

HB

227

Alaska State Legislature

House of Representatives



Official Business

State Capitol
Juneau, AK 99801-1182

SPONSOR STATEMENT FOR CSHB 227(L&C) BY: Representative Tom Anderson

TITLE: "An Act relating to the Alaska Small Loans Act; and providing for an effective date."

The last significant revision of the Alaska Small Loans Act (ASLA) occurred between 1995 and 1996. The bill (then numbered HB 319) was signed into law in July 1996 and brought this section of statute up-to-date with the changing market demands. There have been several changes to the market in the last decade, and more importantly, there has been many more changes in technology. As computer systems become more and more adept at taking, storing, sorting, and retrieving information, our laws must reflect the most efficient use of those innovations.

House Bill 227, the latest revision of AS 06.020, takes into account not only the market-driven or technological changes, but also the changes in the value of money. Put simply, goods cost more today than they did twenty, ten, or even five years ago. For example, it is not unheard of to pay between \$7,500 and \$10,000 for an ATV or snowmachine. Also, manufacturer's list prices for new automobiles can start as high as \$40 - \$50,000. Clearly the definition of what constitutes a small loan needs some adjustment.

HB 227 improves the business environment by encouraging industry competition, which ultimately should decrease loan prices as well as providing consumers additional products and services to choose from. HB 227 will also update the Small Loans Act to reflect current technology. As written today, the law does not recognize automated or centralized process utilized by most companies today.

We worked with both members of financial community and with the Division of Banking and Securities to find language balancing the parties' wish lists and consumer protection. HB 227 updates the ASLA to make the law reflective of current industry practices and raises the limit of a small loan from \$25,000 to \$50,000 broadening the Department's regulatory oversight. Additionally, it doubles the liquid assets and bond requirements from \$25,000 to \$50,000 for businesses writing small loans.

I would ask for your support on HB 227.

ALASKA STATE LEGISLATURE

House of Representatives

COMMITTEE ASSIGNMENTS:

LABOR & COMMERCE COMMITTEE, CHAIRMAN
ADMINISTRATION REGULATION REVIEW COMMITTEE, CHAIRMAN
JUDICIARY COMMITTEE, VICE-CHAIR

website: <http://www.akrepublicans.org/Anderson.htm>



INTERIM:
716 WEST 4TH AVENUE
ANCHORAGE, AK 99501
PHONE: (907) 269-0265
FAX: (907) 269-0264

SESSION:
STATE CAPITOL
JUNEAU, AK 99801-1182
PHONE: (907) 465-4939
1-800-465-4939
FAX: (907) 465-2418

Representative Tom Anderson

email: Representative_Tom_Anderson@legis.state.ak.us

Sectional Analysis CS HB 227 (L&C)

Section 1

Sec. 06.20.010(a)

Permits licensees of the Act to charge interest rates above the rate of interest described in 45.45.010. This provision increases the maximum loan amount subject to this chapter from \$25,000 to \$50,000

Section 2

Sec. 06.20.010(b)

Outlines exemptions from the application requirements of AS 06.20.010(a)

Section 3

Sec. 06.20.015

Adds a new section permitting the Department to issue endorsements for licensees with multiple locations engaging in small loans.

Section 4

Sec. 06.20.020(a)

Outlines application requirements to include applicants mailing address, and the business and residence address of any partners.

Section 5

Sec. 06.20.030(a)

Changes the expenses incurred by the Department in investigating an application from those state in AS 06.01.010 to a rate determined by the Department in regulation.

Section 6

Sec. 06.20.030(b)

Increases the license fee to \$2,500 for a single location license and \$10,000 for a multiple location license.

Section 7

Sec. 06.20.040

Increases the liquid asset requirement from \$25,000 to \$50,000 for each location.

Section 8

Sec. 06.20.050

Increases the bonding requirement from \$25,000 to \$50,000

Section 9

Sec. 06.20.050

Adds new section requiring the bonding stay in force until the Department revokes the license, until all loans made by licensee are paid in full, and while there is pending litigation on a loan.

Section 10

Sec. 06.20.060

Defines the Department's responsibilities in approving and denying an application

Section 11

Sec. 06.20.063

Adds a new section that defines specific grounds for the Department to disapprove an application.

Sec. 06.20.065

Adds a new section requiring written notification of disapproval and outlines the response times for requesting a hearing.

Sec. 06.20.067

Adds a new section making the license continuous until surrendered, revoked, or suspended.

Section 12

Sec. 06.20.070

Outlines that the license will be in a form prescribed by the department, and requires that it be conspicuously posted in each place of business.

Section 13

Sec. 06.20.070

Adds a news paragraph requiring the license state the website domain address and physical location of the principal place where the licensee conducts business.

Section 14

Sec. 06.20.090

Provides requirements for noticing the Department when a licensee changes the place of business.

Section 15

Sec. 06.20.110

Clarifies the grounds for the Department to revoke or suspend a license.

Section 16

Sec. 06.20.120

Outlines the Department's ability to revoke or suspend a licensee who has multiple locations.

Section 17

Sec. 06.20.125

Adds a new section allowing the department to place restrictions on business activities of a licensee during a suspension or revocation.

Section 18

Sec. 06.20.130

Adds a new section that provides for the surrender of a license.

Section 19

Sec. 06.20.130

Adds a new section requiring a licensee to surrender a license after 24 months of inactivity.

Section 20

Sec. 06.20.140

Describes the effect of a license revocation, suspension, or surrender.

Section 21

Sec. 06.20.140

Add a new section stating the surrender of a license does not affect civil or criminal liability for acts committed before the surrender.

Section 22

Sec. 06.20.150

Outlines conditions for license reinstatement

Section 23

Sec. 06.20.155

Adds a new section requiring the Department to proceed under the Administrative Procedure Act when revoking or suspending a license.

Section 24

Sec. 06.20.160

Outlines the Department's responsibilities to conduct inspections and examinations of licensees. allows for the costs of examinations to be bore by the licensee, and describes the type and nature of the examinations.

Section 25

Sec. 06.20.180

Outlines the type of records to be kept by the licensee and for how long they must be kept.

Section 26

Sec. 06.20.190

Sets the requirement for annual reports to be submitted by the licensee.

Section 27

Sec. 06.20.200(p)

Amends current statute to address misrepresentation in advertising for loans.

Section 28

Sec. 06.20.210

Requires a licensee to notify the department if they intend to conduct other business activities at a licensed location and gives the department the ability to prohibit other business under certain circumstances.

Section 29

Sec. 06.20.230

Reduces the maximum amount of interest rates on certain loans from 36% APR or the higher of 24% or 10% above the Federal Reserve discount rate.

Section 30

Sec. 06.20.240

Prohibits a licensee from inducing a person or persons to rewrite loans with the sole purpose of obtaining a higher interest rate.

Section 31

Sec. 06.20.250(c)

Revises the maximum term for loans between \$5,000 and \$25,000.

Section 32

Sec. 06.20.260

Outlines the type of charges a licensee can charge, what charges are prohibited, late fee amounts, NSF amounts, and other types of charges that would accompany a consumer loan or fees associated with the servicing of those types loans.

Section 33

Sec. 06.20.270

Itemizes the type of information licensees must provide to borrowers during the loan process, from consummation to completion.

Section 34

Sec. 06.20.285

Restates the method for calculating interest on open-ended loans.

Section 35

Sec. 06.20.290

This section prohibits a licensee from taking an assignment of earnings as payment or security for a loan.

Section 36

Sec. 06.20.320

Outlines allowable penalties the Department may assess a licensee.

Section 37

Sec. 06.20.340

Requires the Department to notify licensees when regulation changes are made.

Section 38

Sec. 06.20.370

Adds a new section giving the department the authority to issue an order to remove or suspend an officer under certain circumstances.

Sec. 06.20.380

Adds a new section regarding the department's ability to issue a cease and desist order.

Sec. 06.20.390

Adds a new section prohibiting a person from providing false information during and examination or investigation.

Sec. 06.20.400

Adds a new section permitting the department to make rulings necessary to enforce this chapter.

Sec. 06.20.410

Adds new section permitting the department to file an action in court in order to enforce this chapter. Makes the violation of this chapter a Class A misdemeanor.

Sec. 06.20.420

Adds a new section that states if any provision of this chapter are in conflict with federal law, then the provision does not apply.

Section 39

Sec. 06.20.900

Provides additional definitions for the terminology used in this chapter.

Section 40

Sec. 08.76.040(b)

Adjusts the recovery amount a pawnbroker shall pay a pledgor to reflect the change in the 1993 increase in the pawn limit. This change reflects the original intent to allow for twice the maximum pawn limit as it was passed in 1955 and revised in 1982.

Section 41

Sec. 18.80.250(c)

Amends the unlawful financing practice statues to include reflect the new changes in this bill.

Section 42

Sec. 43.70.080(a)

Provides an exemption to the state's business license fee due to the high nature of the licensing fee under this chapter.

Section 43

List of statues to be repealed due to the new changes in this legislation

Section 44

Adds a new section allowing the Department to adopt regulations under Section 1-43, and 45.

Section 45

Provides transition language for the Department to adopt regulation for the implementation of the act.

Section 46

Implements Section 44 immediately.

Section 47

Provides for effective date of Jan. 1, 2007 for Sections 1-43 and 45.



