

# THE NEW LAW OF FINANCE CHARGES: DISCLOSURE, FREEDOM OF ENTRY, AND RATE CEILINGS

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Ever since 1800 B.C., when the Code of Hammurabi fixed the maximum rate of interest "at 33 $\frac{1}{3}$  per cent per annum for loans of grain repayable in kind, and at 20 per cent per annum for loans of silver by weight," there has been an active concern about the prices paid for credit.<sup>1</sup> Although neither the Uniform Consumer Credit Code (UCCC)<sup>2</sup> nor the federal Consumer Credit Protection Act of 1968 (CCPA)<sup>3</sup> have entirely abandoned rate ceilings, they do represent a significant innovation in placing a greater reliance upon competition in the market place to establish rates charged on credit transactions. By requiring the disclosure of the dollar amount of the finance charge and the annual percentage rate, both the UCCC and CCPA provide the means whereby consumers may judge the price of credit and shop effectively for it. By permitting greater freedom of entry into the cash loan market, the UCCC seeks to prevent the growth of localized monopolies in cash lending that would thwart consumers' efforts to shop for credit. Thus the provisions for disclosure and for freedom of entry are essential to the establishment of the price of credit by competition, rather than by governmental fiat. This paper will first examine the objectives and problems of disclosure and free enterprise, and then review the role of rate ceilings as a replacement of usury statutes in the UCCC.

## I

### DISCLOSURE OF FINANCE CHARGES

#### A. Objectives

Disclosure of the finance charge is designed to perform both a descriptive and a shopping function.<sup>4</sup> In its first role, the form of disclosure should enable a consumer to determine whether the utility of a consumer loan or instalment sale justifies the price. For this purpose the form of disclosure should vary with the maturity of contract. On long-term contracts the dollar amount of the finance charge looms so

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<sup>1</sup> See S. HOMER, *A HISTORY OF INTEREST RATES* 4 (1963).

<sup>2</sup> On the text of the UCCC, see *Foreword*, in this symposium, p. 639 n.1.

<sup>3</sup> 82 Stat. 146.

<sup>4</sup> Jordan & Warren, *Disclosure of Finance Charges: A Rationale*, 64 MICH. L. REV. 1294 (1966).

large in relation to the amount financed that its citation is misleading. Because it is paid over a number of years, its present value is considerably smaller than its total. For this reason the UCCC permits disclosure of only the annual percentage rate when the credit service charge does not exceed ten per cent in the case of the sale of a dwelling<sup>5</sup> or a loan secured by a first lien on a dwelling.<sup>6</sup> The CCPA extends this exemption to all such instalment sales and loans, regardless of the level of the annual percentage rate.<sup>7</sup>

On short-term contracts, which are usually associated with small amounts financed, the annual percentage rate of the finance charge may be misleadingly large. Consider the instalment purchase of a ten-dollar electric iron for one dollar down and a dollar a week for ten weeks. Is the time utility of having the iron today or ten weeks from now best weighed against the finance charge of one dollar or against the annual percentage rate of 102 per cent?<sup>8</sup> The statement of the dollar charge is more meaningful here because the credit is outstanding for such a short period of time. When expressed as an annual percentage, the one-dollar charge looms large because of the high proportion of service costs represented in the finance charge in relation to the price of the item financed.

There are those who argue for disclosure of 102 per cent as a means of "scaring" the consumer away from this transaction. In many respects this approach seems to represent an effort to impose by law the Puritan ethic that decries the use of credit. As a minister once commented to the writer, "Nobody should *want* a refrigerator bad enough to pay eighteen per cent for it!" Nonetheless, those who adopt this approach fail to realize that the retailer will not quote a rate of 102 per cent, but will either raise the cash price of the merchandise (thereby penalizing the cash buyer) or refuse to offer credit on small transactions (thereby penalizing less affluent credit buyers).

These considerations are the basis for the provisions in the UCCC and CCPA that only the dollar amount of the finance charge needs to be disclosed on transactions where the finance charge does not exceed \$5 on amounts financed not exceeding \$75, or \$7.50 on amounts financed exceeding \$75.<sup>9</sup> On instalment contracts that are neither very long nor very short it seems appropriate for descriptive purposes to provide consumers with disclosure of the finance charge as both an annual percentage rate and a dollar amount.

The second role of disclosure is to provide a means whereby consumers may shop effectively for credit by comparing the prices of credit from different sources. Dis-

<sup>5</sup> UCCC §2.306(2)(j).

<sup>6</sup> UCCC § 3.306(2)(g).

<sup>7</sup> CCPA § 129(a)(4).

<sup>8</sup> The annual percentage is estimated from the direct ratio formula, which provides quite an accurate estimate of the true, or actuarial, rate. The rate quoted is a nominal annual rate—that is, the weekly rate multiplied by 52.

