COMMISSION AUTHORIZED

FEDERAL TRADE COMMISSION
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May 15, 1987

The Honorable Greg Zito
State Senate
State Capitol
Springfield, Illinois 62706

The Honorable Monroe L. Flinn
House of Representatives
Room 2089 Stratton Building
Springfield, Illinois 62706

Dear Messrs. Zito and Flinn:

The Federal Trade Commission staff is pleased to have this opportunity to respond to your recent letters requesting our comments on Senate Bills 186, 188, 217, and 895, and House Bills 4, 19, and 413, all of which would impose interest rate ceilings in Illinois on credit cards and revolving credit transactions.[1] SB 895 would further establish a minimum grace period, limit annual fees to a maximum of $20, and impose increased disclosure requirements on credit transactions.

We oppose all of the above bills and any other bill that would set maximum credit card interest rates. Any effort to restrict interest rates, even if well intended, is likely to cause substantial harm to many consumers. Such legislation could, for example, result in credit being denied to young people with little credit history and people with low income -- groups in which the use of credit is particularly important. We further oppose efforts to regulate the grace period and annual fee that a lender may allow or collect. Competition among lenders will

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1 These comments represent the views of the Chicago Regional Office and the Bureaus of Consumer Protection, Competition, and Economics of the Federal Trade Commission, and do not necessarily represent the views of the Commission itself. The Commission has, however, voted to authorize us to submit these comments to you.

result in a variety of credit offerings that should fulfill the divergent credit requirements of consumers. Finally, we believe that requiring disclosures in credit card solicitations may be unnecessary because those who solicit credit card applicants already have ample incentives to provide consumers with information distinguishing their products from those of others.

Our interest in this legislation stems from the Commission's mandate to enforce the antitrust and consumer protection laws of the United States. Section 5 of the Federal Trade Commission Act prohibits unfair methods of competition, and unfair or deceptive acts or practices.[2] In enforcing this statute the Commission staff has gained significant experience in analyzing the impact of various restraints on competition, and the costs and benefits to consumers of such restraints. More specifically, by enforcing the Truth in Lending Act,[3] the Equal Credit Opportunity Act,[4] and the Fair Credit Reporting Act,[5] the Commission staff has gained substantial experience in the area of consumer credit.

Interest Rate Ceilings Injure Consumers

Under current Illinois law, virtually all lenders may charge interest at any rate that is agreed upon by the parties to the credit arrangement.[6] Senate Bills 186, 188, 217, and 895, and House Bills 4, 19, and 413 propose to impose maximum interest rates on credit cards and revolving credit transactions.

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2 15 U.S.C. §§ 45 *et seq.*

3 15 U.S.C. §§ 1601-1677e (1982 & Supp. III 1985).

4 15 U.S.C. §§ 1691-1991f (1982 & Supp. III 1985).

5 15 U.S.C. §§ 1681-1861t (1982 & Supp. III 1985).

6 Ill. Rev. Stat. ch. 17, § 4.2 (1985) permits any state or national bank with its main office in Illinois, a state or federal savings and loan association with its main office in Illinois, or a lender licensed under the Consumer Finance Act or the Sales Finance Agency Act to charge any rate that is agreed upon by the parties to the revolving credit transaction.

However, our experience in enforcing the laws pertaining to consumer credit, as well as the economic literature on maximum pricing regulations,[7] indicates that restrictions on interest rates will usually cause creditors to alter other credit terms, such as those relating to maximum monthly payments, administrative or user fees, grace periods, and criteria for creditworthiness. To the extent that creditors cannot maintain their profit margins by altering these terms, they will simply reduce the total amount of credit extended, thus denying credit to consumers who would otherwise have been able to obtain it.

The reason for this reduction is clear. Lenders themselves have costs of borrowing money from investors as well as costs of administering their loans. If the legislation forces their prices (i.e., the interest rates they can charge) below the level of costs, lenders will either go out of business or will stop making those loans that do not provide at least a competitive rate of return.[8] Alternatively, some Illinois-based creditors

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7 For a comprehensive historical and economic analysis of credit card interest rate regulation in the United States, see DeMuth, The Case Against Credit Card Interest Rate Regulation, 3 Yale J. of Reg. 201 (1986). This article concludes that the supply of credit is highly competitive and that interest rate controls cause artificial contractions in the supply of credit. See also Canner & Fergus, The Economic Effects of Proposed Ceilings on Credit Card Interest Rates, Fed. Reserve Bull., Jan. 1987, at 1; Nathan, Economic Analysis of Usury Laws, 10 J. of Bank Research 200 (1980); Ostas, Effects of Usury Ceilings in the Mortgage Market, 31 J. of Fin. 821 (1976). See also Barth, The Effect of Government Regulations on Personal Loan Markets: A Tobit Estimation of a Microeconomic Model, 37 J. of Fin. 1233 (1982).