Wells Fargo Financial
800 Walnut
Des Moines, IA 50309-3636
515-243-2131

STATEMENT OF WELLS FARGO FINANCIAL IN SUPPORT OF HB 227

Wells Fargo Financial, an affiliate of Wells Fargo Bank, operates seven offices in Alaska as Small Loan Licensees. When the Department of Commerce, Community, and Economic Development contacted Wells Fargo Financial a few years ago requesting our input into the modernization of Alaska's Small Loan law, we provided a list of recommended changes. Because of the Department's workload constraints, Wells Fargo Financial, through its retained lobbyist, has been working with the House Labor and Commerce Committee leadership to revise the Small Loan law. The Bill under consideration today considerably improves the lending industry environment in Alaska; it invites new business which ultimately benefits Alaska consumers by creating a more competitive lending environment. Although there are additional revisions Wells Fargo Financial would prefer to see implemented, we feel this proposed legislation is a move in a positive direction for Alaska, its consumers, and its lending industry. HB 227, through the combined knowledge and efforts of the Department, the Committee and Wells Fargo Financial, offers an improved and modernized Small Loan law, and Wells Fargo Financial hopes it meets with your support.

PART III: EFFECTS OF RATE CEILINGS ON CONSUMERS

The previous section has described the benefits of allowing a competitive market to establish the rates charged on consumer credit. This section examines and documents the effects on consumers when government interferes in the market and sets prices on consumer credit.

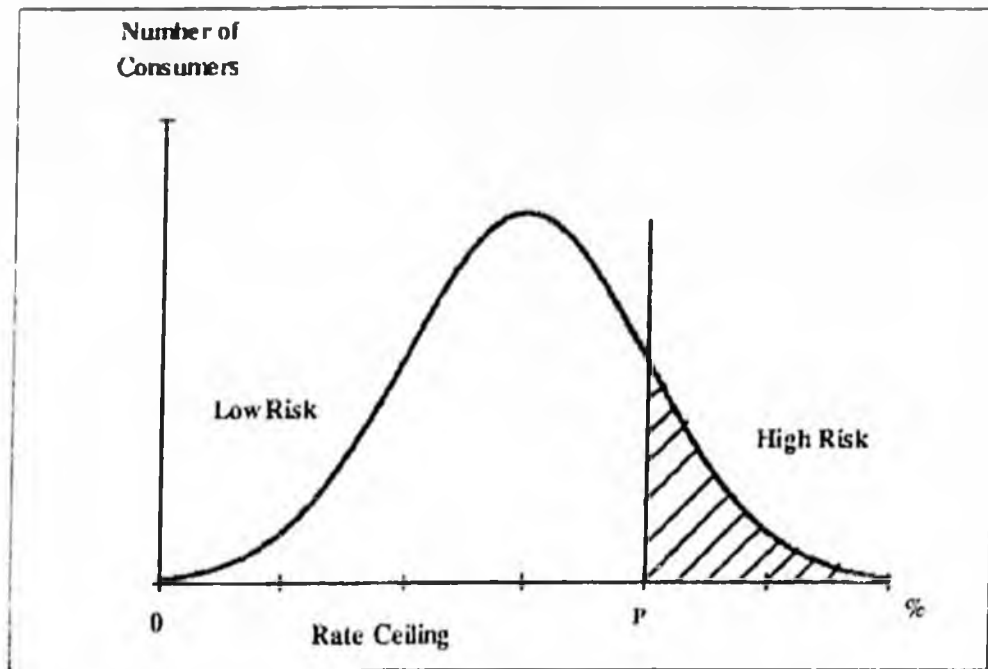
A. Cash credit

Contrary to the best intentions of legislators rate ceilings on loans--primarily installment loans and mortgage loans--"heap distress" on consumers in two general ways. First, some consumers are simply denied cash credit. Second, having been denied credit, these consumers will seek to find other means or sources of obtaining credit to meet their needs. Obviously, these other methods are "second best," or they would have used them in the first place.

1. Availability of credit

The impact of rate ceilings on the availability of cash credit to high-risk consumers is readily illustrated by referring to Exhibit 19. Consumers are arrayed along the horizontal axis according to the minimum percentage finance charge at which creditors would be willing to extend them a loan. A small number of low-risk consumers comprise the left-most tail of the distribution of all consumers. Repayment risk associated with customers increases outward along the horizontal axis, driving up the minimum loan rate at which those customers could be served. The right-hand tail of the distribution represents the highest risk customers in the distribution of all potential borrowers, those whom creditors would be willing to serve only at very high interest rates. Should the government impose an artificial cap on loan rates at p , all consumer to the right would be denied access to the legal market.

Exhibit 19
Effect of Rate Ceiling on Availability of Cash Credit to Consumers



Why is this so? The higher the risk posed by credit applicants, the higher the costs to creditors of granting them credit. High-risk accounts typically breed above-average collection costs and, ultimately, higher credit losses. Experience varies among banks, credit unions and finance companies, but it generally takes eight to ten good accounts to offset the losses on one bad account. If the government does not permit lenders in the private sector to charge a rate high enough to cover these costs, financial institutions will not lend to consumers who would generate these costs.

As indicated earlier, the impact of rate ceilings has been so widely accepted that few empirical studies have been conducted on the issue in the past decade. Fortunately, basic economic principles and data do not wither with age. In a very large national study of loans made by commercial and savings banks, the National Commission on Consumer Finance in 1971 found that in 16 states with high rate ceilings, the dollars of loans per family were 21 percent higher than in the 16 states with low rate ceilings (Exhibit 20).⁴² The data indicate that consumers who were creditworthy in the high ceiling states would not have received legal cash loans in the low ceiling states.

⁴² *Consumer Credit in the United States*, pp. 134-35.

Exhibit 20
Bank Personal Loans, Second Quarter 1971

	Number of Loans per 100 Families	Dollars of Loans per Family
Low-ceiling states	3.66	37.02
High-ceiling states	4.53	44.82

Source: National Commission on Consumer Finance, *Consumer Credit in the United States*, 1972, pp. 134-35.

A rate ceiling not only rations high-risk consumers out of the market, but also tends to ration out consumers seeking small amounts of credit. In addition to the costs associated with credit risk, there are administrative costs in granting credit and managing subsequent collections. Since many of these costs are fixed and unrelated to the amount of credit generated, they are proportionately higher for small amounts of credit. If these costs are not covered by the permitted finance charge, credit will not be extended, even to low-risk consumers.

A simple example illustrates the point. Assume that a hair dryer might be purchased for cash for \$20. Alternatively, it may be purchased for \$2.00 down and \$2.00 per week for ten weeks: total cost equals \$22, of which \$2.00 is the finance charge. Would a 20 percent cap on finance charges permit the transaction? Hardly, the annual percentage rate on that credit transaction is 102 percent. Yet, the \$2 charge imposed by the creditor does not seem unreasonable considering the cost of setting up the credit arrangement and processing 10 payments. It is reasonable to believe that high-risk consumers are often those who, at best, can afford to borrow only small amounts.

The effects on the market and consumers of imposing restrictive rate ceilings on small loans to high-risk borrowers are dramatically illustrated by the experience in Massachusetts. In 1977, in an effort to "protect" consumers the state legislature sharply cut rates that consumer finance companies were permitted to charge, especially on loans of less than \$2,500. Far from protecting consumers who needed to borrow only small amounts of money, the lowered rate ceilings caused lenders to shift away from offering those smaller loans into larger loans which were often collateralized by borrowers' homes, an option not available to less affluent renters. Comparison of their lending activity in 1975 and 1979 shows that:

the number of loans made below \$500 declined by 32 percent, and the large, national finance companies dramatically increased their investment in large second mortgage loans. At the same time the industry structure changed. The number of loan offices fell by 35 percent, with the small, local companies bearing most of the brunt of the decline in loans made and loans outstanding.⁴³

Even when consumers have been rationed out of the market by government price-fixing, they may still want to borrow money. Evidence of the strength of their demand is illustrated by Arkansas, where only a few

⁴³ Robert W. Johnson and A. Charlene Sullivan, *Restrictive Effects of Rate Ceilings on Consumer Choice: The Massachusetts Experience*. Working Paper No. 25. West Lafayette, IN: Credit Research Center, Purdue University, 1980, p. ii.

finance companies operate under a punitive rate ceiling. Law students who interviewed lenders in that state reported that finance companies did not advertise extensively because the expense was not warranted. One lender complained that "an advertising campaign draws borrowers like flies." However, 90 percent of those attracted were rejected because they could not be served under the rate ceiling. In other states, the rejection rate was around 50 percent. The researchers concluded, "This comparison indicated that a large segment of the Little Rock population is not regularly served by potential sources of small loans."⁴⁴

What do we know about these high-risk consumers that are excluded from the cash market by government fiat? Credit-scoring systems provide very good clues to the nature of consumers representing above-average risk. They are primarily consumers who are young, have a short time-on-the job or at their residence, rent homes, and are relatively unskilled workers. They are also likely to have lower incomes than more creditworthy consumers. The adverse effects of rate ceilings on low-income consumers has been documented in a study based on household financial data obtained from the 1983 Survey of Consumers' Finances. In that study, Villegas (1989) segmented respondents into three groups according to household income (high, medium and low) and tested how much credit they were able to obtain in states with and without rate ceilings. He concluded that "on average a low-income household residing in a state with usury ceilings had \$1,012 less consumer credit than an identical household in a state without usury ceilings."⁴⁵ In contrast, those consumers classified as having high-incomes were unaffected by the rate ceilings.

