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IN FOCUS

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Consumer Credit Markets and Loan Pricing: The Basics

Congress has demonstrated an ongoing interest in consumer credit markets. This In-Focus provides an overview of consumer lending markets, pricing, and legislative efforts designed to facilitate efficient credit allocation and pricing.

Consumer Credit Markets: Introduction

Credit allows consumers to make purchases today rather than postpone them until some point in the future, thus avoiding the need to save sufficient amounts of funds to make payments in full. The consumer credit (loan) markets consist of multiple products with numerous market prices. Consumer credit may be in the form of mortgages, revolving credit cards, automobile loans, personal loans, and student loans. Consumers may obtain loans from depository institutions (i.e., banks and credit unions) and non-depository institutions (e.g., payday lenders, finance companies). Lenders generally underwrite loans, meaning that they evaluate loan applicants' credit risk by considering factors such as their income and repayment histories of past loans. (Some non-depository lenders, however, make higher-priced consumer loans without formal underwriting.)

When a loan default occurs, the contract provisions negotiated by the lender and a third-party loan *servicer* (who collects payments from borrowers, administers disbursements to the lender and, if necessary, to escrow accounts, insurance providers, etc.), in conjunction with relevant laws, determine (1) whether the servicer can offer loss mitigation solutions and, if so, what types and with what limitations; and (2) when the servicer can begin the formal debt-collection process or initiate foreclosure and, if so, any rules that must be followed and allowable actions. Servicing rules are designed to minimize the costs to collect defaulted obligations, which are primarily borne by the lender. Lenders may attempt to recover debts by doing their own collecting or by hiring contractors to collect the debt on their behalf. The Fair Debt Collection Practices Act (FDCPA) of 1977 prohibits debt collectors from using abusive, unfair, or deceptive practice while collecting consumer debts. If, however, a lender decides to sell the debts outright, FDCPA may not apply to debt buyers. Because resolving defaults can be expensive, these potential costs are frequently priced into loans.

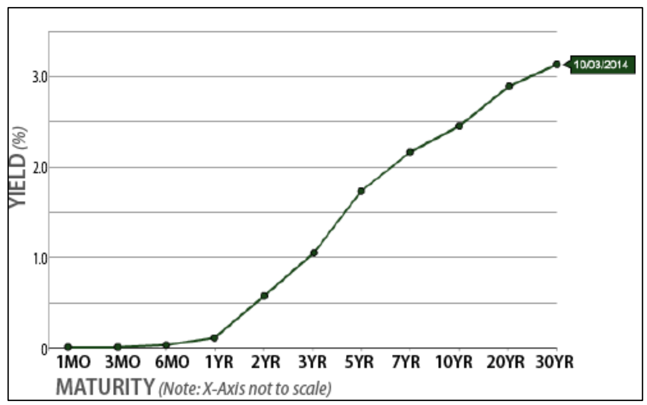
Loan Pricing Mechanics

Lender profits are principally generated from the difference between the *loan price* (interest rate charged to the borrower) and the costs incurred by the lender to acquire the funds that will be lent. A loan price may be separated into two components: the *risk-adjusted base rate* and the *mark-up*, discussed below.

The Base Rate and Risk-Adjusted Base Rate

The determination of the price borrowers will pay for a loan typically begins with the determination of the *risk-free base rate*. Given that U.S. Treasuries have never defaulted (nor do they prepay), Treasury yields or rates are considered "risk-free." Hence, the slope of the yield curve (shown in **Figure 1**) consists of the rates of return that lenders could receive by lending to the U.S. Treasury (i.e., purchasing U.S. Treasury bonds) at different maturities. Lenders require compensation from consumer loans to be at least as high as the risk-free lending rate; otherwise, they would simply purchase risk-free Treasuries. Consequently, the base rates for loans are generally set to comparable yield curve loan maturities. For example, the base rate of a 5-year consumer loan is likely to begin with the current rate of a 5-year U.S. Treasury rate. (The base rate for a 30-year mortgage loan, however, may begin with the 10-year Treasury rate because many mortgage loans are usually repaid or refinanced in 10 years.)

Figure 1. Upward-Sloping U.S. Treasury Yield Curve



Next, the initial base rate is *risk-adjusted* to account for financial risks that are idiosyncratic to borrowers. Risk-based pricing is the practice of charging riskier borrowers higher rates to reflect their additional default (credit) risk. Higher-risk borrowers are likely to pay more for credit relative to lower-risk borrowers, but risk-based pricing may result in fewer credit denials and greater credit accessibility. In short, borrowers pay different prices for credit products, often because they pose varying levels of default risk. Lenders may also factor in the prepayment risk of borrowers, or the likelihood that a borrower pays off a loan ahead of schedule when market interest rates change.

