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REGULATION OF FINANCE CHARGES ON CONSUMER INSTALMENT CREDIT

Robert W. Johnson*

THE subject of adequate disclosure of finance charges in consumer credit transactions has, in recent years, "become a rallying point for consumers and a battle line for industry."¹ Equal heat is generated by discussions concerning the *regulation* of finance charges on consumer instalment credit. The aim of this article is to examine briefly the existing pattern of rate regulation and then to explore the purposes of ceilings on consumer finance charges and the problems involved in their design. As is true with the question of disclosure of finance charges, the problems are extremely complex. Men of good will on both sides of the argument will disagree, but if the economic rationale is clearly understood, the philosophical grounds for disagreement may become more sharply defined.²

I. EXISTING RATE CEILINGS ON CONSUMER INSTALMENT CREDIT

Those states with the most comprehensive schemes for regulation of consumer credit set different maximum rates for each recognized form of instalment credit. The types of instalment credit can be divided into two general categories with much diversity within each category: (1) *instalment loans* by pawnbrokers, licensed lenders, credit unions, industrial loan companies, savings and loan associations, and commercial banks—as well as certain revolving cash credit plans; (2) *instalment sales* of various consumer goods, particularly new and used automobiles—as well as revolving sales credit

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1. Jordan & Warren, *Disclosure of Finance Charges: A Rationale*, 64 MICH. L. REV. 1285-322 (1966) [hereinafter cited as Jordan & Warren].

2. To clarify my aims in this article, the objective is to discuss whether limitation on consumer finance charges is desirable, and, if so, what principles might guide the formulation of rate ceilings. Certain associated problems are not covered. Among these are the form in which any rate ceiling should be stated in legislation, the legal problems of applying state legislation to federally chartered credit grantors, the definition of a consumer credit transaction, the limitation of charges for delinquency, or for extending or refinancing outstanding debts, and limitations on finance charges in lease transactions that serve as alternatives to consumer instalment sales.

plans.³ It is perhaps not too much to say that the irreconcilable diversity of rate ceilings governing the major types of consumer instalment credit today may, in itself, help to justify the move toward greater uniformity in legislation governing consumer credit.

A. Cash Credit

1. Small Loan Transactions

Under the leadership of the Russell Sage Foundation, the Uniform Small Loan Law (U.S.L.L.) was conceived and drafted in 1916 to meet the problem of loan sharks—illegal lenders who extract usurious interest rates from the public—by excepting small loans from the prohibitions of the usury laws. Such an exception was necessary because it was not economically possible for commercial lenders to provide instalment loans to consumers at the rates specified in the general interest and usury laws; thus, a vacuum was created in the loan market which loan sharks rushed to fill. Under the U.S.L.L., lenders licensed by the state were permitted to charge higher, or augmented, rates on loans below a given amount on the condition that they adhered to various stringent regulations designed to prevent abuse of borrowers.⁴ Today, all of the states except Arkansas and the District of Columbia "have laws which permit cash lending by finance companies at rates which would attract responsible capital."⁵ The majority of these laws are patterned after the U.S.L.L., and most specify a rate ceiling that declines as the amount of credit granted increases.⁶

3. A good summary description of various consumer credit institutions may be found in M. NEIFELD, *MANUAL ON CONSUMER CREDIT* 311-464 (1961).

4. See generally, D. GALLERT, W. HILBORN & G. MAY, *SMALL LOAN LEGISLATION* (1932); F. HUBACHEK, *ANNOTATIONS ON SMALL LOAN LAWS* (1938); L. ROBINSON & R. NUGENT, *REGULATION OF THE SMALL LOAN BUSINESS* (1935).

5. NATIONAL CONSUMER ASS'N, 1967 *FINANCE FACTS YEARBOOK* 51.

6. Section 13(a) of the Seventh Draft of the UNIFORM SMALL LOAN LAW (U.S.L.L.) (1942) provides:

Every licensee hereunder may contract for and receive, on any loan of money not exceeding \$300 in amount, charges at a rate not exceeding 3 per cent a month on that part of the unpaid principal balance of any loan not in excess of \$100, and 2 per cent a month on any remainder of such unpaid principal balance. R. BARRETT, *COMPILATION OF CONSUMER FINANCE LAWS* 681 (1952). As some states raised the size of loan ceiling under the U.S.L.L., there has been a tendency to more gradations in the rate ceiling. For example, in Iowa licensed lenders are permitted to levy a monthly charge of 3% on the first \$150 of declining outstanding principal balance, 2% on the unpaid balance from \$150.01 to \$300; 1½% on the balance from \$300.01 to \$700; and 1% on the balance above \$700 to the ceiling of \$1,000. As noted in Jordan & Warren 1286-89, some states permit these charges to be precomputed; that is, the finance charge applicable over the life of the loan is calculated at the time credit is granted on the assumption that the loan will be repaid according to the contract. To appraise these rates, it is important to recognize that each rate applies only to the specified portion of the unpaid monthly balance. Thus, as a loan for \$1,000 is repaid

The maximum finance charge permitted licensed lenders varies greatly among the states. For example, on a \$500 cash advance repayable in twelve monthly instalments, Alaska permits a finance charge of \$129.76, while New York limits the charge to \$64.72. The median charge among the states is \$81.52.⁷ These dollar amounts convert into nominal annual rates to maturity of 44.9%, 23.0%, and 28.8% respectively.⁸ Of course, under the customary graduated rate ceilings, the authorized rates would be somewhat higher on smaller loans and lower on larger loans. In addition, a number of states have ancillary acts under which licensed lenders may make larger loans than permitted under the small loan law, but at rates that are typically below the ceiling rates in the small loan statutes.⁹

The Seventh Draft of the U.S.L.L. provides that "in addition to

monthly, the 1% rate applies only while the outstanding balance exceeds \$700, and then only to that portion of the unpaid balance above \$700. The 3, 2, and 1½% rates apply to their respective portions of the balance below \$700. Consequently, the annual yield on loans under a graduated rate is *not* twelve times the simple average of the monthly rates weighted by the portion of the loan to which they apply. To determine the annual rate permitted by the ceiling requires laborious calculations, a computer, or rather complex formulas. For the formulas, see Stelson, *Graduated Interest Rates in Small Loans*, 69 AM. MATHEMATICAL MONTHLY 15-21 (1962).

Other states have rate ceilings expressed as dollar add-on rates; that is, the ceiling rates are based on dollars per \$100 per year of the *initial* unpaid balance, rather than the declining unpaid balance, as in the case of per-cent-per-month ceilings. For example, licensed lenders in Ohio are permitted add-on rates of \$16-\$9-\$7 per year at \$500 and \$1,000 to a ceiling of \$2,000. Since add-on rates apply to the initial unpaid balance, the average add-on rate can be approximated by an average of the add-on rates weighted by the portions of the loan to which they apply. Thus under the Ohio rate ceiling a one-year loan for \$1,500 could have an average add-on rate of \$10.67 per \$100 per year:

<i>Add-on rate</i>	<i>Portion of initial principal</i>	<i>Dollar charge</i>
\$16/\$100	\$500	\$80
\$ 9/\$100	\$500	45
\$ 7/\$100	\$500	35
	\$1,500	\$160

Weighted average add-on rates: $\$160/\$1500 = \$10.67/\$100/\text{year}$. Since small loans are frequently refinanced, the actual yields will depend upon the methods of refunding the unpaid portion of the finance charge and the time of refinancing.

7. The source for these figures is an unpublished 1967 table prepared by a major consumer finance company.

8. The nominal annual rate is defined as twelve times the monthly rate. This is the most common method of converting a monthly rate to an annual rate. However, some argue that a monthly rate should be compounded monthly to determine the annual rate. The former procedure is advocated by M. NEIFELD, *GUIDE TO INSTALMENT COMPUTATIONS* 146, 315-20 (1953). The latter procedure is supported by M. AYRES, *INSTALMENT MATHEMATICS HANDBOOK* 212-14, 233-35 (1946), and at one time was sanctioned by the FEDERAL TRADE COMMISSION, *REPORT ON MOTOR VEHICLE INDUSTRY* 955-56 (1939). One per cent per month compounded monthly would equal 12.68 per cent per annum.

9. E.g., CAL. FIN. CODE §§ 22000-653 (West 1955); MD. ANN. CODE art. 11, §§ 163-203 (1957).

the charges herein provided for, no further or other amount whatsoever shall be directly or indirectly charged, contracted for, or received."¹⁰ All states, save two,¹¹ have made exceptions to this principle in enacting their own small loan laws; the most common exceptions are various filing and recording fees, delinquency and deferral charges—especially when finance charges have been precomputed—and various forms of credit insurance.¹² Some states also authorize, within limits, certain additional service charges. The effect of these latter amendments is to raise the ceiling rate, while preserving the inverse relationship between rate and size of loan.

2. Credit Union Loans

Credit union laws also had their origin in the early part of the twentieth century, with the first such law being passed in Massachusetts in 1909.¹³ Like the small loan laws, credit union laws provided an exception to the usury laws in order to permit operations of legal lenders. As in many small loan statutes, rate ceilings for credit unions are expressed as a given per cent per month on the declining monthly unpaid balance. However, unlike most rate ceilings on small loans, ceilings on credit union loans are usually constant, regardless of the amount or term of the loan. Federal credit unions must limit their finance charges to 1% per month—a nominal annual rate of 12%.¹⁴ With a few exceptions¹⁵ this is also the rate ceiling for state-chartered credit unions.

