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Statement by

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before the

Committee on Banking, Housing, and Urban Affairs

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I am pleased to appear before the Senate Banking Committee today to present the views of the Federal Reserve Board on S. 1988. This bill would grant additional lender groups the authority, now limited to national banks, to set loan rates up to one percentage point above the Federal Reserve discount rate regardless of any state law stipulating a lower ceiling. In addition, it would permit any state to reimpose its state usury limits by enacting overriding legislation. Another provision of the bill, also subject to state override, specifies that rates paid on deposits would be exempt from state usury regulation.

The Board has long been concerned about the adverse impact that usury ceilings can have on the availability of funds in local credit markets, and has frequently stated its opposition to such artificial constraints. In general, regulatory limits on loan charges tend either to have little or no effect (when market-determined rates are at or below the ceiling) or to be counterproductive (when market-determined rates are above the ceiling). When nominal market interest rates are high, as at present, usury ceilings typically distort credit flows by inducing lenders to channel funds into assets or geographic areas less affected by ceilings. Nonprice lending terms in restrained markets may be tightened severely to compensate for the relatively low nominal interest rates that can be charged, and credit may become totally unavailable except to the most highly qualified borrowers.

Because of the Board's view that credit markets function most effectively when allowed to operate as freely as possible, we support in principle the removal of impediments posed by usury laws. Nevertheless, serious concern has been expressed by some Board members about Federal

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preemption of state law. Also, the Board strongly recommends against tying ceiling rates to the Federal Reserve discount rate. The Board believes that a more effective long-range solution to rate ceilings should continue to be sought--for national as well as state banks and other institutions. While a majority of the Board feels that S. 1988 can be supported as a stop-gap measure, we urge that a more appropriate reference rate than the Federal Reserve discount rate be selected, and that a sufficient differential above that rate be specified to allow more adequate flexibility in various credit markets.

Many members of the Congress are understandably reluctant to preempt state laws or constitutional provisions. The Board also feels that corrective action at the state level would be the most desirable way to redress the counterproductive effects of state usury laws. Quite a few states, in fact, have already revised their usury or other lending statutes since the beginning of this year, although some revisions have been outdated by subsequent market developments. Further state action would await the next legislative sessions or, as in Arkansas, the process of constitutional amendment.

S. 1988 would immediately address the market dislocations due to rate ceilings in any state. As noted earlier, it also would honor state prerogatives by enabling legislatures to reject the rate flexibility provisions of this bill through passage of a new state law reaffirming existing regulations. In the view of the majority of the Board, this approach would provide adequate preservation of state authority to regulate lending practices. However, some members of the Board have strong reservations about endorsing legislation that would further encroach upon state powers.

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The proposed bill would peg the maximum permissible lending rate at one percentage point above the discount rate on 90-day commercial paper prevailing in the Federal Reserve district in which a lending institution is located. The Board recognizes that this formulation has applied to national banks since 1933. Nevertheless, we have strong reservations about it, and I would like to invite your further reflection upon the advisability of indexing loan rate ceilings to the discount rate.

The Federal Reserve discount rate is a short-term rate; by comparison, many of the target credit markets of the proposed bill involve long-term lending, such as home mortgage loans, as well as shorter-term credit. It is unusual for interest rates across maturity categories to be patterned in such a way that a one percentage point markup over the discount rate would provide much practical relief from usury ceilings in all markets. Even now, with the discount rate at a historically high 12 percent, a one percentage point markup would leave the ceiling lending rate below average home mortgage rates in many areas. .Moreover, the discount rate is an administered rate, not a market rate, and may not always closely reflect levels or movements even of short-term market rates. In general, we feel it unwise to single out a tool of monetary policy for a purpose, such as indexing, not directly policy related.

As you know, other bills enacted or now under consideration by the Congress deal with restrictive state usury ceilings in somewhat different ways than S. 1988. The recently enacted Public Law 96-104, which in effect applies only to Arkansas, pegs permissible rates for business and agriculture loans of $25,000 or more to the discount rate, but allows for a five percentage

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point differential. A provision in the proposed Financial Institutions Deregulation Act would remove usury ceilings on home mortgage loans altogether for a broad spectrum of lenders. In contrast to these approaches, the indexing formulation of S. 1988 provides relatively little relief from state usury ceilings. We suggest as an alternative that outright removal of ceilings be considered, or if a ceiling is to be maintained, that a market rate of medium or long maturity be used as a reference rate, and that a markup be established to allow a wider degree of rate flexibility in the target credit markets.

In this connection, I would observe that experience with floating-rate usury ceilings in several states has shown that even a market rate of appropriate maturity may not always perform the pegging function in a fully satisfactory manner. Illinois, for instance, had employed a ceiling for residential mortgage loans that was 2-1/2 percentage points above an index of long-term U.S. government securities yields. However, yields required by lenders on home mortgage loans in unconstrained markets subsequently rose above this floating ceiling, and the volume of home mortgage lending in Illinois was curtailed. Consequently, in November of this year, the Illinois legislature suspended any ceilings on home mortgage rates through the end of 1981.

I would also note that the sponsors of S. 1988 have emphasized the goal of equalizing competition among national banks and other depository institutions. The Board shares the view that, in principle, similarly situated lenders should operate in similar regulatory environments. The bill would achieve partial competitive equality, inasmuch as the provisions now applicable to national banks would be extended to all federally insured state-chartered commercial and mutual savings banks, all federally insured savings and loan

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associations, certain federally insured credit unions, and all small business investment companies. However, various other lenders not covered by the proposal would remain without relief, including all life insurance companies, all mortgage bankers, and some credit unions.

In summary, because of the distortions in local credit markets that result from unreasonably low interest rate limitations, the Board strongly endorses efforts to remove the restraints of usury ceilings altogether. We would urge the states to reevaluate their usury laws in light of recent experience with historically high market rates, and are pleased to note that many states have been and are doing so. In view of the pressing need for some relaxation of usury ceilings and the time lapse before the scheduled opening of legislative sessions in several states, the majority of Board members supports S. 1988--subject to modification in order to incorporate a more appropriate reference rate than the Federal Reserve discount rate--as an interim measure until the states themselves or the Congress can provide a more satisfactory solution.

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