<sup>9</sup> UCCC §§ 2.306(2)(k), .313(2), 3.306(2)(h), .312(2); CCPA § 128(a)(7).

closure of both the dollar amount of the finance charge and a time rate may be useful for this purpose. Early drafts of the UCCC expressed the time rate as a dollar add-on charge per \$100 of unpaid balance per year. Although this would have enabled comparison shopping as readily as an annual percentage rate, consumer groups objected strenuously.<sup>10</sup> Eventually, the annual percentage rate required in the CCPA was incorporated in the UCCC.

Of equal importance as a uniform standard for calculating the rate is a uniform definition of the finance charge. In this respect the UCCC is probably superior to the CCPA. It uniformly defines the finance charge as including "charges incurred for investigating the collateral or creditworthiness" of the debtor.<sup>11</sup> In contrast, the CCPA includes such charges in the finance charge for most consumer credit transactions, but excludes charges for "appraisal fees" and "credit reports" from the definition of the finance charge on extensions of credit secured by an interest in real property.<sup>12</sup> In its Regulation Z,<sup>13</sup> the Federal Reserve Board attempted to remedy in part this obvious favoritism of mortgage lenders by requiring that the charges be "bona fide, reasonable in amount, and not for the purpose of circumvention or evasion" of the disclosure requirements.<sup>14</sup> Nonetheless, the discrepancy remains and can be eliminated only by Congress. With the exception of this item, the provisions of the UCCC, CCPA, and Proposed Regulation Z provide for equivalent disclosure of the amount of finance charge and annual percentage rate on consumer credit transactions.<sup>15</sup>

### B. Problems

Laudable as is the objective of disclosure, it is not achieved without cost. From an economic point of view the cost of providing disclosure information to consumers should not exceed its value to them for descriptive and shopping purposes. A valid criticism of earlier versions of "truth-in-lending" legislation was its apparent insistence on precision in all instances. In addition, a form of rate quotation was required in the case of revolving credit that was precise but which did not in any way reflect substantive differences in revolving credit plans. An objective of the

<sup>10</sup> However, the add-on rate statement does not provide a convenient means of comparing the price of credit to the return received on savings accounts. Probably the number of people who view savings accounts as an alternative to their use of credit is relatively small. The main reason for preferring the annual percentage appeared to be that its size might cause consumers to curtail their use of credit. The add-on method did have the advantage of being a fairly widely used and understood form of time-rate statement. Certainly most consumers should be able to detect that \$10 per \$100 per year is a higher rate than \$8 per \$100 per year.

<sup>11</sup> UCCC §§ 2.109, 3.109.

<sup>12</sup> CCPA § 106(e).

<sup>13</sup> 34 Fed. Reg. 2001 (1969) [hereinafter cited as Regulation Z].

<sup>14</sup> Regulation Z § 226.4(e).

<sup>15</sup> The Final Draft of the UCCC permitted the exclusion of charges "for other benefits" from the definition of the finance charge. UCCC §§ 2.202(1)(c), 3.202(1)(d). The Revised Final Draft makes clear that miscellaneous charges which may be excluded from the finance charge, with the specific approval of the administrator, must be "of a type which is not for credit."

disclosure provisions in the UCCC and CCPA has been to remedy these two difficulties, at least in part.

The precision required in determining the annual percentage rate must represent a compromise between the time and costs of its calculation and the anticipated benefits of the descriptive and shopping functions provided. It is a compromise between what is mathematically feasible and what is commercially feasible. Regulation Z contemplates that most rate disclosure will be effected through the use of rate tables produced by the Board or by private industry. Rates derived from these tables may be rounded to the nearest one-fourth of one per cent; that is, the quoted rate must be within plus or minus one-eighth of one per cent of the exact rate.<sup>16</sup>

What are the principal adjustments permitted in calculation of the annual percentage rate to make it commercially feasible to quote the rate? It is very common for a credit grantor to establish the date of the first payment on an instalment contract to follow immediately after the debtor's payday. Also, as a matter of convenience to both debtor and creditor, whole dollar payments are frequently scheduled, with the last payment differing from all others. Early drafts of federal "truth-in-lending" legislation provided no accommodation for these common trade practices. Under the sanction of the CCPA, Regulation Z permits credit grantors to use "regular" monthly tables to disclose the annual percentage rate, so long as the amount of one payment is unequal but not more than fifty per cent above or below the amount of a regular payment. In addition, if the interval between the date credit is extended and the first payment is not less than twenty days for a monthly contract, a regular monthly table may be used.<sup>17</sup> There is no limit on a longer delay to date of first payment on the assumption that competition will cause a credit grantor to hesitate to make a substantial over-statement of his rate. Many retailers, especially mail order companies, impose the same finance charge for all balances within a specified range. This is a matter of great convenience to their customers. The proposed regulations would permit an understatement of the rate in such cases by as much as eight per cent (*not* eight percentage points).<sup>18</sup> For example, if the actual rate on a contract were fifteen per cent, the quoted rate could not be less than 13.8 per cent [ $15.0 - (0.08 \times 15.0)$ ]. Since a number of small retailers also have bracketed charges for revolving-credit accounts, similar regulations are provided for open end credit. Thus sufficient flexibility is provided in disclosing the annual percentage rate on regular and "slightly irregular" instalment contracts that it is commercially feasible to provide this information to consumers at a fairly low cost.

