

The Costs of Consumer Credit Regulation

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Richard L. Peterson
Research Scholar
Credit Research Center
Krannert Graduate School of Management
Purdue University

The recent growth in regulation of commercial bank consumer lending has generally been of three major types. First, there are regulations designed to inform consumers - such as the Truth-in-Lending, Real Estate Settlement Practices and Federal Consumer Leasing Acts. Second, regulations exist designed to "protect" consumers. These include state consumer loan rate ceilings, restrictions on remedies creditors can use to collect on delinquent and defaulted debts, and "fair-credit-billing" regulations. Third, are regulations designed to affect the way that credit is allocated. Examples are the Equal Credit Opportunity and Community Reinvestment Acts.

Compliance with all these acts and their implementing regulations imposes a number of costs on commercial banks. It is the purpose of this article to analyze the nature of costs imposed on commercial banks by various consumer credit regulations, discuss the issue of who ultimately bears the costs associated with such regulation and assess, where possible, the magnitude of the costs associated with consumer credit regulation.

Costs Associated with Consumer Credit Regulation

Costs associated with consumer credit regulation can be characterized either as direct compliance costs or as indirect compliance costs caused by efficiency losses. Both categories of costs are discussed in detail below.

Direct compliance costs include costs associated with developing, implementing and operating loan application, processing, granting and collection procedures that are in compliance with applicable laws and regulations. They include 1) the use of managerial and legal resources to devise consumer credit operating procedures that will be in compliance with the new regulations, 2) the development of new forms and discarding of obsolete forms (whose use could give rise to costly lawsuits or penalties -up to \$ 10, 000 per violation if inappropriate forms are used to comply with the Equal Credit Opportunity Act. see Smith [9]); 3) the training of personnel in the procedures needed to comply with the new regulations and, relatedly, the hiring of better educated or better qualified credit personnel at higher rates to ensure that inadvertent mistakes that might lead to costly lawsuits will be less likely to occur; 4) revisions in computer procedures and adjustments in computer operating costs to allow new, different or restricted sets of information to be processed and stored; and 5) costs associated with compiling and keeping compliance records in the appropriate manner required by examiners, management or the law.

The last category of costs can be substantial since, for example, the Equal Credit Opportunity Act requires that all loan application records be stored for up to 25 months and also prohibits the collection and use of certain information in making credit evaluations. Further, Regulation C and the implementing regulations for the Community Reinvestment Act (CRA) require that loan records, especially mortgage loan records, be identified and compiled by geographic region. CRA also requires that examiners and management not only have access to such information, but also must review it periodically. Thus, not only must new data be collected but it must be stored and compiled in specific ways.

Other direct costs of regulation include altered costs of collection efforts, litigation, loan losses, penalties or adverse legal judgments rendered under the new regulatory regime. Some of these costs can be quite substantial. Not only are potential penalties imposed under certain acts but also potentially large legal costs of defense against lawsuits. These all add additional costs to creditors. Further, some consumer credit protection acts are so complicated that technically perfect compliance with the acts is all but impossible. For instance, one lawyer used to proclaim that he could find at least one technical Truth-in-Lending violation in any consumer loan contract that was sufficient to invalidate the contract. Such problems are obviously widespread as nearly 2,000 Truth-in-Lending suits per year are filed in Federal courts. Those numbers do not include Truth-in-Lending violation claims that may be filed in state courts, bankruptcy proceedings or cases settled out of court.

Additional direct costs of consumer credit regulation can include increased collection costs or losses. This could result if relatively more bad loans were made because of geographic restrictions imposed by the Community Reinvestment Act. It also could result if prohibitions or restrictions are imposed on remedies creditors can use to collect on delinquent or defaulted debts - such as restrictions on a creditors' ability to take wage assignments, garnish wages, repossess collateral, sue for deficiency judgements, collect attorney's fees if a debtor must be sued to make him pay, etc.

Indirect Costs of Compliance

Indirect costs associated with consumer credit regulations show up in the form of efficiency losses, i.e., either less product is produced per worker hour as a result of the regulation, or else a lower quality product is produced. A good example of a regulation that imposes such costs is the Equal Credit Opportunity Act (ECOA). That Act prohibits the collection of certain "sensitive" information from credit applicants unless the information is used for statistically sound affirmative action purposes. While it has been estimated that not having access to information banned under ECOA would cause creditors to make credit judgments that are 2% less efficient than would otherwise be the case (see Shinkel [8]), except for the very largest creditors, such an efficiency loss does not translate into a sufficiently large monetary loss to make it worthwhile to develop a statistically sound affirmative action program. Thus, most creditors must make their credit judgments with less information, and suffer a loss in credit-screening efficiency, with an attendant increase in losses or decrease in credit revenues as a result. The loss in efficiency may even harm those whom the Act was designed to help (see Chandler and Ewert [3]).

