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Statement by

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Governor, Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer Affairs and Coinage

Committee on Banking, Finance, and Urban Affairs

United States House of Representatives

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I am here today on behalf of the Federal Reserve to discuss the expiration of the federal preemption of state usury laws governing business and agricultural loans and the effect of high interest rates on farmers and businesses. The preemption was passed as a provision of the Depository Institutions Deregulation and Monetary Control Act of 1980. It authorized lenders to charge a rate up to 5 percent above the Federal Reserve discount rate on business and agricultural loans of $1,000 or more in those states with ceilings less than this variable limit. The preemption is scheduled to expire at the end of this month.

The Board has been concerned about the adverse impact that usury ceilings can have on the availability of funds in local credit markets. Usury ceilings tend to reduce the supply of credit in states subject to unrealistic limits by encouraging lenders to channel funds into other investments or to geographic areas permitting a more competitive return on similar investments. Credit thus may become unavailable to all but the strongest potential borrowers, as non-rate lending terms and credit standards are set to compensate for the uncompetitive interest rates that are legally permissible. Moreover, given the growth in money market mutual funds into a large competitive industry and the rapid deregulation of deposit rates at our financial institutions, the cost of funds to financial institutions in local communities has become increasingly sensitive to national money market developments. This creates a much greater need for these institutions to earn a competitive return on their assets.

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Despite the Board's opposition to artificial constraints on credit availability, we continue to have reservations about federal intrusion into an area long regulated by the individual states. The Board prefers that usury ceilings be addressed by corrective action at the state level. In this regard, the law did provide states with the authority to override the federal preemption of their ceilings. Information collected by Board staff indicates that, as of the middle of last year, a dozen states had at least partially overriden the federal law. Among these twelve states, however, eight had no usury ceilings on business loans and four had either usury ceilings that were indexed or ceilings that were fixed so high they had no effect on credit flows. Those states that were most affected by usury ceilings generally have not acted to override the preemption. In fact, many states have moved to relax their regulation of interest rates since the passage of the Deregulation Act. Currently, only about ten states have fixed usury ceilings on business and agricultural loans, and less than half of these could be considered binding.

In this respect, the focus of federal law preempting state interest rate ceilings may have narrowed. But at the same time, it should be emphasized that permitting the federal preemption of state business and agricultural loan usury laws to expire will not resolve the financial problems of businesses and farmers. These problems have resulted from more fundamental economic difficulties. Fortunately, economic and financial

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conditions are now beginning to improve. Interest rates are now well below their levels of one or two years ago, with short-term rates as much as 10 percentage points below their earlier peaks, and long-term rates down about 4 to 5 percentage points. More important, the economic recovery that appears to be underway should bolster business activity and help to restore a more profitable base for operations.

Continued success in lowering interest rates depends on our reducing the lingering doubts about the progress against inflation and on our cutting back on credit-absorbing federal budget deficits. Monetary and fiscal policies need to be directed toward removing these obstacles and achieving vigorous, and lasting, noninflationary growth.

To summarize, the Board feels that, with regard to usury ceilings, state action rather than federal law should prevail whenever possible. Many states have acted to reduce the constraining effect of their usury ceiling on credit availability, and financial conditions have improved considerably. These factors generally weaken the current need for a national law preempting state usury ceilings on business and agricultural loans, but do not eliminate the need for further action to relax interest rate ceilings at the state level.

If the Congress desires to extend the current law, I would like to note again a feature that is of concern to the Federal Reserve Board. The law established a variable rate ceiling based on the Federal Reserve discount rate. The Board

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continues to be opposed to use of the discount rate as an index to which the Federal usury ceiling is tied. The discount rate has an important role in the conduct of monetary policy, and cannot always be counted on to reflect an appropriate base rate for the cost of funds. Moreover, because the discount rate is an administered rate that applies generally to very short-term borrowing by banks and other depository institutions, movements in this rate may not be representative of interest rate movements in markets that involve longer-term lending.

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