8 Villegas, The Impact of Usury Ceilings on Revolving Credit (1986)(unpublished manuscript available from Arizona State University Economics Department); Villegas, An Analysis of the Impact of Interest Rate Ceilings, 37 J. of Fin. 941 (1982).

may choose to transfer their credit card operations to related firms in states with higher or no interest rate ceilings, enabling them to evade the interest rate ceiling in Illinois.[9]

Because the ultimate return from extending credit is a function of the losses from credit defaults as well as the income from interest payments and administrative fees, interest rates may vary with the borrower. A borrower with a long history of timely repayments and a large pool of assets to guarantee repayment can usually obtain lower rates because the expected costs of extending credit to such a borrower are lower. For example, American Express recently has announced a new credit card, the "Optima," with an initial interest rate of 13.5 percent.[10] The card will be marketed only to current American Express card holders with good repayment records. Not all borrowers have such attractive characteristics, yet creditors usually are willing to extend credit to a general pool that includes higher risk borrowers if they are able to charge a higher interest rate.

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9 Under the National Bank Act, a national bank may charge its out-of-state customers an interest rate allowed by its own home state, even when that rate is greater than the interest rate permitted by the state of the bank's nonresident customers. 12 U.S.C. § 85 (1982 and Supp. III 1985). _See also_ _Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv._, 439 U.S. 299, 313-18 (1978) which invalidated a state interest rate ceiling that purported to apply to out-of-state national banks. We note that Section 4.2 of SB 895 proposes to impose all of the credit restrictions and disclosure requirements contained in the bill on out-of-state lenders who solicit Illinois customers through the mail. We take no position, however, on whether or not such a provision is consistent with the National Bank Act.

10 _Charge of the Plastic Brigade_, Time, Mar. 23, 1987, at 52.

If government forces a reduction in allowable interest rates, however, creditors may no longer be able to offer credit to higher risk borrowers with the same freedom they did before.[11] One probable result will be to cut off credit to less well established borrowers, including young people with little credit history, people with low income, or people who have had trouble repaying a loan in the past. In fact, empirical studies in states that have imposed credit card interest rate ceilings show exactly this effect.[12]

In addition, even the credit available to the most qualified borrowers may be extended on less attractive terms, including higher annual fees, lower credit limits, higher monthly payments, shorter or no grace periods, or more time-consuming and costly creditworthiness checks. To increase earnings, bank card issuers may attempt to increase the merchant discount fee -- the fee

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11 Of course, out-of-state national bank creditors still will be free to charge rates higher than the ceiling rate (see supra note 9) and thus could offer credit to these higher risk borrowers. In practice, however, the out-of-state creditors tend to solicit business through mailings and rarely accept unsolicited applications. This may explain why, as discussed infra at note 12, lower income families in states with relatively low interest rate ceilings generally hold fewer credit cards.

12 One study found that the proportion of consumers holding credit cards in Arkansas, a state with an unusually low statutory rate limit, was substantially smaller than that in other states with higher interest rate ceilings. Canner & Fergus, supra note 7, at 10 table 5. A multivariate analysis of the study data (i.e., one that attempted to hold other factors constant) disclosed that "tight ceilings on credit card interest rates are more likely to result in reduced availability of bank credit card accounts for lower- and lower-middle income families than for higher income families." Id. at 10. The tendency of interest rate ceilings to harm lower income groups more than other groups was also found in a New York State study reported in 1975. Id. at 10-11 and table 6.

charged merchants for processing credit card sales.[13] Merchants may in turn pass these costs on to cash customers as well as credit card customers by increasing the cost of their products. Similarly, retail store credit card issuers are likely to increase merchandise prices in an attempt to offset the reduction in finance charge revenue.[14] Such merchandise price increases would harm not only credit card users but also low-income consumers who typically pay cash for merchandise.

Finally, any benefits of lower interest rates will not flow equally to all consumers. Rather, only the estimated 53 percent of consumers who sometimes or usually do not pay off their account balances in full every month -- the "borrowers" -- will enjoy the benefits of lower finance charges on their outstanding balances.[15] "Convenience users" -- the estimated 47 percent of all credit card users and 76 percent of all elderly users who pay off their account balances in full every month and thereby avoid finance charges[16] -- will gain no benefit. In fact, the convenience users are likely to be worse off because of the changes in other credit terms discussed above. Moreover, because of recent tax law changes that make credit card interest charges no longer deductible, it is likely that the number of convenience users soon will increase to more than half of all consumers. Thus, the proposed laws may produce fewer "winners" than "losers."

