For release on delivery

Statement of J. L. Robertson, Vice Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer Affairs

of the

House Banking and Currency Committee

on

H.R. 11601 and related bills

August 7, 1967

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I appreciate this opportunity to present the views of the Board of Governors on H.R. 11601, the "Consumer Credit Protection Act", and the related bills being considered by this committee.

The Board believes that important social as well as economic benefits may be expected to flow from a more effective disclosure of credit costs to consumers. As reasonable and workable ways are found to accomplish this objective, the market system should function more efficiently. Existing trade practices generally fall short of the kind of disclosure that is necessary to enable potential borrowers to make informed judgments about the use of consumer credit. Providing consumers with the basic information they need to compare alternative credit plans and to compare credit costs with returns on their savings should not only help them in managing their money to better advantage, but should also strengthen competition, with resultant benefits for the economy.

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

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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.

Prices of goods and services are usually stated in money terms, 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.

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 installments 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.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The important point here is that the borrower has available for use, over the life of the loan, not $1000 but an average of $542, 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 H.R. 11601 in these respects.

This year, for the first time since Senator Douglas introduced his initial "truth in lending" bill in 1960, the Senate has approved a credit cost disclosure bill. The objective of S. 5, as passed by the Senate, is to see that the consumer is provided with the information that he needs to make up his own mind about whether to borrow, and if so, where. It does not purport to impose rate ceilings or any other restraints on terms and conditions, but only to assure full disclosure. The Board agrees with this approach, and favors enactment of S. 5, although in one important respect we believe that the disclosure provisions of H.R. 11601 are preferable.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The provisions of H.R. 11601 relating to open end credit plans ("revolving credit") offer important advantages, we believe, over the comparable provisions of S. 5. Under the Senate bill, an annual percentage rate need not be disclosed for most revolving credit plans; although the percentage rate per period must be disclosed. To guard against the possibility that existing forms of ordinary installment credit might be converted to revolving credit in order to escape disclosure of an annual percentage rate, the Senate bill's exemption for revolving credit is limited to plans that meet three tests. To qualify for exemption a plan must require payment of at least 60 per cent of the amount of the credit within one year, must not involve retention by the creditor of a security interest in property, and must provide for crediting prepayments immediately to reduce the balance due.

These compromise provisions were adopted in response to criticism by representatives of a segment of the retail industry, who argued that it would be unfair to require disclosure of an 18 per cent annual percentage rate for revolving credit plans under which a monthly charge of 1-1/2 per cent was imposed, because that would ignore the "free ride" period between the date the sale was made and the last date on which the bill could be paid without imposition of any finance charge. Inclusion of the "free ride" period--that is, calculation of the annual percentage rate from the date of purchase rather than the date on which payment must be made to avoid a finance charge--would, it is true, produce annual

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

rates below 18 per cent where a monthly charge of 1-1/2 per cent is imposed. But an 18 per cent annual rate is the exact equivalent of a 1-1/2 per cent monthly rate and is a fair and meaningful figure if one assumes that the credit begins at the end of the "free ride" period. We believe that this is the significant date from the point of view of a customer who is considering whether to pay the entire balance and avoid any finance charge.

In eliminating the revolving credit exemption, the sponsors of H.R. 11601 have recognized the importance of providing consumers with a standardized method of comparing credit costs, and have avoided giving one type of creditor an unfair competitive advantage over another.

In addition to rate information, knowledge of the specific accounting practices employed by the store is necessary for accurate comparison of credit costs in the case of open end credits. Though it is impossible to calculate in advance the influence of such differing practices on effective finance charges, the consumer should at least be alerted in clear and unambiguous language to the differences that may exist. Thus, the Board has recommended, and both the Senate bill and H.R. 11601 require, that information disclosed on all open end credit plans must include the duration of any free period allowed, the method of computing the balance against which the finance charge is imposed, and minimum or special charges (if any).

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Such information would be disclosed in some detail when the account is opened, and, in addition, a brief disclosure of the essentials would be required in the monthly bill.

We believe that this information 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.

