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Volume Title: Personal Finance Companies and Their Credit Practices

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Volume Publisher: NBER

Volume ISBN: 0-870-14460-X

Volume URL: http://www.nber.org/books/youn40-1

Publication Date: 1940

Chapter Title: Summary Survey

Chapter Author: Ralph A. Young

Chapter URL: http://www.nber.org/chapters/c5494

Chapter pages in book: (p. 1 - 18)

Summary Survey

THE personal finance business as it exists today has grown out of legislative attempts to combat the loan-shark evil, which had arisen because the usury statutes prevented the profitable lending of small sums at legitimate rates. In 39 states, the District of Columbia and Hawaii laws are now in effect which regulate this business. Licensed lenders are granted statutory permission to make one over-all charge, including interest, at a rate not to exceed a certain specified percentage. The maximum legal rate ranges in general from 2 to 3½ percent per month, computed on the unpaid balance of the loan, and in most states $300 is the largest amount that may be lent on these terms. The principal is repaid in equal instalments over a specified period, varying mainly between 5 and 20 months.

THE SIGNIFICANCE OF PERSONAL FINANCE COMPANY CREDIT

The volume of personal finance company receivables has increased in the last two decades from about $20,000,000 to nearly $400,000,000 (including about $50,000,000 of interest due and to become due), held at the end of 1937 by licensed lenders in 27 states; this estimate represents about two-fifths of the consumer loan receivables of all cash-lending agencies at that date. During the period 1933-37 probably between 17 and 23 percent of all the non-farm family and individual income-receiving units in the country obtained credit accommodation from personal finance companies. Approximately 3,000,000 individuals, concentrated in somewhat more than half the states, are estimated to have been borrowers from licensed lenders in 1937.

Between cash loan and sales finance credit—the two major types of consumer instalment credit—there are important differences. Sales finance credit is invariably associated with the transfer of a commodity, while cash loan credit, although often used for the purchase of a commodity, is sought for many other purposes as well. Personal finance companies, unlike sales finance companies, deal directly with the borrower, extend only cash loans, state aggregate charges usually as a percent per month of unpaid loan balance, and for security rely chiefly on the character of the borrower. A basic legal distinction exists in the matter of charges: those of sales finance companies are not interest within the legal meaning of the term, and may therefore be determined by a process of bargaining, but those of cash lenders are subject to statutory regulation. The total volume of credit extended by personal finance companies is much smaller than that extended by sales finance companies—probably only about one-third as great.

The differences between personal finance companies and other cash-lending agencies are much less marked. Industrial and Morris Plan banking companies, and the personal loan departments of commercial banks, are in many ways the closest rivals of personal finance companies in the consumer cash loan field. The banks, however, make loans up to $2000 or more, as compared with the usual $300 limit set for personal finance companies, and they tend to charge lower rates. Credit unions and remedial loan societies, the other cash-lending agencies, are relatively unimportant in volume.

The leading industrial and semi-industrial states show the largest concentration of lending activities; 9 of them accounted in 1937 for more than three-fourths of the receivables of personal finance companies and for almost three-fourths of the licensed loan offices. The density of loan offices per 100,000 of population varied in that year from 0.2 in Tennessee to 9.1 in Colorado; available information indicates that facilities are almost non-existent where maximum legal rates of charge are relatively low, and that where the small loan law allows state authorities to restrict the number of licensees facilities are less numerous than in other states. The availability of credit facilities does not, however, indicate the extent to which they are used by consumers. This may be estimated from outstandings per 100,000 of population; in many states there is no direct relationship between the availability and the utilization of facilities.

Most state laws governing personal finance companies are modeled on the Uniform Small Loan Law, first drafted in 1916 by the Russell Sage Foundation, which has pioneered in such legislation. This model law has been revised at intervals, and in its sixth and latest draft, published in January 1935, it continues previous provisions regarding size of loan, licensing, supervision, relations with borrowers, penalties and exemptions, but suggests a graduated instead of a fixed maximum rate. On December 1, 1939, small loan legislation in 34 states, the District of Columbia and Hawaii resembled the model law; in 5 states it differed widely from the model. Even in the former group, however, the statutes of the various states were not equally effective in achieving their purposes.