<sup>16</sup> Regulation Z § 226.5(c). UCCC §§ 2.304(5)(a), 3.304(5)(a) make similar provision for deviations in rate tables.

<sup>17</sup> Regulation Z § 226.5(d). The administrator has the power to enact similar regulations under UCCC § 2.304(5)(b) and § 3.304(5)(b).

<sup>18</sup> Regulation Z § 226.5(c)(2)(iv). UCCC §§ 2.304(5)(b), 3.304(5)(b) provide that the administrator may not allow a tolerance of greater than 8% except to simplify compliance in the case of irregular payments.

A much more difficult problem is created by irregular contracts, such as farm loans, which may call for unequal payments spaced at highly irregular intervals. To approximate the rate on such contracts by hand calculations would be extremely tedious. For the most part, consumers seeking irregular contracts of this type will have to conform to prepackaged rate tables that are designed for some irregularities but which cannot encompass all possibilities.<sup>19</sup> This loss of flexibility on the part of the consumer in seeking his credit is one of the hidden costs of providing rate disclosure.

Another problem area is represented by revolving credit. For many years retailers patiently explained to Congress that a charge of 1½ per cent levied on monthly unpaid balances did not in fact cost every consumer eighteen per cent per year—but often less and sometimes more, depending upon the manner in which he used and paid for his charge privileges. Moreover, even if the pattern of usage were identical in all cases, there were differences among plans that were not revealed merely by multiplying one and one-half times twelve to obtain eighteen. Realization of the truth of these statements evidently came to the joint House-Senate Committee after passage of the Senate and House “truth-in-lending” bills. This belated recognition led to permitting a creditor to show, in addition to the corresponding nominal annual percentage rate (say, eighteen per cent), an “average effective annual rate” or, failing this, a “projected rate of return.”<sup>20</sup> If the average effective rate is intended to be an historical representation of the actual rate collected, this form of disclosure would be thoroughly misleading to consumers. An historical rate would reflect the purchasing and payment habits of many other consumers, none of whom would necessarily represent the consumer who is trying to use the average effective annual rate to shop for credit. Moreover, some retailers have segregated their revolving charge accounts from their thirty-day accounts. They would be forced to quote a higher rate on an historical basis than other retailers and charge-account bankers who do not separate their thirty-day customers from their “true” revolving-account customers. Rather than permit the use of a deceptive number, Regulation Z permits firms offering open end credit to disclose a “Comparative Index of Credit Cost.”<sup>21</sup> This is expressed as an annual percentage calculated on the assumption that a debt of \$100 is incurred on the first day of the billing cycle and repaid, along with all specified finance charges, according to the terms required by the credit grantor.

<sup>19</sup> Tables for irregular contracts must also be accurate to the nearest one fourth of one per cent. However, there are mathematical problems in creating such tables that cannot be explored here. Essentially, on irregular contracts the actuarial method and the U.S. Rule do not produce the same results. In addition, under the actuarial method there may be several alternate periods to choose among for the period of compounding. Rather than force all rate charge manufacturers into one mold, Regulation Z provides for several methods of calculating the annual percentage rate on irregular contracts, although the various methods typically produce very similar results. The UCCC contemplates that the administrator will make rules to deal with irregular payments. See UCCC §§ 2.304(5)(b), 3.304(5)(b).

<sup>20</sup> CCPA § 127(a)(5).

<sup>21</sup> Regulation Z §§ 226.7(a)(5), 226.11.

The consumer can then use this Comparative Index to shop among credit grantors. Although the rate that he will pay in an actual transaction will not be the same as that shown in the Comparative Index, the probabilities are high that the level of the rate actually paid will be closely correlated to the Comparative Index.

The question remains whether the flexibility permitted in calculating the annual percentage rate significantly lessens the value of that information for consumers' use in shopping for credit. A recent survey of the results of "truth-in-lending" in Massachusetts suggests that consumers seldom use the annual percentage rate with such care in their shopping that a precise calculation is required:<sup>22</sup>

Typically, most consumers are apparently either unaware of the law and the concept of disclosure or quite indifferent toward it. To these borrowers the important thing is the ability to make the required periodic payments, while concern about the cost of credit is indicated, occasionally if at all, by questions about the dollar amount rather than the annual percentage.

Over time consumers may become more sensitive to the annual rate of charge and use this information more effectively in shopping for credit. At present, the evidence suggests that the costs of providing a very accurate statement of the annual percentage rate are not justified by the use to which consumers put this information. Indeed, there is good reason to believe that the requirement that rates be quoted to the nearest one-quarter of one per cent is an unnecessary refinement.

