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Customer Charges

CUSTOMER charges on personal cash loans represent a composite of several different items, as do also the finance charges on time-sales transactions. In the case of the cash instalment loan the total charge may include not only an interest or discount rate, but also a credit investigation fee or service charge, and a charge for group life insurance to cover the unpaid balance if the borrower should die before completing his payments. The fine levied on delinquent instalment payments is also a money cost, but it probably does not enter into the price that the borrower considers at the time he contracts for his loan. If a borrower is choosing between two competing lenders he will, of course, take into consideration not only the interest and credit investigation costs, but also the non-price features of the loan contract, especially the security requirements (comaker, chattel mortgage, or other) and the number of months allowed for repayment. Although these latter features are significant from a competitive point of view, we shall deal exclusively with the price characteristics of loans in the present chapter.[1]

The sales finance charge is likewise a composite; it may include—in addition to a charge representing the application of a certain interest rate to the unpaid balance of the cash selling price—a fee for insurance on the purchased commodity which serves as security for the loan, and possibly other costs as well.[2]

[1] See Chapters 1, 4 and 9 for a discussion of the non-price characteristics of personal cash loans.

[2] For a discussion of the non-price features of time-sales financing contracts see Chapter 4.

The data for the following sections on cash instalment loan and sales financing charges were obtained from replies to questionnaires distributed by the National Bureau during the period December 1938 to July 1939, and from correspondence with bank officers during the period November 1939 to February 1940. The dating of the information on which the analyses are based is significant in view of the fact that in some communities rates have tended to decline.

CASH INSTALMENT LOANS

Interest Charges

The method used by commercial banks in quoting interest and discount rates on personal cash loans differs considerably from that followed by personal finance companies. While the latter quote a monthly rate on the unpaid balance, the banks customarily quote a rate of discount which they deduct from the face amount of the loan at the time the money is advanced. Of 134 banks reporting on their methods of handling interest charges, 109 followed this practice. The essential difference between the discount method and the method of adding interest to the face of the note is that the former results in a slightly higher charge than the latter: 6 percent discounted is equivalent to 6.38 percent interest added.

A few banks quote combination rates, but by no means as frequently as do personal finance companies. There are scattered instances, for example, in which the discount rate is quoted by banks at 6-5 percent graduated at $250,[3] or 10-8 percent graduated at $500. An unusual combination rate quoted by one bank is 8-7-6-5 percent, graduated at $200, $350 and $500. Occasionally a minimum charge is set; thus there may be a discount rate of 5 percent and a minimum charge of $2, or an 8 percent discount with a $1 minimum

[3] With this graduated rate the amount of the loan up to and including $250 is discounted at 6 percent, and the amount above $250 at 5 percent.

charge on all loans. A somewhat different principle is followed by one bank which offers 6 percent discount with a minimum monthly charge of $1.

The form of rate quotation is sometimes complicated by the fact that repayments are frequently accumulated in an hypothecated deposit on which the borrower may receive interest. One bank employing this procedure reports that it pays 1½ percent interest on the hypothecated deposit and deducts its insurance charge from this amount, crediting the borrower with the balance when the loan is paid off.

There are distinct variations in the interest or discount rates applied to personal loans in different parts of the country. Data on this point are presented in Table 42, which is based on questionnaire responses from more than 500 banks in the nine regional divisions[4] of the country. Since discount rates tend to be lower in large banks than in small banks, as subsequent data will show,[5] some degree of regional difference may be attributed to the fact that the large and small banks reporting to us were distributed unevenly in the several areas. To make allowance for this possibility "standard" rates computed for each region are included also in Table 42. These standard rates were obtained as follows: the average rate charged by banks in any size class in any region was weighted, not by the number of banks in that size class in that region, but by the number of banks in that size class in the entire country. Thus the "standard" regional rates are the average rates that would be found if the size distribution of banks were uniform throughout all the regions. Because the averages are weighted by the number of banks rather than by the volume of loans made by banks charging different rates, the average rates are somewhat higher than they would have been had we used this alterna-

[4] U. S. Census regional divisions are used here. For a list of the states in each region see above, Chapter 1, Table 1, footnote c.

[5] See Table 44, below.

