

BOSTON COLLEGE INDUSTRIAL AND COMMERCIAL LAW REVIEW

VOLUME VIII

SPRING 1967

NUMBER 3

ECONOMIC ISSUES IN STATE REGULATION OF CONSUMER CREDIT

ROBERT J. McEWEN, S.J.*

I. INTRODUCTION

Forty years ago, Professor E. R. A. Seligman opened a session of the annual meeting of the Academy of Political Sciences with a very thoughtful and farsighted paper on "Economic Problems Involved in Installment Selling." With remarkable insight, he concluded his paper with the following warning:

[I]t must not be forgotten that installment selling, like every institution, is subject to the perils of novelty. If this were the time to deal with the subject fully, it could be pointed out that in the course of history credit has assumed manifold forms; and each new form of credit has had to fight its way to recognition after going through three stages: that of initial growth, that of the sloughing off of abuses, and that of the final emergence of the soundness of the principle.

While [installment selling] . . . has undoubtedly come to stay, all manner of abuses and of perils which it would be shortsighted to deny have crept in. What is needed is a sober and impartial analysis of its true significance. As the years roll by, outworn methods will be discarded; new corruptions will appear. Is it not the part of wisdom to separate the chaff from the grain; to be on our guard against the more obvious dangers; and to eliminate . . . improper practices . . . ?¹

Today, state regulation has become an important, but much misunderstood phase of the community's attempt through government action

* A.B., Boston College, 1940; M.A., Fordham University, 1943; S.T.L., Weston College, 1947; Ph.D., Boston College, 1957; Former Chairman, Massachusetts Consumer Council; President, Council on Consumer Information, 1965-1967; Associate Professor and Chairman of Department of Economics, Boston College.

¹ Seligman, *Economic Problems Involved in Installment Selling*, 12 Acad. Pol. Sci. Proc. 583, 594 (1927).

to insure that the economic processes of borrowing and lending promote the general public welfare.

If they are to be sound, arguments for enacting legal control of consumer credit must rely on the best economic and social research and analysis available. Unfortunately for the public interest, in this as in many other areas of policymaking through legislation, pressures from pecuniary self-interest are so great that they lead to enormous concealment of fact and distortion of analysis. To uncover the real economic issues underlying state consumer-credit laws is the primary purpose of this article.² Three issues are selected for extended discussion, mainly because of their appearance in credit-industry arguments presented in the course of debate on consumer-credit legislation.

1. What is the precise definition of consumer credit? Are legal regulations commensurate with the appropriate economic definitions?

2. What must the state do to establish framework conditions on both the demand and the supply side of the consumer-credit market in order to make it function more effectively and more in the public interest? On the demand side of the market this refers particularly to state action requiring disclosure of information useful to the customer. On the supply side this refers to state control of operating methods of the companies, with particular reference to selling and collection practices, credit-rating bureaus, and the relationship of financing agencies to sellers of merchandise.

3. Can competition be relied upon to produce fair rates after the state has established the framework conditions surrounding the market? If competition in the market cannot be relied upon, then should the state set rates, or should the state set ceilings far above the prevailing rates and designed merely to ward off instances of gross extortion?

II. DEFINITION OF CONSUMER CREDIT

A definition of consumer credit is necessary in order to identify and classify the realities of that to which regulation might be directed.

² It should be emphasized that this article is by no means a complete treatment of the importance or significance of consumer credit in the functioning of the national economy. The questions raised by this issue include the following: (1) Does consumer credit constitute a destabilizing force in the economy? Does it really stimulate consumer saving? (2) In enabling him to enjoy goods and services before accumulating the income to pay cash for them, does consumer credit benefit or harm the consumer? (3) Does consumer credit benefit producers by expanding product markets and allowing the production economies that go with an increased volume? (4) If the objective and subjective gains from the use of credit, whether they be monetary or nonmonetary, are greater than the costs, is not consumer welfare really increased? These questions have been raised by economic writers since the earliest days of installment credit. See Neufeld, *The Economic Significance of Consumer Credit*, in *Consumer Credit in Canada* 5 (Ziegel & Olley ed. 1966).

In a sense, definitions are names we agree to give to things, and the most important element is precision of expression and consistency of use both by the definer and by all others dealing with the same reality. It is quite true that a definition, to be meaningful, must be related to the purpose of the discussion in which it is used. For this reason, legal and economic definitions do not have to withstand the same tests. In economic analysis, for instance, trends in the magnitude of consumer credit are important items of information. For legal purposes, however, the precise nature and essence of the business transactions are more important than their volume or fluctuation.

One way to define consumer credit is to say that it is purchasing power advanced to individual consumers, usually in relatively small amounts, for the purchase of consumer goods and services.³ This definition advances the present discussion only insofar as it includes all those transactions to which consumer-credit legislation can reasonably be directed. Because of the difficulties in classifying types of credit, the definition, to be helpful, must be construed broadly. If legislation cannot precisely include those activities which are capable of producing the evil sought to be prevented, it seems more appropriate, in view of the desired objectives, that such legislation be overinclusive rather than underinclusive.

The difficulties inherent in defining and classifying the various types of consumer credit were well stated by Albert Hart:

The loan classification of the Federal Reserve . . . shows a mixture of at least three classification principles: (A) the line of business in which the borrower is engaged . . . ; (B) the type of collateral . . . ; (C) the purpose of the loan Since the "purpose" of a loan can often be described in several alternative ways, many economists are skeptical of principle C. If either A or B—preferably both—could be carried consistently across the whole mass of loans, bank statistics would be more illuminating.⁴

In viewing broadly the nature of consumer credit, therefore, one must consider an important principle more properly applied to all credit and not just to consumer credit:

The purpose of consumer credit is to enable the borrower to enjoy income before he has earned it or received it. Consumer credit comes into existence whenever an individual acquires

³ As normally used in banking statistics, the figures for consumer credit exclude borrowing for investment in securities, real estate, or home construction.