In addition to the finance charge, federal credit unions may require the borrower to pay for the cost of releasing a mortgage or lien on the collateral property, insuring the property against casualty loss, and restoring clear title to the borrower.¹⁶ Some state laws also permit specified additional charges.¹⁷

3. Industrial and Commercial Bank Loans

Industrial banks were originally established as Morris Plan banks in 1910 to make loans to consumers against hypothecated deposits,

10. R. BARRETT, *supra* note 6, at 681.

11. Virginia and Wisconsin are the two states without exceptions.

12. See B. CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION 25-29 (1965) [hereinafter cited as CURRAN]. This excellent work is a convenient aid in researching existing legislation as of 1965 and will be used in this article to cite compilations of state statutes.

13. Ch. 419 [1909] Mass. Acts now MASS. ANN. LAWS ch. 419.

14. Federal Credit Union Act, 12 U.S.C. § 1757 (1964). Unlike consumer finance companies, credit unions may obtain either a federal or state charter.

15. *E.g.*, OKLA. STAT. ANN. tit. 6, § 2006 (1966) (10% per year); W. VA. CODE ANN. 31-10-16 (1966) (1.5% per month).

16. DEPT. OF HEALTH, EDUCATION, & WELFARE, CREDIT MANUAL FOR CREDIT UNIONS 39 (1964).

17. See CURRAN 49 nn.331-35.

but now they are often difficult to distinguish from commercial banks. The serious entry of commercial banks into the consumer credit market is usually dated at 1928, when the National City Bank of New York first offered cash loans to consumers,¹⁸ although other banks had previously done some experimenting with personal loans. The effect of laws governing the consumer loan activities of both types of banks has been to permit yet another exception to existing usury statutes. Somewhat more than half the states permit industrial banks or industrial loan companies¹⁹ to make consumer cash loans, usually with rate ceilings, and about four-fifths of the states have instalment loan laws applicable to commercial banks.²⁰

Rate ceilings governing cash loans made by industrial and commercial banks are such a mixed bag that it is difficult to generalize.²¹ The heritage of commercial lending led to rate ceilings expressed as discount rates. Under this procedure, banks are permitted to deduct the finance charge from the face amount of the note at the time of the loan.²² In contrast to the graduated rate ceilings discussed above, a rate ceiling expressed as a discount rate permits effective rates that *rise* as maturities lengthen,²³ since the longer the term of the loan, the greater the amount that will be pre-deducted from the face amount, and the lesser the amount that the lender must make immediately available to the borrower. Since long maturities are associated with

18. For a capsule recount of the growth of consumer lending by commercial banks, see AMERICAN BANKER'S ASS'N, *THE COMMERCIAL BANKING INDUSTRY* 163-69 (1962).

19. There is no essential difference between an "industrial bank" and an "industrial loan company" other than the right to use the word "bank" in the corporate name.

20. CURRAN 54-55, 68.

21. See CURRAN 52-57, 66-74, 204-19, 226-43.

22. Rate ceilings expressed as add-on or discount rates have quite different effects; cf. note 6 *supra*. Add-on rate ceilings limit the amount of the finance charge that may be *added* to the principal balance. If the permitted add-on finance charge is \$7 per \$100 of initial principal balance per year, a lender may add to the principal balance of a two-year loan for \$1,000 a finance charge of \$140 ($\$7 \times 10 \times 2$). The total obligation of the consumer is then \$1,140 and his proceeds, \$1,000.

If the rate ceiling is expressed as a discount rate, say \$7 per \$100 of initial principal balance per year, discount, or 7% per year, discount, a lender can *deduct* the \$140 finance charge from the face of the two-year \$1,000 loan, leaving the borrower with net proceeds of only \$860. Thus one difference between add-on and discount rates is that the same rate provides a higher annual yield to the credit grantor if he is allowed to discount the finance charge, rather than add the charge to the principal.

23. As maturities lengthen, the nominal annual yield under the add-on rate ceiling rises and then falls, whereas the yield under a discount rate ceiling constantly rises. This phenomenon is summarized in the table below showing the nominal annual rates for various maturities under add-on and discount rate ceilings of \$7 per \$100 of initial unpaid balance per year (or 7% per annum on initial unpaid balance):

	Terms in Months						
	3	6	12	24	36	48	60
Add-on rate yield (%)	10.5	11.9	12.7	12.9	12.8	12.7	12.5
Discount rate yield (%)	10.7	12.3	13.6	14.9	16.0	17.2	18.5

large loans, the result is a rate ceiling that *increases* with the size of loan. For this reason, some rate ceilings using a discount rate are often coupled with a limitation on maturity of loan.

The most common rate ceilings on instalment loans by industrial and commercial banks vary from 6% to 8% per annum discounted from the face of the note. These figures translate into an actual yield that ranges from about 11.6% on twelve-month loans to 18.8% on thirty-six-month loans.

Statutes regulating loans by industrial and commercial banks also differ from those limiting rates on loans by licensed lenders and credit unions in that they more frequently permit additional charges for making and servicing a loan. Sometimes minimum charges are allowed. The effect of permitting such charges is, of course, to raise the rate ceiling on small loans. In some states the rate ceiling on small loans with short maturities by commercial banks is higher than that permitted licensed lenders on corresponding loans. When minimum charges are coupled with a rate ceiling expressed as a discount rate, the rate ceiling in relation to size of loan becomes a "lazy-J" shaped curve, dropping quite sharply as one goes from very small to medium-sized loans, and then gradually moving upward for large loans with long maturities.

4. *Home Improvement Loans*

Home improvement loans insured under title I of the National Housing Act²⁴ are also subject to rate ceilings. Present maximum charges are \$5 per \$100 per year of unpaid principal balance on the first \$2,500 and \$4 per \$100 per year on the balance above \$2,500. Although the charges may be discounted, the maximum yield may not exceed that available on twelve-month contracts.²⁵ The effect of this language is to limit the available finance charge to a nominal annual rate of just under 10% on twelve-month contracts for less than \$2,500, with slightly lower ceilings prevailing on longer term contracts. On contracts above \$2,500, the rate ceiling falls farther below 10%, the larger the unpaid balance and the longer the maturity. Permitted fees include recording and filing fees, stamp taxes, title examination charges, and premiums for property insurance, if any, required for security for the loan.²⁶

24. 12 U.S.C. §§ 1702-06(d) (1964).

25. 12 U.S.C. § 1703(b) (1964).

26. See CURRAN 63.

5. Check-Credit Loans

Check-credit plans are a procedure whereby an individual may draw against a pre-established line of credit at his commercial bank by simply writing checks. He is, of course, then obligated to commence prescribed monthly payments to reduce his debt. Since these plans are relatively recent innovations, most are governed by the appropriate instalment loan laws or the usury laws. The four states which have passed legislation dealing specifically with check credit plans²⁷ place rate ceilings of 1% per month on the outstanding balance (a nominal annual rate of 12%) plus a fee of 25¢ per check. Various methods are provided for determining the outstanding balance. The effect of the 25¢ fee is to provide a yield slightly over 12%, but the effect is minimal except when a borrower writes a large number of small checks.

B. Sales Credit

In contrast to cash credit, instalment sales credit was considered immune from rate ceilings for a considerable number of years under the time-price doctrine.²⁸ Conceived in an era when sales "on time" were viewed as more appropriate for the purchase of luxuries than necessities, the doctrine is based on the premise that a seller of goods or services actually may have two prices at which he is willing to sell: a cash price and a time price. Arguably, since he is free to set the cash price, he is equally free to set the time price. Thus, the differential between the two freely-set prices is not interest, but a time-price differential. Whatever its legal foundation, the time-price doctrine has provided still another de facto exemption from the usury laws.

1. Retail Instalment Sales

Retail instalment sales acts are of comparatively recent vintage; they first appeared in the 1940's and spread rapidly throughout the 1950's. At present, thirty-five states regulate finance charges on the instalment sale of motor vehicles, and about twenty-six restrict charges on the sale of goods other than automobiles.²⁹ The statutes, in terms,

27. Arizona, New Jersey, New York, and Virginia. See CURRAN 76-79.

28. See Berger, *Usury in Instalment Sales*, 2 LAW & CONTEMP. PROB. 148-72 (1935); Britton & Ulrich, *The Illinois Retail Instalment Sales Act—Historical Background and Comparative Legislation*, 53 NW. U.L. REV. 137, 143 (1958); Warren, *Regulation of Finance Charges in Retail Instalment Sales*, 68 YALE L.J. 839, 841-51 (1959).

29. CURRAN 83-84, 101-07, 256-77. To Miss Curran's compilation should be added Georgia, Nebraska, and Texas (motor vehicles) and Georgia, Massachusetts, Michigan,

may apply only to motor vehicles, only to other goods, or to "all goods."

Most retail instalment sales acts provide for rate ceilings that decline as the amount of credit granted increases. This declining ceiling is a product of several features. First, a number of statutes provide for minimum charges, which, of course, raise the gross yield on small transactions. Second, the majority of "all-good acts" specifically provide for a graduated rate ceiling, such as the New York statute which provides for an add-on rate of \$10 per \$100 per year on the first \$500 of unpaid principal balance and \$8 per \$100 per year on the balance in excess of \$500.³⁰ In addition, most "motor vehicle acts" provide for a lower rate on newer cars, with the result that instalment contracts written on older used cars, with low unpaid balances, carry a higher rate than new car contracts. For example, in New York the ceiling add-on rate on cars over two years old is \$13 per \$100 per year, while the add-on rate on a new car is \$7 per \$100 per year.³¹ Thus if a New York consumer finances a \$300 unpaid balance on a refrigerator for one year, the highest legal finance charge is \$30 ($\$10 \times 3 \times 1$), but the ceiling charge on the same unpaid balance on a used car is \$39 ($\$13 \times 3 \times 1$). It may be seen, then, that, depending on the item financed, the effective annual ceiling rate may vary from 18% to 23%. Even greater variations can be found in other states; seldom are rate ceilings in a given state the same for motor vehicles and other goods.

