

Retail Credit Expansion and Regulatory Overreaction



At the turn of the 20th century, working Americans had relatively few attractive options for obtaining credit. Often, they took out loans with high costs and inscrutable terms. Worried about this trend, New Jersey passed the country's first small loan laws in 1914. Like similar measures to follow in other states, the New Jersey legislation included requirements that lenders who charged more

than the legal interest rate for banks be licensed and that borrowers be informed about the precise terms of their transaction. More than any other effort in the early 1900s, small loan laws were credited with helping to protect poor borrowers from price gouging.

We have witnessed a similar pattern over the past 100 years. When new forms of retail credit have become available, there has often been a political response, ranging from disclosure rules for installment lenders in the 1920s to curbs on payday advances in the 1990s. Sometimes these responses have been driven by populist aversion to financial institutions; sometimes by sound economic principles. Occasionally, they have been counterproductive.

It is important to remember these lessons of history. The United States is currently experiencing what can arguably be called a revolution in retail consumer finance, one of the greatest credit expansions in history. And with it we are encountering the anticipated policy responses. While in general we would expect that regulations ought to adapt to changing credit market practices, there is a very real danger here of regulatory overstep. It's important to remember that, on the whole, the expansion of retail credit has been tremendously beneficial. Limiting this expansion might have the undesirable effect of preventing the people most in need of credit from obtaining it in the first place.

Over the past 15 years, technological advances have reduced the cost of gathering, processing, and retaining consumer account information. These savings have been passed along to borrowers in the form of lower lending rates. Credit cards, which used to be available almost exclusively at high interest rates, are now offered at lower rates to a broader market of creditworthy customers.

The upshot is that more people today can afford to borrow. Because credit allows people to choose a spending pattern that is smoother over time than their income stream, the expansion of retail credit over the last two decades has yielded positive net benefits for American consumers.

So once again we have an episode of expanding credit accompanied by a regulatory response. Among the most recent measures, North Carolina has enacted legislation that limits certain practices in the subprime market. At the national level, the data that lenders are required to submit under the Home Mortgage Disclosure Act now must include information on interest rates if they exceed a certain spread over funding costs. Some advocates have recently proposed expanding credit card disclosure requirements to include, for example, the time it would take to repay the bill while just making the minimum payments. Improved disclosure can strengthen consumers' understanding of financial products and increase the odds of consumers getting the product that is best for them. But to the extent that increased disclosure requirements are simply a prelude to other measures that would reduce the availability of credit, we should be wary.

When weighing measures designed to protect borrowers, we should always keep in mind the inherent trade-off between preventing adverse effects for some and limiting the availability of credit to others. The evidence suggests that constraints on allowable interest rates are counterproductive and generally reduce consumer well-being. While some policies that carefully target truly abusive practices are warranted, the broader risk is of a regulatory overreaction that stifles much of the benefit of the technology-driven expansion in consumer credit.

One thing I think everybody can agree on is the usefulness of educating consumers about managing their financial affairs. Financial institutions depend critically on their customers' trust, and trust is built on their understanding the difference between a legitimate financial transaction and one that is too good to be true. Beyond that, an electorate that has a broad appreciation of the efficiency of credit markets will have an easier time sorting out when any particular policy proposal is truly in its interests.

The United States has arguably the most efficient retail credit markets in the world. We should avoid regulatory actions that would threaten a system that has served so many people so well.

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Editor's Note: This article is based on a speech given on June 14, 2005, at the annual meeting of the North Carolina Bankers Association. To read the speech in its entirety, please visit our Web site: www.richmondfed.org