TABLE 42

Number of Reporting Banks Charging Various Discount Rates on Personal Loans, by Region and by Type of Loan

REGION	DISCOUNT RATES						NUMBER OF BANKS REPORTING	AVERAGE RATE[a]	STANDARD RATE[b]
	9% and Over	8%	7%	6%	5%	4% and Under			
New England									
Single-name	..	..	1	33	3	..	37	5.9	5.9
Comaker	..	..	1	41	3	..	45	6.0	5.9
Collateral[c]	..	..	1	30	11	1	43	5.7	5.7
Middle Atlantic									
Single-name	..	1	..	109	12	1	123	5.9	5.9
Comaker	..	1	..	122	13	..	136	5.9	5.9
Collateral[c]	..	..	..	96	21	8	125	5.7	5.8
East North Central									
Single-name	1	6	36	66	8	..	117	6.4	6.3
Comaker	1	6	33	71	9	..	120	6.3	6.3
Collateral[c]	1	4	17	69	25	1	117	6.0	6.0
West North Central									
Single-name	6	30	23	18	2	2	81	7.2	7.0
Comaker	5	33	18	24	3	1	84	7.1	7.0
Collateral[c]	3	21	11	35	8	3	81	6.6	6.2
South Atlantic									
Single-name	2	7	3	52	4	..	68	6.3	6.3
Comaker	2	7	4	59	3	..	75	6.3	6.3
Collateral[c]	..	4	3	55	10	1	73	6.0	6.0
East South Central									
Single-name	1	5	..	13	..	..	19	6.7	6.4
Comaker	1	6	..	16	..	..	23	6.7	6.4
Collateral[c]	1	4	1	17	1	..	24	6.5	6.3
West South Central									
Single-name	14	10	1	5	3	..	33	8.0	8.1
Comaker	13	12	1	6	4	..	36	7.9	8.1
Collateral[c]	13	7	2	12	3	..	37	7.6	7.7
Mountain									
Single-name	3	8	2	2	7	..	22	7.0	6.9
Comaker	3	8	2	2	8	..	23	6.9	6.8
Collateral[c]	3	4	3	3	8	1	22	6.5	6.3
Pacific									
Single-name	3	7	..	10	2	..	22	7.0	7.2
Comaker	4	6	..	12	2	..	24	7.0	7.1
Collateral[c]	1	5	1	11	4	..	22	6.5	6.5
ALL REGIONS									
Single-name	30	74	66	308	41	3	522	6.5	...
Comaker	29	79	59	353	45	1	566	6.5	...
Collateral[c]	22	49	39	328	91	15	544	6.2	...

[a] In the computation of the average, rates of 9 percent and over were counted as 9½ percent, and rates of 4 percent and under as 3½ percent.
[b] See p. 142 for explanation of method of computing standard rate.
[c] Secured by savings passbooks, stocks and bonds, life insurance policies, etc.

tive weighting system. It is likely, furthermore, that weighting by volume would have sharpened the interregional differences.

Discount rates on personal loans are shown by this table to be lowest in the New England and Middle Atlantic states and highest in the West South Central states. The other regions fall roughly into two groups: the discount rates are somewhat lower in the South Atlantic, East South Central and East North Central states than in the Mountain, Pacific and West North Central states. Average rates vary from just under 6 percent in the New England and Middle Atlantic states to about 8 percent in the West South Central states. In the New England and Middle Atlantic regions the minor divergences from the conventional 6 percent rate are mainly downward. In the East North Central, South Atlantic, East South Central and Pacific regions the concentration is also at the 6 percent rate, with the differential moving chiefly up-

TABLE 43

Average Discount Rates[a] Quoted by Reporting Banks on Three Types of Personal Loans, by Region

REGION	TYPE OF LOAN			NUMBER OF BANKS REPORTING
	Single-Name	Comaker	Collateral[b]	
New England	6.0	6.0	5.7	34
Middle Atlantic	5.9	5.9	5.7	124
East North Central	6.4	6.3	6.0	112
West North Central	7.0	6.9	6.3	50
South Atlantic	6.2	6.2	5.9	34
East South Central	6.8	6.8	6.7	19
West South Central	8.3	8.1	7.8	29
Mountain	7.1	7.1	6.7	21
Pacific	6.9	6.8	6.4	21
ALL REGIONS	6.5	6.4	6.1	444

[a] Each rate is weighted by the number of banks specifying that rate.
[b] Secured by savings passbooks, stocks and bonds, life insurance policies, etc.

ward, especially in the Pacific states. The Mountain states show no distinct concentration of rates, but the West South Central region is characterized by a definite concentration at the levels of 8 percent and 9 percent and over. In all regions notes extended on collateral security carried the lowest rate; when the rates quoted on single-name and comaker notes were not identical, those on the latter tended to be slightly lower.

