Finance companies as business lenders

Finance companies, which have been viewed traditionally as providers of consumer credit, have become important lenders to business as well. Today, business lending represents about half of all finance company credit. In 1978, finance companies accounted for $1 out of every $5 of short- and intermediate-term borrowing by nonfinancial businesses—a total of $63 billion. This lending encompasses a broad spectrum of financial arrangements, including loans by finance subsidiaries of manufacturers to dealers and business customers and asset-based financing such as leasing and various types of accounts receivables financing. Most of this credit is to small- and medium-sized businesses. As financial intermediaries, finance companies fund much of this lending through financial markets that are reserved for the largest corporations, such as the commercial paper market.

Finance companies—function and profile

Finance companies have a long history as intermediaries that channel funds from the financial markets to business and household borrowers. Originally they served largely as lenders to consumers. In recent years, however, business lending has become increasingly important. In fact, by the end of 1978, business credit represented almost half of the accounts receivables of finance companies, compared with only one third in the early 1960's (Chart 1).

The change in the composition of finance company lending has been accompanied by important shifts in the structure of the industry. In its early history, the industry consisted mainly of independent companies. Beginning in the postwar period, a growing number of large corporations—mainly in durable goods industries and to a lesser degree in retail trade—followed the lead of major automobile companies and established finance company subsidiaries. These so-called "captive" finance companies serve as a source of finance for the dealers and customers of the parent companies. While captive finance companies exist in a number of industries, the automotive sector accounts for most of their lending. In addition to large manufacturers and retailers, many bank holding companies now have finance company subsidiaries. As a result of these structural changes, at the close of 1978 the largest 100 finance companies consisted of 45 captive sales finance companies, 41 companies that were either independently owned or subsidiaries of nonbanking firms, and 14 subsidiaries of banking organizations.[1] These large firms account for the bulk of finance company lending to business and consumers. In mid-1975, 88 companies or only about 2½ percent of the approximately 3,400 companies in the industry extended about 90 percent of total finance company credit.[2]

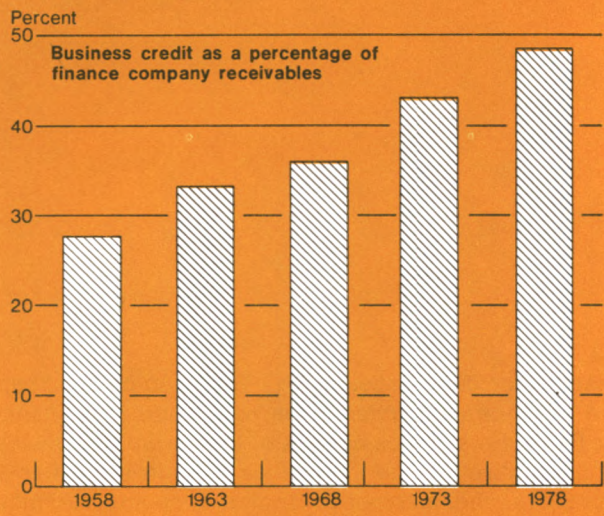
Finance companies depend mostly on nonbank credit, both short- and long-term, to fund their lending activities. As an example of this dependence, finance company borrowing accounts for almost 60 percent of total borrowing in the commercial paper market. This reliance on market debt highlights a key intermediary role played by finance companies. While traditionally the commercial paper and bond markets are viewed as credit sources for only the nation's largest firms,

[1] "100 Largest Finance Companies in the U.S.", *American Banker* (June 11, 1979). In the survey, only companies whose main activities consist of financing sales of their parent firms' products or services are identified as captives. However, such financing is also among the activities of some firms listed in the survey as subsidiaries. The survey understates the role of bank holding companies since some large bank subsidiaries are excluded.

[2] "Survey of Finance Companies, 1975", *Federal Reserve Bulletin* (March 1976).

Chart 1

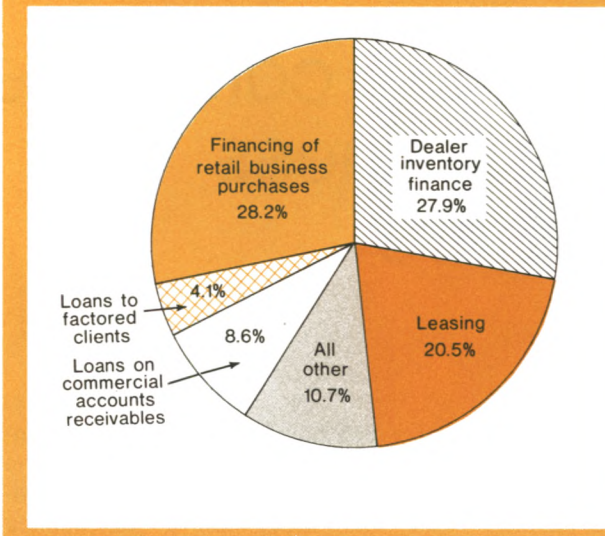
After many years of primarily serving household credit needs, finance companies now conduct about half of their lending with businesses.



