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Statement by

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before the

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of the

Committee on Banking, Housing, and Urban Affairs

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I appreciate the opportunity to appear before the subcommittee to present the views of the Federal Reserve Board on two legislative proposals that would establish nationwide ceilings on credit card interest rates. One of these bills, S. 1603, would specify that the rate of interest on any credit card transaction could not be more than 5 percentage points higher than the average yield on 26-week Treasury bills during the preceding calendar year. The other bill, S. 1922, would limit the interest rate on credit card debt to 4 percentage points above the rate specified by the Internal Revenue Code for calculation of interest payable on overdue income tax payments or income tax refunds. The latter rate is essentially an average of the prime rate charged by commercial banks during a specified earlier six-month period.

Both bills under review today would set floating ceilings on credit card rates that would supersede generally less restrictive state-imposed limits. In the past, the Board has commented on similar proposals, including two bills currently pending in the House of Representatives. In doing so, it has endorsed the principle that--as with other types of credit--consumer loans are most fairly and efficiently allocated where there are no regulatory constraints on interest rates. Indeed, the Board has been concerned about the adverse impact that interest rate ceilings can have on the availability of funds in local credit markets and on individuals with limited access to credit. On frequent occasions, it has stated its opposition to such limits.

Recently, a number of observers have taken note that interest rates on bank credit card loans have edged up since the early 1980s even though market rates, which represent costs of funding, have fallen substantially.

Some of these observers have concluded that the resistance of credit card rates to downward pressure indicates that credit card users have received inequitable treatment as compared with other borrowers--a premise that underlies both bills. However, the Board believes that the relative stability of credit card interest rates reflects the particular cost and revenue characteristics of credit card lending, as well as state regulatory constraints on credit card rates, rather than any significant ability of lenders to take unfair advantage of credit card borrowers.

Implicit in the notion that variations in credit card finance rates should correspond closely to changes in market rates is the assumption that the cost of funds is a dominant cost factor for suppliers of credit card services. In fact, however, the cost of funds seems to be much less important in credit card lending than in most other types of credit. For credit card plans, the bulk of total costs is composed of operating costs incurred for processing transactions, making monthly billings, and evaluating credit applications, along with costs associated with delinquent accounts and credit losses. These cost factors vary in ways that usually differ from the pattern followed by changes in market costs of funds.

The Federal Reserve System each year surveys a number of commercial banks to obtain information about their costs of providing various services. From these average cost data, published under the title Functional Cost Analysis, the importance of financing costs and other costs can be compared for credit card operations and for other kinds of bank lending. During the period 1972 through 1984, financing costs averaged only about three-tenths of total expenses, before taxes, for the credit card function at participating medium- and large-sized banks that issue credit cards. By comparison, financing costs at banks in the same size classes accounted for more than three-quarters of total costs of the commercial lending function, and for nearly nine-tenths of total costs of mortgage lending. Studies of credit card operations at retailers likewise have shown that funding costs are less important than operating and collection costs.

But there is an even more striking difference between credit card loans and other types of lending. The key characteristic of revolving credit plans is that terms of repayment are quite flexible and actual repayments in any given period are largely at the discretion of the account holder. Excluding cash advances, which typically earn finance charges from the transaction date, most credit card plans charge interest only if card holders pay less than the full amount of the outstanding balance by the end of the grace period. Thus, unlike other kinds of credit, the way the credit card holder uses the account determines how much--and, indeed, whether any--interest income is earned by the card issuer.

There is evidence that some credit card holders--perhaps nearly 10 percent at any one time--do not use their credit cards at all. These nonusers produce no revenue from finance charges that would offset costs incurred by card issuers in establishing and maintaining their accounts; however, many bank credit card issuers now charge card holders an annual fee. Of card holders who use their credit cards, some surveys indicate that roughly half usually pay off the entire balance when billed. Customers of this type also generate no finance charge revenue to offset costs of processing, financing, and billing; however, bank credit card issuers do derive some income from fees that merchants pay to help defray processing costs, and, in many cases, from annual card holder fees.

These considerations indicate that the behavior of credit card rates cannot adequately be evaluated simply by comparing them with a market interest rate. Doing so would overlook fundamental differences in the behavior of costs and revenues between credit card operations and other types of lending--namely, that funding costs are a lower share of total costs for credit card lending, and that some credit card borrowers pay little interest, if any.

One measure that takes these differences into account is the net return to card issuers after deducting the cost of funds and other expenses. Again, the Functional Cost Analysis statistics for respondent banks provide some basis for comparison among types of lending. Data for the period 1972 through 1984 show that--in contrast to the higher gross finance rate charged by banks on credit card indebtedness--average earnings before taxes were substantially lower as a proportion of credit outstanding for bank credit card operations than they were for commercial or mortgage lending. These figures, of course, include periods of relatively low or negative net returns on credit card lending, such as in 1980, and periods such as 1984 when the net yield for the credit card function exceeded that for commercial loans and mortgage loans. Thus, the evidence suggests that, on average, credit card rates have remained well in line with costs as compared with other types of commercial bank lending. Accordingly, the data on the relative profitability of bank credit cards and other types of bank lending do not support the view that credit card issuers have been able to take advantage of credit card borrowers.

