For release on delivery

Statement of J. L. Robertson, Vice Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions

of the

Senate Banking and Currency Committee

on

S. 5

May 10, 1967

The Board of Governors appreciates this opportunity to present its views on S. 5, the Truth in Lending Act. We believe that important social as well as economic benefits may be expected to flow from a more effective disclosure of credit costs to consumers.

You have said, Mr. Chairman, that the purpose of the bill is to bring about "full disclosure of the cost of credit so that the consumer can make an intelligent choice in the market place". The Board agrees that as reasonable and workable ways are found to accomplish this objective the market system will function more efficiently. In the field of consumer credit existing trade practices generally fall short of the kind of disclosure that facilitates meaningful comparison shopping. We also agree with the principle stated in section 2 of the bill that competition would be strengthened by a more informed use of consumer credit.

The price system is a fundamental attribute of a free-enterprise, competitive economy. The sale of goods and services in exchange for money is the method by which the vast majority of transactions are consummated, and permits a degree of specialization--with its resulting efficiencies--that otherwise would be impossible. And for this system to function most effectively, it is necessary that the prices at which goods and services are available be stated by the seller, and known to the buyer, in standardized, meaningful terms. It is in this way that the buyer can be informed of his options--among both competing sellers and competing services--so that he may use his purchasing power in what to him is the most desirable way. The objective of S. 5, with which the Board is in full agreement, is to see that such information is provided with respect to the use of credit. It does not purport to impose rate ceilings or any other restraints on terms and conditions, but only to assure full disclosure of the price charged for credit.

Prices of goods and services are usually stated in money terms (a point made frequently during these hearings) but a meaningful price comparison requires also some knowledge about the service to be acquired; namely, quantity and, where applicable, quality and duration of use. When the service to be acquired is the use of consumer credit, quantity and duration of use are the important variables. Duration of use is the period for which the credit is extended, of course, and quantity is the amount of credit used <u>on average</u> over this period. It is customary in finance to standardize the time-period variable by stating price in terms of charge per year, and the quantity variable by stating price per hundred dollars.

<u>Disclosure of Annual Percentage Rate</u>

Now it would be possible to meet this price specification standard by stating the price of credit as dollars and cents per hundred dollars borrowed on average per year. But this is a complex form of statement, and it produces exactly the same result as the use of a percentage rate. That is, on a 1 year loan of $1000, payable in equal monthly instalments and carrying a charge of $60 (a so-called 6 per cent add-on loan), the charge per annum on the average amount of loan available to the borrower may be stated at the standardized rate of either $10.90 per hundred dollars or 10.9 per cent.

The important point here is that the borrower has available for use, over the life of the loan, not $1000 but an average of $541.90, because each monthly payment includes repayment of principal as well as interest. The Board believes that to state the standardized charge as applying to anything other than the average amount of credit available to the borrower would distort the true relationship between cost and benefit received. The Board is also convinced that it is preferable to state the charge in percentage rather than dollar terms, and on an annual basis rather than for some other period. This would facilitate comparison with other financial prices, such as the percentage charge on single-payment loans, the interest rate paid on savings accounts, and the yield available to investors on Government bonds and other securities. Thus, we are in basic agreement with the provisions of S. 5 in these respects.

We also agree that the charge should be calculated on an actuarial rather than a constant-ratio or other basis. Again, it is the question of accuracy--disclosure of the truth--that leads us to favor this approach. On a 5-year, 6 per cent "add-on" monthly reduction loan (not uncommon in the home modernization field), the true charge per annum is 10.85 per cent while the calculation on a constant ratio basis would produce a rate of 11.80 per cent--nearly 1 point higher. The reason for the difference is that the constant ratio method assumes that the proportion of each payment applied to interest is the same. In the actuarial method, the monthly payment is applied first to interest, and second to the outstanding--and gradually declining--credit balance.

The Board also agrees that the rate of finance charge need be specified only within "reasonable tolerances", as provided in the bill. But we believe that Congress should decide, at least in the first instance, what constitutes a reasonable tolerance. We therefore recommend a statutory provision permitting the rounding of the annual percentage rate to the nearest whole per cent. This is a small deviation--viewed in terms of the usual levels of consumer finance charges--and it would make possible the use of standard tables in finding the rate to be disclosed in the vast majority of credit transactions. We also recommend, however, that authority be granted to provide wider tolerances if experience indicates that this would materially simplify the problem of disclosure in difficult cases.

