



UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
SAN FRANCISCO REGIONAL OFFICE

COMMISSION AUTHORIZED

901 Market Street
Suite 570
San Francisco, CA 94103
(415) 995 5220

APR 20 1987

The Honorable Ross Johnson
Vice Chairman
Assembly Committee on Finance and Insurance
State Capitol
Sacramento, California 95814

Re: Assembly Bills 2 and 325

Dear Assemblyman Johnson:

We are pleased to have the opportunity to provide our comments on Assembly Bill 2, which would set minimum and maximum interest rates that may be imposed on bank credit card accounts, and A.B. 325, which would set maximum interest rates that may be imposed on retail store credit card accounts.¹

We recommend against the enactment of either of these bills. Our experience² and the economic literature on maximum pricing regulations³ both indicate that restrictions on interest rates are accompanied by substantial harm to many consumers. Any effort to restrict interest rates will usually cause creditors to alter other credit terms, including minimum monthly payments, administrative or user fees, grace periods, and criteria for creditworthiness. To the extent that creditors cannot maintain their profit margins by altering these terms, they will simply reduce the total amount of credit extended, thus denying credit to marginal consumers who otherwise would be able to obtain it.

¹ These comments represent the views of the San Francisco 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 itself. The Commission has, however, voted to authorize us to submit these comments to you.

² The Federal Trade Commission has been actively involved in consumer credit regulations and in regulations governing pricing generally. 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); Robinson-Patman Act, 15 U.S.C. §§ 13-13(b), 21a (1976 and Supp. III 1985).

³ See, e.g., Canner & Fergus, The Economic Effects of Proposed Ceilings on Credit Card Interest Rates, Fed. Reserve Bull., Jan. 1987, at 1; Nathan, Economic Analysis of Usury Laws, 10 J. of Bank Research 200 (1980); 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.



D. Mulh... Kate J.

Credit Terms Absent Interest Rate Ceilings

In the absence of a statutory ceiling, the maximum interest rate that can be charged is determined by competition among lenders. 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. Any lender who attempts to earn above-normal profits by charging higher than competitive interest rates would lose business to either existing creditors or new entrants.

Proponents of interest rate ceilings assert that because the credit card market has been slow to respond to recent reductions in the cost of money, as reflected by falling interest rates in other areas of commercial lending, credit card interest rates are too high and creditors are earning unreasonable profits. They also argue that consumers cannot shop for better credit terms because all creditors offer the same terms. The facts simply do not support these assertions. The cost of money constitutes a much lower proportion of total costs for credit card operations than for other major types of bank lending.⁴ Thus, one would not expect credit card rates to go down (or up) as fast as general interest rates. While short-run frictions in the market, such as entry lags and imperfect consumer information, may initially have lessened established creditors' incentives to react swiftly to the falling cost of money, the market is now responding to competitive pressures by offering a variety of more desirable credit card plans. In addition, there has been a rapid development of new sources of revolving credit—in the form of lines of credit secured by residential equity and overdraft credit lines on checking accounts—which provide competition to traditional credit cards.

Those who argue that interest rates should be restrained in order to eliminate the apparently unreasonable profits earned by credit card plans ignore the data indicating that, over time, creditors have earned only a competitive return on their invested capital.⁵ The annual net before-tax earnings of bank card plans averaged 1.9 percent of balances outstanding from 1972 through 1985.⁶ Over the same period, average net returns on other major types of commercial bank lending were significantly higher: 2.3 percent on real estate mortgages, 2.4 percent on consumer installment debt, and 2.8 percent on commercial and other loans.⁷ Studies of retail store credit card plans indicate that on average—not considering profits on associated merchandise sales—these plans consistently

4 Canner & Fergus, supra note 3, at 1-2.

5 In other words, the interest earned on credit card accounts has covered the creditor's costs, including losses on credit defaults, and normal profits.

6 Canner & Fergus, supra note 3, at 1-2 (citing Federal Reserve Bank data).

7 Id.



Assemblyman Ross Johnson

have operated at a loss.⁸ Of course, returns on all types of loans fluctuate over time. Profits for 1984 and 1985 on bank credit card balances were 3.4 and 4.0 percent, respectively.⁹ Although these profits were high relative to other types of bank credit, they were earned following a period between 1979 and 1981 where profits on bank credit cards were severely squeezed and considerably lower than profits for other bank credit instruments.¹⁰ Thus, viewed over the perspective of a number of years, profits on bank and retail store credit cards have not been particularly high, nor are recently higher profits likely to persist given the competitive impetus cited above.

