Ministry of the Interior
and
Commissioner for Coordination of Antiracket and Antiusury Action

First National Conference on Usury and Extortion

Interest, usury and banks

Address by the Governor of the Bank of Italy
Antonio Fazio

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The question of usury has tormented philosophers, moralists and economists for more than two millennia. In the ancient and the medieval worlds, any payment on account of a sum of money lent for a fixed term was considered usury.

In the 13^{th} century, however, the greatest Scholastic authority, while reaffirming in general terms that money was unproductive, incidentally acknowledged the legitimacy of a payment to the lender to compensate him for the effects of temporary privation of the sum; and he recognized the legitimacy of the lender's sharing in the fruits reaped by the borrower from using the money lent to him.

In the centuries that followed the concept was revived and extended, in parallel with the growth of trade, money-changing and fairs. This was the context that gave rise to the principle of a premium for the non-recovery of the money lent.

The purpose of freeing the needy from the clutches of usurers led to the creation and growth of the *montes pietatis*.

Interest rates had to be modest. In the 18^{th} century discussion turned on a ceiling of 4 per cent for commercial loans.

In the middle of that century the Church reaffirmed the general illegitimacy of lending at interest but did not ban payments on account of the damage incurred by the lender or as share in the borrower's proceeds from the productive use of the money.

In *The Wealth of Nations* Adam Smith held that a limitation on interest rates on loans was socially beneficial, in order to prevent the dissipation of money in imprudent initiatives and to encourage its productive use. This triggered a vehement polemic with Jeremy Bentham, who argued that in this way one discouraged riskier but higher-yielding investments.

In the 19th century a loan was considered usurious when the interest rate was excessive with respect to the generally moderate money market rates of the day.

As we understand it today, usury can take any number of forms. It always contains an element of violence, deriving from the radical inequality between the position of the usurer and that of his need-constrained victim.

For organized crime, usury is a source of gains that are frequently turned to the commission of other crimes. It involves the imposition of extremely high interest rates. It can be practiced with the aim of subjugating enterprises that could not otherwise be broken. In this way usury serves as a means for organized crime to control the local territory.

Assessing the dimensions and the extent of usury is no easy matter, but one source of useful information is reports of the crime to law enforcement authorities. Usury tends to occur where the social fabric is weak; it increases during recessions.

The Ministry of the Interior's Permanent Observatory has found that between 1995 and 1998 indicators of usury risk were above the national average in all the provinces of the South (except Abruzzo) and in some provinces in Central Italy. The most vulnerable regions are Sicily, Campania, Calabria and Molise.

Experience suggests that usury is also fairly widespread in some major metropolitan areas, especially in the most blighted districts.

1. Usury and the credit market

A properly working legal credit market counters usury. However, where other factors foster it, this social scourge can develop within the interstices that the legal credit system, however efficient, cannot cover.

When banks select investment projects, they perform a resource-allocation function within the economy. Their probity and prudence contribute decisively to balanced growth and social development. The safeguarding of savings and the entrepreneurial nature of banking require that credit allocation be governed by the standards of economy and efficiency, at the lowest possible production cost and with an adequate return on the capital invested.

In their customer selection, banks obtain and assess information on the financial situation of borrowers and their real ability to meet their principal and interest obligations. As the interest rate on loans rises, funds are requested mainly by customers who undertake investment projects that carry higher expected returns but are also riskier.

The difficulty of securing information during the selection stage means that above a given interest-rate threshold the bank's expected profits do not increase but actually diminish.

A well-established finding in banking economics is that informational asymmetries between lenders and borrowers can result in credit rationing.

Generally, the victims of rationing are the smaller customers, often households or artisanal businesses, on whom it may be difficult or costly for banks to get the information needed to assess their future solvency.

Measures intended to combat the unwanted effects of the market but that distort its operation risk cause damage to the workings of the financial system that can outweight the benefit sought.

During the nineties there was a significant increase in lending to households, to small businesses and to artisans, some of it by non-bank intermediaries.

By comparison with the eighties, households progressively reduced their propensity to save and increased their tendency to borrow. Despite this substantial expansion recorded, consumer credit remains lower than in the other leading European countries.

Non-bank finance to small customers remains comparatively costly. The higher level of interest rates is explained in part by the greater average risk attaching to these small borrowers.

The development of consumer credit has nevertheless broadened and diversified supply and diminished the unsatisfied demand for credit.

Law 108/1996 embodies reasonable principles as far as its instruments for prevention and assistance in the repression of usury are concerned.

However, the emergency conditions under which the measure was enacted prevented sufficient reflection on the advisability of introducing a ceiling on the interest rates that could be charged by authorized intermediaries.

In the legal credit market, usury does not exist.

But in difficult conditions credit may be particularly costly and rationing may occur. These are phenomena upon which we must act to help eliminate usury and stimulate economic development.

Setting interest rate ceilings on the operations of banks and supervised finance companies reduces rate dispersion but distorts financial flows and price-setting. Paradoxically, setting threshold rates that are the same nationwide may actually favour the extension of usury, especially in those parts of the country where credit is riskier, by reducing the volume of legal lending.

