Research Department
Federal Reserve
Bank of
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California's Usury Ceilings

Improved information, increased consumer awareness, and a broader range of lenders have helped to increase competition in the market for consumer installment credit in recent decades. But California's 22-year-old usury statute may have had just the opposite effect. According to critics, the Retail Installment Sales Act of 1960 (the Unruh Act) has restricted the ability of retailers to compete effectively with financial institutions providing similar types of credit, and at the same time has made it difficult for borrowers to obtain credit.

In a high interest-rate environment, California retailers have been plagued with the dilemma either of extending credit at a loss, or of not extending credit and possibly losing sales. At a 16½-percent prime business-loan rate, department stores, furniture-appliance stores and other retailers have encountered borrowing costs of 20 percent or more. Yet under the law, they themselves have been able to charge only 18 percent on the first $1,000 of their installment-credit loans, and only 12 percent on the balance over $1,000. Thus, many retailers must refer customers to financial intermediaries whose lending rates are not covered by usury ceilings, or else extend credit at rates well below their own borrowing costs. Either way, this means lost profit opportunities for stores that were once able to complement revenues from sales with income from credit operations.

Changing environment

Legislators have frequently viewed usury ceilings as a substitute for consumer information in protecting borrowers from being charged exorbitant interest rates. That belief helped set the stage in 1960 for California's passage of the Retail Installment Sales Act. However, by setting the ceiling well above prevailing market-interest rates—such as a 5-percent prime rate—the law did not limit either the rates charged to typical customers or retailers' willingness to extend credit, even while it prevented the charging of very high rates to marginal customers.

Since 1960, however, the consumer-installment credit market has changed dramatically. First, inflation has driven market interest rates to, and often above, the levels considered exorbitant in the 1960 law, which was enacted when the inflation rate was under 2 percent. Consumers have also become much more aware of the importance of interest rates, as evidenced by the popularity of money-market funds and market-return consumer deposits. In addition, the widespread use of bank credit cards has improved consumers' array of borrowing opportunities.

Legislation also has led to changes in the consumer-loan market. The Truth In Lending Act standardized information concerning loan contracts, simplifying the process of shopping for and comparing loan terms. The Depository Institutions Deregulation and Monetary Control Act also enhanced competition, by enabling savings-and-loan associations to write installment credit, along with banks, credit unions, and finance companies. Yet despite all these changes, usury laws in California and elsewhere have remained relatively unchanged.

Unintended consequences

When market interest rates exceed usury ceilings, lenders cannot earn a return adequate to compensate them for their costs and risks. The amount of credit supplied at the below-market rate will fall, because lenders will seek to take advantage of more profitable lending opportunities—or lacking such opportunities, will reduce or even stop lending altogether. Moreover, lenders will seek to reduce the cost of providing credit by tightening terms—qualifications, collateral, maturity, and other standards—to reduce the risk of loan losses and the cost of delinquencies. As a result of these actions, the supply of credit will become restricted to only the most

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creditworthy borrowers. Thus, as market rates approach (or exceed) the usury ceiling, many consumers may not be able to find credit at the ceiling rate. The ceiling may force them to borrow from unorthodox and even illegal lenders, at rates that may be higher than they would otherwise have had to pay.

In California, usury ceilings have been less restrictive than in most states because the ceilings do not apply to all lenders, but only to retailers. Financial institutions operating without such limitations have continued to supply consumer credit, offsetting some of the reduction in supply caused by retailers' inability to supply credit profitably. Still, by forcing retailers to restrict their lending, the Act apparently has inconvenienced many households by forcing them to search for credit on their own, and has frustrated their attempts to find credit at the controlled rate.

California statutes

The Retail Installment Sales Act places ceilings on the interest rates and fees that retail establishments can charge on their estimated $3 billion in consumer credit. (For comparison, California banks provide about $5 billion in bank-card and check-overdraft installment credit.) The statute covers a wide range of retail credit, including credit from department stores, home-furnishings and appliance dealers, airlines and gasoline companies. The Act initially allowed retailers to charge customers up to an annual rate of 18 percent on the first $1,000 of installment (revolving) credit, with a 12-percent ceiling on the balance above $1,000. For the less typical installment (non-revolving) contract, the Act set the ceiling at 10 percent for the first $1,000 and 8 percent on the balance over $1,000.

A temporary amendment, effective in 1981, raised the ceiling on the first $1,000 of revolving credit from 18 percent to 19.2 percent, and the ceiling on the first $1,000 of non-revolving credit from 10 to 11 percent. The rates on balances in excess of $1,000 remained at the levels set in 1960. A second amendment (October 1981) extended the temporary rates through September 30, 1982, and lifted the cut-off to $3,000 for credit sales of household furniture, furnishings, and appliances. Yet, these temporary measures have provided little relief. Because it would be costly to implement such minor and temporary changes, and because changing the rate on revolving credit balances might create problems for customer relations, many retailers have elected to continue with the original ceilings and cut-offs.

Losing proposition?