2. *Revolving Credit*

The more recent origin of revolving retail credit plans probably explains the relatively small number of states that limit finance charges in this area.³² The most common rate permitted is 1.5% per month on the unpaid balance, although various methods of determining the unpaid balance are allowed. The charge of 1.5% per month is not equivalent to an annual rate of 18%, as one might suppose.³³ Some state laws provide for a graduated revolving credit rate, so that larger balances carry lower rates.

Nebraska, Nevada, New Mexico, Oklahoma, Oregon, Pennsylvania, and Texas (goods other than motor vehicles).

30. N.Y. PERS. PROP. LAW § 404(1) (McKinney 1962).

31. N.Y. PERS. PROP. LAW § 303(1) (McKinney 1962).

32. Miss Curran lists eleven states which, under some denomination, refer to revolving credit in their more inclusive instalment vendor's acts, CURRAN 93 n.46.

33. Since the customer's pattern of purchases and payments will not typically fall into a precise monthly cycle, it is apparent that he may be getting more or less than a month's credit in return for the $1\frac{1}{2}\%$ charge. For a fuller exploration, see Jordan & Warren 1306-07.

C. General Conclusions

A few general conclusions may be drawn from this somewhat sketchy review of existing rate ceilings. First, all of the ceilings discussed represent an exception to existing interest and usury laws, except in those few states where no general usury statutes exist. These exceptions are necessary to permit legitimate firms to provide consumer instalment credit. Second, with some important exceptions, rate ceilings decline as the amount of credit granted increases. Since large amounts of credit are typically associated with long maturities, it may be concluded that rate ceilings often vary inversely with both the amount of credit and maturity of contract. Third, it should be evident that when a consumer seeks to use a given dollar amount of consumer instalment credit, he is subject to a wide variety of rate ceilings, depending upon the applicable state law, his source of credit, and, in some cases, the consumer good or service that he wishes to acquire. In part, these variations have arisen because different types of consumer credit were introduced at different times by various types of credit grantors. If anything, the brevity of this review has obscured the extent of the variety, or possibly chaos, of existing rate ceilings. To develop sound legislation in this area we will need to examine the purpose of rate ceilings and the economic principles that should guide their design.

II. PURPOSE OF RATE CEILINGS

Except in time of war, our economy is relatively free of price controls. Consumers bid with their dollars for various goods and services, and resources are shifted to those industries producing the goods and services desired by consumers. The interaction of free choice by consumers and free competition among suppliers meeting the expressed desires of consumers sets the prices for the end products. Through the price mechanism, goods and services are rationed among consumers and, if the markets are perfect, each consumer receives an assortment of goods and services that is optimal from his point of view within the constraints of his budget. Of course, it is recognized that no market is perfect.³⁴ We have relatively perfect competition

34. A perfectly competitive market must have all of the following characteristics:

- (1) A commodity or service whose uniform type and quality is recognized by buyers and sellers;
- (2) a large number of buyers and sellers, making offers to buy and sell independently;
- (3) buyers and sellers who are fully informed as to prices; and
- (4) buyers and sellers who are free to enter or to leave the market.

The perfect market is a limiting case found only in theory. Consequently, all markets are imperfect to some extent. Discussions of the nature of competition in consumer credit may be found in Dauer, *The Nature of Competition in Consumer Credit*,

in the grain markets because of the existence of standard grades, sophisticated buyers and sellers, and widely published prices. However, the market for most consumer goods and services is not characterized by standard grades and uniform prices. Suppliers often prefer to rely on consumer brand preference and other forms of nonprice competition, rather than to compete solely on the basis of price. There is no reason why this should not be so. Consumers benefit from product development and other forms of nonprice competition. Our laws are designed, not to enforce *price* competition, but to encourage competition *per se*.

In spite of these imperfections, the rule accepted in most markets is *caveat emptor*. If a consumer pays \$500 for a television set that is "worth" only \$300, there is no law, absent some proof of fraud, that requires a refund of the difference or that levies a penalty on the merchant. The individual consumer pays the penalty for his ignorance, carelessness, or greed. While particular consumers may suffer, imposition of general price controls is shunned in the belief that the general welfare would be damaged in the attempt to remedy individual cases of bad judgment. This belief is well founded. If price controls result in different prices than would have prevailed in a freely competitive market, it follows that the resulting allocation of goods and services is suboptimal. While some individual consumers benefit, among consumers in general there is a net disadvantage because of the distortion of free choice by the imposed price mechanism.

The imposition of rate ceilings on consumer credit is clearly a form of price control. There are two possible economic rationales for this governmental interference in an economic system that is generally thought to operate most efficiently without price controls. First, it may be thought that the consumer credit market is so imperfect that consumers seldom pay a "fair" price for their use of credit. If this is so, the government may be obliged to define and enforce prices that are "fair" to consumers. Second, within each given credit market, suppliers of credit may have monopoly power, so that even with perfect knowledge consumers may be overcharged for their use of credit. If consumer credit is best dispensed through monopolies, government should set prices that will both provide adequate service to the consumer and a "fair" return to credit grantors, just as it at-

1958 PROCEEDINGS, NATIONAL CONSUMER CREDIT CONFERENCE 18-30; Phelps, *Monopolistic and Imperfect Competition in Consumer Loans*, 8 J. OF MARKETING 382-93 (1944); Yntema, *The Market for Consumer Credit: A Case in Imperfect Competition*, 196 ANNALS OF THE AM. ACADEMY OF POL. & SOCIAL SCI. 79-85 (1938).

tempts to do in the case of public utilities. Let us examine the economic rationale underlying these two objectives of price control in consumer credit.

A. A "Fair" Price for Consumer Credit

The assertion that price controls are needed to counteract the effects of an imperfect market must be based upon the following premises:

1. There is a notable lack of knowledge on the part of consumers, coupled with an ability on the part of suppliers successfully to differentiate their goods or services.
2. These imperfections cannot be mitigated significantly by providing more information to consumers.
3. Price controls will on balance improve the allocation of goods and services sufficiently to overcome the misallocation of resources inherent in the design and enforcement of price ceilings.

1. *An Imperfect Market*

The market for consumer credit has often been characterized as an imperfect market, because consumers do not have perfect knowledge about the credit services they acquire and because credit grantors differentiate their services.³⁵ Several studies have shown that consumers are not aware of the annual percentage rate that they pay on various instalment credit transactions.³⁶ However, the absence of specific knowledge of annual rates does not necessarily mean that consumers are unaware that some sources of credit are less expensive than others and that it is more costly to borrow small amounts than large amounts.³⁷ In addition to lack of perfect knowledge by consumers, imperfections may be attributed to differentiation among credit grantors in such matters as credit terms, type of collateral required, leniency of credit policy, collection policy, amount of credit granted, and convenience and status of the credit grantor.

In spite of these forms of nonprice competition in the market for consumer instalment credit, there is considerable evidence that finance charges are influenced by price competition, so that they are forced below existing rate ceilings in many instances. Data provided

35. Phelps, *supra* note 34; Yntema, *supra* note 34.

36. F. JUSTER & R. SHAY, CONSUMER SENSITIVITY TO FINANCE RATES: AN EMPIRICAL AND ANALYTICAL INVESTIGATION 47-75 (1964); W. MORS, CONSUMER CREDIT FINANCE CHARGES 80-91 (1965); Due, *Consumer Knowledge of Instalment Credit Charges*, 20 J. OF MARKETING 162-66 (1955).

37. See testimony of George Katona in *Hearings on S. 2755 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 86th Cong., 2d Sess., 806-07 (1960).

the National Conference of Commissioners on Uniform State Laws by two large sales finance companies on new-car contracts purchased during November 1965, reveal that rates paid by consumers were almost always below the rate ceiling, except in Michigan and Pennsylvania where rate ceilings were abnormally low.³⁸ Even in these two states, where contract rates were most frequently at the ceiling, we cannot be sure that lower finance rates were not offset in part by slightly higher prices of the new car or lower values on trade-ins. An earlier study of new-car finance rates shows that the rates in non-ceiling states averaged 10.95% per annum, compared to an average of 10.86% in all states, with some ceiling states having average rates above the 10.95% average figure.³⁹

Other studies also indicate that competition operates as a fairly effective check on finance charges for most types of consumer installment credit.⁴⁰ The major exception is cash loans made by consumer finance companies. Except in one or two states, finance charges on most short-term cash loans by licensed lenders appear to be at the ceiling rates.⁴¹ Actual finance charges on used cars are probably at the ceiling more often than in the case of new cars, although there is no reliable evidence to support this assertion. Since in both of these particular markets, the consumer is frequently a marginal credit

38. The data may be more clearly shown in tabular form:

COMPARISON OF RATES CHARGED ON NEW-CAR CONTRACTS AND CEILING
RATES NOVEMBER 1965

Rate ceilings expressed as an add-on charge per \$100 of initial unpaid balance	Percentage of contracts in which consumers paid the ceiling rate. ^e
\$6/\$100 ^a	17.65
\$7/\$100 ^b	3.33
\$8/\$100 ^c	1.93
\$9/\$100 ^d	0.18

^a Mich., Pa.