Additional efficiency losses result less directly from ECOA. Because ECOA requires that credit applicants be given formal reasons for their credit rejection, if requested by the applicants, banks report that they "face-screen" fewer applicants. Instead of politely turning away an applicant who clearly will not qualify for a loan without taking a formal application, many banks take a formal credit application and process it completely (at significantly greater expense) in order to obtain formal reasons for rejection and comply with all equal treatment mandates. The taking and processing of more formal applications is more costly and generally does not produce additional output. Thus, operating efficiency is lost.

Related to the problem of providing more formal review of credit applications is the need for banks under ECOA (Regulation B), Regulation C, Regulation Z, the Community Reinvestment Act and applicable state regulations to keep records or past credit applications that can be checked by examiners to assess compliance with the acts. Completing and filing such records takes time that could be used for other purposes. Management review of such records may be quite expensive. Yet such actions produce no new products and thus generate efficiency losses (it costs more to produce the same product, i.e., number of loans) within the bank.

Reductions in remedies available to banks to collect on defaulted debts reduce debt collection efficiency. For instance, it appears that customers pay their bank debts more reliably in states where banks can assess attorney's fees against defaulting debtors. This likely occurs because in such states debtors have a greater incentive to refinance their debts or liquidate assets rather than fall behind in their debts and be sued for their debt plus attorney's fees.

Finally, to ensure compliance with consumer credit regulations, a large number of lawyers and bank examiners must be trained to check for potential violations. Most are funded through public institutions, but some make their living by collecting from creditors in private lawsuits, especially class-action suits where total judgments may be huge. The cost of supporting the regulatory apparatus must be paid out of the public till - either through an increase in the general tax burden (which would affect all banks subject to tax) or through special fees or charges assessed banks. Such assessments could come directly through chartering fees or taxes or, more likely, indirectly, through the taking of non-interest bearing reserves or "deposit-insurance" premiums. To the extent that these charges must be paid, they too represent an "indirect cost" of bank consumer credit regulation.

Who Bears the Cost of Regulation?

In the short-run, commercial banks and taxpayers bear the costs of consumer credit regulation and enforcement. In the longer-run, the costs of regulation are passed on to consumers in one way or another. Bank management's who find consumer loan activities more costly, less efficient and, therefore, less profitable to operate will either curtail such operations and divert their capital to more profitable operations or else take steps to increase the profitability of their consumer loan operations. Profit increasing

steps would likely include either raising consumer loan charges or reducing credit losses by rationing credit only to the best credit risks among their consumer loan applicants¹.

As a result, in the long run, consumers will either have to pay more to obtain credit in the more highly regulated environment or, in many cases, will be forced to do without goods that they might want to finance because they can no longer obtain credit.

Further, to the extent that taxes or fees are raised to support the additional regulatory apparatus, either institutions will raise fees and charges to restore profitability, withdraw capital from the industries most affected by the increased taxes and fees (if possible) or find that lower profits reduce the return to shareholders. Individuals who pay higher taxes, as well as individuals who pay higher fees or charges to financial institutions will find their total income reduced. Shareholders in institutions that experience profit reductions that cannot be passed on will find their wealth reduced.

Evidence on the Costs of Consumer Credit Regulation

Only limited evidence exists on the direct costs of complying with consumer credit regulations. Three studies have been conducted by employees of the Federal Reserve System on prospective and actual costs of compliance with ECOA and/or the Fair Credit Billing Act. One conducted by employees of the Philadelphia Federal Reserve Bank in early 1976 (See Rubenstein [7]) investigated prospective costs of compliance with the Fair Credit Billing and, more specifically, the Equal Credit Opportunity Act. That study surveyed five New Jersey banks varying in size from approximately \$40 million to \$500 million in total assets. Based on the available data, and not all necessary data were available, the Philadelphia Federal Reserve Bank staff estimated that bank costs would increase by an amount equal to approximately 0.1% of the consumer loan portfolio (or 10 basis points per dollar of consumer credit outstanding). If the regulation-imposed costs were not passed on to consumers, but rather were fully absorbed by shareholders, they estimated that bank profits would be reduced by 2.1 to 7.6 cents per share.

In the second study conducted by Federal Reserve personnel, James Smith [9] focussed on the potential costs of Regulation B (the implementing regulation of ECOA). He calculated that the non-recurring costs of implementing the regulation were, at a minimum, \$166 million in total. According to his calculations \$35 million of those costs would be borne by commercial banks. In addition, he calculated that recurring costs of \$128 million would be incurred during the first year of the regulation, and that \$25 million of those costs would fall on commercial banks. The latter category of costs would not be static, however, as it could be expected to grow with inflation and growth in consumer loan activities. Smith's cost estimates suggest that consumer credit costs would rise by nearly 0.2% relative to the total amount of consumer credit outstanding in the first year and by approximately 0.1% in succeeding years.