The allegation that there continues to be complete uniformity in the credit terms offered to consumers is also without foundation. While some bank and retail store credit card plans continue to offer interest rates of between 18 and 21 percent, a recent survey conducted by a San Francisco-based consumer group found that six California institutions and ten out-of-state institutions now offer bank credit card plans with fixed and variable interest rates of between 10.5 and 15 percent.¹¹ Moreover, the survey disclosed that the lower-rate credit card plans offer variety in other important terms, such as annual fees and grace periods.¹²

Consumers may indeed pay higher finance charges on credit card balances than for other types of credit. This type of credit, however, has certain features for which consumers are apparently willing to pay. These 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, the ability to pay off the amount owed within the grace period in order to avoid incurring any finance charges, and the record of purchases created by using the card. All these features are costly for an issuing creditor to provide, which explains why the relatively high interest rate does not necessarily imply the existence of "excessive" profits to the creditor.

The Effect Of Interest Rate Ceilings

When an interest rate ceiling is established by statute at less than the competitive market rate for some borrowers, lenders will reduce the volume of

⁸ Canner & Fergus, supra note 3, at 2 (citing two national surveys of retailers conducted on behalf of the National Retail Merchants Association in 1968 and 1985 and a study of retailers in New York made in 1973).

⁹ Canner & Fergus, supra note 3, at 2.

¹⁰ Id.

¹¹ Consumer Action's National Credit Card Survey (1987).

¹² Annual fees ranged from no charge to \$22.50, and grace periods of differing lengths were offered by ten of the sixteen institutions.



Assemblyman Ross Johnson

credit extended to those borrowers.¹³ The reason for this is clear. Lenders themselves face costs of borrowing money from investors as well as costs of administering their loans. If the proposed legislation forces prices (*i.e.*, interest rates) below the level of costs, lenders will either go out of business or stop making the loans that do not provide at least a normal rate of return.¹⁴

Because the ultimate return from extending credit is a function of the losses from credit defaults as well as the income from interest payments and administrative fees, creditors might consider offering 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 extending credit to such a borrower are lower. For example, American Express recently has announced a new credit card, the "Optima," with an initial interest rate of 13.5 percent.¹⁵ The card will be marketed only to current American Express card holders with good repayment records. Not all borrowers have such attractive characteristics, yet creditors usually are willing to extend credit to a general pool that includes higher risk borrowers if they are able to charge a higher interest rate.

If government forces a reduction in allowable interest rates, however, creditors will no longer be able to offer credit to higher risk borrowers with the same freedom as they did before.¹⁶ One probable result will be to cut off credit to less attractive borrowers, including young people with little credit history, people with low income, or people who have had trouble repaying a loan

¹³ Villegas, *The Impact Of Usury Ceilings on Revolving Credit* (1986) (unpublished manuscript available from Arizona State University Economics Department); Villegas, *An Analysis of the Impact of Interest Rate Ceilings*, 37 *J. of Fin.* 941 (1982).

¹⁴ Alternatively, some California-based creditors may choose to transfer their credit card plan operations to related firms in states with higher or no interest rate ceilings, enabling them to evade the interest rate ceiling in California. Under the National Bank Act, 12 U.S.C. §§ 1 *et seq.* (1982 and Supp. III 1985), a national bank may charge its out-of-state customers an interest rate allowed by its own home state, even when that rate is greater than the interest rate permitted by the state of the bank's nonresident customers. 12 U.S.C. § 85 (1982); *Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv.*, 439 U.S. 299, 313-318 (1978).

¹⁵ *Charge of the Plastic Brigade*, *Time*, Mar. 23, 1987, at 52.

¹⁶ Of course, out-of-state creditors still will be free to charge rates higher than the ceiling rate (*see supra* note 14) and thus could offer credit to these higher risk borrowers. In practice, however, the out-of-state creditors tend to solicit business through mailings and rarely accept unsolicited applications. This may explain why, as discussed *infra* at note 17, lower income families in states with relatively low interest rate ceilings generally hold fewer credit cards.