But while there is no reason to think that credit card rates have been unduly high on average over time, the fact remains that--in contrast to other loan rates--credit card rates have remained essentially unchanged, despite substantial variation in the cost of funds. Partly, as noted earlier, the relative stability of credit card rates reflects the lesser role of financing expense as a share of overall costs. However, it also reflects other special features of the credit card business. One of these is the existence of state-established statutory ceilings on interest rates.

In all but a few states, 18 percent per year was the upper limit on rates that card issuers could charge on credit card balances in the late 1970s when other interest rates were beginning to climb. Judging from the Functional Cost Analysis, average returns to banks on credit card operations in most prior years had been below or no higher than net earnings on other major forms of lending.

Then, when market costs of funds rose sharply between 1979 and 1981 while credit card rates were restrained by the ceilings, net returns became negative on credit card plans at banks. Many diversified creditors such as commercial banks tightened their lending standards and deemphasized their credit card business in favor of other types of lending that seemed more profitable at the time. Some institutions stopped accepting new credit card accounts.

Now that credit card programs generally have become profitable again, many credit card issuers have intensified their efforts to market new credit card accounts and to encourage account usage. That is, credit card issuers in most cases have responded to falling costs of funding their operations mainly by increasing the availability of credit card accounts rather than by reducing finance rates. This move has helped to reverse the earlier curtailment of credit card lending that card issuers undertook when market rates moved up and many lenders were unable to adjust their income to match the rising costs of funding and operations. Thus, it appears that much of the inertia in credit card interest rates has been attributable to the influence of restrictive rate ceilings imposed by the states.

Of course, rate ceilings in the credit card market are considerably less pervasive now than they were before 1980, because a number of states have raised or removed applicable rate ceilings, or have permitted lenders to charge annual fees for credit card accounts. These changes, besides the declines in the cost of funds, contributed to the rise in the overall net return, before taxes, on credit card plans at respondent banks to about 3-1/2 percent in 1984. So it may be that a growing number of credit card issuers now are in a position to consider offering somewhat lower finance rates to credit card borrowers as some institutions already have done.

Factors on the demand side of the market also may have been conducive to the observed stability of interest rates on credit card plans. As noted earlier, a substantial share of card holders either use their credit cards infrequently or usually pay off their credit card balances promptly. These card holders are thus likely to base their choice of credit card plans on features other than the level of finance charges.

Also, even for card holders who "roll over" their balances and pay finance charges, other characteristics of credit card borrowing, such as convenience and suitability for small transactions, may outweigh any rate disadvantage. Whatever the case, credit card debt has expanded rapidly for more than two years--a sign that consumers view credit card use as an attractive source of short-term financing despite what many observers regard as high rates of interest.

Furthermore, the recent emergence of above-average returns to bank credit card lending may not lead to an immediate, widespread reduction in finance rates on credit card borrowing. Credit card issuers may be uncertain whether such favorable conditions will persist. Also, instead of offering lower finance rates, card issuers may seek to compete by easing credit standards somewhat, by making nonrate credit terms more attractive, or by offering other products and services.

In this connection, one should keep in mind that finance rates on credit cards already have shown some tendency to decline. The average finance rate on bank credit card plans at reporting banks moved down by 25 basis points, on balance, during 1985; at year end, it was the lowest in more than three years. In the course of readjusting their finance rates, some credit card issuers have adopted floating finance rates of the general kind proposed by the legislation under review. However, those adjustable rates often have been paired with the imposition of annual credit card fees.

An effort to establish a federally mandated ceiling on credit card interest rates would likely encounter substantial difficulties. From experience with the imposition of credit controls in 1980 and the sharp, unexpected contraction in consumer spending that accompanied them, we know that regulatory measures can have unpredictable and unwanted consequences. Setting a federal ceiling on credit card rates below those that currently prevail in many states would likely reduce the amount of credit made available, forcing consumers to rely instead on less convenient and possibly more expensive substitutes, or to lose access to credit at any rate. Moreover, such a curtailment would be apt to fall most heavily on less affluent borrowers with relatively limited access to other sources of credit. The current ceiling for credit card rates under the proposed bills would be in the vicinity of 13 to 14 percent, well below the finance rates that have been typical since credit cards emerged in the early 1960s as a major method of consumer financing.

Furthermore, the imposition of stringent rate ceilings might be countered by a tightening of nonrate credit card terms by card issuers, for example, by increasing annual fees, by levying processing charges on each credit card purchase or cash advance, and by stiffening penalties for late payments or for exceeding the authorized credit limit. Some card issuers also might begin applying the reduced finance charges from the date of purchase, where permitted, rather than after the grace period expires, and might seek to increase the discount fees charged to merchants who submit credit card vouchers to them for payment.

