HOUSE BUSINESS & INDUSTRY COMMITTEE

Chairman, Jerry Metcalf, called the Business & Industry Committee to order on January 13, 1983, at 9:00 a.m. in Room 420 of the Capitol Building, Helena, Montana. All members were present except Rep. Hal Harper and Rep. Bob Ellerd, who were excused.

HOUSE BILL 63

REP. JAY FABREGA, District 44, sponsor, stated that House Bill 63 and House Bill 64 were basically to amend the language that the Senate amended out of the 1981 bills. Its removal created problems to the retail merchants and charge card operations of the state. This bill is actually a reenactment of last session's bill. I see both of these bills as consumer issue bills. If you can't borrow it in Montana, you have no choice but to go out of state. If we don't pass this law, it will go back to what the law was before the 1981 session which was unsatisfactory.

JERRY RAUNIG, Montana Automobile Dealers Association, Helena, said two years ago they thought that removal of the limit on interest rates would really stimulate business, and that is exactly what has happened. Many banks who had gotten out of the car finance business are now back in the business and are competing with each other. For the first time in 23 years we are seeing loans being offered at interest rates below prime rate and even below the ceiling you removed in 1981. The 1981 bill has worked and we urge the Committee to give favorable consideration to this bill.

RALPH ANDERSON, Automobile Dealer in Helena, said it was heart warming to see legislation working exactly the way it was intended, and that is for competition to be stimulated.

TIM RYAN, Automobile Dealer from Great Falls, said the rates are coming down sometimes on a weekly basis. It means there is more money available to consumers to buy cars.

KEN HOOVESTOL, Montana Marine Trade Association, Great Falls, and BOB BUSHNELL, Montana Snow Mobile Association, said they were in favor of House Bill 63.

GEORGE ALLEN, Montana Retailers Association, said John Krutar, Professor of Economics, Carroll College, compiled a report on, among other things, "is your current finance charge an increase or decrease over that charged two years ago?" 25% increased; 6% decreased; 58% no change; 11% didn't know. This means 25% showed an increase over two years ago. The majority showed no change. This indicates the system does work and we need no controls. (Exhibit #1)

SAM NOEL, Bank of Montana, Great Falls, said they own their own bank cards. They have $300,000 outstanding on their cards and if this bill would not pass, they would have to move their bank card system outside the State of Montana, which would mean a loss of 20 employees.

IRENE RUSSELL, Russell's Timely, Great Falls, owns a small investment firm. She said if the usury had not been passed two years ago, she would be another business out of business.

ED SHEEHEY, JR., Montana Manufactured Housing, said he supported House Bill 63.

JOHN CADBY, Montana Bankers Association, stated that usury ceilings have significantly reduced the availability of credit and created hardships for those who were supposed to be protected. They have curtailed the amount of credit available to lower income borrowers, harming primarily those individuals whom the ceilings are intended to benefit. (Exhibit #2)

DAVID GROSS, Billings Chamber of Commerce, stated his organization supported House Bill 63.

SEN. CHRIS CHRISTIAENS, said he would like to go on record as supporting House Bill 63.

OPPONENTS: none

CHAIRMAN METCALF: As there are no opponents and these bills are so closely related, we will save questions until after testimony for House Bill 64.

HOUSE BILL 64

REP. FABREGA, District 44, sponsor, said HB 64 removes the ceiling that you can charge for the use of money in Montana to regulated lenders such as credit unions, savings and loans, etc. Going back to federal regulations would be ridiculous. It is sky high. In this bill I want to repeal the Sunset provision and make it a permanent statute of Montana as it is in most states in America.

JEFF KIRKLAND, Montana Credit Unions League, gave lengthy testimony in support of House Bill 64 for the 24 state chartered credit unions in Montana. He said most credit unions today have to offer higher-yielding accounts to retain members who want to earn more than just a passbook rate on their savings. One state-chartered credit union recently had to decrease its new car loan rate from 15% to 13% to compete in its community - a result of the 1981 law. (Exhibit #3)

JOHN CADBY, Montana Bankers Association, stated his association was in full support of HB 64.

OPPONENTS: none

QUESTIONS:

REP. FABREGA: Mr. Kirkland, you stated that 24 state chartered credit unions would be affected by this bill. The federal charter can disregard Montana's usury ceilings? Kirkland: Yes.
REP. ELLISON: Do the feds currently have a usury ceiling? Kirkland: Yes - their current usury ceiling is 21%.

REP. BACHINI: Will the interest rate fluctuate from week to week? Mr. Noel: You will find that most banks are on variable rates. Some banks go quarterly but our bank goes weekly.

REP. METCALF: How has eliminating usury limits over the last two years affected the number of loans you gave and have you had an increase in your lending capacity? Mr. Kirkland:We have found the savings and loan income has increased by 16% over the last year. Rep. Metcalf: How about you bankers? Stan Hill: Over the past two years our loans have been relatively static. We have had about 10% growth and it has kept us in the business.

REP. METCALF: On the retail installment bill...when this bill was passed two years ago, the prime rate was 22% and it's now down to 11%. Retail installment loans seem to be holding at around 18 to 20 percent. Do any of you see retail installment loans coming down in the future if the prime rate continues down? Stan Hill: We may be in one of the more competitive rate environments in consumer lending and we have all looked at the ads that give 10 and 11 percent lending and in lieu of that we have had to decrease our rate. The highest rate we are charging is 17% and that's on unsecured loans.

<u>EXECUTIVE SESSION:</u> <u>HOUSE BILL 63</u>

REP. PAVLOVICH: Are the three senators back who put on the Sunset order? Rep. Metcalf: Sen Christiaens is going to carry this. Now that the Senate has seen the effectiveness over the last two years, there shouldn't be a problem.

REP. WALLIN: I have been in the car business since 1946. We are now involved in competition and competition really works. There were many that couldn't borrow money before this bill was passed. I back it 100%.

REP. BACHINI: How many states have eliminated the usury limits?
REP. KITSELMAN: 38 have eliminated the usury limits.

REP. SCHULTZ moved that HOUSE BILL 63 DO PASS. The motion passed by unanimous vote.

REP. WALLIN moved that HOUSE BILL 64 DO PASS. The motion passed by unanimous vote.

The meeting adjourned at 10:20 a.m.

J. Metcalf
JERRY METCALF, CHAIRMAN

Linda Palmer
Linda Palmer, Secretary

STANDING COMMITTEE REPORT

January 13 19 83

MR. Speaker

We, your committee on Business & Industry

having had under consideration House Bill No. 63

A BILL FOR AN ACT ENTITLED: "AN ACT REMOVING THE PROVISION MAKING THE ELIMINATION OF USURY LIMITS UNDER THE MONTANA RETAIL INSTALLMENT SALES ACT TEMPORARY; PROVIDING ALTERNATIVE METHODS FOR COMPUTING THE FINANCE CHANGE; PROVIDING FOR A MINIMUM FINANCE CHARGE; AMENDING SECTION 5, CHAPTER 276, LAWS OF 1981, AND SECTION 31-1-241, MCA; REPEALING SECTION 2, CHAPTER 276, LAWS OF 1981; AND PROVIDING AN IMMEDIATE EFFECTIVE DATE."

Respectfully report as follows: That House Bill No. 63

DO PASS

....
Chairman.

STATE PUB. CO.
Helena, Mont.

STANDING COMMITTEE REPORT

January 13 19 83

MR. Speaker:

We, your committee on Business & Industry

having had under consideration House Bill No. 64

A BILL FOR AN ACT ENTITLED: "AN ACT REMOVING THE PROVISION MAKING THE ELIMINATION OF USURY LIMITS AS APPLIED TO REGULATED LENDERS TEMPORARY; AMENDING SECTION 8, CHAPTER 275, LAWS OF 1981; REPEALING SECTION 32-1-436, MCA; AND PROVIDING AN IMMEDIATE EFFECTIVE DATE."

Respectfully report as follows: That House Bill No. 64

DO PASS

Chairman.

STATE PUB. CO.
Helena, Mont.

VISITORS' REGISTER

HOUSE Bus & Industry COMMITTEE

BILL HB 63 & 64 Date 1-13-83

SPONSOR Fabrega

NAME	RESIDENCE	REPRESENTING	SUPPORT	OPPOSE
JOHN CADBY	706 HARRISON, HELENA	MT BANKERS ASSN	✓	
George E Allen	1600 Highland	Mt Retail Assn	✓	
[illegible] Morton	Kalispell, Montana	Montana Bankers Assoc.	✓	
Stan Hill	3800 Palisades Pk Dr Blgs	Mont. Bankers Assoc	✓	
[illegible]	311 E [illegible] [illegible] Mt.	Montana Bankers Ass.	✓	
George T. [illegible]	1115 Stewart - Helena	Montana Bankers	✓	
[illegible] Kirkland	2842 Festival Road	Montana Credit Unions League	✓	
Irene A. Russell	901-9th St No. Gt Falls	Russell's [illegible]	✓	
David G. Goss	Billings, MT	[illegible]	✓	
RON Vihinen	GREAT FALLS MT	MT BANKERS ASSOC	✓	
LEN Ritzschke	Gt Falls	MT " "	✓	
Jerry Rauning	Helena	Mt. Auto Dealers Assn	✓	
Wm. Ryan	GREAT FALLS	Don Ryan Cars	✓	
RALPH ANDERSEN	HELENA	CAPITOL FORD	✓	
Gene Rice	Helena	State Capitol Employees C.U.	✓	
[illegible]	Helena	Mt. Manufactured Housing Assoc	✓	
Ken Hoovestol	Gt. Falls	Mt. Marine Trade Assn	✓	
Robert Bushnell	Helena	Mt Snowmobile assn	✓	
Chris Christiaens	Gt Falls	Senator	—	
L. Walker	Helena	Dep't of Commerce	✓	

IF YOU CARE TO WRITE COMMENTS, ASK SECRETARY FOR LONGER FORM.

