CONSUMER INSTALMENT CREDIT

by

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I was very pleased when our mutual friend and associate Clyde Roberts asked that I come to Atlanta to participate in your conference. In the first place, I hope to become acquainted with a great many of you before this conference is over. Aside from the sheer pleasure of meeting you, I also welcome this as an opportunity to "get a haircut". I will have to explain what I mean by this expression.

On several occasions when Mr. Harl, Chairman of the Corporation, has introduced me to someone, he has said, "You will notice that Mr. Dauer is not one of those long-haired economists whom you have heard about." Now in all seriousness, I know of two excellent ways for an FDIC economist to avoid becoming impractical, or long-haired. One way is by meeting and conversing with the examiners -- the men engaged in front line duty in the banks. There is only one better way to keep down to earth, to keep closely in touch with the facts of banking life as the examiners face them when they go into the bank. That better way is to go into the bank with you occasionally, and take part in an examination. Meeting with you, and hearing about your problems from you runs it a close second. Therefore, I am pleased whenever I can "get a hair-cut" by meeting with you or by participating in an examination.

In the time available to me I shall (1) indicate the dollar magnitudes involved in consumer instalment credit; (2) describe briefly the methods or plans which banks are using in their efforts to secure as much of this business as possible; and (3) touch on the examination problems involved.

I

We know that consumer financing on an instalment basis goes back at least as far as 1910, when the Morris Plan originated. Reasonably good figures on volume are not available, however, until 1929. By that time such credit had grown to over $3 billion. With the ensuing drop in business activity, it was cut in half by 1932; it increased rapidly thereafter, showing a dip from the fall of 1937 to the spring of 1939, but otherwise growing continuously, until the fall of 1941 when it amounted to over $6 billion. From that peak of $6 billion at the beginning of the war, the amount outstanding dropped sharply to $2 billion in 1943 where it remained until the fall of 1945. In the last year there has been an exceptionally rapid increase of about 75 percent to $3.5 billion at the end of October 1946.

The figures I am quoting include consumer <u>instalment</u> credit only. Figures for <u>total</u> consumer credit have shown the same peaks and dips as instalment credit and have been from $3 to $5 billion larger. I have not included charge accounts at department stores, which show the sharpest seasonal fluctuations and are now at their peak of about $2.5 billion. I have not included so-called service credit consisting of doctor bills, hotel bills, etc., which have been extremely regular in amount and have never exceeded $1 billion. Total non-instalment consumer credit, at $5 billion, is larger now than it has ever been. However, the widespread current interest of bankers in consumer credit is not directed toward those non-instalment types of credit, but rather toward the <u>instalment</u> type; it is the latter to which we will limit our discussion.

In the last year, bankers have talked and written more about consumer instalment credit than about any other area of lending activity. It has not always been thus; in fact, most banks did not become actively interested until after they had had some very favorable experience with FHA insured repair and modernization loans beginning in 1934. In the following years they entered the instalment field at an ever increasing rate and by 1941, 88 percent of all insured commercial banks were in the consumer instalment business. By that date banks held almost one-half -- 45 percent -- of all consumer "direct loans", i.e., the type of loan in which the borrower receives cash. Retail instalment sale credit, the type designed to finance the sale of a specific commodity and in which the borrower ordinarily does not handle the money, has traditionally been the province of the sales finance companies, and even by 1941, banks held less than one-fifth.

Instalment sale credit amounted to almost two-thirds of the $6 billion of instalment credit outstanding in 1941. This is the form of instalment credit which fluctuates the most and is expected to show the greatest increase when durable goods becomes available in quantity. It is not surprising then that for the last year banker interest has been focused upon it.

II

Current controversy among bankers revolves about the method of getting as large a share as possible of this instalment sales business, away from the sales finance companies. Most attention has been devoted to automobile instalment sales credit, because in prewar days its total was as large as all other types combined. I think most bankers would prefer to finance instalment sales by means of <u>direct</u> loans to customers. Many of these same bankers are convinced, however, that it is necessary to acquire paper <u>indirectly</u> through dealers, and to adopt most or all of the methods of the sales finance companies in order to compete with them effectively. Essentially there are only these two methods, although there are any number of variants between the two.

