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PROBLEMS IN IMPLEMENTING FULL
DISCLOSURE OF CONSUMER CREDIT COST

by

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LETTER OF TRANSMITTAL

January 26, 1962

To: The House of Representatives,
State of Hawaii

Transmitted herewith is a report by the Economic Research Center of the University of Hawaii on "Problems of Implementing Full Disclosure of Consumer Credit Cost." It was prepared in response to your request for a study of consumer credit problems in the state and elsewhere.

The University is pleased to have this opportunity to serve the people of this state.

A handwritten signature in cursive script that reads "Laurence H. Snyder".

Laurence H. Snyder
President

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2. To perform basic economic research necessary for the operations of various government agencies.
3. To perform continuing economic and statistical research for the welfare of the community as a whole.
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5. To promote understanding of our economy."

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F O R E W O R D

The increasing willingness of American consumers to buy "on time" or go into debt to meet short-term needs has been dramatized in recent years by the phenomenal rise in the volume of consumer credit outstanding. This rapid growth has led to some concern on the effects of excessive credit use on economic stability and on the prevalence of unscrupulous practices in the industry.

A question that is more fundamental to the functioning of a private enterprise economy arises from the considerable diversity in the terms or contracts under which the credit is offered. Such a system is said to work best when it is guided by independent and informed consumer choice. To the extent that individual decisions are not based on full or accurate disclosure of relevant information, the basic vitality of the system is threatened. The multitudinous array of arrangements or charges that confront potential users of consumer credit, however legal or ethical in nature, lend support to the feeling that they may not always be in a position to make rational decisions.

National concern with this problem is evidenced by extensive hearings conducted by the Senate Banking and Currency Committee on what has been termed the "truth in lending" bill. Its main purposes are to forestall excessive use of credit by consumers stemming from their ignorance of the true cost of credit and to enable consumers to make informed comparisons among different credit alternatives. To achieve these objectives, the legislation calls for full disclosure of two standardized measures of consumer credit cost with each transaction: (1) the total dollar cost; and (2) the simple annual rate on the average unpaid balance.

The present study represents an attempt to evaluate the feasibility and practicality of the national approach in terms of local credit conditions. Background literature on the national problem was consulted and evaluated, and extensive interviews were conducted with local industry representatives and government officials. The findings of the report represent the author's best judgment on the basis of extensive research in a complex subject.

Shelley M. Mark
Director

January 1962

CHAPTER I

INTRODUCTION

The purpose of this paper is to examine the adequacy of information on consumer credit cost and to determine the problems in implementing certain improvements which might aid the borrower in making rational credit decisions.¹ In choosing a lender, the rational consumer will attempt to minimize his cost.² If the various potential creditors' statements of finance charges are confusing or not comparable, the consumer may not be able to shop for the best buy. To the extent that he is unable to minimize his cost, competition is distorted and the efficiency of the economy is impaired. The area of consumer credit covered in this paper will include credit extended both in money and for the purchase of goods and services. Credit extended on real estate mortgages will be excluded.³

Since World War II the consumer credit industry has experienced tremendous growth. During 1960, short- and intermediate-term consumer credit outstanding averaged \$53,345 million, over five times greater than the \$9,631 million average outstanding during 1947.⁴ The 1960 credit outstanding averaged 15 per cent

¹The author is indebted to the many people in the consumer credit industry who have given their time so generously for interviews. She is also indebted to Shelley Mark, Fred Hung, Frank Jackson, and Joyce Matsumoto at the University for their continuing encouragement and assistance. The analysis and conclusions, however, are the responsibility of the author alone.

²The consumer's ability to choose a lender will, of course, be limited by his credit rating and his ability to meet repayment schedules.

³Real estate mortgages, which are for large amounts and long periods of time, have been excluded because they have a unique system that is not comparable to credit discussed in this paper.

⁴This credit includes: installment credit -- automobile paper, other consumer goods paper, repair and modernization loans, personal loans; noninstallment credit -- single payment loans, charge accounts, service credit.

of disposable personal income.⁵ Similar statistics on total short- and intermediate-term consumer credit are not available for Hawaii. The postwar growth of the industry in Hawaii can be observed for two types of lenders. On June 30, 1961, there were 134 licensees, including 59 licensed branches, in Hawaii under the Industrial Loan Act, with \$71,870,965.05 in loans outstanding, excluding real estate mortgages.⁶ This compared with 29 such licensees with \$5,861,250.27 in outstanding loans, excluding real estate mortgages, on June 30, 1947.⁷ Licenses to operate small loan companies in Hawaii were discontinued during World War II and not issued again until 1952. On December 31, 1952, there were three licensees with \$40,659.93 in loans of \$300 or less outstanding.⁸ On June 30, 1961, there were 26 licensees with \$1,358,021.70 in loans of \$300 or less outstanding.⁹

⁵ U.S. Congress, Senate, Subcommittee of the Committee on Banking and Currency, Hearings, on S. 1740, Truth in Lending Bill, Testimony on growth of consumer credit by Dr. Theodore N. Beckman for the National Retail Merchants Association, 87th Congress, 1st Session, 1961, p. 620.

⁶ Territory of Hawaii, Treasurer's Office, Report of the Treasurer to the Legislature, 1949 Regular Session, for the Fiscal Years Ended June 30, 1947, and June 30, 1948, (1949).

⁷ State of Hawaii, Department of Treasury and Regulation, Office of the Bank Examiner, Comparative Consolidated Statement of Condition of Licensees Operating Under the Industrial Loan Act in the State of Hawaii as at the Close of Business, June 30, 1961, December 31, 1960, and June 30, 1960. (Mimeographed.)

⁸ Territory of Hawaii, Office of the Bank Examiner, Consolidated Statement of Condition of Small Loan Licensees Operating in the Territory of Hawaii as at the Close of Business, December 31, 1952. (Mimeographed.)

⁹ State of Hawaii, Department of Treasury and Regulation, Office of the Bank Examiner, Comparative Consolidated Statement of Condition of Licensees Operating under the Small Loan Act in the State of Hawaii as at Close of Business, June 30, 1961, December 31, and June 30, 1960. (Mimeographed.)

The function of consumer credit has changed with its expansion. Where once this credit was used primarily to meet personal disasters, it now is used largely to enable people to improve their standard of living. Retail credit is no longer even confined to durable goods purchases; it extends to the area of soft goods and to such luxuries as vacation travel. The number of institutions offering credit has increased with the demand for this service. Today the consumer is usually in a financial position to minimize his credit cost through his choice of a lender, postponement of consumption and, in some cases, his ability to pay cash. Because of the enormous growth in consumer credit and the new role that it plays, the various statements of cost and the borrower's ability to compare them are of greater importance today.

This paper begins with an examination of the types of loans and their cost statements, followed by a section discussing their comparability. The latter half of the paper deals with the problems for the creditors in standardizing the cost statement.

CHAPTER II

TYPES OF LOANS AND THEIR COST STATEMENTS

Interest is defined as the price, per unit of time, paid by a borrower for the use of a given sum of money.¹ In arithmetic one learns the formula for interest:² interest = principal x rate x time. For a given rate, the interest charge will depend on two variables: the length of time and the amount of principal for the loan. There are two basic types of loans in terms of repayment.

Single Payment Loans

First, the single payment loan is made for a definite period of time with the total amount plus interest to be repaid at the end of this period. On the single payment loan there is no problem in using the formula above. For example, a one year, \$120 loan at an effective rate of 6% per annum will cost \$7.20 in interest.

$$\$120 \times 6\% \times 1 \text{ year} = \$7.20$$

Installment Loans

Effective Monthly Rate: The second type of loan, the installment loan, is made for a definite period, but repayment is in usually equal payments at stated intervals such as each week or month. Here the problem of cost statement arises. It is immediately evident that the declining principal balance

¹The finance charge, or the dollar charge, on retail credit sales are legally not interest. However, the same mathematical equations apply to the finance charge and rate as to interest.

² Effective interest rate is the interest charge for a given period of time as a per cent of the principal outstanding for that period. The equation for the effective rate is:

$$\text{effective rate} = \frac{\text{interest}}{\text{principal} \times \text{time}}$$

over time will affect the charge, or if the charge is held constant, the rate. The consumer credit industry deals with this problem in two ways. The first, used by small loan companies, credit unions, and the various revolving credit plans,³ states an effective monthly rate and applies this to the outstanding balance each month. Thus on a \$120 loan at an effective rate of 1% per month (12% per annum) to be repaid in twelve monthly installments of \$10, the dollar charge would be figured as follows:

Month	Principal Outstanding	Interest
1	\$120	\$1.20
2	110	1.10
3	100	1.00
4	90	.90
5	80	.80
6	70	.70
7	60	.60
8	50	.50
9	40	.40
10	30	.30
11	20	.20
12	10	.10
		<u>\$7.80</u>

In practice the interest may be paid in addition to the agreed installments, as in the above example; or each payment may be used first to pay off all

³Revolving credit plans, which include both retail and bank check credit, are open-end lines of credit. A consumer is allowed to use credit as he needs it up to a predetermined maximum of principal. Repayment is flexible within limitations -- usually for each amount of principal outstanding, a certain minimum monthly payment is due.

interest due with the remainder used to reduce the principal as follows:⁴

Months	Principal Outstanding	Installment Payments		
		Interest	Principal	Total
1	\$120.00	\$1.20	\$9.46	\$10.66
2	110.54	1.11	9.55	10.66
3	100.99	1.01	9.65	10.66
4	91.34	.91	9.75	10.66
5	81.59	.82	9.84	10.66
6	71.75	.72	9.94	10.66
7	61.81	.62	10.04	10.66
8	51.77	.52	10.14	10.66
9	41.63	.42	10.24	10.66
10	31.39	.31	10.35	10.66
11	21.04	.21	10.45	10.66
12	10.59	.11	10.59	10.70 ⁶
	<u>\$794.44⁵</u>	<u>\$7.96</u>	<u>\$120.00</u>	<u>\$127.96</u>

This method has the advantage of stating the exact effective rate which is always charged on the unpaid balance. It is also flexible. Under the various revolving credit plans, the principal can be enlarged or reduced with no difficulty in calculating the charge. Its major disadvantage is the expense of monthly finance charge calculations, either to determine the charge due or to allot the payment to charge and principal to obtain the new unpaid balance.

Block Rate: Add-on: The other method of dealing with the declining balance is to use the block rate. This rate, which is usually used by industrial loan

⁴The annuity formula was used for this example.

⁵The average balance would be \$794.44 divided by 12 months equals \$66.20, and the effective rate would be \$7.96 divided by \$66.20 equal 12% per annum.

⁶The last payment will be \$10.70 to make up for rounding to the nearest cent.

companies, banks, and some retailers, is applied to the original principal as if the total amount were to remain outstanding for the life of the loan. A 6% per annum block rate applied to a \$120 loan for one year would cost \$7.20. This charge is usually added to the principal (called add-on) to determine the amount to be repaid at maturity, or \$127.20 in this case. Then the installment payments are derived by dividing the total due by the number of installment periods. Thus the borrower would pay 12 monthly installments of \$10.60. This method has a lower administrative cost because there is no further calculation to determine the amount of finance charge to the declining balance in each installment period. Usually the total finance charge is stated at the time of the loan. However, the effective rate is frequently not given, and the calculation of it may be difficult for a minority of the installment contracts on which repayment is not in even amounts and at regular intervals. For the great majority of installment contracts, which are even and regular, a chart or a number of formulas may be used to determine the rate. The easiest way to visualize the concept behind these formulas is to calculate the average outstanding balance -- called the action of the principal. To do this the monthly outstanding balances are totaled to obtain the aggregate number of dollars lent for a month. In the table below there is \$120 outstanding the first month; \$110.51, the second; \$100.93, the third; etc. When these amounts outstanding each month are added together, the total is the number of dollars lent for a month. Then this total is divided by the number of monthly installments to obtain the average outstanding balance for the life of the loan. The average balance then may be used as principal in the formula: $i = prt$.⁷

⁷r is effective rate, i is interest charge, p is principal, t is time. To find the effective rate, the formula is transposed to:

$$r = \frac{i}{pt}$$

The average balance for the one year, \$120 loan at 6% per annum add-on to be repaid in 12 monthly installments of \$10.60 would be calculated as follows:⁸

Months	Principal Outstanding	Installment Payments		
		Interest	Principal	Total
1	\$120.00	\$1.11	\$9.49	\$10.60
2	110.51	1.02	9.58	10.60
3	100.93	.92	9.68	10.60
4	91.25	.83	9.77	10.60
5	81.48	.74	9.86	10.60
6	71.62	.65	9.95	10.60
7	61.67	.55	10.05	10.60
8	51.62	.46	10.14	10.60
9	41.48	.37	10.23	10.60
10	31.25	.28	10.32	10.60
11	20.93	.18	10.42	10.60
12	10.51	.09	10.51	10.60
Total	\$793.25	\$7.20	\$120.00	\$127.60

Total dollars lent for a month: \$793.25

Average balance for the loan (1 year): $\$793.25 \div 12 = \66.10

Effective rate: $\$7.20 \div \$66.10 = 10.89\%$ per annum

The add-on method is frequently used by department and appliance stores with no mention of the block rate. In these cases, a dollar charge is stated for the credit service.

Discount

Another practice used on both single payment loans and installment loans with the block rate is discount. In the above examples, using add-on, the charge is figured on the principal (\$120) which is actually advanced to the borrower, and then this charge (\$7.20) is added to the original principal to determine the sum to be repaid (\$127.20). Under discount, the rate of 6% per

⁸The direct ratio formula was used in this example.

annum is applied to \$120, and the resultant charge of \$7.20 is deducted from the \$120 to determine the actual principal of \$112.80 to be advanced. Only \$112.80 would be given to the borrower, and \$120 must be repaid at maturity. Thus on a single payment loan, the effective rate would be \$7.20 divided by \$112.80, or 6.38% per annum. Because less principal is advanced under discount, the effective rate will be higher than add-on. For an installment loan, the calculation would be the same as for add-on⁹

Months	Principal Outstanding	Installment Payment		
		Interest	Principal	Total
1	\$112.80	\$1.11	\$8.89	\$10.00
2	103.91	1.02	8.98	10.00
3	94.93	.92	9.08	10.00
4	85.85	.83	9.17	10.00
5	76.68	.74	9.26	10.00
6	67.42	.65	9.35	10.00
7	58.07	.55	9.45	10.00
8	48.62	.46	9.54	10.00
9	39.08	.37	9.63	10.00
10	29.45	.28	9.72	10.00
11	19.73	.18	9.82	10.00
12	9.91	.09	9.91	10.00
	<u>\$746.45</u>	<u>\$7.20</u>	<u>\$112.80</u>	<u>\$120.00</u>

Average balance for a year: \$746.45 divided by 12 equals \$62.20
 Effective rate: \$7.20 divided by \$62.20 equals 11.58% per annum

Summary: Types of Loans and Their Cost Statements

The various types of loans and their cost statements are compared in table 1.

⁹The direct ratio formula was used for this example.

TABLE 1

COST STATEMENTS ON VARIOUS TYPES OF LOANS
(\$120 loan for one year with 12 equal monthly
payments for the installment loans)

	Single		Installment		
	Payment Loan		Rate Applied to Original		Rate Applied to
	(1)	(2)	Principal (Block Rate)		Unpaid Balance
	Add-on	Discount	Add-on	Discount	Add-on
Stated Principal	\$120.00	\$120.00	\$120.00	\$120.00	\$120.00
Principal Advanced	120.00	112.80	120.00	112.80	120.00
Amount to Be Repaid	127.20	120.00	127.20	120.00	127.96
Monthly Payments	--	--	10.60	10.00	10.66
Average Balance	120.00	112.80	66.10	62.20	66.20
Block Rate per annum ^a	--	6.00%	6.00%	6.00%	
Effective Rate per annum ^c	6.00%	6.38%	10.89% ^b	11.58% ^b	12.00%
Dollar Cost	7.20	7.20	7.20	7.20	7.96

^aWhile the block rate is not considered an interest rate by the industry, it is used here for comparison because it is usually the stated rate in discussing loans.

^bThe effective rates on block loans, which use the direct ratio formula, differ slightly from the State Treasurer's chart due to rounding differences.

^cThese rates are not typical but for illustrative purposes.

^dThe last payment will contain \$10.70 to make up for rounding to the nearest cent.

When borrowing, as in any other purchase, the consumer is interested in the dollar cost for the service provided. The dollar costs in columns 1-4 are the same; however, the service differs greatly. On the single payment loans, the consumer has the use of \$120 for 12 months with the add-on and \$112.80 with the discount; while he has use of only an average of \$66.10 and \$62.20, respectively, under installment over the same period. The effective rates reflect these differences in service. In column 5, the average outstanding balance of \$66.20 is just above those for columns 3 and 4, but the higher effective rate reflects the higher dollar cost. The effective rate is a yardstick that measures the relationship of the service provided (amount and length of loan) with the cost.

