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THE PROS AND CONS OF A CREDIT SOCIETY

by CYNTHIA CARLSON/Assistant Editor

Without credit, hardly anybody would be able to buy a house, Detroit would become a ghost town, and millions of Americans would have to do without televisions, ranges, and refrigerators. Most of the people now employed in making the products sold on credit would be unemployed, and most of the people now working for those companies' suppliers would be out of jobs, too. —The Credit Jungle, *by Al Griffin, a specialist in consumer credit.*

Part of the American way of life since colonial times, when farmers borrowed against crops at the general store, consumer credit is more widely used in the United States than in any other major country in the world. Of 70 million families in the US, about half owe some installment debt (excluding mortgages and medical bills), according to William C. Dunkelberg, associate director of the Credit Research Center at Purdue University. Although the total amount of installment debt owed varies considerably, Dunkelberg reports that every family with such debt owes, on average, more than $4,000.

Statistics show that consumer debt in this country has increased more than 50 percent within the past three years. Delinquency rates on installment loans in 1975 reached a 25-year high, and bankruptcy filings increased more than 30 percent. Of the $161.8 billion in consumer installment credit outstanding at the end of 1975, 46.8 percent was held by commercial banks, 24 percent by finance companies, 15.6 percent by credit unions, 11.3 percent by retailers, and 2.2 percent by mutual savings banks, savings and loan associations, and automobile dealers combined.

Use Of Credit

The concept of credit is closely associated with credit cards, which took a foothold at the start of the twentieth century when a few hotels began to issue them to regular patrons. By 1914, large department stores and chains of gas stations were using them. During the 1950s and '60s, airlines, phone companies, and car rental firms followed suit. Along with this came the concept of the third-party credit card.

Today there are enough credit cards in circulation to provide one for every person in the United States. William Dunkelberg estimates that more than half a billion cards for credit, charges, or cash transfers are in use in the US, accounting for at least $120 billion in transactions each year.

One or both of the two major bank cards—Master Charge and BankAmericard—can be found in about one-third of all households. It has been estimated that at the beginning of the 1970s, there were more than 50 million bank credit cards in circulation; five years earlier, before the credit card explosion, there were only five million. By 1975, the number had risen to 55 million. In mid '75, the average monthly balance outstanding on the two major bank cards was about $340.

Two-thirds of all cardholders constantly use revolving credit and rarely pay bills in full. Banks count on this. If everyone paid their bank card bills by the billing deadline, all banks—not just those few that are doing so—would have to impose fees to supplement the expense of servicing the accounts.

William Dunkelberg has found that installment buying serves as a good budgeting device for many consumers who find it difficult to save effectively. In a study he did at the Credit Research Center, he also found that consumers—whether consciously or unconsciously—can decide if they will benefit economically by using revolving credit. In the study, which involved the purchase of washers and dryers, he found that the rate of return on owning a washer and dryer compared to the cost of going to a laundromat is "exceptionally high," even if time is valued at only $1 an hour. "The money you save in terms of the cost of your driving, the cost of your time, the cost of running the washer and dryer makes the rate of return look like 40 or 50 percent for eight to 10 washer loads. This indicates why consumers are fairly insensitive to what it costs to borrow. They don't care whether they're paying 10, 12, or 14 percent, if the rate of return is going to be 50 percent."

The most economical way to borrow is to borrow against accumulated assets, which may be in the form of a savings account or in the form of stocks and bonds. One bank in New York lends up to 70 percent of the value of securities listed on the New York Stock Exchange and up to 60 percent of the value of those on the American Exchange.

Where to Obtain Credit

To measure the considerations that affect the interest rate charged on a loan, banks traditionally have used a formula called the 3Cs of credit—character, capacity, and collateral. Both the amount of money borrowed and the type

of loan affect the interest rates. Traditionally new car loans carry low rates because cars represent collateral.

People who can't qualify for bank loans often go to finance companies. According to the National Consumer Finance Association, the "average" borrower from a finance company is a skilled or semi-skilled worker, has income of more than $6,000 but less than $12,000 a year, has acquired some material goods, has at least some liquid assets at his disposal, and is probably married, under 50 years of age, and a homeowner.

"We often find that a personal loan customer will be with us continuously five, six, seven years," says Glen Jorgensen, president of C.I.T. Financial Services. "Roughly 50 percent of our unit consumer loan volume is renewal loans. For example, a customer will come in, borrow $1,000, make payments for a year, until the balance is down to $500, and then come in to get $500 more."

Few regulations would be more useful in preventing dangerous expansions of discounts and issues on the part of the city banks, than a regular exchange of notes and checks, and an actual daily or semi-weekly payment of the balances. It is one of the principal ingredients of the system of the banks of Scotland. The bankers of London, by the daily exchange of drafts at the Clearing House, reduce the ultimate balance to a very small sum; and that balance is immediately paid in notes of the Bank of England.

