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Creditor Remedy Restrictions
and Interstate Differences in Personal Loan Rates
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Creditor Remedy Restrictions and Interstate Differences in Personal Loan Rates and Availability: A Supplementary Analysis

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Synopsis:

This study first reviews the 1971 NCCF findings on the economic impact of creditors' remedies.¹ Then it develops an alternative model of the personal loan markets that recognizes that competition may occur among credit unions, banks, and finance companies as well as among members of each group. It uses the NCCF study data to determine what impact creditors' remedies have in the-alternative model. Finally, it summarizes the similarities and differences in the findings of the two studies.

Overall, the findings are highly similar. Both studies suggest that many restrictions on creditor remedies are likely to reduce personal loan credit availability (per capita) and, to a lesser extent, increase personal loan finance rates. In particular, both studies found evidence that prohibitions against attorney's fee clauses were significantly associated with reductions in finance company personal loan credit and that restrictions on wage assignments reduced credit union credit. In supplementary studies of personal loan extensions, Greer also found that wage assignment restrictions were associated with reduced commercial bank and credit union personal loan extensions and that restrictions on garnishment significantly affected the price and availability of consumer credit. Using data on consumer loan outstandings, this study reinforced the garnishment results by indicating that restrictions on garnishment significantly reduced finance company and commercial bank credit outstandings per capita, and that prohibitions against garnishment were associated with significantly elevated finance company personal loan rates.

In contrast with the NCCF study, however, this study also found that restrictions or prohibitions on "confession of judgment" clauses in loan contracts were significantly associated with reduced credit availability and increased loan rates at finance companies and commercial banks. This divergent finding may result from the fact that this study (i) used stepwise regression techniques to eliminate some collinearity among variables, and (ii) controlled for the influence of personal loan extensions by other creditors on each segment of the personal loan market under investigation.

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¹ For example, in recent years consumer finance companies have experienced declining profitability in their consumer lending relative to their corporate lending operations--as money costs have risen in relation to consumer loan rate ceilings. Probably as a consequence of this fact, finance companies have expanded their business lending relative to their consumer lending operations in recent years.

Creditor Remedy Restrictions and Interstate Differences in Personal Loan Rates and Availability: A Supplementary Analysis

I. Overview

Individual states have enacted various restrictions on the remedies that creditors can use to collect on defaulted debts. The purpose of the remedy restrictions is to spare defaulting debtors from possibly harsh collection practices. However, creditor remedy restrictions also make it more difficult for creditors to avoid losses or recoup costs associated with collecting on delinquent or defaulted debts. In addition, insofar as the potential exercise of certain remedies by creditors serves as a deterrent to consumers contemplating default, the abolition of those remedies may also lead to an increased rate of default on outstanding loans. Thus, the abolition of certain creditor remedies can be expected to increase creditor collection costs, increase gross losses, or reduce recoveries on delinquent or defaulted debts. If such effects have a significant effect on creditor profits they will either induce creditors to withdraw from the affected consumer credit markets (as creditors shift their capital elsewhere to earn a more profitable rate of return) or to take actions to restore their profitability. Such actions could include raising loan rates (to increase net revenues to offset increasing costs and losses) or rationing credit to the most credit worthy customers (thereby obviating the potential need to incur collection costs and losses). Increased loan rates would be possible only where legal rate ceilings and the competitive environment were permissive. Theoretically increased rates would cause the total volume of loans demanded to fall.² Withdrawal from the market, or increased rationing of credit to the best-risk customers would also tend to cause the total volume of loans extended to fall.

Therefore, restrictions on the use of creditor remedies that have an important effect on the profitability of creditors will tend to cause the volume of credit extended by those creditors to fall and, possibly, the rate charges on such credit to rise.

The first comprehensive study of the impact of creditors' remedy restrictions on the consumer credit markets was conducted by the National Commission on Consumer Finance in 1971. In NCCF Technical Study V, Greer (1) conducted a number of empirical tests in an attempt to determine whether particular remedy restrictions affected the price or availability of particular types of credit extended by various lenders. Because of collinearity between the remedy variables and other variables that he used in his regression analysis, his results for particular remedies were not necessarily uniform--but varied with the exact specification of the equations that he estimated in the NCCF studies.

