STATE OF WEST VIRGINIA

PRELIMINARY PERFORMANCE REVIEW OF THE

WEST VIRGINIA LENDING AND CREDIT RATE BOARD

Board Has Become Ineffective

OFFICE OF LEGISLATIVE AUDITOR
Performance Evaluation and Research Division
Building 1, Room W-314
State Capitol Complex

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December 1997

WEST VIRGINIA LEGISLATURE

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Antonio E. Jones, Ph.D.
Director

December 14, 1997

The Honorable Billy Wayne Bailey
State Senate
Drawer A
Covel, West Virginia 24719

The Honorable Vicki Douglas
House of Delegates
Building 1, Room E-213
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0470

Dear Chairs:

Pursuant to the West Virginia Sunset Law, we are transmitting a Preliminary Performance Review of the West Virginia Lending and Credit Rate Board, which will be presented to the Joint Committee on Government Operations on Sunday, December 14, 1997. The issue covered herein is "The Board Has Become Ineffective."

Sincerely,

Antonio E. Jones

AEJ/wsc

Enclosure

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EXECUTIVE SUMMARY

The West Virginia Lending and Credit Rate Board (Board) was created in 1981 to set maximum charges on loans, credit sales or transactions, forbearances or other similar transactions executed in the state. Since that time, ***federal preemptions have weakened the Board's authority***, since credit can be imported from state and national banks located outside West Virginia; rate ceilings cannot be imposed on first mortgages from banks and other lenders loaning over a million dollars; and federal parity statutes allow state and national banks to charge the same rates of interest competitors in the local market place may charge.

A state may be effective in the regulation of the credit industry by one of two strategies. ***It may deregulate its credit industry as many states have done to attract the banking industry, or it may decide doing so is not worth the consequences and set ceilings that are sensitive to money market changes. The West Virginia Lending and Credit Rate Board has done neither.*** Ceilings remained flat for the first 13 years of the Board, while interest rates were dynamic, and interest ceilings have been unfavorable to lenders compared with the thirty competitive market states

In addition, there are ***no purposeful enforcement efforts for those lenders subject to the Board's orders, but not examined by State authorities***. The Board members have expressed frustration and most support termination of the Board, which may prevent rates being analyzed as required in the future. (See member comments in body of report.)

The Legislative Auditor recommends termination of the West Virginia Lending and Credit Rate Board.

OBJECTIVE, SCOPE AND METHODOLOGY

This preliminary performance review of the West Virginia Lending and Credit Rate Board was conducted in accordance with the West Virginia Sunset Law, Chapter 4, Article 10, Section 11 of the West Virginia *Code* as amended. The objective of this review is help the Joint Committee on Government Operations determine the following with respect to the West Virginia Lending and Credit Rate Board:

- if the agency was created to resolve a problem or provide a service;
- if the problem has been solved or the service provided;
- the extent to which past agency activities and accomplishments, current projects and operations and planned activities and goals are or have been effective;
- the extent to which there would be significant and discernable adverse effects on the public health, safety or welfare if the program were abolished;
- Whether or not the agency operates in a sound fiscal manner; and
- Whether or not the conducting of a full performance evaluation on the agency is in the public interest.

The scope of this report covers all years of the Board's existence, from 1982 to 1997. The Evaluation included a planning process and the development of audit steps necessary to collect competent, sufficient and relevant evidence to answer the audit objectives. Physical, documentary, testimonial and analytical evidence used in the evaluation were collected through interviews and reviews of records. The evaluation was conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS) issued by the Comptroller General of the United States.

Issue Area 1: The West Virginia Lending and Credit Rate Board has become ineffective.

The West Virginia Lending and Credit Rate Board (Board) was created in 1981 by West Virginia Code §47A-1-1. The intent was to set maximum charges on loans, credit sales or transactions, forbearances or other similar transactions executed in the state. Legislative findings state that changes in these maximum charges

> *requires specialized knowledge of the needs of the citizens of West Virginia for credit for personal and commercial purposes and knowledge of the availability of such credit at reasonable rates to the citizens of this State while affording a competitive return to persons extending such credit.*

The Board consists of nine members as follows: the Commissioner of Banking, who serves as Chairman of the Board; the State Treasurer; the Director of the Governor's Development Office; the Director of the Division of Consumer Protection of the Attorney General's Office; the Dean of the College of Business and Administration at Marshall University; the Dean of the College of Business and Economics at West Virginia University; and three members of the public appointed by the Governor (see Appendix A for list of members). The Board has become ineffective for a variety of reasons, which are as follows: federal regulations supersede state regulations; rate setting remained flat for the first 13 years of the Board, while market forces were dynamic; interest ceilings have been unfavorable to lenders compared with other states.

Federal Regulations

Since the Boards' inception, it has lost control of many lenders and retail establishments. Many of these companies extend credit through out-of-state national and state banks, excluding them from the jurisdiction of the Board. These national and state banks are regulated by the laws of the state in which they reside. For example, Stone & Thomas, whose headquarters is in Wheeling, now extends credit through an Ohio bank. Thus, West Virginia has no regulatory control over Stone & Thomas' credit rates. In addition, the Board's ability to regulate first mortgages was preempted by federal law, and federal parity statutes allow state and national banks to charge whatever rate a competitor may charge who is located in the local market place. The Board has regulatory control over approximately 235 financial institutions and approximately 250 retailers offering credit within the state.

Board Decisions

The Legislative Auditor analyzed the interest rates as set by the Board from 1982 - 1996. There are six categories of rates set by the Board. These are defined as follows:

<u>Supervised Lenders:</u> small loan companies that could only lend a maximum of $2,000. This type of lender could not take real estate as collateral and could charge very high interest rates. This type of license no longer exists as Supervised Lenders are now licensed as "Regulated Consumer

Lenders" pursuant to changes in Chapter 46A, Article 4. The change was effective September 1, 1996.

<u>Industrial Loan Companies</u>: small loan companies originally very similar to banks except that they were funded not by deposits but by "certificates of indebtedness." These types of funded companies no longer exist as they have either gone out of business or converted to banks over the past two decades. Essentially, corporations that continued to exist and be licensed under the statute were privately funded corporations that made higher risk consumer loans. The statute licensing this type of lender ceased to exist September 1, 1996 and all existing licensees were issued licenses as "Regulated Consumer Lenders" under Chapter 46A, Article 4.

<u>General rate lenders</u>: this is the rate that applies to all individuals and entities not licensed under a specific section of the code. Banks are subject to the general rate, unless they can claim parity with other lenders or a federal preemption exists. This rate exists to prevent individuals and entities that are not licensed lenders from engaging in "loan sharking" transactions through excessive charges.

<u>Revolving loan finance charge:</u> cost of credit issued by a licensed lender, the balance of which may increase or decrease with no stated maturity date - such as a bank credit card arrangement.

<u>Revolving sales finance charge:</u> cost of credit issued by a retailer (as opposed to a lender), the balance of which may increase or decrease with no stated maturity date - such as a retail store credit card arrangement.

<u>Non-revolving sales finance charge:</u> cost of a one-time closed end credit contract issued by a retailer - such as an auto loan or loan for an appliance or furniture purchase.