The Bank of Italy and the Italian Foreign Exchange Office have applied the law scrupulously, identifying the separate markets for distinct types of loan and regularly collecting data on the actual distribution of interest rates in the legal credit market.

The problems of application that have arisen recently are a further consequence of the original legislation, which failed to specify the proper reference period for application of the evolving usury threshold rate.

2. Oversight of credit business and financial intermediation

Authorization to engage in banking is subject not only to minimum capital and organizational requirements but also to integrity and experience standards for corporate officers. These regulations are designed to prevent criminal infiltration, which would foster the spread of usury.

In the last three years, 50 applications to constitute new banks have been accepted and 19 rejected.

At our urging, in 1999 the Foreign Exchange Office’s powers of oversight over the financial companies entered in the register referred to in Article 106 of the Banking Law were enhanced. The register now includes some 1,400 intermediaries. In the last three years 58 financial companies have been removed because they no longer met the requirements and, in no few cases, for serious irregularities.

A government regulation on the register of credit brokers has now been issued. This is an area in which experience and integrity requirements and business transparency can effectively select agents, averting the risk of misconduct.

The Bank of Italy’s action is aimed at improving the efficiency of the financial system, in part by fostering and safeguarding competition. The Bank, with its provincial branches, is currently conducting a detailed study of local markets and an examination of conduct that may be in restraint of competition.

Implementation of the rules governing contract terms helps to ensure accurate information for the users of banking and financial services. Inspections are increasingly directed to enforcing the transparency rules on banks’ dealings with their customers.

Usury is closely connected with unauthorized financial business activity.

The need for potential customers to deal exclusively with intermediaries entered in the official registers must be underscored.

The fact that modest, traditional forms of mutual credit have been authorized in restricted spheres does not distort the working of the markets, and it helps to meet a limited demand for small loans.

It is important that legal financial institutions be immediately recognizable. The supervisory instructions require banks to report cases of suspected unauthorized activity or other illicit financial business.

In presumed cases of unauthorized activity the procedure for cooperation with the judicial authorities is initiated. Such cooperation has been stepped up in recent years, with the possible subjection of unauthorized financial enterprises to judicial control, up to and including the appointment of a commissioner and court-ordered liquidation.

The brunt of the battle against unauthorized financial activity is borne by law enforcement authorities. They can use reports from the Bank of Italy and the Foreign Exchange Office on cases of suspected illegal activities. In the last three years the Bank has reported 56 cases of unauthorized activity, the Exchange Office 42.

Like other economic crimes, usury can also be countered at the point where the proceeds are held or reinvested in the legal financial system.

The law on money laundering furnishes specific instruments to prevent the financial system from being contaminated by the usury circuit.

In the last three years the Foreign Exchange Office has found about 300 cases involving possible usury among the banks' reports of suspected money laundering operations. The reports were forwarded to the relevant investigative authorities.

Some days ago we issued a new version of the instructions to banks and other financial agents for the identification and reporting of suspicious transactions.

3. The supply of credit in the areas vulnerable to usury

A diversified, competitive financial system offering a broad range of financing instruments reduces the danger that part of the loan demand of solvent customers will have to be serviced by the illegal market.

In the last decade, the reduction in operating costs and reorganization have enabled banks to take full advantage of the liberalization of branching. At the end of 1989 there were 15,600 bank branches in Italy, one for every 3,600 inhabitants; today there are 27,800, one for every 2,050. The number of towns with at least one branch has increased by 900 to 5,411; nearly 2 million citizens have benefited.

Notwithstanding the overall consolidation of the banking system, at the provincial level the number of banks that households and firms can turn to for financing has increased. The supply of credit for smaller customers has not contracted but actually expanded.

The branch network has also grown rapidly in the areas most vulnerable to usury. Since the start of the nineties, the number of branches in southern Italy has risen from 3,700 to 6,300; in the four regions most exposed, from 2,400 to 3,700.

The pattern of households' borrowing from banks is fairly uniform nationwide. According to regional accounts data for 1998, such debt was equal to 22 per cent of final consumption in the Centre and North and 19 per cent in the South. If lending by consumer credit firms is included, the gap is smaller still.

In recent years, the decline in inflation and interest rates has fostered an especially rapid increase in lending to small borrowers, i.e. firms with fewer than 20 employees and households. Their share of total bank credit has risen from 30 to 34 per cent since 1997.

The growth in lending to small borrowers has been faster than for other categories in the South as well.

Nevertheless, credit risk is still appreciably higher in the South than elsewhere in Italy. Nearly one fifth of loans are classified as bad debts, compared with less than 5 per cent in the rest of the country. The risk differential, which is substantial for all the main sectors of economic activity, is largest for firms with fewer than 20 employees, which have a ratio of bad debts to total lending of 30 per cent in the four regions most vulnerable to usury, as against 25 per cent in the other southern regions and 8 per cent in the Centre and North.

In the South, high default rates are associated with greater difficulty in enforcing the rights of creditors. A Bank of Italy survey has found that judicial credit recovery procedures in the area are lengthier, costlier and more uncertain of outcome than in other parts of the country.