Not all of the banks represented in Table 42 reported rates on all three types of loans. Table 43 shows the average rates charged on single-name, comaker and collateral loans by 444 banks reporting on all three types. From this tabulation it appears that these banks charge, on the average, very nearly the same rates as the banks covered in Table 42.

The relationship between size of bank and quoted discount rates on personal loans is indicated in Table 44, which gives

TABLE 44

Index of Discount Rates[a] Quoted by Reporting Banks on Three Types of Personal Loans, by Size of Bank

SIZE OF BANK[b]	TYPE OF LOAN		
	Single-Name	Comaker	Collateral[c]
Under $150,000	117	117	111
150,000– 250,000	113	112	115
250,000– 500,000	106	106	107
500,000– 750,000	105	106	108
750,000– 1,000,000	103	103	105
1,000,000– 2,000,000	101	99	97
2,000,000– 5,000,000	97	97	97
5,000,000–10,000,000	97	98	96
10,000,000–50,000,000	93	95	94
50,000,000 and over	92	94	93

[a] Weighted average of the ratio of the average rate for the specified class in any region to the "standard" rate for that region.
[b] Total loans, discounts and securities. Total number of banks reporting was 444.
[c] Secured by savings passbooks, stocks and bonds, life insurance policies, etc.

indexes of rates for single-name, comaker and collateral loans. With few exceptions, banks in the larger size classes tend to quote lower interest rates than those in the smaller ones: the index on single-name and comaker notes dropped from 117 for banks with earning assets of less than $150,000 to 92 and 94, respectively, for banks with $50,000,000 and over; on collateral notes the decline was from 111 to 93. These findings do not demonstrate conclusively, however, that it is less expensive for the consumer to borrow from a large than from a small bank, for the indexes refer only to the discount element in the total customer charge. Before the entire problem of consumer cost can be resolved, account must be taken of all the component parts of the personal loan charge. Nevertheless, the data presented in Table 47, which indicate that most banks do not charge a credit investigation fee in addition to the discount, suggest that the differentials given in Table 44 are fairly representative of relative consumer costs. Although the latter table is made up of responses from 444 banks which state that they have personal loan departments, it is possible that some of the small-sized banks may actually make their personal loans on a non-instalment basis as they do commercial loans. If this is the case, the discount rates reported by these small banks are (except for the necessary correction to allow for the discounting of interest) approximately the per annum rates realized by such banks on the amount advanced, and not, as in the case of instalment loans, about one-half that rate. But even if faulty reporting may have introduced a bias of this sort, it is probably not serious enough to impair the finding that discount rates are higher in small than in large banks.

Charges for Credit Investigation, Insurance and Delinquency

In states where such action is not prohibited, many banks impose in addition to the interest charge a fee for the investi-

gation of the applicant's credit standing. Out of 594 banks responding to the question, "Do you charge a credit investigation fee?" 170 banks answered affirmatively. Although 9 of them referred to it as a service fee, their method of quotation did not distinguish this charge from a credit investigation fee. In no case did a bank report a total cost to the customer which included both a credit investigation fee and a service charge.

As may be observed from Table 45, which represents the

TABLE 45

Number of Banks Reporting Specified Credit Investigation Fees[a]

TYPE AND AMOUNT OF FEE	NUMBER OF BANKS REPORTING
Flat dollar fee	107
Under $1.00	*24*
1.00	*45*
1.50	*5*
2.00	*24*
2.50	*4*
3.00	*1*
5.00	*4*
Flat percentage fee	44
1 percent or less	*12*
2 percent	*21*
Over 2 percent	*6*
Not specified	*5*
"Actual cost" of investigation	8
TOTAL	159

[a] Of 594 banks reporting on this question, 424 replied that they charged no credit investigation fee. Of the remaining 170 there were 9 that called the fee a "service charge." Since 11 of the 170 did not specify their method of charging the fee this table is based on 159 reports.

There were 121 banks which reported that they did not collect a credit investigation fee if the loan application were rejected, and 13 which reported that they did collect it in these circumstances.

replies of 159 banks specifying their methods of calculating the fee for credit investigation, a flat dollar charge regardless of the size of the loan is more common than a fixed percentage charge. Of 107 banks which reported the flat dollar charge, 45 specified $1 as the amount, 24 charged $2 and an equal number less than $1. In 4 banks the fee was as high as $5. Percentage fees were quoted most often as 2 percent of the loan (21 banks), and the next most frequent charge was 1 percent or less (12 banks). Occasionally the principle of minimum or maximum charge is applied to this fee: it may then be quoted, e.g., as 1 percent with a $2 minimum, or as 2 percent with a $10 maximum, but this method appears to be much less common than the flat charge. Another variation is found when the credit investigation fee applies only to loans of a certain size; it may, for example, be 2 percent on loans up to $300, or 75 cents on loans up to $100, but this method also is used relatively infrequently.

