N O T F O R P U B L I C A T I O N

CONSUMER INSTALMENT CREDIT

By

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Delivered before the Conference of
The Executive Committee of the National Association of
Supervisors of State Banks
and
The Supervising Examiners of the Federal Deposit Insurance Corporation
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Gentlemen:

In view of the short time assigned to this subject, I shall limit the material presented and shall: (1) indicate the dollar magnitudes involved in consumer instalment credit; (2) describe briefly some of the "plans" which we have been hearing about; and (3) touch on the examination problems involved.

I

Prior to 1920, consumer financing on an instalment basis was practically non-existent; by the end of 1929 the amount outstanding was over $3 billion; and by 1941 it had increased to $6 billion. With the imposition of Regulation W, with the lack of consumer durable goods to be financed, and with the repayment of outstanding accounts, this figure dropped rapidly to $2 billion in 1943, where it remained until the fall of 1945. In the last six months there has been an increase of about 25 percent, to $2.5 billion.[1]

These figures may sound low to you: They are for consumer <u>instalment</u> credit, and do <u>not</u> include single-payment loans made by banks to consumers, charge accounts at department and other stores, or so-called service credit, consisting of doctor bills, hotel bills, etc. These have amounted to $3 or $4

1/ Detailed estimates covering consumer instalment credit outstanding at the end of 1929, 1941 and 1943, and at January 31, 1946 are shown in the table at the end of this paper.

billion dollars on various dates over the last 10 years. Speakers who include them quote a total consumer credit figure of $10 billion for 1941. However, the widespread current interest of bankers in consumer credit is not directed toward those types of credits. You know, even better than I, that bankers have always made consumer loans, but these have been technically, at least, on a single payment basis.

The interest of banks in consumer instalment credit did not become widespread until after the banks had had some very favorable experience with FHA insured repair and modernization loans from 1934 on. As a result, by 1941, 88 percent of all insured commercial banks were in the consumer instalment business. They held almost one-half -- 45 percent -- of all consumer "direct loans", i.e., the type of loan in which the borrower receives cash. They held, however, less than one-fifth of the retail instalment sale credit, designed to finance the sale of a specific commodity, and in which the borrower ordinarily does not handle the money.

Sale credit amounted to the larger share -- almost $4 billion -- of the $6 billion outstanding in 1941; furthermore, it is this form of instalment credit which fluctuates the most and hence should show the greatest increase when durable goods become available in quantity. It is small wonder, therefore, that bank interest is focused currently upon this type of instalment credit. In the past the sales finance companies and the originating retailers held four-fifths or more of this paper; in fact, practically all of it except that held by commercial banks.

II

Current controversy among bankers resolves about the method of getting as large a share as possible of this business. In broad outlines three approaches are discussed. The first involves adopting all of the methods used in the past by the sales finance companies, to meet their competition on their own ground. This applies particularly to automobile financing. The second approach proposes to finance instalment sales by means of direct loans to customers. The third approach is directed to the financing of goods other than automobiles.

Meeting the sales finance company on its own ground is admittedly the best approach for securing a large volume of automobile business rapidly. An example of this approach is the American Bank Credit (A.B.C.) Plan. The A.B.C. Plan is sponsored by the American Instalment Credit Corporation, a wholly-owned subsidiary of the Morris Plan Corporation of America. (Arthur J. Morris, founder of the Morris Plan Banks, is its originator). The national organization proposes to make contracts with manufacturers, to provide field men to develop new business and maintain contacts with the dealers, and to supply advice and assistance. These field men will handle defaults and repossessions and check dealer's inventories. The national office will also provide insurance for all cars through a subsidiary.

One or more banks in each community will be given a franchise to discount the paper originated by local automobile dealers and to finance the unsold cars on the dealer's floor. The dealer makes out all the papers on retail transactions and delivers them in finished form to the bank. Credit risks not acceptable to the local bank may be refused, and are then to be referred to a bank which supervises activities within the respective district.

The plan provides for uniform standard down-payments and time periods. Proposed charges, and the division of those charges are as follows:

AMERICAN BANK CREDIT PLAN

	Total cost[1] to the borrower	Division of Gross Income		
		A.B.C.	Local Bank	Dealer (Through "Reserve")
Floor plan financing of dealer	4% simple interest + insurance coverage	1% simple interest + insurance premium	3% simple interest	nothing
Retailing new cars	5% of original unpaid balance + insurance coverage	1% of original unpaid balance + insurance premium	3%[2] of original unpaid balance	1% of original unpaid balance
Retailing used cars	6% of original unpaid balance + insurance coverage + "pack" (or service fee)	1½% of original unpaid balance + insurance premium	4½%[3] of original unpaid balance	"pack" (or service fee)

1/ The local bank may not make charges exceeding the total shown. If its charges are less, all of the reduction is borne by the local bank since the amounts going to ABC and to the dealer do not change.
2/ The local bank agrees to set up a loss reserve of ½% of original principal amount of loan; unused balance of the reserve accrue to the bank.
3/ The local bank agrees to set up a loss reserve of 1 percent of original principal amount.

