



Credit
Research
Center

WORKING PAPER No. 15
The Impact of
Creditors' Remedies on Consumer Loan Charges
1977

Krannert Graduate School of Management – Purdue University

The Impact of Restricted Creditors' Remedies on Commercial Bank Consumer Loan Charges

Richard L. Peterson*

Synopsis:

This paper uses statistical estimates of the impact of various creditor remedy restrictions on commercial bank loan rates (obtained in Credit Research Center Working Papers #6 and #10) to generate rough estimates of the implications of nationwide remedy restrictions. It concludes that if collection remedies on new automobile loans were restricted to the level applicable in the most restrictive states, nationwide consumer finance charges on automobile debt would likely rise by at least \$214 million per year for all auto loans and possibly by twice that much. In addition, it concludes that the nationwide elimination of various specific creditor remedy clauses on personal loans could potentially have or even greater impact on annual consumer finance charges. Restriction on the use of attorney fee charges alone could add as much as \$95 million to consumer annual finance charges on personal loans.

* Research Scholar, Credit Research Center, Krannert Graduate School of Management, Purdue University. This paper was prepared, in large part, with the assistance of FTC grant #L0089.

The Impact of Restricted Creditors' Remedies on Commercial Bank Consumer Loan Charges

1. Overview

This paper uses the conceptual model and statistical results developed by Peterson and Ginsberg ([5] and [6]) to obtain rough estimates of the implications of creditor remedy removal for consumer loan charges on automobile and personal loans.

II. Study Design

In this study, it is assumed that the quantity demanded of personal loans from an individual bank, Q_D can be described as:

$$(1) \quad Q_D = Q_D (R, C_1, C_2, C_3, \dots, SE_1, SE_2, SE_3, \dots)$$

where: R is the rate charged on loans,
 C_1, C_2, C_3 are determinants of local bank competition, and
 SE_1, SE_2, SE_3 are determinants of the socio-economic milieu in which the bank operates.

The quantity of loans supplied by an individual bank, Q_S , can be described as:

$$(2) \quad Q_S = Q_S (R, RC, CR_1, CR_2, CR_3, \dots, PC, OC)$$

Where: R the rate charged on loans,
 RC the rate ceiling,
 CR_1, CR_2, CR_3 are various creditor remedy restrictions,
 PC represents loan processing and collection costs, and
 OC measures the (risk adjusted) opportunity cost of bank funds.

By noting that, in equilibrium,

$$(3) \quad Q_D = Q_S,$$

equations (1), (2), and (3) can be combined and solved for a reduced form equation, in which (endogenous) loan rates are explained by the independent variables included in (1) and (2). This yields the general form of the reduced form equation that was actually estimated, shown as equation (4).

$$(4) \quad R = f(C_1, C_2, C_3, \dots, SE_1, SE_2, SE_3, \dots, RC, CR_1, CR_2, CR_3, \dots, PC, OC)$$

III. Empirical Results

In the statistical estimations, data were obtained from approximately 320 banks that participated in the Federal Reserve monthly loan rate surveys in May and September 1975. The auto loan rate reported-by the banks were their "most-common" rates charged on 36-month direct new auto loans in the first week of the reporting month. The-reported personal loan rates were similar in that they were "most-common" rates, but apply to 12-month personal loans.

The independent variables used, in the statistical tests reflected (i) differences in individual bank's rural vs. urban (SMSA) location and in applicable state bank branching laws (which, were thought to affect individual bank's competitive environment), (ii) differences in bank size (which were thought to affect banks' loan processing efficiency and yield objectives), (iii) differences in geographical location (which were thought to affect loan demand and terms because of possible differences in socio-economic milieus)-, (W differences in applicable loan rate ceilings (which could directly affect loan rates), and (v) differences in creditor remedy restrictions applicable to different banks (Which were thought to affect loan rates, if highly restrictive, by reducing banks' net yield on loan --thereby necessitating that banks charge higher nominal rates in order to generate a net rate of return sufficient to justify their consumer lending operations). The specific independent variables used are defined in conjunction with equations (5) and (6). Detailed reasons for the selection of each are spelled out in Peterson and Ginsberg ([5] and [6]).