Out of 134 banks, 121 reported that they did not collect a credit investigation fee if the loan application were rejected; only 13 answered that the fee was collected regardless of the decision on the loan application.

An additional charge sometimes borne by the borrower is the premium for a group life insurance policy which serves to protect comakers or the borrower's estate in the event of his death before full payment of his debt. Commercial banks vary in their attitudes with respect to such insurance; according to questionnaire replies from 133 widely separated personal loan departments, 46 did, and 87 did not, require borrowers to provide life insurance on comaker and unsecured loans. Of those banks which did make the stipulation, about half stated that a separate charge was imposed for this service.

Additional data on charges for group life insurance on personal loans were obtained by correspondence with 22 banks which operate relatively large personal loan departments. This correspondence shows that the cost of insurance

to the borrower is usually quoted as a flat fee per $100 of funds advanced, although in some cases it is calculated as a flat monthly rate per $100 of unpaid balance. The former type of rate quotation was cited by most of the reporting banks; it ranged from 50 cents to $1 per $100 advanced, with the rates of most of the banks at the upper limit. The small number of companies which quoted their rates on a monthly basis charged 10 cents per month for each $100 loaned.

There appear to be several methods of computing the cost of this insurance coverage to the bank and of making remittances to the insurance company. Most banks pay the insurance company a sum computed as a stipulated percentage either of the loan balance outstanding at the end of the month or of the average loan balance outstanding over the month. This rate is generally about .1 percent on loan balances outstanding, and comes to approximately 65 percent of the charge commonly paid by the borrower. According to another method, the bank pays 60 or 65 percent of the premiums collected for the policies issued. The difference between the cost of the loan insurance to the bank and the charge collected from the borrower is approximately the same regardless of the method by which the bank makes its remittance. In a few instances banks reported that they received a rebate or dividend, based on claims paid on insured loans; presumably such a rebate would be received only if the bank remitted to the insurance company more than the usual 65 percent of the amount collected from the borrower. Changes in the rates which banks pay to insurance companies for this type of protection are based on changes in the death rate of borrowers or, more rarely, on changes in the average age of borrowers.

Less frequent is the credit insurance scheme whereby a borrower, instead of providing a comaker, pays a fee to protect his loan. Such a plan is now used by the Marquette Na-

tional Bank of Minneapolis,[6] which requires the borrower who desires to dispense with a comaker to pay, in addition to a 3 percent interest charge and a $5 service charge, a credit

TABLE 46

Number of Banks Reporting Specified Delinquency Fines[a]

TYPE AND AMOUNT OF FINE	NUMBER OF BANKS REPORTING
Percentage of delinquent payment	75
2 percent	*5*
4 percent	*7*
5 percent	*60*
7–15 percent	*3*
Monetary charge per delinquent payment	14
25 cents	*4*
50 cents	*6*
50 cents to $1.00	*3*
Graduated[b]	*1*
Charge according to period of delinquency	6
25 cents per day	*1*
25 cents first day, 10 cents daily thereafter	*1*
50 cents first day, 10 cents daily thereafter	*1*
1 percent per week	*1*
1 percent per month	*1*
Graduated[c]	*1*
Charge according to number of notices	3
25 cents each notice	*1*
25 cents each notice, except first	*1*
25 cents first notice, 50 cents second	*1*
TOTAL	98

[a] Of 139 banks reporting on this question 30 replied that they charged no delinquency fee and 1 did not answer definitely. Since 10 of the remaining 108 did not indicate their method of calculating the fee this table is based on 98 reports.
[b] Amounting to about 4 percent.
[c] Amounting to about 1 percent per day.

[6] "Marquette National Refunds on Personal Loan Risk Premium," *American Banker* (August 3, 1939) p. 3.

insurance fee of $5 per $100 of money borrowed. Part of the insurance fee covers life insurance on the borrower, and the remainder goes into a loss reserve for a group of loans made according to this plan. At the end of the insurance period the unused portion of the reserve is returned, pro rata, to the borrowers in this group.

