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8

Commercial Bank Financing of Consumer Instalment Credit Agencies

BANKS have long supplied other consumer credit agencies with operating funds, although it is only recently that they have begun to extend instalment credit directly to consumers. Sales finance companies from their inception have relied heavily on bank loans, and personal finance companies, within the last decade, have come to draw nearly one-third of their funds from this source. Industrial banking companies and credit unions, on the other hand, do not as a rule procure funds from banks. The former obtain their working capital largely from deposits and from sales of investment certificates, and the latter are financed through the sale of shares to members; occasionally, however, both these agencies make use of commercial bank facilities.

COMMERCIAL BANKS AS A SOURCE OF FUNDS

The extent to which commercial banks finance consumer credit agencies is indicated in Table 58, which shows the major sources of funds (in percent of total assets) of sales finance companies, personal finance companies, industrial banking companies and credit unions for the year 1937. From these data it is obvious that bank financing was much more important to sales finance companies than to the other three agencies; more than half the combined funds of 48 sales finance companies came in that year from short-term credit

TABLE 58

Sources of Funds of Four Types of Consumer Credit Agencies, 1937, in Percent of Total Assets

SOURCES OF FUNDS	48 SALES FINANCE COMPANIES[a]	20 PERSONAL FINANCE COMPANIES[b]	69 INDUSTRIAL BANKING COMPANIES[c]	2,248 CREDIT UNIONS[d]
Borrowings	69.0	35.3	83.4	2.3
Short-term debt[e]	*53.8*	*29.3*	*.9*	*2.3*
Deposits	..	..	*82.5*[f]	..
Funded debt	*15.2*	*6.0*	..	..
Equity account	20.1	48.5	10.1	95.4[g]
Preferred stock	*3.3*	*15.5*		..
Common stock and surplus	*16.8*	*33.0*	*10.7*	*95.4*[g]
Total assets[h]	$1,811	$226	$175	$19

[a] Based on year-end (calendar or fiscal) data from 48 sales finance companies and from the National Credit Office, Inc.

[b] Based on year-end (calendar or fiscal) data from the National Credit Office, Inc., covering 20 personal finance company chains.

[c] Based on year-end data from the Federal Deposit Insurance Corporation for 69 industrial banking companies. Since all states do not grant such companies a deposit-taking privilege similar to that exercised by banks insured by the FDIC, the institutions covered in this table are not representative of the whole body of industrial banking companies. They do, however, represent such a large proportion of the industrial banking volume of the country that the inclusion of companies which are not permitted to take deposits would not be likely to alter these percentages substantially.

[d] Year-end data derived from the combined balance sheets of 2,248 federal credit unions reporting to the Farm Credit Administration.

[e] Mainly bank debt.

[f] Includes $32,274,000 of hypothecated deposits.

[g] Includes shares, undivided profits and profit and loss.

[h] In millions.

derived largely from banks. The 20 personal finance companies represented in the table obtained nearly 30 percent of their funds by means of short-term borrowing, while the industrial banking companies and credit unions covered in the tabulation acquired only 0.9 and 2.3 percent respectively in this way. Supplementary data, not included in the table, show that the proportion of personal finance companies' funds supplied by banks has increased markedly since 1929.[1]

Table 59 presents data obtained from 181 large banks whose total outstanding loans amounted to almost $7,000,000,000 at the end of 1937 and to more than $6,000,000,000 at the end of 1938. Loans made by these reporting banks to all consumer credit agencies combined came, at the end of 1937, to $505,000,000 or 7.4 percent of these banks' total outstanding loans, and at the end of 1938, to $254,000,000 or 4.2 percent.

Loans to sales finance companies were extended by all except 9 of the reporting banks, and constituted in both years by far the largest part of the volume of loans to consumer credit agencies; $440,000,000 of such loans were outstanding December 31, 1937, and $201,000,000 a year later. The importance to banks of sales finance company borrowing is illustrated further by the fact that 36 out of the 181 reporting banks also held sales finance company debentures to the amount of $9,000,000 and $8,000,000 at the close of 1937 and 1938 respectively.

Of the 181 reporting banks, 109 made loans to personal finance companies, aggregating $55,000,000 and $46,000,000 in year-end outstandings for 1937 and 1938 respectively. Loans to industrial banking companies were granted by only 16 of the reporting banks, and were relatively insignificant in volume.

The relationship between commercial banks and other consumer credit agencies is of particular interest because banks not only furnish part of the funds of these agencies but compete directly with them in the consumer instalment credit market. It is noteworthy, therefore, that while the total loans of the 181 reporting banks dropped 11 percent

[1] See National Bureau of Economic Research (Financial Research Program), *Personal Finance Companies and Their Credit Practices,* by R. A. Young and Associates (1940) Table 3, p. 40.