^b Conn., Del., Kan., Me., Miss., Mo., Mont., N.H., N.J., N.Y., N.D., Vt., Wis.

^c Ariz., Colo., Fla., Ind., Mass., Minn., N. M., Ore.

^d Ky., Md., Neb.

^e The method of calculation slightly overstates the percentage of contracts at the ceiling rate, because it was assumed that where rates fell within a stated bracket, all rates were at the top rate shown for the bracket.

Source: Confidential data representing over 20,000 contracts.

39. R. SHAY, NEW-AUTOMOBILE FINANCE RATES 1924-1962, 9-12 (1963).

40. Schweiger & McGee, *Chicago Banking*, 34 J. OF BUS. 203, 255-70 (1961). The greatest amount of research in this area has been done by Allen F. Jung. See Jung, *Charges for Appliance and Automobile Instalment Credit in Major Cities*, 35 J. OF BUS. 386-91 (1962); Jung, *Commercial Bank Charges in New York and Ontario*, 3 NAT'L BANKING REV. 397-408 (1965); Jung, *Dealer Pricing Practices and Finance Charges for New Mobile Homes*, 36 J. OF BUS. 430 (1960); Jung, *Terms on Home Improvement Loans*, 2 Nat'l Banking Rev. 51-60 (1964).

41. NATIONAL CONSUMER FINANCE ASS'N, THE CONSUMER FINANCE INDUSTRY 62-3 (1962). Interviews with officers of major consumer finance companies indicate that in one or two high ceiling states not all lenders charge the ceiling rates.

risk, it is not unreasonable to hypothesize that the ceilings set the rates. This is not to say that there is no competition when all the consumer finance companies in a given state charge the same rate on each size and maturity of loan, but that it must then center on obtaining customers who qualify for that rate through various forms of nonprice competition, such as prompt service and flexible terms.

2. Possible Improvements in Quality of Market

Consumer groups view failure to disclose the annual rate of finance charge as a key factor contributing to consumers' lack of knowledge in the market. However, while advocating disclosure, they have not coupled this proposal with a suggestion that rate ceilings could then be removed. It seems apparent that a time-rate form of disclosure of finance charges would probably reduce imperfections in the market, although it would not provide the panacea which seems to be anticipated by some consumer groups. Because time-rate disclosure seems well on its way, the discussion here and in part III relating to the design of rate ceilings is based on the assumption that some form of time-rate disclosure will accompany the institution of any rate ceiling.⁴² Additional improvement in the market should follow from other suggested changes, designed to provide more complete information to consumers. For example, provisions for a fuller disclosure of total finance charges or the total time price in advertising should assist consumers in shopping for credit. Finally, various programs for the education of consumers offer potential for the greatest long-run improvement in the market.

42. By inserting a new chapter 255D into the General Laws of Massachusetts in 1966, the Massachusetts legislature required disclosure of annual rate of charge in all retail instalment sales agreements. The formula provided to calculate the annual percentage rate increasingly overstates the actual rate as the maturity of contract lengthens. Annual rates on irregular contracts are calculated on the pretense that they are regular. See Driver, *The New Massachusetts Retail Instalment Sales Act*, 20 PERSONAL FINANCE L.Q. REP. 110-14 (1966).

Department of Defense Directive No. 1344.7 of May 2, 1966, provides that banks and credit unions with offices on military bases and other credit grantors wishing to obtain collection assistance must disclose the "finance charges expressed in approximate annual percentage rate." The conversion table accompanying the directive converts the dollar finance charge, as defined in the directive, to a fairly close approximation of the actuarial rate; that is, the rate determined by application of the "United States Rule," under which periodic payments are applied first to interest due with the remainder going to the reduction of the principal. The problem of disclosing annual rates on irregular contracts is met by prohibiting irregular contracts.

These approaches to disclosure of finance charges developed after the Jordan & Warren article, and present disclosure of the finance charge in terms of an annual percentage rate, rather than in terms of dollars per \$100 of initial unpaid balance per year, as suggested by Jordan & Warren. The dollar add-on method of rate disclosure is also provided in the current draft of the Uniform Consumer Credit Code. Either approach provides a common unit for measuring the time rate.

3. *Residual Imperfections*

Even if the present market for consumer instalment credit is not highly imperfect, and even if improvements can be made by such means as providing for time-rate disclosure of the finance charge, imperfections in the market will inevitably remain. These will result from "irrational" behavior by consumers and from the continuance of nonprice competition by suppliers of credit. The question posed, then, is whether rate ceilings can eliminate or alleviate these imperfections, which are manifest in those cases in which consumers pay "unfair" prices for credit.

The task of providing "fair" prices to all consumers should not be underestimated. Assume that the regulatory authority wishes to produce a perfect market. Would all consumers then pay the same price for a given dollar amount and maturity of credit? This is obviously not the case. As noted above, credit service is not homogeneous. But more important, all consumers are not the same either. Some have excellent credit standing; others do not. Consequently, even if credit services were somehow forced into a homogeneous mold, the rates would have to vary among different consumers. If the government is to interpose its judgment to counteract imperfections in the credit market, it would thus theoretically be necessary not only to vary the rates based on the type and duration of credit, but also to vary the level of charge on each transaction depending on the individual consumer's credit standing. Clearly, this would not be feasible.

As a practical matter, only one maximum charge can be specified for the use of a given dollar amount of credit for a given period of time, and it must apply without regard to other subsidiary services provided or the credit standing of the consumer. Whatever rate is set must therefore be "fair" to some consumers and "unfair" to others. The consumers who benefit from the rate ceiling are those who would otherwise have paid a higher rate through ignorance or indifference, and whose credit standing is just sufficient to permit them to obtain service at the ceiling rate. Other consumers are shut out of the legal market, because their credit standing is not good enough to enable them to obtain credit at the ceiling rate. As to a third group of consumers, whose credit standing would be good enough in a free market to obtain credit at well below the ceiling rate, some may pay the ceiling rate, when such a rate is established, because of lack of knowledge or skill in shopping. They will be paying a rate that is "unfair" in view of their credit standing, just as

they will pay a price that is "unfair" if they do not shop carefully for a new radio. Others in this third group will shop for their credit and presumably obtain a "fair" rate which is below that set by the ceiling; the ceiling as such has little direct effect here. Thus a uniform, universal ceiling protects only those consumers at the margin who just "deserve" the rate set by the ceiling and who might otherwise have been charged a higher rate. Less credit-worthy consumers are eliminated from the legal market; more credit-worthy consumers are still exposed to the forces of an imperfect market.

The real question, then, is whether consumers who pay more than they should for credit because of ignorance or indifference deserve some special protection. Since optimal rate ceilings cannot be set for each separate transaction for each individual consumer, the number of consumers that actually benefit from rate ceilings is considerably less than even the group that theoretically could benefit. Moreover, for society as a whole, the economic cost of providing protection from excessive charges may outweigh the gains achieved by incompetent consumers. While the high costs of regulation and the doubtfulness of the social benefits have generally been sufficient to rule out the imposition of special price ceilings for most consumer goods and services, it is unlikely that freedom from price control would be politically acceptable in the field of consumer credit, in view of the deep-seated emotions concerning usury and "consumer protection."

B. A "Fair" Return to Credit Grantors

A second possible reason for advocating price controls arises when the market is supplied by only one or a very few firms. Here, even though a consumer might have perfect knowledge of the market, he will nonetheless be in an unfavorable bargaining position relative to the supplier. In such cases, it has been the practice of the government to limit the prices that may be charged, or to halt the growth of monopoly power that would substantially lessen competition.

When the supply of legal cash credit was more restricted than it is today, local credit monopolies were probably not uncommon. With the broad variety of cash and vendor credit now available, however, there is little evidence of any substantial monopoly element still existing in the consumer credit industry. A few states rigorously restrict the entry of licensed lenders, so that there may be cases where

marginal borrowers in a given market can find only one lender willing to service them.⁴³ These instances must be infrequent, since examination of the earnings of consumer finance companies does not indicate the existence of monopoly profits that would follow from the exercise of monopoly power.⁴⁴ The "remedial loan" to the necessitous borrower has become increasingly uncommon, but there are undoubtedly instances where lenders could and would exert monopoly power to extort significantly higher finance charges than permitted by existing rate ceilings. However, consumers facing this threat still have the alternative of obtaining credit through vendors or delaying their use of credit.

Some may view the fact that most consumer finance companies charge the ceiling rate as evidence of monopoly power. However, as has been noted elsewhere, "the fact that actual rates are at the ceiling may be consistent either with monopolistic or competitive practices."⁴⁵ When all prices are at the ceiling in a competitive market, there is good reason to believe that the ceiling simply has been set below the equilibrium level. The imposed ceiling can and, in fact, does hold down prices in the legal market. However, by artificially limiting the supply in the legal market, the price ceiling is simultaneously creating an illegal market, where prices are not merely at what would otherwise be the equilibrium level, but are higher in order to cover the costs and risks of evasion of the law.