In this paper, we first summarize the empirical results that Greer obtained by noting the remedy effects that he found that could be judged to be statistically "significant" in one or more equation. Next, we develop and estimate a set of alternative regression equations applicable to the personal loan market--using stepwise regression techniques and a slightly different formulation of the initial regression equations than Greer used. The major difference in our formulation and that of Greer, is that we attempted to control for possible cross-industry effects on the volume of personal loans extended by particular industry groups, and he did not. However, the same database was used in both studies. Finally, we compare the empirical results that we obtained with those obtained by Greer. In conclusion, we find a substantial area of agreement between the two studies--which helps document the proposition that creditor remedy restrictions affect the availability and/or price of consumer loans.

² Elementary economic theory predicts that as the marginal cost curve of a firm rises, if it faces a downsloping demand curve, it will raise prices and reduce output.

II. Summary of NCCF Results on Creditors' Remedies: Study V: Chapter 4: "An Appraisal of Legal Sanctions."

A number of empirical tests on the effect of creditors' remedies were reported by Greer in NCCF Technical Study V, Chapter 4 (1). In that chapter, he examined cross-section regression results of the effect of creditor remedy restrictions on credit rates and credit extensions during the second quarter of 1971. He analyzed the "personal loan market," consisting of finance companies, credit unions, and commercial banks, and the "other consumer goods market," consisting of retailer extensions, finance company and bank purchased paper, and commercial bank and credit union direct extensions. Findings relating to dummy variables for creditors remedies are summarized below for those remedies having t-statistics significant at the .10 level ($t \geq 1.68$, for two-tailed tests.)³

Attorneys' fee prohibitions. These prevent creditors from collecting an allowance to cover their attorney's fees associated with collecting on defaulted debts. In Greer's equations, prohibitions on their use were found to have a significant effect in explaining the number of personal loans (per thousand families) extended by finance companies.

Wage assignment restrictions. Wage assignments allow creditors to obtain agreements from borrowers that allow them to collect a portion of the consumer's wages (without a court hearing) if the consumer becomes delinquent in his debt payments. In Greer's study, restrictions (but not prohibitions) on the use of wage assignments were found significant in explaining the number of personal loans per thousand families extended by credit union. Wage assignment restrictions, were also found significant in explaining commercial bank and credit union direct installment credit extensions. Wage assignments are evidently important to credit unions because of their usual close association with employers.

Garnishment prohibitions. Garnishment proceedings allow creditors to collect a portion of a delinquent debtor's wages after receiving approval in a court hearing. Prohibitions on garnishment were found significant in explaining the number of personal loans per thousand families extended by finance companies.

Garnishment restrictions. Garnishment restrictions were found significant in explaining the dollar volume of finance company personal loan extensions per family. They were also found significant in explaining the difference between average rate ceilings under the small loan law and the unweighted state average interest rate on finance company personal loans. Thus, restrictions on garnishment apparently-caused finance companies to charge rates significantly closer to legal rate ceilings.

Holder-in Due Course-And Waiver of Buyer Defenses. These allow secondary market purchasers of consumer paper to collect on defaulted debts as though they were the issuer of the debt regardless of consumer claims against the issuer. If both were prohibited, the dollar value of installment credit extended per family at retailers was found to be significantly reduced.

III. Additional Studies of the Personal Loan Market

Because personal loans tend to be higher risk than many other forms of consumer credit, and thus might be more sensitive to remedy restrictions, we used the NCCF data base on personal loans both to determine if Greer's results could be validated using a different model of the consumer financial markets, and to see if any new findings might result from the use of a different model of the consumer loan markets.

The main reason an alternative model was developed was because Smith (in work that he conducted for the NCCF (4)) found significant interactions between different industry groups in the personal loan markets.

³ A 90 percent (two-tailed) level of significance has been used in this summary because high collinearity in the study tended to increase the estimated standard errors associated with individual variables.

Since, Greer's study ignored the effect of industry groups not under consideration on the basic demand for loans for the industry group under consideration, it was felt that his model might be misspecified.

In the alternative models that we developed, we hypothesized that credit availability by a particular industry group would be affected by:

- (i) actual rates of charge and/or applicable rate ceilings
- (ii) the competitive milieu--as indicated both by concentration ratios in the industry under consideration and by competitive pressures (measured by market shares) emanating from other types of lending institutions,
- (iii) specific regulatory factors, such as loan size limits, that might affect credit availability by particular creditors, and creditor remedy restrictions.