⁴ Hart, *Money, Debt, Economic Activity* 55 (2d ed. 1953).

funds or goods for personal use in return for a promise to pay for the same in the future.⁵

An important economic truth which is embodied in this quotation has, unhappily, been freely ignored and distorted by legislators and courts for too many years. It should be emphasized that credit or a loan is involved in every exchange in which there is *delay* in completing the transaction. In any case in which the buyer does not render payment to the seller upon acquisition of the seller's goods or services, the economic reality of the situation requires us to acknowledge that the seller is making a loan to the buyer of the value of those goods or services for as long a period as it takes the buyer to complete his payment.⁶ This concept is often obscured and disfigured by legislated subterfuge, either to avoid the honest statement of actual interest and finance charges or to evade legally prescribed maximum rates of interest. Its importance, however, requires that it be embodied in the definition of consumer credit.

A difficulty in a definition as a basis for regulation can arise because of the nature of the goods for which consumer credit is used. The general distinction between a consumer good and a producer good is frequently obvious; there are not too many overlapping or indistinguishable cases that present much difficulty. However, it does make sense to conceive of consumer credit as any method by which an individual consumer has access to immediate purchasing power, in return for which he obligates himself to make specified future payments out of his income. Thus, a definition should include the transactions which permit the consumer to acquire certain goods that might also be considered producer goods. Furthermore, in those cases where an item that is ordinarily a consumer good can also be used as a producer good (*e.g.*, an automobile), it would seem that legal regulations on the matter should tend to include all loans made for that particular good, on the theory that no great harm will be done by overinclusion, but that great complexity and harm may result from opening loopholes that might be exploited. Because of the nature of personal cash loans, it seems appropriate to include all such loans under the heading of consumer credit without attempting to find out whether the money will be spent to buy a consumer good, to pay off previous debts incurred for the purchase of consumer goods, to lend the proceeds to an uncle for the purchase of securities, or to put the funds to any of the hundreds of uses consumers can find for the proceeds of personal loans.

⁵ Stokes & Arlt, *Money, Banking and the Financial System* 593 (1955).

⁶ Writers of books on credit frequently admit this point in early chapters and then proceed to ignore it in subtle attempts to justify the "time-price differential." See Bartels, *Credit Management* 4 (1967); Neufeld, *Manual on Consumer Credit* 4, 88-92 (1961).

What has been said so far about the difficulty of defining and isolating consumer credit emphasizes the problem of data-gathering in this field.⁷ From an economic point of view, the main objective of gathering such information is the ascertainment of significant trends in the use of credit—trends that may have important bearing on the national economy as a whole or on the behavior of consumers specifically. From the particular point of view of protecting individual consumers, all credit transactions should be included in which research has uncovered some element of deception or abuse. On this principle, we must recognize the unreality of the legal distinction between cash credit and vendor credit. No useful analytical purpose is served by the attempt to separate transactions of this sort. They are each in essence one and the same thing—a postponement of one half of the exchange transaction. Thus, both must be included in the definition of consumer credit.

Care should be taken to exclude from coverage those transactions which are not forms of consumer credit, even though they may include consumer-credit elements. Some authors, for example, attempt to identify lease arrangements as a form of consumer credit.⁸ Such a classification, however, appears to be a mistake, because there really is no granting of credit in a lease. With the possible exception of lease arrangements that include an option to purchase at the end of the term, straight leases are nothing more than the purchase, for a fixed amount, of a specified service for a specified time. For instance, if one leases an automobile for a week or a month, he purchases for a price expressed simply in dollars the use of this machine for that period of time. Since everything is "pay as you go," such economic transactions do not belong under the heading of consumer credit.⁹ To call these arrangements merely other means of financing simply confuses the picture. It is true that, in a long-term lease, the lessee obligates himself to definite payments for definite future time periods. But these payments are tied to the enjoyment of definite future services which the lessor obligates himself to provide. In effect, the lessee is as much granting the lessor credit as the lessor is granting it to the lessee. Moreover, if the leased item should be destroyed, the lease ceases to operate. The continued existence of a consumer good purchased on time, however, in no way affects the validity of the installment contract; money which has been advanced must be repaid.

⁷ See generally Jones, *Measurement of Consumer Credit*, 48 U. Ill. Bull. 83-99 (1951).

⁸ See, e.g., *The Mortgaged Society*, *Forbes*, Dec. 1, 1965, p. 51.

⁹ It should be noted, however, that credit can be extended in conjunction with a lease arrangement. To the extent that use of the leased item precedes payment for such use, the lessor has extended credit to the lessee, in the same manner that a vendor grants credit to a vendee by permitting use before payment.

A recent article in *Forbes* discussed a "new look" at personal debt, and by implication suggested that adoption of this view would make discussion of consumer credit more meaningful.

Some economists—notably economists in the Federal Government and in the nation's major corporations—argue that a whole new look should be taken at exactly what is personal debt. If renting an apartment is not considered a debt but a cost, is it fair to assess mortgage payments as "credit" payments? If a man signs a three-year lease at \$150 a month, isn't he as much "in debt" (for \$5,400) as a man who borrows money to buy a house? Similarly, no one regards the cost of going to work by commuter train as "going into debt." Should payments on a car used for the same purpose be regarded as evidence of debt? Isn't much of what is now called consumer debt merely a replacement for services that people used to buy?¹⁰

Unfortunately, this supposed insight is not an improvement but a further confusion. Credit laws should be aimed at protection of owner as borrower, not as user, and thus consumer credit must be defined accordingly—in terms of borrower.