Despite dramatic changes in interest ceilings and regulations in other states, the interest ceilings set by the Board have hardly changed since its inception, exemplifying the Board's ineffectiveness. The Board set rates as required in 1982 for the different types of credit, and according to information provided by the Division of Banking, ***the Board made no rate decision changes until 1995 - literally 13 years after creation of the Board.*** TABLE 1 on the following page shows credit ceilings as set by the Board from 1982 - 1996. As shown, most maximum rates and finance charges as set by the Board were 18% in 1982, and remained at 18% until 1995 when the Board set the limit for Revolving Sales Finance Charge at 21%, which covers retail establishment

TABLE 1
Lending Ceilings from 1981 to Present
(the two changes in ceilings have been highlighted)

Lender Type	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96
Industrial Loan Co. $5,000 or Less	21	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Industrial Loan Co. $2,000 or Less	†	27	27	27	27	27	27	27	27	27	27	27	27	27	‡
Industrial Loan Co. $2000-$10,000	†	25	25	25	25	25	25	25	25	25	25	25	25	25	‡
Industrial Loan Co. Over 10,000	†	18	18	18	18	18	18	18	18	18	18	18	18	18	‡
Supervised Lenders $500 or Less	36	36	36	36	36	36	36	36	36	36	36	36	36	36	‡
Supervised Lenders $500-$1,500	24	24	24	24	24	24	24	24	24	24	24	24	24	24	‡
Supervised Lenders Over $1,500	18	18	18	18	18	18	18	18	18	18	18	18	18	18	‡
General Rate	18	18	18	18	18	18	18	18	18	18	18	18	18	18	18
Revolving Loan Finance Charge	18	18	18	18	18	18	18	18	18	18	18	18	18	18	18
Revolving Sales Finance Charge	18	18	18	18	18	18	18	18	18	18	18	18	18	21	21
Non-Revolving Sales Fin. Charge	18	18	18	18	18	18	18	18	18	18	18	18	18	18	21

* *This ceiling was discontinued.*
† *These ceilings did not come into existence until 1983.*
‡ *These ceilings were discontinued by the Board's order in September 1996. Statutory ceilings for regulated consumer lenders now apply.*

Source: West Virginia Lending and Credit Rate Board credit cards. The following year the Board raised the limit from 18 to 21% on Non-revolving Sales Finance Charges, which are one time retail loans, such as an auto loan or a large furniture or appliance purchase. ***Thus, the Board has only changed interest and finance charge ceilings twice in its history.*** This shows that the Board has been very inactive in prescribing ceilings "to reflect changed economic conditions, current interest rates and finance charges throughout the United States and the availability of credit within the State..." and is therefore ineffective. (See Appendix B for graphs showing interest rates as set by the Board from 1982 - present).

The question of how to regulate the credit industry is a divisive matter of policy. However, two primary strategies can be identified. These strategies are discussed briefly below.

One strategy is to create a ***wide-open regulatory environment***, which provides for lenders to charge any interest rate that can be viable in a competitive market. For example, thirty states have adopted such policies with respect to retail credit card regulation, including the contingent states of Virginia, Pennsylvania and Kentucky. Due to interstate commerce laws, banks chartered in these states can disregard interest ceilings established in other states. As a result, banks incorporate in states such as Delaware, where the regulatory environment is most advantageous. The disadvantage of this approach is that desperate, unsophisticated, and unaware borrowers are likely to be gouged by some lenders.

The other strategy is to accept that West Virginia will not be a major banking state, and opt to ***protect borrowers*** of the institutions located within the State's borders. To advocate this approach is to accept that there is an ideal interest ceiling, which is high enough to ensure a supply of credit that will satisfy consumers, but low enough to prevent consumer gouging. Under this approach, interest ceilings should track market interest rates to keep the gap between *real interest rates* and *ceilings less the rate of inflation* relatively constant.[1] The disadvantage of this approach is that West Virginia lenders are enticed to move out of state and import credit back to the state under another state's laws.

West Virginia may have lost some credit card operations, such as Stone and Thomas, to other states because the Board's decisions did not track interest ceilings of other states. All of the surrounding states have higher retail credit card limits with Kentucky, Pennsylvania, and Virginia having open competitive markets. Interstate commerce laws, allow credit to be imported from any state, which creates a situation in which the most open regulatory environment wins. TABLE 2 on the following page shows the credit card interest rates in other states as provided by the West Virginia Retailers Association effective on September 8, 1997. Again this evidence shows that the Board has not been setting ceilings "...to reflect changed economic conditions, current interest rates and finance charges throughout the United States..." as mandated by statute.

[1] *Real interest rates* are *nominal interest rates* (or actual rates) less the rate of inflation. Real interest rates allow for a better comparison over time.

TABLE 2
National Comparison of
Retail Credit Card Rates

Retail Credit Card Rate	**States**
Open Competitive Market	Alaska, Arizona, California, Connecticut, Delaware, Florida, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Utah, Virginia, Washington, Wisconsin
25% Limit	Michigan, Ohio
24% Limit	Hawaii, Maryland, District of Columbia
21% Limit	Colorado, Georgia, Indiana, Mississippi, Oklahoma, Tennessee, Texas, Vermont, **West Virginia**, Wyoming
21% on First $800 of Balance (18% Over)	North Carolina
21% on First $750 of Balance (18% Over)	Alabama
21% on First $500 of Balance (18% Over)	Nebraska
18% Limit	Minnesota, Massachusetts
17% or below	Arkansas
Note: States have different policies and ceilings for all types of usury. These policies apply only to retail credit cards and serve as a general example.	

The Legislative Auditor compared the Board's decisions with the ***federal prime rate*** since 1982 as shown in the graph on the following page. This illustrates the Board's inactivity since the prime rate has fluctuated continuously from year to year. In 1982, the prime rate averaged 14.86%, which was the high in the period, settling at a low of 6% in 1993 (see Figure 1). Ironically, the Board made no rate decisions during the high interest rates in the 1980's, and did not ***raise*** ceilings until interest rates went down. These actions seem to go against the West Virginia *Code* which states that ceilings should be "prescribed from time to time to reflect changed economic conditions, current interest rates and finance charges throughout the United States..." Since the prime rate is the interest rate charged preferred customers on bank loans, the Legislative Auditor felt that the prime rate would be a good indicator of yearly changes in finance rates throughout the country. The Legislative Auditor recognizes that the Board is not required or directed to track and compare West Virginia rates to the prime rate.