Irregular Payments

The Board is inclined to believe that the problem of irregular payments, by and large, is capable of practical solution. In the first place, permitting rounding to the nearest whole per cent in the rate disclosure will take care of most of the credit contracts that contain minor irregularities. And contracts calling for the deferment of payments or a final larger "balloon" payment appear to lend themselves to use of special tables or relatively simple adjustment calculations.

For the remaining cases--we hope they are relatively few--the calculation problem could be a good deal more difficult. Where a lender does an appreciable amount of business involving a fairly common irregularity, such as skipping summer payments for school teachers or patterning payments to the seasonal cash receipts of farmers, special rate tables can no doubt be designed. But for highly personalized contracts involving, say, a deferred payment schedule, a number of skips, irregular payment amounts, and a balloon payment at the end, the lender would seem to have no recourse except to compute the rate of finance charge by hand, a process which could be quite difficult. Although rate calculation for such contracts is technically possible, many lenders certainly would resist writing them. Thus, it seems to us inescapable that some tendency towards use of standardized finance terms must be anticipated, and that this should be taken into account in the Committee's consideration of the bill.

Revolving Open-end Credit

Among the difficult problems brought out in these hearings are those involved in the disclosure of finance charges on revolving or open-end credit. First, it has been argued that the annual rate that the customer will pay cannot be calculated in advance, because the time that will elapse from date of purchase to date of repayment is not known in advance. Second, more than one method is commonly used for computing the base to which the finance rate will be applied. Third, some plans call for annual fees, minimum charges, etc., which cannot be converted into an annual percentage rate. These variations complicate the comparison of finance rates charged by different establishments, as well as those charged for different types of credit. Yet the need remains: Users of revolving credit--like the users of any other form of consumer credit--should understand the credit costs that they will pay.

In view of these problems, how can the revolving credit customer have a clear awareness of the terms under which he buys or borrows? We believe this can be largely accomplished--although not entirely--by requiring such terms to be disclosed at the time he opens a revolving credit account. The disclosure required should include the duration of any free period allowed, the method of computing the balance against which the charge is imposed, the periodic rate and the annual percentage equivalent, and the minimum and special charges (if any). It would be entirely appropriate for a store to give new customers a little leaflet, such as the one you have seen that was printed by the National Shawmut Bank of Boston, explaining the advantages of that store's credit plan over alternative plans.

In addition to the original complete statement of terms and conditions, a brief disclosure of the essentials should be included in the monthly bill. For example, the following information might be printed at the bottom of each monthly statement:

> " - No finance charge is made for the period from purchase until billing date, nor is any finance charge made for 30 days thereafter if the account is paid in full within that period.
>
> - If payment in full is not received within 30 days of billing date, a charge will be made of 1-1/2 per cent of the opening balance of this bill.
>
> - A charge of 1-1/2 per cent per month is equivalent to a rate of 18 per cent per year."

The first sentence points out that the lender provides a "free period", during which no finance charge is imposed. The second sentence explains the charge that will be imposed if the free period is exceeded. You will note that this second sentence is quite similar to those now used by many stores not subject to special disclosure laws, except that it adds a statement of the base to which the finance charge is applied. In a store using an adjusted balance method, this sentence would be expanded to add, for example, the words "less any payments or merchandise returns"--underlined if the store wishes. The third sentence points out to the user the annual equivalent of the stated monthly rate. If there are any minimum or special charges, these would be noted in a fourth sentence.

Each of these sentences would disclose necessary information. Taken together, we believe they would give the credit user a picture that is fair to the store, informative to the customer, useful in comparing charges from store to store, and broadly comparable to other rates charged for credit or paid on savings.

Before turning to our other recommendations, we should like to emphasize again what all members of this Committee fully recognize--namely, that this bill is not a cure-all for the myriad abuses practiced by some in the lending of money or sale of merchandise on credit. Thus, S. 5 will not (and it would seem impossible to make it) cover the merchant who sells only on a time-price basis or who marks up the prices of his goods to compensate for a lower finance charge; it will have very little influence on cash lenders who advance small amounts at very high rates; it will provide little assistance to the consumer who pays no attention to what he signs or to the impact of the commitments he makes on his future financial condition. What the bill can accomplish is the disclosure, in the bulk of transactions, of the amount and rate of finance charge on which credit may be obtained. It is only one step--though an essential one--in the process of consumer education and the increased awareness that is required.