The impact of restrictions on creditors' remedies on personal loan markets might be twofold. To the extent that they increase creditors' costs and/or losses, they will induce creditors to raise loan rates (where that is feasible) or reduce credit availability (particularly to higher-risk borrowers). Creditors would take such actions in order to reduce (or recover) incremental costs or losses generated by the remedy restrictions. If they couldn't restore their profitability to adequate levels either way, they would withdraw from the market. Insofar as-remedy restrictions changed all creditors willingness to extend credit, they would reduce credit availability by all lenders. In addition, insofar as the remedy restrictions impacted more severely on credit extended by one lender group, they would disproportionately reduce credit availability by that group. In both cases, other things being equal, the amount of credit outstanding or extended (per capita) by members of that group would be expected to fall as the affected creditors variously raised rates, reduced credit availability to their highest risk customers, or withdrew from the market.

Thus, for each major lender group outstanding personal loans per capita were used as dependent variables in the credit availability equations.

Since it was hypothesized that creditor remedy restrictions might affect finance rates as well as credit availability, tests were also run on creditor finance rates in various states. In these tests it was hypothesized that finance rates on credit would likely be affected by:

- (i) rate ceilings
- (ii) competition--as indicated both by concentration ratios within an industry and by the share of the market accounted for by the industry's competitors, and
- (iii) specific regulatory factors--including creditors' remedies, loan size limits, and so forth, as discussed above.

Statewide aggregate data on outstanding personal loan credit per capita for finance companies, banks, and credit unions were obtained from the NCCF database. In addition, data on bank and finance company personal loan rates and 4-firm concentration ratios were obtained from the NCCF Technical Studies, compiled by Schober and Shay (3). Data on finance company loan rate ceilings and loan size limits in each state were also obtained from that study. Finally, dummy variables that reflected the stringency of various creditors' remedies in various states were obtained from the NCCF data based compiled and used by Greer (1).

Empirical Tests:

Table 1 summarizes the results of the empirical tests conducted with the NCCF data described above. The variables used are defined in the margin. Their relation to the hypotheses set forth above should be obvious. The only variables not previously discussed are the "confession of judgment" restriction and prohibition variables. "Confession of judgment" is a collection device that allows creditors to insert a clause in a loan contract in which the consumer signs away his right to obtain a legal hearing before the creditor can institute legal collection remedies in the event of default on a loan. The "confession of judgment" dummy variables note whether such clauses are prohibited outright, or restricted in their comprehensiveness of applicability in various states. Use of confession of judgment clauses is procedurally restricted by Supreme Court rulings, yet they are still used in the limited number of states where state law is permissive.

The tests indicated that restrictions on creditors' remedies had a significant impact on loan rates and availability. By estimating the equations first without and then with the dummy variables for remedy restrictions included, it was found that the explanatory power of every equation estimated was increased substantially by the inclusion of the creditor remedy dummy variables.

A number of individual creditors' remedy restriction variables contributed substantially to the explanatory power of the equations regardless of their formulation. Because of collinearity which occurred primarily because remedy restrictions tend to come in clusters--i.e., a state that restricts one remedy is more likely to restrict another as well, and vice versa--the standard deviations associated with the remedy restriction variables were often inflated when all remedies were considered simultaneously. This artificially reduced the statistical significance of individual remedy variables unless some redundant variables were eliminated. Thus, stepwise regression procedures were used to eliminate the least important variables in the several equations. As a result, not all variables appear in each equation. In the case of the finance company equations, however, no change occurred in the relative significance of the most important creditor remedy variables when some of them were eliminated. Thus, the full finance company equations were specified.

The equations presented in Table I will be discussed in turn.

The first equation, on finance company credit availability, indicates that finance company personal loan credit outstanding per capita is significantly lower in states that prohibit attorney's fees and in states that restrict garnishment. It also indicates that finance company credit availability, in total, is reduced when non-finance company creditors account for a larger share of the new personal loan credit extensions market in a state. Additional variables were not statistically significant, possibly because the "others' market share" variable is affected by factors that also affect finance company credit availability, and thus are collinear with that variable.

The second equation, on finance company average personal loan rates indicates that finance company loan rates are significantly higher in states that either prohibit or restrict confession of judgment clauses in credit contracts or prohibit garnishment. These effects are very large in absolute magnitude, ranging from nearly 3 to over 3-1/2 percentage points, even though the rate ceiling variable appears to explain most of the variance in finance company rates. No other variables entered the equation significantly--for one-tailed tests.⁴ The

⁴ This study used one-tailed tests because the direction of influence of each included variable set forth earlier., could be predicted from the basic hypotheses.

concentration ratio variable would have entered significantly (with the wrong sign) if two tailed tests had been used, however.⁵

Overall, the finance company equations suggest that numerous creditor remedy restrictions induce finance companies to reduce credit availability or raise loan rates. These responses reduce loan risks and/or recoup increased collection costs or losses incurred while doing business in a restricted environment. Of the remedy restrictions tested in both equations, only wage assignment restrictions (or prohibitions) failed to have a significant effect on either loan rates or credit availability.