In addition to placing a ceiling on interest rates, SB 895 also contains two provisions that regulate the terms of the credit contract. The bill would mandate a minimum "grace period" during which an interest charge may not be imposed on new

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13 One study concluded that bank credit card issuers' retailer merchant discount fees were higher in Arkansas, which has a low interest rate ceiling, than in neighboring states with higher interest rate ceilings. Canner & Fergus, _supra_ note 7, at 11-12.

14 That study also found that retail prices for major appliances were an average of 5 percent higher in Arkansas than in neighboring states with higher interest rate ceilings. Canner & Fergus, _supra_ note 7, at 11.

15 _Id._ at 6 table 3.

16 _Id._

purchases. The grace period proposed by SB 895 is longer than is currently provided by most lenders. Most card issuers continue to offer a grace period to "convenience users," those who pay their entire balance at once, but include current purchases in the average daily balance if the consumer chooses not to pay the full amount of the previous balance. In contrast, SB 895 would require that everyone receive a grace period -- i.e., no finance charge -- for the billing period in which they make additional purchases. Thus, the grace period proposed by this bill appears to arbitrarily permit non-convenience users to impose costs on convenience users.

SB 895 would also limit any annual fee to $20. The likely effect of a ceiling on annual fees is the same as that of a ceiling on interest rates. Creditors can be expected to transfer their credit card operations to other states, cut off credit to higher risk borrowers, increase the fees charged to retailers, and take other steps to maintain their profits. We oppose these proposed requirements because we believe that consumers are generally better off in unrestricted credit markets in which competition among lenders provides the desired mix of credit offerings and terms that consumers prefer.

Free Markets Efficiently Allocate Credit

Interest rate ceilings and other restrictions on credit terms are usually unnecessary as well as counterproductive. In the absence of governmental restriction, competition among lenders will result in a variety of credit offerings that fulfill the credit requirements of different consumers. For example, a consumer who frequently defers payment may select a credit plan having relatively substantial initial costs but lower interest charges. In contrast, a consumer who enjoys the convenience of credit purchasing but seldom defers payment may opt for a plan having lower initial costs but higher interest charges. Unrestricted credit markets, unlike regulated credit markets, can efficiently serve such divergent consumer interests.

A free market will provide these services without excessive costs. Competition among lenders results in total costs to consumers that generally reflect no more than creditors' costs -- including losses attributable to bad debt -- and normal profits.[17] Firms that seek to earn supranormal profits will lose business to other creditors.

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17 Canner & Fergus, *supra* note 7, at 1-2.

Studies provide evidence that over time creditors have earned no more than a competitive return on their invested capital.[18] The annual net earnings (before taxes) of bank card plans averaged 1.9 percent of balances outstanding from 1972 through 1985. Over the same period, average net returns on other major types of commercial bank lending were significantly higher: 2.3 percent on real estate mortgages, 2.4 percent on consumer installment debt, and 2.8 percent on commercial and other loans.[19] Retail store credit card plans stand on a somewhat different footing; studies show that those have, on average, consistently operated at a loss, apart from consideration of profit on the goods sold.[20]

Interest on credit card transactions may be higher than interest on other credit transactions because of certain features for which consumers are apparently willing to pay. These features include the availability of a pre-approved line of credit, the lack of collateral requirements, the acceptance of a credit card by large numbers of merchants in various locations, the ability to pay off the amount owed within the grace period in order to avoid incurring any finance charges, and the record of purchases created by using the card. All these features are costly for an issuing creditor to provide, which explains why the relatively high interest rate does not necessarily imply the existence of "excessive" profits to the creditor.

Although general interest rates have fallen substantially in recent years, it is not surprising that credit card interest rates have not fallen as fast as general interest rates. The cost of money, for example, of which interest is one component, constitutes a lower proportion of total costs for credit card operations than for other major types of bank lending.[21] Thus,

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18 In other words, total costs to consumers have equalled creditors' costs -- including losses attributable to bad debt -- and normal profits.

19 Canner & Fergus, <u>supra</u> note 7, at 1-2 (citing Federal Reserve Bank data).

20 <u>Id.</u> at 2 (citing two national surveys of retailers conducted on behalf of the National Retail Merchants Association in 1968 and 1985 and a 1973 study of retailers in New York).

21 Canner & Fergus, <u>supra</u> note 6, at 1-2.

one would not necessarily expect credit card interest rates to go down or up as fast as general interest rates. Furthermore, because other costs of consumer credit, such as operating costs, overhead, and bad debt have continued to rise,[22] some of the benefits to be realized from the falling interest rates have been offset by these other trends.

Moreover, competitive pressures appear now to have forced credit card issuers to offer a variety of attractive credit card plans. In recent months, at least 10 banks in Illinois have begun to advertise interest charges ranging from about 12 percent to 20 percent.[23] In addition, new sources of revolving credit are rapidly developing, such as overdraft credit lines on checking accounts and so-called "mall cards," which provide credit at all retail outlets in a given shopping center. These newer credit offerings, in turn, increase the pressure on conventional credit card issuers to compete for consumer allegiance on the basis of price and other terms. In short, consumer credit markets currently seem to be operating competitively, and there appears to be no need for interest rate regulation.