Figure 1

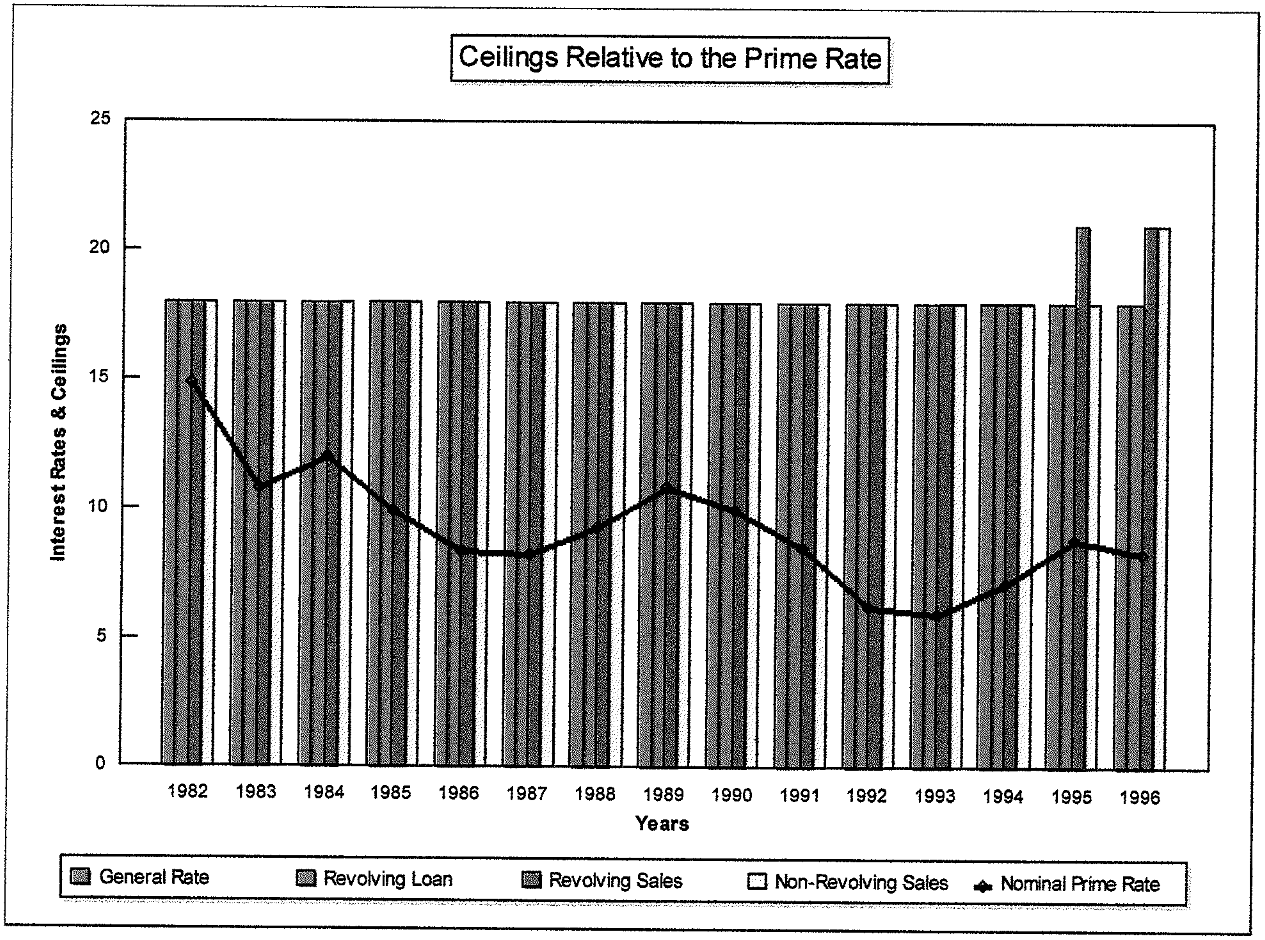

Ceilings Relative to the Prime Rate
Interest Rates & Ceilings
0
5
10
15
20
25
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
Years
General Rate
Revolving Loan
Revolving Sales
Non-Revolving Sales
Nominal Prime Rate