Charges or fines levied on delinquents seem to be much more common than credit investigation charges. Out of 139 banks replying to a question on this item, 108 stated that they imposed delinquency penalties with a view to discouraging tardy payment. As is evident from Table 46, the methods of calculating this charge are far from uniform. The fine may be expressed as a given percentage of the delinquent payment, as a flat monetary charge per delinquent payment, as a charge proportionate to the number of days of delinquency, or as a given amount per delinquency notice sent to the borrower. The first and most common method was reported by 75 out of 98 banks; four-fifths of this number made a charge of 5 percent. Of the remaining 23 banks, 14 imposed a monetary charge ranging from 25 cents to $1 per delinquent payment.

Aggregate Cost to the Consumer

The aggregate cost to the consumer for a personal loan from a commercial bank may be computed in monetary terms. While this total money cost cannot be viewed as interest in the legal sense of the word, it may be expressed in terms of interest and compared with respect to different rate schedules.

Table 47 presents a classification of 543 banks according to their quoted discount rates and their credit investigation fees. The table applies solely to comaker loans for which, as we have already noted, the rates are sometimes lower than for single-name notes and usually higher than for loans backed by savings passbooks, life insurance policies and similar forms of security. Moreover, since some banks tend to charge lower rates on loans of larger size, this distribution cannot be con-

TABLE 47

Number of Reporting Banks Charging Various Specified Interest Rates and Credit Investigation Fees on Comaker Personal Loans[a]

CREDIT INVESTIGATION FEE	INTEREST RATE CHARGED											NUMBER OF BANKS REPORTING
	3%	4%	5%	6%	7%	8%	9%	10%	12%	10–8% at $150	6–5% at $250	
Dollar fee												
$ .25– .50	..	..	2	4	1	3	..	..	..	..	..	10
.50–1.00	..	..	6	39	2	..	1	..	..	..	..	48
1.00–1.50	..	..	4	7	..	..	..	..	..	..	..	11
1.50–2.00	..	..	..	22	2	..	..	..	..	..	..	24
2.00–3.00	..	..	1	1	1	1	..	..	1	..	..	5
3.00–4.50	..	..	..	..	..	..	..	..	..	..	..	..
4.50–6.00	1	..	..	..	1	..	..	..	..	..	..	2
Percentage fee												
1 percent	..	..	..	7	..	..	..	..	..	..	..	7
2 percent	..	..	1	9	4	2	..	..	..	..	..	16
3 percent	..	..	..	3	..	..	..	..	..	..	..	3
No charge	..	1	36	247	38	72	2	18	1	1	1	417
TOTAL	1	1	50	339	49	78	3	18	2	1	1	543

[a] Reports from a small number of banks have been restated so that they will conform to this type of tabulation.

sidered representative of advances in excess of $300. The latter are rare, however; comaker loans in amounts up to $300 make up the bulk of personal loans.

Table 48 expresses the total money costs and the true annual interest rates on 12-month loans of $50, $100 and $300 according to various rate schedules. When studied in conjunction with Table 47, this tabulation shows the actual money costs of certain representative rate schedules applying to comaker loans. Thus we may note from Table 47 that of the 543 reporting banks, 339 charged a 6 percent rate on comaker loans, and that of these banks 247 made no charge for credit investigation. We may then observe from Table 48 that the rate charged by these 247 banks, if deducted in advance from the face of the note, would amount to annual interest of 11.8 percent on a declining balance for a $100 loan of 12-month duration. If interest were added to the face of the note and not deducted from it, the annual interest rate would be 11.1 percent on each of the three amounts of note analyzed in the table. A loan of $100 extending over 12 months at a 6 percent discount rate plus a credit investigation fee of $1 would cost the borrower 13.9 percent per annum, exclusive of insurance, and 15 percent inclusive of an insurance fee of 50 cents. The cost to the borrower for a loan larger or smaller than $100 at these same charges, or for loans made at other rates classified in Table 47, can be estimated readily from Table 48.