## II

### FREEDOM OF ENTRY

#### A. Objectives

It is of little value to a consumer to have the information necessary to shop for credit effectively if he has only a few places to shop. The number of alternative sources of credit is reduced if credit grantors' ability to serve consumers is limited by restrictions on convenience of location, rates charged, and other credit terms. Hence, the more the market is segmented by confining credit grantors to certain classes or forms of credit, the less choice a given consumer has among various sources of credit.

Some segmentation of credit markets will always exist on a geographic basis and among different risk classes of consumers. For some types of credit in large cities the market area might not be more than a few blocks. In some rural areas the only source of loans may be a single commercial bank. Banks tend to specialize in large loans carrying a small risk, whereas consumer finance companies offer smaller loans and bear higher risks.

Segmentation imposed by legislation further encourages the creation of localized

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<sup>22</sup> R. PULLEN, *THE IMPACT OF TRUTH-IN-LENDING LEGISLATION: THE MASSACHUSETTS EXPERIENCE* 7 (1968).

monopolistic positions, with the result that rate competition may be inadequate to control the price of credit, even when it is fully disclosed. Segmentation by law is brought about by limitations on rates that may be charged and on the size, maturity, and form of credit that may be granted by various types of credit grantors. In addition, segmentation is fostered by restrictive licensing that requires consumer finance companies to show that it is to the "convenience and advantage" (C & A) of the public to open an office. Although the drafters of the UCCC have been strongly criticized for not coming up "with sufficiently imaginative ideas,"<sup>23</sup> the abolition of most of this segmentation is a major innovation and a highly significant contribution of the UCCC to the creation of a more competitive market place for consumer credit. Coupled with rate disclosure, the provisions breaking down the segmentation of the industry are designed to provide consumers with credit at the lowest possible cost.

Whereas most rate ceilings are presently related to the type of creditor or to the item financed, the UCCC provides essentially the same rate ceiling for all types of credit and creditors. The philosophy underlying this uniform rate ceiling is that credit grantors should be free to offer any type of credit that they desire. If they wish to advance large amounts of credit to low-risk consumers, competition will force them to operate with rates well below the ceiling. If they wish to seek out high-risk consumers who need small amounts of credit, they must charge higher rates or be driven from the business by their losses. The important point is that the rate ceilings do not restrict the movement from one type of market to another. As the nature of the credit market changes, creditors are free to experiment in an effort to follow those shifts. Admittedly, this is at their peril, but at least the law is not constructed so as to foreclose the possibility of adjustment.

The only exception to this basic approach is found in the ceiling rates on revolving sales credit.<sup>24</sup> Monthly charges are limited to two per cent on unpaid balances to \$500 and 1½ per cent on the portion of the unpaid balances above \$500. In contrast, the equivalent rates on supervised loans are three per cent on balances to \$300; 1¾ per cent on the portion above \$300 to \$1000; and 1¼ per cent on the portion of the unpaid balance above \$1000.<sup>25</sup> This inconsistency is a product of the compromises necessary to constructing the UCCC, rather than of any special economic rationale. For some reason consumer representatives feel strongly about the charges on revolving credit. Although the ghetto consumer is unlikely to have a revolving credit account, consumer spokesmen often seek to "protect" him by demanding low rate ceilings on this form of credit. In fact, the middle- and upper-income consumer who uses

<sup>23</sup> See the testimony of Professor William F. Willier in *Hearings on S. 5 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 312 (1967). However, Professor Willier could not offer the committee a new system.

<sup>24</sup> UCCC § 2.207(3).

<sup>25</sup> UCCC § 3.508(2).

revolving credit is the one who is protected, quite possibly at the expense of the cash buyer.<sup>26</sup>

Another important contribution of the UCCC to breaking down current legal segmentation in consumer credit markets lies in what is not found among the provisions. In general, there is no limitation on the size, maturity, or form of credit that may be granted by any type of credit grantor now authorized to provide consumer credit. The only exception is a provision that loans made at rates in excess of ten per cent per annum (other than revolving credit) may not be scheduled for more than thirty-seven months if the principal is more than \$300 and for more than twenty-five months if the principal is \$300 or less.<sup>27</sup> The purpose of this limitation is to prevent the offering of such loans as \$1,000 repayable at the rate of \$5 a month. At one time this was an abuse in the small loan field. Given the required disclosure of the dollar amount of the finance charge (which would be very large for such transactions), this limitation is probably not necessary.

Somewhat more controversial is the provision in the UCCC permitting a supervised lender to carry on other business at a location where he makes loans.<sup>28</sup> This provision would permit a seller to make loans at his place of business, provided that he complied with article 3 of the UCCC with respect to his loan operations.<sup>29</sup> Some states currently prohibit a "dual business," that is, a sales finance and cash lending operation on the same premises. The origins of prohibitions against combining sales and loans lie in an era when credit grantors evaded usury statutes by selling some trinket to the consumer at an exorbitant price, while making a loan at a rate within the ceiling. Adequate enforcement of disclosure provisions and rate ceilings should prevent this practice. If a consumer were required to purchase a good or service as a condition of credit, the full price would be defined as part of the finance charge for the purpose of both disclosure and rate ceiling. The advantage of the permission to conduct a dual business lies in the possible convenience and lower costs to consumers that may result from a joint operation. So long as the consumer is not deceived by some combination of loan and credit sales, it is to his advantage to permit credit grantors to offer credit in the most inexpensive and attractive packages possible.<sup>30</sup>

<sup>26</sup> Johnson, *Economic Analysis of Credit Revenues and Costs in Department Stores*, in NATIONAL RETAIL MERCHANTS ASSOCIATION, *ECONOMIC CHARACTERISTICS OF DEPARTMENT STORE CREDIT* 3-29 (1969).

