

# Essay on the secret history of the credit card: citibank and south dakota

[Finance](#), [Investment](#)



In the financing market, there is an important need to balance the powers between lenders and borrowers. In this market, the borrowers are in a relatively weak position to negotiate the interest rates of their loans, being the party in need. Lenders, in accordance to the law of supply and demand, can strategically withhold money supply to increase demand and interest rates. Historically, government regulators ensured, through usury laws, that the consumers were protected against financial predators (Bowsher, 1974). However, the current trend in the financing market has moved steadily towards loosening the usury laws and allowing the markets to dictate the interest rates. This paper will attempt to understand this trend through a series of six questions and answers.

1. What is the main purpose of the usury law? Short answer: The main purpose of the usury law is to protect borrowers from excessively high lending interest rates. Norman Bowsher of the Federal Reserve Bank of St. Louis (1974) contended that the main purpose of usury laws is to maintain competitive balance between lenders and borrowers in the financing market. It reflects a public attitude that views small borrowers as underdogs and must be protected from excessively and artificially high interest rates vis-à-vis existing market rates. Regulation acted to balances the market power of lenders, protecting borrowers, avoiding market distortion, and encouraging increased consumption, more investment, and faster economic growth.

2. Why did South Dakota decide to eliminate the cap on interest rates? Short answer: South Dakota decided to eliminate the cap on interest rates because it is not keeping up with the increasing costs of money and the interest cap in the state is lower than the national interest rate. In 1979, the 9-percent-

range mortgage loan rates had been increasing to 9.75 percent. The short-term rates even moved up faster (Hajek, 2004). However, the lending rates, capped by usury laws, were trailing the rapidly rising money costs nationwide. This is the time when the Federal Reserve Regulation Q had been phasing out and Chairman Paul Volcker decided to let the rates float on supply-and-demand forces. The South Dakota Bankers Association Legislative Committee (SDBALC) believed that eliminating the lending rate cap would let it loose to keep up with the increasing money costs. The approach was not to remove the usury law (a complex legislative move), but to gain exemption from usury law for regulated institutions (e. g. banks).

3. Why were the usury laws strangling the banking industry? Short answer: The usury laws were strangling the banking industry because the rate cap prevented the banks from keeping up with the growing cost of money. Usury laws have an expected effect of both strangling the banking industry and encouraging credit outflow to states with more liberal usury laws (Bowsher, 1974). With the high cost of administering loans and the high money risk, banks are forced to be highly selective in granting loans to individuals believed to be lower risks (e. g. people with most wealth, best jobs, and most likely to repay loan) and avoid those of higher risks (e. g. welfare mothers, people with unstable employment, the elderly, and students). Thus, banks decided instead to move their funds to states with either no usury laws or rate cap exemptions.

4. Why Citibank moved to South Dakota? Short answer: The main reason for Citibank's move to South Dakota was the enactment of the "Citibank Bill" of 1980, which exempted banks from the usury laws? Due to the usury limits

imposed in New York, Citibank credit card business lost at least \$100 million in 1978 (Hajek, 2004). The move of the SDBALC, which became effectively translated into law the “ Citibank Bill” of 1980 Congress passed, allowing banks to charge whatever fees they want provided their customers agree in writing.

5. In the Citibank example, how did Citi use existing laws to alter its business mode? Short answer: Existing laws, particularly sec. 85 of the National Banking Act, allowed Citibank to export the laws of South Dakota to any state in the Union even those with usury laws. The federal banking law (e. g. Sec. 85 of the National Banking Act) already existed, which allowed Citibank to effectively bring to other American states the South Dakota legislation. Despite the no-compete rule to be followed, Citibank can use these laws to extend businesses in other states (without need to open branches) by transferring to South Dakota, which has usury law exemption, and issue loans directly from the head office in South Dakota.

6. What was the underlying basis of the Marquette Bank decision? Short answer: The underlying basis of the Marquette Bank decision was section 85 of the National Banking Act, which allows the export of the local laws where a company resides to other states. The Supreme Court decision in the case Marquette National Bank of Minneapolis vs. First of Omaha Service Corp. in 1978 (Powell, 1978) ruled that the state usury law of Nebraska (with an interest ceiling of 18 percent), where credit card issuer First of Omaha operated under, may be exported to another state, such as Minnesota (with an interest ceiling of 12 percent), on the basis that First of Omaha issued the loan from Nebraska (thus, subject to the Nebraskan usury ceiling), without

any branch operating in Minnesota (thus, strictly not under the Minnesota usury law), and to Minnesota residents who sought credit grants through application forms distributed in Minnesota.

Key to the liberalization of the usury laws in the United States, which primarily motivated Citibank to transfer its headquarters to South Dakota, is the appearance of two legal documents: the “ Citibank Bill” of 1980 (Hajek, 2004) and the Marquette vs. First of Omaha case in 1978 (Powell, 1978). The state still continues to define interest rate ceilings under existing usury law. Conversely, the Marquette decision clarified the permission granted in sec. 28 of the National Banking Act that allows banks, like Citibank, to export to other states the home state (e. g. South Dakota) usury exemption. Thereafter is history.

## **References**

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