, and the Oaks Hall Council. Susan served as state vice-president for Phi Beta Lambda, and was named the National Future Business Teacher for 2000.

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