FEDERAL DEPOSIT INSURANCE CORPORATION
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ADDRESS OF

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DIVISION OF RESEARCH AND STATISTICS
FEDERAL DEPOSIT INSURANCE CORPORATION

Before the

ANNUAL CONVENTION AND INSTITUTE OF INDUSTRIAL BANKING
OF THE AMERICAN INDUSTRIAL BANKERS ASSOCIATION

DENVER, COLORADO JUNE 10, 1947

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INSTALMENT CREDIT DEVELOPMENTS

I

You will be interested in a brief survey of the light shed by recent figures on the changing character of those industrial banks whose deposits are insured by the Federal Deposit Insurance Corporation. Between 1941 and 1945 the activities of insured industrial banks were drastically altered as a result of (1) war financing requirements; (2) the almost total absence of production of consumer durable goods; and (3) the desire of individual industrial banks to enlarge the scope of their activity. In the pre-war period, their assets had consisted predominantly of consumer instalment loans, and their liabilities were largely in the form of time and savings deposits. During the war years total assets rose sharply, with almost all of the increase taking the form of U. S. Government securities, the character of the loan portfolio was drastically altered, and demand deposits became almost as large as time deposits. Thus, by the end of 1945, almost 50 percent of the total assets of insured industrial banks was in the form of U. S. Government securities and about 30 percent in loans. Only one-third of the loans, or about 10 percent of total assets, consisted of consumer instalment loans. This was indeed a far cry from the pre-war asset distribution!

During 1946, the total assets of the insured industrial banks showed a substantial growth, increasing 16 percent. Practically all of

the growth in total assets took the form of loans, which grew about 50 percent. One-half of the loan increase was in consumer instalment credit, one-tenth in consumer single payment loans, and the other two-fifths in real estate and commercial loans. Thus considering the group as a whole, the insured industrial banks are continuing to maintain their predominant interest in the consumer credit field, and are extending their lending activities into so-called commercial channels at a more conservative pace. The funds with which to increase total assets were derived in almost equal measure from time and from demand deposits, so that the relationship between these forms of liabilities was practically unchanged.

II

Let us now consider developments in instalment credit, first of a consumer character, then of a non-consumer character. Since the Federal Deposit Insurance Corporation is keenly interested in the soundness of the assets acquired by banking institutions, I will deal with these developments primarily from the point of view of soundness of the assets.

The period from V-J Day to the official end of hostilities was a memorable one in the field of consumer credit. In those 16 months the total volume of consumer instalment credit doubled. Starting in September 1945 from 2 billion dollars — which was essentially the lowest point since the 1941 peak — instalment credit passed the 1929 peak of 3 billion dollars by July 1946, and reached 4 billion dollars by December 1946.

As you know, non-instalment credit (single payment loans, charge accounts and service credit) began to increase earlier than instalment credit. Over the same 16-month period, such non-instalment credit rose from 4 to 6

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billion dollars. Thus by the end of 1946, total consumer credit (instalment and non-instalment combined) had practically re-attained the 1941 peak of 10 billion dollars.

The very rapidity of the increase in consumer credit has caused some question with respect to its desirability. Throughout this period, terms were limited by Regulation W. With that limitation on down payments and repayment periods, with the high level of business activity and employment, and with reasonable judgment in selection of credit risks, it is clear that the credits were destined to be promptly and properly repaid. So, from that point of view, no unsoundness is involved. However, from the point of view of the nation as a whole, such a rapid and large growth in consumer credit — or in any credit — was undesirable, to the extent that it provided purchasing power which exerted upward pressure on prices, particularly those of temporarily scarce goods.

With the passage of time, we may expect the volume of consumer instalment credit to continue to grow, for the present total is small in relation to our post-war level of national income. Re-attainment of the pre-war relationship, which may be anticipated for a number of reasons, will require consumer instalment credit to grow eventually to two or three times its present level, even with little or no further increase in the national income. When those durable goods, for which consumers have been waiting, become available in ample quantities and at sound prices, a substantial increase in consumer credit will not be unreasonable. That increase will place a responsibility on you, as bankers, to see that the individual credits granted are sound.

