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Statement by

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Committee on Banking, Housing and Urban Affairs

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I am pleased to appear before this Committee on behalf of the Federal Reserve to discuss a federal preemption of state usury laws governing interest rates on business, agricultural and consumer loans. As you know, a temporary preemption of business and agricultural rate ceilings, which was passed as a provision of the Depository Institutions Deregulation and Monetary Control Act of 1980, expired on April 1 of this year. The preemption had authorized lenders to charge a rate up to 5 percent above the Federal Reserve discount rate on business and agricultural loans of $1,000 or more in those states with ceilings less than this variable limit. Rate ceilings on consumer loans were not subject to a federal preemption under the Act. Rate ceilings on mortgage credit were preempted permanently except in those states that acted to override the preemption prior to April 1. The bill currently before this Committee recommends a permanent federal preemption of state usury ceilings on business, agricultural, and consumer credit without imposing an alternative federal limit tied to the discount rate or any other interest rate.

The Board has long been concerned about the adverse impact of usury ceilings on the availability of funds in local credit markets. Usury laws that impose unrealistically low limits tend to reduce the supply of credit to local borrowers by encouraging lenders to channel funds into other investments or to geographic areas where they can earn market rates of return. Alternatively, to compensate for the low interest rates that are legally permissable, lenders may tighten non-rate lending terms and credit standards, thus in effect rationing available credit in socially undesirable ways. Also, financial institutions can often restructure the types of loans they make without altering the use borrowers make of the funds. For example, rather than offer traditional consumer loans subject to an interest rate limit, lenders may offer junior mortgages which typically are not subject to a usury law, but which nevertheless add to the generalized purchasing power of consumers.

In sum, since money is fungible, it will tend to flow, in one way or another, to the credit markets offering the highest economic rates of return. Given the rapid deregulation of interest rates paid by depository institutions, moreover, the cost of funds to financial institutions in local communities has become increasingly sensitive to national money market developments. This creates an even stronger incentive for these institutions to earn a competitive return on their assets.

Despite the Board's basic opposition to artifical constraints on interest rates, we have had reservations about federal intrusion into an area traditionally regulated by the individual states. In this regard, retention of a provision clearly permitting states to override a federal preemption of their ceilings seems an important minimal protection of state prerogatives. Information collected by Board staff indicates that, as of the middle of last year, a dozen states had at least partially overriden the federal law imposed on them by the Depository Institutions Deregulation and Monetary Control Act of 1980. Among these twelve states, however, usury ceilings on business and agricultural loans either were unspecified or fixed at levels where they had no effect on credit flows.

Those states that were most restricted by usury ceilings generally did not act to override the preemption. In fact, many states have moved to relax their regulation of interest rates following the passage of the Deregulation Act. Those states that have not relaxed or were slow to relax their usury ceilings, particularly ceilings on consumer loans, frequently have suffered certain costs, as financial institutions increasingly have shifted some lending operations to other states that have no usury constraints.

The Board believes that interest rates are best determined in markets unconstrained by arbitrary rate ceilings of any kind. In the past, we have considered a variable rate ceiling as a preferable alternative to fixed-rate state usury ceilings. However, the Board has viewed the use of the Federal Reserve discount rate as an index inappropriate for a variable interest rate ceiling at either the federal or state level. Thus, the current bill is to be commended for not tying a federal variable ceiling to the discount rate.

To summarize, the Board continues to believe that state action rather than federal law should prevail whenever possible in dealing with the problem of fixed-rate usury ceilings. Many states have acted since 1980 to reduce the constraining effect of their usury ceilings on credit availability, and financial conditions have eased recently to the point where usury ceilings generally are not now a binding constraint. Although these factors weaken the current urgency of the matter, they do not eliminate the underlying need for further action to relax interest rate ceilings. If the Congress determines that this should be done through Federal preemption, the Board would urge, first, that the states continue to be permitted whatever degree of override their circumstances seem to dictate and, second, that the Federal Reserve discount rate not be used in any variable ceiling rate scheme.