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Statement by

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before the

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of the

Committee on Banking, Finance and Urban Affairs

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I appreciate the opportunity to appear before the Subcommittee to present the views of the Federal Reserve Board on two legislative proposals that would establish nationwide ceilings on credit card interest rates. One of these bills, H.R. 1197, would specify that the rate of interest on any credit card transaction could not be more than 5 percentage points higher than the Federal Reserve discount rate. The other bill, H.R. 3408, would limit the interest rate on credit card debt to 6 percentage points above the yield on 3-month Treasury obligations; this plan would not become effective if it were determined by the Federal Reserve that prevailing loan rates reflect the cost of funds to creditors and competition for credit card accounts.

Both bills under review today would set floating ceilings on credit card rates that would supersede generally less restrictive state-imposed limits. In the past, the Board has commented on similar proposals from time to time. In doing so, it has endorsed the principle that consumer loans and other types of credit are most fairly and efficiently allocated where there are no regulatory constraints on interest rates. Indeed, the Board has been concerned for some time about the adverse impact that rate ceilings can have on the availability of funds in local credit markets. On frequent occasions, it has stated its opposition to such artificial limits.

Recently, a number of observers have noted that interest rates on bank credit card credit have edged up since the early 1980s even though market rates, which represent funding costs, have fallen substantially. Some commentators have interpreted the resistance of credit card rates to downward pressure as an indication that the market for credit card lending is not competitive--a premise that underlies both bills. Although the stickiness of rates might lead some observers to conclude that competition is lacking, other characteristics of the market suggest that competition is intense. As my remarks will indicate, the Board believes that factors other than the level of competition explain the relative stability of credit card interest rates.

A large number of suppliers in a market usually is taken as a sign of competitive conditions. In this respect, there is no doubt that many commercial banks, retail stores, and other firms currently offer credit cards of some kind to consumers. Moreover, what used to be known as "bank" credit cards are now issued by a growing number of credit unions, finance companies, savings and loan associations, and others. Thus, there are likely to be a number of competing bank and retail credit cards available in almost any market area. Under these conditions, it seems doubtful that a credit card issuer could maintain a position of monopoly power.

Indeed, the marketing practices of card issuers suggest a zeal for obtaining new customers that generally is associated with vigorous competition. This behavior has been apparent in the heavy volume of solicitations for new accounts--often directed to residents who live outside the market areas typical of most retail deposit and credit services. In view of these indications of healthy competition, another explanation must be found for the lack of association between credit card rates and market interest rates.

Implicit in the idea that variations in credit card finance rates should correspond closely to changes in market rates is the premise that the cost of funds is a dominant cost factor in providing credit card services. In fact, however, the cost of funds seems to be much less important in credit card lending than in other types of credit. For credit card plans, the bulk of total costs is composed of operating costs incurred for processing transactions, monthly billings, and evaluating credit applications, along with costs associated with delinquent accounts and credit losses. These cost factors vary in ways that usually differ from the pattern followed by changes in market costs of funds.

The Federal Reserve System each year surveys a number of commercial banks to obtain information about their costs of providing various services. From these average cost data, published under the title Functional Cost Analysis, the importance of financing costs and other costs can be compared for credit card operations and for other kinds of bank lending. During the period 1974 through 1984, financing costs averaged only about three-tenths of total expenses, before taxes, for the credit card function at participating medium- and large-sized banks that issue credit cards. By comparison, financing costs at banks in the same size classes accounted for more than three-quarters of total costs of the commercial lending function, and for nearly nine-tenths of total costs of mortgage lending. Studies of credit card operations at retailers likewise have shown that funding costs are less important than operating and collection costs.

But an even more striking difference exists between credit card loans and other types of lending. The key characteristic of revolving credit plans is that the terms of repayment are quite flexible and at the discretion of the account holder. Excluding cash advances, which typically earn finance charges from the transaction date, most credit card plans charge interest only if card holders pay less than the full amount billed during the period. Thus, unlike other kinds of credit, the way the credit card holder uses the account determines how much--and, indeed, whether--interest revenue is earned from the account.

Available evidence suggests that some credit card holders--perhaps nearly 10 percent at any one time--do not use their credit cards at all. These nonusers produce no finance charge revenue to offset costs of establishing and maintaining their accounts. Of cardholders who use their credit cards, some surveys indicate that half usually pay off the entire balance when billed. These customers also generate no finance charge revenue to offset processing, financing, and billing costs, although in the case of third-party credit cards such as Mastercard and Visa the card issuer would derive some income from the fees that merchants pay to help defray processing costs.