Personal finance offices may be operated by individuals, partnerships or corporations. The corporate form has become increasingly important with the rise in chain lending. At the end of 1937 the two largest chain companies held almost 40 percent of the reported outstandings of all personal finance companies in the country. Chains enjoy certain operating advantages, but independent lenders, especially in some localities, are able to compete with them effectively. 2 3

At first personal finance companies obtained their funds largely from the investment of individual entrepreneurs, later from reinvestment of earnings, then from the marketing of stocks and bonds, and finally from the short-term money market. Today these companies have access to all leading credit facilities—a change, apparent even since 1929, which indicates their increasing recognition as established credit agencies. Especially the chain companies make use of short-term borrowing as a source of funds, obtaining credit from commercial banks and also selling notes in the open market. Data applying to Indiana, the only state for which comparative figures are available, indicate that independent individuals and partnerships depend less on borrowed capital than do other forms of personal finance company organization.

THE LOAN AND ITS MARKET

Personal finance loans are made in any amount up to the legal limit, which is usually $300. The average size of loan varies in different states, depending somewhat on the extent of the region's industrialization and on the height of the maximum legal rate of charge: in agricultural and semi-industrial states, and in states that permit a charge of 3½ percent per month, the average loan is usually smaller than it is in industrial states and in those that allow a charge no higher than 2½ percent. While the available data are not conclusive, they indicate that the average loan has been increasing in size for a number of years, running currently, for the country as a whole, a little less than $150.

Most loans are repayable over a period of 5 to 20 months. But because many borrowers arrange new loans in order to liquidate existing balances and to obtain additional sums, the actual life span of an individual loan is typically, according to data from one large chain company, between 8½ and 12 months, while the total period of customer indebtedness is usually 26 to 29 months.

Loans are most frequently secured by chattel mortgages, although the use of the unsecured note is increasingly prevalent, amounting in a number of states to 10 to 30 percent of all loans extended. Use of the endorsed and the comaker note varies considerably in different states. Loans on wage assignments are rare, except in Illinois.

Personal finance companies draw their customers almost entirely from urban residents whose annual incomes are between $500 and $3500, a range which contains over three-fourths of the non-farm income-receiving units of the country. The experience of three chain companies, which together handle about half the dollar volume in licensed small loans, indicates that three-fourths of all loans made by personal finance companies are to borrowers with annual incomes between $1000 and $2500. In general, customers whose monthly incomes are below $200 obtain loans approximately equal to, or somewhat greater than, one month's income; those receiving $200 or more obtain loans somewhat smaller than one month's income.

Although borrowers from personal finance companies are drawn from a variety of occupations, the wage-earning and clerical groups constitute the major source of demand. According to data from the same three chains, these two broad groups provide roughly three-fourths of the customers for personal finance credit, a proportion about equal to, or possibly a little higher than, the representation of these occupations among all non-farm, non-relief families in the country. Business and professional groups are next in importance as borrowers; farmers constitute a very minor source of demand.

Any classification of loans according to reasons for borrowing or intended use of funds must be based on borrower statements made at the time of loan application, and is therefore somewhat arbitrary. Available data give some indication, however, of the types of maladjustment between income and expenditure which most frequently necessitate borrowing.

The records of one large chain for 1933-37 show that about half the loans were made to meet "an unusual large expenditure," and more than a third were needed because the borrower had failed to provide for periodic expenses. About 6 percent were due to emergencies such as illness or unemployment.

Data from three large chains on the intended use of borrowed funds indicate that more than one-sixth of all loans are applied to the basic living expenses which are represented by non-durable consumer goods, and that almost the same proportion are applied to medical and funeral expenses. Refinancing is the purpose of a significant proportion of all loans—a proportion ranging from 25 to 75 percent according to the classifications used. Finally, a small percentage of loans are used for business purposes, indicating that no sharp distinction can be drawn between producer and consumer credit in personal finance lending.

OPERATING METHODS AND COLLECTION EXPERIENCE

Personal finance lenders actively solicit loan applications from former borrowers, and also applications from present borrowers for additional sums. Well over half of all applicants come from one of these groups. New customers are sought too, of course, through advertising and special inducements of various kinds, but their applications are accepted in much smaller proportions than are those of present and former borrowers. In their selection of customers lenders also attempt to diversify their risks, both occupationally and geographically. The need for diversification is, in fact, one reason for the growth of chains, and distribution of risks was probably a factor in the relative stability of the earnings of personal finance chains throughout the depression years.