<u>Definition of Credit</u>

Section 3(2) incorporates a definition of "credit" that was originally developed or designed for a different purpose, the selective regulation of down payments and maturities for credit in emergency situations. Some of the specified categories cover matters that it would seem unnecessary or impractical to cover under a credit-cost disclosure bill. This would seem true particularly of the definition of "credit" to include "any contract or arrangement for the hire, bailment, or leasing of property". As to such transactions, it would seem impossible to attribute or determine a "finance charge". Similar questions can be raised as to inclusion in the definition of such things as options, demands, liens, and pledges.

We believe it would be preferable to define credit as "the right granted by a creditor to a debtor to defer payment of debt or to incur debt and defer its payment", followed by an enumeration of some of the important types of credit listed in section 3(2) of the present bill. The quoted definition--which has been proposed in connection with the Uniform Consumer Credit Code now being drafted by the National Conference of Commissioners on Uniform State Laws--is sufficiently broad to cover any situation within what we conceive to be the purpose and intent of S. 5. It would eliminate any concern as to categories of transactions whose inclusion in the present definition might seem to be questionable.

Exemption of Small Credits and Charges

I am sure that none of us wants to press disclosure of credit costs to the point where borrowers are denied access to credit at any price. But there is one area where disclosure of an annual percentage rate might do just that. In a closed-end credit transaction involving a small amount, a high effective rate may be justified to compensate the creditor for the relatively high out-of-pocket costs of handling the transaction. However, he may be understandably reluctant to disclose the very high rate--perhaps 50 or 100 per cent--and might decide instead simply to discontinue this type of credit transaction.

For some borrowers, unable to obtain open-end credit accommodation or not having access to small cash loans, the need to make relatively small purchases on credit may be great indeed. It may also be argued that a small finance charge--in dollar amount--is not of great significance to the credit user regardless of the effective rate of finance charge. Therefore, we would be disposed to see closed-end credit transactions involving a small amount--perhaps under $100--and a small total finance charge--perhaps under $10--exempted from the disclosure requirements. But we think Congress should make the decision and, if it agrees, should incorporate the specific exemption in S. 5.

Exemption of First Mortgage Loans

The Board recommends that the bill be amended to exclude first mortgage real-estate loans, on the ground that there is already reasonable disclosure in this field. The first mortgage contract usually specifies the interest charge in terms of annual percentage rate on the outstanding balance, and full details of one-time costs are customarily given, in dollars and cents, at the time the loan is closed.

The typical first mortgage loan has an original maturity of 20 to 30 years, as contrasted with much shorter maturities for consumer instalment credit. This fact, and the fact that most first mortgage loans are repaid well in advance of the original maturity, lead us to conclude that disclosure requirements developed for relatively short-term credit are inappropriate for first mortgage loans. In the first place, to require that the annual percentage rate be recomputed to reflect costs incidental to the extension of credit would involve particularly troublesome questions in first mortgage lending because of the number and variety of the costs assessed at closing, many of which would be incurred, in whole or in part, by a prudent cash buyer where no credit was extended. Second, while it would be possible to spread discounts and other credit-related costs over the life of the contract as a part of the annual rate of finance charge, we feel that this might tend to mislead the borrower. Such charges are in the nature of "sunk cost" and are borne in full by the borrower whether the loan is repaid in 1 year or 30. Third, to require disclosure of total dollar finance charge, including interest payable over the whole life of the contract, might be more misleading than helpful. As has been pointed out in these hearings, the present value of a dollar of interest to be paid 20 to 30 years hence is substantially less than one dollar, and relatively few first mortgage contracts appear to be carried all the way to maturity.

The Board does believe, however, that second mortgage loans and similar transactions should be retained within the scope of S. 5. Such credits typically are extended for a much shorter term than first mortgages, and discounts, fees, and charges can make up a much larger proportion of total finance charges. Moreover, second mortgage credit is often obtained for purposes such as home modernization, durable goods purchases, and debt consolidation--consumer transactions of the type usually financed with consumer instalment credit.

