For release on delivery
Expected at 10:00 a.m. (E.D.T.)
December 11, 1979

Statement by

Nancy H. Teeters, Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer Affairs of the

Committee on Banking, Housing and Urban Affairs

United States Senate

December 11, 1979

Mr. Chairman, I am glad to appear before your Subcommittee today to offer the Board's comments on S. 2002, a bill that would require the use of the actuarial method in computing rebates of unearned finance charges in transactions scheduled to be paid in more than 36 instalments.

The Board supports the principle of curing abuses that arise from the application of the Rule of 78's in long-term transactions. The Board, however, has serious reservations about whether this problem should be addressed on a piecemeal basis or whether a more comprehensive approach addressing many of the problems isn't preferable. Further, the Board questions whether this is an appropriate area for federal preemption or whether the matter is better left to the states under a revised Uniform Consumer Credit Code or other comprehensive model act. Hopefully, these hearings will shed enough light on the problems associated with the Rule of 78's that it will be taken care of at the state level so the Congress need not act.

The actuarial method of computing rebates required by the bill is basically fair to both the creditor and the consumer. It is based upon the same actuarial principles that are used to compute the annual percentage rate for Truth in Lending purposes, and its application in computing a rebate to the consumer of unearned finance charges upon early prepayment will yield the annual percentage rate disclosed. Under the alternative sum-of-the-digits method commonly used for computing rebates, the so-called Rule of 78's, the finance charge is earned sooner than under the actuarial method. As a result, when a note is repaid in full before maturity, a creditor has earned more finance charge under the Rule of 78's than would have been the case if the actuarial method were used. Although with respect to early prepayments, there is some justification for a creditor's receiving a greater yield than the actuarial method produces when a note is prepaid, on longer term transaction the disparity becomes abusive.

Disclosure is often recommended as an alternative to regulation, but regulating rebate methods through disclosure is ineffective. There is no indication that consumers shop for rebate methods. All the methods are mathematically complicated, and it is hard to imagine that most consumers could distinguish between the actuarial method and the Rule of 78's. You may recall that the Truth in Lending Simplification and Reform Act recognizes this and requires only disclosure of whether a rebate will be made without further distinctions.

One of the Board's reservations about the bill is whether 36 instalments is the proper demarcation between long- and short-term transactions. The Board recommends that a more natural demarcation along industry lines be used. For example, if all auto credit requires fewer than a certain number of instalments and mobile home credit is generally granted on longer terms, a natural demarcation exists. Compliance costs are cut because neither segment of the industry has to learn both methods.

At a more significant level, since replacing the Rule of 78's with the actuarial method reduces the creditor's effective yield on notes prepaid before maturity, the question arises whether the applicable rate ceiling should be adjusted to reflect the changed rebate method. Historically, consumer credit rate ceilings as well as methods of rebate have been set by state law. Adjusting the rate ceiling to keep from cutting creditor yield would, however, involve preempting not only the rebate methods specified by state law but also the state rate ceilings.

The Board has considered alternative methods of achieving the result sought by S. 2002. Instead of prohibiting the Rule of 78's, a possible alternative would be requiring that contracts which exceed a specified maturity be written on an interest bearing basis, i.e., creditors could charge the annual percentage rate on the balance outstanding. This is the method of computing charges used by most credit unions, and it does away with any need for rebates. The problem with this approach is that many state laws are constructed around an "add-on" or "discount" method of computing rates. Under many of these statutes the contract between the creditor and debtor provides for repayment of a total sum comprised of principal and interest to be repaid. If a note is paid off early, some rebate of unearned finance charges is needed, and so state laws specify rebate methods. Hence, any federal action in this area involves a significant preemption of state law as well as difficult technical problems. Interest bearing contracts have one distinct advantage, however. While consumers may not be able to distinguish between actuarial rebates and rebates under the Rule of 78's, the growing number of creditors switching to interest bearing contracts and away from precomputed contracts suggests that consumers prefer the interest bearing approach. It is fair and easier for the consumer to understand.

A discussion of the technical problems of the bill and the alternatives as they relate to existing state law illustrates the Board's serious concern with <u>any</u> piecemeal legislation. With some exceptions, state law tends to be anachronistic and disorderly. Each segment of the industry tends to have its own law regulating rates and practices. For example, a bank engaged in extending a full range of consumer credit services in Massachusetts would have to take into account and comply with the following 19 state laws:

The Massachusetts Retail Instalment Sales of Motor Vehicles Act -- M.G.L.A.c. 225B

The Massachusetts Insurance Premium Finance Agency Act -- M.G.L.A.c. 255C

The Massachusetts Retail Instalment Sales and Services Act -- M.G.L.A.c. 255D

The Massachusetts Small Loan Rate Provisions -- M.G.L.A.c. 140 §§96-114A; and the Small Loan Rate Order issued under these provisions

The Massachusetts Open-End Credit Interest Rate Provisions -- M.G.L.A.c. 140 §114B

The Massachusetts Second Mortgage Act -- M.G.L.A.c. 140 §§90A-90E

The Massachusetts Truth In Lending Act -- M.G.L.A.c. 140C

The Massachusetts Uniform Commercial Code -- M.G.L.A.c. 106

Provisions found in Chapter 255 of the General Laws (a chapter entitled "Mortgages, Conditional Sales and Pledges of Personal Property and Liens Thereon"), including:

§12C -- Consumer Note Requirements
§12E -- Liability of Credit Cardholders
§12F -- Holder in Due Course Provisions
§12G -- Limitations on the Charges for Credit Life Insurance
§§13I-13J -- Repossession Provisions

The Massachusetts Fair Credit Reporting Act -- M.G.L.A.c. 93 §49; and the new Debt Collection Regulations of the Massachusetts Attorney General (CMR cite not yet assigned)

The Massachusetts Provisions Regarding Cancellation of Home Solicitation Sales -- M.G.L.A.c. 93 §48

The Massachusetts Act Regarding the Regulation of Business Practices for Consumer Protection -- M.G.L.A.c. 93A

The Regulations of the Massachusetts Attorney General relating to Unfair and Deceptive Practices, 940 CMR 3.00

The Regulations of the Massachusetts Commission Against Discrimination relating to Discrimination in Credit, 804 CMR 7.00

In addition, the following federal statutes and regulations would apply:

Regulation Z (Truth in Lending,* Fair Credit Billing and Consumer Leasing Acts)

Regulation B (Equal Credit Opportunity Act)

Fair Housing Act

Fair Credit Reporting Act

Fair Debt Collection Practices Act

Real Estate Settlement Procedures Act

Regulation C (Home Mortgage Disclosure Act)

Regulation E (Electronic Fund Transfer Act)

FTC Holder in Due Course Rule

Given the surfeit of legislation and regulation, the Board feels it is time to consider a more comprehensive approach to the regulation of consumer credit. The Board makes no firm recommendation on whether federal or state law or a cooperative venture is the better approach at this time but suggests that further piecemeal legislation will spawn additional regulatory burdens which will add to creditor costs, tend to raise the amounts charged debtors, and in the end will be a disservice to debtors as a group.

---

* Massachusetts has been determined by the Board to be exempt from the Federal Truth in Lending law because it has a substantially similar law that has adequate provisions for enforcement.