These considerations strongly suggest that the behavior of credit card rates cannot be properly evaluated solely by comparing a credit card rate with a market interest rate. Doing so would overlook the fundamental differences in the behavior of costs and revenues between credit card operations and other types of lending--namely, that funding costs are a lower share of total costs for credit card lending, and that some credit-card borrowers pay little or no interest. A more meaningful rate comparison requires a measure that takes account of these differences.

One such measure is the net return after deducting the cost of funds and other expenses. Again, the Functional Cost Analysis statistics for respondent banks provide some basis for comparison among types of lending. Data for the period 1972 through 1984 suggest that--in contrast to the higher gross finance rate on credit card indebtedness--average before-tax earnings have been substantially lower during most of the period in the case of credit card operations than for commercial or mortgage lending. These figures, of course, include periods of relatively low or negative returns on credit card lending, such as in 1980, and periods such as last year when the yield for the credit card function exceeded that for commercial loans and mortgage loans. Over the longer term, returns on credit card plans have not been out of line with other types of lending; as indicated, margins actually have been lower on average in the credit card area. Thus, there must be reasons other than a lack of competition that explain why, of late, credit card rates have not fallen much.

Viewed in this longer perspective, the question of why credit card rates have not dropped during the recent period as sharply as other rates necessarily poses the analogous question of why credit card rates did not increase in previous years when other rates surged. Partly, as noted earlier, the stability of credit card rates reflects the lesser role of financing costs in the overall cost function. It also reflects the impact of state-established statutory ceilings on interest rates.

In all but a few states, 18 percent per year was the upper limit on rates that card issuers could charge on credit card balances in the late 1970s when other rates were beginning to climb. Judging from the Functional Cost Analysis, average returns to banks on credit card operations in most prior years had been no higher than net earnings on other major forms of lending. Then, when market costs of funds rose sharply between 1979 and 1981 while credit card rates were restrained by the ceilings, marginal and even average net returns on credit card receivables turned negative.

The reduced attractiveness of credit card lending prompted several fundamental realignments by lenders, once it became clear that the adverse conditions were likely to persist. Some commercial banks, for instance, relocated their credit card operations to states, such as South Dakota, where there were less restrictive rate ceilings or none at all. At the same time, many state legislatures acted to raise their rate ceilings or--as at least a dozen states have done--eliminate them altogether. Many credit card issuers during this period of high market interest rates began charging annual fees on credit card accounts. And, though precise measurement is difficult, many diversified creditors such as banks tightened their lending standards and deemphasized their credit card business in favor of other types of lending that seemed more profitable at the time. Some institutions stopped accepting any new credit card accounts.

Now that market costs of funds have moved to lower levels, and credit card programs generally have become profitable again, many credit card issuers have greatly intensified their efforts to market new credit card accounts and to encourage account usage. That is, credit card issuers in general have responded to falling financing costs not by reducing rates, but mainly by increasing the availability of credit cards; this reversed the earlier curtailment of such credit that card issuers undertook as market rates moved up and many card issuers were unable to adjust revenues to match rising costs. Thus, it appears that much of the inertia in credit card interest rates may be attributable to the influence of restrictive rate ceilings imposed by the states.

Of course, rate ceilings in the credit card market are considerably less pervasive than they were prior to 1980. As mentioned, a number of states have raised or removed applicable rate ceilings, or have permitted lenders to charge annual fees for credit card accounts. These changes, in addition to the declines in the cost of funds, may help explain the rise in the overall net return, before taxes, on credit card plans at respondent banks to about 3-1/2 percent in 1984. So it may be that a growing number of credit card issuers now are in a position to consider offering somewhat lower finance rates to credit card holders.

Factors on the demand side of the market also may have contributed to the observed stability of credit card rates. As previously mentioned, a substantial proportion of card holders either use their credit cards infrequently or usually pay off their bills in full; these holders are likely to be largely unconcerned about the level of finance charges.

Even card holders who "roll over" their balances and pay finance charges may often be relatively insensitive to the rate of interest charged. Other features of credit card borrowing, such as convenience and suitability for small transactions, may outweigh any rate disadvantage. In any case, credit card debt has expanded rapidly during the past two years--a sign that consumers view credit card use as a desirable source of short-term financing despite what many observers regard as high rates of interest.

