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DISCLOSURE OF FINANCE CHARGES: A RATIONALE

*Robert L. Jordan and William D. Warren**

FOR the better part of the past decade much of the energy of those interested in consumer credit legislation has been expended in debating the problem of fair disclosure of finance charges. While those who have studied the subject concede that full disclosure of finance charges does not offer a solution to some of the most basic problems besetting the credit consumer today, the issue of fair disclosure of finance charges has still become a rallying point for consumers and a battle line for industry. Consumers demand the right to be told what they are paying for credit in terms that they can understand. Industry disclaims the motive of wishing to conceal the amount of finance charges and asserts that its principal activity should be selling credit, not calculating finance charges. To most consumer representatives, full disclosure means time rate disclosure. To some industry representatives, the requirement of time rate disclosure in every transaction is totally infeasible.

One wonders whether in all of the talk generated about disclosure in the past few years the purposes of disclosing finance charges to consumers have not been somewhat obscured. This article is an attempt to examine the subject of disclosure from the standpoint of the function it performs in consumer credit transactions. We shall discuss the various methods of computing finance charges in the different segments of the finance industry, the functions of disclosure of finance charges and the feasibility of using different computational methods in each category of consumer transactions. The problems involved in requiring the disclosure of finance charges are not as simple as one is sometimes led to believe. Each side of the controversy has good arguments to support its view; neither side is the exclusive repository of justice and morality. The problem of required disclosure has long been debated and is ripe for resolution.

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The authors wish to express their gratitude to Professor Robert W. Johnson, Graduate School of Industrial Administration, Purdue University, not only for advising them on the mathematical aspects of disclosure of finance charges, but also for assisting them in clarifying their thinking in the whole area of disclosure.

It is our hope that this article will succeed in pointing out some of the factors that should be considered in a compromise legislative solution of this thorny problem.¹

I. USE OF COMPUTATIONAL METHODS IN DIFFERENT SEGMENTS OF THE FINANCE INDUSTRY

One generally tends to identify certain methods of computation with particular segments of the finance industry. A credit union will normally quote a finance charge in terms of a fixed per cent per month on the unpaid balance of the debt. Many small-loan companies are required by law to calculate and quote the finance charge as a graduated monthly rate, for example three per cent on the first \$100, two per cent on the next \$400 and one per cent on the debt in excess of \$500. Sales finance companies normally give the consumer a statement of the dollar amount of the finance charge, but may advertise their charges as a rate expressed as so many dollars for each \$100 of the original debt for each year the debt is outstanding. Commercial banks usually express their finance charges as an annual percentage interest rate but discount the loan, that is, deduct the interest charge from the amount loaned.

1. *Small loan transactions.* Per cent per month on the declining balance was adopted by statute as the method of computation applicable to the legitimate small loans industry at the time of its birth and early growth under the leadership of the Russell Sage Foundation. This method had previously been adopted by the borrower-oriented credit unions, and was deemed to be most fair to borrowers because finance charges were computed each month and were based solely upon the loan balance outstanding at that time.² In addition,

1. By way of a scope note, it should be made clear that the objective of this article is to discuss whether time rate disclosure of finance charges in consumer transactions is desirable, and, if so, in what kinds of transactions it is appropriate. There are other substantial problems in the area of disclosure of finance charges that we have not attempted to treat in this article. Among these are: (1) how is a consumer transaction defined? (2) How is a finance charge defined? Should it include other charges incident to the granting of the credit, such as credit life insurance and credit accident and health insurance? (3) At what point of time should disclosure of finance charges be made, pre-contract or post-contract? What bearing should the nature of the transaction (telephone sale, catalogue sale, add-on sale, consumer letter of credit loan) have on this question? (4) What disclosure requirements should be made for such re-financing transactions as "rewrites" and extensions? (5) How can finance charges be disclosed in lease transactions that perform the same function as sales?

2. Under the per cent per month method, the finance charge is computed monthly by multiplying the outstanding balance of the credit by a monthly percentage rate. For example, assume that a loan of \$120 is made on the first day of the month and the monthly rate is 2%. On the first day of the next month, the finance charge for the first month is calculated by multiplying 2% by \$120, or \$2.40. If the statute is

the finance charge was all-inclusive; no other charges could be made.³

The supposed advantages to the borrower of the per cent per month on declining balance method notwithstanding, there has been a pronounced shift toward precomputation in the small loans indus-

based on a thirty-day month, the charge will vary with the length of the month. In the previous example, if the first day of the next month came thirty-one days later, the finance charge would be $2\% \times 31/30 \times \120 . At the end of each month, the borrower not only must pay the finance charge but also must make payments to reduce the principle. For example, the contract might require that the principal be repaid at the rate of \$10 per month for twelve months. On this basis, the payment due at the end of the first month is \$12.40 (\$10 principal plus \$2.40 finance charge). The payments due at the end of the succeeding eleven months will be progressively less because the monthly finance charge is calculated on the basis of outstanding principal, which is constantly being reduced. Thus, the finance charge for the second month would be $\$10 \times 2\%$, or \$2.20, and for the third month, $\$100 \times 2\%$, or \$2.00. Monthly payments are thus unequal in amount. However, credit suppliers may adopt a procedure whereby the monthly payment is a constant amount which will pay off the principal and finance charges in one year. This, in fact, is the most commonly used method. Here, the proportion of the monthly payment allocable to finance charge and principal will vary from month to month. The amount applicable to finance charge will decrease and the amount applicable to payment on principal will increase in successive months. By use of annuity tables we can calculate that, with respect to our example, an even payment of \$11.35 per month will amortize the loan in twelve months. See generally MORS, CONSUMER CREDIT FINANCE CHARGES: RATE INFORMATION AND QUOTATION 15 (1965) [hereinafter cited as MORS].

The per cent per month method has certain advantages. It makes it unnecessary to make any adjustment for late payments or for prepayments. The debtor pays a finance charge only for the actual number of days the principal is outstanding. In the case of the unequal monthly payment system, if the monthly payment is made early the finance charge will be less. If the payment is made late, the finance charge will be greater. In the case of the equal monthly payment system, the proportion of the monthly payment allocable to the finance charge will be less if the payment is made early and greater if the payment is made late. If there have been adjustments in allocation because of early or late payments over the life of the credit where the equal payment method is employed, the amount of the last payment will be equal to the sum of unpaid principal and outstanding finance charges, and therefore may be less or greater than previous payments. However, the practice of the creditor will often provide that no adjustment of the amounts allocated to principal and interest will be made for early or late payments within stated limits. Under the per cent per month method the dollar amount of finance charges which the debtor will have to pay over the life of the credit can be calculated at the time the credit is advanced only if it is assumed that all payments will be made exactly on schedule. This calculation will be inaccurate to the extent that there are any late or early payments. See JOHNSON, METHODS OF STATING CONSUMER FINANCE CHARGES 30-31 (1961) [hereinafter cited as JOHNSON].

3. The seventh draft of the Uniform Small Loan Law, 1942, provides: "Section 13. (a) Every licensee hereunder may contract for and receive, on any loan of money not exceeding \$300 in amount, charges at a rate not exceeding 3 per cent a month on that part of the unpaid principal balance of any loan not in excess of \$100, and 2 per cent a month on any remainder of such unpaid principal balance. . . . (c) In addition to the charges herein provided for, no further or other amount whatsoever shall be directly or indirectly charged, contracted for, or received." See CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION 144, 152-53 (1965) [hereinafter cited as CURRAN]. Miss Curran's book is an excellent compilation of the consumer credit laws and will be utilized throughout this article as the authoritative statement of existing laws.

try in the past fifteen years.⁴ Precomputation has become popular for two reasons. First, lenders maintain that it allows simplification of operations. Under the per cent per month on declining balance system, each payment must be prorated to finance charge and principal by a clerk. Under precomputation, the clerk need ordinarily make no calculation at the time he receives the installment. Late payments are handled by means of a penalty charge. Only in the case of a prepayment must any calculation be made. Second, precomputation normally provides the lender with a larger return where a borrower prepays or refinances than does the per cent per month on declining balance method.⁵ If the rate is graduated, the finance charge for the early portion of the contract is made up of a higher proportion of low rate charge than is true of the finance charge for the contract as a whole. This is true because as we move toward maturity the principal of the debt is being reduced, thereby removing more and more of the principal to which the low rate applies. But under a precomputation system the entire finance charge is included in the obligation of the debtor and upon prepayment or refinancing the creditor is allowed to retain that fraction of the finance charge which is "earned." By standard methods of calculating refunds this "earned" fraction is a function of time elapsed and principal outstanding. But if this fraction is applied to the entire finance charge it will produce a greater

4. See CURRAN 22-25, and chart 2, at 158-66. Under many statutes governing small loan companies which compute charges under the per cent per month method, lenders have been authorized to use the alternative method of precomputing the amount of finance charges payable over the period of the installment contract as a whole. Computation is made on the basis of the applicable per cent per month charge and on the assumption that all installments will be made on schedule. The total amount of finance charges is then added to the principal at the time the credit is advanced, and the debtor pays back the sum of the principal and the finance charge in periodic installments.

5. Since the obligation to the creditor includes the total finance charge, if the debtor prepays the creditor would be receiving unearned finance charges unless an adjustment were made. There are various procedures for calculating amounts to be returned by the creditor in the event of a prepayment of principal. The most common method required by statute is the "rule of 78," or "sum of the digits" formula. Under this method, allocation of finance charges is made as follows: First, the numbers of the months of the credit term are added. For example: in a 12-month credit, we add the numbers one through twelve, arriving at a sum of 78. Second, the finance charge is allocated to each month of the credit by multiplying it by a fraction, the numerator of which is the number of the specific month in reverse chronological order and the denominator of which is the sum of the numbers of the period of the credit. For example: for a 12-month credit in which the finance charge is \$6, the charge allocable to the first month is $\frac{12}{78} \times \$6$, and the charge allocable to the second month $\frac{11}{78} \times \$6$. If any part of the principal is prepaid, the creditor is required to refund to the debtor the "unearned" portion of the finance charge. The problem of prepayment is particularly important because refinancing is a very common occurrence. Refinancing is treated as a prepayment in full of the outstanding credit and a simultaneous entry into another credit contract.

yield to the creditor because the entire finance charge is made up of a higher proportion of high rate charge than is the finance charge for the elapsed portion of the contract calculated on a non-precomputation basis. The high percentage of cases in which the borrower refinances makes this additional return yielded of some significance to the lender.⁶

2. *Credit union loans.* There is more uniformity of computational method in credit union operations than in any other segment of the finance industry. The usual statutory mandate allows the board of directors to set a maximum finance charge not in excess of one per cent per month on the declining balance. Credit unions have almost unanimously retained this computational method through the years despite trends in different directions in other segments of the consumer finance industry.⁷ Recently, however, some credit unions have shown interest in adopting a precomputation system.

