Finance Companies

Prof. Salvatore Perdichizzi

Economics of Financial Intermediation

March 7, 2017

Overview

Finance companies

- **Activities** of finance companies
- **Size**, **structure**, and **balance sheet**
- **Global issues**

Finance Companies

- Activities similar to banks, but **no depository function**
- May **specialize** in **installment loans** (e.g. automobile loans) or may be diversified, providing **consumer loans** and **financing to corporations**, especially through **factoring**
- **Commercial paper** is **key** source of **funds**
- **Higly concentrated**
  - Largest 20 fimrs: 65% of assets

- The **first** finance company was created by General Eletric Corp.
- The **General Eletric Capital Corp.** served to **finance** sales to **cash-constrained customers** that were **unable to get** installment credit (i.e., *auto loans, home mortageres and student loans*) from banks.

Major Types of Finance Companies

- **Sales finance institutions**:
  - Ford Motor Credit
  - *Institutions that specialize in making loans to the customers of a particular retailer or manufacturer.*
- **Personal credit institutions**:
  - HSBC Finance, American Express - *Institutions that specialize in making installment and other loans to consumers*
- **Business credit institutions**:
  - Equipment leasing and **factoring**[1]
  - *Institutions that specialize in making business loans*

[1] the process of purchasing accounts receivable from corporations (often at a discount), usually with no recurse to the seller if the receivables go bad.

Balance Sheet 1977

	Billions of Dollars		Percent of Total Assets	
Assets				
Accounts receivable gross	$ 99.2		95.1%	
Consumer	44.0		42.2	
Business	55.2		52.9	
Less reserves for unearned income and losses	(12.7)		(12.2)	
Accounts receivable net		$ 86.5		82.9%
Cash and bank deposit		2.6		2.5
Securities		0.9		0.9
All other		14.3		13.7
Total assets		$104.3		100.0%
Liabilities and Capital				
Bank loans		$ 5.9		5.7%
Commercial paper		29.6		28.4
Debt				
Short-term		6.2		5.9
Long-term		36.0		34.5
Other		11.5		11.0
Capital, surplus, and undivided profits		15.1		14.5
Total liabilities and capital		$104.3		100.0%

Balance Sheet 2012

	Billions of Dollars		Percent of Total Assets	
Assets				
Accounts receivable gross	$1,300.8		74.8%	
Consumer	578.3		33.3	
Business	429.2		24.7	
Real estate	293.3		16.8	
Less reserves for unearned income	(24.3)		(1.4)	
Less reserves for losses	(26.5)		(1.5)	
Accounts receivable net		$1,250.0		71.9%
All other		488.0		28.1
Total assets		$1,738.0		100.0%
Liabilities and Capital				
Bank loans		$76.5		4.4%
Commercial paper		61.8		3.6
Debt due to parent		256.6		14.8
Debt not elsewhere classified		771.5		44.4
All other liabilities		322.4		18.5
Capital, surplus, and undivided profits		249.2		14.3
Total liabilities and capital		$1,738.0		100.0%

Balance Sheet

- **Business** and **consumer loans** are the **major** assets - 58.0% of total assets, 2012 - Reduced from 95.1% in 1977
- **Increases** in real estate loans and other assets
- Growth in **leasing** and **business lending**
- Finance companies face **credit risk**, **interest rate risk**, and **liquidity risk**

Consumer Loans

- **Primarily motor vehicle loans** and **leases**
- Historically charged **higher rates** than commercial banks
- **Low** auto finance company **rates**
  - Following 9/11 attacks
  - Attempts to **boost** new vehicle **sales** via **0.0%** loans lasted into 2005
  - By 2002, *rates were 3.3% lower than banks* on new vehicles
- Generally **riskier customers** than banks
  - **Subprime lender** (*A finance company that lends to high-risk customers*) finance companies
- **Loan shark**[2] firms with rates as **high** as **30%** or more

[2] Subprime lenders that charge unfairly rates to desperate subprime borrowers

Payday Loans

- Another case of **subprime lender** is the **payday lender**.
- **Paylender** provide **short-term cash advances** that are often due when borrowers receive their next paycheck.

Mortgages and Home Equity Loans

- **Mortgages** have become a **major component** of finance company **assets**
- May be **direct mortgages**, or as **securitized mortgage assets**

The Mortgages in the loan portfolio can be first mortgages or second mortgages in the form of **home equity loans**[3]

- **Growth** in **home equity loans** following passage of **Tax Reform Act of 1986** - **Tax deductibility** issue
  - **Defaults** in **subprime** and even relatively **strong** credit mortgages in 2007-2008
  - Root **cause** of the *financial crisis* in **2008-2009**

[3] *Loans that let customers borrow on a line of credit secured with a second mortgage on their home*

Business loans

- **Business loans** comprise **largest** portion of finance company **loans** (*30%*)
- **Advantages** over commercial banks:
  - **Fewer** *regulatory impediments* to types of products and services
  - **Not depository institutions** hence less **regulatory** scrutiny and lower overheads
  - Often have substantial expertise and greater **willingness to accept riskier clients**

Major subcategories:

- **Retail** and **wholesale** *motor vehicle loans and leases*
- **Equipment loans**
  - **Tax** and **other associated advantages** when finance company **leases** the *equipment* **directly** to the customer
- Other business loans and **securitized business assets**

Liabilities

- **Major liabilities**: **Commercial paper and other debt** (longer-term notes and bonds)
- Finance firms are **largest issuers of commercial paper** (frequently through direct sale programs)
- **Management of liquidity risk** *differs* from commercial banks

Industry Performance

- **Strong** loan demand and **solid** profits for the largest firms in the **early 2000s**
  - *Effects of low interest rates*
- Not surprisingly, the **most successful** became **takeover** targets
- Mid 2000s **problems arose**
  - *2005, 2006: falling home prices and rising interest rates*
- Sharp pullback from **subprime mortgage** lending
- End of 2009: National all time **high for mortgage delinquencies 6.89%**
  - *Countrywide Financial failure*

Global Issue

- In **foreign countries** (*Europe specially*), finance companies are **generally subsidiaries** of **commercial banks** or **industrials**
- Importance of nonbank FIs has been increasing over the past decade