It is important to distinguish carefully between the product or the service obtained by a purchaser and the time and the source of the funds or other thing of value by which the transaction is consummated. If there is any delay between the obtaining of the good or service and the handing over of its equivalent price in goods, or more commonly money, then we have an instance of consumer credit. Someone—the purchaser—has come into possession of useful assets whose employment could otherwise produce a return to the person in control or possession of them. Whether the repayment interval be small or great, the possession of assets or the enjoyment of services prior to the fulfillment of the other side of the exchange is properly called credit. The law can reasonably decide which varieties of credit phenomena present problems of public welfare that deserve control, but the law should never speak or act as if certain transactions do not involve credit when essentially they do, nor as if certain transactions do involve credit when essentially they do not.

III. LEGAL CONTROL OF MARKET FRAMEWORK CONDITIONS

Most economists would agree on the fundamental requirements for the proper functioning of a mixed capitalistic economy such as exists in the United States today. Given the proper institutional framework,

¹⁰ The Mortgaged Society, *supra* note 8, at 51.

free producer and consumer decisions—to buy and sell, to save and invest, to produce this product or that product—lead to the best possible allocation of resources. Such choices must be made through a market operating within a social framework which is at least partially the result of legal requirements. Strictly speaking, these legal requirements are not interferences with market operation, but instead are needed guidelines or boundaries which preserve the possibility of a truly free and informed expression of buyers' and sellers' preferences in the market.

From the buyer's point of view, the two chief requirements are *adequacy of information* on which to base a rational choice and *freedom from any coercion* that could force his choice along certain lines. From the point of view of the selling side of the market, fairness requires that there must be no collusion or constraints on the offerings of competing sellers. Because the system is fueled by self-interest, legal proscriptions to prevent forms of monopolistic control, deceit, and misrepresentation are absolutely essential to the proper operation of a market economy. Only then is there a possibility of achieving maximum consumer welfare. For this reason, even the most libertarian economists and political scientists should and do logically accept the principle of some legal control of consumer credit. What matters is that the controls promise to accomplish the objectives italicized above.

The justification for governmental control of consumer credit, as well as of credit in general, is closely intertwined with the economic nature of money and credit.¹¹ Indeed, in most modern economies, many transactions between buyer and seller, or borrower and lender, are based ultimately upon the lender having access to the money-creating powers of the commercial-banking system.¹² As R. I. Robinson put it:

The collective demands of consumers for credit are channeled back to the money and capital markets through a variety of financial institutions. The most important and also the most complex of these institutions in the market are commercial banks. Commercial banks have at least three different channels of extending credit to consumers: they do it directly in the form of cash loans, they purchase installment paper from the auto and other dealers who originate it, and

¹¹ Bartels, *op. cit.* supra note 6, at 474, states: "Still another criterion of the stature of credit in our economy is the extent and manner in which it has been subjected to social regulation. This is an indication of the esteem in which it is held and of the disrepute which it has attained."

¹² The commercial-banking system creates new checkbook money in the form of demand deposits when it makes loans to borrowers. Its money-creating power arises from the fractional reserve requirements against demand deposits permitted by the Federal Reserve System under authority from Congress. Almost 80% of the U.S. money stock in the hands of the public consists of deposit money. See Whittlesey, Freedman & Herman, *Money and Banking* 20 (1963).

they lend to sales or consumer finance companies that make loans or buy paper.¹³

In the last analysis, these money-creating powers are delegated by the federal government itself. This provides an additional reason then, for governments at all levels to be sensitive to the need for legal controls over practices associated with lending and borrowing. State regulation of consumer-credit practices generally includes the following provisions: (1) licensing of firms engaged in this activity; (2) detailed requirements pertaining to contract terms and to practical methods of operating by such firms; (3) some stipulations about rates or maximum charges; and (4) supervision, examination, and code enforcement by a state agency, usually the bank commissioner.

A. *The Capital Market*

The consumer-credit market is only a tiny segment of the much larger and economically crucial capital market. On the demand side of the capital market are grouped the entrepreneurs or producers who have plans for expansion of production and need to borrow capital. They expect to sell their goods at a margin great enough to yield a profit over and above the sum necessary to pay the interest cost of the borrowed capital. Many agencies catering to the demands for consumer credit are in fact on both sides of the market. They are on the demand side of the capital market because they anticipate putting borrowed funds to work by lending them to consumers, thereby earning sufficient income to pay the interest cost of the borrowed capital and to create profits for themselves.

On the supply side of the general capital market are all those financial agencies that specialize in attracting and collecting income from "savers." "Savers" are those people willing to forego temporarily the use of newly earned income in return for interest. In addition to this source of supply of capital funds, the commercial-banking system, operating under federal-reserve requirements, can provide a further source of funds that have never been income and are newly created demand-deposit money. Thus, the supply side of the capital market is made up of two rather different segments.

Consumers of goods and services (including the services of money-lenders) appear in the capital market only indirectly through the agencies (*e.g.*, banks and finance agencies), whose credit is much stronger. Consumer-credit demand, therefore, as anticipated by these financial intermediaries, is translated into the demand side of the

¹³ Robinson, *Money and Capital Markets* 261-62 (1964). For a comparison of the roles played by commercial banks and financial intermediaries in this process, see Smith, *Financial Intermediaries and Monetary Controls*, 73 Q.J. Econ. 535 (1959).

capital market, and the bidding prices create the interest rate when they interact with the supply prices of lenders.¹⁴

It is entirely possible that defects in the demand side of the consumer-credit market can affect the prices paid in the other parts of the capital market. Imperfections in both the demand side and the supply side of the consumer-credit market itself are of concern not merely to consumers, but to everyone interested in the proper functioning of interest rates in capital markets. If the imperfections of the consumer-credit market are such as to attract into consumer lending (through artificially high rates) an excessive amount of the total supply of loanable funds, this inevitably has a disruptive effect upon the productive side of the economy. Some entrepreneurs would be denied funds completely, while others would be made to pay a higher rate of interest than if consumer-credit rates were lower. Therefore, an understanding of the real demand from the consumer-credit side would contribute to a general improvement in the functioning of the whole economic system.