3. *Retail installment sales.* In the nineteenth century, when merchants began to sell their goods on credit, the courts were forced to decide how to treat the credit charge under the usury laws, which set limits on the amount that could be charged for a loan of money or forbearance of debt. As a result, the time-price doctrine emerged; the courts held that one can offer his goods for sale at two prices—a credit, or time, price and a cash price. The difference between the two—the time-price differential—can exceed the amount allowable under the usury law because it is not interest.⁸ Moreover, the courts have upheld the time-price doctrine even when the credit price is determined by merely adding a finance charge to the cash price. Doubtless this background had a part in the development of the practice in sales finance transactions of adding the finance charge to the cash price of the article and having the total repaid in installments. This is the add-on method of computing finance charges, and is the standard method used today in installment sales transactions.⁹ Furthermore, the add-on method of computation

6. For a treatment of the extent of the advantage of precomputation over per cent per month on prepaid loans, see MORS 28-33. Dr. Mors cites a New York Banking Department study indicating that during a period from 1945 to 1957, about eighty per cent of all consumer finance company loans in New York were refinanced. MORS 32-33, 109-11.

7. See CURRAN, chart 6, at 194-203. See also JOHNSON 22-25; MORS 12-13.

8. For a discussion of the time-price doctrine and a statement of authorities concerning it, see Britton & Ulrich, *The Illinois Retail Installment Sales Act—Historical Background and Comparative Legislation*, 53 NW. U.L. REV. 137, 143 (1958); Warren, *Regulation of Finance Charges in Retail Instalment Sales*, 68 YALE L.J. 839, 841-51 (1959); Comment, *Limiting Consumer Credit Charges by Reinterpretation of General Usury Laws and by Separate Regulation*, 55 NW. U.L. REV. 303-10 (1960).

9. See MORS 19-24. The finance charge may be stated in terms of percentages

is the easiest to apply to what is often an irregular amount—the unpaid balance of the cash price. This is an important factor in a business where the initial finance charge computation has to be made by a seller rather than by a financial institution.¹⁰

Virtually all of the retail installment sales acts (most of them passed between 1948 and 1955) adopted the add-on method of computation for rate ceiling purposes. Most rate ceiling provisions are stated in terms of either per cent per year or dollars per hundred per year. A few prescribe the per cent per month times the number of months method of computation, with the total being added on at the inception of the transaction. Other rate ceilings are in terms of per cent per month on the declining balance, to be computed in advance and added on; this essentially amounts to precomputation. Still other statutes allow an add-on charge plus a monthly charge, with the latter being precomputed and added on in advance.¹¹

4. *Installment loan transactions.* When commercial banks entered the consumer financing field in the 1930's, they did so in two ways: indirectly, by purchasing retail installment sales contracts from dealers, and directly, by making personal loans. For the most part their indirect financing of consumer sales did not require legislative sanction because the time-price doctrine insulated these operations from the usury statutes, although in some states there was a problem caused by the limitation of the rate of discount a bank might charge upon the purchase of a note or other obligation. Their personal loans could not, of course, enjoy the sanctuary provided by the time-price doctrine, but as banks became more active in this field statutes were passed allowing them to make personal loans at rates in excess

(6% per year) or dollars per hundred (six dollars per hundred per year), with no change in result. If the annual rate is six dollars per hundred and the term of the credit is two years, the finance charge on a credit of \$100 would be \$12. The debtor would receive \$100 and would be required to pay back to the creditor \$112 over the term of the credit in installments. The calculation of the finance charge under the add-on method is made at the inception of the credit, and the finance charge is computed on the assumption that the payments will be made on time. Hence, the same problems in regard to prepayment previously discussed in note 5 exist here. The statutes tend to deal with them in similar ways. In general, the "rule of 78" is prescribed to govern refunds when prepayments are made. With respect to late payments, it is common for statutes to prescribe delinquency charges expressed in terms of a certain percentage of the delinquent installment, subject to an overall dollar maximum for any one installment.

10. "The main reason that finance companies suggested that sellers use add-on in preference to discount rates in computing finance charges to consumers probably lies in the simplicity of computation. Simplicity was important because many small sellers were not well versed in financing procedures and practices and obtained help from financing agencies." MORS 22-23.

11. See CURRAN, charts 12 & 13, at 256-77.

of those prescribed by the usury acts. Some of these statutes were not restricted to banks, but covered any entity, except small loan licensees, which made the kinds of loans permitted under the statute.¹²

Finance charges on commercial bank loans are usually made under the discount computational method. The traditional discount pattern molded the shape of the statutes which set rate ceilings on personal installment loans made by both commercial and industrial banks.¹³ In many states the lender was simply allowed to deduct in advance the contract rate of interest permitted by the usury statute for the period over which repayment was scheduled. Thus the discount method of computation remains predominant under the installment loan laws. However, the add-on method is employed in a substantial number of jurisdictions, and a modification of the add-on scheme is used in those jurisdictions in which interest is precomputed on the declining balance.

5. *Revolving credit.* The traditional thirty-day charge account, which permits buyers to pay for their goods within thirty days of billing without any finance charge, proved inadequate to meet the credit needs of retail buyers of soft goods. Furthermore, sellers of soft goods found it infeasible to use the traditional installment sale contract. Thus, in recent years soft-goods retailers have turned from the old charge account to the revolving credit account. A retailer offering revolving credit assesses the buyer's credit worthiness and assigns a certain credit balance which the buyer is entitled to carry so long as he makes monthly payments of a prescribed amount. When the buyer pays off his outstanding balance his monthly payments cease, only to commence once more when he makes his next credit purchase at that retail outlet.¹⁴

Computation of the credit charge in revolving credit transactions

12. See CURRAN 65-75. The entry of industrial or "Morris Plan" banks into the area of consumer credit preceded that of commercial banks by two decades. For a discussion of the development and regulation of industrial banking, see CURRAN 52-60; JOHNSON 25-26; MORS 15-19.

13. See MORS 18-19. Under the discount method, the appropriate rate of finance charge is applied to the principal of the credit and the resulting finance charge is deducted in advance. For example, if the rate is 6% per year and the principal is \$100 to be repaid in installments over a term of two years, the computation would be: $6\% \times \$100 \times 2$, resulting in a finance charge of \$12. The \$12 finance charge is then deducted from the \$100 principal, leaving a net advance to the debtor of \$88 to be repaid in periodic installments over the term of the credit. The rate may also be stated in dollars per hundred per year. Under the discount method the finance charge is calculated at the inception of the credit extension on the assumption that the payments will be made on time. Prepayments and late payments are treated in the same manner as that discussed in notes 5 & 9 *supra*.

14. See generally JOHNSON 47-50. For detailed treatments of the subject, see COLE, REVOLVING CREDIT (1957); Comment, *Revolving Credit*, 55 NW. U.L. REV. 330-48 (1960).

can be made in a number of different ways, but usually the charge is a fixed percentage of the balance in the account at a given time each month. A very common practice is to charge the customer 1½ per cent of the balance in his account at the beginning of a billing period. For instance, if the outstanding balance at the beginning of the period is \$100, the \$1.50 finance charge is added to the \$100, and the debtor's balance then becomes \$101.50, which must be repaid in future monthly payments.

6. *Check credit plans.* The commercial banks saw no reason to leave the revolving credit concept to the retailers, and therefore developed check credit plans as their entry into the field. The borrower is extended a line of credit up to a maximum amount, upon which he may draw, by writing checks on the bank. He is obliged to make monthly payments of a specified amount. The computational method employed to determine the finance charge is the revolving credit method, usually at a rate of one per cent per month on the balance plus a flat charge (commonly twenty-five cents) per check. The chief computational problem from the bank's standpoint is how to decide the amount of the principal balance upon which the finance charge is to be computed. Different methods have been employed to arrive at the outstanding principal balance for a billing period, ranging from an average of the actual daily balances to the balance outstanding on one day of the month.¹⁵

The foregoing discussion shows that the different segments of the consumer credit industry use different methods to compute the charges which they make for their service. For some, such as small-loan companies and credit unions, the method of computation adopted by the creditor was a reflection of the form of computation prescribed by the applicable rate ceiling statute. In other cases the method of computation set out in the rate ceiling statute reflected the method used in the business practice of the regulated creditor; for example, the retail installment sales rate ceilings were set in terms of dollars per hundred per year add-on, the computational method which had previously been adopted in the industry, under the influence of the time-price doctrine and because of its convenience. The emphasis of consumer credit legislation has been to set rate ceilings rather than to require disclosure of finance charges in terms of rates. Some consumer credit statutes contain no requirement of disclosure of finance charges; others require only that the dollar amount of the finance charge be disclosed.

