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UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
DALLAS REGIONAL OFFICE

COMMISSION AUTHORIZED

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September 8, 1989

The Honorable Robert H. Henry
Attorney General
State of Oklahoma
112 State Capitol Building
Oklahoma City, Oklahoma 73105

Dear Mr. Attorney General:

The Federal Trade Commission staff is pleased to respond to your invitation to comment on the Oklahoma Constitution Revision Commission's proposed revisions to the Oklahoma State Constitution.[1] In this letter, we focus on the Constitution Commission's proposal to amend Article XIV, § 2 of the Constitution, which, if enacted, would eliminate constitutionally-mandated interest rate ceilings in Oklahoma. In general, we believe that deregulation of interest rate charges in Oklahoma would promote the availability of consumer credit and would be beneficial to consumers.

I. Interest and Experience of the Staff of the Federal Trade Commission

The Federal Trade Commission is charged with promoting competition and protecting consumers from unfair and deceptive commercial practices.[2] In fulfilling this mandate, the staff of the Federal Trade Commission often submits comments, upon request, to federal, state, and local governmental bodies to help assess the competitive and consumer welfare implications of pending policy issues. In enforcing the Federal Trade Commission Act, the Commission staff has gained considerable experience in analyzing the impact of various private and government restraints

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[1] These comments are the views of the staff of the Dallas Regional Office and the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner.

[2] See 15 U.S.C. § 41 et seq.

on competition and the costs and benefits to consumers of these restraints. More specifically, by enforcing the Truth in Lending Act,[3] the Equal Credit Opportunity Act,[4] and the Fair Credit Reporting Act,[5] the Commission staff has gained substantial experience in the area of consumer credit. In addition, the Commission's staff has submitted comments to various state bodies on proposed legislation relating to interest rate ceilings.[6]

II. Interest Rate Ceilings in Oklahoma

Currently, Article XIV, § 2 of the Oklahoma Constitution establishes a maximum interest rate of 10 percent in Oklahoma unless the Legislature sets a different rate. Pursuant to § 2, the Oklahoma Legislature has set a variety of interest rate ceilings in Oklahoma, depending upon the amount or type of credit extended.[7]

The proposed amendment to Article XIV, § 2 would eliminate the constitutionally-imposed interest rate ceiling in Oklahoma. Although this proposal would not automatically repeal the

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3 15 U.S.C. §§ 1601-1677e (1982 & Supp. III 1985).

4 15 U.S.C. §§ 1691-1991f (1982 & Supp. III 1985).

5 15 U.S.C. §§ 1681-1861t (1982 & Supp. III 1985).

6 See letter of March 18, 1987, from Jim Moseley, Director, Dallas Regional Office, Federal Trade Commission, to The Honorable Garrey Carruthers, Governor of New Mexico; letter of April 20, 1987, from Janet M. Grady, Director, San Francisco Regional Office, Federal Trade Commission, to The Honorable Ross Johnson, Vice Chairman of the Committee on Finance and Insurance, California State Assembly; letter of May 15, 1987, from John M. Peterson, Director, Chicago Regional Office, Federal Trade Commission, to The Honorable Greg Zito, Illinois State Senate, and The Honorable Monroe L. Flinn, Illinois State House of Representatives; letter of May 29, 1987, from Edward Manno Shumsky, Regional Director, New York Regional Office, Federal Trade Commission, to The Honorable Herman D. Farrell, Chairman of the Committee on Banks, New York State Assembly.

7 The interest rate ceiling for credit cards in Oklahoma is 21%. 14A Okla. Stat. § 2-207(3). The interest rate ceiling for loans up to $750 is 30%; for loans from $751 to $2500, the ceiling is 21%; and for loans over $2500, the ceiling is 15%. 14A Okla. Stat. § 3-508A(2)(a)(i)-(iii).

interest rate ceilings set by the Legislature, it is a good step toward deregulating interest rates in Oklahoma.

III. Interest Rate Ceilings Injure Consumers

The economic literature on consumer credit indicates that interest rate ceilings may substantially harm many consumers.[8] Lenders, like all others in the marketplace, must earn a competitive rate of return. Therefore, when an imposed interest rate ceiling is lower than the competitive market rate, lenders must make adjustments by either increasing other charges, reducing the volume of credit available to higher-risk borrowers, or doing both.[9] Credit card issuers can respond to interest rate ceilings by moving their credit card operations to states that have higher or no interest rate ceilings[10] and under federal law 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.[11]

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[8] See, e.g., Villegas, "The Impact of Usury Ceilings on Consumer Credit," 56 S. Econ. J. 126 (1989); 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).

[9] Villegas, "An Analysis of the Impact of Interest Rate Ceilings," 37 J. Fin. 941 (1982). A recent article concluded: "[T]he analysis points to the likelihood that usury ceilings divert funds away from high-risk borrowers in states with usury ceilings to borrowers in other states or to other capital markets." Villegas, "The Impact of Usury Ceilings on Consumer Credit," supra note 8, at 140.

[10] See DeMuth, "The Case Against Credit Card Interest Rate Regulation," 3 Yale J. on Regulation 201 (1986). Such banks will then be able to charge Oklahoma consumers rates above the interest rate ceiling in Oklahoma.