With the exception of the provisions on revolving credit, however, the Board believes that the Senate-passed bill is preferable to H.R. 11601. As we see it, the major differences, insofar as disclosure is concerned, relate to real estate credit, insurance premiums, transactions involving small finance charges, and effective date.

We believe first-mortgage loans on real estate should be exempt, as provided in S. 5, because there is already reasonable disclosure in this field and disclosure requirements developed for relatively short-term credit are inappropriate for loans with maturities of 20 to 30 years. 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 if no credit was extended. While it would be possible to spread discounts and other credit-related

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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. To require disclosure of total dollar finance charge, including interest payable over the whole life of the contract, might be more misleading than helpful. 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, land purchase contracts, and similar transactions should be covered. Such credits typically are extended for much shorter terms 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 installment credit.

One of the issues that has proved troublesome during consideration of disclosure legislation 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.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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 inclusion in the finance charge of premiums for insurance that provides a benefit to the borrower over and above the use of credit would overstate the actual charge for credit. Therefore, we think that such premiums are not properly regarded as part of the finance charge, and should be specifically excluded, as provided in S. 5. We do believe, however, that the dollar amount of any such premiums included in the credit extended should be itemized, again as provided in S. 5.

Another provision of S. 5 that is omitted from H.R. 11601 relates to closed end (installment) credit transactions involving small amounts. Presumably no one wants to press disclosure of credit costs to the point where borrowers are denied access to credit at any price. But to require disclosure of an annual percentage rate in small closed end credit transactions might have just that result. For credit of this kind, 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 a high annual percentage rate, and might decide instead simply to discontinue this type of credit. S. 5 would exempt transactions involving a finance charge of less than $10 from the requirements of disclosure of an annual percentage rate, although other disclosure requirements would still apply. We believe that some such exemption is needed.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Turning to the question of effective date, the Board believes that in order to allow sufficient time for consultation, preparation, and publication of regulations by the Board as well as time for those subject to the regulations to study their provisions, procure rate tables, and train their personnel in the new procedures, disclosure requirements should not take effect prior to one year after enactment. The Senate bill provides for additional time, so that State legislatures may have time to make any necessary amendments to their existing statutes and to pass similar disclosure legislation. The Board shares the hope expressed by the Senate committee that enactment of Federal disclosure legislation will prompt the States "to pass similar legislation so that after a period of years the need for any Federal legislation will have been reduced to a minimum" (S. Rept. 392, p. 8).

In addition to the "truth in lending" provisions just discussed, H.R. 11601 embodies provisions regulating credit advertising that affects interstate commerce. Since the information available to the Board in this area is extremely limited, we have little basis for comment on these provisions. On their face, they would seem in effect to prohibit advertisers from specifying rates or other credit terms on radio or television, since it would be impracticable to make the detailed disclosures that would then be required. Perhaps it is desirable to limit this kind of advertising to generalities such as "easy credit available," but such a

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

restriction might also operate to prevent creditors who offer lower rates or other advantages from advertising that fact on the air, thus inhibiting competition.

The bill would also prohibit creditors from advertising "that a specified periodic credit amount or installment amount can be arranged, unless the creditor usually and customarily arranges credit payments or installments for that period and in that amount." A determination of what terms are customarily and usually offered by a creditor would pose considerable problems of investigation and enforcement, and perhaps for that reason provisions are included in the bill (section 209) for administrative enforcement which closely parallel those now provided in section 5 of the Federal Trade Commission Act. No such provisions are included in S. 5; the Senate committee report on the bill stated that the "committee has not recommended investigative or enforcement machinery at the Federal level, largely on the assumption that the civil penalty section will secure substantial compliance with the act" (S. Rept. 392, p. 9). The bills before you provide for civil actions, in which a creditor who fails to comply with the disclosure requirements would be liable to the debtor for $100 or twice the finance charge, whichever is greater (but not more than $1,000), plus attorneys' fees and court costs. The Board hopes that these civil remedies, supplemented as they are by criminal sanctions, will prove adequate to assure compliance with "truth in lending" requirements.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Self-enforcement is probably less effective, however, in the field of advertising. An individual borrower could hardly be expected to prove in a private law suit, for example, that a creditor did not customarily and usually offer particular credit terms. If you determine that regulation of advertising is needed, we urge that you place this responsibility in the Federal Trade Commission, which has the benefit of years of experience in regulating advertising, and has an investigative staff and established administrative procedures for effective enforcement.