<sup>27</sup> UCCC § 3-511.

<sup>28</sup> UCCC § 3-512.

<sup>29</sup> Commercial bankers vigorously opposed this provision. At one point an alternative provision was prepared to prohibit sales of goods and services and loans on the same premises. However, this put the bankers out of the loan business, since they provided consumer goods (coin banks) and services (lock boxes, travel services) on the same premises where they made loans. The next alternative was a section prohibiting sales and loans on the the same premises, except for supervised lenders (primarily commercial banks). Since this provision proved unacceptable to the commercial bankers without added severe restrictions on freedom of entry and curtailment of other protective features for consumers, this special-purpose provision was finally rejected as well.

<sup>30</sup> The controversy may be fairly meaningless. Even in states where loans and sales may now be



As will be shown in the following section, the most controversial innovation of the UCCC has been the grant to cash lenders of the right of free entry into the credit field. In view of the small portion of the credit market to which the UCCC accords freedom of entry where it does not now exist, the degree of emotion aroused by the change is somewhat difficult to understand. Freedom of entry has been traditional in the credit sales field and remains unencumbered by the UCCC. Only in a portion of the cash loan field is entry presently restricted. To obtain a license to open or to move a small loan office, finance companies must show either convenience and advantage or convenience and necessity in about thirty-five states, with only seven of those states strictly enforcing entry.<sup>31</sup> In mid-1968, the personal loans outstanding of finance companies amounted to only 10.6 per cent of consumer instalment credit outstanding. Less than one-third of these outstandings were subject to strict application of C & A provisions, so that only about three per cent of consumer instalment credit is subject to a significant change in freedom of entry. This portion represents a still smaller percentage of the total credit affected by the UCCC, which covers some single-payment credit as well as mortgage credit.

The Comment to section 2.201 of the UCCC notes:

By design the license required to make supervised loans is made readily accessible to those showing financial responsibility, character, and fitness. Provisions for minimum financial assets and for a showing of convenience and advantage have been deliberately omitted, since their inclusion would tend to restrict competition and require establishment of rates, rather than ceilings.

The movement toward a free enterprise system in the cash loan field in no way changes the limitations on the powers of mutual institutions, such as savings banks and savings and loan associations, to enter the consumer credit field. Nor does it free institutions that accept deposits from regulations that are designed to protect the safety of those deposits. Such regulations are, of course, a condition of being a depository institution. It is quite likely that finance companies would accept such regulations with alacrity if they could also accept demand and time deposits.

Freedom of entry into the cash loan market may be independent of requirements for licensing or registration. One can have free entry *and* licensing so long as there are no significant barriers to obtaining a license. Licensing may be employed to ascertain the location of credit grantors and to raise funds for enforcement. In addition, the threat of removal of a license can serve as a deterrent to bad conduct. However, these functions are provided by other means in the UCCC. All credit grantors are required to register with the administrator<sup>32</sup> and to pay an annual fee

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made on the same premises, there is no evidence that retailers have moved into the loan business. A few tried but eventually abandoned the effort.

<sup>31</sup> Shay, *State Regulation and the Provision of Small Loans*, in *THE CONSUMER FINANCE INDUSTRY: ITS COSTS AND REGULATION 112-14* (J. Chapman & R. Shay ed. 1967).

<sup>32</sup> UCCC § 6.202.

based upon the volume of transactions within the state.<sup>33</sup> Numerous deterrents to bad conduct are provided, both in the form of self-help remedies for consumers and enforcement powers for the administrator.<sup>34</sup>

Nonetheless, in addition to its registration requirements, the UCCC does require that, unless a person is a supervised lender (*e.g.*, a commercial bank), he must obtain a license from the administrator if he makes loans at rates in excess of eighteen per cent.<sup>35</sup> Only one license is needed to operate one or more offices within a state. Because licensing serves no real function not provided elsewhere in the UCCC, it is difficult to argue with the criticism of this provision as a wedge that may endanger the principle of freedom of entry:

While the Code specifically requires that the administrator be liberal and permissive in granting licenses, and that the criterion be primarily in terms of character and fitness, there is no guarantee that licenses will in fact be issued on this basis. Indeed, there is some reason to believe that when the Code is enacted many legislatures . . . will add a *convenience and advantage* clause to the licensing requirement. With such a clause it is possible to restrict entry and to limit competition. This requirement, therefore, brings out clearly the instances where the Code may fail to accomplish its goal and may, in fact, permit, if not facilitate, the kind of ad hocery and segmentation that it was designed to correct.<sup>36</sup>

During one brief but exhilarating interval in the drafting of the UCCC the licensing provision was abandoned, but representatives of both consumers and industry made strong representations for its reinstatement. Possibly psychologists or sociologists can explain why the free entry of credit vendors is readily accepted at the same time that rigid restrictions on cash lenders are demanded and why the mere licensing of a business establishment engenders such deep satisfaction. Certainly the answer does not appear to lie in the realm of economics.