Confirming evidence is provided in the area of bank credit cards. A bank that is being squeezed between rising costs and a rate ceiling will attempt to reduce its credit risks. If it is using a credit-scoring system, it will raise the "hurdle rate" or "cutoff point" associated with acceptance. Using a bank's credit scoring system, Shay and Dunkelberg (1975) demonstrated the differences in rejection rates by income groups if the bank raised its cutoff point.⁴⁶

⁴⁴ "An Empirical Study of the Arkansas Usury Law: 'With Friends Like That...'" *Law Forum* (1968), pp. 580-81.

⁴⁵ Villegas, *op. cit.*, 136.

⁴⁶ Robert P. Shay and William C. Dunkelberg, *Retail Store Credit Card Use in New York*. New York: Graduate School of Business, Columbia University, 1975, p. 55.

Exhibit 21
Simulated Rejections of Holders of Bank Credit Cards
by Credit Score Cutoff Points

Cutoff Raised from 19 to:	% of Cardholders Who would be Rejected	Percent of rejected cardholders with incomes:			
		<\$7,500	<\$10,000	<\$15,000	<\$20,000
24	1.6	89%	89%	100%	100%
29	6.6	50	58	82	91
34	18.4	30	55	77	89
39	36.3	19	42	68	87
Percent of total sample of cardholders		8.9	17.3	42.0	68.4

Source: Shay and Dunkelberg, *Retail Store Credit Card Use in New York*, 1975, p. 55.

The results shown in Exhibit 21 are dramatic and consistent with theory. Raising the hurdle rate from 19 to 24 would have eliminated about two percent of the cardholders. However, 89 percent of those rejected had incomes less than \$10,000, the median income at that time. Since only 17 percent of all of the cardholders had incomes of less than \$10,000, tightened credit standards clearly would have had a disproportionate effect on low-income consumers.

Just because consumers have low incomes and need small amounts of credit does not mean that they should not have credit. Important insight into the needs of high-risk consumers who want small cash loans is provided by an extensive study of the small loan industry in Texas by Durkin (1972). At the time of his study the maximum loan that could be made by these high-rate lenders licensed under Article 3.16 of Texas statutes was \$100, with permitted rates ranging from 108.75 percent for \$100 loans for six months to 240 percent for a one-month loan of \$30 or less. Only 4.1 percent of the loans surveyed were for \$30 or less.

Why did these consumers borrow such small sums? Interviews revealed a wide range of needs that were met: old bills, debt consolidation, medical expenses, autos (purchase, parts, or repair), clothing, food, utility bills, house payments or improvements, family aid, taxes or insurance, and so on. Four-fifths of the borrowers knew that their loans were more expensive than bank loans, but these were generally not available to them.

What were the borrowers like? Given their needs, should they have been rationed out of the legal market by lower rate ceilings?

... most of them belong to the parts of the population that often have trouble obtaining credit. Over 36 percent of the borrowers sampled were unmarried, including over 14 percent who were separated or divorced and almost 9 percent who were widowed. The large majority of small small loan borrowers in

the sample were employed at low level unskilled jobs and most had incomes well below the median for the city where they lived. Over 15 percent of the borrowers were living on pensions or social security.⁴⁷

2. Reduction in competition

Since there are some fixed costs in lending to consumers (e.g. computers, development of sophisticated credit-evaluation systems), large lenders may have some competitive advantages over their smaller competitors. In a study for the National Commission, Benston (1972) found that large finance companies were more profitable than smaller firms, although there did not appear to be economies of scale in their operating expenses. However, there were economies of scale for large offices vs. small loan offices.⁴⁸

If there is an advantage to being "big," whether by firm or by lending office, large firms making cash loans are better able to survive under restrictive rate ceilings than their smaller competitors. Evidence is provided by the study of the effect of cutting rate ceilings in Massachusetts. The legislation not only made it more difficult for high-risk consumers to obtain a loan, but it also reduced the accessibility of loans by fostering a reduction in the number of loan offices from 266 to 172 over the period studied.⁴⁹ While individual consumers must usually obtain cash loans from local markets--now under-served as a result of the reduction in rate ceilings--lenders are free to move their funds globally to their most profitable use. Obviously, lenders in Massachusetts did just that, shifting their funds into other states and into second-mortgage loans to homeowners within the state. The least affluent and least creditworthy citizens found loan offices both less conveniently located and less likely to grant credit.

3. Evasive tactics

When the government intervenes between consumers who willingly borrow and lenders who willingly lend, both parties try to work around the impediments placed in their way by the legislature. This is neither cynical or illegal. It is simply the market at work. Unfortunately, evasion imposes additional costs on consumers and not necessarily the consumers who are borrowing. Evasion also imposes costs on society as a whole. Just as any road detour requires extra time and gas, so does a detour that consumers take to obtain cash credit create extra costs that are not productive for society in any sense.

a. Increase in other charges to consumers. The diverse impact on consumers of rate ceilings on cash credit is illustrated by data from a four-state study conducted in early 1979 by the Credit Research Center at Purdue University under a grant from the National Science Foundation. The study permits comparison of lenders' reactions to ten percent rate ceilings in Arkansas with states having much higher rate ceilings: Louisiana, Illinois and Wisconsin. Commercial banks in Arkansas evidently used various means, including raising fees on other bank services, to offset their mandated loss of revenues from loans to consumers.

⁴⁷ Thomas A. Durkin, "A High Rate Market for Consumer Loans: The Small Small Loan industry in Texas," *Technical Studies, Volume II*. Washington, D.C.: National Commission on Consumer Finance, 1972, p. 89.

⁴⁸ George J. Benston, "The Costs to Consumer Finance Companies of Extending Consumer Credit," in *Technical Studies, Volume II*. Washington, D.C.: National Commission on Consumer Finance, 1972.

⁴⁹ Johnson and Sullivan, *op. cit.*, p. 14.

Significant differences between the charges of Arkansas banks and banks in the other three states were found by Peterson and Falls (Exhibit 22).⁵⁰

A study by Sullivan of the same database found that, in relation to banks in the three control states, "banks in the Arkansas area were open to provide consumer services fewer hours per week." They also appeared somewhat less likely than banks in other states to provide ATMs to their customers.⁵¹

b. Resort to sales or lease credit As will be seen in the following section, credit sellers can readily avoid rate ceilings merely by increasing the cash prices of their goods and services. Consequently, when consumers are unable to obtain small cash loans to shop for autos or household goods, then can go directly to sellers of goods and services and obtain financing through them. This practice is, however, a second-best choice for consumers. A consumer who finds a dealer willing to extend credit is "locked in" to the products sold by that dealer. Unable to obtain cash loans, consumers also resort to rent-to-own suppliers to obtain TVs and other household equipment. A perusal of the phone book in Little Rock reveals many such suppliers.

Exhibit 22
Significant* Differences in Credit Terms at
Arkansas Commercial Banks and Those in Three Control
States
(Mean values)

	Arkansas	Other	t-Values
Credit investigation fees (mortgages)	\$23.33	\$11.57	2.83
Bank check charges on minimum balance:			
0-99 dollars	\$4.21	\$0.77	5.43
199-199 dollars	\$3.10	\$1.90	1.96
200-299 dollars	\$1.74	\$1.06	1.99
300+ dollars	\$0.80	\$0.00	2.35
Check overdraft charges	\$6.21	\$4.81	1.97
Minimum personal loan size	\$1,571.52	\$579.94	8.24
Cosigners on most recent loan:			
Family auto purchase	12.7%	6.7%	6.44
Personal loan	13.0%	8.0%	2.82
Average maturity on auto loan (first car)	37.4 mo.	39.1 mo.	2.27
Percent of banks making 48-mo. auto loans	42.9%	87.5%	3.89
*Significant at 10 percent confidence level			
Source: Peterson and Falls, <i>Impact of Ten Percent Usury Ceiling</i> , 1981, pp. 11, 16-17.			

⁵⁰ Richard L. Peterson and Gregory A. Falls, *Impact of a Ten Percent Usury Ceiling. Empirical Evidence*. Working Paper No. 40. W. Lafayette, IN: Credit Research Center, Purdue University, 1981, pp. 11, 16-17.

⁵¹ A. Charlene Sullivan, *Evidence of the Effect of Restrictive Loan Rate Ceilings on Prices of Consumer Financial Services*. Working Paper No. 36. W. Lafayette, IN: Credit Research Center, Purdue University, 1980, pp. 12-13.

C. Resort to high-cost sources of cash credit. When high-risk consumers are denied cash loans by finance companies, banks or credit unions, they turn to both legitimate and illegitimate sources of credit. Some consumers will buy marketable goods, such as TVs, and then sell them for cash. Obviously, the cost of credit with that arrangement is considerably higher than would be the case were more established sources of cash credit permitted to operate.