15. See generally CURRAN 76-79.

Although the various segments of the finance industry are regulated by different statutes and compute their finance charges in different ways, they perform the same general function—the financing of the American consumer. In many cases they are in direct competition with each other for the consumer's business. It is in these areas of actual or potential competition that full disclosure of finance charges is most important. For example, consider the case of a man who wants to buy an automobile which has a cash price of \$2500. He may be told by the dealer that he can finance the purchase at a rate of six dollars per hundred per year on a thirty-month contract through a sales finance company. A bank might offer to lend him the purchase price at six per cent per year, discounted, with a maturity period of twenty-four months. He might also obtain a loan from a small loan company whose rates are $2\frac{1}{2}$ per cent per month on the first \$200, two per cent per month on the next \$300, and $\frac{5}{6}$ of one per cent on the remaining balance, over thirty-six months. A credit union to which the buyer belongs lends money at one per cent per month and pays an annual patronage dividend of uncertain amount. In addition, the buyer may have a savings account at a bank on which he receives four per cent per year interest. It is virtually impossible for the average buyer to determine which of the competing credit suppliers is offering him the cheapest credit. A comparison of these different sources of credit would require a level of mathematical sophistication clearly not possessed by the average consumer. An additional difficulty is that the consumer might not fully understand the meaning of the rate quoted to him in those instances in which rates are in fact quoted. He may not know that on an installment contract, six dollars per hundred per year is not the same as six per cent interest on the declining balance of the debt, but is nearly twelve per cent interest on a twelve-month contract.¹⁶

It is in response to the need of the consumer to be told more about the cost of credit and to be able to compare competing sources

16. In a regular installment contract part of the principal is paid back with each installment; hence, in a loan of \$100 repayable in 12 monthly payments, the average outstanding balance over the period of the loan is about \$50. Thus, if the contract calls for a rate of \$6 per hundred add-on or the actual rate is about double the stated rate, since the finance charge is calculated on the basis of the outstanding balance at the inception of the contract (\$100). Under the constant-ratio method of computation, the actual rate increases on longer term contracts when add-on or discount methods are used; the rate of increase is much greater under the discount method. See JOHNSON 114-17. A number of studies have shown that consumers consistently underestimate the level of finance rates. See JUSTER & SHAY, *CONSUMER SENSITIVITY TO FINANCE RATES: AN EMPIRICAL AND ANALYTICAL INVESTIGATION 47-75* (1964) [hereinafter cited as JUSTER & SHAY]; MORS 80-91.

of credit that the Douglas Bill was proposed.¹⁷ Generally speaking, the Douglas Bill requires all consumer credit suppliers to state their finance charges in terms of an annual interest rate and in terms of a dollar amount.¹⁸ The Douglas Bill is based upon two premises. First, it is assumed that the consumer will benefit from increased competition in the credit market, and that, for competition to work, the consumer must be in a position to know which of competing creditors is offering the lowest credit price. In order for this comparison to be made, the competing credit rates must be disclosed in a manner suitable for comparison. The necessary comparison can be made only if all credit suppliers are required to quote their finance charges in terms of a time rate, since time rates alone allow comparisons to be made regardless of differences in the amount of principal or in the maturity of the credit and variations in the repayment schedule. Second, for disclosure to be effective it must be in a form which is familiar to the consumer. With respect to the cost of credit, the consumer is familiar with the meaning of both dollar costs and annual interest rates, since the two credit transactions most familiar to the average consumer are the home mortgage and the savings account. For these reasons the Douglas Bill requires the disclosure of finance charges in terms of both dollar cost and annual interest rate.

We recognize that disclosure of finance charges is an important problem in the consumer credit area, and we view the Douglas Bill as one possible solution to the problem. However, the purpose of this article is not to debate the merits of the Douglas Bill. It is our objective to examine the theoretical basis for disclosure of finance charges in the light of the practical operations of the consumer credit business with a view toward indicating a possible solution to the problem of disclosure, having due regard for the interests of both consumers and credit suppliers.

II. FUNCTIONS OF DISCLOSURE OF FINANCE CHARGES

The cost of credit may be disclosed to a consumer either in terms of dollar amounts or in terms of a rate based on time. If a rate

17. The most recent version of the Douglas Bill is S. 2275, 89th Cong., 1st Sess. (1965). The extensive hearings on prior versions of this bill are: *Hearings on S. 1740 Before a Subcommittee of the Senate Committee on Banking and Currency*, 87th Cong., 1st Sess. (1961) (Consumer Credit Labeling Bill); *Hearings on S. 1740 Before a Subcommittee of the Senate Committee on Banking and Currency*, 87th Cong., 2d Sess. (1962) (Truth in Lending); *Hearings Before a Subcommittee of the Senate Committee on Banking and Currency*, 88th Cong., 1st & 2d Sess. pts. 1-2 (1963-64) (Truth in Lending).

18. S. 2275, *supra* note 17, § 4.

based on time is used, it can be an annual or a monthly rate. As we have seen, the annual time rate methods in common use are simple interest, discount, and dollars per hundred per year. In order to decide whether the best method of disclosing finance charges is in terms of dollar amounts or in terms of one of these time rates we must first explore the functions to be performed by disclosure of finance charges.

There are three reasons for requiring disclosure of finance charges. First, the user of credit should know its cost in order to judge whether the extension of credit is worth the price. That method of disclosure which most meaningfully describes cost under the circumstances of the particular case should be chosen. Second, the disclosure should be made in such a manner that the user of credit can determine which of alternate sources of credit (which may or may not involve the same type of credit transaction) offers him the best deal. This second aspect of disclosure may conflict with the first, because it may require uniformity of method of disclosure for comparisons to be made. To the extent that some methods of disclosure are more informative in some types of credit transactions than in others, if only a single method is adopted, a compromise may be necessary. Third, the disclosure should allow the potential user of credit to determine whether it would be better to forgo dependence upon credit and to rely upon cash resources instead. This is really an aspect of the second function in that in both situations a comparison is being made between sources of funds. Thus, disclosure may be said to perform a descriptive and a shopping function.

A. Descriptive Function

Dollar disclosure of finance charges is common practice in the field of sales financing. Here retail installment sales laws generally require the seller to disclose the dollar amount of the finance charge as a separate item in the contract. Time rate disclosure is typical in small loan transactions; the buyer is informed that he is paying, for example, three per cent per month for the first \$200, two per cent per month for the next \$300, and one per cent per month for all excess amounts.¹⁹ Time rates can be disclosed in either annual or

19. See JOHNSON 31-32, for methods of disclosure in small loans transactions. Under the small loans acts the debtor need only be informed what the rate ceilings are in small loan transactions. However, since the actual rates charged are usually at the *ceiling* level in this segment of the industry, compliance with the statutes amounts to disclosure of the actual charge made.

monthly terms. One per cent per month on the declining balance equals twelve per cent nominal annual interest. Disclosure of rates as dollars per hundred per annum is an alternate method of stating an annual time rate.

1. *Dollar Disclosure v. Time Rate Disclosure*

In some transactions disclosure in terms of dollars is more meaningful, while in others disclosure in terms of a time rate may be more intelligible to the consumer. The prices of goods and services are usually stated in terms of dollar amounts, and consumers are accustomed to making evaluations on this basis. The price of money, on the other hand, is normally stated in terms of a time rate. In a transaction involving both the extension of credit and the sale of goods or services, the method of disclosure of the finance charge establishes the characterization of the transaction in the mind of the consumer. For example, a person financing the purchase of a house by means of a long-term mortgage normally separates the transaction into two parts: the purchase of the house and the borrowing of money to pay for it. The buyer considers that the house costs \$40,000 and that the loan of \$25,000 obtained to help pay for the house costs 6 per cent per year. However, if the quotation were in terms of the total dollar cost of the transaction, the buyer would see his house as costing nearly \$60,000 on a twenty-five year mortgage. This "cost" figure for the house does not allow for meaningful comparison with the dollar costs of other things that the buyer may purchase. For instance, a person buying a \$17 fan to be paid for in five monthly installments of four dollars does not normally separate the transaction into a purchase and an extension of credit to pay for the purchase. He is simply buying a fan. The \$20 amount accurately indicates to him what the fan costs. The finance charge in this transaction in terms of a time rate—over seventy per cent nominal annual interest—may only lead him to believe that he is paying an exorbitant rate of "interest."

The simple explanation for the different manner in which a consumer looks at these two transactions is, of course, the time differential in the two cases. The payment of a dollar today is not comparable to the obligation to pay a dollar in ten or twenty years. A comparison requires a calculation of the value of the use of money. This comparison can be made meaningfully by talking in terms of interest rates based on time. Where the time factor is not significant, as in the fan situation, the straight dollar comparison gives a more accurate picture.

Another problem which must be faced in choosing between dollar and time rate disclosure is raised by the size of the transaction. Finance charges can be divided into two elements: (1) a charge for the use of money, which can be termed the interest charge (this includes both the economist's concept of "pure interest" and the compensation for the risk of not being paid), and (2) service charges for administrative costs with respect to the credit, such as the costs of processing the credit and investigating the risk.²⁰ If the amount of credit extended is very large, the proportion of the credit charge applicable to service charges will be small and the proportion applicable to interest charges will be large. The converse will be true where the amount of credit extended is small. Thus, a comparison of how much a small amount of credit should cost with how much a large amount should cost cannot be made without taking into account service costs. However, there is a tendency to compare specific credit charges with some hypothetical standard of what the cost of credit should be. The best known examples of the price of money to the average citizen are the amount his money brings when lent to someone else (savings accounts and government bonds) and the amount he pays for money on his real estate mortgage. In these examples the rate is low and the finance charge is made up almost entirely of interest as opposed to service costs. The use of this kind of example has led to the so-called "six per cent myth." Therefore, if the method of disclosure invites comparison of transactions involving high service costs with transactions involving low service costs, the credit consumer may be misled in his value judgments.

2. *Disclosure of Dollar Amount of Monthly Payment*

The sale of goods on installment contracts has been analyzed above in terms of the sale of a product and the simultaneous extension of credit to finance the purchase. This analysis may require some refinement. Customarily, sales and leases have been treated as diverse concepts which can be given separate treatment. Actually, in the modern commercial world the two concepts have often become blurred. A credit sale covering the useful life of a product is economically similar to a lease of the product over the same period. For example, the purchase of an automobile on credit and the purchase of a five-year lease of that automobile may be economically more similar than they are different. There seems to be a trend toward longer time-spans in installment sales contracts while at the same

20. See JOHNSON, ch. 2; MORS 75-78.

time built-in obsolescence has become commonplace in consumer goods. The two trends may converge so that in many cases the useful life of the product and the time-span of the credit are substantially the same. Where this is so it may be misleading to consider the transaction as primarily a purchase and sale. It might be more useful to recognize it as the payment by the "buyer" for the use of the product over its useful life. This analysis is particularly convenient if the proportion of the people who pay cash for the product is very small. Where such is the case, employment of dollar amounts to indicate the purchase price of either the product or the credit may not be very descriptive. The amount of a monthly cash payment may, however, be very meaningful to the purchaser.