Markup Above the Risk-Adjusted Base Rate

The markup above the risk-adjusted base rate consists of additional charges and fees that are generally unrelated to borrower financial risks.

- Markups include loan origination costs, such as the costs to purchase credit reporting data and verify borrowers' identities, incomes, and employment.

- Markups include ancillary costs, such as costs to cover loan servicing.
- Markups may reflect a lack of market competitiveness or shopping for more favorable loan pricing.
- Markups may include poorly disclosed or even unobservable factors such as disparate treatment or overt discrimination, typically investigated using statistical analysis in fair lending examinations of financial institutions. (Sometimes making a clear distinction between the risk-adjusted base rates and the mark-up components is challenging for regulators who conduct fair lending examinations.)

Consumer Credit Market Access and Loan Pricing: Some Legislative Actions

Congress has passed legislation to prohibit discrimination and increase access to credit.

- The Equal Credit Opportunity Act of 1974 (ECOA; P.L. 94-239) prohibits creditors from discriminating against applicants on the basis of race, color, religion, national origin, sex, marital status, age, or because of receiving public assistance.
- The Home Mortgage Disclosure Act of 1975 (HMDA; P.L. 94-200) requires disclosure of mortgage origination information. This information allows regulators to identify geographical patterns of mortgage originations to determine where further investigation of redlining, or geographical discrimination, may be necessary to increase credit access to creditworthy individuals. (In 2002, the Federal Reserve updated Regulation C, which implements HMDA, to require the rate spread reporting for higher-priced loans to discourage discriminatory loan mark-up pricing practices.)
- The Community Reinvestment Act of 1977 (CRA; P.L. 95-128) encourages federally insured banking institutions to make sufficient credit available to creditworthy individuals in the local areas where the institutions were chartered and acquired deposits. For more information, see CRS Report R43661, *The Effectiveness of the Community Reinvestment Act*, by Darryl E. Getter.

Congress has also passed legislation concerning (1) loan price transparency and disclosure requirements; and (2) the reporting of consumer payment history data. These factors may influence the markup sizes above the base loan rates.

- The Truth in Lending Act of 1968 (TILA; P.L.90-301) applies to all forms of consumer credit. TILA requires covered lenders to disclose the total cost of credit, which includes the loan rate and fees, in the form of an annual percentage rate (APR).
- The Real Estate Settlement Procedures Act of 1974 (RESPA; P.L. 93-533) requires lenders, mortgage brokers, or servicers of home loans to provide borrowers with pertinent and timely disclosures regarding the nature and costs of the real estate settlement process.
- The Home Ownership Equity Protection Act of 1994 (HOEPA; P.L. 103-325) amends TILA to require additional reporting of high-cost refinance and other non-purchase loans secured by primary (owner-occupied) residences.
- The Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act,;P.L. 111-24) restricts pricing practices that may result in hidden and complex penalty fees and assessments on credit card holders.
- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA; P.L. 111-203) contains a number of consumer protection provisions. Examples include the DFA's Consumer Financial Protection Bureau (CFPB) established to implement and enforce federal consumer financial laws while ensuring consumers access to financial products and services. The DFA created the ability-to-repay (ATR) rule, which is implemented by the CFPB, to establish minimum standards that all creditors are required to consider during the underwriting of U.S. residential mortgage loan originations. The DFA gives CFPB regulatory authority over banking and nonbanking firms that offer consumer financial products. The CFPB has since implemented or proposed rules pertaining to small-dollar lending products, which may influence their markup and availability. See CRS Report R44868, *Short-Term, Small-Dollar Lending: Policy Issues and Implications*, by Darryl E. Getter.
- The Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (EGRRCPA; P.L. 115-174) contains provisions pertaining to consumer repayment data, possibly having effects on some risk-adjusted base rates. EGRRCPA includes various protections for veterans. The EGRRCPA also requires Fannie Mae and Freddie Mac to consider the merits of using alternative versions of credit scores, which could potentially benefit individuals with limited or no traditional credit history. For more information on consumer repayment data, see CRS Report R44125, *Consumer Credit Reporting, Scoring, and Selected Policy Issues*, by Darryl E. Getter.

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