Banks protect themselves by requiring more collateral or shortening the term of their loans. Excessive demands for collateral can block access to credit, especially for smaller customers. The bias towards short-term lending weakens the financial structure of firms and can transform temporary liquidity problems into full-blown solvency crises.

4. The fight against usury

Usury, or the granting of an illegal loan, exists in Italy as elsewhere. In addition to psychological and cultural causes, which influence subjective choices, a number of environmental characteristics stand out.

Lagging economic development and social degradation ensure that any shortage of banks or information problems that make the granting of legal loans more difficult will be exploited by loan sharks.

In the areas afflicted by these conditions, usury tends to spread. It may be triggered by unexpected liquidity problems for small firms or emergency spending by households. Drawn by the opportunity for profit linked not only to the high interest rates extorted but also to the prospect of taking over all of the debtor's assets, criminal organizations extensively established within a territory take control of the usury market.

The Bank of Italy is actively involved in the fight against usury as part of its supervisory functions.

The leading actors in the fight against illegal financial activities are the law enforcement and judicial authorities. Strong, determined action against usury by the banks, financial companies and supervisory authorities is an essential deterrent to criminal activity in the financial sphere.

The banks' close contact with customers, their knowledge of the latter's financial and consumption habits and economic needs, is the basis of a solid relationship from which both sides benefit. The advantages of strong local roots have made the system of mutual credit an important source of financing for households and small craft firms in the South.

In the last ten years, mutual banks have significantly expanded their branch networks. Today, they account for nearly 7 per cent of fund-raising and 5 per cent of total lending, or about a fifth of all bank customers.

By their nature mutual banks are called upon to continue their historic role in countering usury, especially in the less developed areas.

A part of the customers who have difficulty obtaining funds must be brought back into the market for legal financing. The current level of market interest rates facilitates this process. This is a social necessity with the solid economic underpinning of an expanding market. The intermediaries themselves will benefit.

The share of medium- and long-term lending can be increased and financing relations between banks and firms and households can become more stable.

By reducing the costs of processing loans, collective loan guarantee consortia can facilitate the assessment of the creditworthiness of small and medium-sized firms and develop modern risk-sharing techniques. Although it is expanding, collectively backed financing is still under-utilized. Within a suitable regulatory framework, the extension of collective guarantee bodies could be beneficial, above all for the regions and firms of the South.

"Ethical" banking can be successful thanks to the acceptance of some traditional banking criteria. Its purpose is to support the initiatives of not-for-profit organizations not normally eligible for bank loans, capitalizing on the special convergence of altruistic spirits of employees, shareholders and depositors.

In the area of the regulations governing the activity of banks and firms, action to modernize the management of corporate crises is a priority.

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In one of the final chapters of the work that revolutionized twentieth-century economic thought, Keynes discusses usury, ancient laws and the analyses and disputations of medieval scholars on the cost of money and lending. He acknowledges that those analyses and laws had the historical merit of steering capital towards trade and productive investment, helping to increase overall well-being.

The backwardness of certain components of Italy's economic system has so far made it impossible to eliminate the scourge of usury, with its devastating impact on the social fabric and braking effect on economic development.

The way out of this condition involves first and foremost education of households to the responsible use of money. A share of household demand for loans is in itself ineligible for bank credit, like that from small and medium-sized firms that already operate in conditions of chronic financial imbalance.

Apart from the reform of bankruptcy law and the intervention of foundations for assistance to troubled firms, which with the help of the banks can enable firms to survive liquidity crises, the high road must be faster economic growth, especially for the regions where organized crime is widespread.

Balanced growth and development are the necessary conditions for increasing household wealth and strengthening the financial structure of small and medium-sized enterprises.

In the areas where usury prospers, it undermines the potential for economic development.

The financial system, above all the banks, must undertake an extraordinary and systematic effort at the local level and in the most difficult areas and provinces to reduce the cost of credit for marginal customers. It is necessary to improve techniques for evaluating loan applications and to sharply narrow the difference between the banks' maximum and prime lending rates.

Macroeconomic conditions and the strengthening of the credit system have drastically reduced the average cost of money in Italy. It is necessary to reduce the variance in rates, extending the benefits to a greater number of customers.

By granting a larger number of households and small firms access to the legal market, we reduce the pool of unmet demand on which usurers prey, thus helping to affirm legality and civil and economic progress.

This effort will be successful if, together with the improvement in the development prospects of the backward areas, the country ensures the continued effectiveness of the law enforcement and judicial authorities in suppressing organized crime.

Usury is not invincible. It is not an incurable disease. Greater discipline and awareness in the economic action of individuals, increased efficiency among financial intermediaries under the stimulus of competition and transparency, and appropriate supplementary financial instruments narrow the scope for usury and, with the joint contribution of institutions and market operators, increase the likelihood of rooting it out.

Deliverance from this evil restores the dignity of those subjected to moral and even physical violence. Civil society and the body politic must be united in fighting this social plague.

It is an ambitious objective, one which the banks are also working to achieve.

It is to be hoped that Italy, drawing strength from the example of those who have had the courage to resist, will find a way to raise its performance in this area to the level of the group of the most advanced nations, of which Italy is rightly a member.