Prior to the recent dramatic upsurge in interest rates, most retailers had an incentive to provide credit to finance big-ticket purchases. Retailers could borrow funds to finance customers' purchases and hold their installment contracts as earning assets. Credit often became a profitable complement to retail operations, and as such allowed retailers to compete favorably through lower prices. However, in the current environment, the cost of extending new credit has become prohibitive. The cost of funding a loan (often at prime plus several percentage points), plus overhead expenses, administrative costs, and loan-loss expenses easily exceeds the 19.2-percent ceiling rate—to say nothing of the 12-percent ceiling for loans exceeding the $1,000 (or $3,000) cut-off.

Furthermore, California retailers have found that writing installment contracts for resales to finance companies is also a losing proposition. In the past, many retailers were able to write contracts with terms tailored to the requirements of sales-finance companies that actively purchased such paper. But today, with market rates above the statutory ceiling, retailers must discount paper to induce purchasers to buy the low-yielding contracts. The losses that retailers must suffer in this process have curtailed the practice and have forced many sales-finance firms out of the market.

Faced with potential losses of sales, retailers have looked for other alternatives, such as

accepting bank cards for purchases. However, the use of bank cards reduces retailers' margins, because banks charge them card-processing fees of up to several percentage points. Moreover, retailers cannot adjust credit limits or repayment periods, and have no say about eligibility for bank-card use. Such limitations also may reduce credit availability to some segments of the market, since many high-risk and first-time borrowers might qualify for a retail establishment's secured credit line but not for an unsecured bank line of credit.

Given these shortcomings of credit cards, some retailers instead have referred customers to banks, thrifts, or consumer-finance companies not subject to the Act's ceilings. These lenders may lend directly to individuals at market rates, although the installment paper they purchase is subject to Unruh Act ceilings. Thus, we have experienced a shift towards more direct financing of retail purchases by financial institutions. In effect, the Act has eliminated one important group of lenders from the market. Moreover, it has reduced consumers' options for financing purchases, and may even have frozen out some consumers completely, to the extent that other lenders are unable or unwilling to increase their installment-credit portfolios.

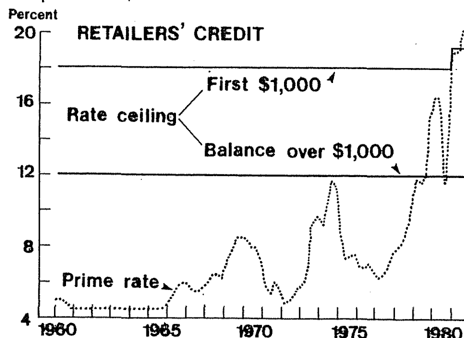
What next?

What would happen if California's usury-law ceilings were lifted or removed? Some critics say that retailers would quickly raise rates, pricing credit out of the reach of many consumers but without increasing available supplies of credit. To answer the question, the Legislature appointed a Retail Credit Advisory Commission last year to report on the state's usury problem by June 30, 1982. Meanwhile, we may find it instructive to examine the installment-credit market in states that have recently removed usury ceilings.

A New York State Banking Department study (February 1981) indicated that rates generally rose towards competitive market levels after deregulation—but that deregulation also expanded the credit pool and broadened the options available to consumers shopping for credit. Another survey, conducted by the New Jersey State Banking Department, reached conclusions similar to those found by the New York study.

Interest rates charged by California commercial banks, which are not subject to Unruh Act ceilings, provide an indication of the level of retailers' rates after deregulation. At the August 1981 peak in rates, seven large California banks charged (on average) 21.7 percent and 22.5 percent for personal loans of 24 and 12 months, respectively, and 19.3 percent for credit cards (excluding fees). Although very high by historic standards, those competitive rates were in-line with the banks' cost of borrowing marginal funds, as measured by an 18.0-percent rate for large time certificates. The California data, like the New York and New Jersey studies, thus indicate that—in a high interest-rate environment—retail credit could become more costly but also more widely available in the absence of rate ceilings.

Gary C. Zimmerman



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/31/82	Change from 3/24/82	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	158,121	668	10,904	7.4
Loans (gross, adjusted) — total #	136,995	747	12,128	9.7
Commercial and industrial	43,023	1,055	6,452	17.6
Real estate	56,529	45	4,907	9.5
Loans to individuals	23,230	– 123	449	2.0
Securities loans	1,666	– 195	87	5.5
U.S. Treasury securities*	6,185	– 101	– 406	– 6.2
Other securities*	14,941	22	– 797	– 5.1
Demand deposits — total#	40,519	3,112	– 2,967	– 6.8
Demand deposits — adjusted	28,016	1,629	– 2,391	– 7.9
Savings deposits — total	31,093	509	33	0.1
Time deposits — total#	91,137	– 362	15,145	19.9
Individuals, part. & corp.	81,973	– 116	14,789	22.0
(Large negotiable CD's)	34,136	– 798	5,057	17.4

Weekly Averages of Daily Figures	Week ended 3/31/82	Week ended 3/24/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	95	69	53
Borrowings	103	11	90
Net free reserves (+)/Net borrowed(–)	– 7	58	– 37

* Excludes trading account securities.
# Includes items not shown separately.

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