An alternative source of cash credit is pawn shops, which are attracted to states where rate ceilings on consumer loans have curtailed the ability of potential competitors to make small, high-risk loans, while permitting pawnshops that privilege. For example, a study comparing the similar cities of Little Rock, AR and Champaign-Urbana, IL found that the former city had four pawn shops, while the latter had only two.⁵²

d. Resort to illegal lenders. Finally, consumers who are unable to detour to legitimate sources of cash credit may, in desperation, turn to illegal lenders. The rates that these consumers pay has been described by John M. Seidl in testimony before the U.S. House Subcommittee on Consumer Affairs:

The rate in some urban areas for small loans is 20 percent per week--"6 for 5." The interest charge--called "vig," "vigorish," or "juice" by borrowers and lenders alike--is due each week as long as the principal is outstanding. The principal can be reduced only by lump-sum or, in some cases, half-lump-sum payments. Since Truth-in-Lending requires statement of interest rates in percent per annum, it will be apparent that 20 percent per week is 1,040 percent per annum.

In other urban areas the rate is 20 percent for a six week or ten week period with interest charges added to the principal and the total repaid in equal weekly installments ... Twenty percent add-on for a six to ten week period produces from approximately 200 percent to 350 percent per annum.⁵³

B. Sales credit

Assume that an amusement park has a large number of hot dog stands, all competing vigorously with each other for sales. The Commissioner of the amusement park decides that some consumers find it difficult to buy hot dogs at the going price of 50 cents each and decrees that, to protect these consumers, the price charged for a hot dog may not exceed 40 cents. Query: what will happen to the prices charged for the bun and mustard?

Just as the forced reduction in the selling price of the hot dog generates a higher price for the bun and mustard, so does a legislated reduction in the finance charge on sales credit get transmitted into a higher price for the goods or services sold on credit. There is abundant evidence of "padding" cash selling prices in order to produce a lower rate of finance charge (annual percentage rate). A study by the Federal Trade Commission of credit and sales practices in the District of Columbia showed that the average rates charged low-income consumers buying goods and services on credit in the inner city was only four percentage points higher than the rates charged by general market retailers. On a \$100 purchase, that difference would amount to about \$2 on a 12-month contract. The costs of the higher risk and the typically small amounts financed appeared in the differences in the cash prices of the goods sold on credit. The average price of a television

⁵² "An Empirical Study of the Arkansas Usury Law," *op. cit.*, p. 580.

⁵³ *Hearings on Consumer Credit Regulations Before the Subcommittee on Consumer Affairs of the House Banking and Currency Committee*, 91st Cong., 1st Sess., pt. 1, at 185 (1969).

set with a wholesale price of \$100 was \$187 at low-income retailers, compared with \$131 at an appliance store serving the general market.⁵⁴ Lowering the rate ceiling on sales credit would merely have generated an even higher cash-price differential between the inner city purchase and one from retailers serving the general market.

Another basic study was done in Arkansas to test the theory that below-market rate ceilings would force credit sellers, such as department stores and appliance dealers, to inflate the cash price. The packing of the cash price would occur regardless of whether the credit seller offered installment sales or issued a retail credit card. Lynch (1968) compared cash prices of identical merchandise in Arkansas and seven other "control" states in the region that did not have low rate ceilings on sales credit. His findings were summarized by a composite price index representing prices on color television, dryers, kitchen ranges, refrigerators and washers, with the composite price in Arkansas set at \$100 for purpose of comparison. The data show very clearly that cash buyers in Arkansas paid significantly higher prices than cash buyers in the control states. (Exhibit 23)⁵⁵ Those findings are consistent with the theory that the higher cash prices were needed in order to subsidize the use of credit.

Exhibit 23
Composite Price Index for Major Appliances
Little Rock, AR = 100

Little Rock, Arkansas	\$100.0
Texarkana, Texas-Arkansas	95.88
Monroe, Louisiana	96.43
Greenville, Mississippi	96.66
Memphis, Tennessee	92.60
Springfield, Missouri	97.05
Tulsa, Oklahoma	93.09
Denver, Colorado	96.72

Source: Lynch, "Consumer Credit at Ten Percent Simple: The Arkansas Case," 1968, p. 599.

Rate ceilings on sales credit clearly do not "protect" credit buyers. Moreover, they force cash buyers, who may not be sufficiently creditworthy to obtain credit, to subsidize other consumers who have been able to obtain credit. Thus, rate ceilings "heap distress," even upon innocent cash buyers.

Whether issuers of bank credit cards, as contrasted to retail credit cards, cause part of the cost of credit to be pushed into cash prices depends on whether the bank issuing the card is out-of-state or in-state. If a national, out-of-state bank has issued a credit card to a resident of a state with restrictive rate ceilings,

⁵⁴ Federal Trade Commission, *Economic Report on Installment Credit and Retail Sales Practices of District of Columbia Retailers* (1968).

⁵⁵ Gene C. Lynch, "Consumer Credit at Ten Per Cent Simple: the Arkansas Case," *Law Forum* (1968), p. 599.

that bank is free to "export" a rate higher than that permitted by the state's rate ceilings. Consumers in that state are already paying higher prices to subsidize credit buyers than would be the case in a free market, but that is a general harm that is not related to the out-of-state credit card.

However, if an *in-state* bank is involved, it must abide by the restrictive rate ceiling of the state. Still, the in-state bank has a number of alternatives to adjust to the restrictive rate ceiling. It may charge an annual fee, do away with the "free" or "grace" period on the card, or increase fees for late payments and over-limit charges. Such adjustments are likely to place the in-state bank at a competitive disadvantage in relation to its out-of-state competitors. A more subtle approach is to increase the discount charged retailers for acquiring their credit-card paper. This is exactly the tactic following by the few banks in Arkansas that issue credit cards. Peterson and Falls (1981) found that the average discount rates on bank credit cards ranged from 2.0 percent in Illinois to 3.3 percent in Wisconsin to 3.6 percent in Louisiana, but they averaged 5.5 percent in Arkansas.⁵⁶ A retailer in Arkansas who sold a \$100 obligation to its bank for \$94.50 would obviously have to raise its cash price in order to realize the same profit on the sales as retailers in other states without restrictive rate ceilings. Since all retailers in Arkansas experienced the same problem, all retailers selling on credit could raise their cash prices to compensate for the higher discount rates paid by the banks.

The easy evasion of rate ceilings on sales credit by shifting all or a portion of the finance charge was captured in an often-quoted passage from Bentham: "As far as prodigality, then, is concerned, I must confess, I cannot see the use of stopping the current of expenditure in this way at the fossset, when there are so many unpreventable ways of letting it run out of the bung-hole."

C. Total consumer credit

In view of the restrictions on the availability of credit, one would expect that consumers in Arkansas would have less credit per household than in the other three control states: Louisiana, Illinois and Wisconsin. That turns out not to be the case.

Overall, the data indicate that Arkansas residents held as much credit as consumers located in the other states. In the aggregate, in fact, the total amount of consumer debt per household held by Arkansas respondents insignificantly exceeded the average amount of consumer debt held by other respondents in the sample.⁵⁷

The explanation for this result is quite simple. Unable to obtain cash credit in the amounts desired, Arkansas consumers took a detour and turned to sales credit. Arkansas residents, especially those with low incomes or in high-risk categories, had significantly less cash credit than borrowers in the other states. This deficiency was offset by increased use of sales credit, whose availability was largely unaffected by rate ceilings. The differences in the ratios of sales credit to cash credit between Arkansas and the control states was highly significant (Exhibit 24).⁵⁸

⁵⁶ Peterson and Falls, *op. cit.*, p. 28.

⁵⁷ *Ibid.*, p. 22.

⁵⁸ *Ibid.*, p. 23.

Exhibit 24
Total Household Debt Holdings, Arkansas vs. Control States

	Arkansas	Other	t-Value
Total consumer debt outstanding per household	\$1,455.71	\$1,367.68	-0.81
Cash credit (excluding credit cards, and dealer-originated credit)	\$605.59	\$846.52	3.28*
Sales credit (including credit cards) as a percentage of total household debt--Average per household	.7286	.5845	-6.22*

* Significantly different at the 10 percent confidence level.

Source: Peterson and Falls, *Impact of Ten Percent Ceiling*, 1981, p. 27.

Finally, in relying on sales credit, Arkansas consumers who had low incomes or were in high-risk categories were much more likely to obtain credit directly from dealers (sellers of autos, household appliances, and so on) than were more affluent consumers, but much less likely to rely on credit card debt, quite possibly because many did not have credit cards. Once again, the least affluent segment of society bore the greatest burden of the regulations that were designed to protect them.

D. Conclusion

Restrictive rate ceilings on cash credit force lenders to deny credit to consumers who pose a high risk or desire only small amounts of credit. These excluded consumers are typically young, have short-time on the job or at their residence, are renters, and are unskilled workers with relatively low incomes. Not only do ceilings ration consumers out of the legal market, but they also drive smaller lenders from the market and thereby diminish competition. Both lenders and consumers find second-best ways around the squeeze imposed by rate ceilings. Where feasible, lenders raise other charges to consumers, and consumers resort to sales or lease credit and various high-cost sources of cash credit, some legal, some not.

Restrictive rate ceilings on sales credit are basically a sham. Denied an adequate return for their credit services, retailers push their shortfall into higher cash prices. Ironically, the higher cash prices adversely affect consumers who have been unable to obtain credit, presumably a group who are less able to afford higher cash prices than the more affluent credit buyers. In-state banks issuing credit cards raise their merchant discounts, an increase that is, again, transmitted to cash buyers through higher prices.