The effective rate, which reflects the two-dimensional nature of credit, seems the logical tool for comparing credit alternatives. But it can be argued that the consumer is able to compare credit on the basis of service received and the dollar cost, as he does in his other purchases. Actually the effective rate is a mathematical abstraction which may not be fully understood, particularly when the declining balance of an installment loan is involved. From the borrower's point of view, the benefits of the service may not be reflected in the rate. To him, the installment loan may represent a greater service than the single payment loan. Under the installment loan, regular payments are a type of forced savings which eliminate the need for self discipline. In addition, the consumer might not be able to use profitably the money he is accumulating to pay off a single payment loan; thus the lower

effective rate when compared with installment may be meaningless in terms of benefit.¹⁰ On the other hand, one source of confusion in using the dollar cost might be the discount. Here a \$120 loan costs \$7.20, but only \$112.80 is actually advanced. To obtain \$120, the borrower must have a nominal loan of \$127.66 at a cost of \$7.66.

Consumers would be able to compare the cost of credit from various sources by using either the dollar cost or the effective rate. But neither the dollar cost nor the effective rate is given by all types of creditors. Here in Hawaii, the laws governing various types of credit provide for different methods of computing the finance charge and have different disclosure requirements for these charges. Let us turn to the State laws to see what information the consumer is legally entitled to.

¹⁰Dr. Frank H. Jackson, formerly an associate economist with the Economic Research Center, in a speech delivered to members of the Honolulu Retail Credit Association on January 18, 1961, observed:

The ordinary buyer of goods on installment does not have the same opportunities for gainful use of money as the businessman. Granted that there are investments he could make which would provide him some return -- he could accumulate funds for repayment in a savings account -- the amount he could earn would in no way compare with what the businessman could. The loss to the consumer from not having the use of funds is, therefore, less than is implied.

CHAPTER III

HAWAII'S CONSUMER LOAN LAWS: CALCULATION AND STATEMENT OF FINANCE CHARGES

Interest and Usury Act: Chapter 191¹

The consumer credit laws in Hawaii are tied to interest rate ceilings. The Interest and Usury Act allows interest at the rate of 6% per annum where there is "no expressed written contract fixing a different rate of interest" and "on any judgement recovered before any court."² On a written contract, interest is allowed up to a rate of 1% per month (12% per annum). There is no disclosure provision nor any required type of calculation under this law. In practice, interest is stated in dollar amount, add-on rate, discount rate, and/or effective rate. In a few cases, the type of rate is not printed on the contract. There are four exceptions to the above usury ceiling: the Small Loan Act, Industrial Loan Act, Retail Installment Sales Act, and the Pawnbrokers Act.

Small Loan Act: Chapter 195³

The Small Loan Act limits loans to \$300 or less. It provides for an interest rate not exceeding 3½% per month (42% per annum) on that part of the unpaid principal balance not in excess of \$100 and 2½% per month (30% per annum) on any unpaid balance from above \$100 to \$300. This law is designed to provide credit service to low income persons who do not have strong credit ratings. A high rate is necessary to cover the cost of small loans with a high risk. The interest may not be discounted nor compounded. The interest

¹Hawaii, Revised Laws of Hawaii (1955), c. 191, Secs. 1-3.

²Ibid., c. 191, sec. 1-2.

³Ibid., c. 195, secs. 16-17.

is computed on the basis of the number of days that actually elapse, and a month is considered 30 consecutive days. Each borrower must be given a copy of Chapter 195-16, which contains the maximum monthly rate, and the agreed rate for his loan. The company also must display a full and accurate schedule of charges and methods of computation. There is no requirement that the lender give the dollar charge. Installments must be payable at the end of approximately equal intervals of time with not more than 45 days between payments, and the first payment must be payable within 45 days of the issuance of the loan. No installment may be substantially larger than any other.

Industrial Loan Act: 194⁴

The Industrial Loan Act provides for four rates which are applied according to the length of the loan rather than to the amount of the loan. The block rate ceilings are: 12% per annum for the first 18 months; 9% per annum for the next 12 months; 6% per annum for the next 12 months, and 3% per annum for the next 6 months. The loans with block rates are limited to four years. The law specifies "interest may be computed on the principal amount of the contract ... as though such principal amount were to remain outstanding and unpaid for the full term of the contract."⁵ It also specifically permits discount to be used under the ceilings. The law provides for disclosure of both the block rate and the effective rate. The dollar charge is generally given though not now required by law. A fraction of a month is considered a whole month under this law.

⁴Hawaii, Revised Laws of Hawaii (1955), c. 194, secs. 3 and 14-17.

⁵Ibid., c. 194, sec. 3

Retail Installment Sales Act: 201⁶

The Retail Installment Sales Act, which was passed in the 1961 session of the state legislature, provides for the same interest rate ceilings and allows the same methods of computation used under the Industrial Loan Act. However, the disclosure provision requires: "The amount of the finance charge; which may be stated as a per cent of the monthly unpaid balance to accrue thereafter, if such finance charge is not capitalized or stated as a dollar amount in any of the documents or payment books connected with the transaction."⁷ In practice the dollar amount generally will be disclosed on installment contracts with definite repayment schedules, while the effective monthly rate will be given for revolving plans.⁸

Pawnbrokers Act: 155-76⁹

The interest rate ceiling for pawnbrokers is 4% per month (48% per annum) for the first \$20, and 2% per month (24% per annum) from above \$20 but below \$100, and 1% per month (12% per annum) above \$100. The law requires that the date, duration, amount, and rate of interest shall be delivered to the pledgor.

⁶Hawaii, Acts of General Session of 1961, 1st State Legislature, Act 102, sec. 3-4 and 29.

⁷Ibid., Act 102, sec. 3.

⁸The Retail Installment Sales Act will be effective on January 1, 1962.

⁹Hawaii, Revised Laws of Hawaii (1955), c. 155, sec. 78.

CHAPTER IV.

COMPARISON OF CREDIT ALTERNATIVES

Under Hawaii's consumer credit laws, the statements in Table 2 would generally be the basis for consumer choice.

TABLE 2

COST STATEMENT FOR A \$120 CREDIT TO BE REPAID IN 12 EQUAL MONTHLY INSTALLMENTS^a

	Dollar Charge	Effective Rate Per Annum	Block Rate Per Annum (add-On)	Effective Rate Per Month
Retailer				
Installment Contract	\$14.40 ^b	--	12% ^b	--
Revolving Credit	--	--	--	1%
Bank: Installment Contract				
Under Industrial Loan Act	9.60 ^c	14.30%	8%	--
Under Contract Rate	7.20 ^c	--	6%	--
Bank: Revolving Credit	--	--	--	1%
Small Loan Company	(28.61) ^d	--	--	3.5% on unpaid balance up to \$100; 2.5% on next \$200.
Credit Union ^e	(7.96) ^d	--	--	1%
Industrial Loan Company	14.40 ^c	21.43%	12%	--

^aThis table is to illustrate the statements from which a consumer must make his credit choice. Among any type of lender, the rates offered by individual companies will vary considerably; the rates in this table cannot be deemed typical. However, the rates do fall within current ranges.

^bGenerally on large durables both statements will be given; however, on small sales only the dollar amount may be given.

^cThe dollar amount is not required by law but is generally given. Because this amount may be obtained by subtracting the principal received from the amount to be repaid, it is considered part of the consumer information in all cases.

^dThe approximate amount is sometimes given automatically and always on request. The provision requiring the calculation of interest on a daily basis usually means that the dollar amount of interest will vary due to slightly early or late payments of installments.

^eThe credit unions operate under Federal law. The maximum amount they can charge is 1% per month on the outstanding balance with interest calculated on a daily basis.

Table 2 shows that the dollar amount of the finance charge is easily obtainable, if not automatically given, for six of the eight credit sources. The finance charge for the revolving credit plans -- the two remaining sources -- cannot be stated in dollars prior to repayment. This is because the repayment terms are flexible and dependent upon the outstanding balance or the desire of the customer. A case can be made that revolving credit is not comparable because it offers a unique service which is based more on convenience than cost. While this is true to a certain extent, the fact remains that some consumer's choice of lender might change on the basis of cost.

The effective annual rate is stated by two sources in Table 2, while the effective monthly rate is stated by four. Conversion of a monthly rate to an annual rate by multiplying it by 12 months may not be obvious to some consumers. Also the psychological effect of 1% per month may be quite different from 12% per annum. Assuming that the consumer can convert effective monthly rates to annual rates, there are still two sources without information on the effective rate -- banks, operating under the 12% per annum contract ceiling, and retailers who grant contracts with fixed repayment schedules. Both of these sources frequently state a block rate. Thus there is also the possibility that a borrower may confuse the block and effective rates.

All loans can be compared if one understand the idea of declining balance and knows the meaning of the various rates. The "consumer" is actually a distribution of individuals with varying understanding of the market and degrees of mathematical ability. The University of Michigan's Survey Research Center, in a nation-wide survey during November 1959, found a good deal of confusion about the cost of credit.¹ In discussing the consumers' lack of

accurate knowledge about credit cost, Mr. Katona, director of the economic behavior program at the Survey Research Center, stated:

How can people be uninformed, or misinformed, about the cost of borrowing even though they actually pay the charges. That the borrower is not told how large the charges are does not suffice as an answer. In many other instances buyers shop around and compare prices and charges while, apparently, many people make no inquiries about the cost of installment credit. The difference in this case is that people are attracted to installment buying for reasons that are powerful irrespective of costs and that people are primarily interested in an item of information other than cost. This item of information is, of course, the size of the monthly payments. Repeated studies have shown that the size of monthly payments is well known (well remembered and correctly reported to interviewers) and is often carefully figured and budgeted.²

Mr. Katona went on to say that the decision to buy is based on the desire for the purchase and the amount of the installment payments. But in deciding where to buy, cost is a significant factor.

Knowledge of cost is essential for the consumer to shop wisely and economize. How can the consumer be made aware of the cost? One answer to the problem is education. The credit industry, schools, Better Business Bureau, unions and other organizations have been working to this end.³ Another solution could be greater standardization of credit cost statements. With a uniform

¹U.S. Congress, Senate, Subcommittee of the Committee on Banking and Currency, Hearings, on S. 2755, Consumer Credit Labeling Bill, Testimony by George Katona of the University of Michigan, Survey Research Center, 86th Cong., 2nd Sess., 1960, p. 803-814.

²U.S. Congress, Hearings on S. 2755, Consumer Credit Labeling Bill, op. cit., pp. 806-807.

³A conference entitled "The Uses and Abuses of Consumer Credit" will be held February 23-24, 1962. It is sponsored by the College of Business Administration, University of Hawaii; Consumer Finance Association of Hawaii; Hawaii Bankers Association; Hawaii Credit Union League; Honolulu Council of Social Agencies; and the Conference Center, College of General Studies, University of Hawaii.

statement either in dollars and/or effective annual rate, consumers could compare cost with little effort. Those consumers who now shop effectively could do so more quickly under a standardized system.

Recently there has been some pressure for legislation to require uniform disclosure. For instance, S. 1740 introduced into the U. S. Senate by Senator Paul H. Douglas (Illinois) would require all consumer credit contracts to state the finance charge in dollars and give the effective annual rate. This bill, considered by two sessions of Congress, was not passed but will probably be introduced again in 1962. During Hawaii's General Session of 1961, two similar bills, S. B. No. 628 and H. B. No. 26, were filed. These bills also would have required both the dollar charge and the effective annual rate to be disclosed in the contract. The Retail Installment Sales Act, however, was passed by the General Session of 1961. Among other things, this act, which pertains only to retailers, requires disclosure of either the dollar charge or the monthly effective rate. Thus the Retail Installment Sales Act does not require one standard statement. One reason for this may be the practical problems for creditors in implementing such disclosure either in dollars or effective annual rate.

CHAPTER V

PROBLEMS IN DISCLOSURE

General Problems for Effective Rate

There are several problems that must be considered when discussing disclosure of the effective rate. What charges should be included in the rate? It would seem that the present definition of finance charges and interest under the consumer credit laws should be adopted. The laws allow fees and charges incidental to the loan and paid to a third party above the rate ceiling or outside of the definition of rate. These include official fees, appraisal fees, abstractor's fees, insurance on property, and credit life insurance. These charges are not required in all cases and could present problems in the use of charts for converting to the effective rate. If these separate charges are allowed uniformly, they will not distort the comparison for the consumer.

Another problem is the length of time from the date credit is granted to the first payment. Under contracts with repayment at regular intervals, the period from the issuance of the loan to the first payment may differ from the other intervals. For instance, a loan may be granted on the first of January with repayment on the 15th of each month starting on February 15. Here, the first period is 45 days rather than 30 days. When the first installment period differs from the length of the other installment periods, the effective rate will be changed slightly. To enable use of rate charts, it would be necessary to allow some variation -- less than the length of a regular interval -- for the first payment period.

The minimum charge allowed under the legal rate ceilings presents a

problem. Because contracts with the minimum charge would have to be calculated each time to obtain the effective rate, it is suggested that an amount just above this minimum charge be necessary for any disclosure requirement. A minimum for disclosure will be discussed in another connection later.

In all cases it must be assumed that the contract will be fulfilled as agreed. Prepayment and late payment charges should be disclosed separately so that the borrower will know what to expect if he does not comply with the terms of the contract.

The administration of the proposed law could present many problems. The national banks and retail establishments are now outside of the jurisdiction of the Office of the Bank Examiner. Thus, such a law, if policed by the State, would be very expensive to administer. It has been suggested that this proposed law could be self-enforcing in the areas not now under the Office of the Bank Examiner. The Retail Installment Sales Act is now self-enforcing. Undoubtedly most of the companies would comply with the law. For those who try to evade the law, policing would have to be accomplished by private citizens and such organizations as the Better Business Bureau and the Chamber of Commerce. If the self-enforcing feature of the law proved unworkable, further steps could be taken at a future date.

Calculation of Installment Payment and Dollar Cost When the Effective Rate is Stated

When the effective rate is stated, there are two types of computations: (1) fixed payments including interest and principal, (2) fixed payments of principal with interest payable as due. As we have seen, the dollar interest

charge on any installment loan will depend on the declining balance. Thus for any consideration of the dollar amount of the finance charge, the repayment schedule must be determined.

Fixed Payments Including Interest and Principal: Repayment schedules can be prepared to cover any number of months, any principal, and any flat rate. These schedules give the monthly payment for a certain principal and rate by the length of loan. Appendix A shows a portion of one of these schedules with an effective rate of 1% per month. For a \$100 loan at 1% per month, the schedule shows a range from two monthly payments of \$50.75 at a cost of \$1.50 to 36 monthly payments of \$3.32 at a cost of \$19.52. The schedules are not exactly accurate because the payments are rounded to the nearest cent. However, this is corrected by monthly computations made for each account. Because the finance charges are based on the number of days that have actually elapsed, frequent variation in payment date make these monthly calculations necessary.

To the author's knowledge there are now no schedules compiled for the graduated rates provided for under the Small Loan Act. According to M. R. Neifeld, "The most practical way to find the monthly rent which will amortize loans made at rates graduated in two or three brackets is by the trial and error schedule computations...."¹ It would seem sufficient for our purposes to state that the schedule could be compiled.² Use of the schedule, once compiled would be similar to the one in Appendix A.

Fixed Payments of Principal with Interest Paid as Due: This method of interest calculation is less common because it usually increases the paper work of a

¹M. R. Neifeld, Neifeld's Guide to Installment Computations (Easton, Pa.: Mack Publishing Company, 1953), p. 350

²The Finance Publishing Company, Boston, Mass., will accept orders to compile rate charts and repayment schedules.

loan. When the installment payments are even in amount, there is rarely any billing; however, if the payments change by the amount of interest due, some provision must be made to inform the borrower of this amount. Schedules showing the total amount of interest and the monthly interest due can be compiled from the repayment schedules.

Irregular Payments: Irregular payments would be difficult to compile into schedules. The volume of the charts would vary directly in proportion to their flexibility. Any complete system of schedules covering all irregularities would be too large and cumbersome to use. For the small loan companies schedules would be possible because the law provides for approximately even payment periods and substantially equal payments. Credit unions, the other major class of lenders that come under this classification, have been vocal in their support of disclosure legislation. In discussing the dollar statement of interest by credit unions, David R. Weinberg, Director of the Legal and Legislative Department of the Credit Union National Association, Inc., said with reference to credit unions:

In instances of uneven or irregular payments under the terms of the loan, some additional work would be necessary. However, we should be mindful of the fact that the lender would normally make these calculations in any event in order to determine the amount of the payments.³

Revolving Plans: It is obvious that the dollar charge can not be calculated for the various revolving credit plans because they have no specific repayment schedule and have frequent fluctuations in principal. These plans are designed

³Letter from David R. Weinberg, Director, Legal and Legislative Department, Credit Union National Association, Inc., Madison, Wis., October 23, 1961.

for quick credit service in amounts as they are needed. To include revolving credit in the disclosure provisions would destroy their use.