Figure 2

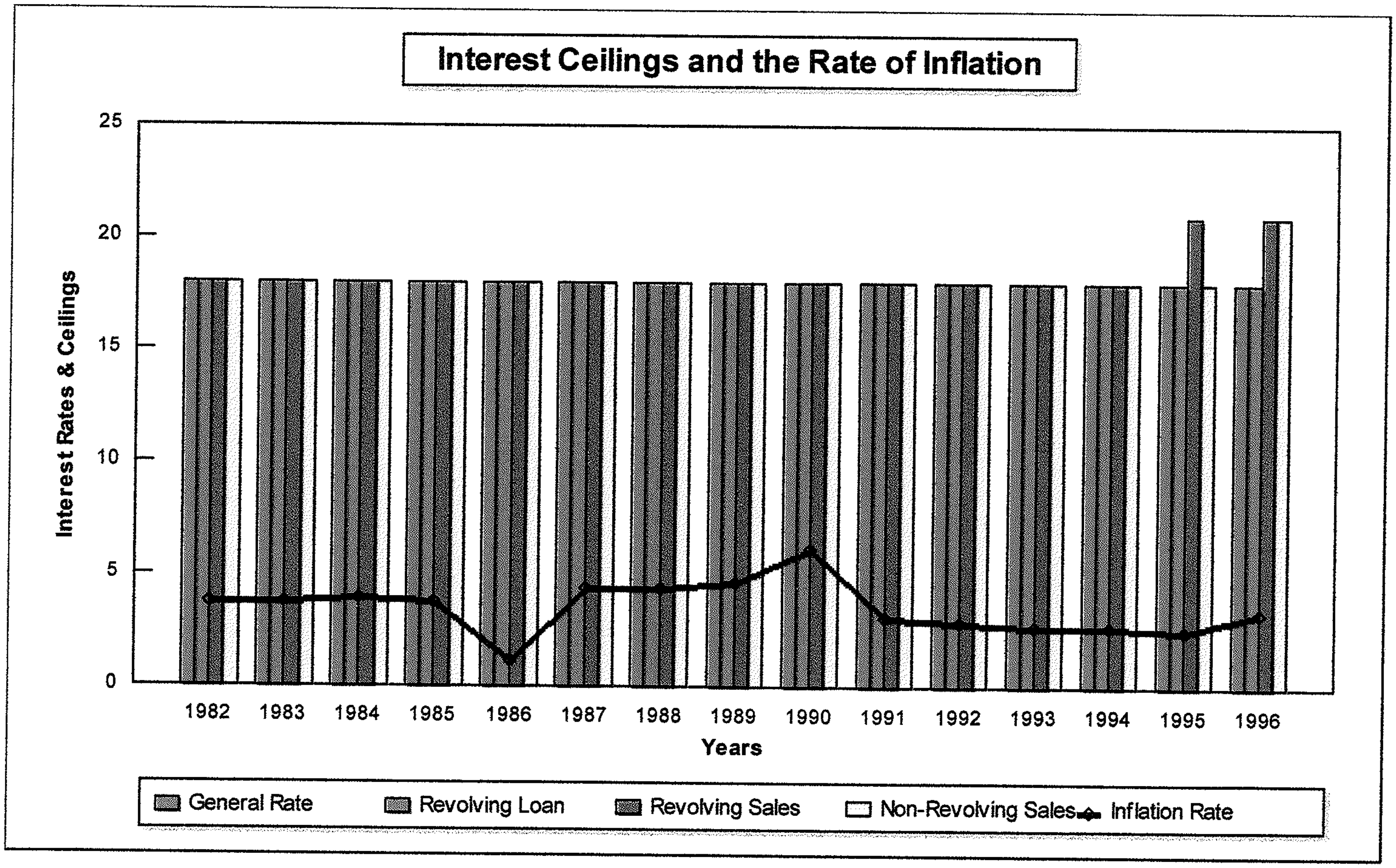
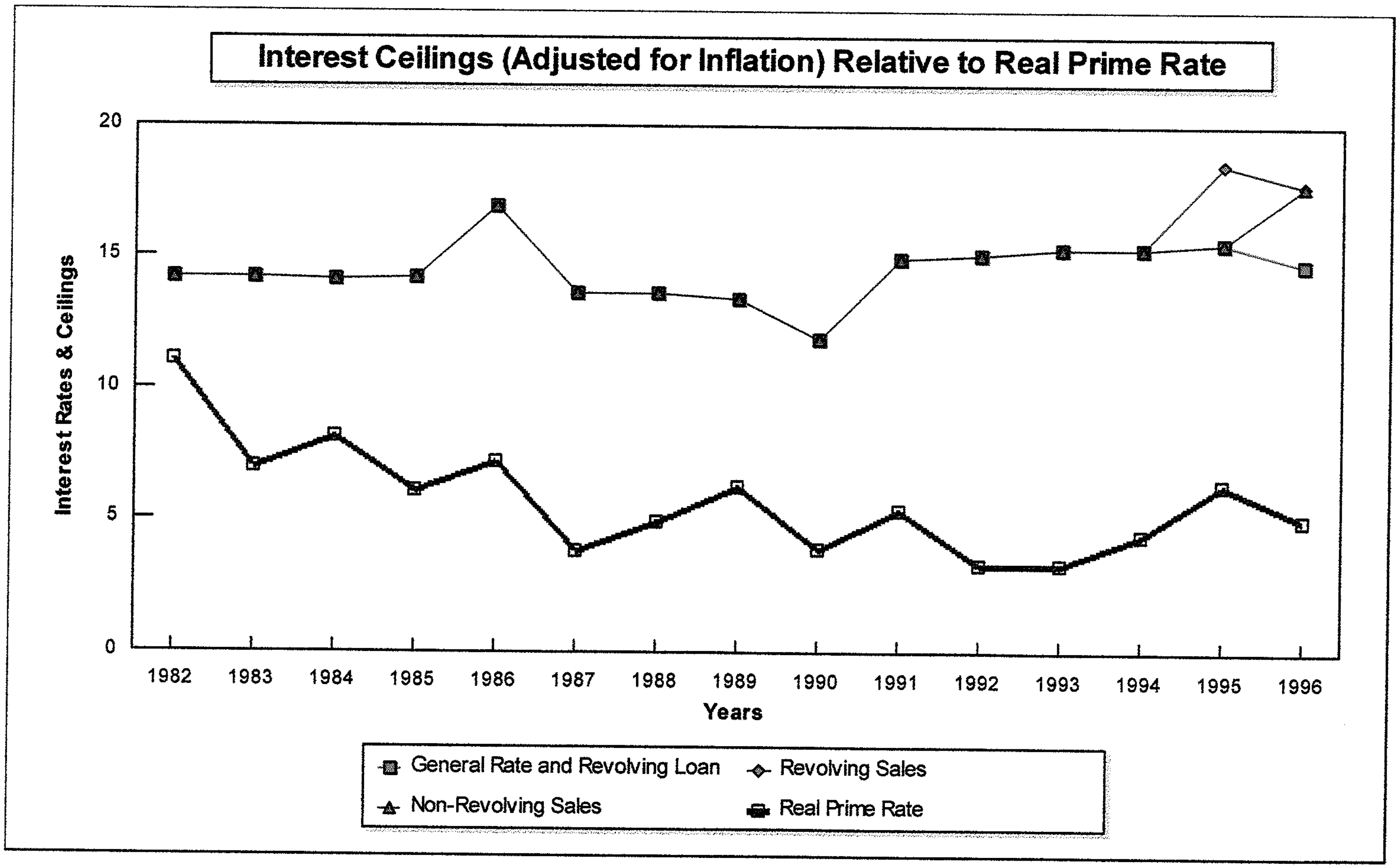

Interest Ceilings and the Rate of Inflation
Interest Rates & Ceilings
25
20
15
10
5
0
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
Years
General Rate
Revolving Loan
Revolving Sales
Non-Revolving Sales
Inflation Rate

Figure 3



Interest Ceilings (Adjusted for Inflation) Relative to Real Prime Rate
Interest Rates & Ceilings
0
5
10
15
20
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
Years
General Rate and Revolving Loan
Revolving Sales
Non-Revolving Sales
Real Prime Rate

Figure 2 shows the variability of the annual rate of inflation over the years of the Lending and Credit Rate Board's existence and changes in interest ceilings. Generally, one would expect ceilings to fluctuate with changes in the rate of inflation. This illustrates a lack of sensitivity to inflation. Figure 3 shows ceilings set by the board less the rate of inflation and the real prime rate. One would generally expect the gap between the ceilings and the real prime rate to remain somewhat constant over time. In 1982, the real prime rate was 11.06% and the ceilings less inflation were 14.20%, making the gap 3.14%. In 1992, the real prime rate was 3.35% and the ceiling was 15.1%, representing a gap of 12.65%. This illustrates the extreme to which ceilings have not been sensitive to market interest rates.

Enforcement Gaps

There is no purposeful enforcement activities for those lenders subject to the Board's orders, but not examined by State authorities. The Division of Banking *examines* state chartered banks, credit unions, regulated consumer lenders (finance companies) and to a lessor degree, secondary mortgage lenders. Other lenders, such as retailers extending their own credit, are under the enforcement jurisdiction of the Attorney General's Office, which must rely upon consumer complaints to bring violators to the Attorney General's attention.

Board Member Comments

In the November 15, 1996 meeting of the West Virginia Lending and Credit Rate Board, the board unanimously voted to recommend to the legislature that they conduct a study regarding the effectiveness of the Board with matters respecting credit and interest rates in the State of West Virginia. Most Board members according to a survey by the Legislative Auditor are in support of termination of the Board for various reasons. Following are comments by the Board members:

> "West Virginia has lagged behind other states in extending credit rate ceilings. Many companies extending credit in West Virginia import credit from other states, leaving only a few small stores that are regulated by the Board."

> "The Board is statutorily mandated to control something which is virtually no longer under its control due to superseding federal regulations and U.S. Supreme Court decisions and changes in the legal and geographic structure of the banking industry. The ability of the states to control interest rates has been greatly eroded."

> "(The Board) was not efficient, because the Board spent two years on one issue. ...government doesn't need to be involved in the regulation of rates, especially around the borders where customers can cross the state line."

> "The market has taken away what function the Board had. The Board was created when usuary laws of the State denied credit to those in need of it. It was able to get higher ceilings when it was created, but the market has changed considerably since that time. The Board has long outlived its usefulness."

"The West Virginia Lending and Credit Rate Board could be abolished without any detriment to the State. Many States have abolished lending and credit regulation with no ill effects. Credit is now extended without respect to state boundaries. The only thing our board can do is penalize West Virginia businesses."

"The taxpayer's money would be better spent elsewhere." [Note: The Board is not funded through general funds, but fees levied against lenders.]