A study of these two tables reveals that the charges reported by the banks covered in Table 47 would equal, for a personal loan of $100 running for 12 months, true annual interest rates ranging from 7.7 percent (for 4 percent quoted discount, with no extra charges) to 30.0 percent (for 12 percent quoted discount, with a $2 credit investigation fee). The bulk of the reporting banks extend loans at rates amounting to an annual interest cost of approximately 12 to 17 percent on declining balances. Since larger banks tend to

TABLE 48

Total Money Cost and True Annual Interest Rate on 12-Month Personal Loans of $50, $100 and $300, by Various Hypothetical Rate Schedules

RATE SCHEDULE			$50 LOAN			$100 LOAN			$300 LOAN		
Quoted Interest Rate (percent)	Credit Investigation Fee	Insurance Fee	Total Money Cost	True Annual Interest Rate[a] (percent)		Total Money Cost	True Annual Interest Rate[a] (percent)		Total Money Cost	True Annual Interest Rate[a] (percent)	
3½	..	..	$1.75	6.5	6.7	$3.50	6.5	6.7	$10.50	6.5	6.7
	$2.00	..	3.75	13.8	15.0	5.50	10.1	10.7	12.50	7.7	8.0
4	..	..	2.00	7.4	7.7	4.00	7.4	7.7	12.00	7.4	7.7
5	..	..	2.50	9.2	9.7	5.00	9.2	9.7	15.00	9.2	9.7
	1.00	..	3.50	12.9	13.9	6.00	11.1	11.8	16.00	9.8	10.4
	2.00	$50	5.00	18.4	20.5	7.50	13.8	15.0	17.50	10.8	11.4
6	..	..	3.00	11.1	11.8	6.00	11.1	11.8	18.00	11.1	11.8
	..	50	3.50	12.9	13.9	6.50	12.0	12.8	18.50	11.4	12.1
	1.00	..	4.00	14.8	16.0	7.00	12.9	13.9	19.00	11.7	12.5
	1.00	50	4.50	16.6	18.2	7.50	13.8	15.0	19.50	12.0	12.8
	2.00	..	5.00	18.4	20.5	8.00	14.8	16.0	20.00	12.3	13.2
	2.00	50	5.50	20.3	22.8	8.50	15.7	17.1	20.50	12.6	13.5

TABLE 48 (Concluded)

RATE SCHEDULE			$50 LOAN			$100 LOAN			$300 LOAN		
Quoted Interest Rate (percent)	Credit Investi-gation Fee	Insur-ance Fee	Total Money Cost	True Annual Interest Rate[a] (percent)		Total Money Cost	True Annual Interest Rate[a] (percent)		Total Money Cost	True Annual Interest Rate[a] (percent)	
7	..	..	$3.50	12.9	13.9	$7.00	12.9	13.9	$21.00	12.9	13.9
	$1.00	$50	5.00	18.4	20.5	8.50	15.7	17.1	22.50	13.8	15.0
	2.00	..	5.50	20.3	22.8	9.00	16.6	18.2	23.00	14.1	15.3
8	..	..	4.00	14.8	16.0	8.00	14.8	16.0	24.00	14.8	16.0
	1.00	..	5.00	18.4	20.5	9.00	16.6	18.2	25.00	15.4	16.8
	2.00	50	6.50	24.0	27.6	10.50	19.4	21.6	26.50	16.2	17.9
9	..	..	4.50	16.6	18.2	9.00	16.6	18.2	27.00	16.6	18.2
10	..	..	5.00	18.4	20.5	10.00	18.4	20.5	30.00	18.4	20.5
12	..	..	6.00	22.1	25.2	12.00	22.1	25.2	36.00	22.1	25.2
	2.00	..	8.00	29.5	35.1	14.00	25.8	30.0	38.00	23.4	26.8

[a] The true annual interest rate given here is computed according to the constant ratio method; rate $= \frac{24}{n+1} \cdot \frac{I}{P}$ where n is the number of equal monthly instalments, I is the total money interest charge, and P is the amount actually received by the borrower.

The computation of the first column is based on the supposition that charges are added to the interest-bearing amount, of the second on the assumption that charges are deducted from the interest-bearing amount.

charge lower interest rates than smaller banks, the bulk of the loans fall within the lower limit of this range. For a few large metropolitan banks which make personal loans at 4 percent discount or under, the true annual interest rate would be 7.7 percent or less.

The ultimate cost to the borrower of a loan repaid before the final date of maturity cannot be computed unless account is taken of the rebate granted. Under the rebating system very frequently employed, the bank returns to the borrower the full amount of unearned interest for the period for which the loan has been prepaid. Of 86 banks reporting their rebating method in enough detail to justify comparisons, 47 used this full rebate scheme. Other schemes vary only with respect to the system of computation or to the differential between the actual unearned interest and the amount rebated. Several methods are apparently in wide use. One is to return one-half, one-third or three-fourths of the unearned interest; another is to rebate at a rate involving a 1 or 2 percent differential as compared with the original rate of discount; a third is to set a minimum service charge applicable to all prepaid loans and to pay only that part of the unearned discount which is in excess of this amount.