B. Demand Side of the Consumer-Credit Market

On the demand side of the consumer-credit market, the most important question is whether or not borrowers are in a position to understand the charges they are paying for consumer credit, because, without this understanding, a rational decision as to whether or not to borrow cannot be made. In most consumer-credit transactions, terms are stated as "add-on" or discount charges or as monthly dollar payments. Often borrowers, or purchasers, have no idea of the price they are paying for credit, as compared to the knowledge they have of the interest rates they receive on savings deposits or government bonds, for example.

One of the most important legal regulations suggested by consumer associations is the requirement that lenders state charges in terms of simple annual interest rates. The basic notion of a rate is nothing more than a measure of flow—of water, income, or what have you. Every rate is a ratio involving a time period, a base amount, and an increment related to that base over the time period. An annual interest rate is derived from the number of dollars which must be paid to borrow one hundred dollars for a year. It is what the market establishes as the price that borrowers pay for command over present purchasing power and that lenders receive for relinquishing command over

¹⁴ Here again, it is useful to put to rest once and for all the artificial attempt to inject a distinction between "pure" interest rate (the *actual* interest cost) and other service costs or charges associated with the demand for funds. As many others have pointed out, there is practically no interest rate anywhere in the economy that is not a mixture of elements of pure interest, service charges, and risk elements.

present purchasing power for one year.¹⁵ This form of disclosure has been resisted by most lending agencies. In doing so, however, the opponents of annual-rate disclosure completely ignore the fact that consumers are always beset with annual-rate quotations when banks and lending institutions attempt to attract savings and deposits from the public. The necessity for a consumer to compare what he is able to earn when he puts his money in a bank with what it will cost him when he takes money out of a bank—the necessity of having these comparisons available in identical percentage terms—is a chief and most compelling consumer argument for disclosure of annual-rate information.

The opponents of such disclosure generally attempt to draw fine distinctions among the actual cost elements in the charges on loans. For instance, Professor Robert Johnson has said:

Examination of the operating costs of credit institutions reveals that the dominant component of this "credit package" is the service element, that only a relatively small portion of the finance charge paid by the consumer can be attributed to pure interest.

... Because the major component of a consumer finance charge is for service and risk, it is more properly viewed as a service charge.

If it is treated as a service charge, the consumer finance charge need not be converted into an annual rate. Indeed most service charges are presented in much the same manner as finance charges are now stated to the consumer.¹⁶

Two comments are in order. First, what Johnson says about the components of cost included in the credit package is correct, but it is likewise applicable to any and every interest rate charged either to consumers or to businesses.¹⁷ Second, the fact that service charges have long been presented in a certain way does not at all mean that their conversion into an annual rate could not be done and would not be an improvement. As far as the borrower is concerned, all types of charges are the same: they are part of the total cost of credit to him. What the consumer needs to know is whether 5 per cent interest from a savings bank provides a better use of his funds than paying off what is called a "4 ½ per cent" auto loan. It usually does not, and it is highly un-

¹⁵ The function of interest rates is so critical to the operation of the economy that sophisticated commercial dealers convert practically every financial instrument and financial transaction into percentage terms. This is done to make as fine a profit calculation as possible, to guide the businessman in the selection of the most profitable investment of his assets.

¹⁶ Johnson, *Methods of Stating Consumer Finance Charges* 14 (1961).

¹⁷ Messner, *Social Ethics, Natural Law in the Western World* 814-15 (rev. ed. 1965).

fortunate that communications media are bombarded with such misleading advertisements.¹⁸

According to the opponents of annual-rate statement, "the most appealing of the arguments for use of the interest-rate form of statement is that it will enable consumers to shop more effectively for credit."¹⁹ They concede that this argument implies also that this more effective shopping for credit will generally reduce its cost. In addition, some of these opponents, notably Professor Johnson, allege the "impossibility" of expressing finance charges as annual rates. There are two main objections proposed by Professor Johnson: (1) "The finance charge can be buried in the prices of items sold on credit"; and (2) "The charge cannot be computed at the time credit is granted on a wide variety of credit transactions."²⁰

Let us examine these two arguments and their implications. It is perhaps true that a retailer could raise the price of a product and either totally eliminate any mention of installment financing or quote a ridiculously low rate. The total elimination of explicit finance charges occurs even now in some types of credit-card and department-store credit, for instance, when one gets thirty-day "free" credit. However, the consumer, as long as he has a single price to deal with, is perfectly able to compare the price on the goods or services he is getting with prices for that same benefit in competing stores. This goes on all the time, and the consumer is well accustomed to handling these situations. The popularity of discount stores, which have eliminated such

¹⁸ The attempt to distinguish lender profit from borrower interest is a determined, if misguided, one. Ray McAllister, speaking of revolving credit and installment credit, noted that

these . . . seem to be *interest rates*, which in fact they are not since in both types of credit interest "on the use of money" represents only a part of the total credit costs.

It is argued that because regular installment credit charges are *not* usually expressed as a "true" annual rate it is improper to express revolving credit charges as a *true annual rate*. Again, it is pointed out, this would equate the charge for revolving credit in the mind of the buyer with an interest rate, which it is not.