Equation 3 shows that credit union credit outstanding per capita is significantly negatively associated with the market influence of other creditors and also significantly lower in states that restrict wage assignments. The wage assignment variable is likely to be especially important to credit unions since they obtain a sufficiently low return on their loans that low-cost collection devices are essential to them—particularly since, in contrast with other creditors, they usually operate with non-specialized staffs and thus, would be forced to purchase expensive outside legal advice if low-cost remedies were not available to them. Thus, where such remedies are restricted, it is not surprising that they cut down on credit availability to minimize possible losses. However, given this line of argument, it is surprising that the "wage assignment prohibited" variable did not also have significant effect on credit union credit availability. Possibly the states that prohibited credit union wage assignments also had some other unusual characteristics.

No data on credit union loan rates were available for analysis.

Equation 4 indicates that bank personal loan credit outstanding is significantly influenced by the existence of creditor remedy restrictions, along with other variables. In particular, restrictions on garnishment and prohibitions on the use of confession of judgment clauses both significantly reduced bank personal loan credit availability. In addition, prohibitions on attorney's fees substantially reduced credit availability, but the difference missed being statistically significant in equation 4 by 0.1 percent, i.e., it would have been deemed significant if a 94.9 percent one-tailed standard of significance had been adopted. With slight changes in the specification of the regression, the attorney's fee variable also became significant,⁶ but the total explanatory power of those regressions was marginally below that of equation 4.

The significance of several creditor remedy variables in the bank credit outstanding equation suggests that banks are more cautious in their personal loan lending when their remedies are restricted—as those results indicate total bank personal loan credit availability is significantly lower in states with restrictive remedies.

Other variables in the equation were designed to control for the effects of market concentration and competition and the effects of elevated loan rates on bank personal loan credit availability. The only one that was statistically significant was the one that measured the market share of credit extensions taken by bank competitors.

Equation 5 indicates that it is difficult to explain bank \$500 personal loan rates on a statewide basis using the indicated variables. The only variables that remained after stepwise regression analysis were creditor remedy dummy variables, and the only one of those that was statistically significant was the variable reflecting

⁵ An aberrant sign on the concentration ratio variable was also noted and explained by Paul Smith in NCCF Technical Study VI—in which he suggested that increased finance company concentration may not influence finance rates as much as be influenced by them to the extent that low rate ceilings may partially discourage entry of a large variety of market participants.

⁶ Also, in related work conducted with microeconomic data on bank loan rates, Peterson and Ginsberg (2) found that prohibitions on attorney's fee clauses in consumer loan contracts were significantly associated with elevated bank personal loan rates.

prohibitions on confession of judgment clauses. Such clauses are probably of consequence in determining bank small personal loan rates because they potentially reduce banks' collection costs significantly in the event of default--and, on a small personal loan, expected costs of loan service play a dominant role in loan pricing.

An analysis of bank \$2,000 personal loan rates was also attempted, but no variables were statistically significant in that equation-- possibly because creditors' remedies have a smaller proportional impact on banks' potential rates of return on larger size loans.

Based on analyses conducted with other data, the bank personal loan rate regressions probably could have been improved by controlling for the impact of legal rate ceilings.⁷ However, such data were not included in the data bank from which these regressions were run.

Summing up on our results by remedy, we found that the following dummy variables for remedy restrictions had significantly added to the explanatory power of one or more equations.

- (i) Prohibitions against attorneys' fees. This variable significantly explained interstate differences in the availability of finance company personal loan outstandings per capita. In addition, it had a strong but not quite statistically significant impact in the bank credit equations,--where it was associated with elevated rates and reduced credit availability.
- (ii) Prohibitions against confession of judgment clauses. This variable was associated with significant increases in loan rates for both commercial banks and finance company personal loans. In addition, it was associated with significant reductions in bank personal loan credit availability.
- (iii) Prohibitions or restrictions on wage assignments. While prohibitions on wage assignments did not appear to be significant by themselves, credit union credit availability was significantly lower in states that restricted wage assignments than in other states--possibly because wage assignments facilitate low cost operation of credit unions that are closely associated with their clients' employer.
- (iv) Other remedy restrictions. Some of these were also found to reduce personal loan credit availability significantly and/or increase its price. In particular, restrictions on or prohibitions against garnishment were associated with significant reductions in bank and finance company credit availability and with significantly higher finance company personal loan rates.

