Report on Consumer Credit Finance Rates

Prepared Pursuant to Chapter 479, Statutes of 1988 (SB 2592, Dills)

May 14, 1991

Legislative
Analyst's
Office

LAO

Introduction

Chapter 479, Statutes of 1988 (SB 2592, Dills), eliminated, for a three-year trial period, the statutorily set limits on the finance rates that retailers may charge consumers on their retail credit accounts in California. The original rate limits were established by the so-called Unruh Act in 1959 (discussed below). Chapter 479 lifts the rate limits from January 1989 to January 1992, after which time these limits will go back into effect. It also requires the Legislative Analyst to report to the Legislature on consumer credit rates charged in California in 1989 and 1990, during the first two years of the deregulation period. Our report below provides this required credit rate information, along with various other information that may assist the Legislature in interpreting the data and deciding whether to allow limits on consumer credit finance rates to go back into effect in 1992.

Specifically, this analysis:

- Provides basic background information on consumer credit and California's finance rate limits.
- Discusses the basic economics of the consumer credit market generally.
- Presents data on consumer credit finance rates in 1989 and 1990.
- Discusses what these data suggest about the effects of limits on finance rates, and the major issues facing the Legislature in considering whether rate limits should be in force in the future.

Findings, Conclusions, and Recommendations

Findings. The data on consumer credit finance rates indicate that:

- During the past two years, credit rates have exceeded the previous 18 percent limit by, most commonly, a couple of percentage points.
- About half of the retailers surveyed had adopted the same 19.8 percent rate.

- The majority of credit rates on retail installment accounts and contracts were of a similar magnitude to the rates on bank cards, which have never been subject to the Unruh Act.

Conclusions. Our analysis of the consumer credit market suggests the following general conclusions:

- *First,* the consumer credit market has many competitive characteristics, and its interest rates are probably in large part determined by a competitive process.

- *Second,* ample credit is available to most of the market, although some submarkets have only limited access.

- *Third,* problems with information about consumer credit are best addressed directly through disclosure requirements.

- *Fourth,* much of the consumer credit market is exempt from California regulation.

Recommendations. We recommend credit rate limits not be reestablished in their previous form, as current law provides. Rather, we recommend continued deregulation of the market. Deregulation could be accompanied by actions to address specific issues of concern to the Legislature in the consumer credit market.

Background

What is Consumer Credit?

Consumer credit comes in basically one of the following three forms:

- *Retail Installment Accounts.* These are generally credit cards issued by a particular store, such as a Macy's credit card, which provide an open-ended line of credit.

- *Retail Installment Contracts.* These involve credit issued by a particular store to buy a certain item or set of items on a closed-ended account. For example, an electronics store may allow a person to pay for a television set over a specified number of months.

- *Bank Cards.* These are charge cards, such as a VISA or MasterCard, which can be used at many different stores for any purpose, up to the particular dollar credit limit granted each card holder.

The rate limits that were imposed on consumer credit prior to 1989 (see below) apply only to the first two credit forms listed above -- retail installment accounts and contracts. The limits do *not* apply to bank cards, which federal law exempts from state credit regulations. Various other types of credit transactions also are not covered under the Unruh Act, including real estate transactions; insurance premium finance agreements; and aircraft, boat, and automobile sales.

On both retail installment accounts and contracts, a store may provide the financing itself or rely on an outside financial institution to do so. For example, an outside financier might issue a credit card in the retailer's name, or directly provide financing for the store's customers.

Rates Vary by Type of Credit Offered. On installment accounts, each retailer tends to offer one rate or standard rate structure to all customers. The rate is stated on the initial application form for the store's credit card, and typically does not change often. On installment contracts, the rates may vary depending on several factors, such as the credit history of the customer, the cost of the item being financed, and the length of the financing period. Thus, on an installment contract, a customer may not know the financing rate until the customer has chosen an item to purchase and negotiated a financing contract.

History of California's Limits on Finance Rates

Limits Were Established in 1959. The Unruh Act of 1959 established limits on the finance rates that retailers may charge on consumer credit, and also established other consumer protection measures regarding consumer credit. The maximum finance charge on credit balances was initially set at an annual percentage rate (APR) of 18 percent for balances up to $1,000 and either 12 percent or roughly 14.5 percent for balances greater than $1,000, depending on whether the rate was for an installment account or contract, respectively.