We should also mention the Nash-Kelvinator plan briefly. Local dealers are asked to select either a local bank or sales finance company which will finance both wholesale and retail paper. The local bank agrees to pay sight drafts for Nash autos shipped to the dealer during the current model year, and makes its own arrangements with the local dealer on rates etc.

The second approach proposes direct loans to purchasers in all cases, with the borrower paying the retailer in cash for the item purchased. The Bank and Auto Agent Plan, typical of this approach, is sponsored by the American Bankers Association and the National Association of Insurance Agents, who are supplying forms, publicity, advice and directions to local banks and local insurance agents.[1] This plan is based upon the self-interest of local bankers and local insurance agents in referring customers to each other, with each handling his part of each transaction. The bank will make out all papers covering each loan, itself, unless it provides some forms to insurance agents.

The third approach can be illustrated by the plans of two regional groups of banks, organized to finance the purchase of household appliances and agricultural implements. One is the Bankredit Time Plan, sponsored by the Bank of America and approximately sixty other banks west of the Rockies. The other is the National Sales Finance Plan, consisting of twelve large banks in strategic centers, and 1,100 of their correspondent banks in thirty states east of the Rockies. The latter has been called the Bank of Manhattan Group. A coordinator's central office will make contracts with household appliance and farm

1/ The American Bankers Association Consumer Credit Department, has published booklets entitled "Direct Automobile Financing", "Home Appliance Financing", and "Aircraft Financing", describing credit requirements and operating procedure, as part of its program to assist the local banker. It proposes to issue other booklets and guides and has made surveys to determine the number of banks which propose to make personal loans, and to acquire through direct or indirect means, automobile paper, other equipment paper, and modernization paper. 3

implement manufacturers. These are non-exclusive contracts. The manufacturers agree to publicize the financing facilities available, and to supply the banks with lists of dealers and distributors and price lists. But the individual bank makes its own contact and arrangements with the local retailer or distributor for the business, both to finance dealers' inventories and to purchase retail instalment paper. On retail transactions, banks will carry life insurance on the borrower, including this in the interest charge. Contract forms covering sales will be filled in by the retailer.

The group is making no contracts with auto manufacturers, in order to avoid becoming involved in the ethical problems related to dealer's reserves. Local banks in the group may handle auto loans on either a direct or a dealer basis.

III

Now what are the problems from the viewpoint of a bank examiner in all of this? Briefly, there are the broad problems (1) related to all consumer lending; (2) relative to floor financing of dealers; (3) relative to paper acquired from retailers; and (4) relative to direct loans.

(1) With respect to <u>all</u> consumer instalment lending, there are three outstanding facts which bankers should have learned from their prewar experience. First, it is a high cost business because there are many transactions each involving a small amount of money. Second, charge-offs need not be high. Third, any reduction of down payments or increase in repayment periods, decreases the purchaser's equity and increases the likelihood of loss. Now on the last fact, so long as Regulation W continues in effect, the time periods of contracts will probably be conservative. Also, in the case of sale credit, down payments will be adequate. The examiner should see that Regulation W is adhered to.

Now with respect to the first two facts: I know of no figures showing costs incurred by commercial banks on consumer instalment loans alone. We do have figures for all insured industrial banks, whose business would be most comparable to that which the commercial banks would be likely to undertake. All operating costs (not including interest on time deposits or other borrowed funds) amounted to a little less than 8 percent of average outstanding loans for 1941. This included net charge-offs of less than one-half of 1 percent of outstanding loans. This amounts to almost 4 percent and one-fourth of 1 percent, respectively, in terms of the original face amount of a 12 month instalment loan.1/

To me, this indicates:

(a) that the banker should know his costs pretty well before engaging in rate cutting in any form;

(b) that streamlining the handling of such loans to reduce costs is important, and that requires an adequate volume (the average insured industrial bank -- without the six largest -- had outstanding loans of $1 million in 1941);

(c) that a reserve should be set up, based on the volume of loans made, to provide for inevitable charge-offs;

(d) that officers and other personnel must be trained and qualified to handle this type of loan.

(2) Now, relative to floor financing of dealers. The two chief problems are over-extension of credit, and subsequent inability to move inventories.

1/ Additional detail with respect to the cost of loan operations of each of the principal types of consumer instalment financing agencies is presented in Chapter 5 of Comparative Operating Experience of Consumer Instalment Financing Agencies and Commercial Banks, 1929-41, by Ernst A. Dauer. (National Bureau of Economic Research, New York, 1944)

These factors will not become important generally until the current seller's market disappears; yet, they could be important to an individual bank and an individual retailer even under present conditions. Under both the National Sales Finance Plan and the Nash Plan, the local bank determines the retailer's credit line, and the manufacturer is advised of it, and is advised periodically how the dealer's account stands. Thus, overloading the dealer is avoided. Also under the National Sales Finance Plan, the manufacturer agrees to repurchase inventory, if the dealer defaults. The A.B.C.Plan is silent on both of these questions.