Calculation of the Effective Rate from Repayment Schedule and Finance Charge
In Dollars

When the repayment schedule and the dollar charge are known the effective rate needs to be found. Each payment is made up of principal and interest. The assumption as to the allocation of this payment to interest and principal will affect the declining balance and thus the effective rate. There are a number of formulas used to find the effective rate, each with a different assumption about the relationship of interest and principal in the payment. The five methods most commonly mentioned are: maximum yield, constant ratio, actuarial, direct ratio, and minimum yield. For our purposes the maximum yield and minimum yield are of little use. They do not facilitate computation and are relatively inaccurate. Of the others, the actuarial is completely accurate because the interest is a direct function of the variables: time and principal.

The Actuarial Method: In determining the distribution of payments between interest and principal, the United States Supreme Court ruled:

The correct rule in general is that the creditor shall calculate interest whenever a payment is made. To this interest the payment is first applied; and if it exceed the interest due, the balance is to be applied to diminish the principal. If the payment fall short of the interest, the balance of interest is not to be added to the principal, so as to produce interest. This rule is equally applicable whether the debt be one which expressly draws interest, or one which interest is given in the name of damages.⁴

⁴R. M. Neifeld, Neifeld's Guide to Installment Computations, op. cit., p. 323.

The actuarial method conform to the United States rule and is thus the "correct rule."⁵ The interest is always a constant proportion of the outstanding principal. On contracts with repayment in even amounts and at regular intervals, the annuity formula⁶ and tables of compound interest functions can be used to get the effective rate. There is no formula to find the rate on contracts with uneven or irregular payments; calculation is long and tedious. Because of the tremendous number of possible variations, the irregular

⁵Ibid. p. 323.

⁶The annuity formula given on p. 119 of Neifeld's Guide to Installment Computations is:

$$W_0 = R \times a_{\overline{n}|i}$$

Where: W_0 = the amount of principal advanced
 R = the amount of the payment
 $a_{\overline{n}|i}$ = the amortization factor, with n the number of installments.

On a \$120 loan at 10% per annum add-on rate to be repaid in 12 equal monthly installments of \$11, the calculation for the effective rate would be as follows:

W_0 is \$120; R is \$11; $a_{\overline{n}|i}$ is unknown, with n equal to 12.

$$\begin{aligned} \text{Thus: } \$120 &= \$11 \times a_{\overline{12}|i} \\ \$120/\$11 &= 10.9091 = a_{\overline{12}|i} \end{aligned}$$

From the tables of compound interest functions we find:

when $a_{\overline{12}|i} = 10.9075$ the effective monthly rate is 1.5%
when $a_{\overline{12}|i} = 11.2551$ the effective monthly rate is 1.0%

By Interpolation:

when $a_{\overline{12}|i} = 10.9091$ the effective monthly rate is 1.4977%
thus the effective annual rate is 17.97%

contracts could not be compiled into charts of usable size.

Direct Ratio Method: On p. 5, a \$120 loan with repayment of \$10 a month for 12 months is shown. It will be noted that during the first month 12 payments are outstanding; the second, 11; the third, 10; and so on until the last month there is only one installment outstanding. The sum of the number of installments from 12 to 1 is 78. The direct ratio method assumes that the proportion of the interest in each installment is computed as a direct ratio of the number of remaining unpaid installments to the sum of the total, or 78. Thus the first payment must include 12/78 of the total interest charge; the second, 11/78; and so forth. While under this assumption interest is not a direct function of principal in each payment, the method is considered accurate enough for practical purposes. The formula⁷ for contracts with regular

⁷The direct ratio formula (sometimes called the 78ths method) provided by the State Office of the Bank Examiner in short form is:

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

Where: i = the effective interest rate
 m = the number of payment periods in 1 year
 n = the number of payments to discharge the debt
 D = the interest charge in dollars
 P = the principal or cash advanced

On a \$120 loan at 10% per annum add-on rate to be repaid in 12 equal monthly installments of \$11, the calculation of the effective rate would be as follows:

$$i = \frac{6 \times 12 \times \$12}{3 \times \$120 (12+1) + \$12 (12-1)}$$

$$i = \frac{864}{4812} = 17.96\% \text{ per annum}$$

For further information on the direct ratio method see:

- R. M. Neifeld, Neifeld's Guide to Installment Computations, op. cit., p. 183-190.
U. S. Congress, Hearing on S. 1740, Truth in Lending Bill, op. cit., p. 1362.
Robert W. Johnson, Methods of Stating Consumer Finance Charges (New York: Columbia University, Graduate School of Business, 1961), p. 110-112.

repayment schedules is provided by the State Office of the Bank Examiner for use by the industrial loan companies, which are required to give the effective rate. The Office of the Bank Examiner has compiled charts for contracts with regular repayment. These charts give the effective interest rate for block rates by maturity on a \$1 loan. A portion of the charts is shown in Appendix B. A similar chart could be based on the actuarial method with no problems. Use of such charts is simple and takes no time. Thus for regular installment contracts where the block rates are applied to the original principal there is no problem in finding the effective rate. However, not all contracts are regular as to time interval between payments nor even in amount of payments. Also some retailers use charts where principal is bracketed with a set dollar charge for each bracket, so no block rate is present for conversion. For irregular contracts the constant ratio method is much easier to use than the actuarial or direct ratio.

Constant Ratio Method: The constant ratio method is less accurate than the direct ratio method. The distribution of each payment to principal and interest is on a constant ratio. In other words, the amount of the interest out of each payment is the same no matter how much the outstanding balance. If a loan is to be repaid in 12 monthly installments, each payment will contain 1/12 of

the interest.⁸ For comparison of distribution of payments to interest and principal with the direct ratio and constant ratio methods see Appendix C and Appendix F. The effect of the constant ratio is to underestimate the amount of interest due during the first part of the loan, thus the outstanding balance declines faster than it would under the more accurate methods. Because the outstanding balance is declining faster, the method tends to overstate the effective rate.

⁸The formula for regular repayment with the constant ratio method is:

$$i = \frac{2mD}{P(n+1)}$$

Where: i = the effective interest rate
m = the number of payment periods in 1 year
n = the number of payments to discharge the debt
D = the interest charge in dollars
P = the principal or cash advanced

On a \$120 loan at 10% per annum add-on rate to be repaid in 12 equal monthly installments of \$11, the calculation of the effective rate would be as follows:

$$i = \frac{2 \times 12 \times \$12}{\$120 (12+1)}$$

$$i = \frac{288}{1560} = 18.46\% \text{ per annum}$$

For further information on the constant ratio method see:

R. M. Neifeld, Neifeld's Guide to Installment Computations, op. cit., pp. 193-200.
U. S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., pp. 208-210, 118-119 and 1362.
Robert W. Johnson, Methods of Stating Consumer Finance Charges, op. cit., pp. 108-110.

Comparison of Direct and Constant Ratio Methods with Actuarial Method:

Table 3 compares the constant ratio and direct ratio methods with the actuarial method.

TABLE 3

EFFECTIVE RATE AT 10% PER ANNUM ADD-ON TO BE REPAYED
IN EQUAL MONTHLY INSTALLMENTS FOR:

Method	12 months		24 months		36 months	
	rate	difference	rate	difference	rate	difference
Constant ratio	18.46	.49	19.20	.77	19.46	1.54
Actuarial	17.97	-	18.43	-	17.92	-
Direct ratio	17.96	.01	18.09	.34	17.78	.14

Note: These rates were figured on a \$120 loan.

The direct ratio method gives a rate very close to the actuarial and presents no real practical problem. The constant ratio method overstates the rate to a degree that may create a problem. The overstatement increases with the rate and with the maturity of the credit. The assumption of a constant ratio of each payment to principal and interest allows it to be used for contracts where payments are unequal or at irregular intervals. The practical problem of computing effective interest on these contracts in the course of business with either the actuarial or direct ratio method would make their use virtually impossible. Even if all computations were made on the constant ratio method, the errors shown in Table 3 would remain. When the effective monthly or annual rate is used to compute the credit charge, the distribution of interest and principal in each payment is the same as for the actuarial method.

The proposed legislation would require all consumer credit to disclose the

cost in terms of the effective annual rate. The purpose is to inform consumers about the relative cost of their credit alternatives. At what point does the error due to method of calculation distort and destroy the comparison? Mr. Charles H. Gushee, president of Financial Publishing Company, Boston, pointed out:

Lenders are afraid of a statute which would require a great precision in a complex field. But if, for example, the interest rate need only be stated within a tolerance of 1 per cent one way or the other, the lender would feel safer and the borrower would have a pretty good idea of where he stood.⁹

In Table 4, the 42 month contract at 9.43% per annum discount has the greatest error likely to be produced on a regular contract under Hawaii's present rate structure -- 3.73% per annum.¹⁰ For the more common 36-month maturity, the error is 3.32% per annum. The effect of this fairly large error on the use of the effective rate statement for comparison must be considered carefully. When the effective rate is required, it would seem wise to restrict the use of the constant ratio method to irregular contracts, which are a fairly small proportion of the total. This is the procedure now followed

⁹U.S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., p. 1178.

¹⁰This is the highest error because the divergence increases with the rate and the length of maturity. After 42 months the decline in the block rate offsets the increase in maturity. The divergence might be somewhat higher for certain irregular installments. When the irregular installments are such that principal outstanding declines faster during the first half of the credit maturity than it would under a regular even contract of the same amount and maturity, the effective rate is higher. Thus these contracts will have a greater divergence due to the higher effective rate.

TABLE 4

COMPARISON OF EFFECTIVE RATES DERIVED BY CONSTANT AND DIRECT RATIO METHODS^a

	Constant Ratio ^b	Direct Ratio ^c	Difference between Constant and Direct Ratio
<u>Add-on per annum</u>			
12 months			
at 12%	22.15%	21.48%	.67
18 months			
at 12%	22.74%	21.65%	1.09
24 months			
at 11.25%	21.60%	20.28%	1.32
30 months			
at 10.8%	20.90%	19.32%	1.58
42 months			
at 9.43% ^d	18.42%	16.68%	1.74
48 months			
at 8.625%	16.90%	15.24%	1.66
<u>Discount Per Annum</u>			
12 months			
at 12%	25.17%	24.24%	.93
18 months			
at 12%	27.73%	26.16%	1.57
24 months			
at 11.25%	27.87%	25.56%	2.31
30 months			
at 10.8%	28.63%	25.56%	3.07
36 months			
at 10.8%	27.80%	24.48%	3.32
42 months			
at 9.43% ^d	27.49%	23.76%	3.73
48 months			
at 8.625%	25.80%	22.08%	3.72

^aThese loans, to be repaid in equal monthly installments, are at the maximum block rate provided under the Industrial Loan Act and the Retail Installment Sales Act.

^bThe constant ratio formula was used on a \$120 loan for figuring the rates.

^cThe direct ratio rates were taken from the Office of the Bank Examiner's "Permitted Charges under Section 194-17A, Revised Laws of Hawaii 1955 with Charges Reduced to True Interest Rates Based on a Loan of \$1.00" found in Appendix B.

^dThe block rate was not rounded for calculation of the effective rate.

by the Office of the Bank Examiner for industrial loan companies.

Irregular Installment Contracts

As stated above companies operating under the Industrial Loan Act have no difficulty in determining the effective interest rate on regular contracts when the block rate is used. Although contracts with irregular repayment schedules are granted much less frequently than regular contracts,¹¹ they will be discussed in some detail because of the difficulty in obtaining their effective rate. The industrial loan companies solve this problem by granting few such contracts. When one is granted, a trained person figures the effective rate, usually from a formula. The most common types granted are deferred first

¹¹In U.S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., pp. 770, William McC. Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System, discusses national data on the frequency of irregular contracts found in the Board's 1954 and 1955 new-car buying survey. Of the installment contracts, 26% were excluded because of difficulties: 9% lacked information on finance charge; 7% were balloon notes; 10% were a miscellaneous group for which there was no breakdown. The last 10% did, however, include some irregular contracts.

payment, final drop payment, and final balloon payment. These irregularities all have formulas. However, most of the irregular contracts are granted by retailers, who are frequently not trained in the use of formulas. In discussing this problem with reference to automobile dealers, Clesson Y. Chikasuye stated on behalf of the Hawaii Automobile Dealers Association:

Conditional sales take place both on the business premises and off the business premises. Furthermore, terms and conditions of payment under conditional sales contracts vary with each contract. For example, some contracts provide for a grace period of several months before monthly installment begin; other contracts provide for fixed monthly payments at one rate for several months and fixed increased monthly payments thereafter; other contracts provide for gradually increasing monthly installment payments during the term of the contract; other contracts provide for decreasing monthly installment payments during the term of the contract.¹²

Thus one of the basic problems in implementing effective interest rate disclosure is the irregular contract.¹³ The allocation of a set proportion of each payment to interest and principal under the constant ratio method permits manipulation of the formula for use on irregular contracts.

There are several formulas based on the constant ratio method for specific irregularities. Most consumer credit with monthly payments calls for the first installment to be paid within 30 to 45 days after credit issuance. When this period is extended one or more months, it is called a deferred first payment

¹²Statement on House Bill 26, Proposed H. D. 1, to Honorable Donald D. H. Ching, Chairman, and Members of the Committee on Trade and Commerce, House of Representatives, from Clesson Y. Chikasuye, on behalf of the Hawaii Automobile Dealers Association, (1961). (Mimeographed).

¹³With the block rate and irregular payments, the effective rate will be higher than the Bank Examiner's chart (Appendix B) if the payments are heavier in the first half of the contract, while the rate will be lower if the payments are heavier in the second half of the contract.

credit.¹⁴ An irregularity similar to the deferred first payment is the skip payment. Under this type, one or more payments are to be deferred at some time during the contract.¹⁵ Both the deferred first payment and the skip payment contracts have a constant effect on the effective rate by the number of payments deferred, the number of the payment which is deferred, and the maturity of the contract. Thus these contracts can be incorporated into charts similar to those of the Bank Examiner (Appendix B). For an example of these tables, see Appendix D.

The balloon and drop payment contracts also have a formula. The balloon contract has equal installment payments until the final payment, which is

¹⁴The formula for the effective rate on deferred first payment contracts is:

$$i = \frac{2mD}{P(2s+n+1)}$$

Where: i = the effective rate
 P = principal or cash advanced
 D = the charge in dollars
 m = the number of payment periods in one year
 n = the number of payments to discharge the debt
 s = the number of periods the first payment is deferred

For further information on this formula see:

R. M. Neifeld, Neifeld's Guide to Installment Computations, op. cit., pp. 210-211.

U. S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., p. 213.

¹⁵The formula for the skip payment is a variation of the deferred first payment:

$$i = \frac{2mD}{P(n+1) + \frac{2s(P-PX)}{n}}$$

Where: i = the effective rate
 P = principal or cash advanced
 D = the charge in dollars
 m = the number of payment periods in 1 year
 n = the number of payments to discharge the debt
 s = the number of periods deferred
 X = the number of the payment paid prior to the deferred payment

substantially larger than the others. The drop payment is just the opposite, with the last payment substantially smaller than the others. By substantially, it is meant that the difference is more than a rounding correction. In practice the balloon payment is frequently a large percentage of the total note.¹⁶ Constructing a rate chart for the balloon and drop payments presents a problem. A chart could be setup with effective rates determined by the percentage of the last payment to the principal by maturity. However, this would require calculations so that the final payment would conform to the chart.

The average cash time decimal formula, also based on the constant ratio method, may be used for any regular or irregular transaction. It uses the face amount of the note, the principal and interest to be repaid at maturity. This

¹⁶The formula for the effective rate on the balloon and drop payment is:

$$i = \frac{2mAD}{Pn (A+L)}$$

Where: i = the effective rate
 P = principal or cash advanced
 D = the charge in dollars
 m = the number of payment periods in 1 year
 n = the number of payments to discharge the debt
 A = principal and finance charge, or the amount repayable
 L = final or balloon payment

For further discussion of this formula see:

R. M. Neifeld, Neifeld's Guide to Installment Computations, op. cit., pp. 207-209.

U. S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., p. 212.

formula¹⁷ is difficult to use because one must frequently set-up the repayment schedule to calculate the rate.