It is very difficult to generalize concerning the extent to which buyers look upon purchases in terms of the monthly dollar cost of using the product. Undoubtedly, a substantial number of buyers are accustomed to looking at their financial affairs in terms of their monthly or weekly disposable incomes and can make appraisals of their ability to pay only in those terms. For them, any disclosure which cannot be translated into periodic terms is meaningless.²¹

It is clear, however, that any disclosure statute should take into account the differing natures of the various consumer credit transactions and the impact that any disclosure system is likely to have on the various kinds of credit consumers. We have discussed the three principal methods of disclosure: (1) total dollar cost of the credit or of the product being purchased; (2) amount of the credit charge expressed as a time rate; and (3) total monthly dollar cost of the credit or of the product being purchased. That these various methods are informative in some situations and misleading in others has been demonstrated. For this reason it might be undesirable to use certain kinds of disclosure in some classes of transactions. It might be that no single method of disclosure of finance charges can effectively further all the different objectives of disclosure. The only

21. Economists disagree concerning the extent to which demand for consumer credit is elastic with respect to such factors as the amount of the monthly payment, the amount of the down payment, or the level of the finance charge. One group assumes that consumer demand is most influenced by the size of the monthly payments and thus that a change in finance rates affects demand only to the extent that it changes the amount of the monthly payment. Since increases in finance charges spread over the length of the contract raise the monthly payments only slightly, this group argues that demand for consumer credit is relatively inelastic with respect to changes in finance charges. A 1964 study has led Juster and Shay to conclude that there is perhaps greater sensitivity to changes in finance charge rates than had been assumed, but only among families described as "unrationed" consumers; this classification includes those families with an economic position which is stable enough that they can borrow additional amounts of credit from low rate sources. See JUSTER & SHAY 6-46.

alternatives, then, would be to require multiple methods of disclosure or to tailor disclosure requirements to classes of transactions.

B. *Shopping Function*

It has long been a part of public policy in the United States to rely upon competition to ensure that the consumer receives the best product or service obtainable at the lowest possible price. However, price competition functions best when the various vendors are all selling the same product. When each merchant sells something a little different from the others, or when each merchant uses a different standard for measuring the price of his product, price competition is more difficult.

Little can be done about the problem of product differentiation. Different credit packages will continue to be available on the market, and such diversity is desirable. Nevertheless, even within a system of diverse products uniformity of method of price quotation may be obtainable. Ideally, we should select the method of disclosing finance charges which best lends itself to the comparison of credit transactions that are not identical.

To rely exclusively on dollar disclosure of the cost of credit does not seem promising in this regard.²² A person desiring to borrow \$1000 will find it very difficult to compare the offer by one lender of a two-year contract calling for the payment of \$1200 in twenty-four equal monthly installments of \$50, and the offer by another lender of a three-year contract calling for the payment of \$1368 in thirty-six equal monthly installments of \$38. The borrower may prefer a long or short contract, and this may affect his judgment, but it is difficult for him to tell whether the higher or lower dollar cost is more "expensive."

The difficulty involved in comparing dollars payable at different times, which is the core of the problem in the last example, can be avoided by the use of rates that are a function of time rather than of dollar amounts. Thus, if all grantors of credit were required to quote charges on the basis of a time rate, such as per cent per year on the declining balance, the consumer could be sure that the one quoting the lowest rate was asking least for his credit, regardless of the maturity time or the amount of the loan. This does not mean the consumer would necessarily accept the least expensive offer. It might be "cheaper" for a low-income consumer to pay less per month for a longer period, even if the rate is higher; but at least

22. See MORS 39-43.

the factors bearing on the choice are clarified. If the consumer is making a sacrifice in order to pay less per month, the rate will tell him so.

It is also important to recognize the limitations of the shopping function. Insistence on uniformity for the purpose of comparison is justified only to the extent that shopping is feasible. To facilitate shopping, it is important that all alternative sources of credit quote their charges on the same basis. However, if in certain types of transactions some sources of credit are available and some as a practical matter are not, uniformity of disclosure need apply only to those sources that are in fact available.

1. *Cash Loans*

We can start with a breakdown between cash loan transactions and credit sales of goods or services. In a sense this dichotomy is artificial, since practically all consumer cash loans are made for the purpose of paying for goods or services (which may have been bought prior to the extension of credit). On the other hand, the dichotomy is useful in analyzing the shopping problem. Since money is fungible, consumer shopping for money can drive the price of money to a competitive level. Assuming that a uniform system of quoting rates is adopted, the consumer can readily shop for money itself, and competition in the credit industry will be more effective.

Different segments of the consumer credit industry charge significantly different rates. For instance, commercial banks normally charge lower rates on personal loans than do small loan companies. Part of the explanation lies in the credit worthiness of their customers and in statutory limitations on the size of loans that each type of lender is allowed to make, but such segmentation seems artificial. Suppliers of a fungible commodity could serve most segments of the market by adjusting rates to credit risks. Undoubtedly some customers of small loan companies would qualify as borrowers from commercial banks. It may be that the difference in techniques of disclosure of charges tends to impede competition between the two groups. If this is true, a common method of computation for disclosure purposes would make price differences more apparent and thus increase competition.

2. *Credit Sales of Goods and Services*

Shopping for credit is effective whenever credit can be separated from the product or service to be bought with the credit. A person desiring to buy a new Chevrolet on an installment contract can

effectively shop for both the car and the credit. Similar Chevrolets are fungible; since all dealers quote cash prices, the buyer can choose the one quoting the lowest price. He can also shop for the cheapest credit if all lenders of credit, including both sales finance companies and cash lenders, are required to quote prices on a common basis, such as in terms of a rate based on time.

Of course, the vendor of a differentiated product who also provides credit financing can arbitrarily allocate part of his price to finance charges and part to the purchase price of the product. However, there are practical restraints on this allocation if the seller makes many sales to cash buyers and if the amount of the finance charge is large enough to encourage buyers to shop for the best credit rate. In this situation, if the vendor must quote a cash price, he cannot allocate too much of the credit price to the finance charge without incurring the risk that buyers will accept his unrealistically low cash price and finance elsewhere. He runs less risk by allocating a disproportionately high amount to cash price, but by doing so he might injure his cash market. At any rate, this kind of problem cannot be entirely avoided whether there is uniformity in credit charge disclosure or not.

On the other hand, if the vendor sells almost exclusively to credit buyers, as do those who deal only with low-income buyers, or if the credit charge is small, there is great leeway with respect to allocation of finance charges. For example, it is common for some credit clothiers and jewelers to make no separate charge for credit; their prices are quoted as the cost of buying the goods over a given period of months with no allocation made between the cash price of the goods and the cost of credit. Other dealers may state a charge for credit that is unrealistically low as compared to the cost to the dealer of extending the credit. These dealers may emphasize in their advertising that no charge or a very low charge is being made for credit. In fact, the consumer may be paying a large price for credit, since the price of the goods sold may have been greatly inflated. This points up one danger in overemphasizing the cost of credit as a shopping device: it encourages some merchants to mislead consumers into believing that they are receiving a benefit in paying low finance charges when the total credit price of the product sold may actually be excessive. One observer has pointed out that in poverty areas customers tend to be captives of the dealer because of their lack of credit worthiness.²³ In such a market there is no shopping for credit,

23. CAPLOVITZ, *THE POOR PAY MORE*, ch. 2 (1963).

and therefore it is doubtful whether disclosure as a protective measure has any beneficial effect.

Shopping for credit is less effective whenever credit is closely tied to the goods or services to be bought with it. For example, assume that a credit buyer goes into a department store to purchase an item for a cash price of \$17.50. Disclosing to him in his contract that finance charges will equal a stated annual rate means much less to him than a similar disclosure means to the purchaser of a new car, because it is more difficult for the former buyer to shop for credit, as such. It is unlikely that he will go to a cash lender to borrow money to pay for his purchase. Consequently, there is no compelling reason to have cash lenders and department stores disclose finance charges on a uniform basis. The chief alternative open to the credit buyer in this example is another retailer. In this kind of shopping, the price of goods and the price of credit are inextricably bound together. The buyer must compare the combined price of product and credit at the two competing sources. To the extent that a large proportion of goods sold by competing department stores and similar retailers are not precisely fungible, the problem is further compounded. Retailer *A* sells electric fans for \$23 on revolving credit, charging 1½ per cent of the monthly balance and requiring a monthly payment of at least ten per cent. Retailer *B*, a mail order company, sells its own brand of electric fan for \$17 cash or for four monthly payments of \$5. The extent to which the price of credit affects the buying decision with respect to this kind of transaction is problematical.

A relatively recent development has changed to some extent the problem considered in the previous paragraph. The check credit plans of commercial banks make it possible to shop independently for credit even in the type of situation just described. These plans are becoming popular in some sections of the country, but in many areas are not yet a major factor. However, it is important to consider this development because it is a good example of a new practice created to meet new competitive needs.

3. *Extent of Credit Shopping*

It is extremely difficult, in the absence of empirical evidence, to categorize transactions in which shopping for credit is a substantial factor. Theoretically, credit shopping can exist with respect to any sale transaction in which the credit balance is as large as the smallest cash loan available from normal commercial sources. It is probable, however, that credit shopping is actually much more limited than

this would suggest. The sale of new automobiles presents a clear case in which credit shopping is practiced; it is difficult to ascertain the extent to which shopping for credit exists with regard to lower priced items such as appliances and furniture.

The sale of small-ticket items is a particularly troublesome area. It is questionable to what extent disclosure of finance charges in terms of a time rate performs any useful function in furthering credit shopping here. Moreover, it is very difficult to obtain any meaningful uniformity of disclosure. We suspect that buyers are more interested in learning the total dollar price of an item than they are in being told that the finance charge amounts to two per cent per month or twenty-four per cent per year. The value of disclosure as an aid to credit shopping is even more questionable if the dealer sells only to credit buyers and states that there is no charge for credit. Requiring him to break down his price into a cash price and a finance charge and to disclose the time rate of the finance charge is likely to result in the establishment of a highly arbitrary rate which would be of little use to a consumer.