Conclusion

The West Virginia Lending and Credit Rate Board is not effective for various reasons. Federal preemptions have weakened the Board's authority, since credit can be imported from state and national banks located outside West Virginia; rate ceilings cannot be imposed on first mortgages from banks and other lenders loaning over a million dollars; and federal parity statutes allow state and national banks to charge the same rates of interest competitors in the local marketplace may charge. A state may be effective in the regulation of the credit industry by one of two strategies. It may deregulate its credit industry as many states have done to attract the banking industry, or it may decide doing so is not worth the consequences and set ceilings that are sensitive to money market changes. The West Virginia Lending and Credit Rate Board has done neither. Ceilings remained flat for the first 13 years of the Board, while market forces were dynamic, and interest ceilings have been unfavorable to lenders compared with the thirty competitive market states. There are no enforcement provisions for those lenders subject to the Board's orders that are not examined by State authorities. Board members seem to support termination of the Board, which shows the members' frustration toward the Board, which may prevent rates being analyzed as required in the future.

Recommendation 1

The Legislature should consider termination of the West Virginia Lending and Credit Rate Board according to the Sunset Legislation in West Virginia Code §4-10-11.

APPENDIX A:
West Virginia Lending and Credit Rate Board Members

WEST VIRGINIA LENDING AND CREDIT RATE BOARD

	INITIALS	DATE	REFERENCE
PREPARED BY	DR	11/12/97	
CHECKED BY			
APPROVED BY			

STATUTORY MEMBERS:

Ms. Sharon G. Bias, Chairperson
Commissioner of Banking
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Charleston, West Virginia 25305
Chairperson of the Board
Statutory Member
Phone: 558-2294

Dr. Calvin Kent, Dean, College of Business
Marshall University - Corbly Hall Room 115
Huntington, West Virginia 25701
Statutory Member
Phone: 696-2316

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West Virginia University
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Morgantown, West Virginia 26505
Statutory Member
Phone: 293-7800

Ms. Jill Miles, Deputy Attorney General
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Statutory Member
Phone: 558-8986

Mr. Tom Burns, Director
West Virginia Development Office
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Charleston, West Virginia
Statutory Member
Phone: 558-2234

Mr. John Perdue, Treasurer
State of West Virginia
Building #1, Room EW-141
Charleston, West Virginia
Statutory Member
Phone: 343-4000

Public Members:

Mr. James Morgan
535 13th Avenue
Huntington, West Virginia 25701
Public Member
Phone: 529-2665 or 523-6120

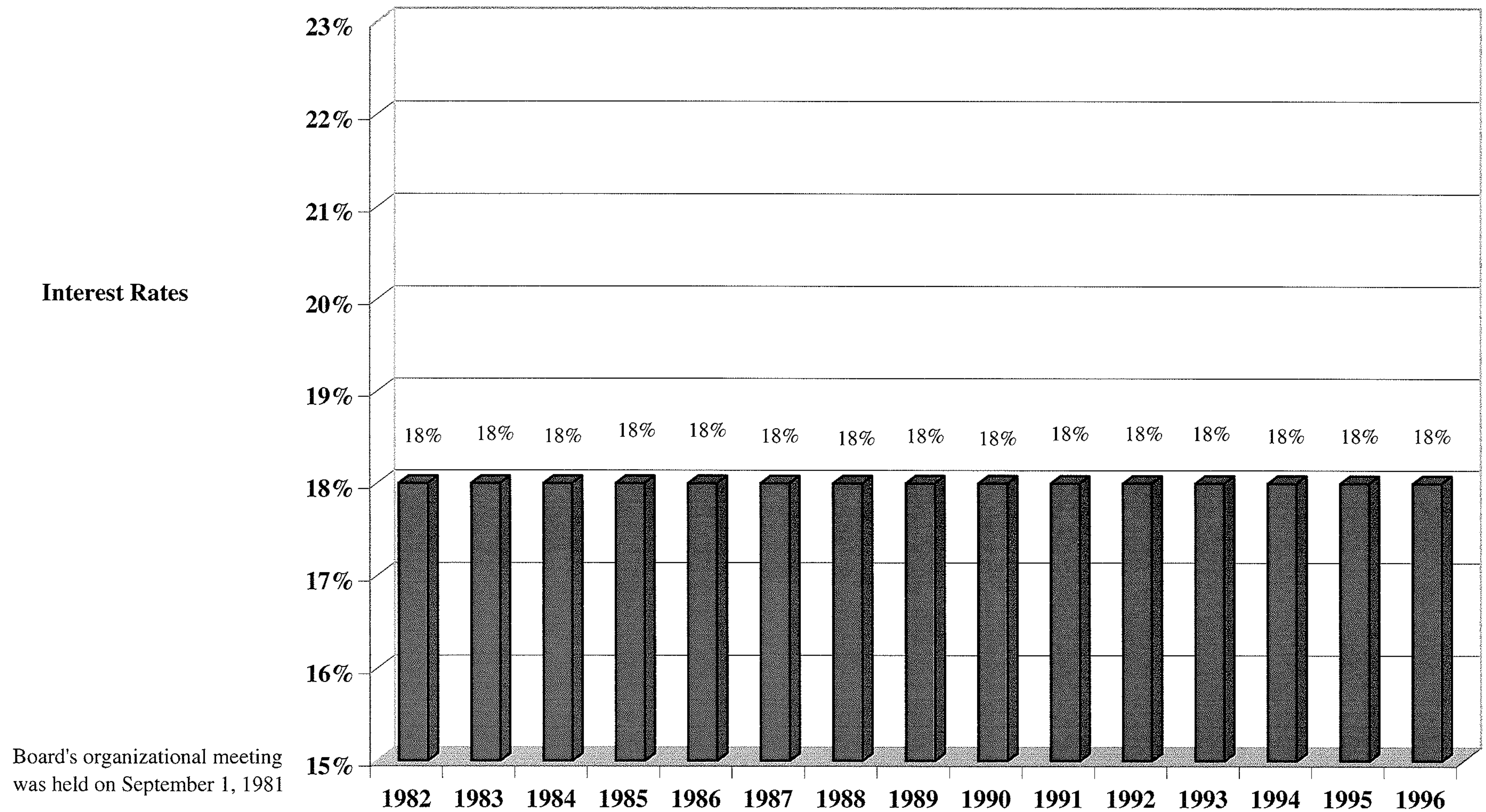
Ms. Anne M. Crowe
729 Cumberland Road
Bluefield, West Virginia 24701
Public Member
Phone: 327-7590 or 1-800-733-0850

Mr. Nelson Wagner
2347 Lumber Avenue
Wheeling, West Virginia 26003
Public Member
Phone: 242-0402

8/20/97

APPENDIX B:
WV Lending and Credit Rate Board Interest Rates
(1981 - Present)