### B. Problems

Where there are technical and practical problems in obtaining useful disclosure, there are no such difficulties in connection with freedom of entry. Indeed, it characterizes most forms of consumer and mortgage credit.

The problems with respect to freedom of entry are thus political rather than legal. The changes proposed in the UCCC have called down a storm of wrath on the heads of the Commissioners, and the industry groups aligned against the free enterprise approach may succeed in defeating the UCCC or at least in emasculating this key feature. A small sampling of the views of the chief opponents to freedom of entry will demonstrate the fervor of the attack and set the stage for a brief analysis of its validity:

<sup>33</sup> UCCC § 6.203.

<sup>34</sup> See Dunham, *Unconscionable Conduct and the Uniform Consumer Credit Code*, 23 J. FINANCE 312 (1968).

<sup>35</sup> UCCC § 3.503.

<sup>36</sup> Fand, *Discussion*, 23 J. FINANCE 322, 326 (1968).

1. In contrast to the unlimited opportunities offered to other organizations in the lending area, the Code does not and cannot increase the powers of the banking industry with respect to entering new fields of business (*e.g.*, direct retail sales of goods). Moreover, the Code cannot affect or increase the location and number of banking offices so as to enable the banking industry to maintain its present competitive position. . . .

In view of the foregoing situation, the banking industry must actively oppose adoption of the Code in each and every state until and unless the Code is amended so as to preserve the historical and delicately balanced relationships of the various types of lenders under the differing laws of the various states.<sup>37</sup>

2. Strong objection is raised against . . . various sections of the Code which interpreted in their entirety would allow any and all low rate lenders to engage in the direct loan business.<sup>38</sup>

3. [U]nbridled entry would promote overselling by some lenders, especially by those without experience in the consumer lending field; many ill-informed or financially irrational borrowers would succumb to the blandishments of easy credit and become overcommitted; duplication of facilities and inefficiency would result; the increased competition would tend to lead to wild credit practices to the detriment of all; and the effect of such a concept on the monetary and fiscal policies of the United States was an unknown quantity, the ramifications of which had not been fully explored.<sup>39</sup>

These types of arguments are hardly new. In one form or another they have been advanced by every protectionist down through history. In their essence they allegedly seek to reduce unit costs by preventing entry of small, inefficient units and to eliminate undesirable practices resulting from "excessive" competition.

### 1. *The Efficiency Argument*

The argument advanced by the banking industry is that instalment loan costs continue to decline as the number of loan accounts increases. Since costs per account are lower the larger the number of accounts, the argument is that legislation should encourage a concentration of consumer loans in the hands of large units (presumably commercial banks).

The analysis is deficient for two basic reasons. First, the evidence is by no means clear that instalment loan costs do continue to decline significantly in relation to the number of loan accounts beyond an optimal level of operations. With respect to the costs of handling instalment loans at commercial banks, the American Bankers Association (ABA) cites principally a recent study by Bell and Murphy.<sup>40</sup> However,

<sup>37</sup> Becker & Rolph, *Comments on Working Draft No. 6*, statement presented at public hearings on the UCCC, January 1968. With the rapid growth of bank holding companies, it is difficult to imagine any field that banks may not enter.

<sup>38</sup> Telegram from Robert A. Fischer, Executive Director, Consumer Bankers Association, to William J. Pierce, President, National Conference of Commissioners on Uniform State Laws, July 25, 1968.

<sup>39</sup> Harper *The Uniform Consumer Credit Code and Freedom of Entry*, 24 BUS. LAW. 227 (1968).

<sup>40</sup> BELL & MURPHY, COSTS IN COMMERCIAL BANKING: A QUANTITATIVE ANALYSIS OF BANK BEHAVIOR AND ITS RELATION TO BANK REGULATION (1968), cited in AMERICAN BANKERS ASSOCIATION, AN ANALYSIS

if read carefully, this study shows that there are only very slight economies of scale between large and small lending offices.<sup>41</sup> Such economies that are present seem to arise only when banks make major leaps in size, whereby they can move from conventional bookkeeping machines to tronic machines to the electronic computer. In contrast, "higher costs for branching operations were found consistently for practically every function" including instalment loans.<sup>42</sup> On an overall basis a measurement of the responsiveness of costs to scale of operation indicated "that there may be no scale economies present in this function" (instalment loans).<sup>43</sup>