In the case of creditors' remedies, in the auto rate equation, a dummy variable was created that equaled one for banks located in states noted by auto finance company executives as having the "most-restrictive" creditors remedies and equaled zero otherwise. In the personal loan rate equation, three dummy variables, CR_{AF}, CR_{CJ}, CR_G, were created based on NCCF data compilations ([1] pp. 266-7). They respectively equaled one for banks located in states where no restrictions or prohibitions existed on the use of attorney's fee clauses, confession of judgment clauses, and garnishment, and equaled zero otherwise. Those remedies were singled out for special attention because NCCF surveys indicated that banks used them most frequently or considered them to be most important when collecting on consumer loans (see [1] and [6]).

Equations (5) and (6) present results of the statistical tests outlined above for May, 1975. Those results suggest that creditor remedy restrictions significantly affect commercial bank auto and personal loan rates in the expected manner. In particular, equation (5) indicates that bank auto loan rates. are significantly higher in states with the most restrictive. creditor remedies. The effect of remedy restriction in the personal loan markets was also significant, in the case of attorney's fees, and uniformly consistent with our a priori notions, i.e., in every case a lack of restriction on (or prohibitions against) a particular creditors' remedy was associated with lower loan rates.

5.

$R_A =$	1135.17	-	36.85C _{UR}	+	20.27C _{LB}	-	4.53C _{SWB}
			(20.86)*		(27.47)		(21.78)
	+ 51.64SE ₂	-	32.17SE ₃	-	-1.65SE ₄	-	20.73SE ₅
	(26.62)*		(29.61)		(29.92)		(32.32)
	+ 5.65SE ₆	-	65.90SE ₇	+	44.41SE ₈	+	35.07SE ₉
	(30.42)		(31.43)*		(34.33)		(29.58)
	- 64.31RC	+	35.37CR	+	18.14S ₂	+	31.30S ₃
	(21.25)*		(18.49)*		(15.62)		16.57)
	+ 53.58S ₄				R ² =.27		
	(17.19)*				Mean=1140.02		

6.

$R_p =$	1475.51 (68.39)*	+	17.31CUR (35.35)	+	136.77C _{LB} (48.85)*	+	43.10C _{SWB} (37.35)
-	151.67SE ₂ (F7.00)*	-	81.56SE ₃ (56.40)	-	91.05SE ₄ (62.03)	-	52.39SE ₅ (59.27)
-	-128.90SE ₆ (51.60)*	-	69.86SE ₇ (58.43)	+	92.01SE ₈ (68.55)	+	99.66SE ₉ (55.07)
-	-226.02RC (31.71)*	-	90.37CR _{AF} (39.49)*	-	11.49CR _{CJ} (32.46)	-	44.32CR _G (39.93)
-	42.92S ₂ (27.25)	-	58.47S ₃ (28.94)*	-	16.61S ₄ (28.87)	-	R ² = .4343 Std. Dev. = 169.69 Mean = 1341.17 Basis Points

where * denotes significance at the 90 percent level; the rural, unit banking, unrestricted rate ceiling, small size, and region I (SE₁) bank categories were omitted; and the included variables are;

R: depending on the subscript equals the "most common" 36-month auto (A) or 12-month personal (P) loan rates charged by each bank in the first week of each month,

C_{UR} : a dummy variable, which equals 1 if the bank is located in an urban area,

C_{LB}, C_{SWB} : dummy variables that equal 1, respectively, if a bank is located in a state that allows limited branching or statewide branching,

SE₂, SE₃, ..., SE₉ : dummy variables denoting the region of the country in which the bank is located,

RC: a dummy variable for banks operating under "restrictive" loan rate ceilings. i.e., in the auto rate equation, RC = 1 for banks located in states where the relevant rate ceiling on \$3000, 36-month new auto loans is below the average most common rate charged by banks operating in other states, and RC = 0 otherwise. For personal loans, RC is analogously defined except the relevant ceiling applies to \$1000 12-month personal loans.