Disclosure of finance charges serves another shopping function; it enables the potential borrower to decide whether he will use credit or draw upon his liquid assets to meet his needs. If a person desiring to buy a \$3,000 automobile realized that he must pay finance charges on that sum at the rate of eighteen per cent per year, he might choose to withdraw the necessary funds from his savings account on which he is earning under five per cent per year. At present, since finance charges in this kind of transaction are quoted in terms of dollars per hundred, purchasers may not be acutely aware of the disparity between the costs of financing and the earnings from their savings accounts. It can thus be argued that since savings institutions quote earnings on deposits in terms of annual interest, finance charges should also be stated in these terms in order to provide maximum comparability.

It is uncertain to what extent consumers actually engage in this kind of shopping for alternate sources of funds. The Juster-Shay study indicates that some consumers are sensitive to finance charges as a basis for deciding whether to use credit or liquid assets.²⁴ Apparently, credit price sensitivity is highest in a particular group of consumers—those who have savings accounts and certain other indicia of economic stability. For this higher economic group, the statement of finance charges in terms of annual interest would pre-

24. See JUSTER & SHAY 6-46.

sumably be of some benefit. On the other hand, there are many consumers who have no savings accounts or who prefer to hold their savings in reserve for emergencies. For this group, a quotation of consumer credit rates in terms of annual interest is of less importance.

III. FEASIBILITY OF DISCLOSING FINANCE CHARGES

The foregoing analysis of the functions performed by disclosure of finance charges indicates that in some transactions disclosure in terms of a time rate would be beneficial to consumers. In other transactions time rate disclosure may be a neutral factor, neither helping nor harming the consumer. Only in short-term, small-size credit transactions is time rate disclosure possibly harmful in that it gives a misleading impression of the cost of credit.²⁵ We can therefore conclude that in the absence of other considerations it would theoretically be sound to require time rate disclosure in most transactions. However, time rate disclosure cannot be given by the credit supplier without some economic cost; any evaluation of the desirability of required time rate disclosure must take into account these economic costs. It would seem sensible to require time rate disclosure only in those cases in which the economic benefit to be derived from such disclosure outweighs the economic cost of providing it.

There are two types of time rates which might be used if time rate disclosure were required. The first type expresses the finance charge as a rate based on the declining balance of the debt as it is repaid. For example, if there is a credit of \$1,200 with a finance charge of \$72, and the debt is repayable in twelve monthly installments of \$106, the finance charge is calculated in terms of the average amount of principal outstanding over the term of the credit. Thus, the rate would be approximately 11.08 per cent per year or 0.92 per cent per month.²⁶ The second type of time rate expresses the finance charge as a rate based on the total amount of the credit

25. We suspect that if a merchant were required to disclose his finance charges in small transactions in terms of a shockingly high rate, he would lower the rate to a tolerable level by arbitrarily allocating a greater part of the total credit price of the product to the cash price. This can be done by any merchant who sells a large proportion of his goods on credit. The net result is that cash buyers would have to subsidize credit buyers.

26. This calculation was made according to the constant ratio method of charge distribution. Under that method, it is assumed that each installment payment is credited partly to the amount financed (principal) and partly to finance charge, in the same proportion that the original amount financed and the original finance charge bore to the original debt. Interest charges can also be calculated according to the annuity method of charge distribution. By that method the interest charges for the example given are 10.9% annual and 0.93% monthly. See JOHNSON 108-10.

at the inception of the credit. Using the same example, the rate would be six dollars per hundred per year, or fifty cents per hundred dollars per month. In the subsequent discussion, the first type of time rate will be referred to as "interest on declining balance" and the second type as "dollar add-on."

The question whether the use of a time rate is feasible has two aspects. First, is it possible to give such a rate in a certain type of transaction? If so, is the economic cost of giving a time rate worth the economic benefit to be derived from the disclosure?

A. Impossibility of Time Rate Disclosure

It is mathematically possible to give a time rate whenever the amount of the credit, the amount of the finance charge, and the amount and time of the payments are known. If the payments are regular in amount and interval, the calculation of a time rate can be made using a simple formula. If the payments are irregular in either amount or interval, the calculation becomes more difficult as the irregularities increase. In cases involving highly irregular repayment schedules, the use of computers may be needed, but there is no situation in which the determination cannot be made. However, if any one of the factors named—amount of credit, amount of finance charge, or amount and time of payments—is not known, it is impossible to give a time rate.

If the purpose of time rate disclosure is to tell the consumer how much he is being charged so that he can decide whether to enter into the contract, then it is vital that the disclosure be made before the contract is made. In some situations it is not possible to make accurate time rate disclosure at the inception of the transaction. There are two common examples: revolving charge accounts and check credit plans.²⁷

27. Revolving charge accounts are of two types, those offered by retailers and those offered by banks or other financial institutions. With a retailer revolving charge account the customer may purchase goods at the retail store with which he has the account, and the purchases are debited to an open account. Normally the retailer will not allow charges above a certain figure. The amounts debited to the customer's account are payable by the customer in installments. Since small retailers frequently find it uneconomical to have their own individual revolving credit system, sometimes a number of retailers will cooperate in forming a commonly owned agency to operate such a system. However, it is becoming more common for retailers, large and small, to rely upon the charge account plans of financial institutions. These plans are represented by such well-known credit cards as BankAmericard, Carte Blanche, and Diner's Club. The retailer allows the customer to pay for the goods by using his credit card. The financial institution then pays the retailer the amount of the purchase, less a charge. The financial institution then bills the customer. Terms of payment vary considerably, but many organizations offer terms similar to those of retailer revolving charge accounts.

There are various ways of computing finance charges in revolving credit accounts, but we will take one common method as illustrative. Each customer is given a monthly billing date. On this date each month he must pay a credit service charge equal to $1\frac{1}{2}$ per cent of the unpaid balance in his account at the beginning of the previous billing period. Assume that a customer, X, is assigned the first day of the month as his billing date and that he opens an account on February 4. He makes several purchases totaling \$100 during the month of February. On March 1 he will be billed. The bill will show an opening balance (unpaid amounts as of February 1) of zero and purchases during the month of \$100. Since the credit service charge is calculated on the basis of the opening balance, no credit service charge is made. If X pays the balance on or before March 31 he will not have to pay any credit charge. If he does not pay, the \$100 becomes the opening balance for the April 1 bill and a credit service charge of \$1.50 will be imposed. To illustrate the impossibility of giving time rate disclosure, we shall assume that X makes the \$100 purchase on February 4 and pays the \$100 on March 31. He has had fifty-five days of credit for which he must pay nothing. However, if he pays the \$100 on April 1 he has had fifty-six days of credit for which he must pay \$1.50. In one sense it might be said that he paid \$1.50 for one day's credit. If he does not pay the \$100 in one payment but rather pays it off in installments over several months, there will be additional finance charges and again the rate will change. The time during the billing cycle when purchases are made and the time when payment is tendered are varying factors which make it impossible to tell the customer in advance how much he will pay for credit in terms of either a dollar amount or a rate. The most that can be done with respect to disclosure by such a seller is to explain to the customer the "rules of the game" so that he may fully understand the conditions under which a credit service charge is made and how it is calculated.

Check credit plans offered by banks raise similar problems. Under one common plan the customer is given a credit of a fixed dollar amount. He may write checks on the bank up to this amount; when the bank clears a check, a loan is effectively made. The customer is charged one per cent per month on the daily balances in his account. Unlike the $1\frac{1}{2}$ per cent charge in the department store plan just described, this one per cent is a true time rate, and if this were the only charge that the bank made it could tell the customer that he was being charged one per cent per month or twelve per cent per year interest. However, it costs money to process checks and to

make entries in an account; it is obviously more expensive to the bank if a customer borrows \$100 by writing ten checks of \$10 each than if he borrows the \$100 by writing one check. To compensate for the cost of processing, the bank makes an additional charge of twenty-five cents per check. This twenty-five cent additional charge applied to the above example makes a substantial difference in the effective rate which the customer is paying for his credit.²⁸ Since the number of checks which will be written cannot be predicted in advance, no time rate or dollar amount can be disclosed to the customer. Again, the most that can be done is to disclose to the customer the method by which the finance charge will be calculated and imposed.

It is possible in both of the above situations for the creditor to construct "typical" patterns followed by users of its credit and to state what the effective rate of charge would have been in such cases. If a particular customer's buying habits fit the hypothetical pattern, the disclosure is valuable. However, if the customer's buying habits do not fit the hypothetical, the disclosure may be not only unhelpful, but even positively misleading. A consumer must be highly sophisticated to compare his credit patterns accurately with those of a hypothetical case and then to make the adjustments needed to arrive at useful information.²⁹

B. *Economic Feasibility of Time Rate Disclosure*

Open-end credit, such as that discussed in the preceding two examples, is the only situation which presents a problem of impos-

28. If it is assumed that the \$100 is paid off in five monthly installments, with the first installment paid one month after the loan, the person who wrote ten checks would pay about 22% annual interest and the person who wrote one check would pay about 13% annual interest.

29. At the request of Professor Robert W. Johnson, a leading retailer selected at random 205 of its revolving credit accounts and calculated, on the basis of the annual interest on the declining balance, the actual rate of the finance charge for the period September 10, 1964, through September 9, 1965. The results were as follows:

<u>Annual Rate</u>	<u>Number of Accounts</u>	<u>Per Cent of Total</u>
0%	53	25.8%
1% - 9.9%	23	11.2%
10% - 14.9%	27	13.2%
15% - 16.9%	22	10.7%
17% - 17.9%	40	19.5%
18% - 18.9%	28	13.7%
19% - 20.9%	12	5.9%
	<u>205</u>	<u>100.0%</u>

This retailer used a billing system and charge identical to that described in the text. If this sampling is representative of revolving credit accounts, it indicates clearly that it is not accurate to equate the 1½% monthly charge with an 18% annual rate as is sometimes suggested.

sibility. Some opponents of time rate disclosure have, however, attempted to fit ordinary closed-end installment contracts into the same pattern. This view seems to have no merit. The arguments made in behalf of this view may be assessed by taking an example previously used. A borrower is given \$1,200, which is to be repaid in twelve monthly installments of \$106. We have indicated that the time rate on this contract is 11.08 per cent per year or six dollars per hundred per year. However, in a large number of cases payments are not made on time and late penalties are imposed. A surprisingly large number of small loan contracts are never carried through to completion according to their original terms. Rather, they are refinanced; the original loan is paid off by a second loan from the same or a different lender. Furthermore, some loan contracts are paid off before maturity. In most cases refinancing or prepayment will result in the refund to the borrower of unearned finance charges, a factor which may materially change the effective rate of charge.³⁰ If a substantial number, or, as in some situations, a large majority, of installment credit contracts are not completed as planned, any rate stated at the inception of the contract will in fact be inaccurate. To the extent that these variations are material, time rate disclosure could be deceptive.