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III

Let us proceed to our discussion of your consumer lending activities. I shall refer first to direct lending to consumers — the traditional field of industrial banks in which you originally made your reputation. I do not need to tell you that you have done excellent work in this field. Your assets have been sound, your charge-offs have been negligible, and profits have been satisfactory. This has been true because over the years it has been your paramount consideration to insist that the borrower have a satisfactory credit standing, and ability and willingness to pay. During the recent war years, it would have taken a genius to sustain losses. Our records show that for the country as a whole recoveries on loans were greater than charge-offs on loans in insured commercial banks in each of the last four years, 1943, 1944, 1945, and 1946. Such a long period without net losses has never occurred before. It may never happen again. The continued high rate of national income and full employment have kept charge-offs at a minimum. Therefore, you should ask yourself, whether prosperity has caused you to become lax? Do you still maintain your credit files in proper shape? Are you still as careful in determining the credit standing of the borrower and his ability and willingness to pay even under adverse conditions? If the prosperity of recent years has lulled you into a false sense of security, you may have a rude awakening one of these days.

It is no news to you that banker interest in the field of consumer credit is being more and more focused on instalment sale credit, which in the past fluctuated the most widely, and which accounted for two-thirds of the consumer instalment credit outstanding at the peak in 1941. On V-J Day bankers expected sale credit, particularly automobile sale credit, to show the greatest increase in the then succeeding period. However, outstanding sale credit for

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autos and other durable goods is still well below the 1941 peak, even though cash loans and repair and modernization loans have exceeded that peak. That disappointing showing made by automobile sale credit can be attributed to the unsatisfactory increase in automobile production, and to the channelling of a relatively substantial proportion of automobiles to fleet purchasers and others for cash.

Those events have been matters of considerable importance to most banks. In common with the sales finance companies, most banks had expected automobile production to increase more rapidly, and many had geared themselves to do a higher volume of business than actually materialized. With overhead spread over a small volume, high operating costs were the result. That in turn brought rate cutting in an effort to gain a competitive advantage. It is clear that those who began that rate-cutting failed to recognize that a reduction in selling prices (in this case, interest rates) is sound only if predicated on an actually realized high volume of business. When based on the hope of a higher volume, rate-cutting is a gamble; when retaliation occurs, there is rarely any shift in business, and the only result is a smaller gross income for everyone.

When the proportion of cars financed and the volume of cars produced increase, those circumstances which have characterized the recent period will tend to reverse themselves. With more transactions, operating costs, per unit, of consumer credit departments should decline, even though there may be some increase in investigation costs and in credit losses.

In December of 1946 the scope of Regulation W was materially decreased. Some people have been pressing for its further relaxation or abandonment. If that occurs, you may expect to experience considerable

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pressure 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.

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. The longer life which cars have demonstrated during the war may well justify longer terms, just as the higher prices may require them. From the point of view of soundness of lending policy, a relaxation which takes the form of a reduction in down payments, is much more dangerous than a lengthening of the repayment period. A reduction in the down payment decreases the purchaser's equity, and this increases the likelihood of default and the rate of loss when default occurs. By way of contrast, the chief effect of a moderate lengthening of the repayment period is to increase the expense of handling a given loan.

Throughout most of the war period, used car prices were highly inflated. With increased availability of new cars, the softening in used car prices which has already become apparent will be more strongly evident. If down payments and monthly payments on new cars are reduced, used car prices will be further affected. If instalment credit terms for used cars are unduly relaxed at the same time, used car prices may be temporarily sustained at unreasonable levels. As a result, when the pressure becomes too great, severe losses on repossessions may result.

Insured repair and modernization loans more than doubled between V-J Day and December of 1946; by October of 1946 they had exceeded the 1941 peak. With total expenditures for repair and modernization work in 1947 estimated at 5 billion dollars, it is probable that such credits will in-

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crease materially as time goes on. Since the average size of such paper is substantial, and the terms long, the income in dollars is sufficiently high so that this paper—even with low volume—can be profitable. Although banks can participate through direct lending, the bulk of this paper is originated by contractors and builders, so that banks acquire it indirectly.