Even if there were convincing evidence of general monopoly power, the task of regulating credit grantors as public utilities would be every bit as complex as setting "fair" prices for consumers. Cost structures vary materially from firm to firm within a particular species of credit grantor and even more widely among different types of credit grantors. Because of joint-cost problems, most non-specialized credit grantors find it very difficult to isolate costs attributable to consumer credit. As in the case of public utility monopolies, rate ceilings would have to be set for each individual credit grantor and for each amount and maturity of credit. There would be a greater variety of rate ceilings than now exists, and there would still be no

43. It should be kept in mind that markets for consumer credit are highly localized on the demand side. A consumer living in Chicago does not seek credit in other cities. Indeed, he may not view his credit market as encompassing more than a few square miles. If he has a poor credit standing, his market is even more constricted.

44. Johnson, *Conclusions for Regulation*, in *THE CONSUMER FINANCE INDUSTRY: ITS COSTS AND REGULATION* 142-43 (J. Chapman & R. Shay eds. 1967) [hereinafter cited as Chapman & Shay].

45. Fand, *Competition and Regulation in the Consumer Credit Markets*, 20 *PERSONAL FINANCE L.Q. REP.* 23 (1965).

assurance that consumers were paying a "fair" charge for their use of credit.

In summary, the analysis suggests that the need for rate ceilings lies more in the realm of philosophy and politics than in economics. On the one hand, there are certainly cases where individual consumers are better off with rate ceilings than they would be without them. There would undoubtedly be a higher incidence of unwary consumers victimized by rapacious credit grantors in the absence of rate ceilings. On the other hand, it is not at all clear that overall social welfare is maximized by having rate ceilings. While regulation of prices may mitigate some problems, it introduces others. Any regulation involves costs for the administrative apparatus and for the regulated industry. The latter incurs added costs both in complying with the existing rules and in trying to influence future changes in regulation. Regulation also tends to fragment the consumer credit industry, with a consequent reduction in competition among different credit-granting institutions. Therefore, against the benefits of rate ceilings to some consumers, we must weigh the costs to others who may find distortions in their optimal consumption patterns imposed by the ceilings and by the costs of regulation per se.

If, however, the rate ceiling is high enough, distortions in allocation of resources are minimized because the price mechanism can operate more freely and because less regulatory policing is required. Thus, our aim should be to establish rate ceilings which are high enough to allow the prices of most credit arrangements to be set by competition, but which will prevent those politically unpalatable and unconscionable transactions that represent the joining of an unwary consumer with an avaricious or relatively powerful credit grantor. Let us examine the basic economic principles for the formation of rate ceilings, so that both consumers and credit grantors can meet in a market unhampered by the existing hodge-podge of rate ceilings.

III. DESIGN OF RATE CEILINGS

Formulation of sound price ceilings on any good or service is difficult at best. Substitution of governmental fiat for the automatic processes of the market place in the field of consumer credit is particularly formidable because of the multiplicity of variables encountered: the different types of credit grantors, the size and maturity of credit, the associated credit services, and the credit standing of each debtor. While perhaps the free market place has its own injustices, price ceilings are capable of creating even more. To minimize

this type of injustice, it is essential that the objective be to set *ceilings* rather than *rates* for all varieties of transactions. The purpose of this section is to set forth certain basic principles that might guide the design of general price ceilings on consumer credit in order to minimize distortions of the market and the consequent misallocation of resources.

A. *Uniformity of Ceiling*

In formulating the Uniform Consumer Credit Code, a major problem has been whether rate ceilings should vary by the type of credit involved, the item financed, the type of credit grantor, and from state to state. It was shown in Part I that this sort of variety is characteristic of present rate ceilings. Given this problem, a discussion of the level and structure of rate ceilings will be more meaningful if we first determine whether it is appropriate to have one or many rate ceilings.

1. *Cash Credit Versus Vendor Credit*

The hallowed time-price doctrine postulating a difference in kind between cash and sales credit has somewhat greater economic merit from the viewpoint of credit grantors than of consumers. Other things being equal, if a cash loan is unsecured, the lender incurs more risk, both because of his lack of security and because his "money at risk" represents the entire loan. In contrast, the credit vendor has at risk only his cash investment in the merchandise at the time of sale. The vendor may even shift that risk to a third party by selling his instalment paper to a financial institution. However, a consumer receives essentially the same credit service whether he finances his automobile through a dealer or directly with a bank. In each instance he obtains an automobile, a given number of month-dollars of credit services, and an obligation to repay the debt.

There is one important economic difference between cash credit and vendor credit that should influence the design of rate ceilings. If legislation is properly drawn, the cash lender has no place to conceal his finance charge and no source of additional income for his credit services. In contrast, the vendor offering both a time price and a cash price may juggle these prices any way he chooses.⁴⁶ Thus,

46. This adjustment, however, is not made without cost either to the retailer or his customers. The demand for credit is derived from the demand for goods and services financed. Since the finance charge is a relatively small portion of the total time price and monthly payment, consumers are probably not as sensitive to changes in the price of credit as they are to changes in the cash price of the goods or services financed.

if rate ceilings limit the permitted finance charge, the credit merchant can merely reallocate his actual total time price between the cash price and finance charge. The point may be illustrated by an extreme example. Complete prohibition of any finance charge undoubtedly would expel all rational legal cash lenders from the field of consumer credit, but would not necessarily eliminate all vendor credit. Some vendors would build the cost of credit into the cash price of their merchandise and would offer "free" credit, just as many credit jewelry, clothing, and furniture stores do now. At this extreme the market would ultimately be segmented into retailers who sold primarily for credit and those who sold primarily for cash, with the price differential between merchants representing the buried finance charge. Less punitive ceilings would permit retailers to continue to offer both a cash price, as such, and a time price.

Low rate ceilings thus discriminate in favor of vendor credit and against cash credit. They also discriminate in favor of credit buyers in relation to cash buyers, because of the forced narrowing of the time-price differential. While the lack of a significant economic distinction between cash credit and vendor credit suggests that rate ceilings should be the same for each type of credit, the ability of credit vendors to evade the full impact of a rate ceiling makes it important to design ceilings that themselves do not discriminate against lenders in favor of vendors, or against cash buyers in favor of credit buyers.

2. *Closed-End Versus Open-End Credit*

The distinction here is between instalment contracts—either cash loans or time sales—and open-end arrangements, such as revolving credit, check credit, and charge-account banking. These two basic forms of consumer credit differ significantly in the manner in which credit is granted and serviced and in the procedures followed in assessing finance charges.⁴⁷

From the standpoint of establishing rate ceilings, one basic dis-

In economic terminology, the demand for credit is probably less elastic than is the demand for the good or service.

Assume that without rate ceilings a retailer has achieved his optimum market strategy by allocation of the total time price between the cash price and finance charge. An imposition of rate ceilings forces him to redistribute a portion of the finance charge to the cash price. Because the demand for the good is more elastic than the demand for credit, this shift will reduce the number of cash sales by an amount greater than any resultant increase in credit sales. Thus, not only are total sales likely to be less, but also the credit sales gained are more costly to service than the cash sales lost. The resultant reduction in profits will force some marginal retailers out of the market.

47. See Jordan and Warren 1290-92.

tion is that in the case of closed-end credit the finance charge can be determined at the inception of the contract on the assumption that payments will be made on schedule. Rate ceilings can then be set on the scheduled finance charge and upon penalties for late payments. In contrast, the finance charges on open-end credit can only be determined *after* the debt has been incurred and *after* payments have been made to reduce the debt. The debt load may vary from day to day and remain outstanding over several years, as in the case of revolving charge accounts at department stores.

It would be possible, conceptually, to limit finance charges on open-end credit by requiring that after the debt has been retired, the finance charges incurred be based on daily unpaid balances over the period of indebtedness. Any amounts received in excess of a specified annual rate would then be refunded. The practical difficulties of such an approach are evident. Further, if finance charges are to be limited *ex ante* on both closed-end and open-end credit, the specification of the rate ceilings must be consistent with each of these two basically different methods of levying the finance charge. A rate ceiling on closed-end credit may be stated in terms of a per cent per month or year or as a dollar add-on rate. The rate ceiling on open-end credit, however, must limit the percentage applicable to monthly unpaid balances, as determined by trade practice or by statute, and possibly provide a limited minimum charge per transaction (as in check credit) or per time period (as in revolving credit).

While this degree of segmentation of rate ceilings seems unavoidable, it does raise problems. Many credit grantors have a choice between offering closed-end or open-end credit. For example, a department store may sell a refrigerator on either an instalment contract or under its revolving credit plan. Similarly, a bank may offer an instalment loan or the same amount of cash under a check-credit plan. Obviously, the rate ceilings should be reasonably comparable in order not to favor one type of credit over another. But this is easier said than done. As pointed out by Jordan and Warren,⁴⁸ under revolving credit plans the customer determines the *actual* rate that he will pay, whereas the credit grantor establishes only the "rules of the game" when he sets the monthly percentage and any minimum charge. Consequently, actual rate ceilings under closed-end and open-end credit will be identical only for hypothetical customers and seldom for real ones.

On the other hand, there may be some merit in setting ceilings

48. *Id.*

on open-end credit that on the average will be lower than rates for similar amounts of closed-end credit. Jordan and Warren point out that "it is not possible to make accurate time rate disclosure at the inception of the transaction" on revolving charge accounts and check-credit plans.⁴⁹ Consequently, it may be desirable to establish rate ceilings on closed-end and open-end credit that do not encourage credit grantors to employ open-end credit as a means of avoiding rate disclosure.

3. *Type of Credit Grantor*

While existing rate ceilings are often based upon the type of credit grantor, this distinction is of doubtful economic merit. Segmentation of rate ceilings on this basis permits credit grantors another means of product differentiation, thereby providing them with some degree of monopoly power. Although each might charge rates below their particular industry ceilings, credit grantors would behave as non-competing groups within the protection of this market segmentation.

