Federal Trade Commission

Office of the Regional Director

26 Federal Plaza, 22nd Fl.
New York, New York 10278
(212) 264-1200

COMMISSION AUTHOR

87-10
(5)

May 29, 1987

Herman D. Farrell, Chairman
N.Y.S. Assembly Committee on Banks
State Capitol Building
Albany, N. Y. 12248

Dear Chairman Farrell:

We are pleased to respond to your staff's invitation to comment on Assembly Bill No. 6248-A ("A. 6248-A"), a proposal to continue deregulation of interest rates and service charges in New York State for an additional four years and to require that certain credit terms be disclosed in credit card applications.[1]

Prior to 1980, interest and finance charges applicable to consumer debt were subject to a statutory ceiling.[2] In 1980 (as amended in 1983), New York State suspended interest rate regulation, but only through June of this year. Unless A. 6248-A (or some comparable measure) is passed, therefore, New York State's credit markets again will be subject to interest rate regulation as of July 1.

We believe that continued deregulation of interest charges would promote the availability of consumer credit and would be beneficial to consumers. In our view, consumer benefit

---

1 This letter presents the views of the New York Regional Office and the Bureaus of Competition, Economics, and Consumer Protection of the Federal Trade Commission, and not necessarily those of the Commission itself. The Commission has, however, voted to authorize the submission of these comments to you.

2 See N.Y. Banking Law § 108(5)(b) (McKinney 1971) and N.Y. Personal Property Law § 413(3) (McKinney 1962).

New York State law distinguishes "interest," which is applicable to loans of money, from "service charges," which are applicable to installment purchases of goods and/or services. Compare N.Y. Banking Law § 108(5)(b) (McKinney Supp. 1987) with N.Y. Personal Property Law § 401(12) (McKinney 1962). We use the term "interest" to refer to both interest and service charges.

can be maximized by permanent deregulation of interest rates. Further, we believe that mandating disclosure of certain terms in credit card applications (as distinguished from the present requirement of disclosure prior to the first transaction) may facilitate comparison shopping by credit card users. Such disclosures would increase consumer welfare to the extent that the costs of providing them are not greater than their benefits.

INTEREST CEILINGS INJURE CONSUMERS

The Federal Trade Commission ("Commission") enforces a variety of laws pertaining to consumer credit[3] and trade practices in general.[4] Our experience, as well as the economic literature on consumer credit, indicates that interest rate ceilings substantially harm many consumers.[5] Lenders, like all others in the marketplace, must earn a competitive rate of return or else leave the business. Therefore, when an imposed interest rate ceiling is lower than the competitive market rate, lenders must make adjustments by either increasing other charges,

---

3 See, e.g., Truth-in-Lending Act, 15 U.S.C. §§ 1601-1677e (1982 & Supp. III 1985); Equal Credit Opportunity Act, 15 U.S.C. §§ 1691-1691f (1982 & Supp. III 1985); and Fair Credit Reporting Act, 15 U.S.C. §§ 1681-1681t (1982 & Supp. III 1985).

4 See, e.g., Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45 (1982); and Robinson-Patman Act, 15 U.S.C. §§ 13-13(b), 21a (1982 & Supp. III 1985).

5 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. Bank Res. 200 (1980); Ostas, Effects of Usury Ceilings in the Mortgage Market, 31 J. Fin. 821 (1976). See also Barth, The Effect of Government Regulations on Personal Loan Markets: A Tobit Estimation of a Microeconomic Model, 37 J. Fin. 1233 (1982).

reducing the volume of credit available to higher-risk borrowers, or doing both.[6]

The projected return on a loan depends on the likelihood of timely repayment, among other things. Accordingly, lenders may wish to offer credit on different terms reflecting borrowers' differing creditworthiness: a borrower with substantial assets (particularly in relation to outstanding indebtedness) and a solid history of timely repayment of loans often may borrow at a lower rate of interest than a consumer with few assets or a marginal credit history. Typically, however, credit card issuers and some other lenders seek to make credit affordable to an expanded pool of consumers -- including higher risk borrowers. They do so by offering credit on terms reflecting the likelihood of timely repayment by pool members, on average. However, if, as a result of interest rate regulation, such lenders are unable to charge sufficient interest, they may compensate by providing credit to the pool -- including even lowest risk borrowers -- on less attractive terms. Hence, credit card issuers and other lenders may charge higher annual and service fees, require larger minimum payments, increase collateral requirements, shorten loan durations, reduce services, and the like. Retail card issuers may also seek to offset reductions in interest revenues by increasing merchandise prices to all consumers, thus shifting the costs of credit transactions to those who pay cash, including those unable to qualify for credit. Bank card issuers may attempt to increase the fees charged to merchants for processing bank card sales.