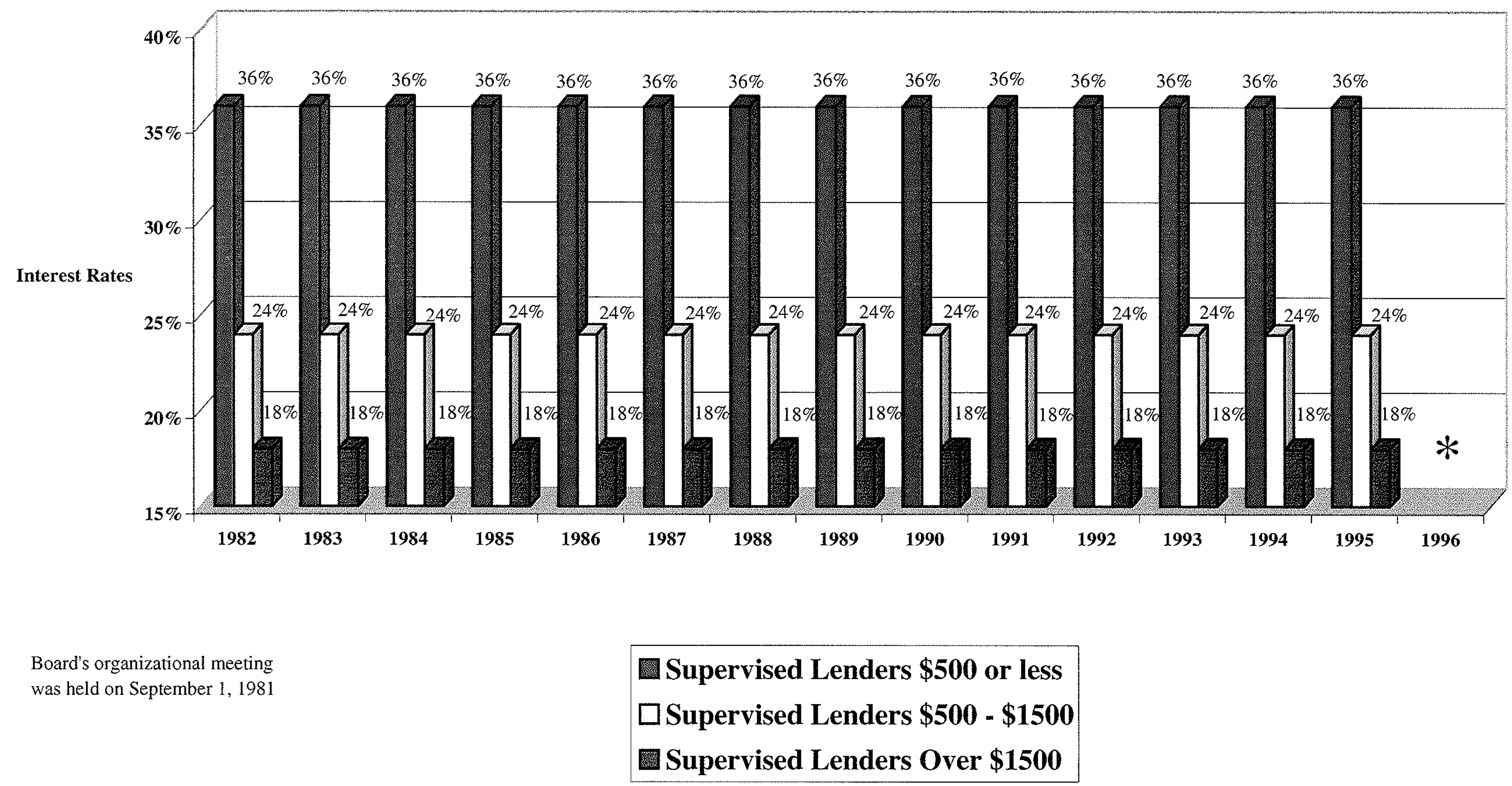
WV Lending and Credit Rate Board
Interest Rates 1981 to Present
Revolving Loan Finance Charge



Board's organizational meeting
was held on September 1, 1981

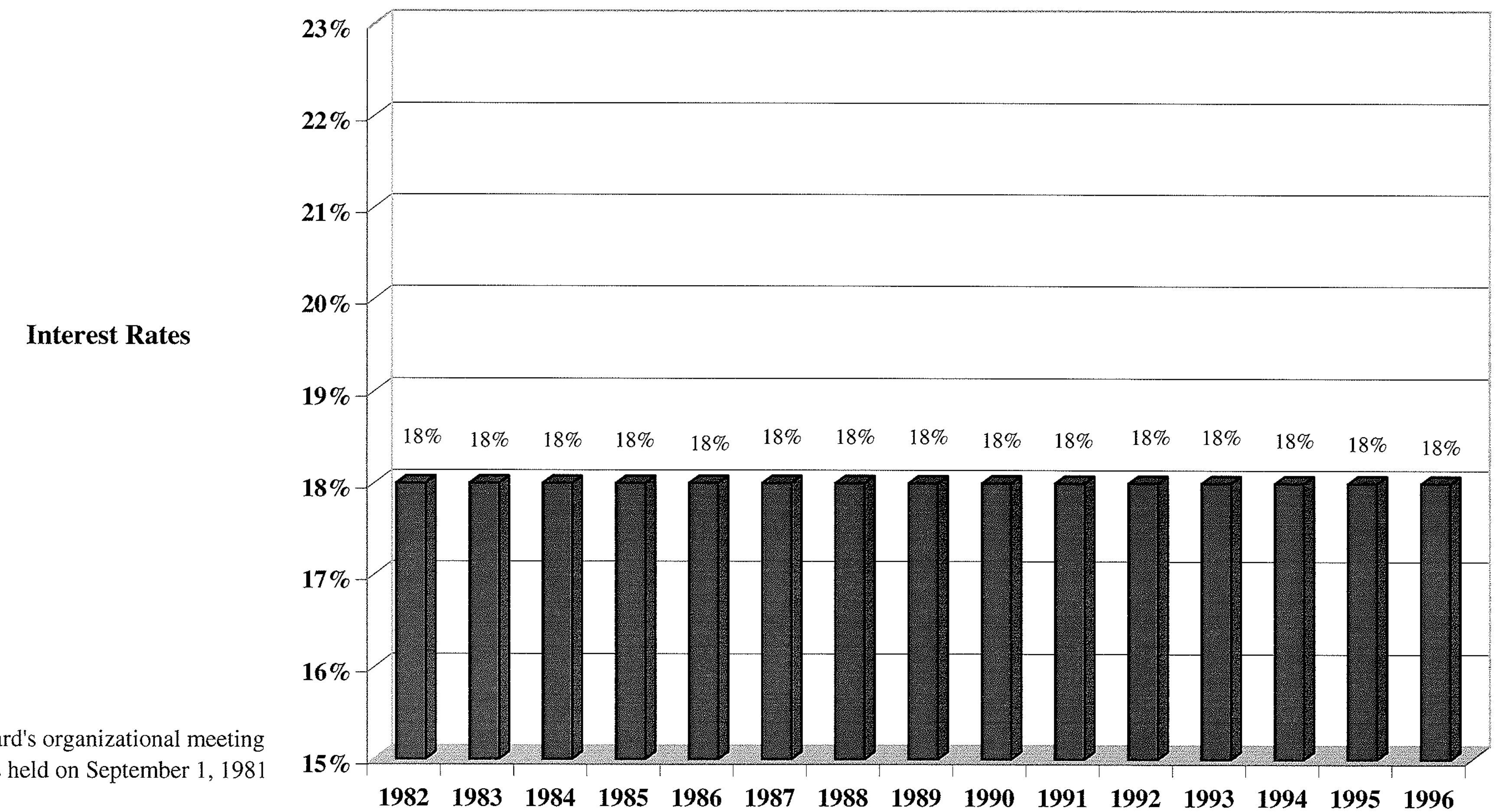
WV Lending and Credit Rate Board
Interest Rates for Supervised Lenders
1981 to Present