[11] National Bank Act, 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).

The projected return on a loan depends on the likelihood of timely repayment, among other things. Accordingly, bank lenders often offer credit on different terms reflecting borrowers' differing levels of 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. However, if interest rate ceilings are established, they may inhibit the ability of lenders to charge sufficient interest. Thus, those consumers who may be viewed as higher credit risks, often the young or those on lower or fixed incomes, may be denied credit.[12]

Credit card issuers and some other lenders, however, are willing to extend credit to a general pool that includes 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 ceilings, such lenders are unable to charge sufficient interest to compensate for this average risk, they may alter other terms of the credit arrangement to cover their costs. 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.

These distortions resulting from interest rate ceilings will affect consumers unequally. For example, among credit card users, only the "borrowers," the estimated 53 percent of consumers who sometimes or usually do not pay off their account balances in full every month, will enjoy the benefits of lower finance charges on their outstanding balances.[13] "Convenience users," the estimated 47 percent of all credit card users and 76 percent of all elderly users who pay off their account balances

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[12] In a recent study, Villegas found that "low-income households in states with usury ceilings had significantly lower levels of consumer credit than low-income households in states without usury ceilings." His study reached a similar conclusion with respect to middle-income households, although the reduction in credit was not so large as for low-income households. Finally, he found that "usury ceilings have no significant impact on the quantity of credit obtained by high-income households." Villegas, "The impact of Usury Ceilings on Consumer Credit," supra note 8, at 140.

[13] Canner & Fergus, supra note 8, at 6, Table 3.

in full every month and thereby avoid finance charges,[14] will gain no benefit. In fact, the convenience users are likely to be worse off if changes in other credit terms, such as higher annual and service fees, are imposed.

Retail card issuers may also seek to offset reductions in interest revenues by increasing merchandise prices to all consumers, thus shifting some of the costs of credit transactions to those who pay cash, including those unable to qualify for credit. Similarly, bank card issuers may attempt to increase the fees charged to merchants for processing bank card sales. This may shift some of the costs of credit transactions to the merchants themselves, who may, in turn, pass these costs to consumers.

Finally, if unable to adjust interest charges to reflect the average creditworthiness of pool members, credit card issuers, like other types of 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.[15] This might reduce the credit available to less wealthy individuals for the purchase of clothing, furniture, and other basic items.

IV. Free Markets Efficiently Allocate Credit

In the absence of government restrictions, 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,

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[14] Id.

[15] Villegas' empirical findings support this conclusion. See "The Impact of Usury Ceilings on Consumer Credit," supra note 8.

including losses attributable to bad debt, and normal profits.[16] Firms that seek to earn higher than competitive 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.[17] The annual net earnings (before taxes) of bank card plans averaged only 1.9 percent of balances outstanding from 1972 through 1985. Over the same period, net returns on other major types of commercial bank lending averaged 2.3 percent on real estate mortgages, 2.4 percent on consumer installment debt, and 2.8 percent on commercial and other loans.[18] Retail store credit card plans stand on a somewhat different footing; studies show that these have, on average, consistently operated at a loss, apart from consideration of profit on goods sold.[19]

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

Although general interest rates have fallen substantially in recent years, it is not surprising that credit card interest rates have not fallen as fast as general interest rates. The total costs of lending include the cost of money as well as other costs, such as operating costs, overhead, and bad debt. These other costs constitute a higher proportion of total costs for credit card operations than for other major types of bank lending.[20] Thus, one would not necessarily expect credit card interest rates to go down as fast or as far as general interest rates.

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[16] Canner & Fergus, _supra_ note 8, at 1-2.

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

[18] Canner & Fergus, _supra_ note 8, at 1-2 (citing Federal Reserve data).

[19] _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).

[20] _Id_. at 1-2.

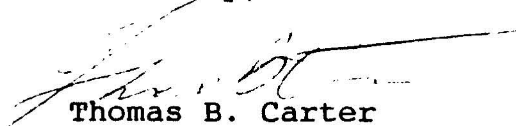
Competitive pressures appear now to have forced credit card issuers and other lenders to offer credit on a variety of attractive terms. For example, a 1988 survey of 18 financial institutions found that bank credit card plans had fixed and variable interest rates between 10.9 percent and 16 percent. 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 $35.00, and grace periods of differing lengths were offered by 14 of the 18 institutions.[21] In addition, new sources of revolving credit are rapidly 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 lenders to compete for consumer allegiance on the basis of price and other terms. Consumer credit markets currently seem to be operating competitively, and there appears to be no need for further interest rate regulation.

V. Conclusion

Government imposition of interest rate ceilings may injure consumers by inflating other costs of credit and reducing the amount of credit available. Consequently, the Oklahoma Constitution Revision Commission's proposal to amend Article XIV, § 2 of the Oklahoma Constitution to eliminate the constitutionally-mandated interest rate ceilings in Oklahoma would be a good step toward removing regulations that harm consumers.

We are pleased to have this opportunity to present our views. Please do not hesitate to contact us if you have any questions or would like further information.

Sincerely,



Thomas B. Carter
Director
Dallas Regional Office

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21 Consumer Action's National Credit Card Survey (1988).