Furthermore, the recent appearance of above-average returns to bank credit card lending may not lead to an immediate, widespread reduction in rates. Credit card issuers may be uncertain whether such favorable conditions will persist, especially given the continuing large federal budget deficits. Until actions are taken that curtail the deficits and thereby reduce uncertainty about the likely future course of financing costs, many credit card issuers may remain reluctant to cut finance rates much if at all, especially in view of their experience with intense cost pressures in previous years. Also, instead of offering lower finance rates, creditors may choose to compete by easing credit standards somewhat or by making nonrate credit terms more attractive.

In this connection, one should keep in mind that finance rates on credit cards already have shown some tendency to decline. One large bank announced in early October that it had cut its finance rate; at the same time, it established separate fees for some types of services for which credit cards are used. Various issuers have adopted floating finance rates of the general kind that are proposed by the legislation under your review. However, those adjustable rates often have been paired with annual fees. This degree of diversity and experimentation may be regarded as further evidence of active competition.

An effort to establish a federally mandated ceiling on credit card interest rates can be expected to encounter difficulties. From experience with the imposition of credit controls in 1980 and the sharp, unexpected contraction in consumer spending that accompanied them, we know that regulatory measures can have unpredictable and unwanted consequences. Setting a federal ceiling rate of interest on credit card debt below those that currently prevail in many states would likely reduce the amount of credit made available. Moreover, such a curtailment would likely fall most heavily on less affluent borrowers with relatively limited access to other sources of credit. Based on recent levels of 3-month Treasury bill rates and the Federal Reserve discount rate, the ceiling for credit card rates under either of the proposed bills would be 12-1/2 to 13-1/2 percent, well below the finance rates that have been typical since credit cards emerged in the early 1960s as a major method of consumer financing.

Furthermore, imposition of stringent rate ceilings might be countered by adjustments in nonrate credit card terms such as increased annual fees, processing charges levied on each purchase or cash advance, and penalties for late payments or for exceeding the authorized credit limit. Some card issuers also might begin applying the reduced finance charges from the date of purchase, where permitted, rather than after the grace period expires, and might seek to increase merchant discount fees.

Turning to the central provisions of the two bills before the Congress, it should be emphasized that credit cards are issued by a broad variety of retail merchants and financial institutions that differ both as to their sources of funding and their liability structures. Under these circumstances, a single index rate would be unlikely to mirror changes in either marginal or average costs for such a diverse array of card issuers. In any case, short-term rates, such as on Treasury bills, fluctuate a good deal more widely than costs of funds of most lenders. They do so because a lender's overall average cost of funds at any point is partly determined by previously issued liabilities, and because market rates on longer-term liabilities--which make up part of the cost of funds--typically vary less than shorter-term rates.

If the Congress should nonetheless decide to enact legislation, the Federal Reserve strongly recommends against designating the discount rate as an index for setting ceilings on credit card rates. The discount rate, as you know, is the interest rate charged by the Federal Reserve Banks on extensions of short-term credit to depository institutions. Because it typically applies to very short-term loans, the discount rate is an inexact measure of either marginal or average costs of loanable funds, which may reflect borrowing at a wide range of maturities. Furthermore, the discount rate is a tool of monetary policy. As such, it is an administered rate that reflects broad policy considerations that frequently are complex, and so may deviate from other market rates, even those for instruments of comparable maturity. It would be wrong, in the Board's view, to employ a tool of monetary policy for this use.

Another question at issue is whether any regulation of credit card interest rates is more appropriately a matter for federal or for state intervention. The establishment of interest rate ceilings has long been a state prerogative, and one that the Board feels should not be preempted lightly. In recent years, virtually every state has reviewed and overhauled its laws regulating consumer interest rates. After studying the situation in their own jurisdictions, many of these states have opted to raise or remove interest rate ceilings for credit card borrowings. The Board is inclined to respect the collective judgment of a growing number of states that higher--not lower--ceilings are appropriate to the viability of the credit card market, and to note that these states retain the authority to lower the ceilings if convincing evidence of noncompetitive rate determination appeared.

In closing, I would like to reemphasize the Board's conviction that financial markets distribute credit most efficiently and productively when interest rates are determined in markets that are as free from artificial restraints as possible. In the credit card business, the balance of the evidence suggests that reasonably competitive conditions exist, notwithstanding the lack of variation in finance rates. Furthermore, recent developments have reflected some tendency for credit card rates to decline. Efforts to constrain credit card rates through federal regulation are likely to have undesirable side-effects in the form of reduced credit availability or less-efficient means of recapturing credit costs. Accordingly, the Board concludes that it would be inappropriate to impose a federal ceiling on credit card rates.