Rates Changed Several Times in the 1980s. The original finance rate limits remained in effect until 1981 when, during a period of high inflation and market interest rates, the Legislature temporarily increased the limits. Table 1 shows how the rate limits changed in 1981, and shows the additional changes that occurred to the rates in the 1980s and will occur in 1992. The higher finance rate limits adopted in 1981 continued until January 1988, when the Governor vetoed an attempt to continue the higher rates. As a result, the original limits once again went into effect. Then, effective January 1989, Chapter 479 removed the limits completely on a limited-term, trial basis. These provisions are due to sunset on January 1, 1992, at which time the 18 percent, 12 percent, or 14.5 percent APR rate caps will once again go into effect.

Table 1
History of California's Finance Rate Limits

Period	*Installment Account Rates by Amount Owed*[a]	*Installment Contract Rates by Amount Owed*[b]
1959 to 1981	18% on amounts up to $1,000 12% on amounts over $1,000	18% on amounts up to $1,000 14.5% on amounts over $1,000
1981 to 1988	19.2% on amounts up to $3,000 12% on amounts over $3,000	19.7% on amounts up to $3,000 14.5% on amounts over $3,000
1988 to 1989	18% on amounts up to $1,000 12% on amounts over $1,000	18% on amounts up to $1,000 14.5% on amounts over $1,000
1989 to 1992	No Limit	No Limit
1992 Onward	18% on amounts up to $1,000 12% on amounts over $1,000	18% on amounts up to $1,000 14.5% on amounts over $1,000

[a] Rates shown are annual percentage rates.
[b] Rates shown are approximations to annual percentage rates, given that installment contract rates are not actually calculated on an APR basis.

15

The Basic Economics of Consumer Credit and Rate Caps

Prior to showing what happened to credit rates in 1989 and 1990, it is first useful to discuss some of the basic issues and economic considerations associated with consumer credit and interest rate restrictions. At the outset, it is helpful to note that the consumer credit industry has many features that appear hospitable to a competitive environment, such as a relatively large number of firms, a fairly homogeneous product, and a general absence of significant barriers to entry.

Finance Rate Caps Raise Three Key Questions. In considering whether a cap should be placed on consumer credit finance rates, there are three key questions to be considered:

- Is the market for consumer credit already fairly competitive, or is some type of regulation actually necessary? (This is a key issue because most economists believe that an industry should be regulated only if there is clear evidence that its performance is uncompetitive.)

- If the market for consumer credit is not competitive and regulation is needed, what types of problems are consumers facing, and exactly what type of intervention makes sense?

- Will the chosen form of regulating intervention, such as establishing rate limits, be effective, or can it somehow be evaded and/or cause undesirable side effects?

Looking at the general nature of the consumer credit market, including credit profitability, availability, and disclosure requirements, provides some insights into the first two of these questions.

Credit Profitability

One way to determine if the consumer credit market is competitive is to see if firms are making a normal -- but not excessive -- profit on credit operations. Answering this question requires knowing both the costs of providing credit and how well a firm covers those costs.

Credit Involves Various Kinds of Costs and Compensation. The costs of providing consumer credit include the costs of borrowing money, accounting for and collecting credit payments, and covering bad debt on money that is never collected. Retailers compensate for these costs in a number of different ways. For example, retailers may:

- Set the finance rates on consumer credit.
- Adjust merchandise prices.
- Limit the cost of bad debt by setting limits on who will receive credit (in other words, limit how poor of a credit risk the retailer will accept).
- Limit the cost of bad debt by restricting the amount of credit a person can get (for example, a store may offer a college student with little or no income a line of credit, but limit it to only $200).

Finance Rates are Just One Part of the Picture. Because there are a number of types of costs associated with credit and various ways to compensate for the costs, just looking at finance rates alone does not give a complete picture about how much profitability a retailer is realizing on consumer credit. For example, a retailer may choose to offer a lower credit rate but, at the same time, also offer credit to fewer people or simply charge higher prices on merchandise in order to subsidize credit costs. Thus, retailers can essentially select one of *several* mixes of credit rates, credit availability, and product prices to achieve some particular profit level. Consequently, in order to draw conclusions on consumer credit profits over a period of time and whether a change in rates has hurt or benefitted consumers, it is necessary to know how *all* of the various costs and forms of compensation have changed. Just because credit rates go up (down), one cannot automatically conclude that profits on credit operations have gone up (down). Unfortunately, comprehensive data of this sort can be difficult to obtain and, thus, the profitability of credit operations can be difficult to determine.