TABLE 59

Total Year-End Outstanding Loans, Year-End Outstanding Loans to Various Consumer Credit Agencies, and Consumer Credit Agency Loans in Percent of Total Loans of Reporting Banks for 1937 and 1938, by Type of Borrowing Agency[a]

TYPE OF AGENCY	LOANS OUTSTANDING DECEMBER 31, 1937				LOANS OUTSTANDING DECEMBER 31, 1938				NUMBER OF BANKS REPORTING
	Total Loans[b]	*Loans to Consumer Credit Agencies*			*Total Loans*[b]	*Loans to Consumer Credit Agencies*			
		Amount[b]	Percent of Total Loans	Percentage Distribution		Amount[b]	Percent of Total Loans	Percentage Distribution	
Sales finance companies	$6,830	$440	6.4	87.3	$6,101	$201	3.3	79.1	172
Personal finance companies	6,047	55	.9	10.9	5,591	46	.8	18.1	109
Industrial banking companies	1,309	2	.2	.3	1,226	1	.1	.4	16
Others	1,729	8	.5	1.5	1,505	6	.4	2.4	30
TOTAL	$6,862[c]	$505	7.4	100.0	$6,136[c]	$254	4.2	100.0	181[c]

[a] Based on questionnaire returns from 181 banks.
[b] In millions.
[c] If a bank reported that it made loans to more than one type of agency, figures for that bank were included more than once under "Total Loans" and "Number of Banks Reporting." For this reason the totals for these columns do not represent the sum of the individual figures.

In addition to the loans included in this tabulation, 36 of these banks, with total year-end outstanding loans of $2,314,000,000 and $2,056,000,000 for 1937 and 1938 respectively, reported $9,000,000 and $8,000,000 of sales finance company debentures held at the end of these two years.

from 1937 to 1938, their loans to consumer credit agencies declined by almost 50 percent. The decline was not uniform with respect to all types of agencies, however. Outstanding loans to personal finance companies dropped from $55,000,000 to $46,000,000, or about 16 percent, but increased in relative importance, from 11 percent of all loans to consumer credit agencies outstanding at the end of 1937 to 18 percent a year later. Loans to sales finance companies were much more sharply reduced, falling from $440,000,000 to $201,000,000, a decline of 54 percent; at the end of 1937 they represented 87 percent of all loans to consumer credit agencies outstanding, but at the end of 1938 only 79 percent.

BANK LOANS TO SALES FINANCE COMPANIES

It is the principal business of sales finance companies to purchase or discount dealers' retail instalment sales paper, but such retail financing is usually closely associated with wholesale financing, that is, the financing of dealers' stocks and inventories. In addition, sales finance companies may make personal cash loans, directly or through a subsidiary, discount accounts receivable, or discount instalment paper to finance the purchase by business firms of commercial and industrial equipment. Their demand for banking accommodation necessarily reflects all of these credit activities. Since the retail dealer's business depends on the flow of consumer incomes, the volume of sales finance company transactions moves in direct correspondence with fluctuations in industrial employment and payrolls. Bank credit therefore serves as a buffer source of funds, expanding as the volume of retail instalment buying grows, contracting as it diminishes. Even in times of severe business depression, however, sales finance companies are seldom free of bank debt, for banks do more than finance a variable margin of working capital according to business fluctuations. They supply regularly some part of the employed working capital of these companies, not only by making direct loans to them but also by purchasing their notes in the open market and, to some extent, by taking over their debentures.

Table 60 shows the various sources of funds used by 72 large sales finance companies in 1925 and by 48 large companies from 1934 through 1938. The 72 companies in the

TABLE 60

Sources of Funds and Receivables of 72 Sales Finance Companies, 1925, and of 48 Sales Finance Companies, 1934–38, in Percent of Total Assets[a]

SOURCES OF FUNDS	1925	1934	1935	1936	1937	1938
Borrowings	69.8	51.3	57.7	64.1	69.0	56.3
Short-term debt	*64.9*	*47.3*	*53.4*	*48.4*	*53.8*	*36.2*
Bank debt	61.6 (Bank debt and Open market)	24.0	32.7	28.9	34.4	20.0
Open market		19.5	18.0	17.1	17.0	12.4
Other	3.3	3.8	2.7	2.4	2.4	3.8
Funded debt	*4.9*	*4.0*	*4.3*	*15.7*	*15.2*	*20.1*
Equity account	23.3	35.3	28.7	22.5	20.1	30.2
Preferred stock	*17.9* (Preferred and Common stock)	*6.7*	*6.6*	*3.6*	*3.3*	*4.8*
Common stock		*28.6* (Common stock and Surplus)	*22.1* (Common stock and Surplus)	*18.9* (Common stock and Surplus)	*16.8* (Common stock and Surplus)	*25.4* (Common stock and Surplus)
Surplus	*5.4*					
Total borrowed and equity funds	93.1	86.6	86.4	86.6	89.1	86.5
Receivables	80.3	82.3	87.1	87.7	88.1	85.1
Total assets[b]	$687	$769	$1,068	$1,535	$1,811	$1,236
Bank lines (in percent of bank debt)	..	259.5	158.5	152.3	138.7	337.2

[a] Year-end figures for 1925 adapted from Bank Service Department of the National Credit Office, Inc., *A Study of Specialized Finance Companies* (1927); figures for 1934-38 based on year-end (calendar or fiscal) data from 48 sales finance companies and the National Credit Office, Inc. The 48 sales finance companies are identical for each of the five years.