One provision of H.R. 11601, not included in the bill that passed the Senate, prohibits any creditor, in extending credit to an individual, from demanding or accepting any finance charge in excess of (1) the limit under State law, if any, or (2) 18 per cent per year, whichever is less. The Board is sympathetic with the apparent purpose of this provision, which is to prevent lenders from overcharging their customers. Nevertheless, we strongly urge that it be deleted from the bill.

Our objections to a statutory interest rate ceiling relate principally to its inflexibility. A single ceiling cannot take account of the widely varying circumstances surrounding individual credit transactions, such as amount of credit, costs of handling, purpose of loan, quality of collateral, and credit standing of the borrower. Hence we fear that potential borrowers, with legitimate and often compelling needs for credit, would be refused accommodation within the rate ceiling set by law.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The selection of an appropriate ceiling rate also would pose very serious problems for the Congress. A maximum of 18 per cent might seem generous--overly so, in the view of many--but it probably would not cover lender costs in some types of transactions. For a small loan, the finance charge may need to be very high--expressed in percentage terms--since many costs incident to the transaction are more or less fixed, regardless of the size of the loan. Moreover, collection costs can be very substantial on some classes of loan, and these too bear little relation to the amount of credit extended. Indeed, almost all states now have special small loan laws, in recognition of the impossibility of providing some types of credit to consumers within the ordinary usury ceiling. For companies chartered under these laws, permissible finance rates run as high as 42 per cent per annum in some States.

Effective enforcement of a ceiling finance charge also could be very difficult to achieve. There is a strong possibility that many consumers, refused credit from legitimate sources within the statutory ceiling, would turn to illegal lenders (the so-called loan sharks) and other unethical sources of credit. Some retail merchants, dependent chiefly on credit business, would be tempted to avoid the ceiling simply by inflating the price of goods sold. Under-the-counter agreements and devices to conceal part of the finance charge would flourish. As is often the case, the stronger the incentives to circumvent a restriction, the more difficult it is to enforce.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

And as you know, in some situations, there is a tendency for ceilings to become floors as well. I am sure none of us would like to see a Federal ceiling rate operate to raise borrowing costs.

For all of these reasons, the Board strongly urges deletion of this provision. We prefer to see the problem attacked through the disclosure requirements of the bill, in the belief that informed consumers will be in a better position to choose among the various financing options available to them in their particular circumstances.

H.R. 11601 contains sections not in the Senate bill that prohibit garnishment of wages and use of any documents, in connection with the extension of credit, authorizing the confession of judgment against the debtor. It is abundantly clear that both procedures are subject to serious abuse in the hands of unscrupulous creditors. An unwary consumer can sign away most of his rights to legal defense against creditor claims and, upon failure to make a payment, may find his wages attached without prior notice. Indeed, in many States he may be deprived of the major share of his current income, with obvious consequences for the continued well-being of his family, and often the fact of garnishment may jeopardize his job.

These considerations raise serious questions as to whether such practices should be condoned from the standpoint of public policy. The Board is not prepared to comment on the legal points at issue, or on the social consequences involved in continuation or prohibition of these practices. But we should bear in mind that

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

these devices, by increasing the security of the creditor, make him willing to extend credit to borrowers that he otherwise might not accommodate. We have no estimate of the number of credit contracts that would not be made in the absence of wage garnishment and confessions of judgment. But it is obvious that there must be many small borrowers with relatively poor credit records who have little in the way of security to offer the lender other than the right to quick legal action and attachment of wages.

As you know, the President has directed the Attorney General, in consultation with the Secretary of Labor and the Director of the Office of Economic Opportunity, to make a comprehensive study of the problems of wage garnishment. The Board believes that a decision on this matter, and on the related problem of confessions of judgment, should be deferred until the Attorney General's report and recommendations become available for your consideration.