The third Federal Reserve study (See Board of Governors [2]) was less instructive, as it reported on incomplete compliance cost data obtained from only three banks: Bank of America, The First National Bank of Chicago and Maryland National Bank. Itemized costs related to ECOA included only direct costs (but not related

¹ Dunkelberg [4] found evidence that banks restricted credit availability after the Wisconsin Consumer Act effectively limited a number of remedies available to them.

overhead and administrative costs) associated with notifying all customers that they could have credit accounts reported in both the husband's and wife's names, the cost of changing accounts to dual reporting status, the extra cost of maintaining a dual credit reporting system, the costs of providing information on reasons for rejection to rejected credit applicants, and (under Fair Credit Billing requirements) the costs of mailing notices to revolving credit customers that they could formally challenge presumed billing errors. The three banks reported direct costs of \$118,000 (or 2-1/2 cents per account) to mail out notices to all accounts plus costs of \$140,000 (or roughly \$0.30 per new account) to establish separate credit records for husbands and wives. In addition, their annual cost of reporting new dual account data was between 11 and 12 cents per account.

The cost of "adverse action" notices explaining reasons for loan turn-downs varied widely from 60 cents each, when they were automatically supplied to all rejected credit applicants, to \$4.14 each when they were supplied individually upon the request of rejected applicants. The direct incremental costs of billing error adjustment statements were not directly ascertainable as all three banks printed them on each monthly statement. If monthly statements were made larger as a result, this could have displaced some advertising, and the revenues it generates.

Overall, these studies indicate that ECOA and Fair Credit Billing regulations increase the costs of processing, obtaining and maintaining consumer credit accounts. If the costs of ECOA and Fair Credit Billing were all to be passed on directly to bank consumer borrowers, they would have to pay 10 to 25 basis points additional interest on consumer credit balances for the bank to break even.

Consumer credit protection law cost studies have also been conducted on laws that limit consumers' abilities to collect on delinquent or defaulted debts. In the study that pertains most directly to commercial banks, Peterson [5] found that if creditor remedies were restricted to the levels prevailing in the six most restrictive states, rates on commercial bank direct automobile loans would rise by approximately 40 basis points. Thus, if creditor remedies were equally restricted on a national level the total costs of consumer automobile credit would rise by approximately \$200 million per year at commercial banks alone, and by \$300 million per year or more at all creditors. Loan rates would probably rise by more at non-bank creditors than at banks because other creditors serve riskier customers who would likely pose greater risks of loss if remedies were restricted.

For instance, Barth and Yezer [1] have found that finance company personal loan rates would likely rise by several percentage points if creditor remedies were restricted to the levels recommended by the Federal Trade Commission (FTC) in a proposed Trade Regulation Rule². In contrast, Peterson [5] found that bank personal loan rates would rise by close to 1 % if certain restrictions were placed on creditors' abilities to collect on personal loans, as proposed by the FTC. Peterson went on to calculate that such restrictions could add approximately \$30 million more to customer finance charges on bank personal loans and, at the very least (assuming non-bank lending institutions were affected like banks), \$ 100 million per year to borrower finance charges on all personal loans outstanding. If, in fact, non-bank institutions were affected like finance companies, the total cost increase could be substantially larger.

² Barth and Yezer [1] noted, however, that a significant portion of the Increase in loan rates would result from increased demand for credit by finance company customers if creditors remedies were reduced or eliminated. Nonetheless, they found that at least 1% of the increase in rates could be ascribed to a reduction in creditor willingness to supply credit in a weak-remedy environment.

Conclusions

Overall, the evidence suggests that the costs of consumer credit regulations are very substantial. Cost studies show that individual regulations may add from 0.1% to 1% or more to the cost of consumer credit operations. Since banks provide the lion's share of consumer credit in this country, they will initially bear most of the costs of regulation. However, since all creditors' cost will be increased, banks likely will be able to pass on most of the increase in costs to consumers, or else bankers would likely divert their funds to more profitable areas.

The cumulative effect of consumer credit regulation is likely to be to raise finance charges on consumer credit by as little as 10 to more than 100 basis points, which will likely cost consumers in the aggregate at least \$2 billion per year. Consumers may bear the cost either in the form of increased finance charges or increased goods costs (since some regulatory costs may be passed on through increased merchant discounts and goods prices rather than increased finance charges *per se*). Additional costs will be borne in the form of increased taxes, goods prices and fees needed to support the private (attorney's and other individuals who profit from bringing suits under the acts) and public regulatory superstructures given powers to enforce compliance with various consumer credit legislation.

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