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What is the cost of revolving credit?

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What Is the

For more than a decade now, retailers have been under pressure from the courts and from legislatures to reduce finance charge rates and to modify the methods used to calculate such charges.

The most recent wave of pressure can be traced to an increasing reliance on the "revolving" charge account—wherein new purchases are added to the balance, the required payment is a function of the open balance, and a finance or service charge is assessed based on the balance.

Among other reasons, the increasing use of this type of account has tended to highlight the revenues that a retailer receives for extending credit. Also, since the revolving accounts have frequently replaced a 30-day charge account, the introduction of a finance charge led some observers to believe that an apparently free service had been replaced by a revenue-generating one. Retailers, they believed, were reaping additional profits by "selling" a service they used to give away.

During hearings held by the National Council on Consumer Finance during 1970, and during hearings held by Senator William Proxmire at approximately the same time, another notion concerning these accounts was introduced: that the nature of the revolving account discriminated against certain groups of consumers either by making them pay more than others for goods and services or by denying them credit privileges granted to others.

A comprehensive study was recently conducted by Touche Ross for the New York State Council of Retail Merchants (available from the Council at 150 State St., Albany, N.Y. 12207). The study demonstrated several key points:

- The retailer, despite highly visible and apparently substantial revenues, earns no profit on the "sale of credit services"—in fact he incurs a substantial loss.
- Contrary to what many well-intentioned people believe, the present situation discriminates against cash customers rather than against credit users; this is so because regulations fail to permit the operation of a free market for credit services.
- The obvious and most popular solutions for the law-

Cost of Revolving Credit?

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makers—reducing service charge ceilings and mandating certain assessment methods—do not solve, and in fact may exacerbate the problem.

The Touche Ross study, completed in September, 1973, involved 17 New York State retailers and 1,700 of their revolving credit customers. These retailers together realize well over 50 percent of the revolving credit sales in New York State. They represent a comprehensive sample of private, public, and chain stores which operate in metropolitan or upstate areas, or both. Some stores use the previous balance method of finance charge assessment and some the adjusted balance method.

Because of the significance of this sample and its scope, the study is probably the most comprehensive one yet to be made of the economics of retail credit operations. It includes:

— Cost analysis of the credit functions of each retailer, identifying the costs associated with revolving credit revenues.
— A revolving credit utilization analysis that identifies the portion of revolving credit account holders who utilize the revolving feature and thereby pay finance charges for extending their repayment periods.
— Simulation of the impact that alternative finance charge assessment methods and rates would have on store finance charge revenue.

The results of the Touche Ross revenue and cost analysis for 17 New York State retailers are summarized as follows:

	Revenue/Cost $(000)	*Percent*
Revolving Credit Sales	$776,454	100.0%
Finance Charge Revenue	59,034	7.6
Credit Costs	87,875	11.3
Deficit on Credit Operation ...	$ (28,841)	(3.7)%

As the summary shows, costs are substantially in excess of revenue, in fact nearly 50 percent greater than revenue.

Continued

What Is the Cost of Revolving Credit?

ECONOMICS OF NEW YORK STATE RETAIL STORE REVOLVING CREDIT OPERATIONS
Revolving Credit Revenue and Cost Analysis

	Amount $(000)	Percent	Store type				
			Private	Metro-politan	Upstate	Chain	Public
Net Revolving Credit Sales (excluding finance charge revenue)	$776,453.5	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Finance Charge Revenue (net) (1)	59,033.9	7.60	7.78	7.71	2.97	8.11	3.13
Credit Costs:							
Personnel costs:							
New accounts	3,914.3	.50	.68	.39	.40	.41	.24
Account servicing	8,060.9	1.04	1.49	.72	1.43	.70	1.15
Account collection	3,265 9	.42	.65	.27	.32	.26	.33
Additional sales personnel	999.1	.13	.16	.11	.14	.10	.15
Supporting services	866.8	.11	.19	.06	.19	.03	.26
Management	376.7	.05	.09	.03	—	.02	.02
Data processing	1,941.2	.25	.14	.33	.13	.34	.14
Total personnel costs	19,424.9	2.50	3.40	1.91	2.61	1.86	2.29
Data processing equipment	1,261.0	.16	.19	.15	.07	.16	.06
Credit investigation	1,075.8	.14	.18	.11	.18	.11	.14
Bad debt losses	10,853.5	1.40	.83	1.81	.72	1.93	.58
Collection agency fees	1,329.1	.17	.11	.21	.18	.22	.12
Credit space and equipment	1,555.4	.20	.25	.15	.58	.15	.27
Postage	3,078.0	.40	.45	.36	.37	.36	.34
Communication	1,161.5	.15	.29	.06	.12	.04	.22
Supplies and other	3,602.5	.46	.34	.54	.42	.57	.35
Cost of capital	44,533.6	5.73	4.23	6.83	3.72	6.93	5.02
Total credit costs	87,875.3	11.31	10.27	12.13	8.97	12.33	9.39
Excess/(deficiency) of revenue over costs	$ (28,841.4)	(3.71)%	(2.49)%	(4.42)%	(6.00)%	(4.22)%	(6.26)%