PART IV: CONCLUSIONS

This study has explained the theories underlying the discussion of how credit markets work and the effects upon consumers of government intervention in those markets. Again and again, the data drawn from studies of credit markets with and without restrictive rate ceilings support the theories that have been advanced and accepted by economists over the centuries. The basic conclusions of this study are summarized below.

- The U.S. experience of the past 25 years has validated the faith of the National Commission on Consumer Finance in the power of free and competitive markets to regulate and moderate the price of credit. **The legal ability to raise rates does not correspond to the economic ability to sustain higher rates.** Rates for various types of consumer credit do not necessarily rise to a regulatory ceiling and are less likely to do so, the higher the ceiling. Instead, knowledgeable consumer and unrestricted entry are the economic forces that make credit available at prices commensurate with the costs and risks of providing the credit.
- **In the absence of restrictive rate ceilings, competition expands the range and variety of credit products available to consumers and broadens the risk spectrum of consumers that can benefit from these products.** For example, deregulation of bank credit card rates over the past 15 years spurred entry into the industry and expansion of credit card offers. As a result, both high- and low-risk consumers are now being served within a highly competitive environment where prices adjust to reflect customers' costs and risk.
- **Risk-based pricing, which is difficult or impossible under binding rate ceilings, substantially broadens consumer access to credit.** This is nowhere better demonstrated than in the bank card industry. Deregulation of bank card rates over the past 15 years spurred entry into the industry and expansion of credit card offers. For millions of households who were too risky for bank cards in the 1970s, the rate deregulation of the 1980s gave them access to the most powerful payment mechanism on the planet. Entry spurred dramatic innovations in card features, and ultimately brought us cards that pay us to use them.
- **Risk-based pricing removes the hidden subsidies of high risk borrowers by low risk borrowers, which occurred when all borrowers were charged a rate equal to the average risk of the entire group.** Both groups are served more efficiently when creditors can charge rates commensurate with risk.
- **Restrictive rate ceilings are most harmful to the citizens they were apparently designed to protect.** Regardless of where a ceiling is set, some higher risk consumers needing cash credit are rationed out of the market because the cost of serving them is too high for the creditor to absorb or to pass on as higher rates to lower risk customers. Excluded customers are typically young, have short-time-on-the-job or at their residence, are relatively unskilled workers, have relatively low incomes, or poor credit histories because of past illness or unemployment.
- **Restrictive ceilings on sales credit (credit offered by merchants for purchase of goods or services) are basically a sham.** Denied an adequate return for their credit services, retailers push

their shortfall into higher cash prices. Higher cash prices affect not only customers who borrow, but those who have been unable to get credit, presumably a group who are less able to afford higher cash prices than the more affluent credit buyers.

- **In the end, consumers obtain the credit they need from sources that are inconvenient and at higher prices that do not efficiently reflect cost and risk.**

In short, rate ceilings that are thought to "protect" consumers do not protect consumers and do clear harm to those who are generally at the bottom of the economic ladder. The most reliable way to protect higher risk borrowers is to ensure that they have alternative sources of financing from which to choose. This is accomplished by facilitating the unrestricted entry of new competitors into a market in which the price of credit is free from artificial constraints.

The Cost Structure of the Consumer Finance Industry

Credit Research Center

Working Paper No. 59

Krannert Graduate School of Management – Purdue University

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Thomas A. Durkin
Board of Governors of the Federal Reserve
Washington, D.C.

Gregory E. Eliehausen
Board of Governors of the Federal Reserve
Washington, D.C.

December 1994

The authors would like to thank Gerald A. Hanweck, Robert W. Johnson, Mitchell A. Post, and John D. Wolken for comments and suggestions. The views expressed here are those of the authors alone and do not necessarily represent the views of the Board of Governors or its staff.

THE COST STRUCTURE OF THE CONSUMER FINANCE INDUSTRY

Erosion of market segmentation in consumer financial services in recent years inevitably raises the issue of future industry structure. If new opportunities to expand produce declining unit costs, a few large firms may come to dominate the market, possibly with adverse effects on market competition. If, in contrast, unit costs do not decline as firms attempt to exploit new opportunities, then large firms do not have a cost advantage. This case will likely produce more firms of various sizes, unless entry is artificially restricted. In such a cost environment, a breakdown of market segmentation should benefit consumers and other users of financial services as they receive the advantages of enhanced competition.

In examining the costs of suppliers of financial services, researchers have focused most of their attention on commercial banks and savings and loan associations (S&Ls).¹ Undoubtedly, the size and importance of these types of financial institutions account for this attention (along with the existence of readily available data), but focusing solely on banks and S&Ls misses much of the picture. Particularly noticeable is the absence of recent studies of consumer finance companies, which hold the second largest share of consumer installment credit (after commercial banks).

The same issues of costs, market structure, and potential competitive impacts that arise concerning banks and S&Ls also surface in the case of the consumer finance industry. Long regarded as specialized and possibly old fashioned, consumer finance companies have recently attracted other institutions' attention because of the finance companies' branch systems, which have always been largely free from regulators' geographical restrictions, and because of their profitability during some difficult times for banks and S&Ls. By themselves these features should focus competitive attention on finance companies' cost structure. More generally, however, as financial-product market segmentation continues to break down, all market participants must become more aware of their own and competitors' costs if they are to survive and prosper.

Despite this, researchers have undertaken relatively few cost studies of the consumer finance industry, especially recently.² The major previous effort was by George Benston (1972b) for the National Commission on Consumer Finance. Benston concluded from his statistical work that since scale economies at the firm level were slim to nonexistent, "large companies, as such, are unlikely to dominate the industry because of a 'natural' cost advantage" (1972b, p. 153).³ This view has become the conventional wisdom and has been consistent with casual observation that both large and small consumer finance companies compete in various markets. The question is whether, more than twenty years later, changing conditions (for example, advances in information and computer technology) might produce a different outcome and another conclusion.

Two possibilities suggest themselves. First, technological changes in both risk management and loan administration in the last quarter century might argue for existence of

¹ For an overview of the research and references, see Clark (1988), Humphrey (1990), or Berger et al. (1993)

² The most recent studies are by Benston (1972b, 1977a, 1977b) using 1968-70 data.

³ Du and McAlister (1977) found similar results in a regional study using a similar methodology.

larger scale economies than in the past. Large firms, for example, might have better access to sophisticated mathematical credit scoring and other new and expensive techniques for credit evaluation. Likewise, larger firms might be better able to afford computerized marketing, record keeping, and collection procedures and equipment. If such techniques and equipment improved the productivity of large firms relatively more than small ones, economies of scale might be more evident recently than decades ago.⁴ Second, if, in contrast, new technology today is as available to small firms as to large, then economies of scale might not be more evident recently than farther in the past, even if large and small firms might both operate more efficiently today. While the former of these two possibilities might seem more likely, certainly the other possibility remains distinctly possible. Ultimately, the issue of scale economies is an empirical question to be answered by appealing to the data.

The purpose of this paper is to estimate the cost function for the consumer finance company industry using a more appropriate functional form than that employed in older studies and using much newer data. This estimation will permit exploration of the issue of scale economies in this industry as well as discussion of costs by size of loan. Both explorations should be useful for analyzing consumer lending because finance company lending activities produce cost data that are relatively uncontaminated by other products and influences.

The remainder of this paper is divided into three sections. Section II discusses the functional form of the estimation equation and describes the data to be used. Section III presents the empirical results, and section IV offers a brief summary and conclusions.

II. Functional Form and Data

Four important questions arise in any attempt to estimate statistical cost relationships: (1) identification of the production or cost function; (2) the proper specification of the production or cost relations; (3) the definition of output; (4) the availability of data appropriate for estimation.

A. Identification

In most cases, estimates of long-run cost curves and scale economies are possible only by using cross sections of firms in an industry. This involves the implicit assumption that the observations trace out the cost curve for a "typical" firm although no one firm is followed over the whole range of output. Bell and Murphy (1968) and Benston (1972a) have argued that a long-run cost function is identified for a cross section of financial firms because it is reasonable to assume that the level of output is exogenous.⁵ Firms do not have access to secret technology or processes which might provide them an inherent production advantage over their rivals. Thus, demand is not cost determined but rather the opposite. Although technological changes in credit granting and marketing functions might appear to suggest that some firms might have a cost advantage, the technology, including automated credit scoring, is well known to all and widely available through credit bureaus. It is still true that each branch office operates in its own

⁴Rogers (1974), Longbrake (1974), and Lawrence and Shay (1986) investigated the effect of computers on the cost of consumer lending using data from commercial banks participating in the Federal Reserve's Functional Cost Analysis Program. The results of these studies suggest that labor and computers were substitutes. They found little or no overall cost savings and no difference in estimates of scale economies attributable to the use of computers. Because of substantial innovation in computer technology since that time, these results are probably dated.

⁵The level of output is not, however, entirely exogenous. Firms can affect demand by advertising and promotions.

local market subject to the vagaries of demand in its own area.⁶ In effect, companies compete in a succession of local markets with basic technology that is known to all. Under these circumstances, local demands for loans determine the level of output. The cost function can be estimated by a single equation using cross-section data on costs and output. This approach seems appropriate and is adopted here.