1. The American Bank Credit (ABC) Plan is the best known coordinated effort of bankers to completely meet the sales finance company on its own ground. The ABC 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). As of the middle of October about 115 banks with 75 branches had agreed to participate in the Plan in the 10 Northeastern States on which the ABC sponsors have concentrated to date.

This Plan provides for a central organization which will make contracts with manufacturers, provide field men to develop new business, and maintain contacts with the dealers, and to supply advice and assistance to the banks. These field men will handle defaults and repossessions and check dealers' inventories. The central office will also provide insurance for all cars through a subsidiary. Thus the central office functions in a manner similar to the head office of a sales finance company.

Each bank which joins the group acts--so far as this business is concerned--very much like the branch office of a sales finance company. It will have the franchise in its community 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.

As an example of the same approach, the Nash-Kelvinator and the International Harvester plans may be mentioned. Local dealers are asked to select either a local bank or a sales finance company which will finance both wholesale and retail paper. The local bank agrees to pay sight drafts for Nash autos, Kelvinator refrigerators or agricultural implements shipped to the dealer; the bank makes its own arrangements with the local dealer on rates, etc.

As you readily recognize, many variations of the same procedure are possible for the financing of time sales, and of floor inventories of retailers of household appliances, and other durable goods.1/

In each such plan regardless of its details, full cooperation with the retail dealer is contemplated; his inventory is to be financed, and he is to be allowed such rebates of finance charges as the sales finance companies customarily allow in that particular industry. Except in the ABC plan, the full responsibility for making contacts with dealers, checking dealer inventories, and handling defaults and repossessions rests with the banker.

2. At the other extreme, stands the second approach which proposes direct loans to purchasers in all cases, with the borrower paying the

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1/ Early this year we heard a great deal about the National Sales Finance Plan, (sometimes called the Bank of Manhattan Group) consisting of 12 large banks in strategic centers, and 1,100 of their correspondent banks in 30 States east of the Rockies. A central office was established to make contacts with household appliance and implement manufacturers, to aid the local banks in securing retail and wholesale business of their distributors. In October the dissolution of the national office was announced, on the grounds that the organizers had not been able to secure assurance that their activities would not be in contravention of the Federal anti-trust laws. It was stated that each of the signatory banks and their correspondents would continue to participate actively in the sales finance field.

retailer in cash for the item purchased. This procedure involves the least deviation from the methods used by banks in making ordinary cash loans. The banker relies on his own ability to attract borrowers through advertising -- without any cooperation from the retail dealer.

To aid in bringing customers directly into the bank, the American Bankers Association has cooperated with the National Association of Insurance Agents in sponsoring the Bank and Auto Agent Plan, 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 the transaction. The bank makes out all papers covering the loan, itself, unless it provides some forms to insurance agents.

III

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

1/ The Consumer Credit Department of the American Bankers Association has published 4 booklets within the last year, entitled "Direct Automobile Financing", "Home Appliance Financing", "Farm Equipment 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.

1. Problems relative to retail sales paper acquired from dealers.

A banker who acquired retail paper from dealers instead of making direct loans attain low acquisition costs and a relatively substantial volume of business once the necessary contacts with retailers have been made. But with the high volume comes the temptation to accept all of a dealer's paper even though some is below the bank's normal credit standard. There is even a temptation to accept any paper sent in by the dealer, without adequate scrutiny to determine whether it meets acceptable credit standards. Thus such a bank will be relying less on the credit of the retail purchaser, and more on the dealer's reserve or repurchase agreement or the resale value of the repossessed article. We recognize, to be sure, that sales finance companies have not experienced a substantial rate of loss by operating in this manner.

When banks which discount dealer paper thus adopt the methods of sales finance companies, as they must, you as examiners will want to be sure that they have mastered the incidental maze of technical problems. For example, on all car credits, particularly used cars, it is essential that the purported sales prices of cars be checked against official or recognized lists of value. Over-valued car contracts should preferably not be accepted, or, at any rate, be protected by a dealer's repurchase agreement. As examiners, you 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.