McAllister, *An Analysis of Proposed Federal Legislation Covering Consumer Installment Credit*, in *Business Studies* 31, 38 (No. Tex. State Univ. Fall 1966).

¹⁹ Johnson, *op. cit. supra* note 16, at 15. Professor Johnson does indeed reach some strange conclusions by his arguments. He decides that consumers will not only be no better off, but will actually be more confused if annual-rate expressions are imposed. It is interesting to examine the reason for his conclusion. He argues that unless each and every type of credit offered to consumers is able to be stated in the annual-rate formula, the consumer will still be confused. To achieve comparability of rate statements for 90% of the types of credit offered to consumers would not, in Johnson's eyes, be an improvement. This argument is totally unacceptable. This is a field in which one is grateful for even a small improvement in the information available to consumers—for even the slightest correction of deceitful and confusing methods of telling the consumer what he is paying.

²⁰ *Id.* at 16.

ancillary services as free delivery or charge accounts, proves that the customer can make the distinction between the goods and services he gets for different product prices in different stores. To think otherwise is seriously to demean the natural intelligence of our countrymen. We must, therefore, totally reject the argument that consumers cannot uncover finance charges buried in the price of items sold on credit.²¹

Let us now turn to Professor Johnson's second objection, namely the fact that on many types of credit the precise rate cannot be calculated in advance, because the conduct of the customer during the life of the loan or the payment period is unknown. By this is meant that no one can precisely foretell, on a revolving-credit plan, how much and on what precise day the customer will buy on this plan and how much he will pay back. Professor Johnson also argues that "on many types of consumer credit it is difficult to identify the finance charge accurately because of various fees or insurance premiums accompanying the payment of the finance charge."²²

The substance of Professor Johnson's argument completely falls, however, when the proponents of the annual rate minimize the need for an expression of the precise annual interest rate equivalent that a revolving-credit customer actually *has paid*. It is quite satisfactory, for purposes of consumer information, if sellers reveal that, in the initial computation of charges on these revolving plans, they are using a broad formula which is roughly equivalent to a particular annual rate under estimated typical payment conditions. So long as some such formula is worked out by the authorities charged with enforcement, and all sellers are required to use a similar formula and manner of expression, then the information available to the public is actually uniform and sufficient. The public would be forewarned that deviations from the assumed conditions will alter the precise rate paid by each individual. This arrangement is perfectly feasible and will give the customer information of exactly the type he needs. What matters is not whether each consumer gets the mathematically precise rate paid on every single contract. Instead, it is important that he get an honest estimate with a margin of error that is relatively small.²³

²¹ This rejection is based, of course, upon the assumption that the retail market is free from collusive pricing. To further strengthen consumer awareness of the problem, consumer groups have in the past mounted campaigns encouraging customers to demand discounts for cash, on the principle that if "free" services of credit or delivery are furnished to a credit customer for exactly the same product price that a cash customer pays, cash customers are made to subsidize credit customers. Consumer education about this practice could eventually force retailers into the practice of cash discounts.

²² Johnson, *op. cit.* *supra* note 16, at 17. This quotation appears to confirm the contention that confusion already exists on a vast scale, and that the only way to avoid multiplication of these deceitful fees and premiums is to force the whole package of fees to be converted into a single percentage rate.

²³ There is no need to fear that there will be a weakening of the competitive position

Finally, it should be pointed out that some arguments employed against consumer-credit controls and contract terms miss the point entirely. For instance, it has often been alleged that consumers do not want and will not use information such as annual-rate percentages. It may be freely conceded that there are some pieces of information that the buyer does not now realize are important for him to know. If, however, it is objectively true that a certain piece of information is essential to a rational decision, then it is perfectly reasonable for the law to require it to be given. It then becomes a matter for consumer education to bring the people to the point where they appreciate the necessity of making a decision only after considering this information. It is inconceivable that anyone can sincerely argue that pertinent information should *not* be made available just because present-day consumers either do not know enough to ask for it or do not use it where it is now available. If the consumer-credit industry really thought this information would have no effect, there would never have been any controversy at all.²⁴

Fortunately for the consumer, several federal agencies supervising financial institutions have recently stepped into this matter with a simultaneous release to all agencies under their control. In it they set out guidelines to be followed by financial institutions in advertising to attract deposits from the public. Chief among these directives is the following:

Interest or dividend rates should be stated in terms of annual rates of simple interest, and the advertisement should state whether such earnings are compounded and, if so, the basis of compounding. Neither the total percentage return if held to final maturity nor the average annual rate achieved by compounding should be stated unless the annual rate of simple interest is presented with equal prominence.²⁵

of individual sellers, since all firms will be required to follow the same formula for the specific type of credit.

²⁴ Some of the arguments or positions advanced by credit-industry spokesmen are obviously well calculated to inject confusion and bewilderment into the debate and should hardly be seriously advanced. For instance, all the talk about how difficult or impossible it would be for companies to train their people to tell customers the true annual interest rate sounds hollow when faced with assurances from the publishers of financial tables that they can add a true annual-rate column to their charts with no difficulty or delay, and at minimal expense. See generally Mors, *Consumer Credit Finance Charges* 108 (1965).

²⁵ See Letter From Board of Governors of the Federal Reserve System to State Member Banks, Dec. 16, 1966, in 52 Fed. Reserve Bull. 1774 (1966). The agencies involved were the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the Board of Governors of the Federal Reserve System. See also *Business Week*, Dec. 24, 1966, p. 81. It is also a source of considerable gratification that the 1967 consumer message from President Johnson contained a request for a percentage rate disclosure per year.

