

BEFORE THE
BOARD OF GOVERNORS OF
THE FEDERAL RESERVE SYSTEM

COMMISSION AUTHORIZED

In The Matter of)
)
Truth in Lending; Home Equity)
Disclosure and Substantive Rule)

Docket No. R-0687

Comments of the Staff of
the Bureau of Economics
of the Federal Trade Commission¹

April 20, 1990

¹ These comments are the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner. Inquiries regarding these comments should be directed to Kenneth Kelly (202-326-3358) of the FTC's Bureau of Economics.

Reporting Act,⁹ and its staff has gained substantial experience in the area of consumer credit. We also note that in 1985, the Commission submitted comments to the Federal Reserve Board on Regulation Z,¹⁰ and the FTC staff has commented to various state bodies on proposed legislation relating to interest rate ceilings.¹¹

III. Analysis of the Proposed Modifications to Regulation Z

Under Regulation Z,¹² a creditor has the right to freeze or limit further borrowing on an open-end variable-rate home equity line when the annual percentage rate on the credit line equals the maximum rate cap.¹³ Two alternative modifications are being considered: (i) delete the provision giving such a right to creditors; or (ii) modify the provision so that creditors who wish to retain this right would be required to place such a limitation in their contracts.

Creditors are required by Regulation Z to have a maximum rate cap in variable-rate open-end credit line agreements secured by a consumer's residence. However, they are free to offer whatever maximum cap they wish, subject only to state usury regulations. When a creditor establishes a maximum

⁸(...continued)
⁸ 12 C.F.R. 202.

⁹ 15 U.S.C. §§ 1681-1861t.

¹⁰ See letter of July 19, 1985, from the Federal Trade Commission to the Honorable William Wiles, Secretary, Board of Governors of the Federal Reserve System on proposed amendments to Regulation Z.

¹¹ 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 Monroe L. Flinn, Illinois State House of Representatives; letter of May 29, 1987, from Edward Manno Shumsky, Director, New York Regional Office, Federal Trade Commission, to The Honorable Herman D. Farrel, Chairman of the Committee on Banks, New York State Assembly. See letter of September 8, 1989, from Thomas B. Carter, Director, Dallas Regional Office, Federal Trade Commission, to the Honorable Robert H. Henry, Attorney General of the State of Oklahoma.

¹² § 226.5b(f)(3)(vi)(G).

¹³ As the proposal states "[the current regulation] does not expressly require that the contract (as opposed to the disclosures) state that a creditor has the right to freeze a line of credit if the rate cap is reached. Creditors are specifically required to disclose if they have retained the ability to freeze a line when the rate cap is reached, and this disclosure duty may be met by including it in the agreement. As a practical matter, the Board believes that most creditors who wish to preserve this right include the provision in their contracts." 55 Fed. Reg. 10465.

rate cap on an open-end, variable-rate home equity loan, it runs the risk that its own cost of funds may exceed this rate cap should interest rates rise.

To solve this problem, some creditors retain a right to freeze additional borrowing when the maximum rate cap is reached, and, in return, provide consumers with features, such as a more favorable interest rate formula (that is, a lower premium over the relevant index), a lower maximum cap, or a higher credit limit. Alternatively, those consumers whose plans may depend on being able to borrow substantial funds in the future, for example, to pay college tuition, may be willing to accept less desirable features (such as less favorable interest rates) in order to preserve their ability to borrow years hence.