IV. Comparisons of Findings with NCCF Findings.

The results found in this study were consistent with those found by Greer in NCCF Technical Study V (1). In particular, both studies found evidence that restrictions on attorneys' fees were significantly associated with reductions in finance company personal loan credit availability, and that restrictions on wage assignments were associated with reduced availability of credit union credit. However, Greer also found that restrictions on wage assignments were associated with significant reductions in commercial bank and credit union personal loan extensions and that restrictions on garnishment significantly affected the price and availability of consumer credit.

Greer did not find as we did, however, that restrictions or prohibition on the use of confession of judgment clauses have a significant effect on the availability and price of personal loans. The discrepancy

⁷ See Peterson and Ginsberg (2).

probably results from the fact that his equations did not control for the influence of other creditors' market activities on credit availability and rates of charge in the portion of the credit industry being intensively studied. Specification differences might easily affect these results as confession of judgment clauses are only allowed in a limited number of states.

In general, in our studies, some difference in results with the NCCF results was to be expected because there was a certain degree of collinearity between variables. As previously noted, states with one type of remedy restrictions would probably be likely to have restrictions on other remedies, while some states might not restrict any remedies at all. Similarly, rates of charge by one creditor group might be affected by the market share and/or rates of charge of another creditor group. Thus, the exact specification of the model being tested, particularly the number and types of remedy restrictions being tested and the degree of control for competitors' activity, might affect the results of any given statistical test.

V. Summary

Overall, our studies and those by the NCCF were in substantial agreement. Both studies found, as would be theoretically expected that restrictions (or prohibitions) on creditors' remedies significantly reduced credit availability and/or increased personal loan rates. We documented highly significant effects emanating from outright prohibitions against attorney's fees clauses, confession of judgment clauses, and garnishment. In addition, we found that restrictions on wage assignments, garnishment and confession of judgment clauses also had statistically significant effects on the price and/or availability of consumer credit.

References

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Table: Impact of Remedy Restrictions on Personal Loan Credit Availability and Finance Rates*

Dependent Variables	Independent Variables			Commercial Banks	
	Outstandings per capita (1)	Average Finance Rates (2)	Credit Union Outstandings per capita (3)	Outstandings per capita (4)	Average rates on \$500 loans (5)
Finance Company Personal Loan Average Annual Percentage Rate	.487 (.724)				
Bank \$2000 Personal Loan Average Annual Percentage Rate				1.940 (1.302)	
Finance Company Ceiling Rate		.639 (.066) *		.3273 (.3605)	
Total Concentration Ratio				.1983 (.2784)	
Finance Companies Concentration Ratio	-.376 (.226)	-.055 (.027)n			
Other Lenders' Personal Loan Extensions (%)	-.704 (.242)*	-.0137 (.0309)	-82.60 (13.93)*	-.8034 (.1870)*	
Inverse of Finance Company Loan Size Limit	-5397. (3760.)	-443.8 (474.6)			
Attorney's Fees Prohibited	-12.05 (5.81)*	-.649 (.754)		-8.231 (4.915)	1.128 (.877)
Confession of Judgment Prohibited	-8.17 (11.46)	3.65 (1.40)*		-10.294 (4.640)*	1.689 (.880)*
Confession of Judgment Restricted	-5.05 (11.84)	2.914 (1.490)*			
Wage Assignment Prohibited	-1.22 (5.91)	.719 (.770)			
Wage Assignment Restricted	3.36 (5.57)	-.544 (.688)	-4.18 (2.24)*		-1.062 (.767)
Garnishment Prohibited	-16.18 (10.76)	3.46 (1.32)*		-3.249 (7.676)	
Garnishment Restricted	-13.05 (6.77)*	1.10 (.863)		-9.501 (5.243)*	
Waiver of Buyer Defense (Holder-In Due-Course) Prohibited		1.12 (.858)			
Constant	34.16 (34.16)	7.64 (3.67)*	92.47 (11.53)*	-7.173 (22.487)	11.83 (1.06)
R ² /(SE)	.54 (14.17)	.88 (1.80)	.45 (7.50)	.46 (11.97)	

*Standard errors are shown in parentheses below the independent variables to which they pertain and variables significant at the 95% level, for one-tailed tests, are starred.

ⁿ Unexpected sign, significant at 90% level for two-tailed tests.