The basic staff for a loan office consists of a manager, an percent of the gross income of licensed lenders in 15 states. The balance was derived from collections on accounts previously charged off (2 percent), interest on bank balances, authorized fees and "other income." Expressed as a percent of "average employed assets," gross income declined steadily from 28.6 in 1929 to 26.0 in 1933, but improved to 27.3 in 1936.

A distribution of expenses, representing averages for 1934-36, shows that salaries made up almost 40 percent of total expenses (not including interest on borrowed funds), that bad debts and insurance against loss constituted about 13 percent, and advertising about 11 percent. Total expenses, exclusive of interest, averaged about 18 percent of average employed assets in the years 1929-36, with bad debts and insurance showing the greatest variation of any of the individual items during this period. The data that are available on money costs as an item of expense suggest that variations in interest rates on borrowed funds have a relatively slight effect on total expenses, and are therefore of minor significance as a determinant of charges.

Net income as a percent of average employed assets, obtained by subtracting the percentage for total expenses from that for gross income, does not show actual return on investment but when calculated for a several-year period it does indicate the magnitude and direction of fluctuation in profits. It is interesting to note that during 1929-36 net income ranged from about 7 to 12 percent of average employed assets; it was highest in the first three years of this period, lowest in the next three years, and steady at about 9 percent during 1935-36.

The relationship between size of office and profitability may be examined for the two industrial states, Illinois and New Jersey. In 1937 net return tended to vary directly with size of office, both of them measured by year-end employed assets. This indication that definite operating economies are streetcar, public and professional service, and iron and steel groups provided the most desirable credit risks, while mining, truck and taxicab, domestic and personal service, building and construction, food manufacture, and wholesale and retail trade groups accounted for the poorest credit risks. The records of most of these industries were consistent throughout the period.

In general, charge-offs vary directly with the size of loan, but the trend is broken at the $300 loan class, which included about 20 percent of the total number and 36 percent of the dollar volume of all loans made in the period 1934-37. These $300 loans showed a record only slightly poorer than average, and markedly better than that of $250-300 loans, possibly because a higher than average proportion of $300 loans are made to borrowers with higher incomes and to members of those occupational groups that typically provide the better risks. It seems likely, however, that size of loan is no more than a secondary determinant of credit risk, for its significance is notably contradicted in the data on certain other factors in relation to charge-off experience.

A special classification of charged-off accounts according to whether they were suspect at the time the loans were made reveals that among all except new borrowers the likelihood that a doubtful loan will be charged off is at least five times as great as that for a loan that was considered sound when made. But in this as in other findings concerning credit risk it should not be inferred that all worse than average credit risks should be refused. It is likely that on the whole the additional income they provide is greater than the additional costs that they entail.

EXPENSES AND INCOME

By far the major source of personal finance company income is the charges collected on loans, which in 1937 averaged 97.5

the exception of those to teachers, showed the least favorable credit record. Teacher loans, constituting about 6 percent of the total, were easily the best risks; even when teacher loans are charged off, the balance owed is a smaller proportion of the original loan than it is in the case of charge-offs of loans to non-teachers. These facts lend support to the general practice among personal finance companies of viewing schoolteachers as preferred risks.

In the period 1934-37 one out of every three borrowers had a monthly income of $100-150; the average loan to this group was $152, and its credit record was very slightly poorer than average. About one-sixth of the borrowers received incomes lower than this, and they showed notably poorer credit records. In fact, charge-off experience improved in direct relation to the income of the borrower; this is readily understandable since payments absorb a larger proportion of the monthly income of borrowers in the lower brackets, and also impinge to a greater degree on basic living requirements.

The stability of a borrower's income may be even more important than its size, and this factor in credit risk may be evaluated to some extent by the borrower's occupation and the industry with which he is affiliated. During 1933-37 charge-off experience was worse than average on loans to proprietors, unskilled workers and salespersons; it was better than average on loans to skilled and semi-skilled workers, managers, superintendents and foremen, schoolteachers and others in professional pursuits, persons with independent incomes, and office and clerical workers. Over this period of general recovery there was a tendency for collections from unskilled workers and professional persons (other than teachers) to become relatively better, and for those from salespersons and office and clerical workers to become relatively worse.