—*Exhibit III of Touche Ross study*

(A more detailed breakdown of costs for the sample appears above.)

The methodology used in isolating revolving credit costs and revenues is designed to count only the "extra" costs and to omit all elements of cost attributable to both cash and other forms of credit sales. Many of these procedures were reviewed and approved in concept by the National Commission on Consumer Finance, which was created by an act of Congress. If anything, the procedures tend to understate rather than overstate costs, and therefore the deficit on credit operations is real and represents an actual "out-of-pocket" deficit.

The deficit on revolving credit does not imply that the retailers would be better off without revolving credit, but it does mean that the profitability of revolving credit sales is lower than the profitability of cash sales. Consequently, cash customers contribute more profit per sales dollar and therefore pay in part for the services received by the revolving credit customer. This "subsidy" flows through prices which are forced upward to maintain constant profit percentages while credit sales expand.

A companion study performed by Professor Robert P. Shay of Columbia University and Professor William Dunkleberg of Stanford University assesses the impact on consumers of changes in finance charge policies. Their research suggests (and is supported by the work performed by Dr. Gene C. Lynch of the University of Arkansas) that the cash customer belongs to, in general, the lower income, and/or minority groups that cannot qualify for credit. Ironically, then, the current deficit on credit operations suggests that the poorer consumer (the cash customer) subsidizes the better-off consumer who can qualify for credit. The reason for this is that retailers cannot, by reason of present law, recoup the full amount of their credit costs through charges for credit services.

The direction of most contemplated and recently enacted credit rate legislation is to increase the credit deficit by reducing the service charge ceiling—now at 18 percent in New York State. The study shows that such changes would tend to aggravate the present situation by causing a larger credit service deficit, which eventually would have to be recovered through general price increases. This will increase the inequity already present.

Furthermore, in the face of an increased deficit on revolving credit services, retailers might well be forced to ration credit. Such rationing is made all the more likely because capital costs and bad debts account for 63 percent of total credit costs. As for the victim of such credit rationing, it is obvious he will be the lower income, more risky account applicant—the person that rate regulation is intended to protect.

Another aspect of revolving credit operations that has been subject to heavy scrutiny by lawyers and legislators is the method used to compute finance charges. The Touche Ross study included a comparison of the revenues generated by six different methods. The two most frequently used are the previous balance method and adjusted balance method, of which the former is in widest use.

The study indicates that the adjusted balance method will generate 84 percent of the revenues generated by the previous balance method at an interest rate of 1.5 percent per month. Hence, legislative pressure to substitute the adjusted balance method for the previous balance method will have an impact similar to rate reduction legislation. Either it will force a rationing of credit, which squeezes out the higher-risk, lower-income applicant; or, it will pass on a greater credit revenue/cost deficit to all consumers via the pricing mechanism.

Conclusion

There is a trend now in U.S. business toward the "unbundling" of related services and separate pricing for those services. This trend probably originated with the government-initiated unbundling by IBM of services and hardware prices during the 1960's. The trend is consistent with the "user fee" concept advocated by consumer-oriented economists who state that the price for a service should be sufficient to bear the cost of that service. This concept is implicit in the antitrust legislation governing our business environment.

The separate identification of revolving credit finance charges is consistent with the unbundling and separate pricing of credit services. However, in this case the price for that unbundled service is regulated and, because it is regulated to a level below the cost of services, inequities occur.

In view of this, it appears that enlightened legislation should permit the retailers to recoup, through a combination of service charge rates and methods, the full costs of revolving credit—for the benefit of the consumer.