Source: Board of Governors of the Federal Reserve System, Flow of Funds.

Chart 2

Components of Finance Company Business Credit



Source: "Survey of Finance Companies, 1975", Federal Reserve Bulletin (March 1976), page 205.

finance companies enable these markets to finance in effect many smaller businesses as well as consumers.

Types of finance company business lending

Finance companies perform their intermediary role in a variety of ways. Somewhat over half of finance company business lending represents financing of finished goods inventories in the trade sector and purchases of equipment by business (Chart 2). Such activities mainly reflect credit extension by captive finance companies of large manufacturers. The other major category of finance company business credit is often described as "asset-based" financing. This broad term includes leasing, loans secured by firms' accounts receivables, liquidation of instalment receivables, and loans to customers by factors, who buy and then usually collect short-term receivables. These forms of finance are based on asset values in contrast to lending which depends more upon net worth and cash flow.

Captive finance company lending

Captive finance companies offer financing for dealers and retail customers of parent companies. The manufacturer can better and less expensively obtain information on its dealers, monitor the borrower, and liquidate repossessed collateral than banks or independent finance companies. Thus, captives may extend credit when other financial institutions might be unwilling to do so. Such financing is generally secured by the goods sold or dealers' inventories. At the retail level, credit may be extended via instalment sales contracts, which are often purchased from dealers, or leases. Seeking diversification as well as an attractive return on investment, some captive finance companies have expanded into various types of inventory, receivables, and equipment financing not directly related to sales of the parent.

While financing by some captive companies has become more diversified, the bulk of lending—somewhat over 40 percent of total finance company business credit—is accounted for by the automotive industry. Propelled by the rapid expansion of auto-dealer inventories and business investment in automobiles and trucks, automobile financing grew at an annual rate of close to 18 percent in the 1974-78 period. Such strong gains are an important reason why business lending over recent years has grown more than twice as fast at finance companies compared with banks (Chart 3).

Asset-based financing

In addition to lending by captive finance companies, the other key component of finance company business lending is asset-based financing. With asset-based finance, the lender either owns a physical asset to be financed (as in leasing), buys the borrower's receivables and extends funds prior to their collection (as in credit extension by factors buying short-term receivables or sales of instalment contracts to finance companies), or has an explicit lien on specific and often closely monitored collateral (as in commercial finance). This wide assortment of financing techniques meets many varied needs of business borrowers.

Commercial finance

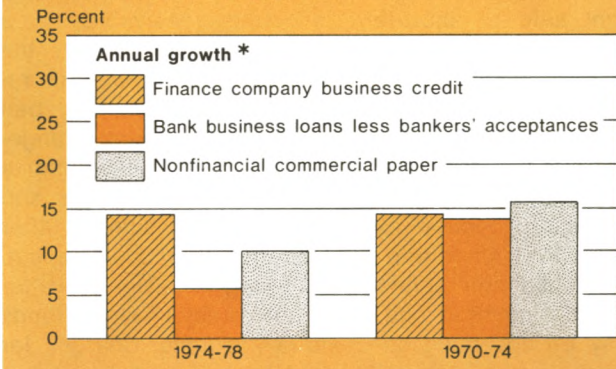
Commercial finance is a form of secured, revolving credit generally designed to meet the short-term working capital needs of a firm. In its most common form, a firm offers its accounts receivables as security, and this lending arrangement is sometimes called accounts receivables financing. Inventories or plant and equipment may also be used as collateral. In a typical financing arrangement, maximum credit is limited to around 75 to 85 percent of eligible receivables, with eligibility defined largely by the receivables' quality (*e.g.,* delinquency status, creditworthiness of customers). The outstanding loan amount varies over time since extensions are tied to receivables and repayments are coordinated with receipts.

The variation in the loan amount under commercial financing is somewhat similar to a revolving credit agreement at a bank. However, the mechanics of commercial finance differ in some important respects. With a commercial financing arrangement the outstanding balance often varies daily, while it generally changes less frequently in the case of many revolving credit loans at banks. Also, commercial financing arrangements are sometimes characterized as "evergreen" loans which can grow continuously with eligible collateral, without the need of being periodically paid off or fully amortized. While conventional bank business loans often are secured, in commercial financing the lender generally monitors the collateral much more closely. Sometimes daily reports on inventories, receivables, and receipts are required, and field auditors may frequently visit the borrower's business.