[b] In millions.

first group obtained almost 65 percent of their funds through short-term borrowing, of which approximately 62 percent was represented by bank loans and open market sales of paper; their funded debt constituted about 5 percent of their total assets. For the second group of 48 companies, short-term debt amounted in 1934 to only 47 percent of their funds, of which bank debt accounted for 24 percent and open market sales for almost 20 percent. The relative importance of short-term debt in general and of short-term bank debt in particular fluctuated considerably over the five-year period. For both types of debt the peak was reached in 1937, a year of relatively high sales finance volume, when direct bank loans furnished 34 percent of the total funds of the group of 48 companies; the lowest point came in 1938, a year of relatively small volume, when such bank loans constituted only 20 percent of their funds. Between the end of 1937 and the end of 1938 their total short-term debt decreased by one-third and short-term bank debt by more than 40 percent.

The relative importance of open market sales of paper declined in each year during this period, falling from almost 20 percent of the total assets of the 48 companies in 1934 to about 12 percent in 1938. The sale of debentures increased: in 1934-35 funded debt constituted only about 4 percent of the assets of this group, whereas in 1936-37 it amounted to over 15 percent, and in 1938 to 20 percent.

Table 61 gives sources of funds in 1937 and 1938 for the same group of 48 companies, broken down into national, regional and local firms. In both years direct bank loans were relatively less important to national companies than to regional and local firms. They supplied about 44 percent of the funds of regional and local companies in 1937, and about 32 percent of the funds of the national companies. A similar relationship prevailed in 1938, but there was a general decline in bank loans in that year: regional firms obtained only about 28 percent of their financing from banks, local firms 34 per-

TABLE 61

Sources of Funds of 3 National, 5 Regional and 40 Local Sales Finance Companies, 1937–38, in Percent of Total Assets[a]

SOURCES OF FUNDS	3 NATIONAL COMPANIES		5 REGIONAL COMPANIES		40 LOCAL COMPANIES	
	1937	1938	1937	1938	1937	1938
Borrowings	70.4	57.7	62.9	48.9	64.1	54.1
Short-term debt	*52.6*	*33.8*	*56.1*	*39.1*	*62.6*	*52.4*
Bank debt	31.8	17.1	44.7	28.5	43.7	33.7
Open market	18.2	12.6	10.1	8.9	14.9	14.8
Other	2.5	4.1	1.3	1.7	4.0	3.9
Funded debt	*17.8*	*23.9*	*6.8*	*9.8*	*1.5*	*1.7*
Equity account	17.9	29.7	26.5	40.3	27.7	38.7
Preferred stock	*2.8*	*2.2*	*9.4*	*13.7*	*10.8*	*15.4*
Common stock and surplus	*15.1*	*25.5*	*17.1*	*26.6*	*16.9*	*23.3*
Total assets[b]	$1,440	$975	$204	$137	$168	$124

[a] Based on year-end (calendar or fiscal) data obtained from 48 sales finance companies. National companies operate in all states, regional companies in 8 or more states, and local companies in less than 8 states.
[b] In millions.

cent and nationals 17 percent. According to this table, the sale of open market paper was less important to regional sales finance companies than to the other two groups: the national companies acquired 18 percent and 13 percent of their funds from this source in 1937 and 1938 respectively, local companies about 15 percent in both years, and regional companies only 10 percent in 1937 and 9 percent in 1938.

Table 61 shows also that the significance of debentures as a source of funds varies directly with the size of the company; in both years this source was used most extensively by national companies, to a lesser degree by regional companies, and to a very limited extent by local companies. For each group of companies its relative importance was greater in 1938 than in 1937.

Cyclical fluctuations in the borrowings of sales finance companies exert a powerful influence on the total loan volume of the commercial banks which accommodate them. As can be computed from Table 60, the total borrowed funds, short- and long-term, of the 48 large sales finance companies, more than tripled between 1934 and 1937 (rising from $395,000,000 at the end of 1934 to $1,249,000,000 at the end of 1937); over the same period their direct bank borrowing increased by 238 percent (from $185,000,000 to $623,000,000) and their open market borrowing ($150,000,000 in 1934) doubled. In 1938 their total borrowed funds declined to $696,000,000, a drop of 44 percent from the 1937 level, while direct bank borrowing fell 60 percent and open market borrowing 50 percent. The 172 large banks (covered in Table 59) which reported loans of $440,000,000 to sales finance companies at the end of 1937 had a decline in total loans during the following twelve months of $729,000,000, or 10.7 percent. In this period their loans to sales finance companies dropped $239,000,000, or 54.3 percent; the reduction in their loans to sales finance companies therefore accounted, in this year of sharp credit contraction, for one-third of the decline in their total loans.

Terms of Bank Loans to Sales Finance Companies

Bank credit lines are usually arranged by sales finance companies according to maximum expected needs, so that they exceed actual borrowings. The 48 companies covered in Table 60, for example, had credit lines over two and a half times as great as their actual bank borrowings at the end of 1934, a year of low sales finance volume, and at the end of 1937, a year of peak volume, their credit lines nevertheless exceeded borrowings by more than a third. Credit lines are subject to revision as business prospects change; thus considerable variation may occur, both from year to year and seasonally within the year, in the actual amount of credit arranged and in the relationship of borrowings to total credit lines.