For the irregular contracts, charts could be constructed for some of the most common types of irregularities, but these would cover only some of the situations. In the retail sales contracts, the terms are frequently fitted to the customers needs rather than to a system of computations. If the disclosure of effective rate were required, what are the consequences? It is unlikely that retailers would assume the expense of figuring individual repayment schedules; and from this, the effect rate. They might continue irregular contracts by passing the added cost on to the consumer either by increased rates or by increased cost of the goods when the rate ceiling is reached. Another solution might be to limit credit to types that are readily converted to effective rates by simple formula. The alternative of adopting the effective monthly rate system is unlikely because this method is more costly to operate. George W. Conniff, Secretary of the Hawaii Association of Credit Management and Secretary

¹⁷The average cash time decimal formula is:

$$i = \frac{D}{P (\text{ACTD})}$$

Where: i = effective interest rate
 D = finance charge in dollars
 P = principal or cash advanced

ACTD = average cash time decimal, or $\frac{\sum F_1}{m.F_1}$

F_1 = principal and finance charge, or the amount to be paid
 $\sum F_1$ = the sum of the principal and finance charges outstanding for each period. It is similar to the total dollars lent for a month on p. 8 but also includes the finance charge due each period.
 m = number of periods in 1 year

For further discussion of this formula see:

U.S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., pp. 180-184 and 431-438.

of the Honolulu Retail Credit Association, stated the following in reference to this problem:

It is the opinion of the writer, after meetings and discussions with businessmen extending credit accommodations, that certain aspects of House Bill Number 26 would be either impossible to perform by certain credit grantors or so difficult that it would tend to curtail certain types of credit transactions.

I refer specifically to Section 7 paragraph (i). The small businessman without advanced training in mathematics would find it difficult, and at times impossible, to compute the effective rates of interest on certain conditional sales agreements where the monthly payments are not on an even monthly basis.¹⁸

The problems involved in calculating the effective rate on these irregular contracts would certainly curtail their use severely, if not do away with them entirely for a majority of the retail credit grantors.

Function of Irregular Installment Contracts: Mr. Katona of the University of Michigan Survey Research Center indicated that the most important single factor in a credit purchase is the repayment schedule (see p. 18). This is because the payments must fit into the family budget for a purchase or loan to be made. Mr. Katona stated:

Whether the interest rate is 1 or 2 percentage points higher or lower could hardly influence the decision to buy or not to buy a car or a washing machine; how large the monthly payments are does influence that decision.¹⁹

This view is substantiated by William McC. Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System, in his congressional testimony.

¹⁸Statement on proposed draft of House Bill 26, to Representative Donald D. H. Ching, Chairman of the Trade and Commerce Committee, House of Representatives, from George W. Conniff, Secretary, Hawaii Association of Credit Management; Secretary, Honolulu Retail Credit Association, March 29, 1961.

¹⁹U.S. Congress, Hearings on S. 2755, Consumer Credit Labeling Bill, op. cit., p. 807.

Also, it is hard to find evidence as to consumer responsiveness to the changes in charges that have occurred. Consumer installment credit has been more responsive to changes in terms, such as maturities and downpayments, and in credit standards of lenders, than to changes in finance charges.²⁰

One of these terms is the irregular installment, tailored to fit the consumer's budget. These contracts can be divided into two classes: (1) those for consumer convenience; (2) those that enable a consumer to borrow or buy where he could not under the usual regular contract. Historically, the conditional sales contract or chattel mortgage was made on durable goods which had a resale value. The general rule was that the customer's aggregate payments must exceed the market value of the property at all times to allow the creditor to repossess without loss in case of default. The portion of value of the good that exceeds the balance due is known as the customer's equity.

This general rule, which is still followed by a large segment of the industry,²¹ has a two fold purpose. First, in case of default the lender is fairly sure of recovering his investment; second, the borrower will have incentive to continue his payments and maintain his property in good condition. If the borrower owes more than the property is worth, he may feel that repossession is the best solution. Usually, of course, he must pay the difference of the proceeds from

²⁰U. S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., p. 276.

²¹The American Bankers Association "Consumer Credit Standards of Practice" (U. S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., p. 527.) states:

The basic principle upon which successful time sales financing is built is that the purchaser will have sufficient downpayment to establish an interest or equity in the merchandise and will be able to pay regular monthly installments of sufficient amount to increase that equity faster than the merchandise will depreciate from time and average use.

the sale of the property (generally wholesale) and the debt, but he may not realize this or feel he can circumvent it. Irregular contracts where repayment is such that the borrower maintains equity in the pledged property are granted for consumer convenience. When the consumer does not maintain some equity, the irregular contract will be considered as an aid in obtaining money or property that would otherwise not be available to him. Naturally this discussion does not apply to the credit sale of soft goods such as clothing where the resale value is close to zero immediately following purchase (although usefulness to the consumer must be considered here.) Nor does it apply to other virtually unsecured credit. Usually repayment on these credits is set as a proportion of the principal with an attempt to keep the maturity in a reasonable balance with the original principal. Due to the relatively low amount of principal involved in these unsecured credits, very few are irregular. This is because the finance charge would be low and the added administrative cost to the creditor would not produce sufficient profit. In addition, the problem of flexibility in this area is largely solved by revolving plans.

Only a few examples of irregular installments for consumer convenience will be given here. The deferred first payment might allow the borrower to recover from the outlay of a large downpayment. The skip payment might be agreed upon for December when Christmas expenses would be high. A borrower might wish to increase his payments after a certain date following the termination of another installment agreement. Or he might wish to decrease his payments during vacation. The elimination of such irregular contracts would work a hardship on some customers. The problem might be solved to some extent by agreeing to one set of regular terms and then revising them. This is not a very good solution, however. The

consumer would have no assurance that revision would be provided when needed. Also the revision of the original contract would add to the expense of administration and thus the cost of borrowing. Fees included in a new agreement would not be included in the effective rate of the first contract.

Any type of installment payments, including the regular even payments, may not cover equity for the consumer's durable purchase during part or all of the credit maturity. This lack of equity is most prevalent for irregular contracts. These credits are generally not granted by financial institutions that depend solely on earnings from loans, but they are most frequently allowed by retailers who stand to profit from the sale of a product as well as from the credit. The lender-seller is trying to maximize his gross income position. From his experience, he can estimate the general level of delinquencies for different risk credit. Thus he may decide to grant high risk credit where the consumer does not maintain equity. His decision, limited by the profit motive, must be based on the expectation that most of the contracts will be fulfilled. If he makes a mistake, the cost of collection or repossession and resale for a large number of products may well put him out of business. The error might be due to a change in the business cycle of the islands brought on by a strike, recession or crop failure.

These contracts, as noted above, enable consumers to purchase goods that otherwise they could not afford immediately. Psychologically this might be of great benefit to the consumer. However, from an economic point of view, the purchase might be unsound or even dangerous. If the borrower defaults at a

point in the contract where he does not have equity, he will lose his purchase and still owe money. If one cannot fulfill an installment contract so that he maintains equity in pledged property, perhaps he should wait until he has a larger down payment or buy a cheaper substitute. The danger will depend, of course, on the type of contract and the borrower's ability to repay. An example of a comparatively low risk type might be under a regular contract calling for a \$500 down payment and \$75 monthly installments. The reliable buyer might be allowed to pay \$175 for the first five months in lieu of a down payment and then \$75 a month for the remainder of the loan. An example of a high risk type would be the balloon note.

Balloon Note: The balloon note calls for usually regular even payments until the last payment which is substantially larger than the others. In a few cases the balloon is granted because the borrower expects a lump sum of money and wishes to dispose of the loan as soon as possible. Under these circumstances the borrower will have equity in any pledged property at all times. However, the more frequent case is when the borrower does not maintain equity in pledged property. Suppose a consumer wants to purchase a new \$3,000 car. He can only afford a \$600 down payment and \$75 monthly payments. It will take him about forty-three months to pay off this loan. Under terms of the Industrial Loan Act and the Retail Installment Sales Act, no contract with the block rate may run more than four years. Actually the usual practice in the industry is to grant only 30 to 36 months credit. The lender may be willing to give this man credit at the maximum rate (12% add-on per annum for the first 18 months, 9% per annum for the next 12 months, and 6% per annum the last 6 months.) Thus the borrower will

agree to re-pay \$3,120 in 36 months at a cost of \$720. There will be 35 monthly payments of \$75 totaling \$2,625 and a final balloon payment of \$495. As the borrower took the balloon note because he could only afford \$75 per month, he must now refinance \$420 of the last payment at a cost of \$25.20 for six months.

The balloon note not only contains the risk of low or no equity but also requires refinancing. The borrower can easily lose his automobile if refinancing is impossible. If the sale price of the car is less than his outstanding balance, he will be required to pay the difference. One argument put forth is that the balloon note is generally refinanced by the original lender. If this is the case, the question may be raised as to why he did not assume a 43 month contract instead of a 36 month contract. The reason seems to be that if the borrower proves a poor risk the creditor can demand payment and thus minimize his losses. The American Bankers Association in its "Consumer Credit Standards of Practice" states: "Balloon notes on time sales financing should be avoided."²² Our interest in the balloon note here is only in connection with disclosure, not as a trade practice.²³ The balloon note's formula might allow it to survive effective rate disclosure requirements more easily than other less controversial irregularities. It should be noted that the disclosed effective rate of the balloon note will not take into consideration the cost of refinancing. Also the effective rate on the balloon note will be lower than that of a note of the same amount and

²²U.S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., p. 527.

²³Correction of possible abuse of the balloon note can be considered in separate legislation. The California law specifies that the consumer is entitled to a new contract with payments which are not substantially larger than the even payments in the original contract. (Know Your Rights When You Buy on Time, California Department of Justice, California State Printing Office. p.7).

maturity with regular payments. This is because the balloon note's outstanding balance declines at a slower rate during most of the life of the contract.

Problem of Bracketed Charges: A common practice used by retailers, particularly on relatively inexpensive items, is the bracketing of principal for a certain finance charge. An example taken from the Sears, Roebuck and Company, Inc., chart follows:²⁴

If Unpaid Balance Amounts to:	We shall add for credit price:	Amount payable monthly is:
\$70.01 to 80.00	\$10.00	\$5.00
80.01 to 90.00	12.00	5.00
90.01 to 100.00	14.00	5.00

The bracketing is used to avoid multiplying the add-on rate by the principal for each credit sale. This saves time and prevents error. The time factor is important not only for good customer service, but also to keep business expense low. This is particularly true for the smaller credit sales.

The principal in each bracket in the above example covers 1,000 possible principals of dollars and cents, each with a slightly different effective rate. Practically, the effective rates would not vary that much because of rounding. Table 5 presents the effective rates by round dollar of principal ranging from \$70 to \$80 by the constant ratio and direct ratio methods and for \$70, \$75 and \$80 by the actuarial method.

²⁴U.S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., p. 974. For the complete chart see Appendix E.

TABLE 5
EFFECTIVE ANNUAL RATES BY ROUND DOLLAR OF PRINCIPAL
FROM \$70 to \$80 with \$10 CHARGE

Principal	Actuarial	Direct Ratio		Constant Ratio	
		Rate	Per cent Spread for \$1 Advance	Rate	Deviation from Actuarial method
\$70..	19.42%	19.35%		20.17%	.82
71		18.86	.49	19.64	
72		18.38	.48	19.14	
73		17.94	.44	18.66	
74		17.51	.43	18.21	
75	17.15	17.10	.41	17.78	.68
76		16.69	.41	17.34	
77		16.30	.39	16.93	
78		15.93	.37	16.53	
79		15.57	.36	16.15	
80	15.29	15.22	.35	15.79	.60

Notes: The rates for the actuarial method could be computed but because of the tedious calculations they have been omitted for the transactions that involve a final drop payment.

It was noted that for flat add-on rates, the constant ratio method Deviation from the actuarial method increases with the rate and maturity. With a flat charge and even payments (excluding a final drop payment) the deviation becomes less with advances in principal and maturity.

The range in effective rate from \$70 to \$80 in Table 5 by the actuarial method is from 15% to 19%, too great to be of practical use to the consumer. When the brackets are for one dollar rather than \$10, the range is less than one half of one per cent. This is less than the divergence of the constant

ratio calculation from the actuarial method for the exact same dollar charge. If a degree of tolerance were decided upon or if both the actuarial and constant ratio methods were allowed, retailers could setup expanded tables with smaller brackets that would be of acceptable accuracy. These new tables would be at least ten times the size of the example in Appendix E, and thus harder to use. However, the bracketing system would not be abolished, with the resultant increase in time and expense.

Problem of New Purchases Added to Existing Contracts: Another problem in implementing the disclosure of effective rates under the current retail situation is the practice of adding new purchases to outstanding installment contracts. Under this practice a person may have a contract that requires payments of \$25 a month. He then makes another purchase on credit that would normally require a \$15 monthly payment. A new payment is now set up on the combined contract; this payment may be less or more than the total required to carry both contracts separately. The change in the consolidated payment from the two separate payments will affect the length of each maturity and effective rate of both credit purchases. Because the charges are levied separately, two effective rates must now be given, and these will depend upon the allocation of the new payment to each purchase. The problem is further complicated by the fact that several purchases can be carried at one time on the one contract. In his testimony at the congressional hearings on S. 1740, Mr. Mitchell, the attorney in charge of credit and finance of Sears, Roebuck and Co., Inc., estimated that 80.8% of Sears' easy payment installment sales both for retail stores and mail order are these "add-on" sales.²⁵ Mr. Morley Theaker, manager of the local

²⁵U.S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., p. 985.

Sears' store in discussing H.B. 26 stated:

It would mean an enormous increase in our paper work.... We might add that our present system which is employed in most Sears stores on the mainland would be completely unworkable if this bill is enacted.²⁶

The stores that offer the "add-on" of purchases to existing contracts do save in overhead costs because instead of handling one account for each credit purchase, they have only one account for each customer. The problem of calculating effective rate in these cases would be so time consuming as to be impractical. One alternative would be to grant separate contracts with their existing repayment schedules but allow the stores to combine them into one account. When the first contract ends, the payments would drop to the level of the remaining purchases still outstanding. This system would probably cost more, and the increased cost would undoubtedly be passed on to the consumer. Another alternative would be to convert to revolving credit plans. The revolving credit costs more to operate, and conversion might mean an increase in the present rates on these plans.

Retailers Who Only Occasionally Grant Credit: Another difficulty is that a retailer may grant credit occasionally only as a service to an established customer. These small retailers are not setup to grant credit nor do they usually gain much profit from this service. It would seem that the disclosure bill introduced into the U.S. Senate, S. 1740, would exclude these retailers from the disclosure requirement. It states:

"Creditor" means any person engaged in the business of extending credit (including any person who as a regular business practice makes loans or sells or rents property or service on a time, credit, or installment basis....).²⁷

²⁶Letter from Morley Theaker, Manager of Sears, Roebuck and Co., Inc. Honolulu, to Donald D.H. Ching, Chairman, Trade and Commerce Committee, House of Representatives, March 29, 1961.

²⁷U.S. Congress, Senate, Truth in Lending Bill, 37th Cong., 1st. Sess., 1961, S. 1740, Sec. 3.

Require Disclosure Only Above a Certain Minimum: One proposal that might ease the burden of retailers in complying with required disclosure would be to place a floor under which the disclosure would not apply. This would avoid calculation of all effective rates where legal minimum charges apply as discussed above. It would also aid the small retailer who does not have resources to comply on small low-return credits. It must be remembered that a large part of the expense of credit comes from the fixed costs of putting an account on the books. To increase the cost through disclosure requirements may make them unprofitable and thus drive them from the market. The possible variations in interest rate for small amounts of principal would produce only small differences in the dollar charge, and thus are not so important to the consumer. The range in effective rate probable for retail credit and the difference in the dollar charge follows:

Principal	Charge under General Minimum Rate on Retail Credit: 6% add-on	Charge under Legal maximum rate of 12% add-on	Difference between maxi- mum and minimum
\$100	\$6	\$12	\$6
150	9	18	9
200	12	24	12
250	15	30	15
300	18	36	18
350	21	42	21
400	24	48	24

Mr. Charles H. Gushee, President of Financial Publishing Co., Boston,
suggested:

Exempt small transactions by means of exemption of a minimum charge. In other words if the charge is less than a given minimum (say \$25) it need not be stated. The retail installment acts usually authorize a minimum charge of from \$5 to \$25.²⁸

²⁸U. S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., p. 1178.

CHAPTER VI

IMPLICATION OF "FULL DISCLOSURE" FOR THE ECONOMY

As with any controversial proposal, the disclosure of credit costs in terms of effective rate has brought forth predictions about its effect on the economy -- both beneficial and detrimental. The important predictions not covered elsewhere in the paper will be presented briefly in this section.

Sponsors of S. 1740 have stated that the purpose of the bill is to promote economic stability.¹ One source of instability might be the excessive use of credit, a difficult term to define. Its definition is dependent partly on current economic conditions and partly on one's philosophy. If the credit were excessive, there is no indication that the disclosure bill would reduce it. Expectations of reduction assume that the consumer presently does not know the general level of cost and that realization of the high cost would restrain him from further credit purchases. It has been previously stated that the need for a purchase and the terms of credit are prime factors in the decision to obtain credit, not cost. Some have felt that the bill would stabilize the economy by encouraging purchase of credit during recession and discouraging it during expansion because of interest fluctuations over the business cycle. Aside from the secondary role of cost, it is questionable that a consumer faced with a recession and possible income decline would purchase credit because of a reduced rate. In discussing this problem, William McC. Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System, testified before Congress that the bill would be "essentially a trade practices law." He pointed out that cost of consumer credit has not fluctuated much over the cycle and there seems to be little consumer response to the changes that have occurred.²

¹U.S. Congress, Senate, Truth in Lending Bill, 87th Congress, 1st. Sess., 1961, S. 1740.

