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# 1. Summary of Findings

THE USE OF CONSUMER CREDIT has grown markedly over the past half century, and particularly in recent decades. Accompanying this growth has been increasing interest in consumer credit problems. This study is concerned with one of these problems, i.e., providing finance charge (credit price) information to consumers.

It describes the methods which financing agencies and sellers use in computing finance charges and in quoting these charges to consumers; assesses the uses of the various types of finance charge information now available to consumers; discusses procedures and problems in converting various types of finance charge information to any given form; and reviews existing empirical evidence on the extent of consumer knowledge of finance charges in dollars, as computational rates and as effective annual rates.

The major conclusions are the following.

1. Three general methods of computing finance charges grew out of the varied arrangements which financing agencies and sellers constructed to provide credit to consumers under charges which, if construed as interest, were substantially above ceiling rates permissible under usury laws:
  - a. Per cent per month method—developed before World War I under special (mainly remedial, credit union, and small-loan) laws exempting specified instalment cash loans from the usury laws.
  - b. Discount method—developed just before World War I under a combined legal loan-hypothecated savings account repayment system which was generally upheld by courts as not usurious; later written in a more direct and simplified form as industrial loan laws (governing cash lending by industrial

banks) and instalment loan laws (governing consumer cash lending by commercial banks).

- c. Add-on method—developed under the common-law time-price doctrine which makes it legally permissible for a seller to have a “cash price” and a “time price” for a good or service, the differential between the two prices not being considered interest subject to usury. The credit charge was “added on” to the cash price to obtain a time price which was to be repaid under the terms of the credit contract.
2. Disclosure of finance charge information to borrowers varies depending on the legislative requirements and voluntary practices of financing agencies and sellers. Of the various types of consumer financing laws, only small-loan laws and retail instalment financing laws have disclosure requirements. Small-loan laws generally require consumer finance (small-loan) companies to disclose rates of charge to borrowers, usually in the form of per cent per month rates. Retail instalment financing laws, enacted by most states since 1935, normally require sellers to disclose to buyers the finance charge in dollars.
3. Financing agencies and sellers vary in their voluntary disclosure of finance charges to borrowers, either in dollars or as rates of charge. Court decisions have influenced disclosure practices by preventing the advertising of rates of charge which might be confused with rates representing simple interest. As a result, some financing agencies and sellers advertise rates of charge as “dollars per hundred” rather than as a corresponding percentage rate.
4. The result of the varying disclosure practices is that consumers do not obtain easily comparable information from alternative suppliers of credit. Some suppliers give consumers information about finance charges in dollars; some give multiple per cent per month rates on outstanding balances; some give multiple annual rates on amounts borrowed; some give single rates of charge in the form of “dollars per hundred” on amounts borrowed (computational equivalents); and some (relatively few) give both rates of charge and dollar charges. Credit unions often give monthly effective rates of charge computed on outstanding

balances in their contracts and sometimes quote annual effective rates orally. Virtually all credit sources, of course, give consumers payment information, i.e., the number of instalment payments and the size of each payment.

5. A review of the mathematics required to convert dollar charges to effective (compound) monthly and annual rates suggests that most credit purchasers would be either unable or unwilling to make these calculations. Similarly, they would be either unable or unwilling to convert computational rate information (i.e., rates used to compute the finance charge, generally applied to the original balance) to effective rates, using any but the simplest conversion formulas.
6. For consumers to make effective comparisons of alternative credit opportunities, ideally they need to know:
  - a. The dollar amount of finance charges.
  - b. The size and number of monthly payments.
  - c. The computational rate(s) used to calculate finance charges.
  - d. The effective finance rate together with the compounding interval used in its computation.

Each of these forms of information contributes to certain comparisons of credit alternatives. None, by itself, can serve effectively as a single criterion because each one applies only to some aspect of credit decisions.

7. A review of empirical studies on the extent of borrowers' information about finance charges indicates that:
  - a. Consumers have little knowledge of the level of charges or rates, when asked about their most recent instalment purchase or loan. Information about dollar charge is more frequently found among lower-income groups and information about finance rates among higher-income groups.
  - b. Consumers consistently underestimate the finance rate actually paid, and the extent of understatement tends to be greater the higher the rate. However, the fact that both estimated and actual rates vary together implies that rate knowledge, although small, is not wholly absent.
  - c. More consumers appear to know the computational rate than the effective annual rate, the former being much the lower

figure. Only 18 per cent of a subsample of credit users in the Consumers Union-National Bureau 1960 survey gave a reasonably accurate estimate of either the computational rate or the effective annual rate. About 7 per cent were able to approximate the effective annual rate actually paid, while about 11 per cent gave a figure close to the authors' estimate of the computational rate.

- d. Most borrowers do not appear to be sensitive to changes in finance rates, although those with substantial liquid assets, higher incomes, and unfavorable attitude toward debt are more apt to be than those with few liquid assets, lower incomes, and a favorable attitude toward debt.
8. The preceding findings reveal that a great variety of useful information is given consumers, but the variety precludes any easy comparison of many kinds of credit alternatives. The merits and limitations of the relevant types of finance charge information can be summarized as follows:
- a. *Dollar charge and monthly payment* information have definite advantages for comparisons among credit transactions with the same maturity, especially for goods with different prices and different finance charges. They have definite limitations for comparisons among transactions with different maturities and when the use of liquid assets in place of borrowing is possible.
  - b. *Computational rates*, normally expressed on a per annum basis, facilitate comparison of credit costs for alternative maturities *provided such rates are all cast in the same form*. Different forms of computational rates are only roughly comparable at best. For comparison with yields on liquid assets, computational rates need to be converted to effective annual rates.
  - c. *Effective rates*, whether computed from dollar charges or from a computational rate, are cumbersome to calculate on an actuarial or annuity basis. It is likely that some substitute formula that would be easier to use, such as the direct-ratio or constant-ratio formula, would offer a more convenient means of approximating the actuarially correct rate. Rate

tables or charts based on any of these formulas represent a further short cut in determining finance rates. Whether computed with an annuity or approximate formula or a rate chart, an effective rate provides the most accurate comparison of credit transactions that have different maturities or involve a choice between liquidating assets and borrowing. Effective rate comparisons should, however, be used with caution whenever they involve short-maturity instalment contracts for small amounts or when the same commodity, e.g., a new car, may be purchased at different prices.