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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Production and Stabilization

of the

Senate Banking and Currency Committee

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on S. 1740

Mr. Chairman and Members of the Subcommittee:

You have asked that I appear before you today to comment on S. 1740, a bill to require disclosure of finance charges in connection with extensions of credit. I am glad to give you such assistance as I can in your consideration of this proposal.

Briefly, the bill would require a person engaged in the business of extending credit to furnish to each of his customers prior to the consummation of a credit transaction a written statement setting forth certain details concerning the credit in accordance with rules and regulations prescribed by the Board of Governors of the Federal Reserve System. These details would include (1) the finance charge expressed in dollars and cents and (2) the percentage that the finance charge bears to the total amount to be financed expressed as a simple annual rate on the outstanding unpaid balance of the obligation.

I should like to begin my statement by reaffirming the Board's general position as set forth in our report and statement on S. 2755, the similar bill considered by your Subcommittee last year, and repeated in our recent report on S. 1740. The Board is in full accord with the objective of requiring lenders and vendors to disclose fully their interest rates and finance charges to credit customers. The regulation of trade practices of vendors and lenders in stating finance charges, where necessary to provide credit customers with better information, is a commendable social and economic objective.

While we are in full sympathy with the "truth in lending" objective of the bill, we also believe, as we stated last year, that administration of such legislation would not constitute an appropriate activity for the Federal Reserve System. As you are aware, the major responsibility of the Federal Reserve is influencing the reserves of the banking system in the interests of economic stability and growth. The statute proposed in S. 1740, it seems to me, would be essentially a trade practices law not related to our primary responsibility, which is to regulate the availability and supply of credit in accordance with the over-all needs of the economy.

The bill is designed to protect the interests of borrowers or other retail credit customers on a continuing basis. It would do this by improving the quality of their information concerning the finance charges on credit contracts into which they may enter. As a result of the better information on financing charges, the bill would presumably facilitate customer choice as to type and source of available credit financing best suited to his pocketbook. In this way, the bill would work from the demand side to make the market for funds more competitive and make more efficient the allocation of resources generally.

The bill would not be administered as a contracyclical instrument, tightened in boom times and eased in times of slack. Rather it would be administered so as to give borrowers truthful information at all times--good and bad alike. Thus, regulation of the disclosure of finance charges under the bill would differ from the administration of general monetary policy. Its administration would also differ with respect to cyclical flexibility from the selective credit regulations, such as regulation of stock market credit which the Federal Reserve administers at present, and from regulations of consumer credit and real estate credit which the Federal Reserve has administered in the past.

The question as to whether or not knowledge as to the actual cost of an article bought on credit tends to diminish cyclical fluctuations can be thought of in two parts. One part has to do with the price of the article itself; the other with the additional cost of buying it "on time."

Decisions as to whether or not to buy the item at all are made more intelligently, of course, when the true price is known. Since prices of goods and services fluctuate, potential buyers tend to be encouraged to purchase by prices they consider low and discouraged by those they consider high. Price changes on the items themselves, therefore, do have contracyclical influence and this influence is enhanced when potential buyers are quoted the total cost as well as the monthly payment.

If consumer finance charges actually did fluctuate with economic cycles, knowledge of the total cost of consumer credit itself would tend to have contracyclical effects. However, finance charges on consumer instalment credit, a major area that would be covered by the bill, have not shown much fluctuation in response to cyclical changes in the availability of credit during the postwar period. Also, it is hard to find evidence as to consumer responsiveness to the changes in charges that have occurred. Consumer instalment credit has been more responsive to changes in terms, such as maturities and downpayments, and in credit standards of lenders, than to changes in finance charges.

Finance charges on instalment loans, like charges on other types of credit, have risen from the lows reached in the World War II period. The rise has been gradual and, unlike money market interest rates, rates on consumer loans have not varied much in response to changes in the availability of and demand for credit over the course of postwar business cycles.

One factor of particular importance in connection with the prevailing level and relative invariability of credit charges on instalment loans is the presence of State laws setting maximum finance rates. Another factor is the relative importance of costs other than the cost of money per se in the consumer lending business. These costs, which include the cost of credit investigation, collection, and provision for losses, do not show much cyclical fluctuation.

This is not to say that consumer instalment credit is unresponsive to changes in monetary policy. Instalment lenders, like other lenders, are affected by changes in the supply of bank reserves. Commercial banks, which are most directly affected by changes in Federal Reserve policy, themselves hold about two-fifths of all outstanding consumer credit and also make loans in substantial volume to finance companies and retailers.

Changes in the availability of credit to instalment vendors and lenders tend to be reflected more in changes in the credit standards which lenders and vendors apply than in changes in their finance charges. When credit conditions tend to tighten, more restrictive credit standards tend to eliminate customers who are marginal risks.

On the other hand, when credit conditions become easier, instalment lenders and vendors are more willing to extend credit and to accept marginal risks. Moreover, consumer lenders and vendors tend to engage in more promotional activity when funds are readily available and to cut back on such activity when funds are hard to come by.

In view of the technical characteristics of the consumer credit business, it seems unlikely that a fuller awareness by consumers of instalment finance charges in and of itself would make for increased cyclical variation in such charges and thereby result in much contra-cyclical effect on consumer borrowing. Whatever increased cyclical variation in rates and in borrower responsiveness to rate changes did result from the bill would, of course, be salutary. Cyclical flexibility in financing costs serves generally to discourage borrowing in boom periods and to encourage it in periods of slack.

Perhaps the most important effect of the bill in the instalment credit field would be in furthering the healthful functioning of the economy generally, through better allocation of resources. It would, indeed, be beneficial if a fuller consumer awareness of credit charges resulted in the avoidance of particularly burdensome indebtedness on the part of some consumers, or caused them to allocate their funds more economically.

While most of the discussion of this bill has been in terms of its role in requiring disclosure of terms on short-term consumer credit, the bill also would apparently apply to the mortgage credit area. Mortgage interest rates, like finance charges on consumer credit, have risen since the war, although they have fluctuated more in response to changes in credit availability.

Contract rates on first mortgages tend to be close to their effective rates. It is true that appreciable discounts are sometimes charged on mortgages insured or guaranteed by the Federal Government. This happens when administratively determined rates are below market rates. However, sizable discounts are seldom charged on mortgages of the conventional type. Moreover, charges other than the cost of money typically add little to the contract interest rates on mortgages.

There is unfortunately little information to be had about practices in disclosing financing charges to borrowers in second and third mortgage financing. If there is a problem requiring compulsory disclosure of contract costs in the mortgage field, it would seem to relate more to this area of financing than to first mortgages.

In conclusion, let me say that the Board of Governors looks with favor on the general principle of the bill of requiring disclosure of finance charges. At the same time, however, the Board believes that the administration of such a trade practice function would be essentially unrelated to the Board's present responsibilities. On behalf of the Board, therefore, I wish to reaffirm the position we took last year that administration of such legislation would not constitute an appropriate activity for the Federal Reserve.