²U. S. Congress, Hearing on S. 1740, Truth in Lending Bill, op. cit., p. 276.

Another view expressed in the hearings is that the bill would bring down the rates. This view is based on the assumption that the industry is not now competitive because consumers can not easily compare cost of credit. In the writer's opinion, the industry is quite competitive. It must be remembered that the institutions with low rates are selective, granting credit only to those with good credit ratings. Also the unit cost of consumer loans, particularly installment loans, are high. The small loan companies, who have the highest rates, accept the lowest credit ratings and grant only small loans, must continue to have high rates. To the extent that consumers do not shop for the best buy now, a disclosure requirement might help transfer purchases to companies with lower rates. Also some companies now charging higher rates without giving more service or accepting greater risk, may be forced to lower their rates. In this framework, the bill might well lower the rate for some customers and some companies. However, it is not likely that large or widespread reductions in rates would occur. In fact, it is possible that the disclosure requirement might increase the finance charge of some retailers by increasing their operating expenses. This has been discussed fully in the preceding section.

A related question is the possibility that retailers will bury part of the cost of credit in the price of goods to avoid disclosing the true cost of credit. As mentioned earlier, if the cost of granting credit exceeds the legal rate ceiling, this is a probable result, however, without this ceiling restriction, it would seem logical to assume that most retailers will continue their current practices because consumers will still be able to shop around for the price of goods. Research for this paper did not investigate the current practices of burying part of the credit cost in the price of goods.

Some fear that disclosure of the effective interest rate would shock consumers to the extent that they would sharply curtail their credit purchases. In view of the facts that price does not seem to be a prime factor in purchase decisions, that the dollar cost would remain the same, and that such disclosure has been in effect under the Industrial Loan Act, this fear does not seem valid. To the extent that a shock effect occurs, it would indicate that the consumer does not understand the present cost statements. Thus any shock effect would be a necessary adjustment in the process of informing the consumer.

CHAPTER VII

CONCLUSION AND FINDINGS

The growth of consumer credit in recent years has had a great impact on our economy. With this growth have come diverse forms of credit and a variety of cost statements: dollar amount, annual add-on rate, annual discount rate, effective monthly rate, and effective annual rate. These various statements provide an area for possible consumer confusion. The consumer may not realize the differences in the various rates or may not be able to compare the statements to shop for the lowest cost. Consumers' lack of credit cost information, however, cannot be attributed wholly to the present system of disclosure. Frequently the consumer does not try to compare finance charges. The most important data to him are the need for money or a purchase and his ability to meet repayment terms.

Problems of Disclosure

Legislation has been proposed to standardize the cost statement by requiring both the effective annual rate and the dollar charge to be disclosed prior to consummating the agreement. Such disclosure would certainly simplify comparison for the consumer. Actually, effective comparison could be based on either the dollar amount or the effective rate. The dollar amount may be more meaningful to consumers because they make their other purchases on this basis. Unfortunately the cost of revolving credit plans cannot be stated on a dollar basis because of the flexibility of repayment terms. Thus it is impossible to have a completely uniform statement in dollars. Uniform disclosure in terms of effective annual rate is possible but presents a number of practical problems and entails certain costs.

The first problem in requiring disclosure of effective rate is to decide upon methods that will be allowed to convert the dollar charge to effective rate. Because of the difficulty in using the completely accurate method, the actuarial method, the direct ratio and constant ratio methods would probably have to be adopted. The direct ratio method gives a close approximation of the actuarial method, but it is difficult to use on contracts where repayment is not in even amounts and at regular intervals. The constant ratio method is more easily used on irregular contracts, but it overstates the effective rate. On long maturities with high discount rates, the constant ratio method will yield an effective rate about 3.7 per cent above the direct ratio method. The effect of this error on the use of the effective rate for comparison must be considered. To reduce the frequency of the error when the effective rate disclosure is required, it would seem wise to restrict the use of the constant ratio method to irregular contracts, which are a fairly small proportion of the total.

Retailers of large ticket items and some financial institutions frequently tailor installment contracts to consumers' budgets by deviating from the usually equal payments or by allowing payments at irregular intervals. Most of these irregular contracts cannot be compiled into rate charts. In addition, computation even with the simplest method, the constant ratio method, would be time consuming. Thus it seems reasonable to assume that this service would be substantially curtailed by effective rate disclosure. In view of the fact that many consumers consider repayment terms more important than small variations in cost, curtailment of irregular contracts should not be considered

lightly. These irregular contracts are of two types: (1) to make repayment more convenient for the consumer, (2) to aid the borrower in obtaining credit by liberalizing the repayment schedule, leading to a lack of equity on durables during part or all of the credit maturity. For those irregular contracts extended, the computation of effective rates would add to the creditor's operating cost. It must be assumed that additional costs will be passed on to the consumer.

Basic operating procedures for some retail installment sales would have to be changed. The system of bracketing principal over a wide range with one charge in dollars for this range (See Appendix E) must be revised. It would be possible to retain the bracket system, which is an efficient tool, by narrowing the range and allowing a certain degree of divergence from the exact rate. Some divergence will be necessary in any case because of the different methods of calculation. Since the bracketing system greatly facilitates operating economy, it would seem wise to preserve it by allowing flexibility in the rate statement. However, the narrower brackets would be harder to use and thus increase the cost somewhat.

The practice of adding a new purchase to a customer's existing credit contract would have to be discontinued. It would be impossible to figure the effective rate on these consolidated contracts. The practice reduces the number of contracts that must be serviced and thus the paper work. Its discontinuance would increase operating costs and, in turn, finance charges. To avoid this higher cost, perhaps some exception could be granted for this practice.

Alternatives to Full Disclosure

Alternatives short of disclosure of the dollar charge and effective annual rate will be discussed briefly here. It is unfortunate that the American Bar Foundation study of consumer credit laws in the fifty states, which will be the basis for a model law to be drafted by the National Conference of Commissioners on Uniform State Laws, will not be completed for some time. It is impossible at this time to predict what codification will be recommended. However, the following improvements within the existing industry structure may be suggested. These improvements would be applied to each of the separate acts now in existence, rather than to all of them simultaneously. The suggestions will be aimed at reducing the number of statements given and requiring more uniformity in the remaining statements.

State the Dollar Charge Whenever Possible: It seems that the most meaningful cost statement to the consumer is in dollars. Therefore, it might be wise to require the dollar cost whenever possible. The credit unions, small loan companies, and revolving credit plans are not now required to give this statement. The credit unions have gone on record for disclosure and do not object to giving the dollar cost statement. The small loan companies could comply fairly easily because of the restrictions on irregularities in their contracts. As stated in the section on general problems, it must be assumed that the contract will be fulfilled as written. In connection with the small loan companies, there is a trend in the United States toward allowing these companies to use the add-on method (which seems cheaper to operate than the effective monthly rate system) under their

effective rate ceilings.¹ If this were allowed in Hawaii, the cost of operations would decrease and the dollar amount could be stated with ease.

This leaves only the revolving credit plans; for these the dollar cost can not be given because of the flexibility of repayment terms. It has been suggested that when a consumer opens a revolving credit account, he be given the dollar cost on several sample loans. He could then use these dollar costs on sample credits for comparison.

Block Rates: On installment credits, the block rates are applied to the original principal as if it were outstanding for the life of the loan, while the effective rate is applied only to the declining balance that is actually outstanding. Because of this, the block rates are only about one-half of the effective rate on such a loan. When the block rates are stated merely as a per cent, consumers may confuse them with the effective rate. For this reason

¹This is a most fruitful area for further research. Under the add-on method administration of a loan is less costly generally; however, the problems of refunding, extension, and default are greater than under the effective monthly rate method. All of the published comments that the author has seen support the idea that the cost of administering the add-on method has less cost than the effective monthly rate method. See the following:

Sales and Consumer Finance Companies; A Lecture Series, The New York Society of Security Analysis Lecture Series. (New York: The Bank of New York and Pacific Finance Corporation, 1960), p. 28.

Roland Stucki, Analysis of Installment Financing Legislation and Practices in Utah. (Salt Lake City: The Bureau of Economic and Business Research, University of Utah, 1956), pp. 24-27.

Lowell C. Yoder, The Consumer Finance Industry in Florida. (Gainesville: University of Florida Press, 1957), p. 19.

the Federal Trade Commission ruled that advertising rates that apply to the original principal on installment loans is an unfair practice. This ruling has been upheld by the courts.² What remedies are there to avoid this confusion? After the FTC ruling, some companies started advertising \$6 per \$100 for a year on installment loans. Requiring this type of expression would eliminate the use of all rates except the effective rate. However, this does not simplify the concept of the declining balance, but only redefines it. An alternative solution would be to foster education by requiring the rate to be labeled. This labeling is generally followed by the industry now, but there are still some exceptions. One local company reportedly gives just the per cent with no statement as to whether this is the effective, add-on, or discount rate. In another case, the percent is merely labeled "block rate" with no specification as to add-on or discount. This could well mislead the consumer and hinder his borrowing decision.

Discount:³ Both the dollar cost and the rate statement for discount may cause some confusion. As previously discussed, the relationship of the interest and principal is distorted by deducting interest from the nominal amount of the loan to determine the amount to be advanced to the borrower. Discount is used by the business community in the transfer of credit instruments with a set yield. It adjusts the instrument's yield to the prevailing market yield. If a \$1,000 prime negotiable bond carries an interest rate of 5% per annum (\$50 a year) and the prime market rate is 6% per annum, the bond cannot be sold unless the price is below its face value by an amount that will produce a rate

²General Motors Corporation v. Federal Trade Commission, 114, F. 2d 33 (2d Cir. 1940), certiorari denied, 312 U.S. 682 and Ford Motor Company v. Federal Trade Commission, 120 F. 2d 175 (6th Cir. 1941), certiorari denied, 314 U.S. 378" (U.S. Congress, Hearings on S. 2755, Consumer Credit Labeling Bill, op. cit., p.13.

³Discount here does not pertain to the sale of paper by one business to another. This report only considers business credit to consumers.

of 6%. So the price of the bond would have to be \$833.33.⁴ The main function of the discount in consumer loans is the same -- to raise the effective rate and thus the rate of return to the lender. The block rate ceiling for loans encourages this practice. The increased earnings from discount over add-on may be important to the marginal company. The discount is sometimes used in high risk loans to reduce the amount of the loan.⁵ With a smaller loan, repayment will be easier, and in case of default, the lender will lose less. However, the alternative would be to make an add-on loan for less principal. Because the discount may be confusing, and it has no essential function in the consumer loan industry, its discontinuance might be considered. The difference in dollar cost between add-on and discount is not very great, but the practice of discount adds one more type of rate statement which the consumer must learn about. Abolishing discount would lower the effective rate ceiling.

Effective Monthly Rate: Five states⁶ have amended their laws similar to our Small Loan Act to require that the effective annual rate be stated. The reason for this requirement is that some people do not realize that 1% a month equals 12% per annum. In addition, the psychological impact of 1% per month may be quite different from 12% per annum. The general procedure is to state the monthly rate followed by the annual rate in brackets:⁷ 3 1/2% per month (42% per annum) for the first \$100 and 2 1/2% per month (30% per annum) on the next \$200. This requirement for all lenders disclosing the monthly rate statement would cause no hardship on creditors and would inform the consumer more fully.

⁴6% of X = \$50. 1% of X = $\frac{\$50}{.06}$, or 8.3333, so 100% of X = \$833.33.

⁵Confidential interview with trade source in Honolulu, 1961.

⁶Minnesota, New Mexico, North Dakota, South Dakota, Wisconsin.

⁷Robert W. Johnson, Methods of Stating Consumer Finance Charges, op. cit., p. 32.

Education: Education is at least a necessary supplement to legislation; at most, an alternative solution. It is a necessary supplement because the consumer must be interested in comparing cost for any disclosure to be effective. However, once consumers are aware of the savings from shopping around, they will be more interested in comparing costs. With this interest and information about the differences between the various statements and the idea of declining balance, they will be able to shop more effectively.


Reasonableness of Interest Rates

A major area for further study in the consumer credit field is the reasonableness of the interest rate ceilings. Consumer credit is now an accepted part of our economic life, contributing to the distribution and marketing of goods and services. Interest rates must be viewed as comprising a price structure that is determined by the market, rather than by moral considerations. Rate ceilings place a limit on the role played by price in market adjustment. Thus careful study must precede any change in these rate ceilings. In the early days of consumer credit, it was found that too low rates create a problem in enforcement and severely restrict the legitimate service extended. On the other hand, too high rates, not only burden borrowers, but also encourage overextension of credit. The rate ceilings must be sufficiently high to encourage capital to flow into the industry, and the structure must be such that well-rounded service is provided. As under our present laws, sufficiently high rates must be allowed on high-risk small loans of the type now offered by the small loan companies. The basic decision about ceilings will depend on rates that will both provide the services that are deemed socially desirable and yield a reasonable rate of return on capital for business.

Such a study must consider the various institutions operating under the present rate ceilings: small loan companies, banks, industrial loan companies, retailers, and pawnbrokers. It must also cover the various services provided by these institutions from revolving credit to single payment loans. Many terms of credit extension are now regulated by the State. These terms affect the rate of return to lenders and must be studied. Some of the more important areas to look into in such a report are as follows: (1) minimum charge for small loans; this minimum may not cover the actual cost of very small loans; because of the high unit cost for each loan, generally some of the cost of very small loans is absorbed by the profit from larger loans; (2) the maximum amount loanable; each loan has a fairly high fixed unit cost; the larger the amount that may be loaned, the lower the rate structure can be; (3) maximum length of loan; too long maturities create over extension of credit, while too short maturities restrict borrowing unduly and cut into profits of the lender; (4) the optimum size of the industry; it has been found that if the competition becomes too keen lenders are tempted to increase their portfolios by extending higher risk loans which leads to instability and harsh collection practices; (5) types of loan practices permitted, such as balloon notes with no provision for refinancing; these may lead to delinquencies and instability; (6) legal methods of computation; these may not be the most efficient; many states, for instance, now permit small loan companies to use the add-on computation because it cuts operating expenses; (7) other legal restrictions that promote inefficiency; Florida found that the collection practices provided for by law were not effective.⁸

⁸Lowell C. Yoder, The Consumer Finance Industry in Florida (Gainesville, Fla.; University of Florida Press, 1957), p. 32.

The heart of the report must analyse the annual statements of credit operations. Methods of bookkeeping must be considered to insure data comparability. The research will necessitate close cooperation from the credit grantors. While financial institutions make regular reports to the Office of the Bank Examiner, retailers do not submit reports on their credit operations. Any comprehensive study for the future, therefore, must take full account of the data gathering problem which would be involved.



APPENDIX A

Installment Payments and Dollar Cost on Contracts
When the Effective Rate is Stated

When the effective rate is stated on installment contracts with fixed payments including interest and principal, the dollar charge can be obtained from repayment schedules which cover any number of months, amount of principal and rate. A portion of one of these schedules with an effective monthly rate of 1% follows:

Monthly Installments Payments and Dollar Charges
for Selected Loans of Various Maturities

months	Size of Principal							
	\$25		\$50		\$75		\$100	
	total interest	monthly payment	total interest	monthly payment	total interest	monthly payment	total interest	monthly payment
2	\$.38	\$12.69	\$.75	\$25.38	\$ 1.13	\$38.07	\$ 1.50	\$50.76
3	.50	8.50	1.00	17.01	1.50	25.50	2.01	34.01
4	.63	6.41	1.26	12.82	1.89	19.23	2.50	25.63
5	.75	5.15	1.50	10.30	2.25	15.45	3.03	20.61
6	.88	4.32	1.77	8.63	2.64	12.95	3.53	17.26
7	1.01	3.72	2.02	7.44	3.03	11.15	4.04	14.87
8	1.14	3.27	2.27	6.54	3.42	9.81	4.55	13.07
9	1.27	2.92	2.54	5.83	3.80	8.76	5.08	11.68
10	1.40	2.64	2.80	5.28	4.19	7.92	5.57	10.56
12	1.65	2.23	3.31	4.45	4.97	6.67	6.61	8.89
14	1.91	1.93	3.83	3.85	5.74	5.77	7.68	7.70
16	2.19	1.70	4.34	3.40	6.53	5.10	8.68	6.80
18	2.42	1.53	4.89	3.05	7.28	4.58	9.78	6.10
20	2.71	1.39	5.41	2.78	8.12	4.16	10.80	5.54
22	2.96	1.28	5.94	2.55	8.93	3.82	11.91	5.09
24	3.21	1.18	6.49	2.36	9.72	3.54	12.97	4.71
27	3.64	1.07	7.26	2.13	10.92	3.19	14.55	4.25
30	4.06	.97	8.12	1.94	12.16	2.91	16.20	3.88
33	4.43	.90	8.94	1.79	13.42	2.68	17.82	3.58
36	4.82	.84	9.71	1.67	14.62	2.50	19.52	3.33

Source: Credit Union "Lightning" Loan Computer, Copyright A.H. Belliveau, 1957.