Interestingly enough, this joint action was stimulated by a veiled threat from the Securities and Exchange Commission to apply the anti-fraud provisions of the securities acts to advertising by financial institutions.

C. Supply Side of the Consumer-Credit Market

To appraise the adequacy of a legislative program which controls market practices of sellers and lenders, several factors must be considered. An effective program must be of sufficient scope to encompass within its provisions all types of credit transactions and institutions, covering all consumer goods and services. The effective program must provide for the licensing and supervision of lenders, and must include appropriate sanctions for abusive activity. Further, the legislation, if it is going to accomplish its objectives, must indicate what contract provisions are to be required, permitted, or prohibited; it must also specify the requirements for inclusion of provisions covering insurance, extensions, and refinancing, as well as the procedures as to collections, defaults, and repossessions. Lastly, the legislation must establish the rate-determination process.

Many of the above factors exist, in varying degrees, in legislation which often takes the shape of small loan laws. The included types of transactions and institutions, the licensing and related items, and rates are reasonably well covered. In addition, state requirements relative to contract terms generally present no great economic issue beyond the elimination of coercion, fraud, or deceit. Several practices, however, still remain in the category of unfinished consumer-protection business.

Credit-Rating Bureaus. For their own protection, lenders have set up a system of credit-rating bureaus. While this system is now mainly local, it is in the process of being developed into a national network. In an age in which access to credit can be a very important aspect of a consumer's economic welfare, a close examination of the operation of such credit-rating bureaus is necessary, and public control of them may be required. In too many instances, consumers have been forced into paying debts by a form of blackmail which insinuates that the credit-rating-bureau files will forever bar that delinquent customer from access to credit anywhere in the world. In some of these cases, payments were made on demands that never should have been honored. In other cases, reputations of debtors and consumers have been blackened and credit denied on the basis of completely unjustified allegations conveyed to the credit-rating bureau. In a recent newspaper article, Vance Packard wrote:

An acquaintance discovered quite by accident that his local credit bureau, in a litigation report on him, said he had been the target of three law suits for failure to meet commit-

ments; on the record he obviously was a bad credit risk. In fact, the first case was a \$5 scare suit back in the nineteen-thirties over a magazine subscription he had never ordered; the second involved a disagreement over a \$200 lawyer's fee and was later compromised amicably; the third concerned a disputed fee he had charged a client, and this suit he won in court. It took my friend two days of digging to clear his record with the credit bureau.²⁶

It will be necessary for legal experts to consider ways and means of protecting the public from potential injury caused by such mistaken reports in the files of private credit-rating bureaus.

Relationship of Seller, Lender, and Customer. Another aspect of the supply side of the credit market that calls for regulation and improvement pertains to the relationship between the seller of goods, the customer, and the lender of the money used to purchase the goods. Frequently there is a sharp legal separation between financing agency and retailer. The lending agency buys the customer's promissory note from the retailer and becomes a detached "third party" to the transaction. The customer is then in a borrower-lender relationship with the finance company or bank. The latter is a "holder in due course" of the customer's promise to pay certain sums of money independent of the underlying transaction. This principle is sacrosanct in the law in order to protect the negotiability of commercial paper.

This protected status was abused, however, by some financing institutions who allowed their credit, their forms, and their good names to be used by unscrupulous businessmen in soliciting business. Abuses multiplied, particularly in the home-improvement field. Fly-by-night operators absconded with down-payments and never completed the jobs they had contracted for, while the bank or finance agency had the legal power to compel the customer to keep paying installments on loans used to pay for goods or work he had never received.

Massachusetts has pioneered in the move to eliminate the divorce between the sellers of goods and the grantors of credit. Several years ago the legislature passed and the Governor signed a bill abridging the holder-in-due-course privilege for any financing agent who takes a promissory note originating from the purchase of a consumer good. Such a note must explicitly state that it is a "consumer note."²⁷ In such cases, the financing agent is also liable for any defenses that the buyer might have against the original seller. The principle on which this law is based is very simple. Were a bank or finance company to know

²⁶ Packard, Don't Tell It to the Computer, N.Y. Times, Jan. 8, 1967, § 6 (Magazine), p. 44, at 90.

²⁷ Mass. Gen. Laws Ann. ch. 255, § 12C (Supp. 1966).

that it could be liable to the ultimate customer, it would be very concerned about the reliability and honesty of the businessman or contractor whose installment sales it was financing. This author can testify, from personal experience with businessmen who were affected by this law, that it actually had the intended effect—banks became much more careful about the integrity of the businessmen whose installment paper they purchased.

The interconnected nature of this tripartite transaction is clearer from the way the British system of hire-purchase works.

Instead of the trader giving credit to the customer he sells the goods to the finance company and thus obtains his price in cash. The finance house then hires the goods to the customer and derives the profits and expenses from the difference between the cash price, less the deposit, paid to the trader and the total of the installments received from the customer.²⁸

The English have thus been wrestling with essentially the same problem from a different angle, created by the different historical development taken by English law. As seen above, the dealer is not considered the owner of the goods purchased on installment plans by a customer, because the dealer has executed a contract of sale to a finance company. However, the finance company has not been considered liable for any defects in the goods. These were serious gaps in the protection of English purchasers on the installment plan. Some have suggested a law making the dealer the agent of the finance company, but even this may not be enough.²⁹

IV. RATES AND CEILINGS

The two previous sections have treated the nature of consumer credit and some required conditions that the government must establish as the framework within which the consumer-credit market must function. Essentially these conditions encompass full disclosure of information to buyers, freedom of buyers from fraud, deceit, or coercion, and the prevention of monopolistic or restrictive trade practices by the credit industry. This latter goal, of course, can only be achieved by vigorous enforcement of all the antitrust laws.