Even if all credit grantors operated under the same rate ceiling, there would be some segmentation of the market. Individual credit grantors tend to charge the same rates for the same credit services to all customers and do not attempt to vary rates according to the credit standing of each applicant. Thus, commercial banks tend simply to reject marginal risk borrowers and specialize in lending to better credit risks. A uniform ceiling, however, would encourage credit grantors to experiment with different rates of charge in order to penetrate new markets and to adjust to changing economic conditions. This would reinforce the present trend toward diversification, discourage customer segmentation, and bring increased competition into the field as a whole.

One possible exception to a uniform ceiling applicable to all credit grantors should be noted. If one group of cash lenders is singled out elsewhere in legislation for licensing requirements and other detailed regulations designed to protect a special, marginal risk class of consumers, these lenders should be given an augmented rate. This rate should be high enough to cover the added costs of regulation and the increased costs associated with managing a more risky portfolio of loans.

Although some consumer representatives express the fear that a uniform rate ceiling would encourage all types of credit grantors

49. *Id.* at 1305.

to raise their rates to the ceiling, the evidence presented in part II⁵⁰ suggests that competitive pressure would tend to keep rates below a properly-designed ceiling. Indeed, even without some form of rate disclosure, in most types of credit, actual rates are held significantly below the ceiling by competition. The major exceptions have been revolving credit, where the rate ceilings are largely set in terms of what is in fact the going rate, and small loans by licensed lenders. In the latter case, competition focuses on assuming credit risks up to the margin, given the ceiling rate fixed by statute. With the advent of rate disclosure, price competition is likely to be even more prevalent.

4. *Type of Item Financed*

It was observed in Part I that a further segmentation of the market is produced by rate ceilings that are related to the type of item financed. Thus the rate ceiling applicable to a \$600 used car under a motor vehicle act is likely to differ from the rate ceiling on the credit sale of a \$600 color television set under an all goods act. A case might be made for differences in rates among types of merchandise, and rates do differ in the free market. For instance, other things being equal, it is more risky to finance the sale of a television set than a used car. In case repossession is necessary, there is a fairly active market in used cars, but not in used home furnishings,

It seems unlikely that any form of rate ceiling can properly take into account these subtle distinctions, even for existing products and services, let alone for yet undeveloped goods and services. Rather than attempt to do so, it would seem more workable to establish a uniform rate applicable to all goods, permitting each credit grantor to assess those subtle risks inherent in the goods or service financed and adjust his willingness to provide credit accordingly. In any case, the potential risk of granting credit to the particular consumer and the margin between costs and rate ceiling are likely to weigh far more heavily in the ultimate credit decision than the characteristics of the good purchased. For these reasons it seems economically unsound to base rate ceilings on the type of item financed, so long as we assume that we are setting ceilings and not rates.

5. *State of Jurisdiction*

At the present time, as we have seen, there are substantial differences in rate ceilings among the states. Just how great is the

50. See note 38 *supra* and accompanying text.

economic impact of these differences, however, cannot be assessed without examining other aspects of the statutes that affect the costs of providing credit and possible additional sources of finance income. For example, in addition to variations in rate ceilings, there are marked diversities among the states in the amounts of credit that may be granted by different lenders, restrictions on freedom of entry, debtors' and creditors' remedies, and provisions relating to credit-associated insurance. Though the interaction of these provisions is difficult to measure, the net effect is a further segmentation of the credit market. The result is that credit capital flows from states with low margins between rate ceilings and costs to more generous states.

There are economic reasons for supporting different rate ceilings among the states, although there is no sound evidence to suggest that existing variations are founded on such economic reasoning. The credit standing of consumers does vary widely among the states. As one indication of credit standing, only 12% of families in the Northeast and West had money incomes of less than \$3,000 in 1965, compared to 25% of the families in the South.⁵¹ If money income is a suitable proxy for credit standing, a national uniform rate ceiling would make cash credit available to a smaller portion of families in Southern states than in other regions. Vendor credit would be less affected for the reasons stated earlier in this section.⁵²

An attempt to set rate ceilings in relation to the credit standings of consumers in various states, however, would face a number of problems. In the first place, the demographic differences among the many markets within a single state may be as great as those among states. Markets for consumer credit are not defined by state boundaries, but are much more narrowly limited geographically. In some areas, especially in large cities, consumers may not range more than a few blocks in shopping for credit. For example, the variations in characteristics of consumers between the Michigan cities of Ishpeming and Detroit and among the various credit markets within Detroit are so great that any state-wide ceiling must represent a substantial compromise between the needs of high-cost and low-cost markets. A uniform ceiling among the several states merely presents the same problem, although possibly in magnified form. Certainly, it would be easier to establish general *ceilings* than to set separate *rates* to reflect the economic characteristics of the myriad markets for consumer credit.

51. U.S. DEP'T OF COMMERCE, CONSUMER INCOME 4 (Series P-60, No. 51, 1967).

52. See text accompanying note 46 *supra*.

In addition, it should be recognized that any uniform rate ceiling—either state-wide or nation-wide—will leave pockets of high-risk consumers that will not be provided credit at the ceiling rate, and there will be more pockets in some cities and states than in others. A rate ceiling high enough to encompass these high-risk areas would probably not be tolerated by the public conscience. Moreover, the scarcity of cash credit in these pockets of poverty reflects much more fundamental economic and social problems than those associated with consumer credit. Rather than distort rate ceilings, it would be more appropriate to deal with these problems directly. In these circumstances if cash credit is to be provided under “reasonable” rate ceilings, it must be supported by some form of subsidy.⁵³

B. *Definition of Finance Charge*

The definition of “finance charge” is pertinent both to the disclosure of the charge to consumers and to the determination of the level of the ceiling. There is no intrinsic reason why the definition should be the same for each purpose, although regulation is likely to be easier if the definitions are identical. It should be clear that a proper definition of the finance charge is crucial—a faulty definition may facilitate evasion of the rate ceiling or unduly restrict the credit market. Because of the scope of the problem we can only sketch its broad outlines here.

Definition of the finance charge is fairly simple if one is willing to adopt the approach used by the Russell Sage Foundation expressed in the first Uniform Small Loan Law: given the principal amount of credit extended to a consumer, everything else that he agreed to repay over and above this amount, however expressed or labelled, was defined as the “finance charge” (although mislabelled “interest” in the first draft). The rigor of this early definition reflects an attempt to combat the loan sharks of that era, who had devised numerous methods of obtaining exorbitant rates by levying additional charges while complying in terms with the usury statutes.⁵⁴

The principle of such an all-inclusive charge, however, became less applicable as new forms of consumer credit were developed and new credit-associated services were provided. The growth of instalment sales financing brought various forms of property insurance covering the goods sold, and there was general agreement that the

53. With the aid and financial support of the Office of Economic Opportunity, some credit unions have been established in poverty areas to provide cash credit to the poor.

54. See Nugent, *The Loan Shark Problem*, 8 LAW & CONTEMP. PROB. 3-13 (1941).

premiums, although paid by the borrower, were not part of the finance charge. More varied treatment was accorded filing fees and charges for the release of liens. Provision of life, accident, and health insurance for the debtor brought on a heated controversy as to whether the premiums on these policies were part of the finance charge or merely a charge for additional benefits received.⁵⁵

Whatever the definition of the finance charge, it is apparent that the more all-inclusive the definition, the higher must be the rate ceiling in order to accommodate the same group of consumers. There is probably considerable merit to excluding insurance premiums from the definition, if for no other reason than to relegate that complex area of supervision to state insurance commissioners. Insurance premiums must be adjusted frequently as loss experience changes, and this would necessitate a change in rate ceilings if the cost of insurance premiums were included in the definition of the finance charge. As we shall see in the next two sections, regulation of those charges commonly defined as part of the finance charge is difficult enough.

C. Level of Finance Charge

In those rare instances in our economy when price controls appear to be justified, there is a great temptation to assume that since price ceilings are needed to protect consumers, even greater protection can be achieved by further lowering the ceilings. This is a gross misconception.

To explore the effects of price control more fully, let us leave the emotionally-charged field of consumer credit and assume that it is thought desirable to limit the prices charged by the more mundane taxi industry. If licensees are free to enter and leave the busi-

55. For representative literature see Cade, *The Fundamental Issues of Consumer Credit Insurance*, 1955 INS. LAW J. 76-93; *Credit Life Insurance: Pro and Con*, 1956 PROCEEDINGS OF THIRD ANNUAL CONSUMER CREDIT CONFERENCE; Dunbar, *Credit Insurance Use by Licensed Lenders*, 1956 INS. LAW J. 443-58; Mors, *Consumer Installment Credit Insurance*, 1956 INS. LAW J. 299-318.

It might be noted that the Department of Defense Directive 373-66 of May 2, 1966, relating to the personal commercial affairs of military personnel defines in its disclosure section as finance charges those "which benefit the seller or creditor, or entities in which either has an interest. These are charges which would not be made if this were a cash purchase:

- a. Official fees for filing or recording credit instrument.
- b. Charges for investigating credit worthiness of borrower.
- c. Insurance premiums (life, disability, accident, health, other).
- d. All other charges for extending credit."