The monthly payments and dollar charge for each loan are computed from the annuity formula.¹

$$W_0 = R \times a_{\overline{n}|i} \text{ or } R = W_0 \times i / a_{\overline{n}|i}$$

Where: W_0 = the amount of principal advanced
 R = the amount of payment

$a_{\overline{n}|i}$ = the amortization factor,² with n the number of installments.

¹M.R. Neifeld, Neifeld's Guide to Installment Computations, op. cit., p. 118

²Ibid, pp. 397-411.

Appendix B

Permitted Charges Under Section 194-17A, Revised Laws of Hawaii 1955
 With charges Reduced to True Interest Rates Based On a Loan of \$1.00

Number of Equal Installment Payments	Interest	Rate			
		Discounted		Added to Principal	
		Yearly	Monthly	Yearly	Monthly
1	\$.01	12.00%	1.00%	12.00%	1.00%
2	.02	16.32	1.36	15.96	1.33
3	.03	18.48	1.54	17.88	1.49
4	.04	19.80	1.65	18.96	1.58
5	.05	20.76	1.73	19.80	1.65
6	.06	21.60	1.80	20.40	1.70
7	.07	22.20	1.85	20.64	1.72
8	.08	22.68	1.89	20.88	1.74
9	.09	23.16	1.93	21.12	1.76
10	.10	23.52	1.96	21.24	1.77
11	.11	23.88	1.99	21.36	1.78
12	.12	24.24	2.02	21.48	1.79
13	.13	24.60	2.05	21.54	1.795
14	.14	24.96	2.08	21.55	1.796
15	.15	25.20	2.10	21.56	1.797
16	.16	25.56	2.13	21.61	1.8011
17	.17	25.80	2.15	21.65	1.8041
18	.18	26.16	2.18	21.65	1.804
19	.1875	26.04	2.17	21.38	1.782
20	.195	25.92	2.16	21.10	1.758
21	.2025	25.80	2.15	21.00	1.75
22	.21	25.68	2.14	20.67	1.7226
23	.2175	25.56	2.13	20.46	1.705
24	.225	25.56	2.13	20.28	1.69
25	.2325	25.56	2.13	20.04	1.67
26	.24	25.56	2.13	19.92	1.66
27	.2475	25.56	2.13	19.68	1.64
28	.255	25.56	2.13	19.56	1.63
29	.2625	25.56	2.13	19.44	1.62
30	.27	25.56	2.13	19.32	1.61
31	.275	25.44	2.12	18.84	1.57
32	.28	25.20	2.10	18.72	1.56
33	.285	24.96	2.08	18.48	1.54
34	.29	24.84	2.07	18.24	1.52
35	.295	24.60	2.05	18.00	1.50
36	.30	24.48	2.04	17.76	1.48
37	.305	24.36	2.03	17.52	1.46
38	.31	24.24	2.02	17.40	1.45
39	.315	24.12	2.01	17.16	1.43
40	.32	24.00	2.00	17.04	1.42
41	.325	23.88	1.99	16.80	1.40
42	.33	23.76	1.98	16.68	1.39
43	.3325	23.40	1.95	16.44	1.37
44	.335	23.16	1.93	16.20	1.35
45	.3375	22.92	1.91	15.84	1.32
46	.34	22.56	1.88	15.72	1.31
47	.3425	22.32	1.86	15.48	1.29
48	.345	22.08	1.84	15.24	1.27

Source: State of Hawaii, Office of Bank Examiner.

Appendix C

Distribution of Payments to Interest and Principal
by Constant and Direct Ratio Methods

A \$120 loan at an add-on rate of 10% per annum to be repaid in 12 installments of \$11.

	Total Month Payment	DIRECT RATIO METHOD			CONSTANT RATIO METHOD		
		Payment Dis- tributed to		Outstanding Balance	Payment Dis- tributed to		Outstanding Balance
		Interest	Principal		Interest	Principal	
1	\$11.00	\$1.85	\$ 9.15	\$120.00	\$1.00	\$10.00	\$120.00
2	11.00	1.69	9.31	110.85	1.00	10.00	110.00
3	11.00	1.54	9.46	101.54	1.00	10.00	100.00
4	11.00	1.38	9.62	92.08	1.00	10.00	90.00
5	11.00	1.23	9.77	82.46	1.00	10.00	80.00
6	11.00	1.08	9.92	72.69	1.00	10.00	70.00
7	11.00	.92	10.08	62.77	1.00	10.00	60.00
8	11.00	.77	10.23	52.69	1.00	10.00	50.00
9	11.00	.62	10.38	42.46	1.00	10.00	40.00
10	11.00	.46	10.54	32.08	1.00	10.00	30.00
11	11.00	.31	10.69	21.54	1.00	10.00	20.00
12	<u>11.00</u>	<u>.15</u>	<u>10.85</u>	<u>10.85</u>	<u>1.00</u>	<u>10.00</u>	<u>10.00</u>
Total	\$132.00	\$12.00	\$120.00	\$802.01	\$12.00	\$120.00	\$780.00

Thus the average outstanding balances are:

Direct Ratio: $\$802.01 \div 12 = \66.83

Constant Ratio: $\$780. \div 12 = \65.00

And the effective interest rates are:

Direct Ratio: $\$12 \div \$66.83 = 17.96\%$ per annum

Constant Ratio: $\$12 \div \$65.00 = 18.46\%$ per annum

No repayment schedule is shown for the actuarial method. The interest would be a constant proportion of principal outstanding. For accuracy, the interest must thus be carried out several places past the decimal.

Appendix D

Effective Interest Rate on \$1.00 Loan
at 6% Add-on per annum with One Skip Payment

Number of Payment	Interest in Dollars	Payment Skipped						
		1st	2nd	3rd	4th	5th	6th	7th
		Effective Rate Per Annum						
1	.005	-	-	-	-	-	-	-
2	.01	6.00	-	-	-	-	-	-
3	.015	7.20	9.00	-	-	-	-	-
4	.02	8.00	9.00	10.29	-	-	-	-
5	.025	8.57	9.23	10.00	10.91	-	-	-
6	.03	9.00	9.47	10.00	10.91	11.25	-	-
7	.035	9.33	9.69	10.08	10.50	10.96	11.45	-
8	.04	9.60	9.88	10.18	10.50	10.84	11.20	11.59
9	.045	9.82	10.05	10.29	10.54	10.80	11.08	11.37
10	.05	10.00	10.19	10.38	10.59	10.80	11.02	11.25
11	.055	10.15	10.31	10.48	10.65	10.82	11.00	11.19
12	.06	10.29	10.42	10.56	10.70	10.85	11.00	11.15
13	.065	10.40	10.52	10.64	10.76	10.88	11.01	11.14
14	.07	10.50	10.60	10.71	10.81	10.92	11.03	11.14
15	.075	10.59	10.68	10.77	10.86	10.96	11.05	11.15
16	.08	10.67	10.75	10.83	10.91	10.99	11.08	11.16
17	.085	10.74	10.81	10.88	10.95	11.03	11.10	11.18
18	.09	10.80	10.86	10.93	10.99	11.06	11.13	11.20
19	.095	10.86	10.91	10.97	11.03	11.09	11.15	11.21
20	.10	10.91	10.96	11.01	11.07	11.12	11.18	11.23
21	.105	10.96	11.00	11.05	11.10	11.15	11.20	11.25
22	.11	11.00	11.04	11.09	11.13	11.18	11.22	11.27
23	.115	11.04	11.08	11.12	11.16	11.20	11.24	11.29
24	.12	11.08	11.11	11.15	11.19	11.23	11.27	11.30
25	.125	11.11	11.15	11.18	11.21	11.25	11.27	11.32
26	.13	11.14	11.17	11.21	11.24	11.27	11.30	11.34
27	.135	11.17	11.20	11.23	11.26	11.29	11.32	11.35
28	.14	11.20	11.23	11.26	11.28	11.31	11.34	11.37
29	.145	11.23	11.25	11.28	11.30	11.33	11.36	11.38
30	.15	11.25	11.27	11.30	11.32	11.35	11.37	11.40
31	.155	11.27	11.30	11.32	11.34	11.36	11.39	11.41
32	.16	11.29	11.32	11.34	11.36	11.38	11.40	11.42
33	.165	11.31	11.33	11.35	11.38	11.40	11.42	11.44
34	.17	11.33	11.35	11.37	11.39	11.41	11.43	11.45
35	.175	11.35	11.37	11.39	11.41	11.42	11.44	11.46
36	.18	11.37	11.39	11.40	11.42	11.44	11.45	11.47

$$\text{Formula } i = \frac{2 mD}{P(n + 1) + 2s \left(P - \frac{PX}{n} \right)}$$

- Where i = effective rate
 m = number of payments in 1 year
 P = principal advanced
 s = number of payments skipped
 n = number of payments made
 X = number of payment paid prior to the deferred payment
 D = the interest charge in dollars

APPENDIX E

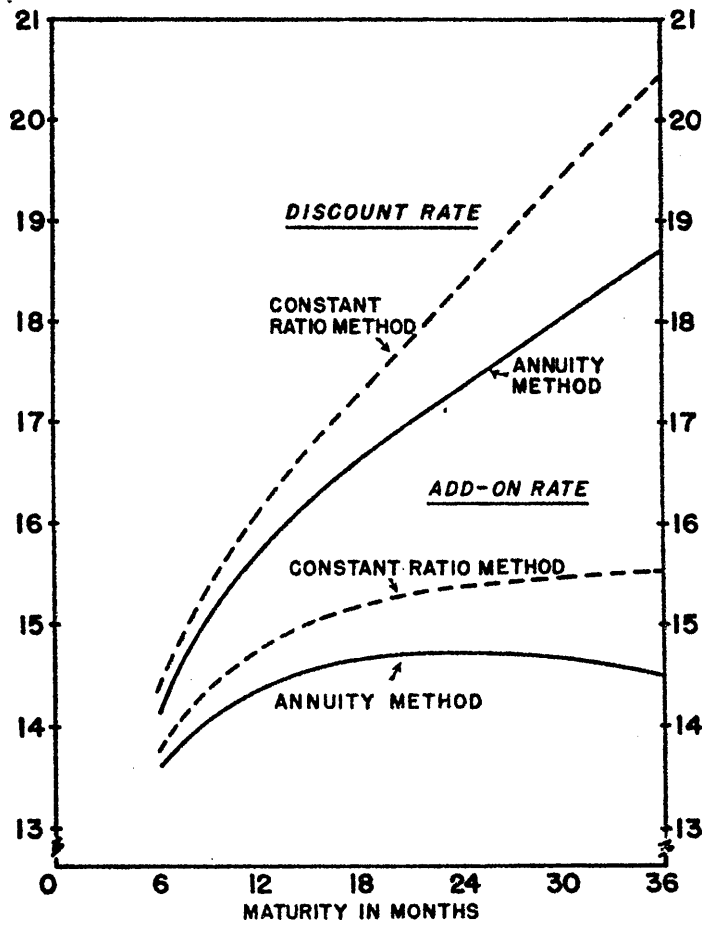
Bracketed Principal with Common Finance Charge and Monthly Payments

If Unpaid Balance Amounts to	We shall Add for Credit Price	Amount Payable Monthly is	If Unpaid Balance Amounts to	We shall Add for Credit Price	Amount Payable Monthly is
\$50.01 to \$55.00	\$6.50	\$5.00	\$200.01 to \$220.00	\$35.00	\$10.50
55.01 to 60.00	7.00		220.01 to 240.00	38.50	11.50
60.01 to 65.00	7.50		240.01 to 260.00	41.50	12.50
65.01 to 70.00	8.00		260.01 to 280.00	45.00	13.50
70.01 to 80.00	10.00		280.01 to 300.00	48.00	14.00
80.01 to 90.00	12.00		300.01 to 320.00	51.00	15.00
90.01 to 100.00	14.00		320.01 to 340.00	54.50	16.00
100.01 to 110.00	15.00		340.01 to 360.00	57.50	17.00
110.01 to 120.00	17.00		360.01 to 380.00	61.00	18.00
120.01 to 130.00	19.00	\$6.00	380.01 to 400.00	64.00	19.00
130.01 to 140.00	21.00		400.01 to 420.00	67.00	20.00
140.01 to 160.00	25.00		420.01 to 440.00	70.50	21.00
160.01 to 180.00	29.00		440.01 to 460.00	73.50	22.00
180.01 to 200.00	32.00		460.01 to 480.00	77.00	23.00
			480.01 to 500.00	80.00	24.00

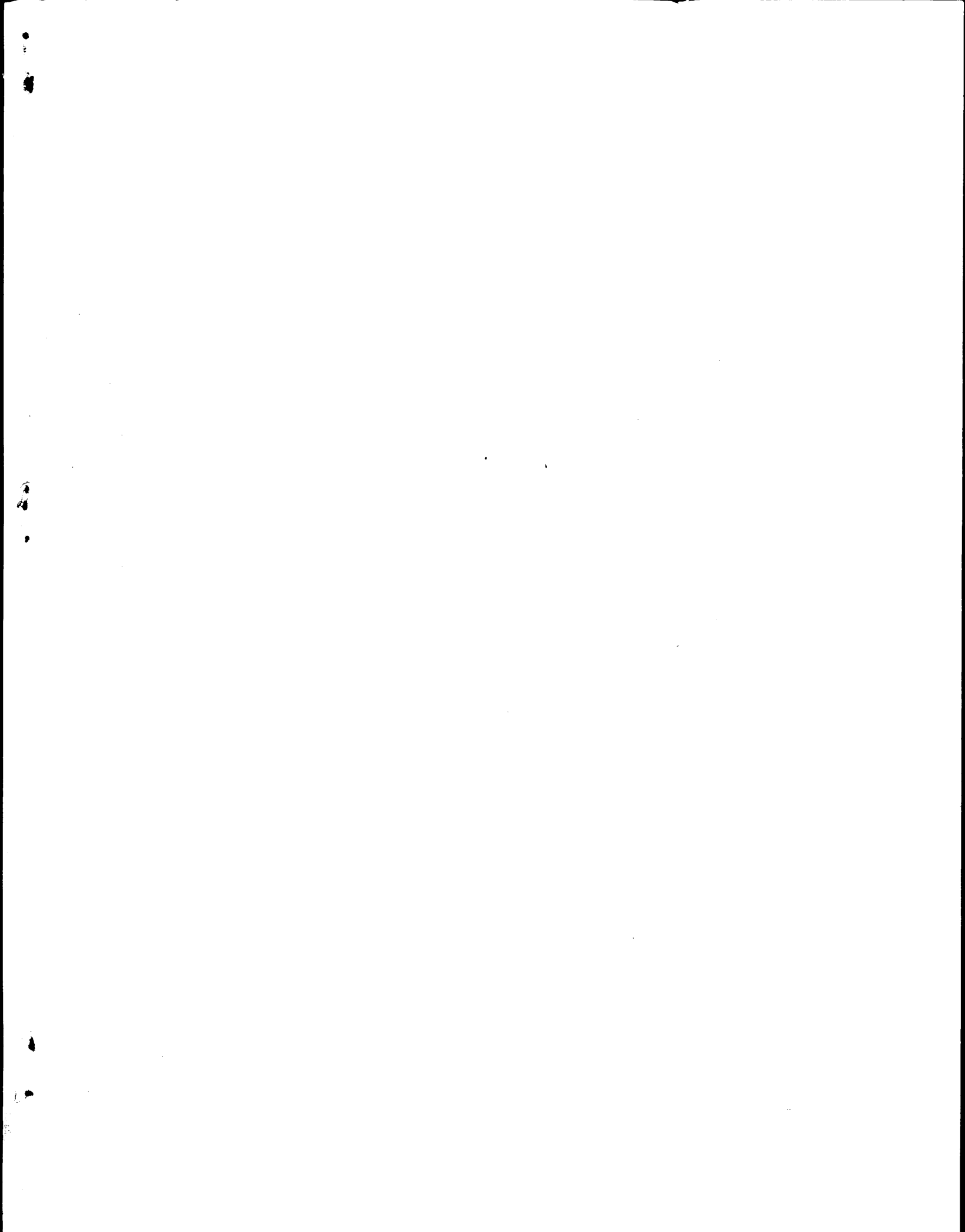
Source: U.S. Congress, Hearings on S. 1740, Truth in Lending Bill, op. cit., p. 974,

APPENDIX F

COMPARISON OF ANNUAL FINANCE RATES
FOR MONTHLY PAYMENT CONTRACTS
WITH 8 PER CENT ANNUAL ADD-ON AND DISCOUNT RATES



Source: Robert W. Johnson, Methods of Stating Consumer Finance Charges, op. cit., p. 116.