(* In September 1996, these companies ceased to be governed by the Board's Order)



Board's organizational meeting
was held on September 1, 1981

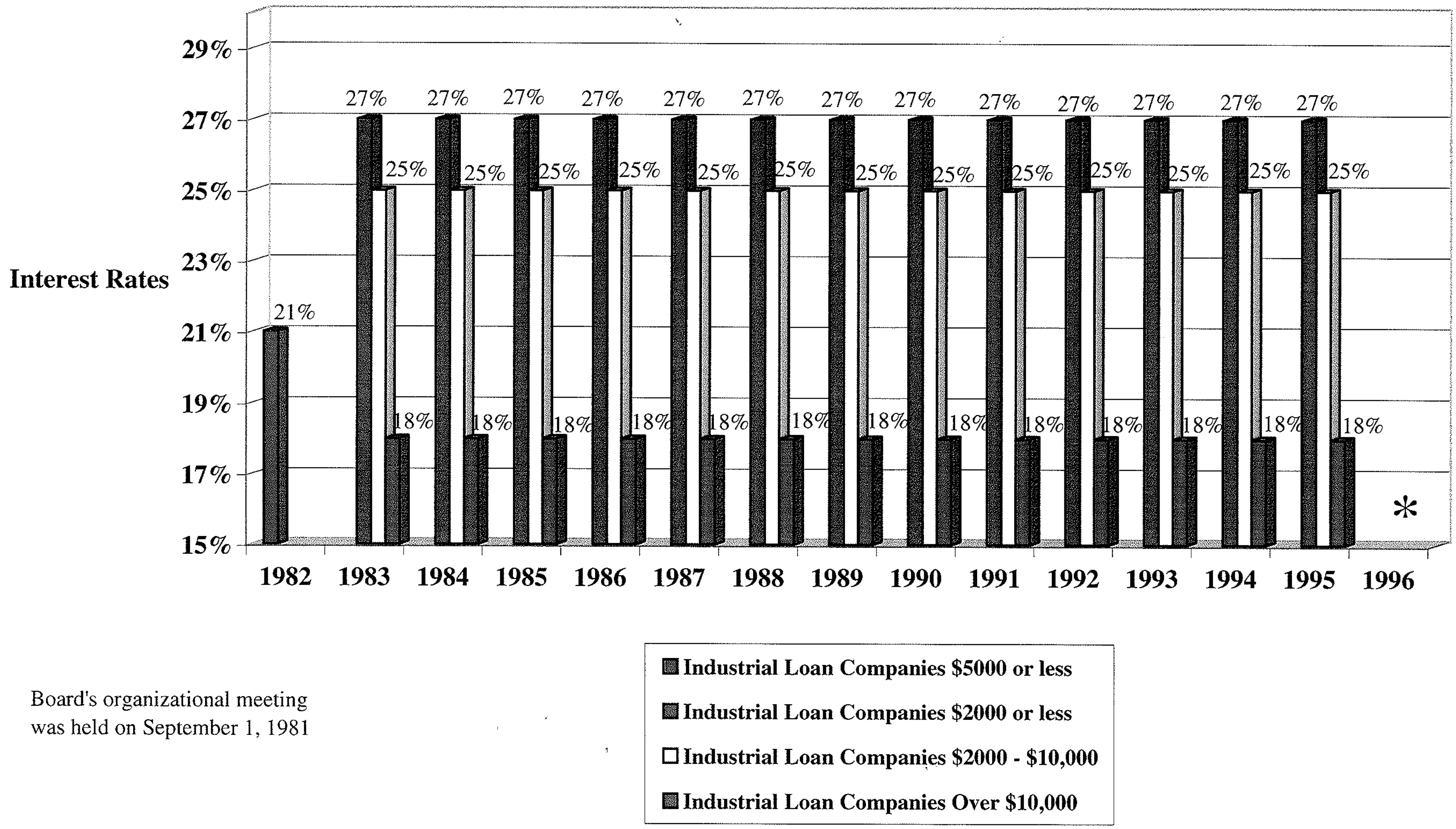
WV Lending and Credit Rate Board
Interest Rates 1981 to Present
General Rate



Board's organizational meeting was held on September 1, 1981

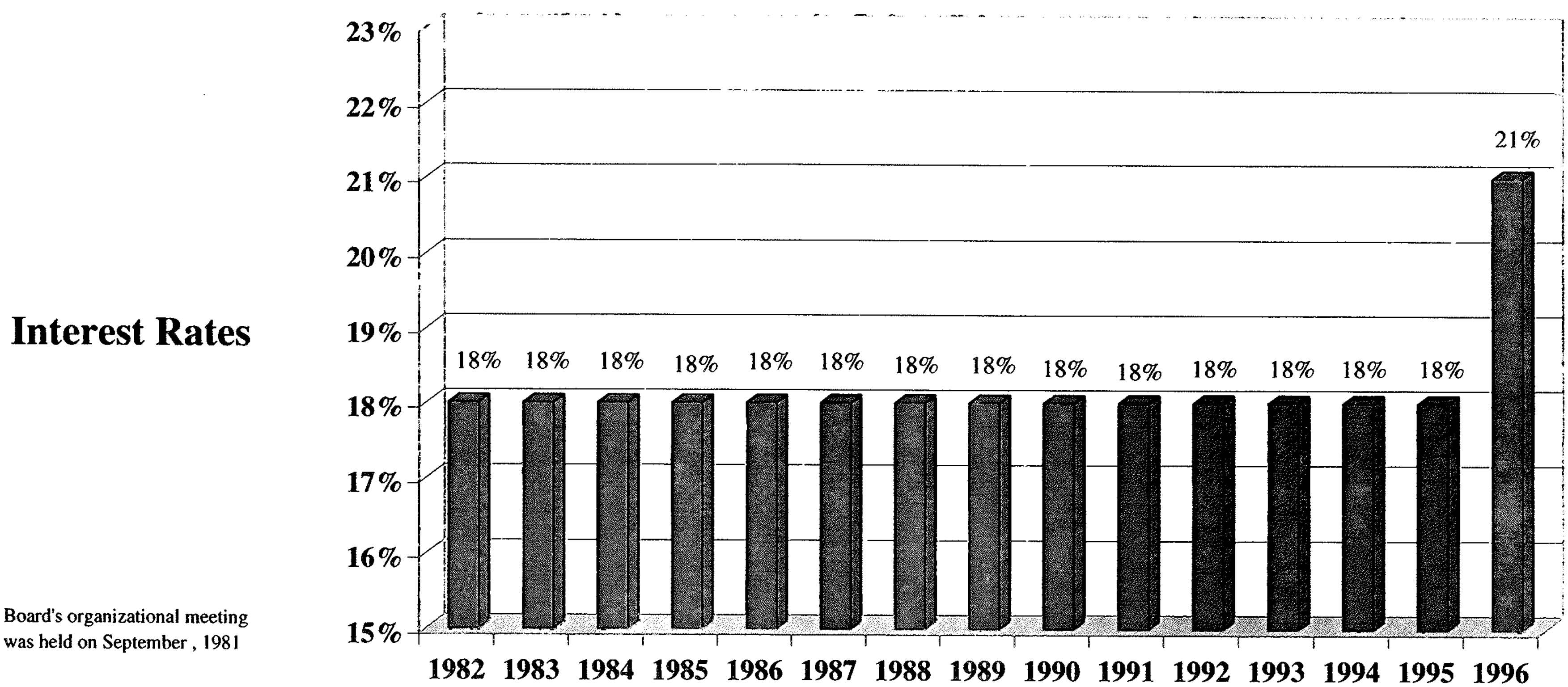
WV Lending and Credit Rate Board Interest Rates for Industrial Loan Companies 1981 to Present