SALES FINANCING

The sales financing activities of commercial banks are conducted according to two general methods:[7] the bank either obtains sales finance paper directly from the consumer or discounts consumer notes for retail dealers. Although commercial banks tend to follow one practice or the other, such information as is available indicates that the two are sometimes employed concurrently by the same bank. The direct transaction with the consumer is much the simpler of the two methods, at least as far as the problem of customer charges

[7] See above, Chapter 4.

is concerned, for the second arrangement involves a calculation of dealer loss reserves which is likely to vary from bank to bank.

Customer Charges on Direct-to-Consumer Financing

The time-sales department of a commercial bank usually quotes its direct-to-consumer charge on automobile time-sales contracts as a percentage per annum discount exclusive of insurance charges. Since reports on rates charged are available only from 17 companies, it is not possible to discuss the level of finance charges conclusively. The lowest new-car rate reported was 4 percent discount and the highest 8 percent. Eleven banks charged a 5 percent discount on some of their new-car notes. Rates are higher for used cars, generally by 1 percent, and some banks also provide differentials in rates to take account of differences in the maturity of the loan, the equity of the borrower and the age of the car purchased.

For time sales of automobiles, both new and used, buyers are usually required to purchase fire and theft insurance and collision insurance—$50, $75 or $100 deductible—depending on the value of the car. When a car is financed directly it is customary for the bank to permit the buyer to arrange for the required insurance through any agent he chooses. In the present study some banks reported that they did act as agent in selling automobile insurance, many stated that they received no commission for this service, and one bank wrote that it placed insurance with its own affiliate. Generally, the amount charged for insurance is added to the face of the note and paid off in instalments. A few banks reported exceptions to this procedure, however, for cases where it would reduce the buyer's equity in the car below the point considered desirable by the bank.

In direct financing banks prefer, of course, to set up a reserve out of finance charges to cover losses incident to re-

possession. Only limited data are available on the amount of reserves set up. One commercial bank finances used cars at 6 percent for the two most recent models and at 6 percent plus $10 for the next two in order of age. The $10 charge is then treated as a reserve against losses.

Customer Charges and Reserves on Instalment Paper Obtained through Dealers

From the information at hand it appears that where commercial banks finance the instalment purchase of automobiles, new or used, through arrangements with retail car dealers, the customer pays charges which are either equal to or slightly higher than those he would pay for direct financing. Financing transacted directly with the consumer tends to cost around 5 percent on new cars, whereas new-car paper discounted for dealers generally involves a customer charge of 6 percent. Further comparison of the rates paid by consumers under these two methods of financing is afforded by reports from seven banks which engage in both. Four of these institutions maintained the same rates for both types of paper, but three made the direct-to-consumer advances at a lower rate than that charged for paper discounted for dealers. Used-car paper is discounted for both consumers and dealers at a rate 1 or 2 percent higher (depending on the age of the car) than that for new-car paper. For purposes of convenience dealers are sometimes provided with rate charts, similar to those used by sales finance companies. By consulting the chart the dealer can compute readily the finance charge on any given unpaid balance. Some banks have reported, however, that they dispense with the rate chart and simply stipulate the rate at which the customer finance charge is to be computed.

An obvious difference between the two methods of obtaining automobile finance paper, and incidentally one which accounts in part for the customer charge differential, revolves

about the issue of loss reserve. If the dealer assumes liability for losses under a recourse or repurchase arrangement, a dealer reserve is usually set up out of the finance charge.[8] Several methods of establishing the dealer reserve are followed. First, banks may discount consumer notes for a dealer at a rate lower than that charged the customer. The differential varies between 1 and 2 percent of the amount of the note in the few cases for which information on this point is available. The sum is then set up as a dealer reserve, against which losses on the notes are charged. When the contract is paid out in full, that portion of the dealer reserve which was set up against the contract is released and paid to the dealer at some stated interval—monthly, semi-annually or annually. The amount of the reserve is conditioned mainly by the extent of the dealer's liability, although the dealer's financial standing constitutes another significant factor in its determination. It is commonly observed that the reserves allowed for weaker dealers are usually smaller than those held for the stronger establishments, and that a dealer who is able to originate a large volume of paper is likely to obtain a more liberal reserve arrangement than a dealer whose volume of business is smaller.

