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Federal Trade Commission

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**COMMISSION
APPROVED**

March 18, 1987

The Honorable Garrey Carruthers
Governor of New Mexico
State Capitol Building
Santa Fe, New Mexico 87503

Dear Governor Carruthers:

We are pleased to submit this letter in response to your staff's request for comments on House Bill 275 and Senate Bill 171, which impose interest rate ceilings on credit card transactions, and on Senate Bill 203, which imposes an interest rate ceiling on all credit transactions.¹

As you are aware, the Commission does not regulate maximum prices for credit. However, the Commission is directly and actively involved in other consumer credit regulations² and in regulations governing pricing generally.³ Our experience and the economic literature on maximum pricing regulations both indicate that ceilings on interest rates are accompanied by substantial harm

¹ These comments represent the views of the Dallas Regional Office and the Bureaus of Consumer Protection, Competition, and Economics of the Federal Trade Commission and do not necessarily represent the views of the Commission or any individual Commissioner. The Commission has, however, voted to authorize their submission.

² See, e.g., Truth in Lending Act, 15 U.S.C. § 1601 (1982); Equal Credit Opportunity Act, 15 U.S.C. § 1691 (1982 and Supp. III 1985); Fair Credit Reporting Act, 15 U.S.C. § 1681 (1982 and Supp. III 1985).

³ See, e.g., Federal Trade Commission Act § 5, 15 U.S.C. § 5 (1982); Robinson Patman Act, 15 U.S.C. §§ 13-13(b), 21a, (1976 and Supp. III 1985).

to many consumers.⁴ An effort to restrict interest rates will cause lenders to alter other loan terms, including collateral requirements, minimum monthly payments, administrative or user fees, duration of the loan, and criteria for creditworthiness. These offsetting changes are likely to affect many consumers adversely. We therefore recommend against the enactment of any of these bills.

INTEREST RATES ABSENT INTEREST RATE CEILINGS

In the absence of a rate ceiling, the interest rate that a creditor can charge for a loan of a given size and duration is determined by competition among creditors. This competition can be actual -- where a would-be borrower has several sources of credit -- or it can be from potential entrants into the business of extending credit.

Data on the rates of return earned by various categories of creditors suggests that creditors earn only a competitive return on their invested capital.⁵ In other words, the interest earned on loans covers the creditor's costs, including losses on bad loans, and normal profits. This conforms to economic theory and experience, as any creditor who attempts to earn supranormal profits by charging higher than competitive interest rates would lose business to either existing creditors or new entrants.

Consumers may pay higher finance charges on credit card balances than for other types of credit. However, this type of credit has certain features for which consumers are apparently willing to pay. These features include the availability of a pre-approved line of credit, the lack of collateral requirements, the acceptance of a credit card by large numbers of merchants in various locations, and the record of purchases created by using the card. Further, profitability data indicates that disparity

⁴ See, e.g., Canner & Fergus, The Economic Effects of Proposed Ceilings on Credit Card Interest Rates, Fed Reserve Bull. Jan. 1987, at 1; Ostas, Effects of Usury Ceilings in the Mortgage Market, 31 J. of Fin. 821 (1976). See also Barth, The Effect of Government Regulations on Personal Loan Markets: A Tobit Estimation of a Microeconomic Model, 37 J. of Fin. 1233 (1982). On a similar subject, maximum rent regulations, see Bethell, No Growth-No Vacancies, Regulation, Jan.-Feb. 1979, at 48; Rent Control and the Decline of the Cities, Regulation, Jan.-Feb. 1981, at 13.

⁵ Canner & Fergus, supra, note 4, at 1-2.

between finance charges associated with credit cards and the interest rates charged for other types of credit does not result in directly corresponding higher profits for card issuers.⁶

THE EFFECT OF INTEREST RATE CEILINGS

When an interest rate ceiling is established at less than the competitive market rate for some borrowers, lenders will reduce the volume of credit extended to those borrowers. The reason for this is clear. Lenders themselves face costs of borrowing money from investors as well as costs of administering their loans. If legislation forces prices (interest rates) below the level of costs, lenders must either go out of business or stop making the loans that do not provide at least a normal rate of return.

Because the ultimate return from making a loan includes the losses from loan defaults as well as the positive income from interest payments and administrative fees, lenders are able to offer different rates to different types of borrowers. A borrower with a long history of timely repayments and a large pool of assets to guarantee repayment can usually obtain lower rates because the expected costs of such a loan are lower. Unfortunately, not all borrowers have such sterling characteristics, yet lenders are usually willing to make loans to a general pool that includes higher risk borrowers if the lenders are able to charge a suitable overall interest rate.

If government forces a reduction in allowable interest rates, however, lenders will no longer be able to make loans to higher risk borrowers with the same freedom as they did before the regulations. Lenders will compensate for the lower interest payments with other charges, such as higher annual fees, more restrictive loan terms, or denial of credit to borrowers who are relatively high credit risks.

⁶ The annual net earnings of bank card plans before taxes averaged 1.9 percent of balances outstanding from 1972 through 1985. Over the same period, average net returns on other major types of commercial bank lending were significantly higher: 2.3% on real estate mortgages, 2.4% on consumer installment debt, and 2.8% on commercial and other loans. Canner and Fergus, supra, note 4, at 1-2, citing Federal Reserve Bank Data. Returns on all types of loans fluctuate over time. Profits for 1984 and 1985 on credit card balances were 3.4 and 4.0%, respectively; high for the period but considerably less than highs for commercial and other credit, which reached more than 5% in 1981. Id.

⁷ Villegas, An Analysis of the Impact of Interest Rate Ceilings, 37 J. of Fin. 941 (1982).

Consequently, one probable result of restricting interest rates on loans will be to cut off credit to less attractive borrowers. Those borrowers will include young people with little credit history, people with few assets to use as collateral, or people who have had trouble repaying a loan in the past.

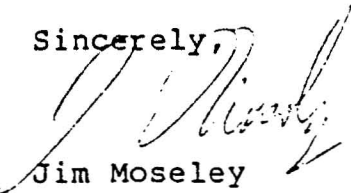
In addition, credit available even to the most qualified borrowers may be extended on less attractive terms, such as shorter repayment periods, lower lines of available credit, higher (or higher minimum) monthly payments, or more time-consuming and costly creditworthiness checks. In the case of credit cards, retail card issuers may increase merchandise prices in an attempt to offset the reduction in finance charge revenue. Bank card issuers may attempt to increase the merchant discount fee -- the fee charged merchants for processing credit card sales.

CONCLUSION

Interest rates are determined by the market forces that result from competition among lenders to loan money to consumers. Setting an interest rate ceiling lower than the market rate is likely to result in countervailing restrictions on the terms of credit, a reduction in the number of New Mexico consumers who qualify for credit, and a reduction in the aggregate amount of credit available for New Mexico consumers as a group. In particular, many consumers who are most in need of credit to buy clothing, furniture, cars, and homes will be less able to do so if binding interest rate ceilings are imposed. Among consumers who continue to be able to obtain credit, many will find that the advantages of lower interest rates will be offset because lenders will seek to reduce their costs or increase their non-interest revenue by requiring higher minimum monthly payments, reducing amounts of credit available, increasing down payment or collateral requirements, raising fees, and shortening repayment schedules.

Thank you for considering our comments. We would be happy to supply copies of the various studies mentioned in this letter if you so desire, or to provide any other assistance.

Sincerely,



Jim Moseley
Regional Director
Dallas Regional Office

8 Canner and Fergus, supra, note 4, at 8.