As you can well imagine, the sales finance companies have not looked with favor upon the energetic entry of banks into this field. One of their most effective weapons has been to cut their charges on wholesale paper, or to allow higher rebates to the retailer. At this game they have all the advantage, because they have been in the business longer and should know their costs better than the banks which are relative newcomers. Yet men within that industry, addressing a recent convention of sales finance companies, have stated that rates have been cut too far. Now you as examiners will want to be sure that the banks are not cutting rates, or splitting the gross income with the retailer or with others, to a point where the business becomes unprofitable.

2. Problems relative to floor financing of dealers.

Any banker who acquires retail paper indirectly, also has the problems of its Siamese twin--floor financing of dealers. Here the two chief problems are over-extension of credit and the subsequent inability to move inventories. Today there is still a sellers' market for most commodities. Yet scattered price cutting is already in evidence in furniture, table model radios, costume jewelry, some foods, and cotton dresses; in addition there have been more sales recently to reduce inventories or to move them faster. Warning signs on the horizon indicate that lesser known brands in all fields may have heavy sledding. Buyer resistance to top prices for used cars has also appeared.

Taken as a whole, these developments indicate that yesterday's frantic demand for goods is disappearing. Production of goods, in spite of work stoppages, is increasing. It is probable that production will overtake demand in one important class of durable goods at a time rather than occurring for all at once. I can make no pretense of calling the turns. As an examiner, you will want to assure yourself that the banker is exercising the necessary precautions to see that the dealer does not become overloaded. As you know, the sellers' market can become a buyers' market very abruptly.

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. You 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. The bank should also 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 collution between the bank representative and the dealer.

3. Problems relative to direct loans.

A bank which limits its consumer instalment credit activities to direct loans may incur substantial advertising expense and yet build up volume slowly. If its volume remains low its operations may be unprofitable; it may thereby be tempted to cut rates to attract business. I know of several banks in Washington who are advertising a rate on direct loans materially below that charged by the local Morris Plan bank; if the latter composed of consumer credit specialists cannot afford the lower rate, I don't believe the newcomers can. In that direction lies danger.

The bank which makes direct loans will also have somewhat higher clerical costs than the banks which acquire paper indirectly, since in the latter case the retailer prepares all of the papers. However, it saves the rebate which is customarily allowed the retailer, which more than offsets the increased clerical costs.

The outstanding characteristic of direct lending is that the bank can keep full control of its selection of credit risks. As an examiner you will want to be sure that the loan is justified by the credit of the borrower; if not, if it is based in fact upon an automobile or other durable good, the problems of verification are the same as for a loan acquired from a retailer.

4. <u>Problems relative to all consumer lending.</u>

I should like now to consider briefly three points with respect to <u>all</u> consumer lending: Terms, rates of loss, and operating costs.

For the last five years, consumer credit terms have been limited by Regulation W. Since the first of this month its scope has been materially decreased. If it is relaxed further or removed, we can look for a reduction in down payments and a lengthening of repayment periods, as a result of two influences, competition among sellers and competition among credit agencies.

By way of illustration: After the urgent demand for automobiles has been satisfied, retailers will have to begin "selling" cars instead of merely "delivering" orders. Then dealers will want to lower down payments and reduce monthly payments. This desire together with the competition between banks, sales finance companies and other credit agencies will bring about such pressure as to have only one inevitable result, a relaxation of lending terms.

We all recognize that with present automobile prices, a one-third down payment, and a 15-month term results in monthly payments beyond the reach of a large proportion of prospective purchasers.1/ The longer life which cars have demonstrated during the war may well justify longer terms, just as the higher prices may require them. But you and I will want to watch this development closely to see that it does not become excessive. To summarize, you will recognize that a reduction of the down payments or an increase in the length of the repayment period decreases the purchaser's equity. When carried too far it definitely increases the likelihood of loss.