---

6 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. Fin. 941 (1982).

Alternatively, credit card issuers can remove their credit card operations to states that have higher or no interest rate ceilings. Such banks will then be able to charge New York consumers rates above the interest rate ceiling in New York. Under the National Bank Act, 12 U.S.C. §§ 1-200 (1982 and Supp. III 1985), a national bank may charge its out-of-state customers an interest rate allowed by its 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. Corp., 439 U.S. 299, 313-18 (1978).

If still unable to adjust interest charges to reflect the average creditworthiness of pool members, lenders may eliminate less creditworthy borrowers from the pool altogether, in effect adjusting the pool, and hence the risk of default, to reflect permitted interest charges.[7] Excluded borrowers who might otherwise have been able to obtain credit will include the young, who often have little credit history, and people with less substantial assets -- the people most highly dependent on credit for the purchase of clothing, furniture, and other basic items.

FREE MARKETS EFFICIENTLY ALLOCATE CREDIT

In the absence of governmental restriction, competition among lenders will result in a variety of credit offerings tending to fulfill the credit requirements of different consumers. For example, a consumer who frequently defers payment may select a credit plan having relatively substantial initial costs but lower interest charges. In contrast, a consumer who enjoys the convenience of credit purchasing but seldom defers payment may opt for a plan having lower initial costs but higher interest charges. Unrestricted credit markets, unlike regulated credit markets, can efficiently serve such divergent consumer interests.

A free market will provide these services without excessive costs. Competition among lenders results in total costs to consumers that generally reflect no more than creditors' costs--including losses attributable to bad debt--and normal profits.[8] Firms that seek to earn supranormal profits will lose business to other creditors.

Studies provide evidence that over time creditors have earned no more than a competitive return on their invested capital.[9] The annual net earnings (before taxes) of bank card plans averaged 1.9 percent of balances outstanding from 1972

---

7 Villegas' empirical findings support this conclusion. <u>See</u> The Impact of Usury Ceilings on Revolving Credit, <u>supra</u> note 6.

8 Canner & Fergus, <u>supra</u> note 5, at 1-2.

9 In other words, total costs to consumers have equalled creditors' costs -- including losses attributable to bad debt -- and normal profits.

through 1985. 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.[10] Retail store credit card plans stand on a somewhat different footing; studies show that those have, on average, consistently operated at a loss, apart from consideration of profit on goods sold.[11]

To the extent that consumers bear higher charges for credit card use than for some other forms of credit, the difference appears to reflect the advantages of credit card use -- for example, preapproved and unsecured availability of credit for purchases from a host of merchants -- rather than greater returns to credit card issuers. 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.

PERMANENT DEREGULATION IS APPROPRIATE

Notwithstanding this evidence of effective competition among credit card issuers, the proponents of A. 6248-A contend that in recent years credit card interest rates in New York State have not reflected decreases in creditors' costs of funds. In their opinion, this is due, in part, to a lack of convenient comparative information about the rates charged by different card issuers.[12]

We are unaware of any systematic study concluding that credit card interest rates have been unresponsive to changes in the cost of funds. Moreover, the cost of money constitutes a

---

10 Canner & Fergus, supra note 5, at 1-2 (citing Federal Reserve Bank data).

11 Id. at 2 (citing two national surveys of retailers conducted on behalf of the National Retail Merchants Association in 1968 and 1985 and a 1973 study of retailers in New York).

12 Regulation Z of the Truth-in-Lending Act requires that pertinent disclosures be made prior to the first credit transaction using the card. 12 C.F.R. Part 226 (1986). The proponents of A. 6248 contend that such disclosures are provided too late to facilitate comparison shopping by consumers.

much lower proportion of total costs for credit card issuers than for other major types of lenders.[13] Thus, one would not expect interest rates applicable to credit cards to respond as dramatically as other interest rates to changes in the cost of funds.