As to the borrower's industrial affiliation, in 1933-37 postal service, telephone and telegraph, agricultural, railroad and of those to new and former customers and three-fourths of those to customers who were already repeat borrowers. This is striking evidence of the importance of present customers as a steady source of demand for the credit extended by personal finance companies.

CREDIT STANDARDS

The personal finance lender must choose carefully among potential borrowers in order to avoid costly collection problems. In each case his decision depends partly on certain intangible factors, not capable of statistical measurement, but it depends also on certain characteristics of the borrower and of the loan contract which are capable of empirical analysis in relation to charge-off experience. Our analysis of these latter indicators of credit risk is based on the charge-off experience of one large chain lender between 1933 and 1937. The data naturally reflect the lending policies of this particular firm and therefore are not necessarily typical of the experience of the entire trade, but they are based on a large volume of business and they are fairly representative of certain central factors in credit risk for this type of lending.

During the period 1934-37 charge-offs on loans to new customers, who constituted about one-fourth of all borrowers, were more numerous than average. Former customers, about one-seventh of the total, were by far the best risks, but present customers (those who refinance an unpaid balance and receive additional funds) were numerically far more important than any other group, and they too had a better than average record. Loans to renewal customers (those who refinance an existing balance but receive no additional funds) were very few, and they showed the highest relative number of charge-offs.

More than four-fifths of all loans made during 1936 and 1937 were secured by household goods, and these loans had a charge-off record well above average. Unsecured loans, with of chattels almost never covers the unpaid balance outstanding.

Data from two chain lenders indicate, as would be expected, a fairly close relationship between trends in delinquency experience and in bad-debt loss. For one of these lenders over 40 percent of the accounts charged off in 1937 had been delinquent 90 days or more on both principal and charges. The length of delinquency at the time of charge-off is somewhat less when delinquency is measured, as in this figure, from the last date on which at least some payment was received, than when it is measured from the last payment of charges plus half the principal instalment due; this is because payments typically fall off before they cease altogether.

Bad-debt losses in the years before 1929 have been estimated at less than 2 percent of total outstandings for chattel lenders, and less than ½ percent for endorsed-note lenders. During the following depression years these losses rose sharply, but substantial recoveries on charged-off accounts were subsequently made.

Though small in proportion to total loans, bad-debt losses form a substantial part of the operating expenses of personal finance companies. Data covering all states for which such figures are available show that bad-debt losses of all reporting personal finance lenders averaged 10.3 percent of total expenses in 1929, 22.7 percent in 1932 and 10.6 percent in 1936.

A special analysis of a large sample of loans made by one chain, according to the method of their termination, gives a clear summary of trends in the collection experience of personal finance companies. Only about 1 percent of the loans were terminated by charge-off, and a substantial proportion were fully repaid in cash; in fact, repayment before scheduled maturity was not at all uncommon. The majority of the loans, however, were terminated by a new loan—nearly three-fifths outside man and a clerk; such a staff can handle about 750 loans, representing outstandings of as much as $100,000. A minimum volume of $50,000 is regarded as essential for a chain office to operate profitably. Chain operation necessitates centralized control and uniform training of personnel.

Successful operation of a personal finance company requires that at least ninety-five out of every hundred loans pay out, and that delinquency be kept at a minimum. Therefore the detection of dubious risks is a vital factor in credit administration. The procedure involves a private interview by the manager, during which the first selection is made. A not insignificant proportion of applications are refused at this time, without further consideration—14 percent, according to the experience of one chain company in the period 1933-37. All applicants that are considered eligible are carefully investigated through various channels, this procedure being greatly facilitated when the applicant is a present or former customer.

On some delinquent loans payments are overdue on both principal and charges, and on others the tardiness is on principal payments alone. The extent of both types of delinquency has been estimated at 15 percent (the ratio of unpaid principal on all delinquent accounts to unpaid principal on all outstanding accounts). Figures which exclude "delinquency on principal only" show wide variation, ranging from 3 to 14 percent in 1937 for 15 states for which data are available.