PLEASE LEAVE PREPARED STATEMENT WITH SECRETARY.

Form CS-33
1-81

VISITORS' REGISTER

HOUSE Bus & Ind. COMMITTEE

BILL HB 63 + 64 Date 1-13-83

SPONSOR

NAME	RESIDENCE	REPRESENTING	SUPPORT	OPPOSE
Mike Cronin	615 N. Davis	MT Bankers Assoc	✓	
Herbert Walberg Jr	Blue Sky Heights, Clancy	Mt. Credit Union League	✓	
J. Fallan	Helena	Mont. Ch	✓	
Sam Noel	Great Falls	Bank of Montana System	✓	
Joseph Morales	Alhambra, CA	Sears, Roebuck and Co	✓	

IF YOU CARE TO WRITE COMMENTS, ASK SECRETARY FOR LONGER FORM.

PLEASE LEAVE PREPARED STATEMENT WITH SECRETARY.

Form CS-33
1-81

Exhibit #1

House Bill 63

Mr. Chairman and Members of the Committee:

My name is George Allen, registered lobbyist for the Montana Retail Association. I am here today in support of House Bill 63, which changes the way finance charges are computed.

During the last session the legislature lifted the ceiling on revolving credit, and it was also determined that finance charges must be computed on the adjusted month end balance.

The bill you have before you today gives the store three options:

1. Adjusted month end balance.
2. Average daily balance.
3. An average daily balance within a $10.00 radius.

Some companies that do business outside Montana have a real problem with our present law. As you know, we are in the computer age. Computers are programed to charge a certain percentage rate. For example, in the Western states Idaho, Utah, Colorado, Wyoming, North Dakota and South Dakota, the interest rates are all computed the same way. But when they send their statements to Montana they find they must reprogram their computer to accomodate our billing law. This creates more expense that eventually gets past on to the consumer.

Computing finance charges on adjusted month end balance is an unfair method. Some of the credit card people have raised their finance charge from 18% to 21% just to stay even with what was generated two years ago.

For example: The moneys received through finance charges figured at 18% on an average daily balance, are just about the same as the moneys received on the finance charge figured at 21% based on an adjusted month end balance. This appears to our customers that the finance charge percentage rate is higher in Montana than in the surrounding states. While it is true that the percentage rate is higher, it is not true that the actual moneys paid for the use of credit is higher. This is one example of well intended legislation that ends up confusing the customer.

For a businessman to extend credit he must consider three things:

1. His cost of borrowed money;
2. His cost of bad debts;
3. His cost of administration.

It is easy for some one to compare the New York prime rate of 11% or 12% or whatever, with the interest rates charged by a business of 18% or 21% and feel the business is making a great profit when they are not.

When you consider the three factors that must be included in establishing a rate you can see a company is lucky if it breaks even. Very few companies in the West can borrow at the New Yrok prime rate. We must pay "in house prime" at the local banks, which is almost always higher than the well publicized New York prime.

In the past two years Montana has had a deregulation of interest rates. We all wanted to know if the free interprize system works, would competition hold the line. To help us see the true picture of what has actually happened we wanted an independent, unbiased opinion. We hired John Krutar, Professor of Economics, Carroll College, to help us find some answers. His report is attached to my testimony.

One of the most important questions we were interested in (is your current finance charge an increase or decrease over that charged two years ago.)

Results show:

25% increased
6% decreased
58% no change
11% didn't know

As you can see, 25% indicated an increase over two years ago. The important thing to realize here is that the increase of all but two stores raised their interest rates from zero to 18%. Only two stores raised their interest rates above 18%. The stores that raised from zero to 18% showed that they charged no interest rates previously. The majority - 58% - showed no change. This indicates the system does work and we need no controls.

The survey also pointed out that most retailers would rather not extend credit at all, but find it necessary in order to survive. Moneys received on interest rates do not pay for expenses of hiring money, cover losses for bad credit, ~~nor~~ and pay for administration.

I'd like to call your attention to the last couple of sentences on the survey that say, "there has never been a period of time in recent history when general credit conditions have provided a more legitimate reason to adjust interest rate charges upwards. Perhaps Montana retail merchants are uncomfortable with charging their customers higher interest rates and prefer instead to utilize restrictive credit policies to survive the times."

As can readily be seen, deregulation of interest rates and how billing procedures affect the retailer are important issues. Each individual retailor needs to be able to choose which of the three options, as proposed by House Bill 63, will best benefit his business. House Bill 63 is an important bill and the retailers of Montana support it.

I'd like to give you a few highlights of the survey done by Mr. Krutar. He contacted ten different types of businesses in eighteen towns around Montana, asking seven specific questions regarding credit. The survey pointed out that after all the information was pulled together, the retail community did not abuse their new-found freedom to set their own interest rates.

It is also important to point out to you that in order to continue offering credit to our customers, we need the flexibility that this bill gives us. We urge you to support House Bill 63.

Respectfully Submitted,

George E. Allen
Executive Vice-President
Montana Retail Association

1621 Broadway
Helena, MT 59601
December 23, 1982

Mr. George Allen
Executive Director
Montana Retailers Association
34 West Sixth Street
Helena, MT 59601

Dear Mr. Allen:

Enclosed is a summary of results from the telephone survey I recently conducted to ascertain credit policies of Montana retailers. I am also enclosing the support documents including the original list of merchants, the random numbers program, and the actual questionnaire form.

If I can be of further assistance, please do not hesitate to contact me.

Sincerely,

Jon A. Krutar
Economist

Attachments

4B65

ANALYSIS OF MONTANA RETAIL MERCHANT CREDIT POLICIES

December, 1982

HB 63

During mid-December Montana retail merchants were contacted by telephone and asked questions regarding their retail credit policies. Sixty names were randomly selected from a list of 153 provided by the Montana Retailers Association. The analysis which follows revolves around the answers provided by fifty of the merchants contacted. The remaining ten were either not available or not willing to answer questions regarding their credit policies.

Any sample of an entire population is, by definition, not a complete representation. However; the size, type, and geographical distribution of the sample, and the consistent responses received allow the analyst to draw several conclusions with a comfortable degree of confidence.

Tables I and II indicate the distribution of retailers by business classification and geographical location, respectively.

TABLE I

Business Type	Number
Appliance	2
Business Machines and Supplies	3
Clothing and Shoes	18
Drug	1
Furniture and Flooring	10
Hardware	7
Jewelry	3
Photo and Printing	2
Sports	3
Tire	1

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TABLE II

Location	Number
Billings	6
Bozeman	3
Butte	5
Conrad	2
Culbertson	1
Dillon	1
Glasgow	1
Glendive	1
Great Falls	5
Havre	1
Helena	6
Kalispell	2
Lewistown	2
Malta	3
Miles City	2
Missoula	6
Shelby	1
Wolf Point	2

Seven separate questions were asked key personnel who were familiar with each firm's credit policies. Summary results for each question are provided, followed by interpretative comments.

Question One - Do you extend credit?

Yes - without qualification	72%
Yes - with qualification	24%
No	4%

Those answering "no" to this question were included in the sample since they had just recently eliminated credit to customers. The "qualified yes" respondents tended to confine their credit offerings to a low risk clientele such as established businesses, government agencies, or select consumers.

Question Two - Do you use a finance charge for your credit accounts?

Yes - without qualification	62%
Yes - with qualification	13%
No	25%

The percentages shown here are based on the forty-eight businesses who answered the first question affirmatively. The qualified responses indicated that finance charges are not universally applied to all credit customers or are only applied after a specified grace period of thirty to sixty days.

Question Three - What is the annual percentage rate of your finance charge?

Rate	Percentage of those using a finance charge
17%	3%
18%	69%
21%	3%
22%	3%
24%	5%
Don't know or would not reveal	17%

In order to properly interpret the results of this question, it must be remembered that the first two questions naturally reduced the number of responses, i.e., those indicating they did not extend credit or did not use a finance charge are not included here. The data suggests that an annual interest rate of 18% is favored by over two-thirds of the sample group.

Question Four - Is your current finance charge an increase or a decrease over your rate two years ago?