—ALBERT GALLATIN, 1841

Another popular source of credit is credit unions, which have been growing faster than any other thrift institution during the past five years. In 1975, the nation's 23,000 credit unions accounted for virtually the entire growth of consumer credit, traditionally the most profitable area for commercial banks and finance companies.

While bank lending declined in 1975, credit unions posted an 18 percent gain in extension of auto loans and a 15 percent increase in overall installment paper. Most credit union loans are short-term, averaging under $1,500, but a growing number are moving into home mortgages.

Credit unions were originally organized to benefit low-income workers, but the average family income of members ran to $17,000 in 1975. Although credit unions make loans to some people considered poor risks by other lenders, they claim that their loan losses have been surprisingly low—less than one percent nationwide.

Establishing credit is not easy for everyone. Credit managers of today are more interested in a record of payments than in family assets. It's a classic case of Catch-22: how do you establish credit if you don't have a credit record? The way most often recommended by bank officials is to take out a passbook savings loan.

Often when people—particularly minorities—are turned down for credit, they cry discrimination. Although New York's Manufacturers Hanover Trust asserts that they have never discriminated against classes of credit applicants, senior vice-president Edward D. Miller states that, "Credit evaluation, by the very nature of the process, is a kind of discrimination. Prudent better judgment means you have to discriminate against those applicants that your experience shows will not repay if credit is granted. But discrimination for artificial reasons such as race, age, sex, and marital status has never been our policy."

Consumer Credit Legislation

A rash of consumer credit legislation began in 1969 with the enactment of the Federal Truth in Lending Act. Among the most recent major consumer credit bills, the Equal Credit Opportunity Act, passed by Congress in October 1975, provides that creditors can no longer discriminate on the basis of sex and marital status. "It makes the financial institutions look at the *real* elements of credit worthiness and not at some assumed or erroneous bits of information about the ability of people in certain classes to repay loans," says Gerald Kluckman, chief of the Fair Credit Practices Section of the Federal Reserve Board's Office of Saver and Consumer Affairs.

James Egan, vice-president and general counsel of C.I.T. Financial Services, terms the act "laudable" but goes on to cite it as "probably one of the most slippery subjects that has come to pass in the consumer credit industry since the

passage of the Truth in Lending Act."

There is disagreement even within the industry about the necessity of knowing a credit applicant's marital status. "Prior to the Equal Credit Opportunity Act," says Egan, "one of the first things you did was to find out whether the person was married or unmarried."

However, J. Pat Wright of Wachovia Bank and Trust, headquartered in Winston-Salem, North Carolina, says that in none of their 186 branches did they regard knowledge of marital status as essential even before the enactment of ECOA. "The divorce rate shows that marriage is less and less applicable to the approval of credit," he observes.

An amendment to ECOA will make it illegal to bar credit based on age, race, color, and religion.

Expressing concern about the restrictive nature of such consumer credit legislation, Miller of Manufacturers Hanover says: "Recent legislation has made it more expensive to make and collect loans. To compensate for this expense, we have had to reduce our number of credit write-offs by tightening our credit criteria. In this way, the legislation has restricted the supply of credit."

The Impact of Credit Scoring

To avoid the issue of discrimination, some financial institutions are following retailers in the establishment of credit scoring plans. Under scoring, a set of numerical weights is assigned to measure the reliability of a loan applicant. The individual is then given a number of points for such characteristics as length of employment, length of time at current address, debt repayment, and, of course, salary.

Wright, who heads Wachovia Bank and Trust's consumer credit review function, believes that credit scoring will "play a big role in the administration of making fair credit determinations." But he cautions, "Credit scoring is not the sole determining factor in credit approval."

C.I.T.'s Glen Jorgensen reports that they tried credit scoring and dropped it. "We found there's no substitute for judgment," he explains.

The general feeling is that credit scoring schemes are good for the industry. "It's been demonstrated that those models make better decisions on average than individuals using their own judgment—and it's cheaper when large numbers of applications must be processed," explains Purdue's Dunkelberg.

Yet the C.I.T. response has a certain validity, for in spite of their unbiased intent, scoring schemes can work against the very people the ECOA is designed to help. "Studies have shown that a minority woman is a much better credit risk than a minority man, and now that can't be taken into account," elaborates Dunkelberg.

Another study shows that ignoring sex as a credit criterion actually penalizes women. According to Dunkelberg, the study shows that the development of two separate scoring schemes—one for men and one for women—enables a higher proportion of women applicants to get credit than with a single scheme. But the establishment of dual schemes is now precluded by law, and women, Dunkelberg predicts, will lose out. "If a woman applies for credit, she has fewer references, so she doesn't get as many points," he says. "A separate scheme would give more points for those same references."

The Credit Research Center has helped the federal government estimate the cost of administering the ECOA. "In the first year, its cost to businesses, which will be passed on to consumers, will be something like $3 or $4 per family and it's not clear what we've bought with that," says Dunkelberg. This, he explains, is just the cost of compliance, excluding the cost of law suits.

