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Statement by

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Federal Reserve System

before the

Subcommittee on Financial Institutions

of the

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Mr. Chairman and members of the Subcommittee, I am pleased to have the opportunity to present the view of the Board of Governors on proposals to authorize national banks, Federally-insured banks and savings and loan associations to charge their corporate borrowers interest rates that reflect current market conditions.

The Board has been concerned for some time with the impact which usury ceilings have on the availability of funds in local credit markets. It goes without saying that no one wants to pay higher rates of interest for borrowed money than is absolutely necessary. But at the same time, it is very important to insure the availability of credit and the flow of funds in all financial markets on an equitable basis. When interest rates in specific markets are limited to artificially low levels, the continued availability of credit in these markets will be severely threatened. Under such circumstances, lenders are likely to impose much stricter non-price lending terms in order to compensate for the relatively low nominal rates which can be charged. And borrowers, finding it increasingly difficult to obtain financing in local markets, may be forced to seek funds from out of State sources.

There is no question but that the potential for disruption of credit flows in States with relatively low usury ceilings has increased greatly in recent months due to the general

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increase of interest rates in competitively-determined markets. Large commercial banks have been paying rates of 12 per cent or more on large certificates of deposits in recent weeks in order to obtain loanable funds. These rates exceed by as much as 2 percentage points the maximum rates that banks are allowed to charge on loans to businesses in several States--including Tennessee, Arkansas and Montana. Since July, moreover, the prime rate charged by large money market banks to their best corporate customers has been at 12 per cent--also above the usury ceiling on business loans in the aforementioned States. It is reasonable to assume that many of the lending institutions in these States are finding it unattractive to lend at the relatively low usury rate, and since they cannot afford to compete effectively for money market funds, these institutions will find it increasingly difficult to continue to accommodate local credit needs of these conditions persist.

Our information--although limited--does indicate a noticeable slowdown in business lending at some of the larger banks in Tennessee and Arkansas in the last two months. In late April, the national prime rate rose above the 10 per cent usury ceiling that prevails in these two States, and in May and June commercial and industrial loans at 12 of the large Tennessee and Arkansas banks (the only regional banks for which we have current data) declined by approximately 5-1/2 per cent. This decline contrasts with experience in the comparable months of previous years, when loans at these banks generally increased;

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and it contrasts especially with the continued substantial expansion this past spring in business loans at other large banks around the country. It might also be noted that in the last few weeks Federal funds--which are overnight loans sold by one bank to another--have traded at rates above 12 per cent. Thus, there is some temptation for banks in States like Tennessee, Arkansas, and Montana to sell Federal funds or to direct their money into other more attractive investments, rather than to lend to local borrowers at the 10 per cent ceiling rate.

Because of distortions such as these that result from artificially low rate limitations, the Board strongly encourages efforts to reduce the restraints imposed on local credit markets by usury ceilings. We would prefer that remedial action to correct these inequities be undertaken at the State level, and in this regard we believe that States should promptly reevaluate their usury laws in light of recent experience. We understand, however, that in some States this is a constitutional problem which may require considerable time to resolve. In view of this, and given the urgency of the problems developing in some markets currently, the Board supports the emergency measure proposed by S.3817 as a means of providing some relief to these markets.

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The Board has reservations about two specific items in the pending bill. First, we strongly urge that the maximum loan rate which institutions will be allowed to charge not be tied to the Federal Reserve discount rate. As you are aware, the discount rate is a policy rate, administered by the Federal Reserve for monetary policy purposes. It is not a market-determined rate, and at times may not move in parallel with market rates.

Instead the Board would advise that the loan rate be tied to a market-determined interest rate, one which more clearly responds to changes in credit market conditions. We suggest for this purpose the rate paid on 90-day Treasury bills, and specifically the average rate paid over the preceding month or quarter on such bills. The bill rate is published weekly and is a familiar rate to lending institutions. If the loan rate were tied to such a market rate, then adjustments would be made automatically to changing market conditions, whereas this might not necessarily be the case if the base rate used were the discount rate.

The second concern which the Board has with the proposed bill is that the legislation would apply only on loans to corporations and would exclude all noncorporate borrowers. For equity reasons the Board believes that the bill should be expanded to cover all loans for business purposes. Indeed, if lending institutions are allowed to charge higher rates on loans to corporations, we can foresee sharp

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diminution in the availability of credit for unincorporated businesses. Available funds will be channeled into higher yielding corporate loans, and credit which is already scarce for other borrowers could become virtually unavailable. And, as a side effect, we would probably see many partnerships and proprietorships incorporating in order to obtain financing. This has reportedly occurred in Missouri, a state with a relatively low usury ceiling from which only corporate borrowers are exempted.

With the inclusion of the above two modifications--i.e., tying the loan ceiling to a market rate and not the discount rate, and expanding the coverage to all business loans, not just corporate loans--the Board favors the proposed legislation as a productive and desirable emergency measure that should help to ease disproportionate credit contraints in certain local markets.

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