Turning to the specific provisions of the two bills before the Congress, it should be emphasized that credit cards are issued by a broad variety of retail merchants and financial institutions that differ both as to their sources of funding and their liability structures. Under these circumstances, a single index rate would be unlikely to mirror changes in costs for such a diverse array of card issuers. In any case, short-term rates, such as on Treasury bills, fluctuate a good deal more widely than costs of funds of most lenders. They do so because a lender's overall average cost of funds at any point is a blend of current interest rates and rates on previously issued liabilities, and because market rates on longer-term liabilities--which usually make up part of the cost of funds--typically vary less than shorter-term rates.

Another question at issue is whether any regulation of credit card interest rates is more appropriately a matter for federal or for state intervention. In contrast to efforts at the federal level to assure the safety and soundness of financial institutions, the establishment of interest rate ceilings on consumer loans has long been a state prerogative, and one that the Board feels should not be preempted. In recent years, virtually every state has reviewed and overhauled its laws regulating consumer interest rates. After studying the situation in their own jurisdictions, many of these states have opted to raise or remove interest rate ceilings for credit card borrowings. The Board respects the collective judgment of a growing number of states that higher--not lower--ceilings are appropriate to assure that an adequate supply of credit card services is available from lenders located there. Of course, these states retain the authority to lower or restore ceilings if convincing evidence of excessive rates appeared.

In addition to the issue of the desirability of federal rate regulations that is central to both proposals under review, there are certain other aspects of S.1922 about which the Board would like to comment. Section 3 would amend the Truth in Lending Act to require that credit card issuers clearly and conspicuously disclose on initial applications for credit cards the annual percentage rate to be charged for credit extensions made with the credit card--or the means of determining that rate--and any annual or other fee imposed for issuing or using the credit card.

Many of us routinely receive credit card solicitations in the mail inviting us to apply for a particular credit card program. Generally, credit card mail solicitations are considered advertisements under the Truth in Lending Act. If a credit card issuer includes in an advertisement any of the specific credit cost terms of its credit card program, then current disclosure rules under Truth in Lending and the Federal Reserve Board's Regulation Z require the card issuer to clearly disclose at that time additional important credit cost information--for example, minimum finance charges, transaction charges, membership or participation fees, and any annual percentage rate that may be applied. However, if no cost information is contained in the mail solicitation, the card issuer is not now required to include the Truth in Lending disclosures. In such cases, the proposed disclosure requirements probably would aid consumers in comparing offers to apply for particular credit card programs.

S.1922 also would require each credit card issuer to report to the Board on a monthly basis the average annual percentage rate and any annual or other fee applicable during the preceding month. While this idea may seem appealing on initial examination, there are a number of questions about its practicality and cost that would need to be considered. In that connection, the Federal Reserve currently is analyzing the results of a study that is being conducted at the request of the Congress to measure the benefits of providing consumers with comparative cost information about closed-end credit. The findings from this project will provide a means of better evaluating the use that consumers make of published lists of comparative rate data in the process of obtaining credit. In view of the costs that would be associated with the collection and dissemination of comprehensive information about credit card interest rates and fees, the Board suggests that the Congress consider postponing any action in this area until the results of the demonstration project are available.

Section 4 of S.1922 would direct the Consumer Advisory Council of the Federal Reserve Board to transmit a report to the Congress each year describing and analyzing several detailed aspects of credit card markets. Among the matters to be addressed would be the costs and risks of issuing credit cards, the proportion of credit card customers whose cards have been revoked for nonpayment or delinquent payments, revenues received by credit card issuers derived from finance charges, annual fees, and application fees, and the impact of the statutory rate ceiling on consumers and card issuers. The preparation of such a comprehensive document, however, would far exceed the range of the Council's own resources.

As you may know, the Consumer Advisory Council is an independent advisory group to the Board. It consists of 30 individuals drawn from the financial services industry, the academic community, state government offices, consumer advocacy groups, legal aid offices, and community organizations. Its function is to provide the Board with a cross-section of informed opinion about current regulatory matters in the area of consumer financial affairs. Members of the Council meet three times a year for one-and-a-half day sessions to consult with the Board on various questions related to the Board's consumer financial protection responsibilities. As an outside advisory body, the Council has no independent staff; as needed, it draws on Board staff support. Therefore, the duties assigned to the Council under Section 4 of S. 1922, requiring a substantial information gathering and analysis effort, would go well beyond the Council's capabilities and perhaps would even be inconsistent with its consultative nature.

In closing, I would like to reemphasize the Board's conviction that financial markets distribute credit most efficiently and productively when interest rates are determined in markets that are as free from artificial restraints as possible. In the credit card business, the balance of the evidence suggests that revenues have stayed well in line with total costs notwithstanding the minimal variation in finance rates. Furthermore, in recent months there has been some tendency for credit card rates to decline. Efforts to constrain credit card rates through federal regulation are likely to have undesirable side effects in the form of reduced credit availability, especially for those consumers that these bills would seek to aid. Moreover, they may encourage less efficient means of offsetting costs of credit card operations. Accordingly, the Board concludes that it would be inappropriate to impose a federal ceiling on credit card rates.