The technical auditing or examination questions relative to floor financing are familiar to you. The examiner should ascertain that all forms used by the bank in its agreement with the retailers have been checked for legal loopholes. He should check or spot-check the chattel mortgage conditional sales agreement or trust receipt covering cars on the dealer's floor and demonstrators; also the fire and theft policy on both, including a collision clause on the demonstrators. Also the bank should carry insurance to cover conversion or other fraudulent acts of the dealer. In the periodic verification of the inventory on the dealer's floor -- which is an absolute essential -- proper precautions should be taken to avoid collusion between the bank representative and the dealer.

(3) Problems relative to retail paper acquired from dealers.

Every plan under which paper originated by a dealer is discounted, forces the bank to give up some measure of control over the seclection of its risks, if it wishes to keep the dealer satisfied. Today and tomorrow, with business volume limited by ability to <u>get</u>, not to <u>sell</u> goods, this will be less of a problem than later. Under the Nash and National Sales Finance Plans, there will be variation from bank to bank in its ability to sell the local retailer on the maintenance of acceptable credit standards. The A.B.C. Plan contains a threat right in its contract, that the local bank will lose its franchise if it "repeatedly or unjustifiably" refuses to discount paper offered by the local dealer.

So as an examiner you are faced with the prospect that banks, which discount dealer paper, like sales finance companies, will rely <u>less</u> on the credit of the retail purchaser, and <u>more</u> on the dealer's reserve or repurchase agreement, or the resale value of the repossessed article. This creates an entirely new set of technical questions to be examined. For example, on all car credits, particularly used cars, it is essential that the purported sales prices of cars be checked against official or accepted lists of value. Over-valued car contracts should preferably not be accepted, or, at any rate, be protected by a dealer's repurchase agreement. The examiner will want to inquire into the character and value of the dealer's contingent liability, if any, looking into both the adequacy of the dealer's reserve and the credit worth of the retailer. It is desirable to look into the rapidity with which the banker acts after a default occurs because it is almost axiomatic that a borrower who neglects to pay also neglects to maintain the article which can be repossessed.

On paper indirectly acquired, the bank presumably has low acquisition costs and is assured of a high volume of business once it has made the necessary contracts with retailers. But you will want to know that the bank has not cut rates, or agreed to split the gross income with the retailer, or with A.B.C. promoters, to a point where the business will be unprofitable.

(4) Lastly, problems with respect to direct loans. A bank which limits its consumer instalment credit activities to direct loans either under the Bank-Agent Plan, or on its own, may incur substantial advertising expense and yet build up volume slowly. If its credit standards remain high, its faster stepping competitors will say that it isn't serving the entire community. The A.B.A., however, says that its business will be clean-cut. It will not be building up bad customer relations by giving secret rebates to retail dealers. Furthermore, it will keep full control of its selection of credit risks. If its volume is low, its operations may be unprofitable; it may thereby influence its net worth more unfavorably than the relaxation of credit standards of its brethern.

CONSUMER INSTALMENT CREDIT OUTSTANDING

(Estimates in millions of dollars)

	Dec. 31, 1929	Dec. 31, 1941	Dec. 31, 1943	Jan. 31, 1946
TOTAL	$ 3,167	$ 5,981	$ 2,000	$ 2,427
Retail Sales Credit - Total	2,515	3,744	814	882
Held by Commercial Banks	a	(676)	(113)	(153)
Automobile	a	411	55	70
Other than auto	a	265	58	83
Held by others	a	(3,068)	(701)	(729)
Automobile	a	1,531	120	169
Other than auto	a	1,537	581	560
Instalment Loans - Total	$ 652	$ 2,237	$ 1,186	$ 1,545
Made by Commercial Banks	43	(1,018)	(401)	(617)
Direct auto loans	a	310	81	154
Direct loans on other articles	a	23	10	25
Repair & modernization loans b/	a	234	89	125
Other loans	a	451	221	313
Small Loan Companies	263	535	372	446
Industrial Banking Companies	219	298	165	203
Credit Unions	32	217	123	123
Miscellaneous Lenders	95	102	86	93
Other FHA Insured Repair and Modernization b/	0	67	39	63

SOURCE: Federal Reserve Bulletin

a/ Breakdown not available. Estimates indicate that bank holdings of retail sales credit in 1929 were very small.

b/ The estimates for other FHA Insured Repair and Modernization Loans are understated to the extent that Repair and Modernization Loans held by Commercial Banks include loans in this category which are not insured.