This definition represents substantially a return to the early all-inclusive definition of the finance charge, perhaps reflecting the suspicion that servicemen remain particularly susceptible to loan sharks.

ness, the rate ceiling will determine not only the price on the meter but also the level of taxi services provided consumers. A high rate will attract operators into the business; a low rate will discourage entry. If the Taxi Commissioner should seek to "protect" consumers by lowering the rate ceiling to ten cents a mile, he would probably drive most of the operators out of the business. To obtain taxi service consumers would be forced to deal with unlicensed taxis, or "gypsies" as they are sometimes called. Here, the rates would be whatever the market would bear, and consumers would be unprotected by insurance, more stringent driving tests, and other responsibilities required of licensed taxi drivers.

Moreover, in establishing the rate ceiling, the Commissioner would also have to be concerned about the level of rates in relation to distance traveled. Thus price control places with the price setter the responsibility of establishing a variety of rate ceilings that are high enough to provide an "adequate" level of service and are so related to the services performed that no particular type of service is unduly priced out of the market. In essence, he is trying to reproduce the prices that would result in a perfectly competitive market. If the Taxi Commissioner is not uneasy in his role of playing God over the price system, he should be.

The legislator who places price ceilings on consumer instalment credit is faced with essentially the same type of problem. Both the level and the slope of the rate ceiling in relation to size and maturity of credit will have important economic effects upon consumers and upon credit grantors as well.

1. *Effect Upon Consumers*

It is very common for legislators to ask for a full disclosure and analysis of credit grantors' costs of doing business in order that they may set appropriate rate ceilings. Unfortunately, this approach puts the cart before the horse. If capital is free to move from one industry to another and across state lines, a ceiling on rates determines the level of allowable costs, which in turn sets the permitted level of service. In other words, given a rate ceiling, a credit grantor must adjust his operations to generate sufficient profit on owners' equity. Higher rate ceilings permit those credit grantors lending at the margin to assume greater risks, or, in other words, to incur the higher costs necessarily involved in serving more marginal customers. Lowering of ceilings drives marginal customers from the market, and they either forego their use of credit or turn to illegal lenders. In

this manner rate ceilings determine which consumers will be served by the legitimate market. Consequently, the real question to ask in a rate hearing is what proportion of the state's consumers do we wish to have served by legal credit grantors operating under the protective provisions of the statute. It should be remembered that changes in rate ceilings leave relatively undisturbed those credit grantors and consumers doing business at below-ceiling rates. Just as a change in the minimum wage laws directly affects only those workers receiving the minimum, so does a change in rate ceilings directly affect only those borrowers operating at the ceiling.⁵⁶

Evidence to support the foregoing analysis of the economic effect of rate ceilings can best be derived from the consumer finance industry. Because licensed lenders are dealing with high-risk borrowers, their rates are generally at the ceiling. In addition, unlike the credit vendor, they find it difficult to offset the effect of lower ceilings by reallocation of the finance charge to the price of the goods and services. Consequently, the small loan or consumer finance industry provides the clearest illustration of the effect of price ceilings on the size of market that can be served. In a recent study of this industry, there is considerable evidence supporting the theory that costs follow rate ceilings. Analysis of the operating statements of forty-eight companies, located in different states, shows a very close correlation between gross income (that is, annual yield from credit granted) and operating costs: "[w]hen gross income per \$100 of loans outstanding is high, operating costs per \$100 of loans are high, and vice versa."⁵⁷ The higher operating costs that follow the higher ceilings implicit in the higher percentage yield appear directly attributable to an assumption of higher risks. Given freedom of entry and freedom to compete, consumer finance companies react to higher ceilings by turning down a smaller proportion of applicants and serving a larger proportion of the population. Serving more marginal customers means that companies in states with higher or more lenient ceilings incur greater operating costs for investigation and collection, as well as a higher net charge-off of bad debts. But consumer finance companies in these states do not show any apparent improvement in profits.⁵⁸ Thus costs tend to follow rate ceilings be-

56. Note also that such a rate ceiling change has a more direct and substantial effect on lenders, because vendors have the opportunity of transferring part of the finance charge to the cash price of goods and services if the rate ceiling is lowered. See text accompanying note 44 *supra*.

57. Zwick, *A Cross-Section Study of Industry Costs and Earnings* in Chapman & Shay 71.

58. Shay, *State Regulation and the Provision of Small Loans* in Chapman & Shay, 104; Zwick, *A Cross-Section Study of Industry Costs and Earnings* in Chapman & Shay 77.

cause credit grantors operating within high ceilings undertake more risky portfolios.⁵⁹

Even if we have a reasonable concept of the size of the market that should be served by legitimate credit grantors, it is difficult to measure the adequacy of existing services, just as it is difficult to evaluate the sufficiency of taxi service. The size of the legal market may be judged in part by studying the amount of consumer installment credit outstanding per person. The extent of the illegal market is obviously even more hazardous to measure. Reports of activities of "goon squads" and "juice men" dealing with consumers might lead one to suspect that some rate ceilings are so low that a large enough market of poor credit risks has been created to warrant the activities of illegal lenders.

In summary, it is not possible to say precisely that a particular rate ceiling is too high or too low. Once we have decided that we wish to have rate ceilings, we have also implicitly decided to segment the market into "haves" and "have nots." We admit some consumers to the market and hope that each will shop for the best credit buy available. Others with a lower credit standing are denied entry to the legal market and to the other protections afforded by the legislation. Clearly, we hope that they will postpone satisfying their needs until their credit standing is sufficient to gain entry. But we should not be surprised if some turn to the "gypsies" of the credit industry.

Since credit grantors must maintain an adequate margin between revenues and costs to attract capital, it should be apparent that the level of credit service is as much affected by statutory provisions affecting costs as by those setting rate ceilings. For example, there is good reason to argue that consumers may need more protection "in the area of creditors' remedies and effective policing by public officials"⁶⁰ However, to the extent that these added safeguards result in significantly higher costs to credit grantors, rate ceilings may have to be raised to avoid pinching off the supply of credit. Because of this intimate relationship between rate ceilings and costs, it should be apparent that the different sections of a comprehensive statute, such as the proposed Uniform Consumer Credit Code, are similarly interrelated. Thus it would be difficult to make significant changes in any one section without creating a need to amend several other sections.

59. For added support, *see* GOUDZWAARD, *THE EFFECT OF RATE STRUCTURE UPON THE AVAILABILITY OF CREDIT AT CONSUMER FINANCE COMPANIES* (Unpublished Ph.D. Dissertation, Michigan State University 1965).

60. Jordan & Warren 1322.

Because a high proportion of the costs of granting credit are for services performed, rather than for the mere use of money, the costs of these services are likely to rise with general increases in wage rates and price levels. Consequently, a rate ceiling that is appropriate for one year may become quite inappropriate for later years. Given fixed rate ceilings, a prolonged rise in operating costs will progressively squeeze more and more consumers from the legal market as the credit grantors seek to maintain their profit margin by eliminating high risk borrowers. If rate ceilings are to be uniform among the states, it appears desirable, therefore, to allow for a partial increase in rate ceilings in relation to some price index. Such an automatic adjustment appears preferable to leaving the changes to the vagaries of fifty different state legislatures.

2. *Effect on Industry Structure*

One general result of rate ceilings is to limit the ability of the particular restricted credit industry to compete for capital against those other types of credit grantors who may not face such ceilings. This effect was particularly evident in 1966, when the savings and loan associations and other mortgage lenders in some states found it difficult to compete for funds to invest in mortgages whose yields were unduly restricted by usury laws.

In addition to this inter-industry effect of rate ceilings, there are important intra-industry effects. Lower rate ceilings force both marginal customers and marginal credit grantors from the market. This is particularly so in the case of cash lenders. As the rate ceiling presses down, the market ultimately becomes too restricted for economical operation, and some cash lenders must leave the market.⁶¹ The recent study of the consumer finance industry shows that the small companies have lower net operating income ratios and notably higher costs of financing. Not only do they pay more for what they borrow, but they cannot borrow as much in relation to their net worth as their larger competitors.⁶² Consequently, low rate ceilings probably force out the small lenders and bring a greater concentration of the

61. This has happened. See Nugent, *Three Experiments With Small-Loan Interest Rates*, 12 HARV. BUS. REV. 35-46 (1933). In three states, at different times the legislatures reduced the rate ceilings permitted licensed lenders in response to public allegations that rates were too high. When the market was so restricted that legitimate lenders could not operate at a profit, they withdrew their capital from the state. Illegal lenders flocked in and were only driven out when new legislation providing higher rates was passed. See also Birkhead, Murray & Lockmoeller, *Illegal Lending in Missouri*, 16 MO. L. REV. 251-73 (1951).

62. Shay, *supra* note 58, at 114-18.

industry in the hands of the large cash lenders. Since large companies tend to make relatively more large loans, such concentration would also be likely to reduce somewhat those services available to borrowers of small amounts.

D. Slope of Rate Ceiling

It was noted in Part I that a number of existing statutes provide for rate ceilings that decline as the amount of credit increases.⁶³ Since large grants of credit are ordinarily accompanied by long maturities, it is also generally true that ceiling rates decline as maturities lengthen. The question is whether this is an appropriate design for an overall rate ceiling, or whether the ceiling should be level for all sizes of debt, as in the case of the rate ceiling on loans by credit unions.