If the only purpose of time rate disclosure is to state accurately the actual cost of credit to the consumer, this argument would have great weight. If, on the other hand, the principal function of time rate disclosure is to tell the consumer which one of various sources of credit is least expensive, accuracy with respect to the actual amount which will in fact be charged is not vital. The variables are created by the possibility that the consumer will incur penalties for late payment, will prepay, or will refinance. In allowing the consumer to shop for credit, these variables are material only if the competing creditors used different methods of dealing with late payments, prepayments, and refinancing. For example, creditor *A* offers a loan at twelve per cent and creditor *B* offers a loan of the same amount and with the same repayment schedule at eleven per cent. *B*'s loan appears to be cheaper. But suppose *B* exacts larger penalties for late payments and refunds less of the finance charge in the event of prepayment or refinancing. If *B*'s experience is that a majority of his loans result in late payments, prepayments, or refinancing, he may in fact be charging the majority of his customers more than *A* would charge them. A person contemplating borrowing from either *A* or

30. See notes 5 & 6 *supra*.

B would therefore have to consider the likelihood of his completing the contract as planned before choosing *B*'s loan. However, if penalties for late payment and refunds of unearned finance charges for prepayment or refinancing are standardized by statute, the possibility of deception in this kind of case is removed, and time rate disclosure will allow the borrower to shop effectively. Even though the variables discussed may affect the actual cost of the credit to the consumer, if they are standardized they will not affect the relative price of credit among competing lenders. Thus, with respect to installment contracts with set schedules of payments, rate disclosure based on the assumption that the contracts will be completed as written can be meaningfully made.

Another argument often made by opponents of time rate disclosure is that it is very difficult to take into account the irregularities in a certain contract. This argument has been directed principally against disclosure expressed in terms of interest on the declining balance, but it also applies to some extent to dollar add-on disclosure. Suppose, for example, that a dealer offers to sell an automobile for a cash price of \$3,000. A buyer offers a used car valued at \$1,000 as a down payment and wishes to finance the rest. The purchase is made on December 1. The dealer agrees that the \$2,000 balance will be financed on a contract requiring twenty-four monthly payments of \$96.67. As a selling point the dealer agrees that the first payment will not be due until February 1. Or, if the buyer is a seasonal worker who is not paid during the two summer months (such as some teachers), the dealer might agree to let the buyer postpone the July and August payments until the end of the contract. The finance charge in both cases is \$320, and it can easily be computed by the dealer. If his rate is eight dollars per hundred per year, it is a simple matter to multiply \$8 by 20 by 2. The monthly payment is also easily computed by dividing \$2,320 by 24. However, if in either case the dealer is required to give the interest rate on the declining balance or a true dollar add-on rate, he cannot do so without a complex mathematical calculation. The term of the credit is not twenty-four months, but rather is almost twenty-five months in the first case, and is nearly twenty-nine months in the other case. Furthermore, in both hypotheticals some of the payments fall at irregular intervals. For these reasons the true dollar add-on rate is under his usual eight dollar rate. Nor can the true dollar add-on rate or the interest rate on the declining balance be obtained from a standard precomputed chart. A chart can be prepared only on the basis of a given term and a given schedule of payments.

If exact rates were not required, a reasonable approximation of either a dollar add-on rate or an interest rate on the declining balance could be given in relatively long-term contracts.³¹ Therefore, economic feasibility in cases involving irregular contracts may depend upon whether approximations are acceptable. To require more accurate disclosure than that indicated in the above examples may mean that substantial additional economic costs will have to be incurred by lenders. It seems doubtful that business can operate effectively if complex calculations must be made with respect to every transaction. The calculations could not be made by salesmen; rather, they would have to be made by special personnel using mechanical calculators. Although there is no basis for estimating what these additional economic costs might be, it is unlikely that the increased accuracy obtainable by precise calculations is worth any substantial expense.

In order for approximations to be meaningful with respect to an irregular contract, the irregularities cannot depart too much from the norm. In the case of highly irregular contracts it is not possible to give even a reasonably accurate time rate except with the aid of complex mathematical formulae. Such contracts are probably not

31. Most contracts are irregular in some respects. Most irregularities are due to the fact that (1) the period between the date of the contract and the due date for the first installment is either shorter or longer than the period between all other payments, or (2) the debtor is allowed to postpone some other payments. A person whose first payment falls due thirty days after the date of sale pays a slightly higher rate than the person whose first payment falls due after forty-five days if in all other respects the contracts are the same. Similarly, the debtor who can postpone some later payments pays a lower rate than the one who cannot. In short-term contracts irregularities in the time of first payment can cause significant distortion, but where the time is relatively long—one year or more—the distortion is much less. For the first example given in the text (a delayed first payment in a 24-payment contract at \$8 per \$100 per year) the effective annual rate is 14.68% if the first payment is regular, *i.e.*, made one month after the contract date, and is 13.54% if the first payment is not made until two months after the contract date. In most cases the first payment will not be delayed as much as two months. Irregularities of this kind are ignored if a formula which gives a rate based on the number of payments rather than exact lapse of time is used. Under such a formula all contracts calling for twenty-four monthly payments would yield the same rate, and slight differences in the lengths of the contracts are not considered. The following formulae will produce a rate which does not take into account irregularities and which will always slightly overstate the actual rate paid if there is a postponement in either the first or a subsequent payment:

$$\begin{array}{r} \text{Annual Interest Rate} \\ R = \frac{2 PC}{A(N + 1)} \end{array} \qquad \begin{array}{r} \text{Dollars Per Hundred Per Year} \\ R = \frac{100 PC}{AN} \end{array}$$

R is the rate; P is 4 if payments are quarterly, 12 if payments are monthly, or 52 if payments are weekly; if the payment period is other than monthly, weekly, or quarterly, P is the closest whole number resulting from the division of 365 by the number of days in the payment period; C is the finance charge; A is the amount financed; N is the number of installments in the contract.

common, since effective business operations normally require a high degree of standardization. In the absence of contrary evidence they can be dismissed as an economically insignificant factor.

With respect to small balance contracts, rate charts cannot be used in precisely the same manner as they are used in larger transactions. In large transactions the amount financed can be rounded off to the nearest ten dollars by adjusting the down payment, and conceivably the creditor could quote a dollar add-on rate by making a simple manual calculation. If, as is usually the case, a chart is used, it can give the time rate for each dollar amount. However, in small transactions the amount of the purchase, including sales taxes, will commonly be an odd amount and often will not be rounded off to the nearest five or ten dollar amount. If the retailer is required to give a time rate for these small purchases, serious problems of feasibility arise. Considering the size of the transaction, it is clearly unreasonable to expect the retailer to make a separate manual calculation for every dollar amount; but if the seller wants to use a chart which will give an accurate statement of time rates, he would need a chart which takes into account every dollar amount of purchase price possible. A chart of this description would be highly cumbersome, and the economic costs of clerical time and clerical errors would undoubtedly be great. Thus, for many merchants this type of chart would be completely infeasible. A good example may be drawn from mail order buying, which is a widespread practice. The buyer has access to a catalogue describing the products offered for sale and listing the cash price of each. In normal practice the buyer may choose several items, which he lists on an order form. He then adds the cash prices of the individual items. Suppose the total is \$125. The buyer is given the opportunity of deferring payment of this \$125 by signing an installment contract, and is referred to a table which indicates that the finance charge on all amounts between \$120.01 and \$130 is \$13. He simply adds \$13 to the \$125 to arrive at his total debt of \$138. If the law required disclosure of the precise time rate in catalogue sales, it would be necessary to have a chart detailed to every dollar amount which could possibly be a total purchase price, and such a chart would be very difficult for mail order buyers to use.

An alternative solution for small retail transactions, whether by catalogue or otherwise, is to adapt the charts now in use. Charts such as that described with respect to catalogue sales are also used in face-to-face retail sales. The chart could indicate the time rate on a \$120 purchase and the time rate on a \$130 purchase. The buyer

would then know the range of rates and could estimate what he would be paying. In the above example, the range is between 18.1 per cent and 15.7 per cent annual interest on the declining balance. This range is not very wide and gives a reasonably accurate statement of time rate.

Even with the use of charts, however, time rate disclosure can be given only if the particular transaction is an isolated one. For example, a customer buys an item selling for \$127 cash. A finance charge of \$13 is added, and the total of \$140 is made payable in fourteen monthly payments of \$10. The chart indicates that the rate is between 15.7 per cent and 18.1 per cent. Two months later the same customer buys an item selling for \$10.75 cash. A finance charge of \$1.25 is added, and according to the chart the total of \$12 is payable in four monthly payments of \$3. The chart indicates that the rate is between 42.6 per cent and 62.4 per cent. But, because it is inconvenient for both the customer and the store to have several individual contracts with different terms outstanding at the same time, the two contracts are consolidated; the store informs the customer that under the new contract he must pay \$11 per month for twelve months. The total, \$132, is the total of the unpaid balance on the first contract, \$120, plus the amount of the second purchase, \$12. The term of the contract is the unexpired term of the longer contract. Thus the effective rate on the second purchase is not between 42.6 per cent and 62.4 per cent, but is actually 21.5 per cent!

Where revolving credit is not used, such consolidation of time sale contracts is common practice. It is of great benefit to the consumer, since he makes one payment instead of several without any increase in his finance charge. However, as the above example shows, the effective rate can change very substantially. The example also points up the fact that the \$1.25 is a service charge primarily designed to cover the cost of handling the transaction. The term over which the finance charge is payable greatly affects the time rate, but the length of this term is determined fortuitously by the term of the outstanding contract with the customer. Neither the 21.5 per cent or the 42.6 per cent to 62.4 per cent figure is very significant; however, the \$1.25 figure is highly significant.