For more than a decade bank loans to sales finance companies have shown a definite trend from secured to unsecured loans. In 1925 collateral trust notes comprised 65 percent of the total notes payable of 72 larger sales finance companies,[2] but today most such notes are unsecured. According to Table 62, which shows, by type of loan, the percentage distribution of the short-term borrowings of 48 large sales

TABLE 62

Percentage Distribution of Short-Term Borrowings of 48 Sales Finance Companies, 1934–38, by Type of Borrowing[a]

TYPE OF SHORT-TERM BORROWING	1934	1935	1936	1937	1938
Bank loans	50.7	61.3	59.7	63.9	55.4
Unsecured	*41.3*	*51.3*	*53.8*	*57.6*	*48.0*
Secured[b]	*9.4*	*9.8*	*5.6*	*5.9*	*7.4*
Other	..	*.2*	*.3*	*.4*	..
Open market paper	41.3	33.6	35.2	31.5	34.1
Other	8.0	5.1	5.1	4.6	10.5
TOTAL	100.0	100.0	100.0	100.0	100.0
Total short-term borrowings[c]	$363	$571	$744	$975	$448

[a] Based on year-end (calendar or fiscal) data obtained from 48 large sales finance companies.
[b] Secured by collateral trust notes.
[c] In millions.

finance companies, collateral trust loans constituted only 7 percent of all notes payable in 1938, and in each year of the period 1934-37 accounted for less than 10 percent of the

[2] Based on Bank Service Department of the National Credit Office, Inc., *A Study of Specialized Finance Companies* (1927).

total.[3] The trend toward unsecured borrowing has been deplored by some bankers.[4] Although the fact is not revealed by Table 62, most of the bank borrowing of national companies and of the larger regional firms has been unsecured in recent years; the secured loans have gone chiefly to the smaller sales finance companies.

With respect to maturity, bank loans to sales finance companies range from those made on a demand basis to notes which run for 24 months or, in very rare cases, for an even longer period. Table 63 shows the minimum and maximum maturities on loans to sales finance companies at the end of 1938, as reported by 156 large banks located in various parts of the country. The most frequently mentioned minimum was 3 months, reported by 45 percent of these banks, and the most common maximum was 6 months, reported by 47 percent. A total of 67 banks stated that the bulk of their loans to sales finance companies extended over 6-month periods, 43 reported a preponderance of 3-month loans, and 22 that most of these notes ran 4 to 5 months. For 15 banks the majority of loans to sales finance companies extended longer than 6 months (11 of these banks reporting a period in excess of 9 months) and for 9 banks most of the loans matured in less than 3 months.

The interest rates charged by banks for direct loans to sales finance companies ranged at the end of 1938 from 1 to 12 percent,[5] according to reports from 142 banks with a large volume of such loans. As Table 64 indicates, for 81 banks, or almost

[3] Supplementary data, not tabulated here, show that of the total loans to sales finance companies held by a group of 166 banks at the end of 1937, 82 percent were unsecured, 15 percent were secured and 3 percent were open market; and of all such loans held by a similar group of 177 banks at the end of 1938, 73 percent were unsecured, 19 percent were secured and 8 percent were open market.

[4] Privately circulated address of A. W. Newton before the Association of Reserve City Bankers at White Sulphur Springs, April 27, 1937, *Finance Companies*, pp. 17-18.

[5] The 12 percent rate is exceptional.

TABLE 63

Number of Banks Reporting Various Maximum and Minimum Maturities, and Usual Maturities, Prevailing December 31, 1938, on Loans to Sales Finance Companies[a]

MINIMUM MATURITY (in months)	MAXIMUM MATURITY (in months)							TOTAL
	1 to 2	3	4 to 5	6	7 to 8	9	Over 9	
Demand				2		1	2	5
1 to 2	2	4	5	17	3	10	8	49
3			3	44	2	14	7	70
4 to 5				9	2		2	13
6				1		2	3	6
7 to 8								
9								
Over 9				1			7	8
TOTAL	2	4	8	74	7	27	29	151[b]
Distribution of banks by maturity most frequently required	8	43	22	67	2	2	11	156[c]

[a] Based on questionnaire returns from 156 banks.
[b] Excludes 5 banks which did not report on maximum and minimum maturities.
[c] Includes 1 bank which reported demand notes as most customary.

60 percent of those reporting, the minimum rate was 1.5 percent, and for 22 banks it was even lower. Maximum rates between 2.5 and 5.5 percent were reported by over half of the banks, and one-quarter of these obtained rates between 3.5 and 4.5 percent. Only 3 of the 142 banks reported a maximum rate in excess of 6.5 percent. The commonest rate on loans of this sort appears to be 1.5 percent; this was the prevailing rate for most of the sales finance company loans made by 79 of the reporting banks. Of the remaining 63

TABLE 64

Number of Banks Reporting Various Maximum and Minimum Rates, and Usual Rates, Prevailing December 31, 1938, on Loans to Sales Finance Companies[a]

MINIMUM RATE[b]	MAXIMUM RATE[b] Under 1.5%	1.5%	1.5 to 2.5%	2.5 to 3.5%	3.5 to 4.5%	4.5 to 5.5%	5.5 to 6.5%	Over 6.5%	TOTAL
Under 1.5%	1	6	2	2	4	4	2	1	22
1.5		13	5	12	29	12	9	1	81
1.5 to 2.5			1	3		1	2		7
2.5 to 3.5				1	1	1			3
3.5 to 4.5					1	5	1		7
4.5 to 5.5						2	7		9
Over 5.5							1	1	2
TOTAL	1	19	8	18	35	25	22	3	131[c]
Distribution of banks by rate most frequently required	3	79	7	15	13	20	4	1	142

[a] Based on questionnaire returns from 142 banks.
[b] Each level is inclusive of the lower figure and exclusive of the upper.
[c] Excludes 11 banks not reporting on maximum and minimum rates.

banks, 20 extended such loans customarily at 4.5 to 5.5 percent, 15 at 2.5 to 3.5 percent, 13 at 3.5 to 4.5 percent and only 5 banks at 5.5 percent and over. Since most loans to sales finance companies are concentrated among the larger banks from which our sample was drawn, these rates are probably typical.

National sales finance companies obtain lower rates than companies of more limited scope. Of 82 banks reporting on this question, 13 indicated that there was a difference of less than 1 percent between the interest rates for nationals and those for other companies; 34 banks reported a differential of 1 to 2 percent, 22 banks 2 to 3 percent and 13 banks more than 3 percent.

Open Market Paper of Sales Finance Companies

Since 1922 sales finance companies have procured some of their working funds by selling their paper through commercial paper dealers in the open market. This procedure, which distributes the paper among banks and other financial institutions, developed swiftly—from 1922 to 1926 the number of companies using the open market rose from 6 to 76.[6] Perhaps the concurrent development of direct lending relations with banks operated to check the growth in the use of open market facilities; at any rate by 1938 only 56 sales finance companies were drawing funds from this source.[7] Incidentally, commercial paper brokers have stated that foreign central banks which maintain balances in American markets include in their short-term investments some open market paper of sales finance companies.

The maturity terms for sales finance company paper, like those for most open market commercial paper, range up to 6 months. Prevailing interest rates appear, however, to run somewhat higher than those which apply to commercial paper classed by the market as prime. Table 65 classifies reporting banks by minimum and maximum rates required on paper held at the close of 1938, when a rate of 0.625 percent was current in the market for prime paper.[8] Interest rates received on open market sales finance company paper by these banks ranged from just under 1 to 4.5 percent. Out of 54 banks, 22 reported minimum rates of less than 0.75 percent, and 20 minimum rates between 0.75 and 1.25 percent. For maximum rates 18 banks set rates of less than 1.25 percent, 16 reported 1.25 to 1.75 percent, and 13 obtained rates of 1.75 percent

[6] National Credit Office, Inc., *op. cit.*

[7] Records of the National Credit Office, Inc.

[8] As reported by the Board of Governors of the Federal Reserve System.

TABLE 65

Number of Banks Reporting Various Maximum and Minimum Interest Rates, and Usual Rates, Prevailing December 31, 1938, on Open Market Paper of Sales Finance Companies[a]

MINIMUM RATE[b]	MAXIMUM RATE[b]					TOTAL
	Under .75%	.75 to 1.25%	1.25 to 1.75%	1.75 to 2.25%	Over 2.25%	
Under .75%	1	9	9	2	1	22
.75 to 1.25		8	6	2	4	20
Over 1.25			1	2	2	5
TOTAL	1	17	16	6	7	47[c]
Distribution of banks by rate most frequently required	9	31	9	2	3	54

[a] Based on questionnaire returns from 54 banks. Rates on a small amount of open market paper of personal finance companies are included.
[b] Each level is inclusive of the lower figure and exclusive of the upper.
[c] Excludes 7 banks not reporting on maximum and minimum rates.

and above. The rates yielded by the bulk of open market paper ranged from 0.75 to 1.25 percent for 31 banks; they stood at less than 0.75 percent for 9 banks and at 1.25 percent and over for 14 banks.

Bank Standards for Loans to Sales Finance Companies

The sales finance company differs from the ordinary commercial or financial enterprise with regard to the problem in credit evaluation it presents to the banker. Since the sales finance company rarely has physical assets like real estate, equipment or merchandise inventories, its credit standing must rest chiefly on notes and accounts receivable representing hundreds of relatively small unit transactions. It is the banker's initial task, therefore, to ascertain the quality of the paper which comprises the company's portfolio, and to acquire a knowledge of the operating policies followed in its accumulation, since such policies must be reflected ultimately in portfolio quality.[9] Only when he has appraised and approved the general quality of the paper does he find it worth while to analyze the balance-sheet relationships and the profit-and-loss account. The poorer the paper, the more acute is the company's collection problem and the higher its ratio of expenses and losses to earnings.

In general, sales finance paper is deemed to be of inferior quality when the credit rating of the makers is unsatisfactory, the down payment or the makers' original equity in the merchandise financed is inadequate, and the average length of the notes is excessive in view of possible interruptions in the flow of the makers' income. The banker cannot determine accurately the character of the makers of the receivables held by a sales finance company, but he can study the company's records of repossessions, delinquencies and losses and thus arrive at a general impression of the character of its customers. He can insist also on information as to the down payments and contract lengths which prevail in the portfolio of a given company and estimate roughly, from past records, the relative risk inherent in its notes receivable.

From long experience in granting credit to sales finance companies, bank credit officers have developed quite definite ideas regarding the down payments and contract lengths that should prevail in the portfolio of a conservative company. Banks responding to our questionnaires were asked to state what terms they considered desirable in connection with automobile financing, which accounts for the bulk of sales finance company business.

[9] Privately circulated address by A. W. Newton before the Federal Reserve Member Bank Conference, Minneapolis, March 12, 1938, *Instalment Finance Paper,* p. 23.

For new-car sales the down payment most frequently recommended was 33 1/3 percent of the cash price. Table 66 shows

TABLE 66

Number of Banks Reporting Various Down Payment Standards Recommended to Sales Finance Companies on New- and Used-Car Retail Paper[a]

DOWN PAYMENT RECOMMENDED ON NEW CARS	DOWN PAYMENT RECOMMENDED ON USED CARS						TOTAL
	25%	30%	33⅓%	35%	40%	Over 40%	
Under 25%	1	2	4		1		8
25	2	2	25	2	4	1	36
30			5	1	9	1	16
33⅓	2		42	1	37	9	91
Over 33⅓						3	3
TOTAL	5	4	76	4	51	14	154

[a] Based on questionnaire returns from 154 banks.

that almost two-thirds of the 154 reporting banks, which extend a considerable volume of loans to sales finance companies, favored this down-payment percentage on new cars; almost one-fourth of them endorsed a 25 percent down payment, and one-tenth recommended a 30 percent payment. For used cars, too, the down payment most frequently reported was 33 1/3 percent; this was suggested by half of these banks. One-third of them preferred 40 percent, and almost one-tenth held that the down payment for used-car sales should exceed 40 percent.

Answering a similar question about standard contract lengths for new-automobile financing, a large majority of the reporting banks (122 out of 149) approved an 18-month contract for new cars, 20 banks a 24-month contract, 2 banks a 20-month contract, and 5 banks a contract of less than 18 months. For used cars 132 banks favored a 12-month contract, although 13 banks were satisfied with a contract of 18 months; a standard maturity of 16 months was favored by 2 banks, and 2 recommended 9 months or less.

These recommendations on average down payment and contract length for sales finance companies are the general reference standards by which the banker tends to assess the risk involved in any sales finance company portfolio. From the standpoint of his own credit operations, he must pass judgment on these matters before he can approve the bank credit lines for sales finance companies. Once satisfied that a company's portfolio conforms closely enough to preferred standards, banks insist that the company's borrowings stand in some specified relationship to its net worth, so that they may be assured a margin of protection. Of 127 banks reporting on this topic, 47 stated that they regarded 2½-to-1 as a satisfactory ratio of borrowed funds to net worth, while 41 allowed a more liberal standard, 3-to-1; 10 banks approved a ratio of 4-to-1 or higher, 22 banks held to the more conservative standard of 2-to-1 and 7 prescribed a still lower ratio.

The ultimate concern of banks which lend to sales finance companies is, of course, the liquidity and eventual solvency of the borrowing firms. It has been said that "if a finance company's debts are so high or its paper is of such length that it cannot liquidate itself in six months, its bankers have every reason to say that it must bring itself to such a liquidity or lose its credit."[10] There is, however, little agreement among bankers as to what constitutes a conservative liquidity position for sales finance companies. Of 117 banks responding to such a question, 65 maintained that a company should be able to liquidate within 5 to 7 months, and 49 specified 6 months. An 8- to 10-month period was mentioned by 24 banks, and an 11- to 13-month period by 17 banks. Only 9 banks recommended periods of 4 months or less, and at the

[10] Privately circulated address of A. W. Newton before the Association of Reserve City Bankers at White Sulphur Springs, April 27, 1937, *Finance Companies*, p. 12.

other extreme 2 banks were satisfied with as long a period as 14 to 16 months.

Because of the importance that bankers attach to the liquidity position of sales finance companies, the latter are frequently required to submit, at prescribed intervals, maturity schedules of their retail notes receivable. Of 167 banks reporting on this question, less than half required such schedules; of the remainder, 24 banks demanded maturity schedules annually, 46 every 6 months, 5 every 3 months, and 7 every month.

BANK LOANS TO PERSONAL FINANCE COMPANIES

Personal finance companies specialize in small cash loans of $300 or less, usually repayable in equal monthly instalments and subject to interest on monthly unpaid balances. They operate under sanction of special small loan legislation, which requires loan offices to be licensed, sets maximum charges and otherwise regulates credit operations. Loan offices are frequently linked together under common corporate ownership: a few large chain companies account for half or more of the total volume of business. Before 1930 over three-quarters of the total funds of chain personal finance companies were represented by capital stock and surplus, and only one-eighth to one-fifth by borrowings, mostly from banks.[11] The situation has changed, however, in recent years; according to Table 67 the borrowed funds (largely bank debt) of 9 personal finance companies rose from about 17 percent of total assets in 1934 to 34 percent in 1938.

Despite the increasing importance of bank credit as a source of funds for personal finance companies, the total volume of their borrowings is small in comparison with that of sales finance companies. Table 68 shows that 102 banks, with total loans of $6,018,000,000, reported $56,000,000 of loans to

[11] See R. A. Young and Associates, *op. cit.*, Table 3, p. 40.

TABLE 67

Sources of Funds of 9 Personal Finance Companies, 1934–38, in Percent of Total Assets[a]

SOURCES OF FUNDS	1934	1935	1936	1937	1938
Borrowings	17.4	25.6	29.2	33.5	34.0
Equity account	61.5	69.5	61.7	57.2	36.0
Preferred stock	*28.2*	*18.5*	*18.7*	*20.8*	*17.0*
Common stock and surplus	*33.3*	*51.0*	*43.0*	*36.4*	*19.0*
Total assets[b]	$119	$121	$156	$172	$177

[a] Based on year-end (calendar or fiscal) data from the National Credit Office, Inc. It was not possible to obtain a breakdown of "Borrowings" for all companies for all 5 years; the figures on this item cover bank debt chiefly.
[b] In millions.

TABLE 68

Total Year-End Outstanding Loans to Personal Finance Companies of 102 Reporting Banks for 1937, and of 111 Reporting Banks for 1938, by Type of Loan[a]

TYPE OF LOAN	OUTSTANDINGS DECEMBER 31, 1937		NUMBER OF BANKS REPORTING	OUTSTANDINGS DECEMBER 31, 1938		NUMBER OF BANKS REPORTING
	Amount[b]	Percentage Distribution		Amount[b]	Percentage Distribution	
Unsecured	$51	91.1	77	$42	89.3	79
Secured[c]	4	6.3	34	3	6.6	45
Open market	1	2.6	14	2	4.1	21
TOTAL	$56	100.0	102[d]	$47	100.0	111[d]
Total outstanding loans of reporting banks[b]			$6,018			$4,970

[a] Based on questionnaire returns from 102 banks reporting for 1937 and 111 banks reporting for 1938.
[b] In millions.
[c] Secured by collateral trust notes.
[d] If a bank reported that it made more than one type of loan to personal finance companies, figures for that bank were included more than once under "Number of Banks Reporting." For this reason the totals for these columns do not represent the sum of the individual figures.

personal finance companies at the end of 1937, and that 111 banks, with total loans of $4,970,000,000 reported only $47,-000,000 of such loans at the end of 1938—in each year less than 1 percent of total loans. About 90 percent of these loans were unsecured. These banks also held $1,000,000 and $2,000,000 of open market personal finance company paper at the close of 1937 and 1938 respectively, and collateral trust notes amounting to $4,000,000 and $3,000,000.

Terms of Bank Loans to Personal Finance Companies

Maturities for bank loans to personal finance companies were, as indicated in Table 69, generally shorter than those reported for loans to sales finance companies (Table 63). While a minimum maturity of 3 months or less was specified by about 80 percent of the reporting banks for loans to both types of companies, a maximum maturity of 3 months or less was required by over 32 percent of the banks reporting on personal finance company loans but by only 4 percent of those reporting on sales finance company loans. Maturities not exceeding 6 months were prevalent among 90 percent of the banks reporting on personal finance company loans as compared with 56 percent of those reporting on sales finance company loans. Table 69 shows also that for 62 out of 102 banks the bulk of personal finance company loans were made at maturities of 3 months or less, and that for 22 banks the majority of such loans ran for 6 months; only 4 reported that most of their personal finance company loans covered a period longer than 6 months.

Not only do maturities tend to be shorter, but interest rates tend to be higher on loans to personal finance companies as contrasted with sales finance companies. From a comparison of Tables 70 and 64 it appears that over three-fourths of the banks which reported on sales finance company

TABLE 69

Number of Banks Reporting Various Maximum and Minimum Maturities, and Usual Maturities, Prevailing December 31, 1938, on Loans to Personal Finance Companies[a]

MINIMUM MATURITY (in months)	MAXIMUM MATURITY (in months)						TOTAL
	Demand	1 to 2	3	4 to 5	6	Over 6	
Demand			1		1		2
1 to 2		4	15	6	8	1	34
3			12	9	23	2	46
4 to 5	1			4	7		12
6					2	1	3
Over 6						1	1
TOTAL	1	4	28	19	41	5	98[b]
Distribution of banks by maturity most frequently required		10	52	14	22	4	102

[a] Based on questionnaire returns from 102 banks.
[b] Excludes 4 banks not reporting on maximum and minimum maturities.

loans obtained a minimum rate of 1.5 percent or lower, whereas about 40 percent of the banks reporting on personal finance company loans obtained such a low rate, and almost 40 percent maintained minimum interest charges ranging from 2.5 to 5.5 percent. A corresponding tendency is to be noted with respect to maximum rates: 65 percent of the banks reporting on sales finance company loans set the maximum at 3.5 percent or above, as compared with 76 percent of those reporting on personal finance company loans. For sales finance company loans the greatest concentration of reports on maximum rates was noted for the 3.5 to 4.5 percent range (mentioned by 25 percent of the reporting banks), but for personal finance company loans it was in the 4.5 to 5.5

TABLE 70

Number of Banks Reporting Various Maximum and Minimum Rates, and Usual Rates, Prevailing December 31, 1938, on Loans to Personal Finance Companies[a]

MINIMUM RATE[b]	MAXIMUM RATE[b]						TOTAL
	1.5%	1.5 to 2.5%	2.5 to 3.5%	3.5 to 4.5%	4.5 to 5.5%	Over 5.5%	
Under 1.5%	1						1
1.5	10	3	4	12	5	1	35
1.5 to 2.5		1	1	1	4	1	8
2.5 to 3.5			1	2	5	4	12
3.5 to 4.5				4	6	2	12
4.5 to 5.5					8	5	13
Over 5.5						8	8
TOTAL	11	4	6	19	28	21	89[c]
Distribution of banks by rate most frequently required	31	7	5	19	17	18	97

[a] Based on questionnaire returns from 97 banks.
[b] Each level is inclusive of the lower figure and exclusive of the upper.
[c] Excludes 8 banks not reporting on maximum and minimum rates.

percent range (cited by 30 percent of the reporting banks). Finally, more than half of the banks reporting on sales finance company loans stated that most of these loans were made at a rate of 1.5 percent, but less than one-third of the banks reporting on personal finance company loans applied this rate to the bulk of their personal finance company loans. Rates between 2.5 and 5.5 percent obtained for a majority of the sales finance company loans made by one-third of the banks reporting such grants, but rates of 3.5 percent or higher were charged on most of the personal finance company loans of more than half of the banks reporting transactions in this field.

The shorter maturities and higher rates characteristic of bank loans to personal finance companies reflect a consensus among bankers as to the relative risk involved in the extension of credit to the two types of consumer credit agencies. This judgment is expressed also in the differences in bank standards covering the proper ratio of borrowed funds to net worth. While 95 percent of the reporting banks stated that for sales finance companies they regarded a ratio of 2-to-1 or higher as conservative, only 42 percent of the banks reporting on personal finance company loans considered this ratio adequate. For the latter type of agency as many as 31 out of 97 reporting banks advocated a ratio of 1-to-1 or better, 13 banks stipulated 1½-to-1, 19 banks 2-to-1, 9 banks 2½-to-1, and only 13 banks held that a ratio higher than this was a satisfactory basis for the extension of bank credit.

BANK LOANS TO INDUSTRIAL BANKING COMPANIES[12]

The consumer credit business of industrial banking companies resembles that of personal loan departments of commercial banks more closely than it does the activities of personal finance or sales finance companies. Like personal loan departments, industrial banking companies engage principally in making small cash loans, with or without comakers and with or without collateral, and many have branched out into time-sales financing as well. Unlike personal loan departments, however, they are subject in most states to legislative regulation of customer charges as well as size and length of note.

In contrast to sales finance and personal finance companies,

[12] The term industrial banking company is used here to refer to both Morris Plan and non-Morris Plan institutions which specialize in instalment loans to consumers and obtain part of their funds through the acceptance of deposits or the sale of instalment investment certificates. See National Bureau of Economic Research (Financial Research Program), *Industrial Banking Companies and Their Credit Practices*, by R. J. Saulnier and Staff (ms. 1940).

whose working funds are obtained largely through bank borrowing and the sale of equity securities, industrial banking companies secure most of their funds from depositors or from the sale of instalment investment certificates. As was indicated in Table 58, the time and demand deposits (including hypothecated deposits) of 69 industrial banking companies accounted for 82.5 percent of their total assets in 1937, while short-term borrowings came to less than 1 percent.[13] Table 59 showed that 16 large banks, with total outstanding loans and discounts of $1,309,000,000 at the end of 1937 and of $1,226,000,000 at the end of 1938, reported that their loans to industrial banking companies amounted to only $2,000,000 in 1937 and $1,000,000 in 1938—less than 0.5 percent of their total loans in either year. According to reports from these banks, secured loans constituted about two-thirds of the $2,000,000 outstanding to industrial banking companies on December 31, 1937, and about half of the $1,000,000 outstanding on December 31, 1938.

Three out of 14 reporting banks declared that they made loans to industrial banking companies on a demand basis. Of the remaining 11, all but one required a minimum maturity of 3 months or less. With regard to maximum maturity, 7 of the 11 banks set an upper limit of 3 months, 1 allowed a maximum of 5 months and 3 a maximum of 6 months. Only 1 bank granted most of its loans to industrial banking companies for as long as 6 months, whereas 11 made the greater part of these loans on a 3-month basis.

Interest rates on loans to industrial banking companies varied from 1.5 to 6 percent or over, according to reports from a small number of banks. As for the proper relation-

[13] These 69 firms are not entirely representative of the industrial banking field, for most industrial banking companies do not enjoy deposit-taking privileges, and therefore obtain a larger proportion of their funds from bank borrowings and from the sale of instalment investment certificates. Nevertheless they account for such a large part of all the industrial banking volume of the country that the inclusion of companies which do not exercise deposit-taking privileges would not alter these figures to any great extent.

ship of borrowed funds to net worth for such companies, 6 out of 14 banks reporting advocated a ratio of 1-to-2 or less; the remaining banks favored a higher ratio and one of them stipulated a relationship of 1-to-4.