Business Credit Exemption

The Board recommends that the exemption in section 8(1) of extensions of credit to "business firms" be revised to exclude, instead, credit extended to corporations and partnerships and all credits that exceed $20,000. We agree that credit extended for most business purposes should be excluded from the Act, but we are concerned about the difficulty of applying a purpose test for the many small businesses and farm operations in which expenditures for household and business purposes are closely associated and often intermingled. Such purchases as transportation and refrigeration equipment (or miscellaneous purchases from mail-order concerns) often serve both household and business uses, and such items are frequently purchased on the same instalment credit terms as strictly household goods. Furthermore, many small business and farm operators need the protection of full disclosure of credit costs as much as do purely household consumers.

This reasoning leads us to suggest rewording the exemption along the lines I have mentioned. The disclosure provisions would then apply to credit extended to most small business and farm operators, but not to larger businesses and agricultural operations. This would avoid unnecessary burdens and reduce administrative problems, while conforming to the objective of the bill in providing for full disclosure to those credit customers who need it most. Discretionary authority to increase the dollar limitation by regulation would also be desirable, since experience or changing conditions may indicate a need for a higher ceiling.

Exclusion from "Finance Charge" of Insurance Premiums, Taxes, and Official Fees

One of the issues that has proved troublesome during these hearings has been the question of how to treat insurance premiums on policies taken out by borrowers as a condition of, and covering the amount of, the credit contract. If such insurance is required, the borrower bears a cost which probably would not have been incurred if no credit were obtained. Moreover, exclusion of insurance from the finance charge creates a potential area of abuse, since some lenders may be encouraged to promote high-cost insurance to compensate for a somewhat lower finance charge.

The fact remains, however, that any insurance provides a benefit to the borrower over and above the use of credit. To require that the finance charge include insurance premiums would overstate the actual charge for credit. Therefore, we think that the cost of any kind of insurance is not properly regarded as part of the finance charge, and should be specifically excluded in S. 5. Similarly, we feel that the statute should specifically exclude official fees and taxes from the "finance charge", since generally they benefit neither creditor nor borrower, are not within their control, and are the same regardless of the source and terms of the credit. Both types of charge should be required to be itemized among the non-finance charges that must be disclosed pursuant to section 4(a)(4).

Mail and Telephone Sales

Under section 4(a) a seller on credit is required, prior to consummation of the sale, to furnish the customer "a clear statement in writing" setting forth specified information. It seems to us that compliance with this section generally would not be feasible where a customer orders goods or services by mail or telephone.

Appropriate allowance for this situation might be patterned after the 1966 Massachusetts statute (Chap. 255D, subsection F of section 9). Thus, there might be added to section 4(a) of S. 5 an exception for mail or telephone orders given without personal solicitation by a representative of the creditor, if the cash and deferred payment prices and the terms of financing are clearly set forth in the creditor's catalog or other printed material distributed to the public, and if the creditor delivers to the customer before the date for payment of the first instalment on the purchase a written statement setting forth the information required to be disclosed by section 4(a).

Exemption of Registered Broker-Dealers

Section 8(b) exempts "transactions in securities or commodities in accounts by a broker-dealer registered with" the SEC. We know of no reason for such an exemption, and suggest that the Committee consider whether it should be eliminated.

States with Substantially Similar Laws

We believe that section 6(b) of the bill should be modified. That section now provides that the implementing agency shall exempt from the Act any credit transactions "which it determines are effectively regulated under the laws of any State so as to require the disclosure by the creditor of the same information" as required under S. 5. We seriously doubt that a Federal agency should be called upon to judge how effectively State laws in this field are enforced, particularly where, as in the case of S. 5, they are enforced in the courts. Action at the State level should be encouraged, not discouraged, by enactment of S. 5, and it should be made clear that the States need not follow precisely the provisions of this bill. You have indicated during the hearings, Mr. Chairman, that this is your intent, but we think it should be spelled out in the bill. The Board recommends, therefore, that section 6(b) be amended to exempt transactions that are determined to be "subject to State law that requires disclosure substantially similar" to that required under S. 5.

Effective Date

Section 9 of the bill provides that the disclosure requirements shall take effect 180 days after enactment. This period may prove to be too short. Sufficient time should be allowed to permit consultation, preparation and publication of the regulations, and a period during which those subject to the regulations may study their provisions, procure rate tables, and train their personnel in the new procedures. We urge you to amend section 9 so as to make the disclosure requirements effective at a time to be prescribed in the regulations, but in no event later than one year from enactment of the law.