The Availability of Credit

Another indication of competition in the consumer credit market is the range of credit options available to people. This can be viewed in terms of the different types of credit cards available, the number of retailers offering credit, and/or the variation in credit rates or other credit terms. The more credit options available to consumers, the more likely it is that the overall profitability of credit operations is not excessive due to the forces of competition and thus, that regulation may not be necessary to protect consumers.

Many People Have Credit Options, But There is Also Market Failure. In the consumer credit market in general, a broad portion of consumers have a variety of credit options. Many different bank cards are available and may be used in many stores. Additionally, countless retailers offer their own credit. (The issue of rate competition is discussed later, following the findings on credit rates in 1989 and 1990.)

However, there is also a narrower portion of the market where people have more limited access to credit. Many bank card issuers and retailers follow similar guidelines in extending credit. Thus, a person who does not meet an income threshold may be excluded from most sources of credit. Also, some people may not have access to credit because they live in certain areas where few credit options are available, such as in certain inner-city or rural environments. Thus, in these segments of the market, people may have few credit options, even though a majority of people have many credit options.

For example, in a 1990 Consumers Union survey of small retailers conducted in inner-city areas in Los Angeles, San Francisco, and Oakland, the survey found that only 25 percent of the retailers offered their own credit or worked with an outside financier to do so. The survey did not look into how many of these stores accept bank cards, but the survey does offer some indication that very limited credit is available to low-income people living in certain inner-city areas.

The Availability of Information

Another requirement of a competitive market is that people have good access to easily understandable information about the products available in the market, such as different credit terms. Some of the Unruh Act provisions have already placed disclosure requirements on retailers that offer credit. However, if it is the case that finance rates and other consumer credit provisions still are not easily understandable, an argument could be made for additional regulatory actions to better protect consumers.

Some Types of Credit are More Understandable Than Others. In general, the provisions of installment accounts are easier to understand than installment contracts by most people. With installment accounts, the credit rate is disclosed on the application form for the credit card. The rate generally does not change, and people know the rate before they begin looking at merchandise in the store.

With installment contracts, rate information also is available. However, it may be more difficult for consumers to understand because there are more factors to consider. The finance rate may vary depending on the customer's credit worthiness, the amount to be borrowed, and the payment period. Because there are more factors involved, the buyer may have trouble taking note of the interest rate per se. This is especially true when buyers become focused primarily on monthly payment amounts, as many credit managers encourage them to do. Additionally, the customer may not be aware of the store's range of finance rates up front, only that credit is available. Thus, even though finance rate information is available on installment contracts, it may be difficult to obtain or understand, particularly on contracts with variable rates. For example, in the 1990 survey of inner-city retailers, the Consumers Union found that many retailers were unable or unwilling to quote their interest rate or range of rates over the phone.

This is not to suggest that the consumer is not ultimately responsible for understanding the credit provisions that he or she agrees to. However, to the extent that information is excessively difficult to obtain or understand, the argument for better disclosure requirements to aid buyers is strengthened.

How Much of the Credit Market Would be Affected by Rate Limits?

The nature of the consumer credit market in general offers some clues as to whether finance rate limits would effectively regulate the overall consumer credit market, even in those instances where some sort of regulatory intervention seems necessary because of lack of competition or information in the consumer credit market.

Significant Portion of the Market is Exempt from Finance Rate Limits. As noted earlier, bank cards are exempt from state credit laws. Yet, bank card charges account for a significant portion of retail credit purchases. Additionally, some retailers are not subject to California's rate regulations if the retailer issues its credit from another state and meets certain other conditions. (This issue is discussed further below under the section on specific credit rates and retailers in the state.) In general, the "bottom line" is that, as a result of these two exclusions, a significant portion of the consumer credit market is not subject to any rate restrictions California may choose to impose. This, in turn, means that rate restrictions can only be partly effective in regulating the consumer credit market.

Finance Rates in 1989 and 1990

This section presents data on consumer credit finance rates in 1989 and 1990, as mandated by Chapter 479.

Sources of Data. The California Retailers Association, the Consumers Union, and the California Financial Services Association have provided us with credit information on both large and small retailers. Additionally, the federal government has published information on bank card rates. Table 2 summarizes the average finance rates offered by many of California's larger retailers on their installment accounts and contracts in 1989 and 1990.

Summary of Rate Information. The finance rates of retailers shown in Table 2 range from 18 percent to 24 percent APR. Most of the retailers shown had fixed, rather than variable, finance rates which clustered between 18 percent and 20 percent. Almost half of the retailers set their finance rate at 19.8 percent. Additionally, information included in the 1991 California Retailers Association survey suggests that over half of the major retailers surveyed now issue credit financing from outside the state. Of these, many would potentially not be subject to any finance rate limits imposed by California, as noted earlier.