With respect to the cost structures of consumer finance companies, a recent study of operating costs in four states found that after an office reached a level of about 2,000 accounts, average direct costs per account either rose or levelled out.<sup>44</sup> There was no evidence of continued significant decreasing costs as the size of office increased. Another statistical study of forty-eight companies failed to find a statistically significant relationship between operating costs per \$100 of loans outstanding and the number of loans per office.<sup>45</sup>

The second deficiency of the ABA argument is the suggestion that lower costs will lead to lower prices of credit for consumers. Even if it were true that banks experience long-run declining costs for the instalment loan function, the assertion that banks should then be protected from competition is a *non sequitur*. If certain lenders are to be protected from competition, what incentive do they have to pass on lower costs to consumers in the form of lower prices? Thus the real issue is whether legislation should be designed to provide certain lenders with low costs or consumers with low prices.

The evidence that lower costs are indeed *not* passed on to consumers comes, surprisingly enough, from the ABA study, which shows that "banks in states with convenience and advantage provisions relating to small loan companies clearly have a higher proportion of their assets in consumer loans."<sup>46</sup> The evidence does seem clear and is probably not a chance phenomenon. Surely the only factor that would cause banks to divert funds from commercial loans to consumer loans would be the

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OF THE ECONOMIC EFFECTS OF THE PROPOSED UNIFORM CONSUMER CREDIT CODE IV-3 (1968). Part V of the study has been published in 23 PERSONAL FINANCE L.Q. REV. (1968).

<sup>41</sup> BELL & MURPHY, *supra* note 40, at 67. The data show that, on the average, if an existing facility is expanded, direct costs of handling installment loans do not rise quite as rapidly as their volume. Thus, if outstandings at a branch expand by 100%, total direct costs would rise by only 97%

<sup>42</sup> *Id.* at 66 (emphasis added).

<sup>43</sup> *Id.* at 129.

<sup>44</sup> Comiskey, A Study of Loan Cost Behavior in Consumer Finance Companies 117 (unpublished thesis in Michigan State University Library, 1965).

<sup>45</sup> See Zwick, *A Cross-Section Study of Industry Costs and Earnings*, in THE CONSUMER FINANCE INDUSTRY, ITS COSTS AND REGULATION, *supra* note 31, at 73 n.17. Zwick's study is cited by the American Bankers Association as evidence of declining costs in the small loan industry. AMERICAN BANKERS ASSOCIATION, *supra* note 40, at IV-4. However, the conclusion cited relates to the ability of large firms to build large offices. This does not provide evidence of declining costs per loan or per \$100 of outstandings as the number of loans per office increases.

<sup>46</sup> AMERICAN BANKERS ASSOCIATION, *supra* note 40, at VIII-3.

attraction of higher profits on consumer loans. This, of course, is precisely the issue faced by the National Conference of Commissioners in drafting the UCCC. Should the profits obtained from these quasi-monopolistic positions be protected, or should all grantors of cash loans be required to operate within the same context of free enterprise as credit vendors? After much agonizing in the face of extreme pressures, the Commissioners decided for freedom of entry.

## 2. *The Excessive Competition Argument*

If competition in the consumer credit field leads to "wild credit practices," one wonders why competition is not equally undesirable in all other fields.<sup>47</sup> In the market for consumer credit there are certainly imperfections that are revealed in irrational use of credit by borrowers and irresponsible lending by credit grantors. However, these imperfections are not lessened by reducing competition but by providing proper disclosure of the price of credit and by educating consumers to use this information efficiently. There is no reason or evidence to suggest that creditors and consumers are somehow wiser in states that have C & A licensing restrictions on small loan companies. Because of their protected positions, lenders in C & A states may be able to afford more mistakes. However, the competitive system is designed not to shield business operators from the results of their imprudence but to remove them from the market place.

The arguments against restricting entry into the cash lending field by restrictive licensing were well summarized almost twenty years ago:

Control over maximum rates without limiting the number of firms can certainly accomplish just as much if not more than control over rates with a limitation on the number of firms. For in this connection it should never be overlooked that rate regulation may prevent excessive rates, but it cannot encourage a voluntary reduction of rates. The only hope for the latter is through the pressure of competition, which can be effectively stimulated by free entry of capital into the field.<sup>48</sup>

### III

#### CEILINGS ON FINANCE CHARGES<sup>49</sup>

##### A. Objectives

The previous discussion should make clear that the objective of the UCCC is not to have rates set by ceilings but by competition engendered by disclosure

<sup>47</sup> *Id.* This section of the American Bankers Association report alleges that the absence of C & A restrictions on small loan companies leads to "unbridled competition," whereas an earlier section of the same report claims that "States with convenience and advantage provisions . . . actually experience increased competition." *Id.* at V-12. Whatever the startling inconsistencies involved, the latter conclusion is based upon a regression analysis that is faulty because of collinearity among the independent variables.

<sup>48</sup> Upton, *An Economic Appraisal of Convenience and Advantage Licensing by Small-Loan Statutes*, 25 J. Bus. 249, 262-63 (1952).