Section 207 of the bill assigns the Board broad authority to prescribe regulations governing the extension and maintenance of margin requirements on commodity futures contracts. It is stated that the purpose of such regulation is to prevent excessive speculation in, and use of credit for, trading in such contracts with undesirable effects on prices.

There may well be need to attempt through regulation to dampen some of the speculative movements in commodity futures markets, with their possible repercussions on spot commodity prices. The

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Board recognizes that the futures markets perform a valuable economic function in permitting producers and users of commodities to hedge their operations against near-term price changes, and that speculators are an essential part of the futures market in balancing the supply of and demand for futures contracts. But we also recognize that speculative sentiment at times can be so massive and one-sided that it constitutes a disruptive force in the functioning of markets.

In any event, however, we feel that the Department of Agriculture, rather than the Board, would be much the more appropriate agency to administer any such commodity market legislation. The formulation of workable regulations, as well as their administration, requires close and continuing contact with the futures markets and a knowledge of present and prospective demand and supply conditions in the spot commodity markets underlying them, which the Board simply does not have.

Furthermore, the principal concern of the Federal Reserve is with credit conditions, and it is our belief that relatively little credit is used in connection with futures trading. The margin in such trades, as we understand it, is in the nature of "earnest money" assuring completion of the contract by buyer and seller at a later date. Unlike the stock market, title to property does not change hands; there is no immediate payment and hence no need for credit.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The statutory purpose of margin regulation as applied to stocks is to prevent the excessive use of credit in stock market trading. Since rapid growth of credit-financed margin purchases can contribute to destabilizing speculative advances in stock prices, one indication that use of stock market credit may be becoming excessive is a rapid growth in margin credit coincident with sharp increases in stock trading activity, and substantial gains in the stock price averages. At such times the Federal Reserve may increase margin requirements in order to slow the rate of stock market credit expansion. But the governing purpose is not to affect stock price movements, either for individual stocks, groups of stocks, or the market in general. Regulation of stock market credit, not stock prices, is the goal.

We understand that the Department of Agriculture is currently studying the advisability of applying margin requirements to trading in those commodity futures markets under the general supervision of the Commodity Exchange Authority. The Board would like to reserve judgment on this matter pending completion of the Department's study.

Section 208 of the bill would give the Board, upon a Presidential determination that a national emergency exists, authority to impose selective controls on the use of consumer credit. This could be done either directly, by limiting the terms on which credit is made available to individual borrowers, or

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

indirectly, by limiting the use of funds by creditors to finance consumer credit operations. There is clearly no need to activate such controls at present, in our view, but it is possible to visualize a combination of economic circumstances in which this authority could prove a useful supplement to our general instruments of monetary and credit control.

We do question, however, whether an authorization for standby selective credit controls properly belongs in an Act intended to provide greater protection for consumers in their use of credit. Standby credit controls would only remotely--and fortuitously--protect the consumer in his individual use of credit. The object of such controls, activated only in a national emergency, would be to limit the consumer's recourse to credit for purposes of national economic stabilization. The Board cannot conceive of the use of these controls to protect the consumer against himself by denying him overly liberal credit terms or excessive use of credit relative to his means.

The use of selective credit controls is a controversial matter. There are always bound to be differences of opinion as to when such controls should be invoked, how broad their coverage should be, how they should be administered, and when they should be suspended. Furthermore, there is some question as to the desirability of singling out this one area for standby authority, rather than considering the whole array of special actions that might prove

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

necessary or desirable in a national emergency. We therefore respectfully suggest to the Committee that it would be preferable to consider the question of selective consumer credit controls in a broader context and to delete this provision from the pending bill.

In summary, let me express the hope that your Committee will act favorably on S. 5, with an amendment eliminating the revolving credit exemption. The Board of Governors believes there is a need for this legislation, and while we have no special qualifications for the function of writing regulations to implement it, we will do our best to carry out this responsibility if the Congress assigns it to us. If, however, you determine that there is a need for additional measures, such as regulation of advertising or trading in commodity futures, to protect consumers, responsibility for their administration and enforcement should be assigned elsewhere.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis