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Scope and Character of Analysis

FROM an unknown but probably negligible amount prior to 1920, the financing of consumers on an instalment basis had grown into a 6 billion dollar business by 1941. The bulk of this credit was extended by retailers and by specialized types of institutions; extensions of credit by the latter were either in the form of retail instalment credit, designed to finance the purchase of a specific commodity, or of instalment loans for which the borrower received cash. During the 1930's, when bank earnings were declining, commercial banks began to recognize the profitability of this type of credit, and increasingly participated in its extension, but at the end of 1941 there were still relatively few commercial banks in which consumer instalment credit accounted for a high proportion of loans. Bank lending as a whole continued to consist primarily of the traditional financing of business enterprises.

The present study was undertaken to examine the operating characteristics of the specialized *consumer* instalment financing agencies and to contrast them with the operating characteristics of commercial banks, the specialized *business* financing agencies. It proposes to answer a number of questions regarding operations, which may be summarized as follows: first, how the consumer instalment financing agencies—sales finance companies, personal finance companies, investment type industrial banks, non-investment type industrial banks, and credit unions—differ from one another with respect to sources and uses of funds, income, costs of operation, profits and dividends; second, how the operations of the specialized agencies contrast with those of commercial banks; third, how individual companies among the specialized agencies and individual commercial banks differ from one another; fourth, how differences in the character and size of the typical loan affect the operations of individual enterprises; fifth, how size, as such, affects the sources and uses of funds and the income, expenses,

profits and dividends of the individual enterprises; and sixth, how operations were affected by the severe business recession of 1929-33, and by the subsequent recovery.

NATURE OF THE CONSUMER INSTALMENT FINANCING BUSINESS

The term consumer instalment credit, as used in this study, refers to credit extended to consumers under a formal legal contract which requires repayment of principal and interest in regular scheduled instalments. The two principal types of consumer instalment credit arise from the financing of retail sales and from the extension of cash loans.

An individual who buys an article on the instalment plan is usually required to make a down payment,¹ which may be in cash or wholly or partly in the form of a trade-in, and to sign a credit instrument for the balance plus the finance charge and, in some cases, plus insurance. This balance is embodied in the contract, which provides for payment in instalments, usually equal in amount, at monthly or other equal intervals of time.

The dealer may sell the contract to a financing agency or a commercial bank, or he may hold it himself. The sales finance company specializes in the purchase of such paper. If the dealer sells the paper the subsequent collection of instalments is in the hands of the agency, although often the dealer signs the finance paper with recourse and is liable, in greater or lesser degree, for loss sustained by the agency through failure of the purchaser to pay the debt in full.

In the extension of cash loans, on the other hand, the borrower deals directly with the credit agency. He may use his loan proceeds as he pleases, and the security required of him varies widely. The institutions that specialize in cash instalment loans are personal finance companies, industrial banking companies and credit unions.

During the rise of the specialized types of consumer instalment financing institutions, commercial banks were making little pro-

¹ Minimum down payments are now required, as specified in Regulation W, issued by the Board of Governors of the Federal Reserve System, pursuant to the provisions of Executive Order No. 8843 of August 9, 1941, providing for "Regulation of Consumer Credit."

vision for the financing needs of low income groups. The cash loan needs of these groups were rapidly expanding, and their demand for retail instalment credit was stimulated by the development and intensive promotion of new types of durable consumer goods, notably automobiles.

But commercial banks traditionally considered cash loans to consumers unsound and outside their province, and looked with only slightly less suspicion upon the acquisition of retail instalment paper. Moreover, banks recognized that the extension of credits in small amounts, and collection on an instalment basis, constituted a high-cost business which was uneconomic at the rates permitted under most usury statutes. Thus the opportunity was provided for the development of specialized types of institutions. These, too, were confronted by the usury statutes, but they were able to skirt this obstacle either by receiving specific legislative authorization to charge higher rates or by avoidance of laws through the use of technical devices or through the benefit of favorable judicial interpretations.

The personal finance company, also known as the "small loan company" or the "licensed lender," operates under the sanction of special "small loan" legislation designed to combat the loan-shark evil.² By 1941 regulatory laws were in effect in 39 states, the District of Columbia and Hawaii. Under most of them the lenders are granted permission to make one over-all charge, including interest, at a rate not exceeding a specified percentage of the unpaid balance of the loan; the rate varies considerably but is never more than 3½ percent a month. As a rule the maximum loan allowed is \$300. The principal is repaid in equal instalments plus interest charges over a specified length of time, generally varying during the period under examination between 5 and 20 months.

The credit union is a cooperative association which, because of its nature, is able to operate at a nominal cost. Its rates are therefore

² Before the passage of small loan laws most credit facilities available to low income consumers were provided by illegal lenders at very high rates. For the activities of the illegal lender, including his rates of charge, see Russell Sage Foundation, *Regulation of the Small Loan Business*, by Louis N. Robinson and Rolf Nugent (New York 1935) Chapters 2 and 3. An extensive bibliography on illegal lending appears in *Consumer Credit Bibliography*, compiled by Ernestine Wilder (New York 1933) pp. 31-43.

generally lower than those of personal finance companies, amounting ordinarily to not more than 1 percent a month.³

Both the credit union and the personal finance company have been *exempted* from the usury statutes. The industrial banking company, first developed about 1910 under the name "Morris Plan," has made credit facilities available to "industrial" workers by utilizing a device for *avoiding* the usury statutes. This is done by linking a loan transaction, calling for lump payment at maturity, with a deposit or investment transaction in which the borrower agrees to deposit small sums, generally equal in amount, until a total equal to that of the loan has been accumulated. This total is then applied to the payment of the loan at its maturity.

Since the loan transaction calls for lump sum repayment, and is separate from the deposit or investment certificate agreement, interest can be charged at the maximum legal rate on the face amount of the loan for the entire period, whereas the same rate of charge would result in an effective rate of interest approximately double the specified rate, if payments were applied directly to reduce the loan.

This practice of accepting "hypothecated" deposits, or of selling "hypothecated" investment certificates for instalment repayment, is characteristic of the operations of industrial banking companies,⁴ and those that follow it are called investment type companies throughout this study. There are some, however, that are not permitted to use the hypothecation device, and these are here called non-investment type companies. The latter operate, in some jurisdictions, through the imposition of service fees, commissions or other charges, in addition to the interest charge, and in others through licenses enabling them to make small instalment loans at stipulated rates of charge.⁵

³ Federal credit unions are limited to a rate of 1 percent a month (*United States Code*, Title 12, Section 1757). For a summary of credit union laws in the 48 states and in the provinces of Canada see Roy F. Bergengren, *Credit Union North America* (Kingsport, Tenn., 1940) pp. 364-81.

⁴ In some states commercial banks engaged in consumer instalment financing make use of the same device; where industrial banking companies are authorized to make charges in excess of the usual usury rates there is a tendency for them to discontinue the use of the hypothecation device.

⁵ The first companies organized "to lend money to persons employed in industry" were chartered under general incorporation laws, but today over half the states provide for the organization of such companies under special legislation. A list of state statutes applying to industrial banking companies is given in National Bureau

In most states judicial interpretations permit avoidance of usury laws also by sales finance companies, since the finance charge added to the price of the goods sold is legally construed not as an "interest charge" but as a part of the retail price of the goods. The income of the sales finance company—represented by the difference between the amount paid the retail dealer and the amount collected from the purchaser—is also, technically, not an interest charge.

The finance charge is highly variable, on new merchandise ranging in general from 10 to 20 percent in terms of simple interest, depending upon the nature of the goods and the length of the transaction.⁶ In automobile sales financing an added outlay is imposed on the consumer by the usual requirement of fire, theft and collision insurance (which would be optional with a cash purchaser).

In practice there is considerable overlapping in the business of the principal types of consumer credit agencies. Thus sales finance companies, while they engage characteristically in the financing of retail sales to consumers, may also, and usually do, finance the wholesale purchases of dealers. In addition, they sometimes finance the purchase of producer goods, such as taxicabs, trucks and tractors. Some also engage in other types of business financing, through the discounting of accounts receivable, or factoring. Enterprises regarded as sales finance companies are sometimes licensed to make small loans, either directly or through subsidiaries.⁷

⁶ The Federal Trade Commission has published a study, *Report on Motor Vehicle Industry* (Washington 1939), which shows variations in automobile finance charges. For a summary in annual percentage rates see National Bureau of Economic Research (Financial Research Program), *Sales Finance Companies and Their Credit Practices*, by Wilbur C. Plummer and Ralph A. Young (New York 1940) pp. 211-12, 214. For rates charged in diversified sales financing see the same volume, pp. 224-25.

⁷ See Plummer and Young, *op. cit.*, pp. 36-40. There the distribution of outstanding receivables of 48 large sales finance companies is given as follows: automobile retail paper, 66 percent; other retail paper (including some industrial equipment), 13 percent; total wholesale paper, 15 percent; small loans, 0.5 percent; open accounts receivable and factoring, 4.6 percent; rediscounted paper and miscellaneous, 0.8 percent. A Census Bureau tabulation of the outstanding sales finance receivables of 302 sales finance companies, December 31, 1940, gave the following distribution: retail automobile paper, 65 percent; other retail paper, 17 percent; wholesale automobile

of Economic Research (Financial Research Program), *Industrial Banking Companies and Their Credit Practices*, by Raymond J. Saulnier (New York 1940) pp. 184-86, and Chapter 2 of that volume is devoted to a discussion of the companies' legal status. A short summary of the law of each state under which industrial banking companies carry on operations is presented in Consumer Credit Institute of America, *Industrial Banking*, by Margaret Grobden (New York 1940) Chapter 11.

In a great many cases the cash-lending agencies engage also in sales financing, both wholesale and retail. Moreover, enterprises regarded as industrial banking companies are frequently licensed to make small loans, their activities thus tending, particularly if they do not issue investment certificates or accept deposits, to merge into those of personal finance companies.

AMOUNT AND DISTRIBUTION OF INSTALMENT CREDIT OUTSTANDINGS⁸

The estimated amount of consumer instalment loans outstanding increased from about 3 billion dollars at the end of 1929 to about 6 billion at the end of 1941. Changes in total monthly outstandings closely followed changes in retail instalment outstandings, which represented a preponderant proportion of the total throughout the period, even though that proportion showed a conspicuous decline.

Fluctuations in retail instalment outstandings during the period were closely related to cyclical changes in retail sales of durable consumer goods customarily sold in this manner. The estimated amount of retail instalment paper outstanding declined from 2.5 billion dollars at the end of 1929 to 0.9 billion at the middle of 1933, or by more than 60 percent. The business revival from 1933 to the autumn of 1937 resulted in as great an increase, with the total exceeding the 1929 level during most of 1937; but the subsequent sharp recession was accompanied by a decline amounting to approximately 25 percent in one year, so that by December 1938, the total amount of retail instalment paper outstanding had fallen to 2.0 billion dollars. During 1939-41 the amount increased to 3.7 billion. Retail instalment outstandings showed some seasonal movement over the period, rising in the spring months and again in December.

Cash loan outstandings were less affected by the fluctuations in

⁸ This analysis is based on National Bureau of Economic Research (Financial Research Program), *The Volume of Consumer Instalment Credit, 1929-38*, by Duncan McC. Holthausen in collaboration with Malcolm L. Merriam and Rolf Nugent (New York 1940), and *The Business of Consumer Instalment Financing—A Summary Review*, by Ralph A. Young (ms. 1941) Chapter 2.

paper, 17 percent; other wholesale consumer goods paper, 0.3 percent; industrial, commercial and farm equipment, 0.8 percent. See United States Department of Commerce, Bureau of the Census, Current Statistical Service, *Sales Finance Companies* (March 24, 1942).

general business conditions, exhibited a greater growth over the decade, and gave practically no indication of a seasonal pattern. They stood at 0.7 billion dollars at the end of 1929, decreased to 0.5 billion in 1933, and then increased almost steadily to 2 billion at the end of 1941.

The distribution among the different agencies of retail instalment and cash loan outstandings for various years of this period is shown in Table 1.⁹ Also included are outstandings on instalment credit advances insured by the Federal Housing Administration, which were first issued in 1934, and were soon handled by all the agencies except personal finance companies.

For most years of the period there are not sufficient data for determining the distribution of retail instalment paper among the various agencies. It is known, however, that the share held by commercial and industrial banks notably increased during 1929-41, and it is likely that the share held by sales finance companies declined. It seems reasonable to assume that sales finance companies' share of total consumer instalment outstandings declined to a degree perhaps greater than the decline in the proportion of retail instalment paper.

The bulk of cash loan outstandings in 1929 was held by personal finance companies and industrial banking companies; by 1941 they held less than half of the cash loans due to the increase in holdings of commercial banks and credit unions. The amount held by personal finance companies declined less from 1929 to 1933 than that held by the other cash-lending agencies, and consequently the proportion they held was almost doubled. With the very rapid expansion of total consumer instalment outstandings after 1933, the share held by personal finance companies declined as sharply as it had increased in preceding years. From 1936 to 1941 it increased gradually but fairly regularly, in dollar amount, though it declined considerably in relation to all cash loans.

The share of consumer financing handled by industrial banking companies showed a small increase from 1929 to 1933. Thereafter the proportion declined, notwithstanding a substantial growth in dollar volume.

Credit unions held only 1 percent of total consumer instalment

⁹ The commercial bank estimates for 1936 and prior years include only those banks that had personal loan departments (see Holthausen, *et al.*, *op. cit.*, pp. 28, 122), but it is not likely that this limitation seriously affects the accuracy of the figures.

TABLE 1

PERCENTAGE DISTRIBUTION OF TOTAL ESTIMATED CONSUMER INSTALMENT OUTSTANDINGS, YEAR-END 1929, 1933, 1936, 1941, BY AGENCY^a (dollar figures in millions)

Agency	1929	1933	1936	1941
<i>Retail instalment credit</i>				
Sales finance companies	b	b	b	31.1%
Commercial banks	b	b	b	10.7
Insured industrial banks	b	b	b	.7
Other industrial banking companies	b	b	b	} 20.0 ^o
Retailers and others	b	b	b	
Total	78.3%	69.3%	69.4%	62.5
<i>FHA Title I loans^d</i>				
Sales finance companies	..	..	1.5	1.0
Commercial banks	..	..	4.7	3.5
Insured industrial banks	..	..	} .4	} .3
Other industrial banking companies	..	..
Credit unions and others	..	..	.1	} .1
Total	6.7		4.9
<i>Cash instalment loans^e</i>				
Personal finance companies ^f	9.6	16.6	9.9	10.2
Commercial banks	1.3	1.8	3.7	12.3
Credit unions	1.0	1.7	1.9	3.4
Insured industrial banks	} 6.8	} 7.5	} 5.4	} 1.6
Other industrial banking companies				
Other lenders	3.0	3.1	3.0	1.7
Total	27.7	30.7	23.9	32.6
TOTAL OUTSTANDINGS	100.0%	100.0%	100.0%	100.0%
	\$3,211.3	\$1,618.9	\$3,514.2	\$5,997.7

^a Based on data in the *Survey of Current Business* (November 1942) pp. 9-25, which revised and brought up-to-date the National Bureau of Economic Research estimates published in *The Volume of Consumer Instalment Credit, 1929-38*, by Duncan McC. Holthausen in collaboration with Malcolm L. Merriam and Rolf Nugent (New York 1940). For 1941, based, in addition, on data from Federal Deposit Insurance Corporation and Federal Housing Administration.

^b Breakdown not available.

^c Holdings of other industrial banking companies are a negligible percentage.

^d Notes under \$2,000 insured by the Federal Housing Administration. Breakdowns estimated from data obtained from the FHA for May 1 call dates.

^e Includes direct instalment loans for financing retail purchases, repair and modernization loans not insured by the FHA and loans made by unregulated lenders.

^f Inflated by "interest due and to become due" by the formula $oi \frac{(d+2)}{3}$ with *o* representing outstandings, *i* the monthly interest rate, and *d* the duration of the loan. The duration was estimated at 15 months and the monthly interest rate in 1929 at 3.0 percent, in 1933 at 2.9 percent, in 1936 at 2.8 percent, and in 1941 at 2.5 percent.

loans outstanding at the end of 1929, the smallest share of any one of the principal types of agencies. The increase to more than 3 percent in 1941 may be attributed in large part to the rapid expansion in the number of federal credit unions after their authorization in 1934, and to the organization of additional state-chartered institutions.

In the last decade commercial banks, while they have invested a consistently decreasing proportion of their total assets in loans, have held a consistently increasing share of total consumer instalment outstandings. Through 1933 their cash instalment loans represented almost as small a share of the over-all total as did those of credit unions, but thereafter they increased very sharply.

It may be estimated that commercial banks' holdings of consumer instalment paper—retail and cash loans combined—rose from 2 or 3 percent of the total in 1929¹⁰ to more than 10 percent in 1936 and to more than 26 percent at the end of 1941. In the latter year commercial banks held more than one-third of all instalment cash loan outstandings, more than one-half of outstanding FHA Title I loans, and about one-sixth of other instalment outstandings arising from retail sales.¹¹

SOURCES OF DATA

The data used for this study may be summarized, as follows: WPA-Treasury income tax tabulations; information from the National Credit Office, Inc., tabulated by the National Bureau; Farm Credit Administration data on credit unions; figures on individual insured commercial and industrial banks, from the Federal Deposit Insurance Corporation; data on national banks from the reports of the Comptroller of the Currency; and miscellaneous data from other published sources.

¹⁰ Indirectly the commercial banks had participated in the consumer instalment financing business to a much greater extent. The *Federal Reserve Bulletin* (January 1923) pp. 41, 44, pointed out that banks purchased (through commercial paper houses or directly) "almost all" the collateral trust notes issued by the larger sales finance companies to finance themselves, and that the smaller sales finance companies "frequently rely upon their lines of credit with their local banking institutions." The relatively high interest rates obtained in the 1920's by commercial banks on the paper of consumer instalment financing agencies undoubtedly contributed to their reluctance to participate in the business directly.

¹¹ It is generally agreed that many commercial banks first became interested in consumer instalment paper after the inception of the Federal Housing Administration, and that their interest was due to favorable experience with FHA Title I loans.

A large portion of the analysis is based on tabulations compiled from income tax returns for the years 1929, 1933 and 1936, of selected samples of each of four principal types of consumer instalment financing institutions—sales finance companies, personal finance companies, investment type industrial banking companies, and non-investment type industrial banking companies.¹²

These tabulations were prepared upon recommendation by the National Bureau of Economic Research to the Technical Advisory Committee of the Income Tax Study, an intensive analysis of income tax returns conducted under the joint supervision of the Work Projects Administration and the Division of Tax Research of the United States Treasury Department.¹³ All tabulation work, including the handling of the income tax returns and the statistical abstracts of individual companies, was performed by employees of the Income Tax Study, and every precaution was taken to maintain the confidential character of the data.

The institutional studies already published under the Financial Research Program of the National Bureau of Economic Research analyze certain aspects of the operating experience of consumer financing agencies.¹⁴ In general, the samples used in those studies, while they consisted of only a small number of companies, included the larger institutions in the respective fields.

Since the income tax samples do not include the largest companies, the two sets of data tend to complement each other. For

¹² Data on credit unions could not be included in these tabulations, since credit unions are exempt from federal income tax. Data on commercial banks were not included in the income tax tabulations, since ample data on the operations of commercial banks were readily available from other sources.

¹³ The Technical Advisory Committee, representing governmental and non-governmental agencies interested in income tax statistics, invited various agencies to submit proposals for special tabulations, to be undertaken in addition to those prepared for the Division of Tax Research. The tabulations recommended by the National Bureau, referred to hereafter as the income tax data, were designated as Proposal 22 of the Income Tax Study.

¹⁴ Sources and uses of funds, and income and expenses are discussed in: *Personal Finance Companies and Their Credit Practices*, by Ralph A. Young and Associates (1940) pp. 38 ff., 78 ff., 107 ff.; *Sales Finance Companies and Their Credit Practices*, by Wilbur C. Plummer and Ralph A. Young (1940) pp. 60 ff., 121 ff., 244 ff.; *Industrial Banking Companies and Their Credit Practices*, by Raymond J. Saulnier (1940) pp. 57 ff., 107 ff., 146 ff.; and *Commercial Banks and Consumer Instalment Credit*, by John M. Chapman and Associates (1940) pp. 101 ff., 140 ff., 163 ff. A description of the history and operations of credit unions appears in *The Business of Consumer Instalment Financing—A Summary Review*, by Ralph A. Young (ms. 1941).

this reason liberal supplementary use is made of samples available subsequent to the publication of the earlier studies, and covering essentially the same companies. The samples of sales finance and personal finance companies, which were obtained from the National Credit Office, Inc., consist of companies that financed themselves through the sale of commercial paper in the open market; although these samples are small the institutions they represent accounted for a substantial proportion of the outstanding loans in their fields.¹⁵

Figures for federal credit unions since their inception in 1934 provide a contrast between the operations of the privately owned agencies and of these cooperative institutions. Since, in the years after 1934, federal credit unions expanded very rapidly, both in number and assets, these data may not be entirely representative of the operations of credit unions as a whole. For the older state-chartered credit unions, however, data on earnings and expenses are either entirely lacking or are incomplete and of doubtful comparability.¹⁶

Data covering insured industrial banks, obtained from the Federal Deposit Insurance Corporation,¹⁷ have been utilized in conjunction with the information accumulated for the National Bureau study of industrial banking companies to provide a further insight into their operations. The degree of detail in which these FDIC data have been available to the writer, and the increased manipulative possibilities resulting from the use of ratios for individual companies, have made this information particularly effective in appraising the influence of limitations in the form of the income tax data.

To contrast the operating experiences of the principal consumer instalment financing agencies with those of institutions traditionally

¹⁵ The number and average total assets of the companies included in these samples, in each of the years 1929-41, are presented in Appendix Tables B-1 and B-2.

¹⁶ The Bureau of Labor Statistics has published figures on the net earnings and dividends of a large sample of reporting federal and state credit unions for 1939-41, and on the amount of dividends for 1938. See *Monthly Labor Review*, August 1939, September 1940, August 1941, September 1942.

¹⁷ In the tables in the present volume these data are designated as covering all insured industrial banks. In each year, however, the reports of a few banks had to be excluded because they did not cover a full year of operations, or because errors were discovered for which corrections could not be obtained. For these reasons, and also because of corrections that could be made, the figures in the present volume differ in some cases from those in Saulnier, *op. cit.*

engaged chiefly in the financing of business enterprises, this study has used data pertaining to commercial banks. Operating ratios of over 13,000 individual insured commercial banks were available for the years 1938-41, and for about 7,000 that submitted reports to the FDIC, ratios were available for the period 1936-41. These data have made it possible to isolate the effect of size and other factors on the expenses and profitability of commercial banks.

Comprehensive figures on the consumer instalment loans of these insured commercial banks became available for the first time at the end of 1940, through a special questionnaire addressed to insured banks by the federal bank supervisory agencies. These data made possible comparison of the operating experience of banks having a high proportion of consumer instalment paper with that of the consumer instalment financing agencies, and other insured commercial banks.¹⁸

For the historical analysis of the operations of commercial banks prior to the formation of the FDIC, reliance has been placed upon aggregate figures on national banks rather than upon figures covering the larger number of banks that are members of the Federal Reserve System. This choice was based on the fact that the former, despite shifts to and from state systems as a result of charter changes, may be presumed to be the more representative of *all* commercial banks, both as to size and geographic location; figures for member banks are dominated by the banks in larger centers.

The coverage of the samples varies materially, but the combination of data from several sources has resulted in a significant total coverage and a satisfactory distribution with respect to size and geographic location. These aspects of the data are fully discussed in Appendix A, as are also various limitations and procedures regarding their use and specific considerations regarding terminology.

¹⁸ Specific data on banks' consumer instalment lending activities are either not available or inadequate; in this field their costs of operations and rate of operating profit probably do not differ materially from those of the insured industrial banks. Because of the lack of information no attempt has been made to compare the operating results of their consumer financing with those of the specialized agencies.