Retailers Discuss Consumer Credit at Proxmire Hearings

At a hearing on "inaccurate and unfair billing practices" held May 24, 1973, before the Senate Subcommittee on Consumer Credit, its chairman, Senator William Proxmire, discussed methods of computing credit with Leonard Gay of the National Home Furnishing Association and Michael Zaroya of the National Retail Merchants Association. What follows is a condensation of their exchange on this subject.

PROXMIRE: Wouldn't it be better for the retail industry if everyone were on the same billing system? Then no one would gain an unfair competitive advantage by charging lower prices and recovering revenue through some billing system that is not clearly understood by the customers.

GAY: Senator, I would go back to what you [have] said: competition is the life of the business. Frankly, when we made our own studies between the difference in the previous balance and the ending balance, there was very little difference.

PROXMIRE: But for competition to be effective, the consumer has to know where there is a difference, even if it is rather modest. If the bill-

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ing system is the same, then he can compare the rate.

GAY: We are talking about a previous balance and an ending balance, and a daily adjusted balance. Frankly, the small retailer could not possibly handle the daily adjusted balance, as the giants do with computers. That leaves you two [methods with] little difference between the two. If you say all of us must go to one or the other, any increase in cost is going to affect the customer in the long run. I urge all retailers be given the privilege of using their own method. Competition is going to hold you in line.

PROXMIRE: The National Commission on Consumer Finance has suggested that the rate on revolving credit plans be set low enough to avoid a subsidy to cash buyers and high enough to avoid a subsidy to credit users. Would you agree?

ZAROYA: We have a growing amount of data that simply says the present finance charge rates do not cover the cost of credit programs. The general view by the retailer today is if he can approach covering his credit costs, that's [all] he is trying to do.

PROXMIRE: The one who gets the subsidy is the one who charges and then pays up within the charge period. I don't think I have any charge accounts at all. I never charge a thing. So I don't get a free ride. The man who goes in and charges, and pays up, is getting a free ride at my expense.

ZAROYA: I think the misconception is we tend to think of it being two different customers. More often the customer opts to pay in 30 days, but let's say there's a coat on sale for $50, and it's an $80 coat. She can use her revolving charge, and take advantage of this account in order to effect much greater savings.

PROXMIRE: What I'm saying, however, is that the person who pays up without a finance charge is being subsidized either by the cash customer or by the person who pays on a longer basis.

ZAROYA: The important thing is that every customer gets that option.

PROXMIRE: Does every customer get a charge account?

ZAROYA: No . . . Senator, we are struggling now to cover our credit costs with the revenues we are getting. To go to the adjusted method [would be] a great loss to the retailer who uses another method today.

PROXMIRE: The impact on total revenues will not be great. Prices can always be raised to absorb the reduced finance charge revenue. It seems to me the question boils down to one of social policy. Are the benefits to the consumer in uniformity and simplicity in billing systems, does that outweigh any potential discriminatory effect imposed on cash buyers? Your feeling is that the option should be open, even though a customer may be confused, and may pay more than he thinks he is paying.

ZAROYA: Certain retailers like to give their customers a package, and the management may decide that his package should be free delivery or free check-cashing — or an adjusted balance method on his accounts. We heard the chairman of the board this morning of the largest retailer in the country [Sears Roebuck and Co.] say that they changed their method because of competitive reasons. To me that is quite an important statement.

PROXMIRE: You told me earlier that if you went to the adjusted balance system, the rate would be higher, and there would be no way to charge a higher rate. What would prevent the retailing industry from petitioning the state legislatures for a higher rate based on this higher cost?

ZAROYA: We are worrying about keeping the rates we have. We see more action in legislatures in the opposite direction.

PROXMIRE: If the adjusted balance system were mandated, how much of an increase would you need in the rate to break even?

ZAROYA: Generally, going from the previous balance method to the adjusted-balance method, it is accepted that there would be a reduction of from 16 to 20 percent.

PROXMIRE: What is the source of those studies?

ZAROYA: Studies in our own companies, part of it was from a Touche Ross study that was made. I would like to give you that later.

PROXMIRE: Very good. One final question. Your general statement states that if minimum finance charges are eliminated, small retailers would be forced out of the credit granting market. It was my impression that minimum finance charges were employed more often by large retailers than small retailers.

ZAROYA: If I may read the initial sentence, [it says] the public interest would not be served by prohibiting computational methods, including minimum charges. I think it was again shown this morning that the difference between the annual percentage rate applied to the balance, and the minimum charge, is very small.