It is not many years ago since most bankers considered consumer credit unsound and risky. But they have learned in their prewar experience that losses and charge-offs on consumer instalment loans need not be high. Losses sustained by all banks in the State of New York on all loans made by personal loan departments from 1936 through 1942 averaged slightly less then 1/3 of 1 percent of the total loans granted. The Superintendent of Banks of New York also reports that over a 31-year period 14 industrial banks sustained an almost identical average rate of loss, namely 30.8 cents per $100.00 of loans granted, on loans totaling over $400 million. In terms of average outstanding loans, it would be about double that or two-thirds of 1 percent. This is not high and compares favorably with losses on commercial and agricultural loans. However, losses are inevitable. Setting up an adequate reserve for losses based on loans made is one way to facilitate taking those losses promptly and currently.

Another fact which bankers should have learned from their pre-war experience is that the consumer instalment business is a high cost business,

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1/ On a Ford, Chevrolet or Plymouth, the monthly payment would be about $70-80 in the Washington area.

because there are many transactions each involving a small amount of money. There is a marked lack of satisfactory information on the costs incurred by commercial banks in making consumer instalment loans. The only recent figures covering a substantial number of banks are in the report of the Superintendent of Banks for New York to which I just referred. On the average these show that operating costs, without allowance for the losses just referred to, ran from about $5\frac{1}{2}$ to $8\frac{1}{2}$ percent of outstanding loans in various sized centers in 1944. In 1941, when volume was higher, operating costs were as much as 1 percent lower than in 1944, on reduced volume. Our own figures for insured industrial banks also show operating costs (not including interest on time deposits) of a little less than $7\frac{1}{2}$ percent of average outstanding loans for 1941. These figures do not include net charge-offs of about one-half of 1 percent of outstanding loans. Since the consumer instalment business is a high cost business, it is important to streamline the handling of such loans to reduce costs, and that requires an adequate volume. I believe you will also agree that it would be the height of folly for a newcomer, as most banks are, to cut rates in the hope of getting volume, unless the bank is absolutely sure of its cost figures. Furthermore, it is impossible to over-emphasize the desirability of having officers and other personnel who are trained and qualified to handle this type of loan.

IV

Gentlemen, I am reminded of the story of the lady organist who wanted to impress the distinguished visiting clergyman. She feared that on this occasion, as frequently happened, the old sexton might fail to pump enough air for the organ to function properly. She therefore wrote him a note, which was handed to him at the beginning of the service. Through a misunderstanding the sexton gave the note unopened to the visiting clergyman, who read: "Kindly blow away this morning until I give you the signal to stop." I've blown away pretty long already, so I'm going to stop before Clyde Roberts makes me do so.

Before concluding, however, I want to answer one question which some of you may have. The volume of consumer instalment credit is going to continue to grow from the present total of $3.5 billion. I should not be surprised if it reaches the 1941 peak figure of $6 billion in the next 18 months. In the years prior to 1941, the volume of consumer instalment credit amounted to 6 or 7 percent of the national income. With a national income of $160 billion, this would amount to $10 billion, or about three times the present total. That figure will probably be reached in the next three or four years, unless legislative or regulatory steps are taken to prevent it.

The bank share of the business may be expected to grow at a similar rate. On June 30, 1946, insured banks in these four States (Alabama, Florida, Georgia, and Mississippi) held $49 million of consumer instalment loans, as compared with $75 million in June 1941. If consumer instalment loans were to triple in this area, they would be larger than total agricultural loans are now and almost one-half of commercial and industrial loans, which is the largest category in your loan schedule.

Banks which wish to enter this business actively need not fear that those already in it have cornered all the business. But in the words of the traffic cop to the lady who failed to see the change in the lights, "It ain't going to get any greener!" In fact, competition is going to become keener. The sales finance companies have had loan fare waiting for automobile production to increase, and they are aggressive and capable. As we have already noted, competition may create excesses. It will be your responsibility as examiners to guard against those excesses, and to see that the consumer instalment activities of your banks remain on a sound basis.