It is hard to imagine how the consumer-credit market might have developed in the absence of government regulation. Historical and economic factors made it necessary to have state regulation of the small loan business. Restrictions on charges for extensions of credit

²⁸ Final Report of the Committee on Consumer Protection, Stat. Instr., 1962, No. 505, at 166.

²⁹ See generally Borrie & Diamond, *The Consumer, Society and the Law* (1964).

began in ancient times and continued through the Middle Ages.³⁰ In the United States, there have been many usury laws which set maximum ceilings on interest rates somewhere in the range of 6 to 10 per cent. With such ceilings, however, it was totally impossible to make small loans profitably. Lending to the consumer in small amounts was much costlier and more risky than business lending. Investigation, service, collection and other handling costs, plus the market rate of interest, drove the total cost of a loan to a consumer well above the ceilings set in traditional usury laws. If the state did not wish to leave the whole field of small loans to illegal "loan sharks," with interest-rate charges sometimes as high as 50 or 100 per cent a year, it had to make it possible for legitimate capital and legitimate lenders to function within the law. This conflict between law and economic reality led to the practice of special small loans licensing and to controlled exemption from ordinary maximum rates. As one author on consumer credit has written, "The lending of money to consumers is an economic activity which apparently thrives with or without legal sanction. The only choice is whether such lending is to be done in large part by loan sharks or by legitimate lenders."³¹

Most states now have laws establishing ceilings on the interest rates and finance charges that may be applied to consumer credit. This is particularly true of most categories of what are commonly called "small loans." Presuming, therefore, that the government has done all it can to establish the proper framework conditions for the credit market to operate in the public interest, is this enough, or must the state go further? Should it attempt to fix any rates at all, or should it leave the whole matter to the forces of competition at the market? Assuming it is decided that the state should fix some maximum rates, at what level should these be set? Should they be set deliberately high in order to make it possible for all, even the most inefficient suppliers of credit, to function in the market, or should they be set very low so that only the most efficient suppliers can stay in the market, and if so will this accentuate whatever trend to monopoly already exists? Should ceilings be set close to prevailing market prices, or should they be set rather high in order to prohibit only the most exorbitant charges? The issue raised by this problem—freedom of pricing—is one on which hot debate and lively dissent take place among economists.

On the one hand is a school of thought which believes that, apart

³⁰ Those governmental and church restrictions on interest stemmed largely from several aspects of the borrower-lender relationship in early times; loans were frequently made to a person in distress, while capital and money were not considered productive goods as they are today. In fact, in some periods a negative interest rate was paid by the owner to someone who guaranteed to keep his principal safe for him.

³¹ Edwards, *Consumer Credit Institutions Other Than Banks*; in *American Financial Institutions* 716 (1951).

from assuring truthful and accurate information to the customer, the state should keep out of the credit-pricing process and leave it to the forces of the market. Some of their objections to state-set rates are quite persuasive. By what criteria will rates be set? Frequently, they are set on a cost-plus basis, thus encouraging continuing support even to inefficient and costly suppliers of this service. In addition, it is claimed, with a fair amount of evidence, that whatever ceiling is set automatically becomes a floor, if not the actual price, that the majority of lenders charge. Is the credit industry to be treated like a public utility? What theory of a fair price will govern the action of the state in setting rates? Interminable delays and problems are also involved when a legislature or an administrative board attempts to set rates.

On the other side of the argument, those who maintain that the state must set rates point to several considerations: (1) The borrowers in the market for consumer credit are often not in a financial position to shop around among competing sellers; (2) they frequently are not intellectually able to judge or digest the meaning of the information currently furnished them about rates and terms of credit;³² and, (3) the supply side of the credit market is not sufficiently competitive to trust it to force rates down to a reasonable level.³³

The evidence on this third point is voluminous but frequently contradictory. One writer, however, has summarized his study of banking concentration by saying:

Examining bank performance in 36 major metropolitan areas, we found that structural differences among these markets exert an important influence on bank performance. Market concentration, especially, was found to be significantly associated with the pricing, output, and profits of banks—high

³² Note the significant conclusion on this point from the Juster & Shay study. "Since the majority of consumers probably fall into the rationed category, there will be little rate response observable in the population as a whole under existing conditions [R]ationed consumers showed virtually no knowledge of rates." Juster & Shay, *Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation* 2-3 (1964). "Rationed consumers are defined as those who, given the finance rate, desire more credit than the major or 'primary' credit sources . . . are willing to grant; unrationed consumers are those whose demand for credit is satisfied by their actual borrowing from primary credit sources." *Id.* at 1. See also the types and levels of ignorance discussed by the Malony Committee Report in the section on hire-purchase and the English consumer. *Final Report of the Committee on Consumer Protection*, *supra* note 28, at 168-71.