The first alternative modification would deny creditors the right to restrict borrowing when the maximum rate cap is reached on a home equity line of credit. This alternative could harm consumers. Creditors could be more reluctant to offer variable-rate open-end home equity lines of credit if they were not able to limit borrowing when market interest rates exceed the maximum rate cap. If creditors continue to offer these credit lines, they will be forced to bear additional risk. To cover the costs of bearing this risk, creditors may adjust other aspects of the loan package, such as the interest rate formula, the maximum rate cap, introductory rates, origination fees, and frequency of adjustment.¹⁴

There is empirical evidence that restricting credit terms through regulation causes changes in other aspects of credit agreements to the detriment of consumers. For example, the economic literature on consumer credit indicates that interest rate ceilings may substantially harm many consumers.¹⁵ Creditors, 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 that would prevail in its absence, creditors will make adjustments, for example, by increasing other charges or reducing the volume of credit available to higher-risk borrowers.¹⁶ Villegas found that "low-income households in states with usury ceilings had significantly lower levels of

¹⁴ Under one interpretation of this first proposal, while creditors would not have the right to unilaterally limit borrowing when the maximum rate cap is reached, borrowers would be able to seek inclusion of such terms in their contracts to obtain the favorable interest rates and other benefits that might be satisfactory to creditors if they were permitted to limit borrowing at the maximum rate cap. If transactions of this sort proposed by borrowers were not costly, then the first alternative modification would have no effect. However, if creditors cannot offer such a restriction as part of their standard contract forms, then it may be too costly for individual borrowers to negotiate their rights away in order to secure what they want from creditors.

¹⁵ 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).

¹⁶ Villegas, "An Analysis of the Impact of Interest Rate Ceilings," 37 J. Fin. 941 (1982).

consumer credit than low-income households in states without usury ceilings. A similar result is also found for middle-income households, but the reduction in credit is not as large."¹⁷ Villegas found no benefit to consumers from such ceilings, since his results showed no significant difference between the interest rates paid for consumer credit in states with usury ceilings compared to states without them.¹⁸ Therefore, to the extent that this regulation restricts competition among creditors by forcing all firms to offer the same terms for lending when the maximum rate cap is reached, it could result in packages of terms and rates for open-end variable-rate home equity credit lines that are less preferable to *both* borrowers and creditors.

The second alternative modification proposed does not present these problems because it allows creditors to offer variable-rate open-end home equity credit lines that may be frozen or reduced when the maximum rate cap is reached, as long as this right is disclosed in the contract. Since this alternative leaves lenders free to compete on terms as well as rates for such lines of credit, informed consumers are free to choose those combinations of rates and terms that best suit their needs.¹⁹

Consumers who are not willing to pay a premium (in terms of less favorable terms or rates) for the right to borrow additional funds when the maximum rate cap is reached will then not be forced to do so as, in effect, they would be under the first alternative modification. If there are consumers who are willing to pay a premium sufficient to make it profitable for lenders to forego imposing a freeze or a reduced lending level after the cap has been reached, competitive forces could be expected to make such rates available. If lenders do not in fact offer the option, this may simply suggest that the cost to lenders of providing the option of continued borrowing when the maximum rate cap is reached is greater than what consumers are willing to pay (in terms of higher maximum rate caps, interest rates, origination fees, closing costs, etc.) in order to get this feature. Those consumers who anticipate a need for funds in the future, who expect interest rates to rise, and who, therefore, would place greater value on a credit line without restrictions on borrowing, have alternatives that may better suit their needs than a variable-rate open-end home equity credit line. For example, rather than obtaining a home equity line of credit, they might obtain a second trust loan for the full amount of their need for funds, and invest those funds in excess of their immediate needs until such time as they will be needed.

¹⁷ Villegas, supra note 8, at 140.

¹⁸ Ibid.

¹⁹ A recent Washington Post story describes the wide variety of terms and rates for home equity credit lines available to Washington area homeowners. See H. Jane Lehman, "The Home Equity Loan Attraction: Decline in Default Rate Has Lenders Competing for Borrowers," Washington Post, Saturday, March 24, 1990 at F1.

IV. Conclusion

Both economic theory and empirical evidence indicate that regulatory restrictions on the supply of consumer credit are often not in the interests of consumers. It would therefore appear preferable to modify Regulation Z to grant lenders the right to offer contractual terms that give them the option to freeze or limit further borrowing on open-end variable-rate home equity credit lines when the annual percentage rate on such credit lines is at the maximum cap rate, rather than to eliminate this option.