<sup>49</sup> For a more complete discussion, see Johnson, *Regulation of Finance Charges on Consumer Instalment Credit*, 66 MICH. L. REV. 81 (1968).

and freedom of entry. In fact, in most areas of our economy these two features are usually considered to be sufficient to rule out the need for any price ceilings. That this is not true for consumer credit may be attributed in part to a long heritage of biblical injunctions against usury and the special attitudes that consumers and legislators appear to have about the lending of money. Nonetheless, until consumers become better educated in their use of credit, there will undoubtedly be imperfections in the market, so that it may be desirable to prevent the occasional transactions where ignorant or indifferent consumers are bilked by avaricious credit grantors.

A rate ceiling does not accomplish a great deal. Assume that the ceiling on a given size of loan is twenty per cent. On the one hand, this excludes from the legal credit market and from the protective features of the UCCC those consumers whose credit standing is not good enough to warrant lending to them at twenty per cent.<sup>50</sup> On the other hand, the ceiling does not protect consumers who deserve a rate of twelve per cent but pay eighteen per cent because of carelessness or indifference. In short, a rate ceiling protects only borrowers who might have paid a rate higher than the ceiling but are just sufficiently creditworthy to receive credit at the ceiling rate. Most consumers are protected only by careful shopping for credit. These considerations, coupled with the reliance on competition, led to the establishment of fairly high or "loose" rate ceilings in the UCCC. They also led to the effective abolition of general usury ceilings on the grounds that the protections against irresponsible shopping for credit were not needed in the case of commercial transactions (although the Uniform Commercial Code would still apply with respect to unconscionability).

One other consideration influenced the level of rate ceiling in relation to the amount of credit granted. There is a large element of fixed costs in providing credit and in processing periodic collections. Since many of these costs are unrelated to the amount of credit granted, they are proportionately higher for small amounts of credit. Were the UCCC designed to set rates, rather than ceilings, the slope of the ceiling in relation to the amount of credit granted would become critical, since discrimination against a particular size of loan would affect its availability.<sup>51</sup> For this reason the rate ceiling in the UCCC slopes downward from thirty-six per cent per year on amounts of credit under \$300 to a level of eighteen per cent on amounts of credit around \$5,500 to \$6,000.<sup>52</sup> The exact point at which the ceiling levels off to eighteen per cent depends upon the maturity of the contract.

<sup>50</sup> Rate ceilings that are too low will simply cause lenders to withdraw from a state and create a flourishing market for illegal lenders. See Nugent, *Three Experiments with Small-Loan Interest Rates*, 12 HARV. BUS. REV. 35 (1933).

<sup>51</sup> Canadian legislation inadvertently pinched off cash credit in the range from \$1,000 to \$1,500. REPORT OF THE ROYAL COMMISSION ON BANKING AND FINANCE 209 (1964).

<sup>52</sup> UCCC §§ 2.201, 3.201, 3.508.

### B. Problems

Not only are rate ceilings of limited use to consumers who are excluded from the legitimate credit market and to consumers who must shop effectively to benefit from lower rates, but what little effectiveness they have is limited almost entirely to the cash loan field, only about two-fifths of total consumer instalment credit outstanding. On credit sales all or some portion of the finance charge may be buried in the cash price. This has been strikingly demonstrated in the study by the Federal Trade Commission of sales practices of low-income market retailers in the District of Columbia. If the wholesale price of a television set were \$100, the average cash retail price of the low-income retailer was \$187, compared to \$131 at appliance stores serving the general markets. This \$56 difference far outweighed the difference in finance charges of \$2 per \$100 of unpaid balance.<sup>53</sup> Thus, only careful shopping, and not rate ceilings, will protect consumers buying goods and services on credit.

Finally, the proposed rate ceilings do not meet the credit problems of the low-income, high-risk consumer. Many of these consumers are probably squeezed from the legitimate cash-loan market. Here one is forced to make a social judgment. Should higher rates be permitted in certain markets, or should some means be found to provide needed credit, possibly through some special quasi-governmental agencies? The answer is not readily apparent.

## IV

### SUMMARY

The UCCC represents a dramatic attempt to cut through the present hodgepodge of inconsistent and economically irrational state laws. It consciously attempts to permit the market place to set terms on the wide variety of credit transactions that occur every day. To create an effective market the UCCC provides for full disclosure in a manner substantially equivalent to the provisions of the CCPA and for greater freedom of entry than now exists in some portion of the cash loan field. These two features are essential to the effectiveness of competition to force rates below the ceiling rates on all but marginal credit transactions. The ultimate effectiveness of the UCCC will depend largely upon preservation of these key features and the education of consumers to make effective use of the protections accorded them in this innovative proposal.

<sup>53</sup> FTC, ECONOMIC REPORT ON INSTALLMENT CREDIT AND RETAIL SALES PRACTICES OF DISTRICT OF COLUMBIA RETAILERS 40, 62-65 (1968).