Whenever a purchase is to be consolidated with previous debts owed by the customer, time rate disclosure by the salesman is not feasible, since he needs information concerning the outstanding debt which he normally will not have. Even if he had this information, a salesman would not normally be expected to spend his time mak-

ing the required calculations. A central record office ordinarily would be consulted to provide the information. With respect to large transactions, it might be economical to get the information for the purpose of precontract disclosure, but it certainly is not economical in the case of small transactions. Of course, precontract time rate disclosure would be impossible with respect to such transactions as mail order sales; the most that could be required in such a case would be that the purchaser be informed, after the contract is in effect, of the effective rate.

IV. TRANSACTIONS IN WHICH TIME RATE DISCLOSURE IS DESIRABLE

Having examined the different functions of disclosure of finance charges and the feasibility of making time rate disclosure in various transactions, we shall relate function to feasibility and evaluate the desirability of the various methods of finance charge disclosure. It is our thesis that disclosure of finance charges is not an end in itself; rather, legal requirement of disclosure by any method must be justified on the ground that it performs some useful function. How finance charges should be disclosed and in what transactions disclosure should be required are questions that must be solved by balancing the benefit to the consumer against the cost to the creditor.

There are three methods of disclosure: in terms of total dollar amount of the finance charge, in terms of periodic dollar payment, and the expression of the finance charge as a time rate. We believe that, with the exception of very long-term debt, the consumer should be told the total dollar cost of the credit in all transactions in which such disclosure is possible.³² In most instances information about the dollar amount best performs the descriptive function of finance charge disclosure. Except in open-end credit transactions, such as revolving credit, it is feasible for the creditor to supply dollar disclosure at the inception of the transaction. In open-end credit, periodic disclosure of dollar amount of finance charges can be made after debts are incurred. Disclosure of the amount and number of periodic payments has long been regarded as a minimal standard with respect to consumer credit transactions and should be required in every situation in which it is feasible.

The remaining question concerns the desirability of time rate disclosure. In the section on feasibility it was concluded that it is not possible for a creditor to make time rate disclosure in open-end

32. Such a requirement is contained in § 4 of the Douglas Bill, S. 2275.

credit transactions.³³ It was also concluded that in closed-end credit transactions it is *possible* for a creditor to give time rate disclosure whenever the amount of the credit, the amount of the finance charge, and the time and amount of the payments are known. Furthermore, by use of charts it is *feasible* to make time rate disclosure in all closed-end credit transactions except small retail sales if (1) an approximation rather than an exact rate is acceptable, and (2) the contract is a reasonably regular one. In small retail transactions, however, the feasibility of disclosing finance charges by time rate is questionable. As was suggested in the previous section, in cases involving small, odd-dollar retail sales, time rate disclosure can, as a practical matter, be given only in terms of a range of time rates covering a spread of different dollar amounts. Disclosure of rate by range of dollar amounts gives a reasonably accurate approximation of how much is being charged if the transaction is an isolated one. Ordinary sales clerks could be trained to use the necessary charts, which appear to be no more difficult to use than a sales tax chart. However, if the transaction is not isolated but is to be consolidated with existing debt, meaningful time rate disclosure cannot economically be made before the contract is signed. It is pointless to require disclosure of a rate that may not bear any relation to the true rate. Furthermore, to require the calculations necessary to arrive at a reasonably accurate rate in a non-isolated small transaction would impose inconvenience and serious economic cost upon both seller and buyer. To appraise fully whether imposition of these additional economic costs is justified, the question whether time rate disclosure serves a significant purpose in small transactions should be considered.

In the section on the function of disclosure of finance charges, it was concluded that time rate disclosure does indeed further the major function, that is, credit shopping. Our analysis leads to the conclusion that in those transactions in which shopping for credit as such is possible, such as auto sales, time rate disclosure contributes

33. The current version of the Douglas Bill, S. 2275, requires time rate disclosure in open-end credit transactions. Section 4(b) provides that in open-end credit transactions the creditor shall "(1) Furnish to such person, prior to agreeing to extend credit under such plan, a clear statement in writing setting forth the simple annual percentage rate or rates at which a finance charge will be imposed on the monthly balance; and (2) furnish to such person, at the end of each monthly period . . . a clear statement in writing setting forth to the extent applicable and ascertainable . . . the simple annual percentage rate or rates at which a finance charge has been imposed on the monthly balance." The September 25, 1964, Committee Print of S. 750 included amendments to the original version of the bill that abrogated the requirement of time rate disclosure in open-end credit transactions. In deleting these amendments, Senator Douglas in S. 2275 has gone back to his original across-the-board requirement of annual percentage disclosure.

to improving the consumer's ability to shop more wisely. Not only does time rate disclosure allow the credit shopper to compare the rates of the different major segments of the finance industry (banks, credit unions, sales finance companies, small loan companies, and retailers), but also allows him to evaluate more accurately which companies within the different institutional segments offer the most attractive deal. We believe that credit shopping is possible with respect to virtually all sizes of loan transactions and with respect to large retail sales.

In the smaller retail sales, we doubt that time rate disclosure serves any beneficial function for the consumer; in such transactions it might even be detrimental to consumers. It was indicated in a previous section that the likelihood of consumers shopping for credit as such in small retail transactions is questionable. A purchaser buying a \$30 bicycle on credit is more likely to compare the total dollar cost of the transaction, such as \$35, with that offered by competing retailers than he is to consider whether he could borrow the \$30 more cheaply at a bank or small loan company. Such an approach is reasonable, for another retailer may be offering a comparable bicycle for \$27 with a \$6 finance charge. In the small retail sale, the buyer is understandably more interested in shopping with respect to variation in the quality and price of the goods than he is with respect to the amount of the finance charge imposed.

In fact, there is some danger in encouraging consumers to over-emphasize the finance charge element of the total credit price of goods in retail sales. The allocation by a credit seller of the total credit price of goods between cash price and finance charge can be quite arbitrary, particularly if credit sales make up a large part of the seller's business. The bicycle seller can price the article at \$30 with a \$5 finance charge, or he can "bury" the finance charge in the cash price and quote a \$33 cash price and a \$2 finance charge. In the second case, the credit seller can quote the buyer a dramatically lower time rate than in the first case. If retail consumers are taught to seek out the lowest time rate, sellers will be encouraged to compete on what may be a completely arbitrary and meaningless basis—the amount and time rate of the finance charge. To the extent that retailers compete by burying the finance charge in the cash price, the cash consumer must subsidize the credit consumer.

Another factor pointing to the futility of requiring time rate disclosure in small retail transactions is the limited number of cases in which accurate rates could be given. We have discussed the difficulties caused by consolidated contracts. Moreover, there has been a

sharp increase in the use of open-end credit in the small sales area. A department store may sell a \$30 chair on the traditional title-retention contract, or it may add the sale to the buyer's revolving credit account; the store will base its choice as between the two methods upon such factors as the desire of the buyer, the total amount financed, the amount of the monthly payments, and the nature of the goods. We have postulated that there is no method of making accurate time rate disclosure of finance charges in revolving credit transactions. In fact, even dollar amount disclosure cannot be made on a precontract basis. Hence, time rate disclosure in closed-end credit situations gives the buyer little assistance in comparing these finance costs with those in open-end credit situations. It is somewhat ironical that over the decade in which the controversy over the Douglas Bill has raged, the actual importance of percentage disclosure has probably diminished because of the strong trend toward revolving credit. It is almost inevitable that credit cards, a form of revolving credit, will become the standard method of financing all but larger credit purchases. As the revolving credit volume continues to expand in retail sales at the expense of closed-end credit, time rate disclosure in the latter becomes less useful for credit shopping purposes. Any disclosure requirements which make the use of closed-end credit more onerous to the retailer will simply accelerate the trend toward revolving credit.

There are other arguments against requiring time rate disclosure in these transactions. In small balance, short term credit transactions, whether sale or loan, the finance charge must necessarily contain a large service charge component. It costs almost as much to process and service a \$50 credit extension as a \$500 one. Hence, for the creditor to deal in small credit transactions at a profit, he must charge nearly as much for giving the \$50 credit as the larger one. This results in comparatively high finance charge rates on small sales and loans. Lawmakers have recognized this economic fact by allowing sellers to impose minimum finance charges on retail sales and by prescribing graduated rate ceilings on both sale and loan credit charges.³⁴ The question we pose is whether quoting to a consumer a very high time rate in small credit transactions materially assists in his credit shopping.

Suppose a buyer purchases a \$20 fan in a state which allows the

³⁴ See CURRAN 270-77 (chart 13), indicating that in "all goods" retail installment sale statutes, finance charge minima run from \$5 to \$20, with several statutes allowing \$10 to \$12 charges.

seller to impose a \$10 minimum charge in all credit sales of goods.³⁵ If the contract called for repayment of the balance of \$30 in weekly payments of one dollar, the time rate calculated by the constant ratio method would be 168 per cent per annum. In setting the minimum charge, the state legislature recognized that it costs the seller at least \$10 to sell any item on installment credit. Yet when this charge is expressed as a time rate, the buyer will conclude that he is being outrageously overcharged. The customer's reaction is probably due to the fact that time rates have traditionally been used to describe the cost of money, and consumers compare any time rate with the cost of money in other familiar transactions, such as real estate loans or savings deposits (the "six per cent myth"). A time rate is not a good way to describe the price of services; here dollar amounts are traditional. Thus in cases in which the finance charge is made up mostly of service charges, time rate disclosure becomes largely meaningless. The service charge distortion is also present in small loan transactions, but since the commercial small loan is rarely under \$100 and is usually much higher than that, this service charge problem is not as great in such transactions.

It is significant that in larger transactions a creditor will have a "rate of the house"; for example, he may finance all new car sales at six dollars per hundred per annum. He will often advertise this rate and will work from this rate to determine the finance charge in each case. On the other hand, in the small retail sale situation, the seller will decide how much it costs him to make a credit sale at a given price level, and he will then set a finance charge in dollars to cover this cost. Dollar disclosure alone more clearly describes the amount of the charge.