Increase	25%
Decrease	6%
No Change	58%
Don't Know	11%

Again, the above percentages are with respect to only those presently using financial charges. It appears that very few retailers have adjusted the numerical value of their financial charges, particularly when one considers that over half of those indicating an increase had just recently implemented a charge. Only two respondents indicated an increase from their 18% rate charged two years ago.

Question Five - Has the number of your charge accounts changed during the past two years?

Increase	22%
Decrease	38%
No Change	36%
Don't Know	4%

The answers to this question, combined with those of the prior question, suggest a couple possible hypotheses.

JB 63

The higher rates charged could tend to reduce the number of credit accounts, or as credit conditions have worsened over the past two years, merchants may have relied more heavily on restricting credit availability than relying upon the automatic rationing effects of higher finance charges. Examining specific responses, the questionnaire reveals that only a third of those merchants who raised their charges noted that the amount of credit extended had decreased. It appears other factors are operating to reduce the number of charge accounts.

Question Six - Are you currently extending credit to new customers?

Yes - without qualification	44%
Yes - with qualification	34%
No	22%

The results of this question initially seem to be in conflict with those of the prior question. Merchants could be actively extending additional credit and discovering the number of charge accounts declining or staying the same only if business in general was in a slump and/or finance charges were escalating. As suggested, the data does not seem to support the latter. While the general economic slowdown could certainly explain part of the apparent disparity between the responses to the two questions, an additional possibility seems very likely. The degree to which those questioned qualified their "yes" responses to this question is quite significant, particularly since such qualifications were totally unsolicited. The nature of the comments indicates retailers are making a sincere effort to carefully screen applicants in today's depressed economic climate. The number of qualified "yes" responses would undoubtedly have been even higher had the interviewer specifically solicited qualifications. The overall number of positive responses probably also reflects a merchant's tendency not to discourage potential business.

Question Seven - Do you have any additional comments about your retail credit in general?

Yes	56%
No	44%

The magnitude of "yes" responses to this open-ended question, particularly during the busy holiday season, suggests retail merchants are extremely concerned with customer credit. The nature of the comments is even more revealing. A consistent theme is that retailers are not particularly enthusiastic about being in the credit business, but perceive it as a necessary requisite for their businesses. Numerous comments also support an earlier hypothesis that the dismal state of the economy is forcing them to ration credit more carefully, typically relying on more stringent screening as opposed to adjusting finance charges. Those merchants who commented favorably upon their credit

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approach stressed their cautious approach, while those expressing dissatisfaction focused their comments on problems of collections. Several mentioned they were relying more heavily on third party lenders such as banks, credit cards, and finance companies. In general, the merchants do not seem to view charging customers for extending credit as part of their revenue generating operations, but instead accept such a responsibility as a necessary part of surviving in the present business climate.

Summary

The random merchants contacted by telephone were asked to respond to seven questions regarding their retail credit policies. Some of the questions asked participants to contrast their present policies with those of two years ago in an attempt to determine if there was significant change in lending behavior as a result of legislation removing finance charge ceilings. Unfortunately, in this case, as in all cases of economic research, other factors change as well and a completely controlled experiment is not possible. The deterioration of the economy during this two-year period has obviously been a major factor in determining retail merchants' credit policies. An argument could be made that in an attempt to maintain sales, merchants have responded by actively extending new credit. An opposite possibility is that retailers, faced with

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mounting uncollectibles as well as increased charges and stringent credit requirements from wholesalers, have retreated from aggressive retail credit offerings. Both the data and comments collected tend to support the latter thesis as the dominant response.

General national and state statistics as well as the data provided by the survey suggest that over the past two years, consumer demand for credit has been rising relative to merchants' desire to provide it. Given this scenario, retail merchants have had two options. They can either allow the marketplace to ration credit by increasing interest charges, or they can implement more selective credit practices. The data acquired through the telephone survey indicate Montana retailers have preferred to ration by restricting those eligible for credit. It is impossible to discern whether this reaction has been one of conducting business as usual with the old finance charge, or a result of a common perception about a "just" interest charge. Since Montana merchants had previously faced interest rate ceilings, it is possible they failed to respond to the opportunity to raise their charges because of ignorance of the new law or just because of habit. Whatever the reason, there has never been a period of time in recent history when general credit conditions have provided a more legitimate reason to adjust interest rate charges upwards. Perhaps Montana retail merchants are uncomfortable with charging their customers higher interest rates and prefer instead to utilize restrictive credit policies to survive the times.

EXHIBIT #2

MONTANA BANKERS ASSOCIATION

Testimony on House Bill 64

House Business and Industry Committee

9:00 a.m.
Room 420

Thursday
January 13, 1983

Mr. Chairman and Members of the Committee:

My name is John Cadby. I am executive vice president of the Montana Bankers Association. Our association consists of large and small, independent and system, state and national, city and rural, or approximately 98% of all banks in the state of Montana. In their behalf, we thank you for giving us this opportunity to speak in support of House Bill 64.

A multitude of studies have been made on interest rate ceilings. From the attached study are the conclusions by Donna Vandenbrink, an economist for the Federal Reserve Bank of Chicago:

> "Economic research clearly supports the current legislative moves toward deregulation of usury ceilings. The evidence on the impact of usury ceilings shows that they have not achieved their objectives. According to the empirical studies surveyed, usury ceilings have significantly reduced the availability of credit and created hardships for those who were supposed to be protected. Ceilings have encouraged lenders to use such credit rationing devices as higher down payments, shorter maturities, and higher fees for related noncredit services, which increase the effective interest rate. They have curtailed the amount of credit available to lower income borrowers, harming primarily those individuals whom the ceilings are intended to benefit. Finally, the lack of uniformity of usury laws across states has distorted credit flows and economic activity, favoring those states and regions which are less regulated".

We have additional studies on the subject of interest rates by experts throughout the nation, if the committee would like more information on the subject. Virtually every study reaches the same conclusions and supports the position taken by the 1981 Legislature in exempting financial institutions from interest rate ceilings. We urge passage of HB 64 to permanently remove these ceilings for the betterment of Montana's economy.

'B64

The effects of usury ceilings

Donna Vandenbrink

Regulations designed to prevent usury, or the taking of "excessive" interest, have been debated from the time of Moses. Today, as a result of a prolonged period of high inflation, record interest rates, and sluggish economic growth, the usury ceilings in effect in many states are the center of controversy. Are the critics of these usury ceilings simply speaking out of self-interest when they argue that interest rate ceilings work to consumers' disadvantage by restricting credit flows and distorting financial markets? Do usury ceilings protect consumers from abusive lending practices and enable them to obtain loans at reasonable rates, as their advocates claim?

Recent legislation, at both the federal and state levels, has been in the direction of relaxing interest rate controls. The 1980 Depository Institutions Deregulation and Monetary Control Act overrode state interest ceilings on some categories of loans, and additional federal action may be forthcoming. At the same time, many state legislatures have revised their usury statutes. In large part, these recent changes in usury regulation have been in response to the current economic situation. But is deregulation of usury ceilings desirable? And if it is desirable, should it be left to the states or is it best accomplished by federal preemption? This article surveys the economic research on usury ceilings in order to help answer these questions.

Usury ceilings in a competitive market: the theoretical arguments

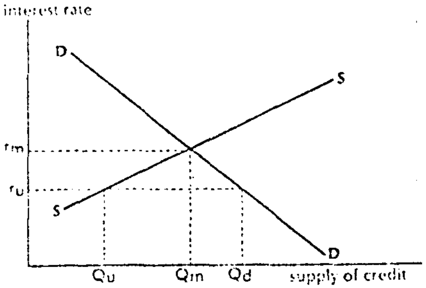
In economic theory, the credit market is viewed like any other market.[1] There are buyers (borrowers) and sellers (lenders) of credit; the price of credit is the interest rate. The credit market is easily represented in a conventional supply and demand diagram (see figure). The demand curve indicates the amount of credit borrowers are willing to purchase at various prices (interest rates). The supply curve indicates how lenders' marginal cost of funds varies with the amount of credit supplied and, thus, the amount of credit they are willing to grant at various interest rates, assuming the market is competitive. According to theory, borrowers and lenders will eventually establish an equilibrium in the market at a price which just balances the supply and demand for credit. We can call this price the market rate of interest. Such a rate is shown as r_m.

Usury laws stipulate a maximum rate of interest which lenders may legally charge. When a usury law is introduced, it may alter the way in which both price and quantity are determined in the credit market. Exactly what happens depends on the level of the usury ceiling relative to the market rate. When the legal ceiling is above the market rate of interest (r_m), the law has no effect at all. The market forces of supply and demand are unconstrained by the usury ceiling, and the equilibrium price and quantity of credit are unchanged. However, when the legal ceiling is below r_m, the regulation does affect the market outcome. Such a usury ceiling, like the rate r_u in the figure, is said to be binding or effective.[2] A binding ceiling obviously alters the price of credit—the ceiling rate becomes the rate of interest charged. Therefore, if the market rate r_m were considered too high, a usury ceiling of r_u would lower the rate of interest for those borrowers who were able to obtain credit.