Changes from State systems to the national system are rapidly taking place, and it is hoped that, very soon, there will be in the United States, no banks of issue not authorized by Congress, and no bank-note circulation not secured by the government. That the government and the people will derive great benefit from this change in the banking systems of the country can hardly be questioned.

—ABRAHAM LINCOLN, 1864

"If consumers knew what legislation was really costing them, they'd probably be unhappy," continues Dunkelberg. "Somehow or other they think that the costs all disappear, but they keep forgetting that these costs are being imposed on merchants and financial institutions that employ consumers, serve consumers, and for the most part, are owned by consumers. The pension funds own 50 percent of the Fortune 500. When those companies don't perform well, it's your future that isn't performing well . . . It gets complicated when you question who's benefitting and who's really paying. Those are tough questions."

Holder-In-Due-Course Doctrine

"To a certain extent, any time you impose regulations that increase the cost of doing business, it's going to move the margin of the credit industry to a more restrictive

direction," observes James L. Brown, associate director of the Center for Consumer Affairs at the University of Wisconsin Extension in Milwaukee.

"We have reduced our volume in retail paper 12 percent just in the last couple of months," notes Miller of Manufacturers Hanover. This is since the Federal Trade Commission's ruling last May on the holder-in-due-course doctrine, which relieves the public from having to pay for shoddy goods and services by extending responsibility to the lender. Thus, financial institutions that buy installment paper from dealers are responsible for faulty merchandise and may be expected to put pressure on the merchant to satisfy a disgruntled consumer. The FTC's rule covers loans—arranged by both consumers and dealers—commonly used to finance such items as cars, appliances, and home improvements; it does not affect third-party credit card transactions, which are covered by the one-year-old Fair Credit Billing Act.

About $122 billion of credit was extended in 1975 to finance the kinds of transactions covered by the revised holder-in-due-course doctrine. Charging that they will have to, in effect, guarantee a product whenever they lend someone money to buy it, bankers have pressed Federal Reserve chairman Arthur Burns to do battle for them with the FTC. Burns has received more than 1,000 complaints.

As a result of the rule, Wachovia's Wright says, "We are not sure that we are protected to the extent that we feel we should be protected in lending money." Nor does he feel that the rule should be implemented among lending institutions. "It has caused utter chaos among lenders, sellers, and consumers," he contends. "We cannot be put in the position where we're guaranteeing the performance of automobiles, televisions, mobile homes, and so on."

James Egan at C.I.T. foresees that the ruling presents "a real opportunity for mischief on the part of consumers and on the part of lawyers who represent consumers." He suggests that lawyers will be able to "create problems" to get consumers out of paying for something like a mobile home that they bought several years ago and are now having trouble paying for.

However he concedes that the ruling has some merit. "There's no doubt that the financial institution has a greater ability to use its financing leverage in trying to keep a dealer in line in properly merchandising and properly representing the merchandise that the dealer sells."

What overall effect has the rule had? The general feeling is that it's too soon to tell. Bill Dunkelberg, however, predicts that the rule will have little effect on the availability of consumer credit. "A lot of third-party paper will become two-party paper," he says. "Dealers will start financing their own paper, probably at a higher cost to the consumer."

"There seems to be a feeling among the FTC and legislators that credit is a sacred right for everyone, but it is not," contends Glen Jorgensen. "You earn the right to have credit. I can't help but feel that they're (the FTC and legislators) trying to force lenders to make loans by fiat, and there's no way that's going to happen." △

Where to Shop for a Loan

Here is a list of borrowing sources, based on Citibank's booklet, "Borrowing Basics for Women." Typical costs range from 5 percent to more than 30 percent a year in New York State:

Retail stores: More than 50 percent of home appliances and furniture are bought on store revolving credit and installment contracts. The annual percentage rate (APR) on these usually runs 18 percent on the first $500 to $700 and 12 percent on any amount over that.

Dealers: More than 70 percent of new cars and 50 percent of used cars are bought on dealer installment contracts. The APR on dealer loans runs from approximately 11 to 13 percent.

Banks: They offer consumer installment loans for cars, home improvements, and many other personal purposes. The APR on such loans runs from approximately 11 to 13 percent in New York State.

Credit unions: Most credit unions are legally prevented from charging more than 12 percent a year on loans, and many offer rates as low as 9 percent.

Credit cards: The APR on purchases made with bank credit cards runs 18 percent a year for the first $500 and 12 percent thereafter. A cash advance costs 12 percent.

Checking accounts with credit lines: This type of account allows consumers to write checks for more than their balance. The APR on the excess, which must be within a line of credit, is 12 percent.

Finance companies: They charge higher interest rates, ranging from 17 percent to as high as 30 percent on loans. Usually, the smaller the loan, the higher the rate.

Passbook loans: This involves borrowing against money in a savings account while continuing to earn interest on it. A consumer can borrow $1,000 from a savings account earning 5½ percent at an APR of 7½ percent.

Insurance companies: Consumers can borrow against the cash value of their ordinary insurance policies at an APR of from 5 to 8 percent each year.