Less information was available on smaller retailers, which probably tend to offer more closed-ended installment contracts rather than installment accounts. However, the Consumers Union, the California Retailers Association, and the California Financial Services Association did do limited surveys of various small retailers. The responses indicated that smaller retailers offered credit at rates varying from 14 percent to 24 percent, although the rates generally tended to be above 18 percent.

Regarding bank credit cards and rates, the Federal Reserve Board issued a report on this topic in March 1990. This report suggests that, for bank cards available in California, finance rates vary from 14 percent to over 22 percent. However, bank card rates also tended to cluster at between 18 percent and 20 percent, as 60 percent of the bank cards have finance rates falling within this range.

Table 2
Average Credit Rates Charged by Larger California Retailers 1989 and 1990

Retailer	Annual Percentage Rate	Retailer	Annual Percentage Rate
Angelus Furniture	19.2%,18%[a]	House of Fabrics	20.4%
Bailey, Banks & Biddle	21.6	Howard's	19.8
Breuners	19.8	Hughes Markets	18.0
Broadway	19.8	I. Magnin	19.8
Brooks Brothers	19.8	IBM	Variable
Bullock's	19.8	J.C. Penney	19.8
BusinessLand	19.2	L.A. Tronics	20.9
Casual Corner	19.8	Lane Bryant	22.8
Chevron	18,12[a]	Lerner Stores	22.8
Circuit City	19.8-24[b]	Macy's	19.8
Color Tile	21.3-23.8[b]	May Co.	19.8
Daly's	18.0	Mervyn's	18,12[a]
Emporium	19.8	Mitsubishi 3 Diamond	19.8-21.6[b]
FEDCO	19.8	Montgomery Ward	21.6
Firestone	22.2	Neiman Marcus	19.8
Ford's	19.8	Nordstrom	19.8
Geary's	18.0	Office Club	18.0
Good Guys	19.8-24[b]	Pep Boys	21.6
Gordon's Jewelers	21.0	Pier 1 Imports	18,12[a]
Gottschalk's	19.8	R B Furniture	18.8
Granat Bros.	21.6	Radio Shack	19.8
Harris'	19.8	Robinson's	19.8
Henshey's	19.8	Sears	19.2
Hilson's	18.0	Slavick's	21.6
Hinshaw's	19.8	Weinstock's	19.8
Home Club	19.8-21.6[b]	Winston Tires	21.6
Home Depot	19.8	Zales	21.6

[a] Lower rate applies to balances over a certain amount.
[b] Variable rate structure depending on nature of credit agreement, such as repayment period.

Source: Based on data from the California Retailers Association and the Consumers Union.

In summary:

- During the past two years, credit rates have exceeded the previous 18 percent limit by, most commonly, a couple of percentage points.
- About half of the retailers surveyed had adopted the same 19.8 percent rate.
- The majority of credit rates on retail installment accounts and contracts were of a similar magnitude to the rates on bank cards, which have never been subject to the Unruh Act.

Analysis of Rate Information

Are Consumers Worse Off Financially Under Deregulation?

Have Profits Gone Up? Finance rates did go up in the past two years. However, as discussed earlier, increased finance rates alone do not indicate whether retailers are making a greater profit on consumer credit or that consumers are worse off now than previously. Detailed information is not available on what happened to other variables, such as credit standards and product prices. For example, credit may have been made more available or merchandise prices may have been lower than they would have been under a lower finance rate. However, this kind of comprehensive information about California's credit market is not currently available and would be very difficult to compile.

What About the Clustering of Rates? The fact that the credit rates clustered within a fairly narrow band also leaves us uncertain whether the consumer is better or worse off. Clustered rates would be the outcome one would expect in a basically competitive credit market, where competition pushed the interest rates to an appropriate level to cover credit costs. Alternatively, however, the clustered interest rates could be the result of price leadership and imperfect competition, where one retailer or bank card issuer sets the rate and the other institutions follow suit. In this case, a lack of competition might allow retailers to set the rates high to earn an excessive profit.

Another reason the interest rates may have clustered is because retailers simply choose not to compete in the credit market on the basis of interest rates, perhaps because consumers do not respond much to changes and variations in finance rates, as certain empirical studies have suggested. Consequently, the clustering of rates offers little indication whether the credit market has been competitive and responsive to consumers.

Thus, looking at just the change in credit finance rates in the past two years, it is difficult to say whether consumers are better or worse off under deregulation. This uncertainty is not surprising in view of the data problems noted above.