However, establishing a lower-than-market interest rate by means of a usury ceiling will also bring about a decrease in the quantity of credit supplied. Given lenders' costs (as reflected in the supply curve shown in the figure), the most credit which they will provide when the interest rate is held down to r_u is Q_u. Therefore, the binding usury ceiling will lead to a reduction from Q_m to Q_u in the amount of credit supplied. Furthermore, in contrast to the situation in the unregulated market, this amount of credit will not satisfy all those who are willing to borrow at the ceiling price. The usury ceiling creates a situation of excess demand with borrowers seeking an amount of credit, Q_d, that exceeds the amount supplied by lenders, Q_u. Borrowers are prevented by the ceiling from bidding to obtain more credit and lenders will not provide any more credit at the legal maximum interest rate. Thus, at the legal ceiling price the reduced amount of credit must be rationed among borrowers by some means other than price.

The important implication of this straightforward supply-demand analysis is that usury laws can succeed in holding interest rates below their market levels only at the expense of reducing the supply of credit to borrowers.

The effects of a binding usury ceiling



The effect of usury ceilings on the quantity of credit supplied: the evidence

Potential borrowers would surely find it less than desirable if binding interest rate ceilings did have the predicted effect on the supply of credit. In order to test this predicted relationship and to measure its importance, investigators have examined a number of different credit markets.

Because commercial loans are usually exempt from state usury ceilings, there have not been many studies of the effects of usury ceilings on commercial lending. In one of the few such studies, Robert Keleher of the Federal Reserve Bank of Atlanta [9] determined that banks in Tennessee extended fewer commercial loans the further market interest rates rose above the state's 10 percent usury ceiling.[3]

More widely studied has been the mortgage market, where binding usury ceilings also have been found to have very restrictive effects on credit supplies. The Federal Reserve Bank of Minneapolis [3, 20] analyzed Minnesota's experience with an 8 percent usury ceiling on conventional home mortgages. In this case, the usury ceiling had a significant impact on the composition of mortgage credit even though the total volume of mortgage lending apparently was unaffected. The Minneapolis study found that when market rates climbed to between 9 and 10 percent in 1973-74, home financing in Minnesota shifted substantially from conventional mortgages that were subject to the ceiling to FHA or VA loans that were exempt from the ceiling. About 40 percent of all new mortgage loans issued in the state in late 1974 were FHA-insured, almost double the usual share, and conventional mortgages were virtually unavailable in the Twin Cities.

More formal analyses of the effect of

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[1] For a simple theoretical treatment of usury ceilings see Chapter 9 in James Van Horne [25]. For a more advanced discussion see Rudolph C. Blitz and Millard F. Long [2].

[2] What has happened in many states over the last decade is that for various economic reasons market interest rates have risen above what were initially nonbinding statutory ceilings. While the ceilings always existed, only recently have they begun to impinge on the market.

[3] The exceptions were loans to nondurable and durable manufacturing and loans to service industries. Keleher speculates that these loans were not adversely affected by the ceiling because of previous commitments, strong customer relationships, and nonprice rationing.

usury ceilings on the supply of mortgage credit were carried out by James Ostas [16], Philip Robins [19], and James McNulty [12]. Ostas and Robins approached the issue indirectly, looking at the impact of ceilings on home building rather than on mortgage lending. Ostas estimated that the number of authorized housing permits fell by 11 to 19 percent for every one percentage point that the market rate was above the usury ceiling. Robins found that for each percentage point by which market rates exceeded usury limits, single-family housing construction was reduced by 16 percent. Looking directly at mortgage lending, McNulty found that usury ceilings have an impact on the supply of credit even before the average market rate hits the ceiling. He estimated that as the average market rate rose from a point below, but still close to the ceiling, mortgage lending was lowered 7.5 to 12.5 percent for each 1 percentage point rise in the market rate relative to the ceiling.[4]

Usury ceilings appear to have some adverse effect on the supply of consumer credit as well. In a technical study for the National Commission on Consumer Finance (NCCF), Robert Shay [21] found that state usury ceilings had a small but statistically significant negative effect on the number of consumer loans extended. Each 1 percentage point decrease in the usury ceiling on small loans was associated with 18 fewer loans per 10,000 families.[5] In addition, Shay found that lower rate ceilings were associated with fewer new auto loans. However, he found no significant effect on the supply of credit to purchase other consumer goods (mobile homes, boats, aircraft, and recreational vehicles).

The Credit Research Center (CRC) at Purdue University has conducted several studies of usury ceilings and consumer credit. In one such study, Johnson and Sullivan [8] found that a 1977 change in Massachusetts law which lowered the usury ceiling on small loans was an important factor in the 12.5 percent drop in the amount of such loans outstanding in that state between 1975 and 1979.

In another study for the CRC, Richard Peterson [17] compared urban consumer credit markets in Arkansas, which had a 10 percent comprehensive usury ceiling, with similar credit markets in Illinois, Wisconsin, and Louisiana, which had less restrictive ceilings. Although he found that residents of Arkansas obtained as much (or more) credit overall as consumers in the other states studied, he also found that consumers in Arkansas obtained significantly less *cash* credit and more point-of-sale credit (retail credit and credit cards) than their counterparts in the states with less restrictive ceilings. Here, as in the Minnesota mortgage market, the usury ceiling apparently did not reduce the total supply of credit, but it did cause consumers to substitute one type of credit for another—and, importantly, the change in the mix of credit favored lenders rather than consumers. Merchants and dealers who issue point-of-sale credit can compensate for the reduced profitability of their credit operations by raising prices on the goods they sell.

Noninterest credit conditions: usury ceilings and credit rationing

Altogether, the empirical research on the effects of usury ceilings largely substantiates the argument that binding usury ceilings lead to a reduction in the amount of credit provided by lenders. But credit transactions involve a number of terms other than the interest rate. Usury ceilings determine the price that lenders can charge, but they do not constrain the other conditions that lenders may choose to offer. Faced with a bind usury ceiling, lenders may be expected alter these noninterest conditions in orde

[4]Despite finding this impact on the number of loans extended, McNulty did not find that Georgia's ceiling had a significant impact on housing construction. McNulty believed this was because Georgia's ceiling was only moderately, and briefly, restrictive during the period under study.

[5]Shay also found a positive but insignificant relationship between the dollar volume of loan extensions and usury ceilings. If the average size of each loan were to rise while the number of loans fell, the usury ceiling might not affect the total dollar volume of loans extended.

achieve a higher effective return on the smaller amount of credit they will offer. For example, by such means as strengthening loan terms, adjusting borrower-screening criteria, or increasing noninterest fees and charges, lenders may be able to skirt the impact of usury ceilings on their overall profitability. It is important to consider how these strategies affect the borrowing public.

As pointed out above, under binding usury ceilings borrowers demand more credit than lenders are willing to provide. This requires lenders to rely on nonprice means to allocate credit among potential borrowers. Many of the strategies lenders are likely to follow in this situation can be expected to concentrate the impact of usury ceilings on certain borrowers. For example, making loan terms more stringent reallocates credit away from those who are unable to afford larger down payments or the larger monthly payments necessitated by shorter maturities and higher minimum loan size. Determining credit-worthiness according to individual borrower characteristics rations credit away from high-risk consumers who might be willing to pay higher-than-ceiling rates. Finally, adding noninterest charges eliminates from the market those for whom these extra costs are too great.

By encouraging these lending practices, usury ceilings may fail to give consumers the protection and benefits which they were intended to provide. For example, usury laws may work against the goal of ensuring that credit is available to small, inexperienced borrowers. When lenders ration credit by some means other than price, small borrowers, low-income borrowers, and high-risk borrowers are likely to find it more difficult to obtain credit. Prime borrowers, on the other hand, may obtain even more credit than they would have at normal market interest rates. Furthermore, when lenders institute noninterest charges to compensate for interest rate ceilings, they effectively raise the cost of credit for the successful borrower. This means that, while a ceiling may reduce the explicit price of credit (the interest rate), it may not result in lower overall costs of borrowing even for those able to obtain loans. The noninterest charges also make it more complicated for customers to comprehend the total cost of borrowing and make it more difficult to make well-informed credit decisions.

These lending practices and their undesirable consequences may exist in the absence of interest rate ceilings. However, some empirical studies have found that the extent to which these devices are used is influenced by the restrictiveness of usury laws. Several studies have established that loan terms do become less favorable to borrowers when usury ceilings become more restrictive. For example, the Minneapolis Federal Reserve Bank [3, 20] found that during one period when Minnesota's ceiling on mortgage loans was binding, the average maturity of conventional mortgages in the Minneapolis-St. Paul SMSA fell significantly. The same study found that required down payments increased much more sharply in the Twin Cities compared with SMSAs not subject to binding usury ceilings. Similarly, according to the New York State Banking Department [10], down payment requirements increased and maximum maturities decreased during the 1974 credit crunch when market interest rates rose above New York's 8.5 percent ceiling on mortgage loans.

