For Release on delivery
Expected at 10:00 a.m. EDT

Statement by

Nancy H. Teeters

Governor, Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions

Committee on Banking, Housing, and Urban Affairs

United States Senate

July 21, 1981

I am pleased to appear before the Subcommittee on Financial Institutions to present the Federal Reserve Board's views on two bills--S.963, a bill to authorize loans at interest rates in excess of certain state usury ceilings, and S.1406, the Credit Deregulation and Availability Act of 1981. S.963 would temporarily allow any type of lender to originate loans at a rate of up to 1 percent above the Federal Reserve discount rate. S.1406 would permanently remove all state limits on interest rates on business, agricultural, and consumer credit, and also would preempt state restrictions on transaction and access fees on consumer credit and payment services. Both bills would permit any state to establish its own ceilings by enacting overriding legislation.

S.963 and S.1406 would thus broaden the coverage of preemptive actions under the provisions of the Depository Institutions Deregulation and Monetary Control Act of 1980. That Act, as you recall, authorized the orderly phase-out and ultimate elimination of interest rate ceilings on deposit accounts. In addition, it permanently preempted state usury laws affecting most first mortgage home loans, and temporarily preempted state usury laws governing most business and agricultural loans, permitting lenders to charge a rate of up to 5 percent above the Federal Reserve discount rate. The Act also extended to certain financial institutions the authority, previously granted only to national banks, to set rates on all types of loans of up to one percentage point above the discount rate. Any state, however, was allowed to override certain of these preemptions.

In many localities during the past few years, rising costs of funds have seriously eroded the profitability of lending at rates permitted by state law. Consequently, the supply of credit in areas with restrictive rate ceilings has at times been curtailed, especially to higher-risk borrowers, as loanable funds obtained at market rates have been channeled to other investments or to geographic areas permitting a more competitive return. These developments have underscored the importance of allowing leeway for financial markets to function without being hampered by artificial constraints on loan rates. With that broad objective in mind, the Board has consistently supported the removal of impediments posed by usury laws. This view, of course, has recently been reinforced by the prospect of the eventual removal of all controls on the rates that banks and thrift institutions can pay for deposits.

Although the Board favors termination of artificial constraints on interest rates, we continue to have reservations about endorsing preemption by the federal government of state usury laws. The Board would prefer that the counter-productive effects of usury ceilings be addressed by corrective action at the state level. However, if the Congress chooses to act, we endorse the inclusion of provisions that would allow individual states to override the federal preemption, and that would defer to actions already taken in a number of states to override the preemptive provisions of the Monetary Control Act. Although S.963 and S.1406 would both permit states to supersede Congressional action, only S.1406 would recognize the binding character of overriding state actions which had been taken since the Monetary

Control Act was enacted but before the effective date of the new legislation.

If the Congress should choose to impose a federal usury limit rather than to remove interest rate controls altogether, the Board would strongly advise against tying such a ceiling rate to the Federal Reserve discount rate, as would be provided by S.963. It would be inappropriate, we feel, to employ a tool of monetary policy for a use that is not directly related to policy needs.

The Federal Reserve discount rate, as you know, is the rate of interest charged by Federal Reserve banks on extensions of short-term credit to depository institutions that are subject to significant restrictions on the amount and the frequency of their discount window borrowing. Ordinarily, large institutions with access to national money markets are expected to repay these loans the following business day; smaller institutions that lack such broad market access may require accommodation for somewhat longer periods of time. In any case, the maturity of this special type of borrowing--largely to meet temporary requirements for funds--is ordinarily much shorter than is typical for business, agricultural, or consumer credit. The discount rate thus provides no sensitive indication of the course of interest rates on longer maturity credits.

Another reason why the discount rate is inappropriate for indexing is that it is an administered rate which reflects frequently complex general policy considerations. As a result, it deviates fairly often from other market interest rates, even those of comparable maturity. Tying the usury limit to the Federal Reserve discount rate would thus increase the likelihood that a statutory ceiling might at

times be below market interest rates, thus constraining the availability of credit subject to the usury law. That is especially the case in consumer lending, where going rates at any one time typically range widely depending on loan size, collateral (if any), and other determinants of credit risk.

Also of concern to the Board is that Title II of S.1406 would authorize and direct the Federal Reserve to publish official interpretations about the scope and the application of the consumer credit preemption provisions of the Act. The Board recognizes that these rulings could help resolve uncertainties about the relationship of the federal law to state usury laws. Even so, it is unclear whether the benefits accruing to the public from these interpretive rulings would outweigh the costs of the additional paperwork and the administrative apparatus that would be required. Moreover, the Board is reluctant to assume the role of interpreting these legal relationships and of resolving possible statutory conflicts. These are functions primarily of a judicial character that, in the Board's opinion, should remain within the purview of the courts wherever possible. They are far removed from the Board's primary responsibility for formulation of monetary policy.

Another special feature of S.1406 is the removal of state controls on periodic fees associated with credit card or debit card accounts as well as transaction charges for credit cards or payment mechanism services. As in the case of interest rate ceilings, the Board favors the determination of such fees and charges by market forces. The prohibition in some states of account or transaction fees on credit card accounts has allowed customers who pay in full by the

end of the billing cycle to use credit services without paying for them. Permitting transaction and access fees in such instances makes economic sense because these charges enable creditors to allocate costs in accordance with the usage of specific services. However, the Board believes that--where necessary--corrective action at the state level would be the most desirable way to address any counter-productive effects of limitations on these fees and charges.

To summarize, the Board supports attempts to remove ceilings that can constrain the price of business, agricultural, and consumer credit. It also supports efforts to eliminate controls on fees that may be charged in connection with consumer credit accounts and payment services. The Board continues to feel, however, that state action rather than federal law should prevail whenever possible in governing pricing policies of these kinds. In view of the large and rapid recent changes in the underlying determinants of the cost and the availability of credit, appropriate action at the state level has become all the more imperative.