Surveys Did Not Show Evidence of Extremely High Rates. The survey results do offer some evidence that extremely high rates are not being charged in the broad part of the market. No retailers in the survey charged a credit finance rate greater than 24 percent, and most of the rates clustered under 20 percent. Thus, to the extent that there are cases of extremely high credit rates being charged, it may be a narrower problem in the market, associated with those instances where credit users have very limited sources of credit to choose from.

Is Credit Now More Readily Available?

We have no specific information on whether there has been more credit offered to people during the past two years of rate deregulation than previously. However, it is possible that the increased credit rates have permitted retailers to be more liberal in their credit policies. If so, this might have helped those persons with more marginal credit ratings to obtain credit.

Conclusions

Our analysis of the consumer credit market suggests the following general conclusions:

- ***First, the consumer credit market has many competitive characteristics, and its interest rates are probably in large part determined by a competitive process.*** Given the limited information available regarding profits on consumer credit operations and exactly what causes rates to cluster, it is difficult to say exactly how competitive the consumer credit market is. However, given the diversity of credit sources available, it seems likely that cases of unreasonably high finance rates may be more of a problem within certain submarkets of the credit market than for the market as a whole.

This does not mean that some sort of regulatory intervention should not be considered, but only that the intervention be targeted as well as possible to address specific problems in these submarkets.

- ***Second, ample credit is available to most of the market, although some submarkets have only limited access.*** In terms of credit availability, the range of credit options available to the broad portion of the market suggests that, in this respect, the market is competitive and is not in need of regulation. Problems may exist for a limited portion of the market, however, such as inner-city or low-income areas, where credit is not always available. However, limiting credit rates will not solve the availability problem and, if anything, could make credit harder to obtain for certain borrowers.

- ***Third, problems with information about consumer credit are best addressed directly through disclosure requirements.*** In terms of adequate information for credit users, while information currently is available, it is not as easily obtained or understood in the installment contract arena as for installment accounts. A cap on finance rates would be one way to protect people who may not fully understand the process. However, this also would produce a number of undesirable side effects, and the issue could be addressed more directly and effectively with stricter disclosure requirements -- for example, requiring a retailer to provide a potential customer with the retailer's range of interest rates.

- ***Fourth, much of the consumer credit market is exempt from California regulation.*** In addition to bank cards being exempt, many of the major retailers providing credit in California also are potentially exempt from California rate regulations. Thus, it appears that a significant portion of the consumer credit market would not be subject to finance rate limits, which would make such regulation of more limited value and produce unequal treatment of businesses and consumers alike.

What Should the Legislature Do?

In our view, the Legislature has two basic options from which to choose regarding finance rate limits:

- ***Permit the previous rate limits to go back into effect in 1992, as the law currently requires.***

- ***Make the current deregulation of the market permanent.***

Regarding the first option, ***we recommend that credit rate limits in their previous form not be reestablished.*** Given that the consumer credit market appears fairly competitive, at least in many respects, and that rate limits would only apply to part of the market, we believe reinstituting the rate limits is not the best course of action. Even some economists who believe the consumer credit market does not perform very competitively have noted that interest rate caps are not necessarily desirable, given their various potential negative side effects. Even if the Legislature chooses to reinstitute rate limits, it is not clear to us that the levels of the previous rate caps are appropriate; thus, the levels need to be reevaluated. Also, it is not clear why a fixed rate that does not vary should be used when market interest rates change.

Rather, ***we recommend the second option of continued deregulation.*** Deregulation could be accompanied by actions to address specific issues of concern to the Legislature. For example:

- ***Prohibit the Charging of Truly Excessive Rates.*** Such a prohibition, like the 25 percent ceiling implemented in New York State, could guard against retailers charging extremely high rates. In determining what constitutes an excessive rate, the Legislature would need to take into account the level of general market interest rates.

- ***Establish Stricter Disclosure Standards.*** This type of action could be taken to address whatever credit information problems continue to exist. For example, the Legislature could require a retailer to list credit rates or ranges in advertisements stating that credit is available.

A combination of deregulation and targeted actions, along with continued monitoring of the consumer credit market, would seem to ensure that consumers are adequately protected, while at the same time enabling the market to respond to basic competitive forces.

This analysis was prepared by Margo Buckels, under the direction of Dana Curry, (916) 445-5921. For additional copies, contact the Legislative Analyst's Office, State of California, 925 L Street, Suite 610, Sacramento, California, 95814, (916) 445-2375.