Disclosure Requirements May Be Unnecessary

If consumers actually value early receipt of credit terms, we would expect credit card issuers to compete in the provision of such information. In fact, some credit card issuers now provide Truth-in-Lending Act disclosures not only in consumer

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22 D. Vite, Consumer Credit Issues (1987) (unpublished manuscript available from the Illinois Retail Merchants Association).

23 Dannen, Credit Card Ceilings Bad For Economy, Consumers, Chi. Daily L. Bull., Apr. 29, 1987, at 2. Moreover, a nationwide survey of sixteen financial institutions found that bank credit card plans had fixed and variable interest rates between 10.5% and 15%. The survey also disclosed that the lower-rate credit card plans offer variety in other important terms, such as annual fees and grace periods. Annual fees ranged from no charge to $22.50, and grace periods of differing lengths were offered by ten of the sixteen institutions. Consumer Action's National Credit Card Survey (1987).

credit contracts but in applications and solicitations as well. Hence, the market already may be responding efficiently to consumers' information needs.

Although we lack direct evidence, it may be possible that the benefits of a state requirement for disclosure of key terms in solicitations to potential credit card applicants would outweigh the costs of such regulation. Mandating disclosure of certain terms in credit card applications (as distinguished from the Truth in Lending Act requirement of disolosure prior to the first transaction) may facilitate comparison shopping by credit card customers. The Commission staff believes, however, that concerns about the adequacy of present credit card disclosures can be sufficiently addressed by limiting disclosures to a few key terms in credit card solicitations.

Specifically, in order to be most effective, a disclosure requirement should be restricted to essential terms, such as the annual fee, the annual percentage rate of interest, and whether there is a grace period. This limitation would avoid overwhelming consumers with details that may detract from the more significant features or that may crowd out other useful information creditors might otherwise provide to consumers. We would also suggest that any disclosure requirements apply only to solicitations that contains an application and not to general advertisements. Increased disclosure requirements could well raise the cost of, and hence discourage, advertising that provides useful information to consumers and increases competition.

SB-895, however, appears to go far beyond requiring disclosure of a few key terms in credit card solicitations. This bill would require advertisements, applications, and solicitations to explain the method of determining the unpaid balance on which the credit service charge will be computed, the method of determining the amount of the credit service charge, and the conditions under which a security interest may be retained or acquired, in addition to disclosing key terms such as the annual fee, the annual percentage rate, and whether there is a grace period.[24] These additional requirements appear to be quite burdensome and may discourage advertising that would otherwise provide useful information to consumers. Requiring that credit terms appear on unsolicited application forms would also appear to present a logistical problem for card issuers who provide merchant displays with application forms. Such card issuers would have to recall their application forms every time they changed the terms of their accounts, or risk misleading consumers as to their current terms. To avoid the costs that would be associated with recalling the application forms, some issuers may simply choose to discontinue their practice of having these forms readily available.

Conclusion

Interest rates should be determined by the market forces that result from competition among lenders to obtain credit customers. Setting an interest rate ceiling lower than the market rate is likely to result in countervailing restrictions on the terms of credit, a reduction in the number of Illinois consumers who do qualify for credit, and a reduction in the aggregate amount of credit that is available to Illinois consumers who qualify for credit. In particular, many low-income consumers who are most in need of credit to buy clothing and other necessities will be less able to do so if interest rate ceilings are imposed. Among consumers who continue to be able to obtain credit, many will find that the advantages of lower interest rates will be offset by larger minimum monthly payments, reduced amounts of available credit, and higher annual fees.

Regulation of grace periods and annual fees in connection with credit card transactions also appears to be contrary to the interests of consumers. As previously discussed, the Commission staff believes that consumers are generally better off when the market is allowed to offer the mix of goods and services that consumers prefer. We further believe that additional disclosure

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24 We further note that Section 4.2(g) of SB 895, by providing that compliance with the Truth in Lending Act meets the disclosure requirements under the bill, appears to be inconsistent with the intent of the new disclosure requirements of Section 4.2(a)(2)(ii). Under the Truth in Lending Act, disclosures are required in advertising only if certain triggering terms are used.

requirements may be unnecessary. We would expect credit card issuers to compete in the early provision of credit terms if consumers actually value such information.

For all of the above reasons, we respectfully recommend that these bills not be enacted. We have referred to a number of studies and other materials, and would be happy to supply copies of them if you so desire. Please let us know if we may be of any further assistance.

Sincerely,

John M. Peterson
Director
Chicago Regional Office