Phaup and Hinton [18] actually measured the magnitudes of the changes in noninterest mortgage terms due to New York's usury ceiling. Using data on new mortgage lending for single-family dwellings in Schenectady, New York for 1961 through 1976, they estimated that for each 1 percentage point the market rate rose above the usury ceiling, there was a 4 percent shortening of mortgage maturities and an 8 percent decline in loan-to-value ratios.[6]

Peterson's study [17] indicated that usury ceilings have similar impacts on noninterest loan terms in the consumer credit market.

[6]Ostas also found mortgage down payments were larger and maturities shorter, the more binding the usury ceiling. The maturity effect, however, was not statistically significant.

This study found that maturities of auto loans in Arkansas were shorter than in states with less restrictive usury laws. In addition, the average minimum size for personal loans at commercial banks and credit unions was 2.5 times larger in Arkansas than in other states covered by the study. Peterson found that Arkansas lenders charged higher fees for mortgage credit investigations and appraisal than did lenders in other states with less restrictive interest rate ceilings. Arkansas residents also paid higher charges for checking accounts and overdrafts. (Moreover, retailers faced bigger discounts and less desirable terms when selling their retail credit contracts to other creditors.)

Empirical research has also tended to confirm the expectation that the burden of usury ceilings falls unevenly on the borrowing public. The availability of credit to certain groups of borrowers appears to depend on the restrictiveness of usury ceilings. Peterson, for example, found that cash credit was significantly less available to low-income and high-risk borrowers when usury ceilings were more restrictive. The lowest income group and the three highest risk groups of consumers in Arkansas obtained a larger proportion of their credit from point-of-sale sources than in other states in the study with more liberal interest rate ceilings. In their study of the Schenectady, New York mortgage market, Phaup and Hinton [18] found that lower income areas felt the impact of usury regulations on mortgage lending activity more than other areas. They found that mortgage activity in census tracts of the lowest economic stratum was more sensitive to the usury ceiling and to noninterest credit terms than mortgage lending in tracts characterized by higher economic status. Johnson and Sullivan [9] found that Massachusetts' lowered ceiling had a greater impact on the availability of small regulated loans than of large ones, particularly at small, local finance companies. They concluded that less prosperous consumers who needed and could afford only small loans "were progressively excised from this portion of the legal cash loan market" (p. 14).

The survey data collected by the National Commission on Consumer Finance (NCCF) have been used in several studies of the impact of usury ceilings on consumer credit markets. Greer's [7] analysis showed that differences in finance company rejection rates were closely related to differences in state usury ceilings. The lower were rate ceilings, the higher was the rate of rejection for personal loan applicants. Greer concluded from this study that, with higher allowable interest rates, lenders are more willing to accept risky borrowers and, consequently, binding ceilings make it more difficult for riskier borrowers to obtain credit. Finally, using the same NCCF data, Shay [21] found additional evidence that high-risk borrowers are most affected by usury ceilings. Generally, higher-risk borrowers obtain credit through auto dealers and finance companies rather than banks. The fact that the higher rate ceilings specifically applicable to auto dealers and finance companies were found to be responsible for curtailed credit in the new auto and personal loan markets led Shay to conclude that the burden of the ceilings falls largely on those whose credit standing is weakest.

The broad conclusion that emerges from these empirical studies is that usury ceilings create a climate in which lenders are able to pursue practices unfavorable to some or all borrowers. On balance, usury ceilings appear to be a type of regulation whose benefits to borrowers are extremely questionable. The primary benefit is a lower-than-market interest rate. But, depending on lenders' actions, borrowers may end up facing higher noninterest credit charges and less favorable terms as a result of usury ceilings. Moreover, attached to the lower-interest benefit of usury ceilings is a direct cost to the borrowing public in the form of a reduced supply of credit. Furthermore, it is likely that the cost of restricted credit availability falls disproportionately on high-risk, low-income borrowers—those whom usury ceilings are usually designed to protect.

Thus far, usury ceilings have been discussed in terms of their effect on individual

borrowers. Usury ceilings also affect consumers and the economy in a more general way. This broader impact is a consequence of the particular way in which interest rate regulation has been implemented in the United States.

Diversity of usury ceilings. Since colonial times, the responsibility for regulating interest rates on credit has rested with the states. As credit markets have evolved since that time, states have developed complex sets of statutes which apply to specific types of lenders and specific types of credit, often with different limits depending on the size of the loan. As a result, there is great diversity in the coverage of interest rate ceilings within individual states.[7] Furthermore, there is also great diversity in ceiling rates and coverage across states.

These legal arrangements have important implications for the economic impact of usury ceilings. Lack of uniformity of limits and coverage means that some forms of credit are constrained by ceilings while others are not. Under these circumstances, lenders will want to shift their portfolios into loan categories which are not subject to binding ceilings.[8]

State-imposed usury laws establish interest rate ceilings on credit extended to borrowers within a particular state. But, since credit markets are not confined by state boundaries, lenders may find it more attractive to extend credit across state lines to borrowers in states which offer less constraining usury laws. Thus, interstate differences in limits and coverage will distort the geographic distribution of credit and alter the allocation of funds to credit-sensitive economic activities.

Many of the studies cited previously provide implicit support for the notion that the diversity of usury ceilings among states affects the geographic distribution of credit. Studies comparing loan volumes across states with different usury ceilings suggest also that credit availability varies among states depending on the restrictiveness of their usury ceilings.

A study by the staff of the New York State Banking Department [10] shows somewhat more directly how credit flows away from states with restrictive usury ceilings. The study found that during the period 1966 to 1974, when national mortgage market rates were almost continuously above New York's usury ceiling, savings and loans in New York increased their proportion of out-of-state mortgage holdings from 6.5 percent to over 18 percent. Over the same period, in-state conventional mortgage holdings by these institutions fell from 67 percent of total assets to 47 percent and from 75 percent of total mortgages to 57 percent. Clearly, New York State S&Ls responded to the ceiling which bound in-state conventional mortgage rates by increasing their relative holdings of uncovered loan categories, including out-of-state mortgages.[9]

In the long run, state differentials in usury ceilings may even influence the location of suppliers of credit and of credit-sensitive economic activities. Arkansas, which had a low, comprehensive 10 percent usury ceiling, provides several examples of the locational effects. There are no consumer finance

[7]A 1981 listing by the Financial Institutions Bureau of the Michigan State Department of Commerce contains 25 different loan categories subject to interest rate ceilings imposed by state law. The effective maximum rates ranged from 5 percent on personal loans by individuals for nonbusiness purposes to 36 percent on loans by pawnbrokers. A 1980 survey of Iowa usury laws summarized that state's current interest rate ceilings under 9 categories, with maximum permitted rates ranging from 5 percent (the legal rate) to 36 percent (the maximum rate on the first $500 of a loan by a chattel loan licensee).

[8]For example, according to an article in *Business Week*, March 22, 1982, finance companies are switching emphasis from consumer lending to commercial lending in part because commercial loans are generally exempt from usury regulation while consumer loan charges are not.

[9]Savings banks and state-chartered commercial banks did not exhibit the same large, steady increase in the proportion of out-of-state mortgage holdings. However, New York State savings banks already held almost one-half of their mortgages on out-of-state properties. Furthermore, in-state conventional mortgages, those subject to the ceiling, comprised very small proportions of the total assets of savings banks (approximately 12 percent) and commercial banks (approximately 2 percent) compared with S&Ls.

How ceilings vary among Seventh District states

	First mortgage	New auto loan	Bank credit card	Unsecured personal instalment loan*
Illinois	No limit by state law	No limit	No limit	No limit
Indiana	No limit by state law	←	21% or {36% on unpaid balance to $540; 18% on unpaid balance to $1,800; 15% on unpaid balance over $1,800}	→
Iowa	No limit by state law	21%	18% on unpaid balance to $500 15% on remainder	31% of unpaid balance to $150 24% of unpaid balance to $300 18% of unpaid balance to $700 12% of unpaid balance to $2,000
Michigan	No limit due to federal override	16.5%	18%	18% or {31% of unpaid balance to $500; 13% of unpaid balance to $3,000}
Wisconsin	No limit by state law	Greater of 18% or 6-month T-bill rate + 6%	18% or no limit when 2-year T-bill rate remains above 15% for 5 consecutive Thursdays**	Greater of 23% or rate on 2-year or 6-month T-note + 6%

*Rate limits often vary by type of lender. Limits shown are highest permitted for any lender. Under the 1980 Monetary Control Act, banks, S&Ls, and credit unions may charge the greater of the Federal Reserve discount rate plus 1 percent or the highest rate permitted any state lender for the type of loan in question.

**The operative limit has been 18% since the law became effective November 1, 1981.

companies located in Arkansas and that state has a much larger number of pawnbrokers than Illinois, Wisconsin, or Louisiana, which have more lenient ceilings on consumer credit. In addition, a survey of merchants in the adjacent cities of Texarkana, Texas and Texarkana, Arkansas [1] revealed that there were many more automobile, furniture, and appliance dealers on the Texas side of the border than on the Arkansas side. Furthermore, 84 percent of the merchants interviewed indicated that Arkansas' usury ceiling had been an important factor in their decision to locate in Texas.