When borrowers cannot meet payments due, or when they seek additional funds before a loan is paid off, refinancing is often arranged, the new contract usually having the same terms as the original. "Renewal" loans—those that are refinanced without the provision of new funds—are rare, but the extension of new funds to present borrowers is a highly important source of business. Foreclosure on chattel mortgages is seldom resorted to, because this practice alienates community goodwill, and the amount realized from the sale associated with larger volume is confirmed by the fact that there was a general tendency not only for gross earnings to be higher for larger offices but also for total expenses in percent of gross earnings to be lower. In view of the greater profitability of the larger offices it is not surprising to find that they control a substantial share of the personal finance business in these two states.

Data for various types of lenders in the state of Indiana show that chain lenders have, on the whole, the largest offices, enjoy the highest ratio of gross earnings to total employed assets, and show a lower ratio of expenses to earnings than any other type except partnerships; the latter, though second smallest in average size, have the lowest expense ratio and the highest net return on employed assets. While variations in lending policy and in accounting practices may cause some of the differences observed among the various types of Indiana lenders, it seems reasonable to assume that chains occupy a comparatively favorable profit position, especially in view of the corroborative evidence from the analysis of office size.

RATES OF CHARGE

In any state the maximum legal charge on personal finance company loans is not necessarily the charge made by all lenders, but the various legal maxima are representative of the types of rates that are quoted. At present 13 states and the District of Columbia set as a maximum a flat monthly percentage of the unpaid balance of the loan; the per annum equivalent of such a rate is of course twelve times the monthly rate, and this latter percentage times the average outstanding balance gives the total dollar charge for one year. In 14 states and Hawaii the maximum legal charge is a combination of one rate on the unpaid balance up to a specified figure and a lower rate on the remainder, a form of quotation which is suggested in the latest draft of the Uniform Small Loan Law. One state, Missouri, provides for a combination rate of this type graduated according to the original size of the loan rather than according to the unpaid balance. A rate which provides for a regular interest charge and, in addition, for certain stipulated fees, is permitted in a few states. Such a rate, and also the combination rate, makes it difficult for the borrower to compute total charges per year, either in percentage or in dollar terms.

There has been much controversy as to the ideal form of rate schedule, some experts favoring the flat percentage rate, because of its simplicity, and others contending that rates should be adjusted in such a way as to reflect the actual costs incurred in various typical circumstances. No adequate studies have been made, however, on the actual costs of various types of loans. Available studies classify total costs according to several all-inclusive categories (such as investigation cost, carrying cost, capital cost) and calculate from this the average cost per loan. Such a computation gives results which make it clear why lenders consider very small loans, and loans repaid within a very short time, as unprofitable under a flat rate of charge, but as a meaningful treatment of costs it has serious shortcomings. First, there are several cost items which do not fit into any convenient category and must be allocated according to an arbitrary standard. And second, the very concept of average cost makes it necessary to ignore such significant variables as size and duration of loan, size of office, type of borrower, and nature of the security. Nor is average cost a reliable determinant of lending policy. If the lender's facilities are not fully utilized he may find it expedient to make loans of a type which, according to the criterion of average costs, would be unprofitable at existing rates; in other words, his average cost may be reduced by the additional volume of business.

THE EFFECTS OF CHANGES IN MAXIMUM LEGAL RATES

To support their contention that if licensed credit facilities are to be provided to low income groups legal rates must be high enough to encourage profitable operation, lenders often cite the experience of states that have drastically changed the maximum rate provisions of their small loan laws. Data are not available for a complete analysis of the effects of such changes, but fairly complete information is available for 5 states.

In New Jersey the maximum legal rate was reduced, effective February 15, 1930, from 3 to 1½ percent per month. Between 1929 and 1931 there was a sharp drop in the number of licensed lenders and in the amount of loans outstanding, while the size of the average loan increased substantially. During this same period the personal finance business in Massachusetts, a state similar to New Jersey in its economic structure, and also licensed lending in the country as a whole, showed the opposite trend; it therefore seems probable that these New Jersey changes cannot be attributed to general economic conditions.

In 1932 the law was amended, raising the maximum legal rate to 2½ percent per month. Thereafter the volume of outstandings rose sharply and the average size of loan decreased, while both remained fairly constant in Massachusetts. There was only a slight rise in the number of loan offices in New Jersey, but this may be explained by certain provisions of the amended law regarding the size and number of offices.

A rate reduction from 3½ to 2 percent per month was in effect in West Virginia from 1929 until 1933. Here too the period of lower rates showed a great decrease in the number of licensees and in loans outstanding, a decrease far out of proportion to that in the country as a whole, and there is some indication that the situation encouraged illegal lending.