CR: a dummy variable, applicable only to the auto loan rate equation that indicates whether the bank is located in a state with "highly restrictive" creditor remedies or not.

CR_{AF}, CR_{CJ}, CR_G : dummy variables applicable to the personal loan rate equation that equal 1 in the absence of particular creditor remedy restrictions. The subscripts respectively note that Attorney's Fee clauses, Confession of Judgment clauses, and Garnishment are not restricted or prohibited.

S₂, S₃, S₄ : are dummy variables denoting increasingly large banks (by deposit size).

IV. Implications of Nationwide Restrictions on Creditor Remedies for Consumer Finance Charges

It is possible to use the statistical tests presented in the preceding section to estimate the effect of nationwide restrictions on creditors' remedies.

In the case of automobile credit, if it is assumed that all creditor remedies were restricted to the level prevailing in the most restrictive states, the results obtained in equation (5) suggest that auto finance rates would likely rise by approximately 40 basis points.

This is a conservative estimate because, although the rate difference ascribable to restrictive creditors' remedies was somewhat less than 40 basis points in equation (5), it was more than 40 basis points (47.24 points) in an identical equation estimated with September data (see [5]). Thus, on average, the impact of creditor remedy restrictions is probably greater than 40 basis points. Furthermore, because some interaction between creditors' remedies and the socio-economic (geographic) variables exists, i.e., remedies are evidently more valuable in some parts of the country--where customer payment habits may be worse--than in others, the 40 basis point estimate is, if anything, too low. For instance, when the socio-economic (geographic) variables were removed from the equations cited, the impact of the remedy restriction variable rose to 75 basis points in May and 79 basis points in September. In addition, an absence of remedies is likely to have a greater effect on used car loan rates (which are riskier) than new car loan rates and rates on loans extended by non-bank lenders (who typically service more risky customers than banks).

Nonetheless, one can obtain an estimate of the minimal probable effect of creditor remedy restriction by using the 40 basis point figure to calculate the increase in annual consumer finance charges that would be implied by remedy restrictions.

In the case of auto credit, if it is assumed that total new and used car loan rates would rise by 40 basis points if creditors' remedies were severely restricted, it is possible to calculate the minimal extra cost to consumers of severely restricting remedies on a nationwide basis. For instance, at year-end 1976, bank auto loans outstanding amounted to \$35.3 billion and total auto loans outstanding amounted to \$60.5 billion. Thus, if auto loan rates nationwide were to rise by 40 basis points as a result of a restriction in creditors' remedies, annual consumer finance charges on outstanding auto loans would rise by \$141 million for commercial bank loans and \$242 million for all auto loans.

Because six states already have highly restrictive remedies, these estimates need to be rounded downward to allow for the fact that nationwide remedy restriction will have no incremental impact on those states. Assuming that lenders in unaffected states hold an average amount of auto credit, the estimates should be reduced by 6/51 (since there are 50 states plus the District of Columbia).¹

¹ Implicit in this procedure is the assumption that credit is evenly distributed over all states. That assumption, of course, is not true. However, in the absence of current data on the volume of credit outstanding in each state, that assumption is believed to be reasonable. While some states may hold a greater than average amount of credit, other states will hold less. Thus, when states are clustered it is likely that the average amount of credit outstanding for each state in the cluster will be pretty close to national average credit holdings per state

Thus, the minimal impact of nationwide auto creditor remedy restriction on finance charges paid by consumers is likely to amount to \$125 million for bank customers and \$214 million per year in total.