Differences in state usury regulations also were cited in recent decisions to relocate the credit card operations of Citibank, First National Bank of Maryland, Philadelphia National Bank, and the First National Bank of Chicago.[10] In addition, banks in Seattle and Detroit are reported to be considering relocating credit card operations to other states because of usury limits.[11]

The macroeconomic impacts of usury ceilings. When usury ceilings make it unattractive to make loans in a particular state, the adverse impact of the ceilings falls most heavily on the credit-sensitive sectors of the state's economy. The health of a state's residential construction industry, for example, can be seriously affected by its usury regulations. As Ostas and Robins showed, housing starts and permits are sensitive to ceilings on mortgage rates. Furthermore, the New York State Banking Department concluded that New York's restrictive usury ceiling contributed to the depressed condition of the housing market in that state during the late 1960s and early 1970s.

Similarly, there is evidence that restrictive usury ceilings on automobile loans and other forms of consumer credit can affect the level of consumer purchases and retail trade. The survey of merchants in Texarkana, Arkansas, and Texarkana, Texas [1] revealed that approximately 38 percent of credit sales among merchants on the Texas side of the border were to customers from Arkansas. This substantial out-of-state shopping, which is presumably due to the 10 percent usury ceiling in Arkansas, represents a significant loss of potential business revenues for Arkansas-based retailers. Furthermore, as the authors of the study concluded, it represents a loss of jobs and local tax revenues.

A state's usury ceiling is likely to have far-reaching consequences for the state's real economy. Its effects can be expected to show up first in the level of credit-financed expenditures and eventually in levels of state employment and income. A study by Richard Gustely and Harry L. Johnson, described by Harold Nathan [14], used an econometric model of Tennessee to examine the impact of that state's comprehensive 10 percent usury ceiling. According to Nathan, the authors found that Tennessee's economy grew faster than the national economy except at times when market interest rates exceeded the state usury ceiling. The ceiling was estimated to have cost the state annually between 1974 and 1976 $150 million in output, $80 million in retail sales, and 7,000 jobs. This study indicates how restrictive usury ceilings may deprive a state of the credit needed to keep its economy expanding. All residents of the state are affected, not only those borrowers who find credit difficult to obtain.

Usury ceilings and competition

As the foregoing discussion has shown, the impacts of usury ceilings extend well beyond simply holding a lid on interest rates. The adverse effects on the economy as a whole may even be sufficient to outweigh the benefit to those who are able to borrow at below-market interest rates. However, a common argument is that without usury laws borrowers would be forced to pay exorbitant interest rates, or at least rates that were unreasonable in relation to the cost of supplying credit. Thus, evaluation of usury laws is not complete without a consideration of the consequences of not having usury ceilings.

According to economic theory, a competitive market is sufficient to prevent lenders from exercising power over pricing or earning more than a normal return. The price established in a competitive market reflects suppliers' costs of providing the given amount of the good. To be sure, removing a binding usury ceiling will result in higher interest rates. However, if credit markets are competitive, the resulting market rate of interest will not exceed lenders' cost of providing credit. It is when competition is absent that consumers may face unreasonable interest rates. Thus, the consequences of not having usury ceilings depend importantly on the competitiveness of credit markets. Indeed, the absence of competition is the only clearly defensible theoretical reason for imposing a usury ceiling.

We might argue that U.S. credit markets today are fairly competitive. Many types of institutions—banks, finance companies, credit unions, thrift institutions, and retailers—make up the supply side of the credit market and frequently offer credit in closely substitutable forms. Moreover, in many (but not all) local market areas, consumers can choose among several lenders of any particular institutional type. However, competition in credit markets may be hampered by the fact that lending institutions have become specialized according to the types of credit they offer and/or the types of borrowers they serve. In the area of personal consumer credit, for example, banks and other depository institutions primarily offer cash credit to lower risk borrowers while finance companies specialize in servicing higher risk customers. Thus, the question of whether credit markets are sufficiently competitive to protect consumers from unreasonable interest charges is one which must be answered empirically. Unfortunately, studies of the extent of competition in credit markets do not provide a definitive answer to

[10]See *Wall Street Journal*, December 5 and 15, 1981 and *The American Banker*, September 30 and October [illegible]. The ability of banks to take advantage of interstate differences in ceilings on credit card lending derives from a 1978 Supreme Court ruling. In Marquette National Bank v. First of Omaha Service Corporation, the Court determined that national banks may charge out-of-state credit customers the rate permitted by the law of the bank's home state. See *Federal Reserve Bulletin*, vol. 67 (February 1981), p. 181 fn. The same option does not apply to department stores, gasoline companies, or other issuers of retail or sellers' credit cards.

[11]See *The American Banker*, May 6, 1982.

the question.

Smith [22] concluded from a study of the structure of rates on personal loans at commercial banks that there is a considerable degree of interbank competition for the more profitable type of loans, but that this does not extend to the small high-risk loan where the social problems of credit regulation are most acute (p. 524). He also found evidence of interinstitutional competition in the influence of consumer finance companies on bank loan rates and portfolio composition. On the other hand, Geer's analysis of the NCCF data on personal loan rates [5] did not allow him to conclude firmly that finance companies and commercial banks compete vigorously.

The NCCF Report provided some evidence of the existence of competition in its findings regarding the pattern of interest rates across states. The Commission's 50-state survey revealed that rates on auto loans and unsecured loans at banks clustered within a rather narrow range (the market rate?) regardless of state usury ceilings.[12] Also, average observed interest rates for these loans were in the same range even in states with no ceiling at all.[13] In contrast, in the finance company loan market, the Commission noticed a much closer correspondence between observed rates and the state usury ceilings.

The conflicting findings of these few studies illustrate the difficulty in reaching a definitive conclusion about the extent of competition in credit markets. The studies described here suggest that competitive behavior may vary considerably among different segments of the credit market. Rates on finance company personal loans, for example, appear to be set less competitively than rates on auto loans or personal loans extended by banks. Another factor which makes an overall assessment of competition difficult stems from the potentially great differences in local market conditions. Lending institutions located in urban areas may face much greater competitive pressures than lenders in smaller cities or towns.

What can be stated definitively, however, is that from the point of view of protecting borrowers from unreasonable interest charges, competition is desirable, and the more the better. To the extent that competitive pressures arise from the presence and ready entry of many firms into the market, consumers are best served by policies that foster these conditions in credit markets.[14]

There is some evidence that usury ceilings, rather than fostering these conditions, tend to restrict competition in some parts of the credit market. The NCCF found, for example, a strong inverse relationship between statewide finance company concentration ratios and the average level of legal rate ceilings on personal loans. (Higher concentration ratios are usually associated with lower levels of competition.) The relationship was even stronger within the group of states having low rate ceilings. The finding that lending firms tend to be more highly concentrated in states with lower rate ceilings can be attributed to several factors. First, low usury ceilings drive inefficient firms out of the market, thereby increasing concentration [6, p. 1377]. In addition, low usury ceilings create barriers to entry making it difficult for new firms to compete during the start-up phase [15, p. 137].

[12]Of course, it could simply be that the state usury ceilings were above the optimum price for an oligopolistic competitor. Even if that were the case, however, the situation indicates that the rate oligopolist lenders establish is below what most legislatures consider usurious.

[13]In addition, an investigation by the Federal Reserve Bank of St. Louis revealed that mortgage rates in the Chicago, Minneapolis, and Pittsburgh SMSAs did not rise to state ceilings when these usury limits were allowed to float. See Lovati and Gilbert [11].

[14]The literature on the structure of banking markets has established that firm entry and concentration have highly significant, although quantitatively small, effects on competitive pricing behavior. See Stephen Rhoades, *Structure-Performance Studies in Banking: A Summary and Evaluation*, Staff Economic Studies 92 (Board of Governors of the Federal Reserve System, 1977); Harvey Rosenblum, "A Cost-Benefit Analysis of the Bank Holding Company Act of 1956," *Proceedings of a Conference on Bank Structure and Competition* (Federal Reserve Bank of Chicago, 1978); and George Benston, "The Optimal Banking Structure: Theory and Evidence," *Journal of Bank Research*, vol. 3 (Winter 1973), pp. 220-37.

Rate ceilings may impede competition in various other ways. The NCCF argued that different rate ceilings for different types of consumer lenders tend to segment the market artificially and restrict interinstitutional competition [15, p. 147 and 5, p.60]. A recent study by Sullivan for the CRC [23] supports this argument. She found that the extent of competition between banks and finance companies for consumer loans depended on whether the two types of lenders operated under the same or different rate ceilings. In a local personal loan market in Illinois, which differentiates ceilings by type of institution, borrowers from banks had significantly different risk characteristics than borrowers from finance companies. Such segmentation was not found in a comparable local loan market in Louisiana where all lenders are treated equally.