³³ Past efforts of lenders and vendors seem to have been directed to avoiding competition on price alone. Bartels, *op. cit. supra* note 6, at 36. "Clear distinction has not been made between the total charge and the charge for credit service; therefore the purchaser has not always been critical of price or aware of competitive practices." *Id.* at 471. To increase competition it is necessary to require suppliers of credit to state their charges in ways that facilitate price comparison. *Ibid.*

concentration being associated with high loan rates, low rates on time and savings deposits, and high profits.³⁴

Professor Donald Jacobs, too, has reached the conclusion that changes in the regulations governing bank operations and changes in entry restrictions on new banks are necessary if banks are really going to be able to compete with other financial intermediaries.³⁵

In a recent credit conference in Canada, Professor Wallace P. Mors stated the case for ceilings as follows:

There are some grounds . . . for believing that interest or finance rate ceilings might be necessary even with rate and dollar disclosure. Like most markets, the consumer credit market is imperfectly competitive. Imperfections are many and include differentiation of loan services among financing agencies, limitation of buyer-seller contracts, and borrower inability to determine price. Rate and dollar disclosure of finance charges would reduce only one of the many factors which contribute to market imperfections.³⁶

Professor Neufeld, upon whose paper Professor Mors was commenting, had suggested the desirability of making entry into the credit industry easier, and of thus avoiding monopoly profits by encouraging competition. Mors answered this by saying:

Proliferation of installment lenders might increase competition and reduce monopoly profits without reducing prices to consumers. Judging from small-loan experience, the greater the number of loan offices, the smaller is the size of the average office and the greater is the cost of operations. Any intensification of competition takes the form of increased advertising and other forms of sales promotion, rates of charge remaining at the ceiling level allowed by law.³⁷

Several conclusions should be drawn from this discussion. First, the essence of a credit transaction—delay of payment by the buyer—should be acknowledged and laws revised to agree with economic reality. Second, the imperfectly competitive nature of the market should be faced. On the buyer's side of the market there are imperfections because of the lack of knowledge of alternatives in rates,

³⁴ Edwards, *The Banking Competition Controversy*, in *Studies in Banking Competition and The Banking Structure* 327 (1966).

³⁵ Jacobs, *The Framework of Commercial Bank Regulation: An Appraisal*, in *id.* at 350.

³⁶ Mors, *The Economic Significance of Consumer Credit: Commentary*, in *Consumer Credit in Canada* 21-22 (Ziegel & Olley ed. 1966).

³⁷ *Id.* at 22.

terms, and sources, and differences in creditworthiness between buyers. On the seller's side there is a naturally differentiated product because of the nature or availability of the goods offered, and an artificially differentiated product created by brand-name advertising; no two sellers are really selling identical, homogeneous commodities or services. Other elements of differentiation between one lender and another may be: collection methods and policies, ease of obtaining loans, down-payment and/or security needed. Third, state governments should still do all in their power to introduce more competitive features into the market. On the demand side this means (a) encouraging full disclosure of all pertinent facts, rates, and terms to enable comparisons, and (b) consumer education to make consumers aware of their choices and their rights. On the supply side, the state should encourage (a) entry of new credit grantors, and (b) expansion of the types and fields into which old and new lenders may enter.

Even after all these improvements in market conditions and practices have been achieved with the aid of state law, there remains the nagging question: Will banks and finance agencies engage in sufficient price competition to keep interest and finance rates at levels reasonably fair to the consumer? The answer to that question is probably "no." Even with vigorous regulation by banking authorities and diligent application of antitrust law to bank structure and conduct, it seems likely that state control of interest rates on consumer credit will still be necessary in the public interest. If so, the proper course of action should be to set rates and not ceilings.

V. CONCLUSION

In the larger context, it is clear that glaring abuses in the consumer-credit field have led to popular demands for state regulation. This raises an economic issue that far transcends the credit field: How do we reconcile and relate the interests of business and the public within the broad context of a free capitalistic economy? It is commonly accepted that the general public makes very little distinction between abuses associated with the financing of a sale and problems caused by the seller or his product. In the eyes of a buyer, it is all one. He usually attributes all problems directly and immediately to the original seller and focuses his complaints accordingly. How much popular conflict and disenchantment with business is really due to finance industry abuses is anyone's guess, but in no event is it small. Otherwise, consumer associations and consumer groups throughout the fifty states would hardly have made consumer-credit abuses the focal point of their attack.

Popular disenchantment with business is emphasized by those economists and social psychologists who are devoting their attention

to the study of conflict in society and the requirements of social harmony. One European author recently wrote:

[I]n the majority of cases hire purchase could better have been avoided. . . . *First save, then spend, is as a rule better than the other way around.* This is quite clear in the cases in which the original harmony between seller and buyer changes into an open conflict: the buyer has become overburdened by debts which exceed his means

. . . [Most consumers] believe that they are often overcharged. This brings us to the clash of interests which, next to that on wages, is perhaps the strongest in contemporary folklore: the businessman is frequently regarded as the consumers' natural enemy, if not as a *swindler*.³⁸

This is a very disturbing state of affairs, mainly because it is so unnecessary. If the businessman ceased looking on consumer credit as an additional source of profit for him, and concentrated his attention on making a profit from his real business—selling good quality products to satisfied customers—this suspicion and hostility toward businessmen in general might diminish or even disappear. It was a sorry commentary on business when a consumer magazine could headline its credit article "Bait the Hook with Merchandise."³⁹ Hopefully, businessmen will see that it is in their own interest to work for an equitable system of regulation of the consumer-credit field.⁴⁰ This will then restore credit to what it was intended to be—a valuable and convenient tool to facilitate the production and exchange of goods and services to the mutual benefit of business and the consumer.

³⁸ Pen, *Harmony & Conflict in Modern Society* 135-36 (1966).

³⁹ 31 *Consumer Reports* 457-61 (1966).

⁴⁰ Some actual business "deeds" along this line would be much more effective than the pious declarations adopted by The Better Business Bureau Managers and widely published in November 1966. The following is an example of such language:

The Better Business Bureaus decry and regret actions or publicity by whomsoever, which create the false impression that American Business generally is opposed to consumer interests—or which unfairly disparage or degrade the general dependability and integrity of American Business.

. . . .
[They] . . . deplore any attempts to set up business and their customers as antagonists when, in fact, they are dependent on each other for the mutual benefit of both.

The Bulletin, Better Business Bureau, Nov. 1966, p. 1.