B. Specification of Cost Relations

The single-product nature of the consumer finance company industry simplifies specification of the cost relationship.⁷ Consumer finance companies are, of course, financial intermediaries that have a source and use of funds, but unlike the depository and insurance-type intermediaries, whose sources of funds (deposits, policies, pension plans) are products in themselves, the consumer finance companies' funds sources (bonds and commercial paper issued locally and on Wall Street) are largely incidental to the lending function, at least in terms of costs. In a cost sense, they are analogous to the legal or data processing departments. They do not exist apart as separate outputs. Since separate cost functions are not required, arbitrary cost allocations are unnecessary. Similarly, if consumer finance companies produce only one product, there can be no output-cost complementarities or scope economies, and scale and scope economies do not confound.⁸

Total operating costs are a function of input prices and output, with output homogeneity and company structure variables to account for differences in types of loans extended and branch structure among companies. The implicit cost relationship is found in equation 1:

$$1. C = f(Q, P, A, \theta)$$

where C is total operating cost, Q is output, P represents input prices, A represents output homogeneity variables (for example, average loan size), and θ represents company structure variables (for example, number of offices).

Concerning the explicit functional form, the empirical model estimated here employs the translog cost function. Essentially, the translog is a quadratic function of the logarithms of its parameters (namely, output quantity, input prices, and other factors affecting cost), which includes all of the cross products to allow for interactions.⁹

⁶ For discussion of the local nature of the market for consumer financial services see Elliehausen and Wolken (1992).

⁷ See Baumol, Panzar, and Willig (1982) for a general discussion of multiproduct cost functions. Clark (1988) and Humphrey (1990) discuss recent studies of costs at depository institutions.

⁸ Traditional cost studies could possibly confound scale economies and differences in X-efficiency of firms operating at different output levels. This potential problem does not appear to be of practical significance, however. Several researchers have estimated scale economies for financial firms using both traditional cost functions and frontier estimation methods and found little or no differences in results from the two approaches (Berger and Humphrey 1991; Bauer et al. 1993; McAlistar and McManus 1993; Mester 1993). For further discussion, see Berger et al. (1993).

⁹ Sometimes, the effects of control variables are of interest as much as the effect of output on cost. For example, the inclusion of average loan size as an output homogeneity variable permits calculation of a cost elasticity with respect to average size of loan.

$$\begin{aligned}
2. \ln C = & a_0 + a_Q \ln Q + \frac{1}{2} b_{QQ} (\ln Q)^2 + a_L \ln P_L + a_K \ln P_K + \frac{1}{2} b_{LL} (\ln P_L)^2 \\
& + \frac{1}{2} b_{KK} (\ln P_K)^2 + b_{LK} \ln P_L \ln P_K + b_{QL} \ln Q \ln P_L + b_{QK} \ln Q \ln P_K + d_A \ln A \\
& + \frac{1}{2} d_{AA} (\ln A)^2 + d_{AQ} \ln A \ln Q + d_{AL} \ln A \ln P_L + d_{AK} \ln A \ln P_K + d_0 \ln 0 \\
& + \frac{1}{2} d_{00} (\ln 0)^2 + d_{A0} \ln A \ln 0 + d_{0Q} \ln 0 \ln Q + d_{0L} \ln 0 \ln P_L + d_{0K} \ln 0 \ln P_K
\end{aligned}$$

The translog cost function to be estimated is shown in equation 2.

where C = total operating cost; Q = output quantity; P_L = price of labor; P_K = price of capital; A = average size of loans made; and 0 = total number of branch offices.

In order to correspond to a well-behaved production function, a cost function must be positively linearly homogeneous in input prices. This theoretical requirement imposes the following restrictions on the parameters of the translog cost function:

$$3. a_L + a_K + b_{QL} + b_{QK} = 0; b_{LL} + b_{LK} = b_{LK} + b_{KK} = 0; d_{AL} + d_{AK} = 0; d_{0L} + d_{0K} = 0$$

The translog is a valid local second-order approximation to an arbitrary cost function.¹⁰ Under reasonable assumptions (nonnegative, real valued, nondecreasing function of output, linearly homogeneous in input prices), the translog is dual to a general production or transformation function, although it is not directly derivable from them (Diewert 1971; Caves, Christensen, and Tretheway 1980).

Because of its greater generality, the translog functional form offers a number of advantages. First, it permits estimation of U-shaped average cost curves. Second, it permits exploration of how factor prices may affect scale economy results (nonhomotheticity). Third, it permits estimation of scale, branch office, and account size economies and allows them to vary by size of institution.¹¹

C. Definition of Output

To estimate a statistical cost function, it is necessary to relate cost measurements directly to measures of the outputs that produce the costs. The output of the consumer finance industry is loans, but a number of potential output measures exist: number of loans made, dollar amount made, number serviced, amount serviced, and total assets devoted to lending. In considering

¹⁰ The translog cost function is flexible at the point of approximation, but it imposes generally a specific structure, namely, a symmetric U-shaped average cost curve. If this assumption does not hold generally, then the cost function would be misspecified, and estimates of scale economies derived from it would be biased. In studies of commercial bank costs, bias in translog estimates of scale economies appears to result largely from differences in the output mixes of small and large banks (McAlister and McManus 1993). This consideration probably would not bias translog estimates of scale economies for consumer finance companies because consumer finance companies produce essentially a single product.

¹¹ Both homogeneity and homotheticity can be imposed on the translog form by constraining the parameters in estimation. Thus, homogeneous, homothetic, and Cobb-Douglas forms can be tested as subsets of the analysis. Tests by the authors (available on request) reject homotheticity and homogeneity and, therefore, the Cobb-Douglas formulation. An important implication is that the percentage change in cost resulting from a given percentage change in output is not the same at different levels of output. In other words, economies of scale are not constant over all output levels.

these possibilities, it seems that costs are more likely to be related to the number of loans rather than amounts of loans or total assets. Many cost-causing activities such as recording and booking loans and payments must be undertaken for each loan and probably vary very little, if at all, with size of loan. This suggests that numbers of loans made or serviced are the candidates for the output variable. Of these, the number serviced seems the more reasonable choice. Most consumer loans require periodic payments (typically monthly), and so both the number of employees and the size of the systems, paperwork, and compliance efforts involve more than just making loans. In fact, it seems that the size or scale of a lending operation is more dependent on the number of loans serviced (which require regular and recurring activities) than on loans made (which are more irregular and discontinuous). Consequently, the output variable employed in this study is number of loans outstanding (that is, serviced) rather than number made. Average size of loans outstanding is included in the regression as an output homogeneity variable. Care and credit checking and some other cost-causing activities of making and servicing a loan are generally greater for larger loans than for smaller loans. Larger loans are also more likely than smaller loans to be secured, a process that creates added costs.

D. Data

Cost data for estimation are from the American Financial Services Association (AFSA), the renamed trade group that supplied finance-company data to Benston in 1972. The AFSA surveyed its finance company members annually between 1960 and 1989 to collect information on the consumer finance industry.¹² Data for 1987-9 were available for this study. Survey schedules include detailed balance sheets, income and expense statements, loan activity, delinquency, and loss reports. Companies providing usable reports numbered 84 to 101 over the three years. These companies ranged from very small, including about one-third single-office companies, to the largest finance companies in the industry. In all, the companies had total assets of \$245-350 billion. Their gross consumer receivables represented 73 to 88 percent of the Federal Reserve's estimate of total consumer credit at consumer finance companies, depending on the year.

For this study, we used data for 51 companies that had greater than 50 percent of their receivables in consumer credit and reported costs in each of the three years. These restrictions ensure that the results reflect the costs of consumer lending rather than business lending or leasing and that any differences among the years are not due to differences in the composition of the samples.¹³

Table I lists the variables used in the statistical estimation and the sample means and standard deviations for these variables. The dependent variable is total annual operating expense excluding losses, advertising (which concerns demand, not production costs), and cost of funds. Independent variables are output (average number of loans serviced during the year), input prices (labor and capital prices), average size of loans serviced, and a structural variable (average number of branch offices). The price of labor for a company is the average annual wage rate, which is calculated as total annual salary and wage expenses including social security and fringe benefits divided by the average number of employees. The price of capital is

¹² These surveys were discontinued after 1989.

¹³ On average, consumer receivables were about 95 percent of the total number of accounts and 90 percent of the total dollar amount of receivables at these companies during 1987-9. The subsample of companies preserves the range of company sizes in the full sample.

the replacement cost per square foot of office buildings. It is computed for each company by weighting regional estimates of the cost of office space compiled by the F.W. Dodge Company (1987-89) by the proportion of the company's offices located in each region. The AFSA's office directory provided the addresses necessary for calculating the weights.