Another difficulty with usury ceilings, suggested by Shay's findings, is that rate ceilings may offer convenient focal points for setting rates higher than they might otherwise be set, when lenders already have some power to set prices [21, p. 457]. Finally, the Treasury Department's Interagency Task Force on Thrift Institutions [24] recently argued that very low usury ceilings discourage thrift institutions from adding consumer loans to their portfolios and from actively competing with finance companies by offering consumer loans. According to all of these arguments, the removal or easing of usury ceilings would tend to make credit markets more competitive.

Knowledgeable, informed borrowers also foster competition in credit markets. When consumers do not know or cannot compare rates being charged by various lenders, each lender has more scope to charge whatever rate he chooses. Thus, a high level of borrower awareness can place a natural constraint on interest rates, in lieu of the external constraint of a usury ceiling. Indeed, as the NCCF pointed out, "Not all consumers need be aware of the APR [annual percentage rate] or shop for credit to bring about effective price competition. A significant marginal group of consumers who are aware and do shop is sufficient to 'police' the market" [15, p. 175].

It is difficult to say exactly what the size of that group needs to be, but the Commission suggested that one-third to one-half of all borrowers is certainly sufficient. By this criterion, today's consumers seem to exert a rather effective pressure on lenders. A 1977 Consumer Credit Survey sponsored by the Board of Governors of the Federal Reserve System [4] classified 65 percent of consumers as aware of APRs on revolving credit. The awareness level on bank credit cards was 71 percent, and on closed-end credit it was 55 percent.

Consumer awareness levels were not always this high. Surveys comparable to the 1977 one were conducted in 1970 and 1969. Only 38 percent of credit users were found to be aware of APRs on closed-end credit in 1970 and only 15 percent in 1969.[15] Awareness levels on retail revolving credit and bank credit cards were only 35 and 27 percent, respectively, in the 1969 survey, although they stood at 56 and 63 percent by 1970.

At least some of the improvement in consumer awareness since 1969 revealed by these surveys is probably attributable to the consumer protection legislation enacted in the late 1960s and 1970s. The Truth-in-Lending Act (Title I of the 1968 Consumer Credit Protection Act) was passed only shortly before the 1969 survey, and its impact seems evident in the 1970 survey results. This association of improved consumer awareness with the passage of Truth-in-Lending suggests that, in the absence of usury ceilings, such legislation could effectively ensure consumers of reasonable interest rates by fostering more intense price competition in the credit market.

Policy action and options

Over the past few years there has been a spate of legislative activity affecting usury

[15]In analyzing the results of the 1970 survey, the NCCF found awareness levels in the "general market"—the market comprised mainly of higher income, more highly educated, white, homeowning borrowers who live in nonpoverty areas and use mostly cash credit—sufficient to police the market. The high-risk market, on the other hand, had disturbingly high levels of unawareness.

egulations at the national and state levels. Probably all of these legislative changes have helped to ease the adverse economic effects of binding usury ceilings during the recent period of high market interest rates. However, the specific policies implemented have differed greatly in the extent of their move toward deregulation; not all have involved completely removing legal price constraints.

For example, some states have acted to raise, but not eliminate, ceilings when they have impinged on credit availability and economic activity. This approach preserves fixed statutory interest rate limits and whatever protection they might afford consumers from outrageously high interest charges. But, if state legislatures intend to avert the negative economic impacts of fixed usury ceilings, they must act deliberately and quickly to adjust ceilings limits in response to changes in market rates—a task made more difficult by the increased volatility of rates in recent years.

A second approach, tying ceiling limits to market interest rates, avoids this problem and at the same time preserves the protection afforded by statutory limits. Some states have instituted legislation to allow ceilings to float, usually by stipulating limits several percentage points above certain specified interest rates—such as Treasury bill yields or the Federal Reserve discount rate—over which neither borrowers nor lenders have control. These usury ceiling limits, then, adjust automatically at frequent intervals to changes in the market interest rate. While floating rate ceilings are designed to be nonbinding with respect to the rates charged on the vast majority of loans, they prevent lenders from charging rates which are out of line with the market.

The difficulty with floating ceilings is in choosing a tie-in formula which will keep the ceiling above the average market rate over time. In a 1979 study of floating ceilings in the mortgage market, the Federal Reserve Bank of St. Louis [11] concluded that ceiling rates at 2.5 percentage points above yields on ten-year U.S. Treasury bonds or 5 percentage points above the discount rate were high enough not to distort the flow of credit to housing. Other floating rate schemes, however, continued to bind mortgage rates and impede housing activity.

Action by state legislatures has not been limited to partial easing of controls, by raising limits or implementing floating ceilings. Many other states have completely eliminated their usury ceilings. These states can and still do regulate lenders in other ways, of course.

In addition to these changes on the state level, the federal government has also acted recently to remove legal constraints on interest rates. The 1980 Monetary Control Act temporarily preempted state usury limits on mortgage loans and on large business and agricultural loans. The same act also overrode state interest ceilings on loans by national and state banks, S&Ls, and credit unions when the state ceiling is below the local Federal Reserve discount rate plus 1 percent. Proposals to extend federal preemption to include consumer credit were considered during the 1981 congressional session.[16]

This move by the federal government to supplant state usury regulations raises an important and difficult issue. From an economic point of view federal action has an advantage over states acting individually. It would impose uniformity on credit markets, eliminating legislatively created differentials in interest rates that artificially distort credit flows among states. (Uniformity could be achieved, of course, whether the federal government imposed its own fixed usury ceiling, instituted floating ceilings, or eliminated ceilings altogether.) From another point of view, however, federal action may not be so desirable. The economic advantage of uniform treatment needs to be weighed against the political implications of the federal government stepping into an area—usury regulation—which has traditionally been under the jurisdiction of the states. Thus, the question whether deregulation of usury ceilings should be left to individual states or whether it is best accomplished by federal preemption should not be answered on the basis of economics alone.

[16] A Senate bill was introduced by Senator Lugar and incorporated in S. 1720 by Senator Garn; House bills were sponsored by Representatives John La Falce and William Alexander.

Summary

Economic research clearly supports the current legislative moves toward deregulation of usury ceilings. The evidence on the impact of usury ceilings shows that they have not achieved their objectives. According to the empirical studies surveyed, usury ceilings have significantly reduced the availability of credit and created hardships for those who were supposed to be protected. Ceilings have encouraged lenders to use such credit rationing devices as higher down payments, shorter maturities, and higher fees for related non-credit services, which increase the effective interest rate. They have curtailed the amount of credit available to lower income and higher risk borrowers, harming primarily those individuals whom the ceilings are intended to benefit. Finally, the lack of uniformity of usury laws across states has distorted credit flows and economic activity, favoring those states and regions which are less regulated.

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Exhibit # 3

HOUSE BILL 64
TESTIMONY OF JEFFRY M. KIRKLAND
VICE PRESIDENT-GOVERNMENTAL RELATIONS
MONTANA CREDIT UNIONS LEAGUE

BEFORE THE HOUSE BUSINESS & INDUSTRY COMMITTEE
ON THURSDAY, 13 JANUARY 1983

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, FOR THE RECORD I AM JEFF KIRKLAND, VICE PRESIDENT-GOVERNMENTAL & COMMUNITY RELATIONS FOR THE MONTANA CREDIT UNIONS LEAGUE. OUR LEAGUE IS A TRADE ASSOCIATION REPRESENTING 118 OF THE 121 CREDIT UNIONS IN MONTANA. NINETY-FOUR OF THOSE ARE FEDERALLY-CHARTERED, AND 24 ARE STATE-CHARTERED.

ALTHOUGH HOUSE BILL 64 WOULD AFFECT ONLY OUR 24 STATE-CHARTERED CREDIT UNIONS, WE JOIN WITH THE OTHER REGULATED LENDERS HERE TODAY IN SUPPORT OF THE BILL, SINCE WE BELIEVE THAT THERE IS INDUSTRY-WIDE NEED FOR RELIEF FROM ARTIFICIALLY-IMPOSED USURY CEILINGS.

DURING THE LAST LEGISLATIVE SESSION, THE LEGISLATURE OVERWHELMINGLY PASSED HOUSE BILL 238, A BILL THAT SUSPENDED THE USURY CEILINGS OF ALL REGULATED LENDERS FOR A LITTLE OVER A TWO-YEAR PERIOD, UNTIL 1 JULY 1983. THOSE OF YOU WHO WERE MEMBERS OF THIS COMMITTEE WILL RECALL THAT THE ORIGINAL BILL CALLED FOR PERMANENT REMOVAL OF THOSE USURY CEILINGS, AND THAT IS THE WAY THE BILL WAS REPORTED OUT OF THIS COMMITTEE AND HOW IT PASSED THE HOUSE BY A VOTE OF 94-3.

However, when the bill was acted on by the Senate, there were Senators who, I believe, were concerned that lenders might abuse the absence of usury ceilings and raise rates unjustifiably high to the detriment of consumers. Therefore, the bill was amended in the Senate to suspend usury ceilings until 1 July 1983.