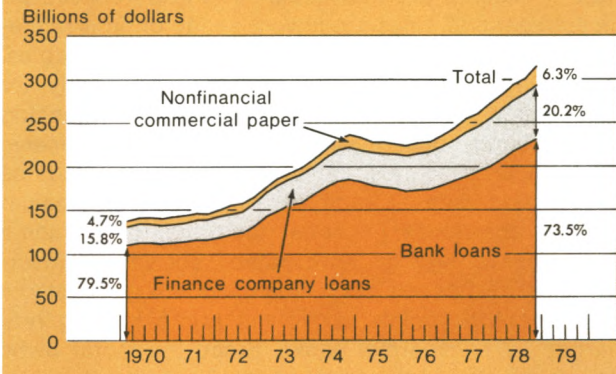
The monitoring and coordination of repayments with daily receipts under a commercial financing arrangement enable the lender to limit risks. Thus, commercial finance is used to accommodate new businesses, small- and medium-sized firms experiencing relatively fast growth, and companies having temporary business difficulties. The financial markets are usually unavailable to these borrowers and conventional bank credit can be inadequate relative to their needs.

Chart 3

In recent years, finance companies have become a relatively fast-growing source of of business credit . . .



. . . and account for an increasing portion of short- and intermediate-term business borrowing.†



* Compound growth rates computed from year-end levels.

† Shares of short- and intermediate-term business lending are shown for the beginning of 1970 and the end of 1978.

Source: Board of Governors of the Federal Reserve System.

The monitoring costs and the comparative riskiness of typical borrowers result in rates on commercial finance anywhere from 2 to 5 percentage points and more above the prime lending rate. However, this difference overstates the relative cost of funds for a borrower. First, the daily flexibility of outstanding borrowing means that the borrower pays interest only on funds required for immediate working capital purposes. Alternative lending forms, such as revolving credits at commercial banks, are generally less fine tuned to such needs. Also, commercial finance arrangements

generally exclude compensating balances or commitment fees sometimes required on bank business loans.

Factoring

In contrast to the lien on assets acquired by the lender under commercial finance, factoring involves the outright sale of short-term accounts receivables to a factor. It is the factor who usually then collects the receivables on a nonrecourse basis (*i.e.*, without recourse to the seller of the receivables for any bad debts). Depending on the particular factoring arrangement, the factored client receives funds either after a maturity period, which reflects stated due dates and average collection experience, or occasionally after collection. In addition to credit checking, bookkeeping, and collection services, factoring is also used for credit protection and cash flow stability since funds may be advanced on overdue accounts. Charges for these services generally range from ¾ to 2 percent of purchased receivables, with specific rates varying with the volume purchased, average size of the invoice, terms of sale, and credit quality of the purchased invoice. In general, rates are lowest on factoring arrangements in which clients collect their own receivables.

Factoring is used by some businesses simply for its collection and credit protection services. Financing also frequently occurs when factored clients receive advances prior to negotiated average maturity dates or collection dates. Credit can be advanced against existing receivables (discount factoring) or, in some arrangements, against anticipated receivables (overadvances). Rates on such financing are generally a few percentage points above the prime lending rate charged by commercial banks. Since the factor owns and often collects the receivables, borrowing on factored accounts receivables generally permits a higher maximum credit than with commercial finance.

Sales of longer term receivables to finance companies

In addition to financing short-term accounts receivables through factoring and commercial finance, businesses also receive funds on longer term instalment receivables by selling them to finance companies. These transactions are sometimes referred to as instalment or industrial sales finance. The mechanics of such sales vary with respect to who collects the receivables and the arrangements for recourse. In addition to the longer maturities of the receivables sold, there are a number of other differences among sales of instalment receivables, commercial finance, and factoring. Sales of instalment receivables generally require less monitoring by the finance company. Also, individual transactions can be larger than those typically associated with most factoring and accounts receivables financing arrangements. While companies borrowing via commercial finance or factoring often have limited alternatives, industrial or instalment sales finance is selected by some borrowers from a variety of options.

Leasing

Aside from receivables and inventories, longer term fixed assets are also financed by finance companies via leasing. This financing technique has been growing rapidly at finance companies as well as at banks. For example, in the 1965-75 period the volume of leasing grew almost tenfold at finance companies and national banks. By way of comparison, over the same interval commercial bank business loans only about tripled.

The fast expansion of leasing reflects its appeal to a variety of borrowers. From the standpoint of the small borrower, leasing can be an attractive alternative to direct borrowing, in spite of the sometimes relatively high implied interest cost. For instance, capital and liquidity are conserved as a result of no compensating balances and little or no downpayments. Also, fixed monthly payments may be preferred to variable payments on a floating rate bank loan. Moreover, lessors may be less conservative than the commercial lending departments of some banks because their expert knowledge of used equipment markets raises the likely value of equipment in the event of default.