III. Empirical Results

This paper estimates the cost function (equation 2) restricted to be positively linearly homogeneous in input prices (equations 3) jointly with input-demand equations (equations 4 and 5 below). The input demand equations are obtained by differentiating the translog cost function with respect to the input prices, P_L and P_K :¹⁴

$$4. \quad \partial \ln C / \partial \ln P_L = S_L = a_{LL} + b_{LL} \ln P_L + b_{LK} \ln P_K + b_{QL} \ln Q + d_{AL} \ln A + d_{OL} \ln O$$

and

$$5. \quad \partial \ln C / \partial \ln P_K = S_K = a_{KK} + b_{KK} \ln P_K + b_{LK} \ln P_L + b_{QK} \ln Q + d_{AK} \ln A + d_{OK} \ln O$$

where S_L and S_K are the cost shares of labor and capital. This procedure is recommended by Christensen and Green (1976) because the input-demand equations add degrees of freedom without adding any unrestricted regression parameters, resulting in more efficient parameter estimates than would be obtained by estimation the cost function alone.¹⁵

Random disturbance terms are added to the cost function and input-demand functions. We assume that the disturbances are correlated across equations but not across firms (see Zellner 1962). Because cost shares must sum to unity, one of the input-demand equations is redundant. The capital input-demand equation is therefore dropped, and the cost function and labor input-demand function are estimated jointly using the iterated version of Zellner's seemingly unrelated regression procedure. This procedure produces maximum likelihood estimates of the parameters, which are invariant to which one of the input-demand equations is dropped (Kmenta and Gilbert 1968).

Table II presents results of estimation. According to the likelihood-ratio test, the estimated cost and input-share equations are significant in each of the three years 1987-89. Adjusted R-squares of the cost functions are between 0.980 and 0.988.

A. Estimates of Economies of Scale

Economies of scale are measured as the percentage change in cost resulting from a small percentage change in output. There are two types of estimates of scale economies, which involve different assumptions about the relationship between costs and outputs, that have been derived for financial institutions (see Benston, Hanweck, and Humphrey 1982).

¹⁴ This result is known as Shephard's lemma (Shephard 1953).

¹⁵ In other recent studies of financial firms' costs, Benston, Hanweck, and Humphrey (1982) and Gilligan, Smirlock, and Marshall (1983) estimated only cost functions. Mester (1987) and Kim and Zion (1989), on the other hand, estimated cost functions jointly with input-demand equations.

A simple scale economies measure is the cost elasticity when the number of production facilities (offices) does not change as output varies. An augmented scale economies measure allows the number of offices to vary along with output.

1. Simple Scale Economies. The simple scale economies measure (SCE) is derived by differentiating the translog cost function with respect to output.

$$6. \quad SCE = \frac{\partial \ln C}{\partial \ln Q} = a_Q + b_{QQ} \ln Q + b_{QL} \ln P_L + b_{QK} \ln P_K + d_{AQ} \ln A + d_{OQ} \ln O$$

SCE values less than one indicate the presence of scale economies; values equal to one indicate constant costs; and values more than one indicate diseconomies of scale.

Equation 6 indicates that scale economies depend on the level of factor prices, average account size, and number of offices as well as output. For estimates of the simple scale economies measure, we hold all variables constant except output. In the first three columns of table III, SCE is computed at various levels of output for 1987-9. Means of the third output quintile are assumed for P_L , P_K , A , and O . These SCE estimates can be viewed as scale economies facing a "typical" medium-sized firm.¹⁶

Estimates of the simple scale economies measure suggest that there are economies of scale in operating costs of consumer finance companies and that these scale economies diminish as output increases. For a medium-sized firm operating at low levels of output, SCE estimates indicate that a 10 percent increase in output raises costs about 4-6 percent in the 0.6-3.4 thousand accounts output range. Scale economies gradually fall from the second to the fourth output quintiles; a 10 percent increase in output raises costs about 5-7 percent in the second quintile and about 7-9 percent in the fourth quintile. In the fifth quintile, economies of scale appear to be exhausted. Estimates of the scale economies measure generally are not significantly less than one for the fifth quintile.¹⁷

2. Augmented Scale Economies. To allow adjustment of the number of offices for the level of output, Benston, Hanweck, and Humphrey (1982) developed an augmented scale economies measure. They defined the augmented scale economies measure as

$$7. \quad SCE^* = SCE + (\partial \ln C / \partial \ln O) / (\partial \ln O / \partial \ln Q),$$

where $\partial \ln C / \partial \ln O$ is a measure of office economies and $\partial \ln O / \partial \ln Q$ indicates the change in offices associated with a change in output. Again, values less than one indicate the presence of scale economies; values equal to one indicate constant costs; and values more than one indicate diseconomies of scale.

For the translog function, the measure of office economies is

¹⁶ On average, firms in the third output quintile had 47 offices

¹⁷ As mentioned, these estimates of scale economies apply to the medium-sized firms in terms of number of offices. Different values of SCE would be obtained if the number of offices were different, although the finding of significant scale economies would generally hold. The assumption that firms keep the number of offices constant may be appropriate in the short run, but it probably is unrealistic over longer periods of time. Firms might avoid diseconomies of scale by opening additional offices, or to the extent allowed by the size of their geographic markets, they may realize scale economies by consolidating accounts in a smaller number of offices.

$\frac{\partial \ln C}{\partial \ln O} = d_0 + d_{0O} \ln O + d_{0Q} \ln Q + d_{0L} \ln P_L + d_{0K} \ln P_K + d_{A0} \ln A$. We estimate the change in offices associated with a change in output, $\frac{\partial \ln O}{\partial \ln Q}$, by the regression $\ln O = e_0 + e_1 \ln Q + e_2 (\ln Q)^2$.

To estimate SCE*, we use the same output levels that were used for estimates of the simple scale economies measure and the appropriate mean number of offices for each quintile. Factor prices and average account size are held constant; we use means of the third output quintile for P_L , P_K , and A to maintain comparability with estimates of the simple scale economies measure.

The augmented scale economies measure provides a better indication of scale economies facing the firm. None of the estimates of the augmented scale economies measure shown in the last three columns of table III is significantly less than one. This result suggests that firms can adjust the number of offices to exploit all scale economies. According to these estimates, even relatively small firms are able to operate at approximately constant costs. None of the estimates of the augmented scale economies measure is significantly greater than one either, which suggests that firms can also adjust the number of offices to avoid diseconomies of scale.

3. Discussion. As mentioned, the simple scale economies measure SCE indicates the effect on cost of changes in the level of output for a fixed number of offices and thus can be viewed as a measure of economies of scale at the office level. The augmented scale economies measure SCE* allows the number of offices to vary as well as the level of output and can be viewed as a measure of scale at the firm level. The finding of economies of scale at the office level (SCE) but not at the firm level (SCE*) is consistent with Benston's earlier findings. Thus, our analysis indicates Benston's findings are robust, despite the simplifying assumptions implicit in his methodology. Although we find economies of scale at the office level, our estimates indicate that these economies decrease as output increases.¹⁸

A. Cost Elasticity of Average Loan Size

We also estimated cost elasticities of average loan size, which show relationship between operating costs and the average size of loans in creditors' portfolios. An elasticity less than one suggests that firms producing smaller loans have higher costs per dollar of credit than firms producing larger loans. Such might be the case if some expenses of consumer credit—for example, recording and booking loans and payments—are relatively constant and not related to the size of the loan.

For the translog cost function, the cost elasticity of average loan size (SCA) is

$$SCA = \frac{\partial \ln C}{\partial \ln A} = d_A + d_{AA} \ln A + d_{AQ} \ln Q + d_{AL} \ln P_L + d_{AK} \ln P_K + d_{A0} \ln O$$

Like SCE and SCE*, SCA depends on the values assumed for number of loans outstanding, factor prices, and number of offices as well as average loan size. We assume average values of

¹⁸ An appendix to an earlier version of this paper updates Benston's estimations using data from the more recent period. The estimated scale economies at the office and firm levels for 1987-89 using Benston's methods are similar to Benston's 1968-70 estimates. A copy of this appendix is available from the authors on request.

Q , p_L , P_K , and 0 . Values chosen for A lie between the 10th and 90th percentile of the sample distribution of average loan size.

Estimates of SCA shown in table IV are significantly less than one for most average loan sizes, suggesting that smaller loans are indeed relatively more expensive to produce than larger loans. At an average loan size of \$2,210 (the median average loan size in the sample), for example, a 10 percent increase in average loan size would increase costs about 1.5-3.0 percent, or about 1 percent for a \$1 increase in average loan size. At an average loan size of \$8,620 (the 90th percentile), estimated values of SCA indicate that a 10 percent increase in average loan size would increase costs about 4.5-5.0 percent, which is about 0.5 percent for a \$1 increase in average loan size.

Our finding that operating costs at finance companies rise less than proportionately with increases in average loan size is similar to results of earlier studies.¹⁹ Unlike earlier studies (which constrained cost elasticities of average loan size to a constant value because they used Cobb-Douglas cost functions), our estimates of the cost elasticity of average loan size rise as average loan size increases. This result seems reasonable. Firms may evaluate credit applications more carefully, take collateral, monitor more frequently, and make greater efforts to collect overdue accounts on larger loans than on smaller loans.

IV. Conclusions

Scale economies are an important factor determining the structure of an industry. If scale economies exist, an industry may come to be dominated by a few large firms. Such an outcome would reduce the cost of providing a product, but it could also adversely affect competition. Research conducted in the early 1970s concluded that significant scale economies existed in the consumer finance industry at the office but not at the firm level. The results suggested that although larger finance companies were not more efficient than smaller finance companies, firms could nevertheless have reduced costs by consolidating business in fewer offices. This anomaly results from the use of a restrictive functional form, the Cobb-Douglas cost function, which limits estimates of scale economies to a constant value. Consequently, estimates of scale economies may not reflect the cost relationships at all levels of output.