If the purpose of the amendment was to provide both the Legislature and the lending community a two-year trial period in which to assess the results of the absence of usury ceilings, I firmly believe that credit unions--and the other regulated lenders, for that matter--have passed the test with flying colors.

Obviously, some rates have increased over the past two years from what they were prior to the 6 April 1981 effective date of the legislation. That was to be expected, particularly for our state-chartered credit unions whose usury ceiling prior to passage of the legislation was 15%. However, what I find to be of much more interest is that, where warranted, many of those rates that were initially increased have also decreased during the two years as credit unions adjusted their rates in response to rapid and sometimes wild changes in the money market, which is one determinant of credit unions' cost of funds.

For example, one credit union immediately raised its rate on loans collateralized with household goods--which, incidently, the Federal Bankruptcy Code of 1978 makes practically worthless as collateral--to 24%. However, less than a year later, the credit union lowered its rate on that type of loan to the current 18%. Interestingly, that same credit union charged 15% on share-secured loans both prior to and after passage of House Bill 238. It subsequently lowered that rate to the current 9%.

YEARS AGO, USURY CEILINGS COULD BE ESTABLISHED BY THE LEGISLATURE WITH LITTLE WORRY THAT THEY MIGHT BECOME OUTDATED BEFORE IT CONVENED AGAIN IN TWO YEARS. TODAY, THAT IS NOT THE CASE. CREDIT UNIONS AND OTHER LENDERS NEED THE FLEXIBILITY TO BE ABLE TO ADJUST RATES IN RESPONSE TO RAPIDLY CHANGING FACTORS: COST OF FUNDS (SAVINGS), COST OF BORROWED FUNDS, AND COMPETITION FROM FINANCIAL AND NON-FINANCIAL INTERMEDIARIES.

HOUSE BILL 64, BY PERMANENTLY REMOVING USURY CEILINGS, WILL PROVIDE CREDIT UNIONS AND OTHER LENDERS THE NECESSARY FLEXIBILITY TO TAILOR LENDING RATES TO CURRENT MARKET CONDITIONS. IN OUR CASE, IN TODAY'S ECONOMY, IF OUR USURY CEILING WERE TO REVERT TO THE 15% IT WAS PRIOR TO 6 APRIL 1981, MANY OF OUR STATE-CHARTERED CREDIT UNIONS WOULD HAVE TO CURTAIL MOST, IF NOT ALL, LENDING ACTIVITY.

AND THE ABSENCE OF USURY CEILINGS WILL BECOME EVEN MORE CRITICAL IN THE FUTURE. OVER THE PAST THREE YEARS, CONGRESS HAS INCREASINGLY DEREGULATED THE CEILING RATES FINANCIAL INSTITUTIONS CAN PAY SAVERS FOR PASSBOOK SAVINGS, CERTIFICATES, AND SPECIAL MONEY MARKET ACCOUNTS. AS THE SAVINGS-RATE CEILINGS COME OFF, THE COMPETITION FOR THE SAVER'S DOLLAR HEATS UP--WHICH MEANS THAT CREDIT UNIONS ARE PAYING INCREASINGLY HIGHER RATES FOR WHAT WE'VE BEGUN CALLING "RATE SENSITIVE" FUNDS.

AS LITTLE AS FOUR YEARS AGO, MOST CREDIT UNIONS ONLY OFFERED ONE SAVINGS RATE--THE BASIC PASSBOOK RATE. THAT RATE HAD A CEILING OF 7%. THERE ARE STILL CREDIT UNIONS IN MONTANA THAT OFFER ONLY ONE SAVINGS RATE, BUT THE FLOOR RATE TODAY TENDS TO BE 7%--WITH SOME CREDIT UNIONS PAYING AS HIGH AS 10%. MOST CREDIT UNIONS,

HOWEVER, HAVE HAD TO BEGIN OFFERING HIGHER-YIELDING ACCOUNTS TO RETAIN MEMBERS WHO WANT TO EARN MORE THAN JUST A PASSBOOK RATE ON THEIR SAVINGS. WE HAVE CREDIT UNIONS IN MONTANA THAT HAVE UP TO 73% OF THEIR TOTAL SHARES IN "RATE SENSITIVE" FUNDS. AND WITH FURTHER DEREGULATION, MORE AND MORE SAVERS' DOLLARS WILL BE LEAVING LOWER-YIELDING PASSBOOK ACCOUNTS AND GOING INTO HIGHER-YIELDING "RATE SENSITIVE" ACCOUNTS.

THAT IS CERTAINLY GOOD FOR THE SAVER, BUT CREDIT UNIONS AND OTHER FINANCIAL INSTITUTIONS USE INCOME GENERATED FROM LOANS TO PAY INTEREST (CREDIT UNIONS CALL IT "DIVIDENDS") ON SAVINGS. AS SAVINGS RATES INCREASE, SOME LOAN RATES MUST INEVITABLY INCREASE TO COMPENSATE. THE EXISTENCE OF ARTIFICIALLY-IMPOSED USURY CEILINGS MAY WELL RENDER IRREPARABLE HARM TO THE FINANCIAL INSTITUTION THAT FINDS ITSELF HAVING TO PAY EVER HIGHER RATES FOR SAVINGS BUT UNABLE TO CHARGE ENOUGH FOR LOANS TO PAY THOSE SAVINGS RATES.

THE CONCEPT OF USURY CEILINGS AROSE HUNDREDS OF YEARS AGO WHEN THE USE OF CREDIT WAS RELATIVELY RARE AND WHEN THERE WAS NOT ENOUGH OF A MARKET NOR ENOUGH COMPETITION TO EFFECTIVELY DETERMINE LENDING RATES. TODAY, HOWEVER, THERE IS NO NEED FOR ARTIFICIAL USURY CEILINGS, FOR WHAT THE MARKET GIVETH, THE MARKET ALSO TAKETH AWAY. THAT IS, COMPETITION AMONG THE VARIOUS LENDERS TODAY ALSO HELPS DETERMINE THE RATES CHARGED ON LOANS. ONE STATE-CHARTERED CREDIT UNION RECENTLY HAD TO DECREASE ITS NEW CAR LOAN RATE FROM 15% TO 13% TO COMPETE IN ITS COMMUNITY.

COMPETITION IS A POWERFUL FORCE IN OUR INDUSTRY, FOR IF FEWER MEMBERS BORROW FROM THE CREDIT UNION, CREDIT UNION EARNINGS DECREASE. SO THE RATE MUST COME DOWN TO MEET THAT OF THE COMPETITION. THAT TYPE OF COMPETITIVE INTERACTION AND NOT USURY CEILINGS

HELPS DETERMINE ACCEPTABLE LEVELS FOR LENDING RATES.

TO MY KNOWLEDGE, FROM A SURVEY WE TOOK IN LATE DECEMBER, 19% IS THE HIGHEST RATE BEING CHARGED FOR A LOAN BY A STATE-CHARTERED CREDIT UNION, AND THAT IS FOR A SIGNATURE LOAN. THE LOWEST RATE IS 9%, AND THAT IS FOR A SHARE-SECURED LOAN. THE REMAINDER OF RATES TEND TO FALL IN THE 12%, 15%, AND 18% CATEGORIES, WITH THE HIGHER RATES BEING CHARGED FOR LOANS OF GREATER RISK.

OBVIOUSLY, CREDIT UNIONS HAVE PROVEN BOTH TO THEIR MEMBERS AND TO THE LEGISLATURE THAT THEY ARE RESPONSIBLE LENDERS--EVEN THOUGH THERE HAS BEEN NO USURY CEILING TO RESTRICT THEM.

IN CONCLUSION, THERE IS A DEFINITE NEED TO ADDRESS THE PERMANENT REMOVAL OF USURY CEILINGS FOR CREDIT UNIONS AND OTHER REGULATED LENDERS. LENDERS NEED THE FLEXIBILITY TO ADJUST THEIR RATES IN RESPONSE TO RAPID AND SOMETIMES WILD CHANGES IN THEIR COST OF FUNDS, PARTICULARLY IN LIGHT OF FURTHER SAVINGS RATE DEREGULATION BY THE FEDERAL GOVERNMENT AND INCREASING COMPETITION FOR THE SAVERS' DOLLARS BY NON-FINANCIAL AND NON-REGULATED INTERMEDIARIES SUCH AS MONEY MARKET MUTUAL FUNDS, SEARS, AND THE FORD MOTOR COMPANY TO NAME JUST A FEW.

SINCE FIRM CEILINGS HAVE THE EFFECT OF CURTAILING THAT FLEXIBILITY AND IN DOING SO MAKING CREDIT MORE DIFFICULT TO OBTAIN FOR THOSE WHO MOST NEED CREDIT AT RELATIVELY REASONABLE RATES, WE SUPPORT THE PERMANENT REMOVAL OF USURY CEILINGS AS PROVIDED FOR IN HOUSE BILL 64.

FOR THOSE VERY COMPELLING REASONS, WE URGE THAT THIS COMMITTEE RECOMMEND THAT HOUSE BILL 64 DO PASS.