Moreover, competitive pressures appear now to have forced credit card issuers to offer a variety of attractive credit card plans. For example, American Express is offering its new "Optima" card to its most valued American Express card holders at a rate of 13.5% per annum, and CitiBank is offering a "Preferred MasterCard" at 16.8%. In addition, new sources of revolving credit rapidly are developing, such as overdraft credit lines on checking accounts and so-called "mall cards," which provide credit at all retail outlets in a given shopping center. These newer credit offerings, in turn, increase the pressure on conventional credit card issuers to compete for consumer allegiance on the basis of price and other terms.[14] Consumer credit markets currently seem to be operating competitively, and there appears to be no need for further interest rate regulation.

DISCLOSURE REQUIREMENTS MAY ASSIST COMPARISON SHOPPING

If consumers actually value early receipt of credit terms, we would expect credit card issuers to compete in the provision of such information. In fact, some credit card issuers now provide Truth-in-Lending Act disclosures not only in consumer credit contracts but in applications and solicitations as well. Hence, the market already may be responding efficiently to consumers' information needs. Nonetheless, the information required to be disclosed by A. 6248-A appears pertinent to well-

---

13 Id.

14 A survey of sixteen financial institutions (six within the state of California) found that bank credit card plans had fixed and variable interest rates between 10.5% and 15%. Moreover, the survey disclosed that the lower-rate credit card plans offer variety in other important terms, such as annual fees and grace periods. Annual fees ranged from no charge to $22.50, and grace periods of differing lengths were offered by ten of the sixteen institutions. Consumer Action's National Credit Card Survey (1987).

informed decisionmaking by consumers, and may facilitate increased comparison shopping. The disclosures can be expected to increase consumer welfare as long as the costs of providing them are not greater than their benefits.

Sections 2 and 3 of A. 6248-A would require disclosure of (1) the annual percentage rate of interest,[15] (2) the amount of any fee for participation in the card system, (3) the amount of any late charges or other fees, and (4) the length of any period during which the consumer may pay the account balance without incurring any interest charge. These disclosures would apply to any application form or preapproved written solicitation, other than an application form or solicitation included in a magazine, newspaper, or other publication. An application included in a publication may use, in lieu of the disclosures, a box that the consumer can check and return to the creditor in order to obtain a disclosure circular. Required disclosures must be in specified type faces and sizes and in a prescribed format.

Two modifications, in particular, may permit the bill's objectives to be accomplished at lower cost. First, a requirement that the mandated disclosures be "clear and conspicuous," as is required under Regulation Z of the Truth-in-Lending Act, could be substituted for the bill's rigid specifications on format. This would permit multistate lenders to comply readily with Regulation Z and with otherwise inconsistent disclosure laws that may be enacted in other states. The Assembly then may wish to designate the disclosure format contained in A. 6248-A as a model format, use of which would constitute compliance with the "clear and conspicuous" standard.

Second, the disclosure requirement could be limited to applications and solicitations that are distributed by mail. Credit card issuers often distribute applications through displays located on the premises of merchants. The issuer loses effective control of such applications once it has forwarded them for display. Thus, the credit card issuer cannot, without incurring substantial costs, continuously update such applications to reflect changes in credit terms. In lieu of its present disclosure requirement, therefore, A. 6248-A might

---

15 If the interest rate charged is variable, the creditor must so state and must disclose either the method by which the rate is determined or the rate in effect on a date certain.

provide that applications distributed other than by mail must advise consumers that they can obtain a disclosure circular by checking a box and returning the form to the credit card issuer. In this manner the Assembly can ensure consumer access to credit terms prior to application, without imposing undue costs on credit card issuers.

CONCLUSION

Governmental regulation of interest rates may injure consumers by inflating other costs of credit and reducing the amount of credit available. In contrast, unregulated credit markets usually allocate credit among consumers efficiently and responsively. We, therefore, urge the Assembly to permanently deregulate interest rates in New York State. Further, if the Assembly is inclined to require early disclosure, it may wish to consider the modifications discussed above. We believe that enactment of A. 6248-A as so modified would satisfy the intent of the bill's framers without imposing excessive costs.

We hope that these comments assist the Assembly in its deliberations. Please do not hesitate to contact us if you have any questions or would like further information.

Very truly yours,

Edward Manno Shumsky

Edward Manno Shumsky
Regional Director