Assemblyman Ross Johnson

in the past. In fact, empirical studies in states that have imposed credit card interest rate ceilings show exactly this effect.¹⁷

In addition, even the credit available to the most qualified borrowers may be extended on less attractive terms, including higher annual fees, lower credit limits, higher monthly payments, shorter or no grace periods, or more time-consuming and costly creditworthiness checks. To increase earnings, bank card issuers may attempt to increase the merchant discount fee--the fee charged merchants for processing credit card sales.¹⁸ Merchants may in turn pass these costs on to consumers. Similarly, retail store credit card issuers may increase merchandise prices in an attempt to offset the reduction in finance charge revenue.¹⁹ Such merchandise price increases would harm not only credit card users but also low-income consumers who typically pay cash for merchandise.

Finally, any benefits of lower interest rates will not flow equally to all consumers. Rather, only the estimated 53 percent of consumers who sometimes or usually do not pay off their account balances in full every month--the "borrowers"--will enjoy the benefits of lower finance charges on their outstanding balances.²⁰ "Convenience users"--the estimated 47 percent of all credit card users and 76 percent of all elderly users who pay off their account balances in full every month and thereby avoid finance charges²¹--will gain no benefit. In fact, such convenience users are likely to be worse off because of the changes in other credit terms discussed above. Moreover, because of recent tax law changes that eliminate the deductibility of credit card interest charges, it is likely that the number of convenience users soon will increase to more than

¹⁷ One study found that the proportion of consumers holding credit cards in Arkansas, a state with an unusually low statutory rate limit, was substantially smaller than that in other states with higher interest rate ceilings. Canner & Fergus, supra note 3, at 10 table 5. A multivariate analysis of the study data (i.e., one that attempted to hold other factors constant) disclosed that "tight ceilings on credit card interest rates are more likely to result in reduced availability of bank credit card accounts for lower- and lower-middle income families than for higher income families." Id. at 10. The tendency of interest rate ceilings to harm lower income groups more than other groups was also found in a New York State study reported in 1975. Id. at 10-11 and table 6.

¹⁸ One study reported that bank credit card issuers' retailer merchant discount fees were higher in Arkansas, which has a low interest rate ceiling, than in neighboring states with higher interest rate ceilings. Canner & Fergus, supra note 3, at 11-12.

¹⁹ One study showed that retail prices for major appliances were an average of 5 percent higher in Arkansas than in neighboring states with higher interest rate ceilings. Canner & Fergus, supra note 3, at 11.

²⁰ Canner & Fergus, supra note 3, at 6 table 3.

²¹ Id.



Assemblyman Ross Johnson

half of all consumers. Thus, the proposed laws may produce fewer "winners" than "losers."

The Effect Of Interest Rate Floors

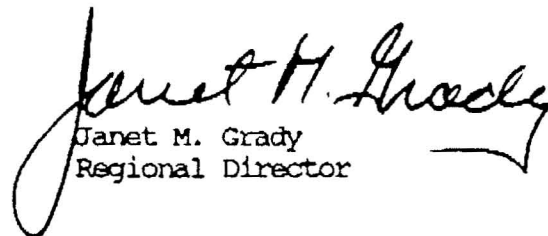
A.B. 2 would set the minimum annualized interest rate on bank credit card plans at 12 percent. Current law does not establish an interest rate floor. As noted above, some creditors currently charge an annualized interest rate of only 10.5 percent on outstanding balances. Presumably such creditors believe they can make an adequate rate of return by charging 10.5 percent. A.B. 2 would outlaw such low interest rates to the direct detriment of California consumers. The interest rate floor would also harm competition by artificially protecting some firms from their more efficient competitors. We know of no economic or consumer welfare justifications for any interest rate floor.

Conclusion

Interest rates should be determined by the market forces that result from competition among lenders to obtain credit customers. 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 California consumers who qualify for credit, and a reduction in the aggregate amount of credit available to them. In particular, many low-income consumers who are most in need of credit to buy clothing and other necessities will be less able to do so if 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 by higher minimum monthly payments, increased creditworthiness standards, reduced amounts of available credit, and higher annual fees.

For all of the above reasons, we respectfully urge you to reject A.B. 2 and A.B. 325. We have referred to a number of studies and other materials, and would be happy to supply copies of them if you so desire. Please let us know if we may be of any further assistance.

Sincerely,


Janet M. Grady
Regional Director