*Credit
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WILLIAM F. QUINN
GOVERNOR



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January 16, 1960

MEMORANDUM

To: The Honorable John C. Lanham, Chairman
House Committee on Economic Development

From: Frank Lombardi, Director of State Planning

Subject: Questions to be Considered by Committee, January 16, 1960

This statement is offered in reply to the questions submitted with your letter of December 11, 1959, regarding economic development in Hawaii. Items are numbered to conform with the numbering in your letter.

1. Hawaii 'Business Development Corporations' Act. There are indications that local financial institutions and businessmen generally made little or no use of this act. One reason may have been that the need evident to the authors of the act failed to materialize in the degree they expected, adequate credit becoming available without recourse to the act. Another reason may have been the failure of the act to assign direct responsibility to a single agency for encouraging its use, with attendant failure to give it sufficient publicity and stimulus among potential users.

Any improvements added by the forthcoming Legislature might take the form of assigning specific responsibility and liberalizing provisions of the act. It would appear to fall within the sphere of the Department of Economic Development.

2. Steps taken under Act 150, S.L.H. 1957, to improve economic conditions. The following studies and planning programs were undertaken under this act:

(a) The State Transportation and General Plan, including a detailed economic study to use as a basis for policy recommendations and set the scale for the physical plan.

(b) The six-year capital improvement program, made in cooperation with the Bureau of the Budget.

(c) Planning assistance to the four counties, to encourage acceptance of planning principles in these areas, offer them technical and financial assistance, and administer the Section 701 Federal planning assistance grants recently obtained by the State Planning Office for the Hilo metropolitan area and a number of communities on Kauai.

(d) Planning for development of tourism, through preparation of a detailed plan for Kona, cooperation with the Hawaii Visitors Bureau in a number of research and promotional efforts, and preparation of a State parks program for all islands.

(e) A number of special project plans, all of them with important economic development implications -- the military lands study, an analysis of submerged lands, a report on the proposed capitol site, and, in cooperation with the Economic Planning and Coordination Authority, studies of economic indicators and industrial sites.

2a. Steps not taken under Act 150. Although the scope of Act 150 made it possible for the Planning Office to undertake a number of studies not as yet initiated, such work was effectively precluded by limitations of staff, budget and time. The Planning Office has reason to believe that all important and high-priority projects within its authority have in fact been begun, and that any additional programs possible under Act 150 were not seriously pressing.

2b. Operation of the Hawaii Development Council. The Council held several meetings, at which a beginning was made in the coordinative efforts intended for it under Act 150. It should be remembered, however, that the Hawaii Development Council will achieve its maximum usefulness from now on, as substantial progress is being made on the Transportation and General Plan. A much more active role is envisioned for the Hawaii Development Council in the coming months. It is also expected that the problems inevitably resulting from reorganization will also have subsided by that time, with attendant improved stability in the membership of the Hawaii Development Council. Government reorganization will require new legislative designation of membership.

2c. Operation of the Planning Director in regard to tourism. The State Planning Office contributed both staff time and funds to a number of Hawaii Visitors Bureau efforts. Staff members served on important Hawaii Visitors Bureau committees, devoting time especially to the executive and research committees. The former assistant director was chairman of a special Citizens' Advisory Committee on the Tourist

Industry, reporting to the House Committee on Tourism. The Planning Office published an analysis of the impact of Oahu residents on neighbor island tourism. Two special projects, the State Parks Plan and Kona study, have important implications for Hawaii's visitor industry. This tourism function has been transferred to the Department of Economic Development.

3. Comparison of the New Hampshire, Pennsylvania, Puerto Rico, and Massachusetts industrial development acts. These acts appear to be highly specific and geared to the unique conditions evident in their respective areas. In consequence, some are not especially applicable to Hawaii and its problems, most of which differ considerably from those found in these older states. The Planning Office is keenly aware of the need for industrial and business development in Hawaii, and recommends that the Legislature request the Department of Economic Development continue its investigation toward formulating a similar program for Hawaii.

4. Other steps the Legislature can take. All public works should be scheduled with the need for private development kept uppermost. Considerable attention should be given to fact-finding and research requirements. Promotional activities should be intensified. Further development of inter-island and intra-island transportation would greatly enhance possibilities for economic development. Recommendations on this will be completed as part of the Transportation and General Plan scheduled for presentation to the 1961 session.

5. Economic development in other jurisdictions. Examples include hotel construction in Puerto Rico, ferry operation in Puget Sound by the State of Washington, construction of a railroad to maintain trade with the South by the City of Cincinnati, and the institution of capital improvement programs directed to specific developments in various other jurisdictions.

6. State credit agency or expansion of Farm Loan Board activities in Hawaii. This important question cannot be answered with any confidence by the State Planning Office with the limited information now available. The question is obviously one of considerable importance. It would thus appear desirable to mandate the Department of Economic Development, properly the agency most intimately concerned with this question, to make a detailed analysis for submission to a future Legislature.

REPORT ON SENATE BILL 105 (TOURIST DESTINATION AREA STUDY)

The State Planning Office is completing this action program for the February 1960 session. No recommendations can be made now but a progress report will be given orally. This program will be vital to the orderly and accelerated development of the visitor industry, especially on the neighbor islands.

STATE TRANSPORTATION STUDY

A brief comment will be made on this major program being prepared by the State Planning Office.

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BEN DILLINGHAM'S TALK AT THE HEARING OF
THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENTS
JANUARY 15, 1960

First, gentlemen, may I thank you for this opportunity to appear before you as a businessman in this community to offer specific views on the question that seems to be uppermost as far as this group is concerned.

Some weeks ago your chairman was kind enough to send along to me a questionnaire which, he explained in a covering letter, covered some of the matters which, in your minds, should be settled soon in order to let the economic development of this State go forward.

I hope you will understand that my forte, as a businessman, is transportation and I would be remiss in not suggesting to this group that one of the keys to the future of Hawaii's economic development is the improvement of our transportation system between Hawaii and the mainland, and between Oahu and the neighboring islands. And my company, Oahu Railway and Land Company, is moving forward as rapidly as possible to contribute its share toward the improvement of our State's transportation system.

I believe you would like my views on the several questions put forth in the questionnaire your chairman sent along to me.

The first asks why the Hawaiian "Business Development Corporations Act" of 1957 has failed thus far to operate. As I understand it, this was an enabling act to permit private financial institutions to pool their capital and reserves up to 2-1/2% in order that they might make risk loans to various businesses in our community. My reply to the question is this... from all the information I have been able to gather, the current era of prosperity we seem to be enjoying indicates a lack of need for this type of loan at the present.

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However, because the future is always a mystery I would like to see this measure kept on the books for it may someday play an important role in our business community. I would like to suggest, though, that this committee give some thought to a similar law which is on the Rhode Island State books. This statute, I believe, not only provides for risk loans to businesses by private financial institutions but goes one step further and permits the lending institution to move in and improve the management practices of the business seeking the loan.

As of this moment, I see no need to improve the statute we have on the books but ask that you investigate the Rhode Island statute. I would suggest, however, that since our statute was only put on the books for a four-year period... it be extended for at least another four-year period.

The second question put before me is in three parts. The first asks what steps could have been taken under Act 150 to improve the economic conditions of our State, which apparently have not been taken. Frankly, I can offer but one answer. And that is that Act 150 should have been passed a lot sooner than 1957. In my opinion, we, in Hawaii, got a belated start on the matter of economic development. Following the premise that it is better late than never, however, I would like to applaud Act 150 and offer the further observation that it is making possible the groundwork for our economic development in that we now have a Planning Office that is looking over the entire State, identifying, in specific terms, all of our problems, with the ultimate objective of arriving at a master plan of solutions which will set

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forth Hawaii's path toward economic development. In short, then, I believe all the steps provided for under Act 150 are being taken to improve our economic condition.

Not being an expert observer of government agencies, I do not think it would be proper for me to evaluate the operation of the Hawaii Development Council. However, I have been informed that it was given little else but coordinating power and because of that has not really functioned. I really feel that we would be well advised to carefully outline the duties of those government agencies responsible for the development of our State's economic condition and those government agencies responsible for the over-all planning of the State. Well defined responsibilities clearly laying out the areas these two government agencies are to cover would, in my opinion, be most helpful. In connection with this, I might also suggest that the one area in which we might permit an over-lap where these two areas of government are concerned is tourism. That over-lap, however, should only be of a coordinating nature to insure the fact that these two agencies are up-to-date on what each other is doing in connection with our fast moving tourist industry. And I suggest this only because we are operating under what I consider emergency conditions in the area of tourism and must move with haste in order to keep pace with the demands this industry is placing upon us. Again, in my opinion, we must recognize this fact and adjust ourselves accordingly so that we do not jeopardize that industry.

I do not wish to evaluate the operation of the Planning Director in regard to the tourist industry because I believe we are now operating under

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an entirely different set of circumstances than those which existed when Act 150 was passed. But again I reiterate, we must leave room for a great deal of flexibility in this field. We must not hamstring ourselves where the tourist industry is concerned.

The third question put to me in your questionnaire calls for an evaluation of four State statutes with regard to industrial and economic development. I have not had the time to study these statutes to the extent where I could offer a considered evaluation. However, I might suggest again that any State which will encourage private enterprise to develop industrial parks, which sets up an over-all State planning authority to specifically study the industrial needs of the State, is moving in the right direction. And I say this because with the proper encouragement, private enterprise could contribute the creativity and imagination which any government needs to move ahead. Such creativity and imagination encouraged within the limitations set forth by State Planning agency studies will go a long way toward clearing up our economic development problems. But again I must add... that private enterprises' imagination must be given a great deal of flexibility. As I see it, this kind of a partnership between the State and private enterprise can create industrial parks out of Sand Island, provide the answer of what can be done about our waste lands, find a way to make lava rock useful and therefore valuable to us.

The only specific steps other than the development of credit which I believe the State Legislature might consider to help develop the economy of the State of Hawaii involves a serious study of our present tax structure.

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My first inclination, as a businessman, is to suggest the removal of any gross sales tax on business and the replacement of it with a tax on business earnings. And I don't believe I need to go into that because I think we are all conversant on that score. However, I sincerely believe our entire tax structure needs a thorough and careful study on two counts. One, with the idea of removing existing inequities. And two, with the idea of improving the tax climate for both local and mainland businesses.

One other suggestion I might offer is the inclusion in the State program of public works projects to enhance our tourism climate. That, specifically, would mean improvement of our parks, historic sites and highway development. And, I might observe, I am delighted to see that the Administration of our Federal government sees our highway needs and plans to ask Congress for the necessary funds to help get our serious highway problems solved.

Question number five is another which I believe really requires the comment of an expert who has thoroughly studied the statutes of other jurisdictions with regard to economic development. Frankly, I have not. But, I might suggest that this committee review some of the laws the State of California has on the books. And I say this only because the State of California has been experiencing a population boom for several years and has had to develop laws which would help cope with the problems such a boom brings with it.

In short, I believe Hawaii should study the economic development statutes of all States with similar problems. . . . problems of a population explosion, problems of a young and virile population which needs jobs, problems of keeping pace with tourism, problems of developing light industry,

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problems of improving a woefully weak agricultural industry.

In answer to the question of whether there is a need in Hawaii for a State Credit Agency, I say....no. Attempts at this in the past here have not been too successful. As I understand it, in the agricultural field, private enterprise has pretty much carried the ball. But I do say that such an idea should not be entirely discounted because should the need ever develop, then I say the State should enter into the credit field. I do not feel there is such a need at the present time, nor do I see such a need in the foreseeable future. This does not mean, however, that I am opposed to having the State guarantee business loans. Again I say, if there is a need, so be it. But let's be sure such a need exists and is widespread.

Gentlemen, those are the extent of my views on the general subject of this hearing. May I again thank you all for the privilege of appearing before you. May I also say that I believe transportation holds one of the several keys to the gateway of Hawaii's economic development and I would be delighted to express my views on that subject at another time.

Thank you very much and aloha.

Walter Lee

credit
over

QUESTIONS FROM THE

HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT

(Testimony of Frank H. Jackson, Associate Economist, Economic Research Center, University of Hawaii, before the Committee on Economic Development, House of Representatives, Hawaii State Legislature, Friday, January 15, 1960.)

Before I begin, let me state that the views I am about to express are my own and are not necessarily shared by the institution with which I am associated.

I would also like to apologize to the Committee for the sketchy character of my answers to these questions. The questions were referred to me at a time when I was rushing to complete another project of interest to the Legislature. As a result, I was unable to devote sufficient time to these questions to do them justice. The questions are so basic and penetrating that any one of them would be worth taking up as a full-fledged and long-range research project.

QUESTION 1.: "Why has the Hawaiian "Business Development Corporations" Act of 1957 (Ch. 176A, 1957 Supp. to R.L.H. 1955) failed thus far to operate?"

- (a) Can its provisions be improved?
- (b) If so, how?"

ANSWER: My best guess would be that there has been no activity under the Business Development Corporations Act because it offers no special incentive to prospective members of such corporations in the present economic climate. Hawaii has been expanding at a rapid rate, and there has presumably been no shortage of opportunities to make conventional loans and investments. Since the purpose of the Act seems to be to promote ventures for which conventional financing cannot be obtained because of high risk relative to anticipated returns, it is not surprising that investors have shown little enthusiasm for participating in such Corporations.

An additional factor may well be the compulsory loan feature of the Act under which members are required to make loans on call from the Corporation.

Many investors may be unwilling to commit themselves in advance to making loans to the Corporation for two reasons. First of all, they may at any given time have more attractive opportunities for investment than making loans to the Corporation. Secondly, members may not agree with the loan policies followed by the Corporation, yet they cannot withdraw except on five-years notice and must continue to lend on call during this period.

Comparable Acts in the New England area may have had more success because of the particular economic conditions existing there. This area has been growing at a much slower rate than other areas in the U.S. and there has been actual outmigration of firms in several lines and areas. The financial institutions and individual investors in this region may not have the same alternative and more attractive opportunities for local investment that are present in a growth area such as Hawaii. They may, therefore, be willing to take greater risks in terms of the immediate return on their investment in hopes of checking the relative decline in New England's rate of growth and of revitalizing depressed areas.

The only suggestion I can make for improving the Act is that it be amended to permit withdrawal of members on immediate rather than five-years notice. Given current money-market conditions, I doubt if this would help much, but it would somewhat allay the fears of those who feel that the loan commitment provision of the Act is too inflexible.

QUESTION 2.: "What specific steps have been taken under Act 150 of 1957 to improve the economic condition of the state of Hawaii?

- (a) What steps which could have been taken under Act 150 to improve economic conditions, were not taken?
- (b) Evaluate the operation of the Hawaii Development Council established under Section 5 of Act 150.

QUESTION 2.: (Cont'd)

- (c) Evaluate the operation of the Planning Director in regard to the tourist industry under the authority granted in the seventh paragraph of Section 4 of Act 150."

ANSWER: To provide answers to this series of questions would have required a full-scale research project which could not have been completed in time for these hearings. I therefore concentrated on the other questions.

QUESTION 3.: "Please compare the following acts and give your opinion as to whether similar legislation should be passed for the betterment of the economic development of Hawaii and state the reasons for such opinion:

- (a) The New Hampshire Industrial Parks Authority law.
- (b) The Pennsylvania Industrial Development Act.
- (c) The Puerto Rican Development Company Act.
- (d) The Massachusetts Industrial Authority Act."

ANSWER: Each of these Acts is designed to serve a different purpose and to deal with problems which are unique in the areas concerned. The Pennsylvania Act is intended to help rehabilitate depressed areas by making loans on especially favorable terms to local groups which are trying to help themselves. The New Hampshire Act provides for the direct or indirect development of industrial parks and facilities with state funds but without particular reference to local efforts at development. The Puerto Rican Act provides for an almost unlimited range of activity by its Company including direct participation in production and marketing in many lines. I was unable to obtain a copy of the Massachusetts Act.

Viewed in other terms, the Pennsylvania Act is designed to aid communities only if they try to help themselves, the New Hampshire Act to promote the development of industrial facilities on a limited scale to attract private

operators, and the Puerto Rican Act to promote economic development on all fronts by methods which apparently include permanent state ownership and management of business.

All the Acts have in common the objective of promoting enterprise which private investors would not undertake by having the state underwrite or directly assume some or all of unusual risks involved. Thus in Pennsylvania, the state takes a junior lien on the property against which it makes loans; in New Hampshire, the bonds of the Parks Authority can be purchased by the state on terms favorable to the Authority and can be made full faith and credit bonds; and in Puerto Rico, the funds with which the Company is to operate are appropriated directly to it by the state.

QUESTION 4.: "Can you suggest any specific steps other than the Development of credit that the Legislature can take to develop the economy of the State of Hawaii?"

ANSWER: Legislation similar in a general way to these Acts might well be beneficial to economic development in Hawaii though such legislation should be tailored to the particular needs of this community rather than patterned directly on the laws of other states.

To be more specific, I visualize the need for state action to influence the pattern rather than the rate of local economic development. While it is true that the general rate of growth can be forced, such forcing seems to me to be of less benefit than selective support for growth in areas where some special public interest would be served. In this connection, let me cite two illustrations.