Implementing Agency

Let me turn now to the question of what agency should be designated to prescribe regulations to implement this legislation. The Board's familiarity with the trade practices that would be subject to regulation under this legislation is very limited. Its regulatory responsibilities are principally confined to banks. We do collect consumer credit statistics as a part of our responsibility for monitoring flows of consumer credit along with other kinds of credit. And we have developed sources of data on current trends in all financial markets so as to be continuously informed of the flow and terms of credit needs and uses by the economy as a whole. But this experience, helpful though it is in meeting our responsibilities in the field of monetary policy, has not prepared us for implementing with appropriate regulations the type of legislation before you today. Administration of a law such as S. 5 is a function essentially different from the functions that Congress heretofore has considered appropriate for the Federal Reserve System.

Formulating regulations under this bill would involve the Board in time-consuming consideration of trade practices about which we have very little knowledge and would thereby diminish the time we can devote to the formulation of monetary policy--our principal responsibility.

However, we believe the need for legislation of this kind is great. If the Congress decides to designate the Board as the agency to prescribe regulations to implement this bill, we will do our best to carry out the assignment, but we hope that in time either the States will promulgate substantially similar disclosure requirements, leading to exemptions under section 6(b), or administration of Federal disclosure requirements will be reassigned to an agency better suited to perform the function.

The task of implementing this proposed law will be complicated not only by our lack of knowledge in this field but also by the fact that the Board has no trained investigative staff at its command to determine whether the Act and the regulations are being complied with. Consequently, we would hope that our only function under this legislation would be to prescribe regulations to implement it in a manner designed to cope with special situations and to prevent evasions. We are aware that it is contemplated that the Act will be largely self-enforcing, but we recommend that responsibility for enforcement and investigation of complaints be vested specifically in the Department of Justice or the Federal Trade Commission. A similar division of regulatory and enforcement responsibility was made between the Board and the Securities and Exchange Commission with respect to margin requirements for securities transactions. We also hope that Congress will express its desire that all Federal agencies endeavor to secure compliance with the law by lenders and sellers subject to their jurisdiction and transmit information indicating violations directly to the Department of Justice or the Federal Trade Commission for investigation and appropriate action.

Administrative Provisions

Let me mention briefly a few amendments we recommend in the provisions of section 5, which relate to administration of the Truth in Lending Act.

Section 5 provides that the regulations prescribed by the implementing agency "may contain such classifications and differentiations . . . as in the judgment of the" agency are necessary or proper. We recommend that after the word "differentiations" there be added ", may provide appropriate rules therefor," to make it clear that any class of persons or transactions may be subject to special rules appropriate to that class.

The last sentence of section 5(a) provides that, in prescribing any exceptions under the bill, the implementing agency "shall consider whether . . . compliance is being achieved under any other Act of Congress." To make it clear that the authority to make exceptions is not limited to that situation, we recommend that after the word "consider" the phrase ", among other things," be inserted.

Section 5 provides that the implementing agency "shall request the views of other Federal agencies exercising regulatory functions with respect to creditors" subject to the legislation. The Board assumes that any agency preparing regulations to implement the bill would, as a matter of course, seek comments and assistance from other agencies that might be affected or might possess relevant information. We are concerned, however, that a mandatory requirement to this effect might result in the voiding of a regulation on the ground that an agency with some related functions had been overlooked in the consultation process. We suggest, therefore, that the quoted provision be deleted.

A measure such as S. 5 obviously will depend for its success largely upon the cooperation of the various classes of businesses affected. Therefore, the agency that prescribes the regulations necessarily will consult with representatives of the creditors to whom the bill would apply in order to develop regulations that are as simple and effective as possible. The agency should endeavor not only to tap the best sources of business advice but also specialists from the non-business sphere. The Board, accordingly, sees no need to establish an advisory committee as provided in section 5(c) and it seems particularly doubtful that the best sources of advice would be available at $25 per day.

We appreciate the cooperation that the Committee and its staff have already extended, Mr. Chairman, in connection with these hearings, and we are eager to assist in any way possible your efforts to perfect the bill. Members of our staff will gladly consult with the Committee's staff to that end.