Some banks prefer to let the dealer reserve increase to a stipulated percentage of notes outstanding, and then repay the excess to the dealer on a monthly basis. One bank reported this ratio as 5 percent, another as 3 percent and a third as 10 percent. Problems frequently arise in connection with the accounts to be charged against the reserve. One

[8] A dealer *reserve* is a portion of the finance charge which the financing agency retains in an account for the benefit of the dealer, to be applied against possible dealer losses or repossessions when the dealer endorses the paper or executes a repurchase agreement. When paper is discounted by the financing agency with no dealer liability, any reserve set up out of the finance charge serves mainly to retain the dealer's patronage. Such an account might be termed a dealer *subsidy* or *bonus* to distinguish it from the dealer reserve. A dealer *pack* is an addition made to the standard finance charge and is passed on to the dealer by the financing agency in addition to any reserve which the contract may stipulate.

bank states that any payment 10 days delinquent is charged against the reserve, but apparently the usual practice is to allow the dealer to charge against the reserve any losses he incurs on notes he has guaranteed for the bank. Another bank reports that the reserve on a note is returned to the dealer when one-half the amount of the note has been paid.

In other cases notes originated by dealers are discounted by the bank at the same rate charged the customer, and a portion of the finance charge is set up as a dealer reserve to cover losses arising out of customer default and repossession, reconditioning and resale of the collateral. In effect, this method differs from that described above only in that the note is not formally discounted at a rate lower than the charge to the customer. In both cases the dealer executes a repurchase agreement, and an arrangement is made by which the unused reserve is credited to the dealer. These two methods do not, apparently, make for any difference in the amount of the finance charge paid by the consumer. Sometimes dealers originate time-sales notes which banks discount without dealer endorsement; in such cases the bank may set up its own loss reserve. A different reserve practice, reported by a few banks, is to hold back a certain percent of the amount of the note discounted. This procedure is comparatively rare, however; it is used mainly when banks purchase contracts from dealers who are considered to be in a weak financial position.

A different method of handling dealer paper was described by a few other banks. These institutions vote a line of credit to the dealer, generally at a 6 percent discount rate. The dealer may then borrow up to the limit of this credit line on his 30-, 60-, or 90-day demand notes secured by customers' automobile paper. One bank reported that it loaned up to 75 percent of the posted collateral and that the dealer substituted a new note for an old note that became 65 days delinquent. In this instance the bank had no control over customer charges. Another bank stated that its loans of this type

might be either secured or unsecured. A third permitted the dealer to discount notes up to the amount of his line of credit, on a full recourse basis, but required him to keep a 20 percent cash reserve with the bank against his outstanding notes.

The practice of commercial banks with respect to insurance on cars financed through arrangements with dealers does not vary substantially from that described above in connection with direct-to-consumer financing. The insurance charge is quoted separately in most cases, and normally provides for the same coverage, i.e., fire, theft and deductible collision. Sometimes but not usually the insurance is sold by the bank as agent. The dealer, if permitted by state law, may sell the insurance and receive the commission, or the customer may obtain the necessary policy through an agent of his own choosing, in which case he may include the premium in the amount to be financed. It appears that banks which do a substantial volume of sales finance business, whether direct-to-consumer or through dealers, find it to their advantage to place all of their insurance with one or two companies. In this way they not only achieve accounting economies but also expedite settlements and exert some influence toward having the necessary repairs made by the dealer who sold the car. Repair work is of considerable importance to certain dealers, and since sales finance companies generally arrange to have repairs made on this basis the commercial bank with a large volume of sales finance business is likely to follow suit.

Commercial banks' charges for loans made to finance the instalment purchase of household appliances are roughly similar to their charges for new-automobile financing. Customer paper generally carries a financing charge of either 5 or 6 percent of the original unpaid balance, more frequently the latter. Because many notes arising out of the sale of household appliances are likely to be of small face amount, minimum charges are sometimes stipulated. Thus the basic rate

may be 6 percent discount, with a $5 minimum for notes running 6 months, $7.50 for notes maturing in 9-12 months and $10 for all notes running for 15 months or longer. In most cases the bank provides the dealer with a rate chart, similar to those used by sales finance companies.

In appliance financing, as in automobile financing, dealer reserves and the handling of accounts give rise to special problems. If it discounts dealers' accounts on a full or limited recourse basis, the bank finds it necessary to build up a reserve which usually reverts to the dealer when the customer's note is paid out. Current methods of establishing this reserve are similar to those already described for automobile financing: the paper is discounted at less than the customer rate and the difference is set up as a reserve, or else the notes are discounted at the same rate charged the customer and a portion of the face amount of the customer's note, sometimes as much as 10 percent, is held back as a reserve.