This study uses the more general transcendental logarithmic functional form and newer data to investigate scale economies in the consumer finance industry. The results reject the restrictive assumptions of the Cobb-Douglas cost function. Significant scale economies are found at the office level, and these scale economies decline as output increases. Thus, increasing office volume beyond a certain number of accounts (for the "typical" medium-sized firm of Table III about 1 million accounts in 47 offices) yields no additional savings in operating costs. The finding of a limit to the size of offices is an important difference from previous estimates of scale economies that relied on the Cobb-Douglas formulation.

At the firm level, neither significant economies nor diseconomies of scale are detected throughout most of the range of output levels in the industry. This finding-----together with the finding of significant, decreasing scale economies at the office level-----is consistent with the

¹⁹ For 1968-70, Benston (1972b) estimated cost elasticities of average loan size between 0.391 and 0.592 depending on year; and in a regional study, Durkin and McAlister (1977) obtained average loan size cost elasticities between 0.293 and 0.504 for 1968-73.

view that finance companies are generally able to adjust their offices to exploit scale economies or avoid scale diseconomies. Size of firm does not confer a cost advantage.

Failure to find scale economies at the firm level (and the finding of decreasing scale economies at the office level) suggests that the benefits technological change in the lending business over the past two decades have not exclusively accrued to the benefit of larger firms. There have been, of course, important developments in office automation equipment, but these do not appear to have generated significant scale economies in consumer lending at finance companies. Likely, the availability of smaller and smaller computers with ever greater computing power at lower and lower cost has been important in this respect. Today office automation equipment is within the budget of even the smallest companies. Similarly, sophisticated mathematical credit evaluation systems have become with the reach of even the smallest firms in recent years with the development of generic scoring-model results that are available instantaneously from credit bureaus with routine purchase of individual credit reports. It is not obvious that large firms have any decided advantage in this area either.

Our results also confirm earlier findings that operating costs rise less than proportionately with average loan size (Table IV). This result suggests that smaller loans are relatively more expensive to produce than larger loans. However, we also find that the relative savings in operating costs decline as loan size increases, probably because firms incur greater costs for credit evaluation, obtaining collateral, monitoring, and collection for larger loans than for smaller loans.

In sum, our findings for consumer finance companies are consistent with most of the recent evidence on scale economies at other financial institutions, which find little or no evidence of economies or diseconomies of scale. We find that smaller finance companies do not operate at a cost disadvantage to larger finance companies. Despite advances in information and computer technology, many of the activities associated with loan acquisition and maintenance may still be labor intensive and not provide much scope for scale economies. It is also likely that personal computers are accessible to even the smallest finance companies, so that any cost savings from this source would be available to all. Thus, operating costs would not lead to consolidation in the consumer finance industry.

The implications of these findings are that public policies that promote competition better serve customers than those that might seek cost savings by restricting entry or encouraging consolidation of firms.

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Table I
Descriptive Statistics

Mean (standard deviation)

Variable	1987	1988	1989
Operating cost, excluding losses, advertising, and cost of funds; in thousands of dollars (C)	145,244.8 (388,211.7)	158,032.7 (381,124.0)	173,154.8 (397,775.9)
Output, average of number of accounts and notes outstanding at the beginning and end of the year, in thousands (Q)	569.0 (1,413.2)	600.9 (1,447.1)	629.8 (1,442.7)
Price of labor, annual wage and salary expense divided by average of number of employees at the beginning and end of the year, in thousands of dollars (P _L)	25.2 (6.3)	25.8 (6.7)	27.0 (6.4)
Price of capital, replacement cost per square foot for office buildings, in dollars (P _K)	82.1 (8.6)	88.2 (11.8)	93.6 (10.9)
Average size of loans serviced, average of the dollar amount to the number of accounts and notes outstanding at the beginning and the end of the year, in thousands of dollars (A)	3.2 (2.8)	3.5 (3.2)	3.7 (3.6)
Number of branch offices, average of the number of offices at the beginning and end of the year (O)	189.9 (280.6)	204.9 (317.7)	204.0 (317.1)

Table II
Cost Function Parameter Estimates
(Standard errors in parentheses)

Variable and Parameter		1987	1988	1989
Constant	(a ₀)	1.548 (.110)**	1.580 (.095)**	1.606 (.104)**
lnQ	(a _q)	.730 (.087)**	.638 (.077)**	.589 (.084)**
(lnQ) ²	(b _{qq})	.071 (.066)	.060 (.044)	.045 (.046)
lnP _L	(a _l)	.769 (.068)**	.863 (.050)**	.876 (.070)
lnP _L lnP _K	(b _{LK})	-.149 (.046)**	-.202 (.032)**	-.191 (.047)**
lnP _Q lnP _L	(b _{QL})	-.077 (.016)**	-.067 (.012)**	-.054 (.012)**
lnA	(d _A)	.288 (.127)*	.202 (.122)	.180 (.122)
(lnA) ²	(d _{AA})	.138 (.174)	.161 (.149)	.110 (.161)
lnAlnQ	(d _{AQ})	-.041 (.084)	.002 (.007)	.086 (.081)
lnAlnP _L	(d _{QL})	-.044 (.027)	-.067 (.021)**	-.078 (.022)**
lnAlnO	(d _{AO})	-.007 (.099)	-.037 (.082)	-.102 (.097)
lnO	(d _o)	.274 (.121)*	.387 (.108)**	.409 (.119)**
(lnO) ²	(d _{oo})	.079 (.098)	.071 (.069)	.115 (.077)

lnOlnQ	(d _{oQ})	-.072 (.070)	-.065 (.044)	-.077 (.046)
lnO lnP _L	(d _{oL})	.071 (.018)**	.058 (.014)**	.045 (.014)**
Adjusted R-square		.980	.985	.988
Likelihood ration		87.945	87.807	84.347

*/** Coefficient is significantly different from zero at the 95/99 percent confidence level.

Table III

Estimated Scale Economy Coefficients By Output Level and Output Quintile

Output level, in thousands	Simple scale economy Coefficients (SCE) ¹			Augmented scale economy Coefficients (SCE*) ²		
	1987	1988	1989	1987	1988	1989
First quintile						
.6	.462	.438*	.438*	1.001	1.007	1.017
.7	.473	.447*	.455*	.998	1.005	1.011
3.4	.585*	.543**	.517**	.972	.987	.962
Second quintile						
4.8	.610*	.564**	.532**	.981	.988	.978
6.2	.628*	.579**	.543**	.978	.985	.971
14.1	.687*	.628***	.581**	.970	.979	.946
Third quintile						
23.5	.724*	.660**	.604**	.991	.980	.993
38.2	.758**	.689**	.626**	.985	.976	.978
88.0	.818**	.739**	.663**	.979	.970	.954
Fourth quintile						
191.0	.873*	.786**	.698**	.987	.966	.978
236.1	.888	.799**	.708**	.985	.964	.971
780.0	.974	.871	.762*	.981	.960	.938
Fifth quintile						
1,236.8	1.007	.899	.783*	.982	.956	.941
1,839.9	1.035	.923	.801	.982	.955	.931
5,645.0	1.115	.991	.851	.985	.955	.903

1. Evaluated at mean values of P_L, P_K, A, and 0 in the third output quintile.

2. Evaluated at mean values of P_L, P_K, and A for the third output quintile and quintile means of 0.

*/** Coefficient is significantly less than one at the 95/99 percent confidence level.

Table IV

**Cost Elasticity of Average Loan Size
By Average Loan Size**

Average loan size, in thousands of dollars ¹	Cost elasticity of average Loan size (SCA) ²		
	1987	1988	1989
.98	.153**	.146**	.211**
1.38	.200**	.201**	.249**
2.21	.265*	.277**	.300**
4.52	.363	.392**	.379**
8.62	.452	.496*	.449**

1 Values of A are selected points of the sample distribution of average loan size between the 10th and 90th percentiles.

2. Evaluated at mean values of P_L , P_K , A , and O for the third output quintile.

* / ** Coefficient is significantly less than one at the 95/99 percent confidence level.

FISCAL NOTE

STATE OF ALASKA
2006 LEGISLATIVE SESSION

Fiscal Note Number: 1
 Bill Version: CSHB 227(L&C)
 (H) Publish Date: 3/27/06

Revision Date/Time (Note if correction): _____ Dept. Affected: Commerce
 Title Alaska Small Loans Act RDU Banking & Securities (536)
 Component Banking & Securities
 Sponsor Labor and Commerce
 Requester Labor and Commerce Component No. 2808

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES (1156)	3.0	3.0	3.0	3.0	3.0	3.0
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2006) cost: 0.0
 Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

This legislation implements several provisions to the Alaska Small Loans Act (AS 06.20). It raises the maximum loan amount from \$25,000 to \$50,000 and removes the 36 percent maximum rate for loans less than \$850.00 and the blended rates for loans over \$850.00. The bill has the most impact on loans over \$10,000 by imposing an interest cap on loans to 24 percent. Currently there is no maximum limit on interest rates on loans over \$10,000. In addition, the cap of 24 percent extends to loans up to \$50,000.

Prepared by: Mark Davis, Director Phone: 907.465.2521
 Division: Banking and Securities Date/Time: 3/16/06 3:19 PM
 Approved by: William C. Noll, Commissioner Date: 3/16/2006
 Agency: Commerce, Community, and Economic Development