In the personal loan market, equation (6) indicates that state restrictions on attorney fee clauses are associated with 90 basis point increases in bank consumer loan rates. Since commercial bank personal loan outstandings equaled \$15.6 billion and total personal loan outstandings at banks and finance companies (plus non-auto or home improvement loans at thrift institutions and credit unions) totaled \$53.8 billion, applying the same analysis as before, this suggests that a nationwide abolition of attorney's fee clauses would add \$28 million per year to consumer finance charges at commercial banks and \$95 million per year to consumer finance charges in total (after adjustment for the fact that only ten states do not presently restrict the use of such clauses--see [1] pp. 266-7).

Similar estimates can be made for the impact of the removal of other remedies included in the personal loan rate equation. However, in this case, it must be kept in mind that the estimated coefficients were not significantly different from zero--thus, these estimates must be viewed as tenuous, at best. For confession of judgment clauses, the equation suggested that personal loan rates might be 11 basis points lower if they were not restricted or prohibited. Since only three states neither prohibited nor restricted them at the time of the NCCF study ([1], pp. 266-7) restriction on a nationwide basis to the average level of restriction now prevailing in the other 47 states (and Washington, D.C.) would only add \$1 million per year to consumer finance charges at commercial banks and \$3.5 million per year to consumer finance charges in total. The increase would likely be greater, however, if the use of such clauses were restricted nationally more than they are restricted, on average, in Washington, D.C. and the other 47 states.

Regarding garnishment, while the coefficient for a lack of restrictions on garnishment also was not significant in equation (6), it is still possible to make rough estimates of the effect of nationwide restrictions against the use of garnishment on personal loan finance charges--subject to the same qualifications that apply to the preceding paragraph. In this case, equation (6) suggests that personal loan rates are, on average, 44 basis points lower in the 41 states that neither prohibit nor restrict garnishment than in the ten that do ([1], pp. 266-7). Thus, if garnishment were to be restricted nationwide to the average level of restriction prevailing in the states that restrict or prohibit its use, consumer finance charges would be expected to rise by \$55 million per year on commercial bank personal loans and \$190 million per year in total.

These results suggest that the total effect on consumer personal loan finance charges of nationwide attorney's fee, confession of judgment, and garnishment restriction or prohibition could amount to as much as \$84 million per year at commercial banks and \$288 per year in total.

Not all of these potential effects might show up in the form of finance charge changes, however, as evidence suggests that restrictions on creditors' remedies also induce lenders to reduce their supplies of consumer credit--both in the aggregate (see [1] and [4]) and to the most risky borrower groups (see [2] and [3]).

Conclusions:

Nationwide reductions in the amount of remedies available to consumer creditors might cause finance charges on consumer personal and auto loans to rise by as much as \$500 million to \$1 billion dollars per year. Some reductions in credit availability (particularly to riskier customers) probably would accompany these finance charge increases--particularly in states where creditors are already operating at or near applicable rate ceilings.

REFERENCES

1. Greer, D., "Econometric Analysis of the Personal Loan Credit Market," in National Commission on Consumer Finance, Technical Studies, Vol. 4 Superintendent of Documents, Washington, D.C., 1972.
2. Peterson, R., "Changes in Finance Company Personal Loan Policies Following Enactment of the Wisconsin Consumer Act," Credit Research Center, Working Paper #13, Krannert Graduate School of Management, Purdue University, 1977.
3. Peterson, R., "The Impact of Restricted Creditors' Remedies on Automobile Finance Companies in Wisconsin," Credit Research Center, Working Paper #12, Krannert Graduate School of Management, Purdue University, 1977.
4. Peterson, R. and Frew J., "Creditor Remedy Restrictions and Interstate Differences in Personal Loan Rates and Availability: A Supplementary Analysis," Credit Research Center, Working Paper #14, Krannert Graduate School of Management, Purdue University, 1977.
5. Peterson, R. and Ginsberg, M., "Determinants of Commercial Bank Automobile Loan Rates," Credit Research Center, Working Paper #6, Krannert Graduate School of Management, Purdue University, 1977.
6. Peterson, R. and Ginsberg, M., "Regulatory Influences on Commercial Bank Personal Loan Rates," Credit Research Center, Working Paper #10, Krannert Graduate School of Management, Purdue University, 1977.