In contrast to the rates on leases of relatively small dollar volume, rates on big-ticket leasing—such as airplanes and computers—are more likely to be competitive with business lending rates at banks and in the financial markets. These big-ticket leases, which are generally motivated by tax considerations, were boosted in the 1960's by the introduction of the investment tax credit and accelerated depreciation. Some firms discovered that the added tax write-offs and credits associated with new investment more than offset their taxable income. Through the leasing mechanism, the tax benefits of ownership could be obtained by lessors who can use tax credits and deductions. Competition motivates the lessors to incorporate their lower aftertax ownership cost in the lease rate. Thus, the lessee effectively receives the benefits of the tax-based investment incentives.

When a firm's tax situation does not make leasing an attractive alternative, finance companies may also offer the option of financing equipment with longer term loans. Credit is also sometimes extended for plants and commercial real estate. Unlike users of big-ticket leasing, borrowers are less likely to have ready access to financial markets.

Finance company business lending and commercial banks

The wide variety of business lending by finance companies naturally leads to competition as well as to cooperation with banking institutions. Asset-based lending is an area of competition between independent finance companies and many commercial banks and their holding company affiliates.[3] There are also areas of cooperation with business finance companies who participate in loans with some banks and utilize bank credit and bank lines of credit in raising funds through the commercial paper market.

Nonbank subsidiaries of bank holding companies have achieved a substantial presence in asset-based finance. In 1976, close to 500 bank holding company subsidiaries reported either commercial finance, factoring, or leasing as their primary activities. These subsidiaries had total assets of more than $7 billion.[4]

Further perspective on the role of banking institutions in asset-based financing is provided by industry studies. One survey of the factoring industry reports that almost two thirds of the industry volume is now accounted for by bank-related factors.[5] According to a survey by the American Association of Equipment Lessors, bank holding company subsidiaries and commercial bank divisions or subsidiaries now account for around 45 percent of lease financing. While the survey covered only part of the leasing industry, it does give some impression of the role of banks and bank holding company subsidiaries in leasing. In addition to factoring and leasing, commercial banks are also involved in commercial finance, although it is difficult to measure the extent of their involvement precisely.

Competition is only one facet of the interaction between finance companies and banking organizations, since there are also areas of cooperation. For example, commercial banks lend to finance companies. However, the importance of bank loans as a source of funds has been declining. At the time of the most recent comprehensive Federal Reserve survey of finance companies in mid-1975, bank loans represented only around 10 percent of their liabilities and capital versus slightly over 20 percent in mid-1960. More recently this share has declined further, as bank loans to finance companies have been about unchanged over the past four years, while finance company lending has increased rapidly. Nevertheless, although direct loans to finance companies have not grown, banks also provide lines of credit to support the expanded borrowing by finance companies in the commercial paper market.

Bank lines and direct lending still give an incomplete view of banks' interaction with finance companies. For instance, some banks have become increasingly involved in loan participations with asset-based lenders. Under these arrangements a finance company or asset-based lending division of another commercial bank monitors the collateral, allowing a bank to participate in loans that it would not otherwise extend. From the standpoint of borrowers, this arrangement can result in a "blended rate" which is lower than the rate that would be charged by the asset-based lender. From the perspective of the bank, this allows the bank to maintain customer relationships that otherwise might have been terminated. In particular, this arrangement enables smaller banks without asset-based lending capabilities to compete for customers more effectively.

Summary and conclusions

In recent years there have been marked changes among the suppliers of business credit. At one time, asset-based financing was conducted primarily by independent finance companies. Today, commercial banks and subsidiaries of bank holding companies are also important suppliers. Business lending by the captive finance companies of the major automotive manufacturers has jumped to over 40 percent of finance company business lending. Their credit extension has been boosted by the relatively rapid increases in auto dealer inventories and business investment in automobiles and trucks. Such lending is a major reason for the faster growth of business credit at finance companies than at commercial banks in the 1974-78 period.

In addition to these changes within the ranks of suppliers, there is also somewhat more diversity among businesses utilizing finance company credit. The rapid growth of leasing suggests that finance companies are increasingly serving large companies. Still, most finance company lending is to small- and medium-sized firms. Thus, finance companies remain an important link between such borrowers and financial markets that are directly tapped only by large corporations.

Maury Harris

[3] Asset-based lending by nonbank finance company subsidiaries of bank holding companies is included in the Federal Reserve data on finance company business loans. Credit extended by commercial banks or their majority-owned domestic subsidiaries via factoring or commercial finance is included in commercial bank commercial and industrial loan data. Leasing receivables of commercial banks is reported separately.

[4] R. Michael Rice, "Financial Impact of Nonbank Activities on Bank Holding Companies", Board of Governors of the Federal Reserve System, unpublished staff paper, June 1978.

[5] "Factors Hit Record in '78 Volume", *Daily News Record* (January 29, 1979).