Much concern has been expressed over the failure of industry to develop on the outer islands and the concomitant tendency for economic activity to be

increasingly concentrated on the Island of Oahu. Legislation to promote economic development might, therefore, make special provision for state aid to industry locating on the outer islands. At the same time, state promotion of expanded inter-island transportation facilities would almost certainly be required. Industrial growth on the outer islands will not take place without the assurance of adequate transportation, but transportation agencies, on the other hand, can hardly be expected to expand unless there is real assurance that demand for expanded services will be forthcoming. Therefore, some underwriting of the risk involved in expanding transportation facilities would be a necessary part of such a program.

Concern has also been expressed over the fact that it is difficult to obtain the capital necessary for beginning new businesses or for expansion of existing ones where the businesses are of small or medium size. These firms need equity rather than debt capital, but there is no adequate market in which firms of such size can obtain equity funds. If the state wishes to encourage the development of such firms as a means of promoting competition or for any other reason, there are a number of ways of doing so including direct purchase of securities by the state. And to the extent that the agency does its job well, most of the funds involved could be recovered and reinvested in other deserving enterprises.

Since the objectives outlined above would promote the general public interest by promoting a publically desired pattern of economic growth, there should be no objection either to the fact that the state would be participating in the market process or to the fact that the direct money return on state funds would probably be less than could be earned on conventional investments.

As to methods of providing aid, I think the agency should be allowed to use whatever methods seem most appropriate in a given situation. In some instances, low cost loans would be adequate, in others, the agency could do the

most good by purchasing an equity interest, and in still others it might be desirable for the agency to acquire or construct facilities which could be rented or leased. Whatever the frame of reference within which the agency operates, it should be allowed as much flexibility as to method as possible.

QUESTION 5.: "In what other jurisdictions in which steps similar to those mentioned in question 4 above were taken to further local industrial development?"

ANSWER: I did not have time to make a survey of state activities in this field and am therefore not in a position to comment on the question as it is posed.

QUESTION 6.: "Should Hawaii create a State Credit Agency or should the Farm Loan Board's activities be augmented so as to aid businessmen as well as farmers?"

ANSWER: It appears to me that a credit agency would serve a useful purpose where it could be demonstrated that private agencies were failing to supply certain types of credit. However, if the major purpose of such an agency were in reality to promote development, it would be unfortunate to limit its activity to lending. As already indicated in answer to Question Four; the greater area of need is for equity capital or something equivalent thereto. Credit involves fixed obligations that must be met at specified times and lacks the flexibility that could be provided by other aids. }

On the other hand, whatever agency is charged with the promotion of development should be allowed to extend credit as well as provide other forms of aid. The more rigid the frame of reference of such an agency, the less it will be able to accomplish. I have a strong preference myself for direct subsidization, but there might be situations in which indirect subsidization by means of especially favorable credit terms would be desirable.

DEAL AND BANK
ONE-TERM REAL ESTATE LOANS

The Federal Land Bank, a privately owned cooperative, makes one-term real estate loans through local farm loan associations and ranchers in California, Arizona, Nevada, and a group of 12 privately owned land banks chartered in the United States.

Loans—Land Bank loans are designed to fit the needs of farmers and ranchers, including farming and livestock loans. Part-time farmers and ranchers, as well, are often dependable outside income is assured. Land Bank loans are secured by first liens on land and buildings and are made on a refinancing mortgage on farms and ranches; purchase and improve farm and ranch real estate; purchase livestock, equipment, and supplies; pay operating expenses, including feed and insurance; provide a home and family living expenses for the owner; pay any bona fide obligation of the owner; and meet other requirements of the owner who actually is engaged in farming or ranching.

Funds—Funds for lending are obtained through the investing public of land bank bonds, for which the 12 land banks jointly and severally are liable. Banks and security investors are the original purchasers, and through them individuals may purchase the bonds in denominations of \$100 to \$500. Three bonds are not guaranteed in any manner by the Government and the Government has no investment in the land banks.

Interest Rates—The Land Bank maintains the lowest possible interest rate consistent with sound business practices. The interest on new loans depends primarily on the interest rate which must pay for borrowed money.

How to Apply for a Loan—Application for a Land Bank loan may be made through the national farm loan association in the territory where the land to be offered as security is located. Association offices are conveniently located in the farming and ranching areas they serve.

FEDERAL INTERMEDIATE CREDIT BANK
SHORT-TERM OPERATING LOANS

It is the function of the Federal Intermediate Credit Bank of Berkeley to act as a bank of discount for primary lenders which are eligible to use its services.

Eligibility—Chartered in 1923 as one of 12 similar banks operating throughout the country, it is authorized to do business with cooperative production credit associations, agricultural credit corporations, livestock loan companies, commercial banks and trust companies.

Types of Loans—The bank is empowered to purchase notes representing short-term and intermediate-term credit extended for any general agricultural purpose to qualified farmers and stockmen, including partnerships and corporations principally engaged in farming. Most of the loans involved are made for production purposes on notes of one-year maturity. Funds advanced for semi-capital purposes may be loaned for maturities up to five years.

Source of Funds—As a wholesaler of credit the Berkeley bank brings funds from money markets of the nation to farmers and ranchers of the States of California, Arizona, Nevada, and Utah. Each month for the past 35 years the 12 intermediate credit banks have sold their debentures to the investing public, paying prevailing market rates. These securities are the joint and sole obligations of the 12 banks and are collateralized primarily by the notes of the farm operators who negotiate their loans with the lending institutions named above. The recent average yearly participation of the Berkeley bank in debenture sales has been \$91,935,000. Loans made during the same time have averaged \$224,877,781 annually.

Interest Rate—The interest rate charged by the bank varies from time to time to yield a small margin above the fluctuating cost of money the system is required to pay on its monthly offerings of securities in the market.

Capital Structure—The Berkeley bank is capitalized in the amount of \$8,694,420 with surplus of \$4,540,732. Where formerly this capital was owned solely by the United States Government, a program is now in operation under which ownership of the bank is being acquired by the production credit associations through purchase of the stock. Upon the completion of this purchase the last of the Government stock will have been repaid, thus converting the bank to the status of a cooperative. Thereafter the net earnings of the bank after provision for reserves will be distributed to the users of the bank's services in the form of dividends and percentage refunds.

BERKELEY BANK FOR COOPERATIVES
LOANS TO FARMER COOPERATIVES

The Berkeley Bank for Cooperatives is a bank of discount for cooperatives engaged in marketing farm products, farm supplies, or furnishing farm business services to members.

Eligibility—To be eligible to borrow from the Berkeley Bank for Cooperatives, the cooperative must operate for the mutual benefit of its members and at least 50% of the area must be done with farmer members. Loans must be made to members who have more than one vote or dividend or exceed 8%. At least 90% of the voting stock must be controlled by farmers.

Types of Loans—Loans are made to the members of a cooperative such as financing construction of facilities, providing operating capital to members and carrying inventories.

Interest Rates—Interest rates depend on the term of the loan and are set in accordance with the Federal Reserve Board's policy and fiscal planning percent interest in the period loan funds are outstanding.

Source of Funds—Loan funds are obtained from consolidated debentures of the 12 Banks for Cooperatives from other Farm Credit Banks and commercial banks; and by use of the Bank's own funds. A plan for cooperative stock investment was provided by the Farm Credit Administration in 1934. The plan provides for the purchase of one share of stock at par value of \$100, and make additional purchases of the new "C" stock at the rate of \$100 per share. The "A" stock provides for a Class "A" stock which cooperatives and others may purchase and on which dividends may be paid at rates not to exceed 6% per annum.

Earnings—The Bank's earnings are distributed each year as a percentage refund in the form of stock to the members of the new "C" stock issued in that year.

Operations of Cost—After retirement of the Government owned stock, full ownership will be in the hands of the cooperatives who have used its services. Capital stock of the Berkeley Bank for Cooperatives will then start accumulating in accordance with the Bank's fiscal plan. Thus, with all net margins and patron's and a revolving capital plan effective on the stock, the Bank's loans and services are provided to the members of the Bank for Cooperatives.



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UNIVERSITY OF HAWAII

HONOLULU 14, HAWAII

ECONOMIC RESEARCH CENTER

November 25, 1959

Representative Thomas P. Gill
Hawaii State Legislature
Iolani Palace
Honolulu, Hawaii

Dear Rep. Gill:

Let me first answer the specific points raised in your letter of November 10th. With respect to Rep. John C. Lanham's questions, only the first can be answered without intensive study which we do not presently have the personnel to undertake without postponing or abandoning the projects on which we are presently engaged. This first question asks why a Business Development Corporation has not come into being. Our answer would be that it has not come into being because it does not provide profit opportunities for participants equal to other profit opportunities available to them. We are very skeptical about the possibility that such a Corporation will ever come into being unless it is state-supported.

The other questions posed by Rep. Lanham are, as indicated above, simply beyond our capacity to answer on short notice or to answer at all with the presently limited facilities at our disposal.

Your own second question is whether there is a need for a credit development corporation in Hawaii. We can only answer this question conditionally unless we are allowed time and money for research of truly mammoth proportions. If small and medium sized businesses cannot obtain loans, the soundness of which can be clearly demonstrated, then such a corporation, financed by the state, might well serve a useful purpose. Or, if it is desired to subsidize small and medium sized businesses by loans of doubtful credit worthiness, then again such a state-financed corporation would be desirable. We cannot determine whether there is in fact economic discrimination against small and medium sized business without careful study which would require substantial amounts of both time and money. It is not our place, on the other hand, to decide whether subsidization of small and medium sized business is desirable; this is properly a matter for those responsible for over-all public policy.

Finally, you ask about the need for anti-monopoly legislation. We believe there is need for such legislation but that the form which it takes should be decided only after completion of careful study of the problem of monopoly at the state level. Because we agree that this is a critical problem, Dr. Frank Jackson has been pulled off his other projects to work

on this question now. He will work as quickly as possible and will try to have some suggestions by the time the legislative session in 1960 begins. However, there is no assurance that a complete answer can be provided on such short notice. The project can, on the other hand, certainly be completed before the 1961 General Session.

Having answered your specific questions as adequately as time and circumstances permit, I should like to take this opportunity to ask your help in resolving a problem which is becoming increasingly critical at the Economic Research Center. Our staff is so limited that we can work on only a small number of projects at any one time, and we have already taken on as many studies as we can handle with the funds and personnel at our disposal. Our problem, therefore, is how to deal with additional claims on our resources such as your own request.

The solution to this problem depends on what the legislature believes should be our primary area of responsibility. We can either engage in basic research on a limited number of projects or we can function as a source of information on specific questions as they arise. Without a vastly expanded staff we cannot do both. Our own belief is that we should concentrate on the former and leave informational and operational research to other agencies (the Legislative Reference Bureau and the State Planning Office).

We believe most strongly in the value of basic research and that this value has been clearly and repeatedly demonstrated. Private industry has come to recognize its importance and now provides those charged with it with a free hand, making use of the results as and where they are of value. That they have been of value is clearly indicated by the fact that industry has poured increasing amounts of funds into such research and has explicitly rejected the position it once took that basic research was "impractical."

Basic research is possible, however, only under rather special conditions. Those engaged in such research must be free of partisan pressure either concerning the projects undertaken or the results of such projects. The projects themselves will inevitably be of a controversial nature, but the obligation of the researchers is to remain as objective as possible and to produce results which are capable of substantiation. After sufficient time has passed for legislative evaluation of the results of such research, if it is felt that objectivity is lacking, the Center should legitimately be charged with failure to perform its duties properly. Time must be allowed, however, since basic research cannot be quickly done nor can the value of such research be determined on the basis of one or a few projects.

If you and others in positions of legislative responsibility feel that our proper function is something other than basic research as described above, then we will, of course, adapt our activities to conform with your wishes. If this is to be done, however, two problems confront us. First of all, we need to establish some sort of formal relationship with the legislature so that priorities can be established. Our staff consists of

November 25, 1959

three professional research personnel, only two of whom are available on a full-time basis. We cannot in the very nature of things handle all the requests that come to us, yet we feel we are in a poor position to take it upon ourselves to determine which requests shall be given precedence. With an expanded staff, we could, of course, do more, but this same problem of priorities would always exist.

We respectfully request your help with this problem. We recognize our obligation to those who helped make the Center possible and wish to serve them in every way we can. At the same time, we hope you will recognize our present dilemma and that you will give serious consideration to our views on the proper function we should discharge.

Respectfully yours,

A handwritten signature in cursive script that reads "Daniel M. Slate". The signature is written in dark ink and is positioned to the left of a large, decorative flourish that extends from the right side of the signature area.

DANIEL M. SLATE
Acting Director

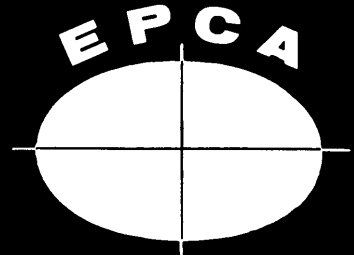
cc: Rep. Donald Ching
Rep. John Lanham

TURNING POINTS

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Number 3

November 8, 1956

DEVELOPMENT CREDIT CORPORATIONS

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WHAT ARE DEVELOPMENT CREDIT CORPORATIONS?

Development credit corporations are a product of New England "Yankee" ingenuity. Essentially, the idea is to make available medium and long-term credit and equity capital to small and medium-size businesses by establishing a privately financed corporation through enabling legislation. The first such organization to be established was the Maine Development Credit Corporation which began operating in 1950. This idea has spread so that at present, not only do all six New England States have credit corporations, but other states such as Kansas, New York, Florida, North Carolina, Michigan and Wisconsin have also established them.

* * * * *

HOW ARE THEY FINANCED?

There is one essential characteristic of all the development credit corporations studied and that is that they are privately financed and operated.

Initially, the credit corporation begins with a capital stock base. This stock is purchased by private individuals and companies and is used primarily as a reserve against losses. The principal lending or investing power of the development credit corporation is obtained by a pooling of funds from existing financial institutions. These include commercial banks, savings banks, trust companies, building and loan associations and insurance companies.

Any financial institution that becomes a member must agree to lend funds to the credit corporation at its call up to a maximum of 2.5 per cent of its own capital and surplus or its equivalent.

Several of the corporations pay a low interest rate to their members, commonly two per cent, under the theory that lending institutions obtain indirect benefits as the community prospers. On the other hand, one credit corporation pays the prime

rate in New York City and another one-fourth per cent over, on the theory that an institution should become a member because it is making a sound investment.

* * * * *

HOW ARE THEY ORGANIZED?

The organization of development credit corporations have generally followed the same procedure.

First, sponsors of the corporation held informal discussions of the need for such a privately owned and managed lending agency and delineated its purposes and objectives. Only after obtaining assurance of support from substantial groups of financial institutions with regard to becoming members and from business firms and individuals who would become stockholders, did they ask the state legislature to pass a special act chartering the credit corporation.

They have been chartered under special legislation in order to make it legal for state-chartered financial institutions, public utilities and others to participate as members; it makes stock of the corporation a "legal investment" for certain types of fiduciaries who otherwise could not buy the stock; and the public is educated to the purposes of the corporation and clear support of the legislative and executive branches is obtained for the program.

* * * * *

HOW ARE LOANS MADE?

The credit corporations may lend to or invest money in any business which is or plans to be located within the state. No loan is made which can be taken by another financial institution. Generally, most loans have been restricted to concerns engaged in manufacturing, processing, fabricating, or assembling operations on the premise that industrial payrolls create the most jobs and greatest income.

The interest rate charged for most loans made is six per cent. Some of the corporations make a one per cent service charge to cover the costs of processing the loan. All loans made call for periodic repayment, most commonly on a monthly basis.

* * * * *

WHAT IS THE EXTENT OF
THEIR LOAN ACTIVITIES?

Since the beginning of their operations and up to June 30, 1956, the six New England development credit corporations have made 214 loans for a total of \$13,627,816. Over this period, 460 applications for a total of \$20,086,668 were rejected. The cumulative total of losses incurred by all of the New England development credit corporations is \$8,346. Fourteen loans have been made for new business enterprises, 166 for businesses already established in the state, and 24 loans for businesses relocating from other states.

* * * * *

WHAT ARE THE ADVANTAGES OF
A DEVELOPMENT CREDIT
CORPORATION?

There are three principal reasons why such an organization can contribute to the solution of the credit difficulties of small business.

1. Capitalization: The ratio of equity to debt of \$1 to \$8, as in the Massachusetts corporation, or \$1 to \$10 as in the other credit corporations, cannot be matched by a conventional corporation.
2. Pooling of Funds: Member banks are willing to participate because the amount involved to any one bank is insignificant in proportion to the bank's resources.
3. Expense Ratio: The development credit corporation is able to operate at an expense ratio inconceivable to any conventional corporation because loans are primarily serviced by the banks, and its directors are willing to devote their services without compensation.