(*In September 1996, these companies ceased to be governed by the Board's Order)



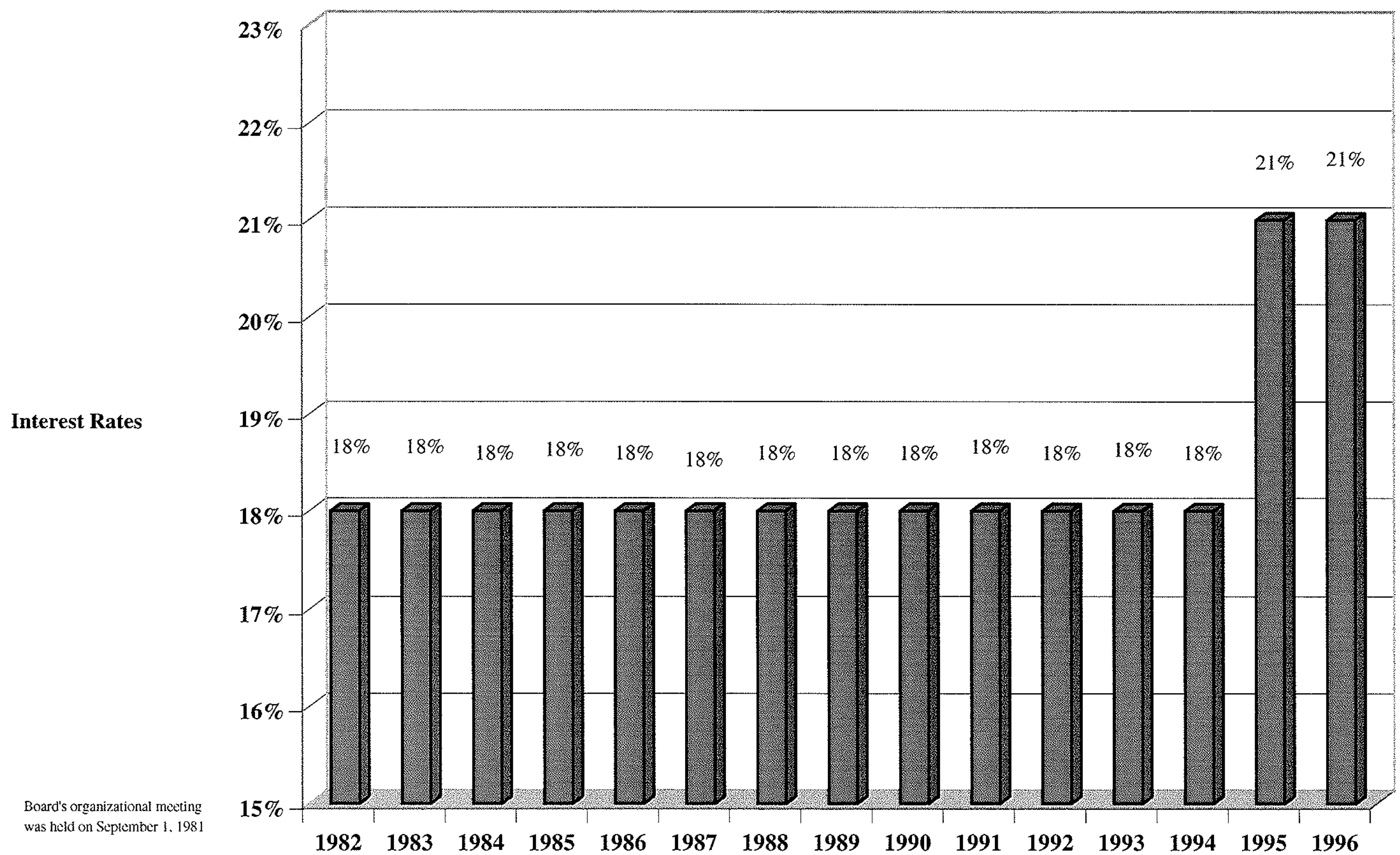
Board's organizational meeting was held on September 1, 1981

WV Lending and Credit Rate Board
Interest Rates 1981 to Present
Non-Revolving (closed-end) Sales Finance Charge



Board's organizational meeting
was held on September , 1981

WV Lending and Credit Rate Board
Interest Rates 1981 to Present
Revolving Sales Finance Charge



APPENDIX C:
Agency Response

DIVISION OF BANKING

Building #3, Room 311 • State Capitol Complex • 1900 Kanawha Blvd., East • Charleston, WV 25305-0240 • (304) 558-2294 FAX: (304) 558-0442

December 11, 1997

Dr. Antonio Jones
Director
Performance Evaluation and Research Division
Building I Room W-314
State Capitol Complex
Charleston, WV 25305

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RESEARCH AND PERFORMANCE EVALUATION DIVISION

Dear Dr. Jones:

Thank you for giving me the opportunity to meet with you and your staff this past Monday to discuss the findings of your performance audit of the WV Lending and Credit Rate Board. I have had an opportunity to review the preliminary report and have attached hereto some technical changes that I would recommend related to information regarding state law or applicable interest rates. As to the overall findings and recommendation of your staff, I am in agreement that the Board has been ineffective and has become in many ways obsolete. I hope the legislature will consider carefully whether or not the Board should continue.

There is one area of the report that I would like to address.

You correctly and briefly note that the various states generally elect one of two responses in regard to setting consumer interest rates. One is to completely deregulate and remove all interest rate caps and the other is to "protect consumers" by determining an ideal interest rate and keeping the rate(s) in effect as best they can for their own lenders. It may be helpful to the Government Operations Committee if you would bring to their attention that in fact a third strategy might be adopted by a state. That strategy would be to remove caps only from the prime, competitive markets and keep them in place for those lenders which target the less affluent, more vulnerable citizens. There is no reason that a state must choose any extreme position.

I appreciate an opportunity to comment on your findings. My staff and I thank you for the courtesy and professionalism you demonstrated in your work on the audit.

Sincerely,

Sharon G. Bias
Commissioner of Banking

Enclosure
Cc: Robin Capehart
Dale Steager

E.E.O./AFFIRMATIVE ACTION EMPLOYER