In the middle of 1933 an amendment became effective which raised the maximum rate from 2 percent to 3½-2½ graduated at $150 and, as in New Jersey, making certain stipulations as to the size and number of offices. Subsequently both the number of licensees and the amount of loans outstanding increased far more than in the country as a whole.

Georgia reduced its legal maximum in 1935 from 3½ to 1½ percent per month and this rate is still in effect. By 1937 licensed lenders had practically disappeared from the state, and various forms of illegal lending are said to have developed.

The Tennessee rate change, which took effect in February 1937, amounted to a reduction from 3½ to 1½ percent per month. It is estimated that since that time the number of licensed lenders operating in the state has decreased by almost 90 percent, and that the capital invested in the industry has decreased 95 percent. In a single year after the rate change the volume of loans fell 87 percent.

The Missouri rate reduction—from 3½ to 2½ percent per month—became effective in August 1929. Not only was the reduction less severe than any of the others, but when it occurred the Missouri small loan law had been in operation for only two years and the industry was still expanding rapidly; thus the effects of the change were somewhat different from those in the other states. The number of licensees fell sharply but the volume of loans outstanding remained about the same for two years, decreased somewhat during the next two years of general business depression, and by 1937 had almost regained its 1929 level. Immediately after the reduction the average loan became larger, but then tended to decline in size. Late in 1939 the law was modified to increase the rate to 3 percent on loans of $100 and less.

Even with due allowance for the fact that rate changes cannot be examined apart from the specific conditions prevailing in the state, it appears reasonable to draw a few broad conclusions as to the effects of such changes. After a rate reduction many licensed lenders go out of business or move to neighboring states, and there is evidence that illegal lenders increase in number. There is also a decrease in the volume of outstanding loans. The average size of the loan offices that remain shows no conclusive trend, perhaps partly because of insufficient data, but available information suggests that fewer small-size loans are made. A rate increase, on the other hand, appears to be accompanied by a rise in the number of licensed lenders and in the volume of loans outstanding.

RELATIONS AMONG LENDERS

Cooperative relations among personal finance companies have developed from the need to initiate and maintain special permissive legislation, and also from attempts to foster the demand for small loans, to protect the interests of lenders, and to supply to one another the services which can best be provided by concerted action. There is one national organization in the business, the American Association of Personal Finance Companies, located in Washington, D. C.; its membership comprises about a third of all reported licensees, and represents three-quarters of the total volume of outstanding loans. The main purpose of the Association is to elevate the standards of business conduct in the trade and to promote a more favorable public attitude toward licensed lending. Direct services to its members include the publication of a monthly magazine and of an annual roster of licensees, and also the provision of advertising information and other advice on lending practices. Through its National Council the Association maintains contacts with the 27 voluntary state associations; the latter represent their members at legislative hearings and otherwise perform much the same functions as the national association. Local organizations function chiefly for the exchange of credit information, and sometimes serve as collecting agencies.

Competition among licensed lenders is reflected mainly in the terms which they quote to borrowers. The upper limits to the rates they may charge is set by the small loan laws, but competition may bring quoted rates below this level and ease other terms of the contract; it may also determine the amount of money that a company will lend to any one borrower. Small competitive rate cuts are not likely to cause borrowers to shift from one lender to another, although substantial rate cuts may do so.

Competition between personal finance companies and other consumer credit agencies is becoming increasingly important. The trend is for all such agencies to diversify their activities, and a complicated situation has thus been created wherein companies that might serve fairly distinct markets find themselves offering practically the same services to the same potential customers.

Finally, in states where maximum legal rates are low, licensed lenders meet competition also from unlicensed lenders, particularly on middle-size loans, and from licensed lenders in neighboring states where higher legal charges make possible a less restricted lending policy.

The natural limitations of the small loan market serve to restrict competition to some extent, and in some states supervisory authorities are empowered to limit the number of offices in a single community. It is quite possible, however, that a few large offices with high operating efficiency may mean a more competitive situation than many small offices. Competition, not only among personal finance companies but also among all consumer credit agencies, would undoubtedly be stiffened if they all quoted rates on a uniform basis; with the present variation in the methods of rate quotation it is difficult for the borrower to compare the prices he must pay for the various kinds of credit available to him.