There is good reason to believe that credit grantors' operating costs do not rise in proportion to the amount of credit extended. The initial cost of granting credit is typically quite large in relation to other costs of handling the contract once it is on the books. To illustrate, a recent comprehensive survey of operating data of 171 commercial banks shows an average acquisition cost per loan of \$17.47, compared with an average monthly processing cost per payment of \$.96.⁶⁴ If one allows a return of 14% before taxes for cost of capital funds, these data suggest a required annual rate of about 90% on a \$100 loan for six months, compared to a required rate of not quite 18% on a loan of \$1,000 for twenty-four months.⁶⁵ This cost structure

63. See note 6 *supra* and accompanying text.

64. FUNCTIONAL COST ANALYSIS 171 BANK COMPARATIVE STUDY DEPOSITS UP TO \$50 MILLION 1964-1965, A-11. The study, undertaken by the respective Federal Reserve Banks, covers banks in the Boston, New York and Philadelphia districts.

65. Consider first a loan for \$100 for six months. To process the loan application, to investigate the credit standing of the consumer, and to set up the loan on the books costs the bank about \$17.47—the acquisition cost. Each monthly collection costs the bank \$.96, or \$5.76 for the six monthly payments. The acquisition cost and the monthly collection cost sum to \$23.23, which may then be converted, on an annual basis, to a ratio of cost against declining unpaid balance. This annual rate, then, represents the yield which the lender must receive to cover these costs alone. A very accurate estimate of the "true" or actuarial annual rate, calculated according to the "United States Rule" [*Story v. Livingston*, 38 U.S. 359 (1839)], can be obtained by the direct ratio formula:

$$\text{Yield} = \frac{6mD}{3P(n+1) + D(n-1)}$$

in which m = the number of payments per year (if payments are monthly, m is always 12); D = the dollar finance charge; P = principal amount of credit granted; n = number of payments required by the contract. Inserting the cost data in the formula, we have

$$\text{Yield} = \frac{6 \times 12 \times 23.23}{3 \times 100(6+1) + 23.23(6-1)} = .7547, \text{ or } 75.5\%$$

suggests that as the size of credit increases, total costs per \$100 of credit granted decline at a decreasing rate and eventually level off.

Empirical evidence supports this hypothesis. The consumer finance study shows that operating costs as a percentage of loans outstanding were lower by an average of \$1.26 for each \$100 increase in average loan balance.⁶⁶ A review of the 1964 annual reports of state supervisors indicates that operating expense ratios per \$100 of average loan balance outstanding ranged from 32.8% on an average balance of \$131 to 16.2% on \$400 and 11% on \$588.⁶⁷ Given the similarity between their basic operating costs, there is no reason to expect a significant difference in the general nature of other credit grantors' costs.

It was argued in the previous section that since costs follow ceilings, it is inappropriate to base the level of rate ceilings upon some calculation of costs. Why then is the structure of costs significant to establishing a slope in the rate ceiling? Indeed, why not have a rate ceiling that is constant, regardless of the amount of credit granted? The answer lies in the fact that if the rate ceiling is high enough to provide an adequate level of credit service for small amounts of credit, a non-sloping ceiling would permit rates on large amounts of credit considerably in excess of the rate required to elicit a similar level of service for those amounts. For example, the annual rate of 36% might be thought "appropriate" (though probably inadequate) to finance a thirty dollar radio for ten weeks, but would be more than enough to cover the costs of making most cash loans of \$2,000. Even if time-rate disclosure and rate competition would drive the rates actually charged well below 36% on large extensions of credit, the political problems of attempting to support and pass a rate ceiling of 36% for large amounts of credit would be staggering. So long as rate ceilings are viewed as a necessity, their design should

This figure represents only the operating costs expressed as an annual percentage of the monthly declining unpaid balance on the loan. Nothing is yet allowed for interest on the money at work, corporate income taxes, or return on the owners' equity. An estimate of this "cost of capital" of 14% before taxes is probably a bit high for commercial banks and too low for other credit grantors assuming a higher risk. In any event, by adding the 75.5% operating cost requirement and the 14% capital cost requirement, we obtain a required rate of return on the \$100, six-month loan of 89.5%—the minimum annual yield necessary to cover operating costs, taxes and a return on the funds at use.

By similar calculations it may be shown that the operating-cost rate for a \$1000, twenty-four-month loan is about 3.8%. With the cost of capital funds added, the total required yield is 17.8%.

66. See Shay, *supra* note 58, at 100-01; Zwick, *supra* note 58, at 64.

67. Since these ratios exclude cost of capital, they understate the total costs of providing credit.

rest both on economic principles and political realities. Consequently, given the demand for ceilings, a rate ceiling that slopes downward with size of credit extension and levels off at some point has economic merit, as well as being a political necessity.

The acuteness of the problem of designing an appropriate slope to the rate ceiling depends in large part upon the overall level of the ceiling. There are two distortions in the credit market that may be brought about by an inappropriate slope *if* the overall ceiling is low. On the one hand, if the slope is too steep, so that rates permitted on small amounts of credit are quite high in relation to those permitted on large amounts, credit grantors will favor small extensions of credit. An excellent example of this result is afforded in a study by the Royal Commission on Banking and Finance in Canada:⁶⁸

[I]t is striking that a very low proportion of loans is made in the \$1,000 to \$1,500 range. This is not because there is little demand for loans over \$1,000—about one-quarter of all cash lending is in amounts over \$1,500—but because the companies find the 1½ of 1 per cent a month maximum rate allowed on balances in the \$1,000 to \$1,500 range barely covers their cost of funds and in fact involves them in losses after administrative and bad debt expenses.

Another disadvantage of a too-steeply sloped ceiling is that it encourages credit grantors to fractionalize their grants of credit. Thus a consumer who wishes to borrow \$900 might be forced to obtain three loans for \$300, so that lenders can obtain an adequate overall rate. On the other hand, if the slope is too gradual, the rates provided for small amounts of credit may be so low as to pinch off loans under some dollar amount. For example, Maryland has a ceiling on size of loan from licensed lenders of \$300 and a flat maximum rate of three per cent per month. As a result, about three-fourths of the dollar volume of loans made by licensed lenders are in the range from \$200 to \$300, while virtually none are made below seventy-five dollars. In contrast, licensed lenders in Alabama, operating under a more steeply sloped rate ceiling, make about one-fourth of the dollar volume of their loans for seventy-five dollars or less.⁶⁹

In short, we are confronted with the same problem faced by regulators of taxi fares. An initial charge is made when the customer enters the cab. The longer the trip, the more the charge is spread out over the miles covered, so that the rate per mile gradually declines and then levels off. The larger the initial, or "acquisition charge," the higher the return on short trips. If this charge is insufficient,

68. REPORT OF THE ROYAL COMMISSION ON BANKING AND FINANCE 209 (1964).

69. See Shay, *supra* note 58, at 94.

drivers will avoid short trips, as anybody who has attempted to take a cab from one terminal to another at the Kennedy Airport can attest. If the initial charge is too high, drivers will avoid long trips. In formulating rate ceilings that decline with the amount of credit granted, our objective must be to provide about the same amount of credit service in each category that would have been available in a free market, while at the same time cutting off unconscionable transactions. No scientific formula can be devised to determine the proper slope. Costs of granting credit vary among credit grantors, because they provide credit in varying amounts and maturities. Many, such as retailers and banks, provide additional goods and services, and the costs of providing these items are often shared with the consumer credit department. The variations among credit grantors and the many instances of joint costs are major barriers to the scientific design of rate ceilings. The dangers inherent in designing a sloped rate ceiling provide one more justification for having "loose" ceilings and encouraging competition to set rates below the ceiling.

IV. SUMMARY

Existing rate ceilings on consumer credit transactions vary widely between cash credit and vendor credit, between closed and open-end credit, by type of credit grantors, by type of item financed, and by state of jurisdiction. Ceilings on cash credit were established to legalize transactions that could not have been accommodated under most usury laws. Rate ceilings on credit sales are of more recent vintage. In part they were a response to greater concern about consumers and their use of credit; in part they reflect credit grantors' fears that the time-price doctrine may not provide a sufficient shield against the charge of usury.

The alleged purpose of rate ceilings has been to achieve a "fair" price to consumers, or a "fair" return to credit grantors. But the great variations among consumers and credit grantors force us to rely upon the effectiveness of shopping by consumers and competition among credit grantors to attain a price that is fair to both parties. The best that rate ceilings can do is to nip the unconscionable transactions which result from a joining of an unwary or desperate consumer and an avaricious credit grantor. The worst that rate ceilings can do is to distort the market for legal credit, so that consumers are thrust into the hands of illegal lenders.

While rate competition appears to be reasonably effective in many types of consumer credit, it would probably be improved to

some extent by a rate form of disclosure, especially in transactions involving an appreciable dollar amount, where comparison shopping is likely to occur. In addition, greater competition among credit grantors would be fostered by breaking down the market segmentations created by present rate ceilings and other regulations. With some possible exceptions, the same general ceiling should apply to cash and vendor credit, to all types of credit grantors, and to all items financed. It may be desirable to provide higher rates in states with very low income levels, although the merits of this rest more on questions of social values than economics. It does appear necessary to set ceilings for closed-end and open-end credit that reflect the different methods of calculating finance charges in these two fields.

To mitigate distortions of the credit market and to allow for the infinite variety of credit transactions we must set ceilings, rather than rates, and then rely on competition to establish rates charged that are generally below the ceiling. Inflationary increases in operating costs of credit grantors should be reflected in automatic adjustments to the rate ceilings. A rate ceiling that slopes downward in relation to size of credit granted is appropriate. The less oppressive the ceiling, the less significant is the precise definition of the slope.

If the formulation of rate ceilings on consumer credit appears to be a complex and uncertain task, this analysis will have served its purpose. Substitution of governmental fiat for the free operation of the market in making price determinations is never easy.