Some might say that time rate disclosure is most important with respect to the small transaction in which the time rate would be high, on the theory that one function of disclosure is to shock the consumer into realizing how much he must pay for credit. They would argue that if people realized how much credit costs they would use it less frequently, and therefore overcommitment would become a smaller problem for credit consumers. Even assuming that the desired effect is obtainable, this view seems indefensible if the shock results from misleading figures. Moreover, if the Government wishes to contract consumer credit, there are more direct methods of doing so; the "Regulation W" approach of increasing low pay-

35. California, for example, would allow a \$10 minimum charge in this case, so long as the term of the credit is less than eight months. If the term were more than eight months, \$12 would be the highest permissible minimum charge. CAL. CIV. CODE § 1805.1.

ment requirements and shortening maturities is the best example.³⁶ Furthermore, it is doubtful that time rate disclosure, even in the small transactions in which rates would appear to be very large, would have any lasting effect in reducing credit extensions. In the very month in which manufacturers first printed the legend "Caution: Cigarette smoking may be hazardous to your health" on cigarette packages there was an increase in cigarette consumption in the United States.³⁷

Our conclusion is that there should be no requirement of time rate disclosure in open-end credit or small retail sales transactions. It has been shown that time rate disclosure is impossible in open-end credit situations, and there are serious questions both as to the economic cost of requiring time rate disclosure and the desirability of doing so with respect to small retail sales. It is difficult to draw a line between large and small transactions. The division must necessarily depend on somewhat arbitrary assumptions concerning the level at which credit shopping is potentially effective. A figure in the range of \$200 to \$300 is probably defensible.³⁸ No doubt there is some degree of credit shopping going on amongst all but the most necessitous borrowers in the loan credit area. Time rate disclosure to the necessitous borrower is a neutral factor; he is neither helped nor harmed by it. Presumably the ease of giving time rate disclosure in the small loan transaction is greater than in the small retail sale. In all other areas of consumer credit, time rate disclosure would give the consumer benefits that would at least justify the cost to creditors of supplying the additional information. Such disclosure should be given before the consumer enters into the credit transaction if precontract disclosure is at all feasible. It should be recognized, however, that in some areas, such as catalogue selling and the consolidation of retail contracts, only post-contract disclosure may be possible. To the extent that retailers rely on repeat business or continuing relationships with customers, post-contract disclosure may be effective.

36. Regulation W was imposed during wartime by the federal government to control the volume of consumer credit. See MORS 46.

37. Los Angeles Times, March 30, 1966, pt. 1, p. 18, col. 3.

38. A useful starting point for fixing the dividing line between large and small transactions might be the level at which the general ceiling rate rather than minimum charges sets the finance charge ceiling. For example, the California Retail Installment Sales Act, CAL. CIV. CODE § 1805.1, provides for an add-on rate of ten dollars per hundred per year ($\frac{5}{8}$ of 1% per \$100 per month) for credits of \$1,000 or less. The minimum charges are \$10 for a contract of 8 months or less and \$12 for contracts of over 8 months. For contracts of just over 8 months, the general ceiling rate of ten dollars per hundred will apply for credits of \$180 and more.

If time rate disclosure is to be required in many common credit transactions, the question arises whether it should be stated in terms of an annual percentage rate (as the Douglas Bill requires), a monthly percentage rate, or as dollars per hundred per year. Any of the three methods would be adequate to afford the consumer a method of comparing credit costs. A sociologist recently concluded:

There has been considerable dispute on the "best" way of formulating the costs of consumer credit, and it has been thought that some psychological experiment might help solve the problem. To some extent this is true, but on reflection, the main problems must lie elsewhere. The competing formulations are not too different and the trouble is not so much that each could be better, but that there are so many different ones abroad. If there were only one formula, no matter which one were chosen—although one should strive for the best one—there would be no problem. As time went on, everybody who cared could understand its meaning. Thus, standardization more than choice of a "best" formula might be the most valuable contribution.³⁹

Our preference would be for an annual time rate, but, as between dollars per hundred and annual interest, we see little basis for choice.⁴⁰ Dollars per hundred is the common method of computing and advertising finance charges in the whole range of retail credit transactions. There is no uniform method used in loan credit contracts. However, credit life insurance and credit accident and health insurance rates are commonly stated in terms of dollars per hundred. Thus if finance charges were stated in terms of dollars per hundred, credit insurance charges could be similarly stated on the contract, allowing the consumer to see the relationship between the two; he could learn the total cost of credit expressed as a time rate by merely adding the two figures together. For example, if the finance charge is expressed as eight dollars per hundred per year and the credit insurance charge is expressed as two dollars per hundred per year, the consumer can add the two amounts to obtain the time rate of ten dollars per hundred per year. On the other hand, it can be said that the time rate should be expressed in terms of annual interest because this method would allow the consumer to make a

39. Memorandum prepared by Professor Hans Zeisel, of the University of Chicago School of Law, for the use of the Consumer Credit Project of the National Conference of Commissioners on Uniform State Laws.

40. It is here assumed that a workable definition of "finance charges" can be drafted. It should be noted in passing that § 3(3) of the Douglas Bill has been severely criticized for its vague, all-encompassing definition of finance charge. See *Hearings on S. 2275 Before a Subcommittee of the Senate Committee on Banking and Currency*, 88th Cong., 1st & 2d Sess., pt. 2, at 1063 (1964) (remarks of Mr. Walter D. Malcolm).

more meaningful comparison between the return to him on his savings and the cost of consumer credit. This would help the consumer who has savings to decide whether to use credit or to withdraw his savings and pay cash, but the number of people who look to savings as an alternative source for financing consumer purchases is probably very limited.

V. DISCLOSURE IN CONTEXT

It has often been observed that one of the principal social evils in consumer credit is the financial overcommitment to which many consumers are led. The man who is burdened with debts and hounded by creditors presents a substantial social problem. The hearings on the Douglas Bill indicate that the problem is widespread. However, it is extremely doubtful that time rate disclosure of finance charges represents a significant answer to the problem.

The concept of time rate disclosure is in the mainstream of previous legislative approaches to the problems of the consumer. Existing statutes in many cases closely regulate the content of the contract between creditor and consumer. Under these statutes the consumer is typically given very detailed information about the transaction: he is warned in large type to read the contract before he signs; he is advised not to sign if the contract has blank spaces; and he is told what legal rights he possesses in a wide variety of situations in which he might find himself. Still he is frequently cheated. The simple truth is that for a very large percentage of consumers, contract disclosure is meaningless. Selling is not normally done in the contract. The consumer is sold before he ever signs the contract and he seldom reads it before *or* after he signs. This is not an argument against either time rate disclosure or existing state disclosure statutes; disclosure legislation can be very useful to some consumers—those who read contracts—and it may even be of some value to those who do not read them. If high rate creditors are forced to disclose their charges in a graphic way it is more likely that their practices will become generally known. However, it is well to point out that whatever the benefits of disclosure may be, other action might be of much greater significance in helping the consumer. We are fearful that in the great emphasis which many have placed upon time rate disclosure, the limitations on disclosure as a protective device have been overlooked.

Disclosure statutes follow the traditional pattern; they constitute an attempt to equalize the struggle between consumer and creditor

by giving the consumer certain weapons. The theory is that if the consumer is given all relevant information and an array of legal rights he can then do battle with the creditor. This approach simply has not worked in many cases.

Our experience indicates that the principal victim of the deficiencies in the consumer credit system is the person who gets too far into debt, who receives poor quality goods or services, or who pays too much for the product he receives. All too often all three elements are present at the same time when the buyer becomes involved with a disreputable seller. Typically the victim is unsophisticated, uneducated, and foolish. He is often the person who is least able to benefit from detailed disclosure provisions. His problem is not one of credit charges but rather of credit itself. The use of credit makes it possible for someone to sell him goods and services which he would never buy for cash. Rarely is he cheated because he is overcharged for the credit itself; indeed, he often buys from a merchant who makes "no charge for credit."

If the marginal consumer cannot be relied upon to avoid bad bargains, a more fruitful approach may be to take away from the creditor some of the weapons that make it possible for him to profit at the expense of the unwary. Frequently an unscrupulous merchant will sell shoddy goods which are greatly overpriced. Normally title is retained by the seller. If the buyer misses a payment or wants to withhold a payment because the goods are unsatisfactory, he is faced with the threat of repossession. If the creditor repossesses he may sell the goods, perhaps to himself, at a small fraction of their original price. He may then get a judgment against the original buyer for the unpaid purchase price plus the expenses of the repossession and his attorney's fee. To collect his judgment the creditor may then garnish the buyer's wages, and an employee whose wages are garnished frequently loses his job. The buyer faced with the prospect of losing what he has already paid on the goods, the goods themselves, and perhaps his job, is more likely to pay the creditor even if it is an unjust debt and even if payment means sacrifice of necessities for his family. Furthermore, the unavailability of legal assistance in cases of this kind leaves the buyer with many rights that go unvindicated.

Creditors have many weapons available to them for bringing debtors to heel, and courts of law serve as inexpensive and efficient collection agencies. Thus the unscrupulous may find it profitable to sell to the consumer who cannot afford to pay. However, if some of these weapons are taken from the creditor he may be encouraged to ration credit. For example, if the creditor is not allowed to get a de-

iciency judgment or, what is more important, if he is not allowed to garnish the wages of someone earning no more than a living wage, it is more difficult for him to victimize the buyer. He will have to rely upon larger down payments and upon collateral to secure the unpaid balance.

It is frequently the case that victimization of consumers is done by creditors who make a regular practice of illegal or unconscionable behavior, relying upon the default judgment, and the inability of some consumers to assert legal rights, in order to maintain their operations. By means of effective administrative remedies designed to force creditors to desist from such practices, many of the more outrageous credit practices could be stopped.

The disclosure of finance charges on a rational basis is an important element of consumer protection, and we have sought to give a balanced analysis of the function which it can serve. However, we would like to close with the observation that little may be gained from disclosure legislation unless it is coupled with effective provisions for protection of the consumer in the area of creditors' remedies and effective policing by public officials of unconscionable creditor practices.