On loans insured under Title I of the Federal Housing Act, an unknown contingent loss has been replaced by a fixed expense. On uninsured paper, losses have been abnormally low in recent years. To keep them as low as possible, it is important on this—more then on any other type of—consumer credit paper to recognize that the integrity of the dealer or installing contractor is paramount in determining the quality of these indirectly acquired loans. The borrowers on all repair a nd modernization loans are home owners: that very fact is evidence of industry, thrift, and stability. However, poor workmanship or chicanery on the part of the contractor may materially impair what is normally a very sound type of credit. It is imperative, therefore, that banks thoroughly investigate the dealers or contractors from whom they expect to acquire such paper.

Anticipated sales of radios, refrigerators, and other electrical and gas appliances indicate that there may be a significant increase in the volume of such instalment sales credit. As in the case of automobiles, removal or relaxation of Regulation W will probably be the signal for a reduction in down payments and a lengthening of repayment terms. Again, it is the reduction in down payments which is the more dangerous. In this connection, the slogan attributed to a Grand Rapids furniture store is a tempting one: "Feather your nest with a little down." But the cartoon which reads: "$1 down and $1 when you catch me!" clearly emphasizes, that a reduction in

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down payments quickly reaches the point of unsoundness. On the other hand, with significant down payments, a lengthening of terms is dangerous only if carried to the point at which the equity value does not equal the unpaid balance.

In addition, the appliance field has its own set of problems. In view of current high prices, there is a high degree of vulnerability to the introduction of low priced economy models without "frills" and gadgets; such introduction will increase the danger of repossessions on higher priced lines, with resulting losses upon disposal. In the appliance field, there is the added danger of failure of manufacturers of off-brand merchandise, which when repossessed will have little sales value.

In concluding my remarks on consumer credit, let me re-state a few fundamentals. The determination of the credit standing, ability, and willingness to pay of the borrower, or of the purchaser of goods, in the paramount consideration; everything else is secondary. Down payments and repayment periods should always be judged with that in mind, in the individual case. Therefore, it is highly important: (1) That you keep your credit files in good order; (2) that you place the necessary emphasis on determining the borrower's willingness and ability to pay; and, (3) that the required service-interest and amortization -- on the borrower's obligations of all kinds be not too large a portion of his regular income. If credits are not up to standard on all counts, I hope you have a very strong, energetic collection department in your bank which consistently follows up on all delinquent collections. Otherwise, you are relying, in fact, on recourse to the dealer; if that is so, you will want to satisfy yourself as to the value of the

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dealer's endorsement. If you acquire paper without recourse, or if the dealer's endorsement does not add value, then you are relying upon repossession of the merchandise. Such reliance is illusory. Repossession and sale are costly; they place the bank in the merchandising business where it does not belong; when resorted to frequently, they destroy good-will in the community.

IV

Let us now consider, briefly, the central problem in connection with the floor financing of retail inventories, that Siamese twin of the acquisition of dealer paper. One point requires continual emphasis: It is essential to the satisfactory operation of the bank and of the dealer, that the latter not become overloaded with inventory.

I have no desire to make a forecast of the business outlook. However, whether we have a "readjustment", a "recession", a "depression", or a "boom", one thing is certain: At no time since December 7, 1941 has it been so essential as in recent months and in the months ahead to exercise caution in making loans which are in any way dependent for repayment upon inventory values. In the last year, we have seen a sellers' market somersault into a buyers' market in more than one commodity. So long as an unbalanced inventory situation, and a distorted price structure exist, we must expect that to continue to occur. To be most certain of avoiding loss, a bank engaged in the floor financing of inventories must <u>know</u> each separate industry involved, the character of flow of its commodities, trade trends, price fluctuations, and the credit position of the manufacturers concerned. That is a big order for a big bank, and a staggering order for a small bank.

But if we do not help the dealer to become overloaded on high-priced inventory, the danger of loss is materially reduced. Let us be speci-

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fic with respect to a few products. In automobiles we still have a sellers' market, so that overloading is not an immediate problem in the case of standard cars. But there is a definite danger today that dealers may become overloaded with slow moving deep freeze units, de luxe refrigerators, radios, and other electrical appliances. In the appliance field, particularly, bankers must proceed with caution with respect to merchandise of little known manufacturers. They may well find, if the time comes to take possession, that resale possibilities are distinctly limited. That will be especially true of "orphan" merchandise, namely, the products of manufacturers who have failed.

V

In the time at our disposal, it is impossible even to scratch the surface with respect to all types of instalment loans to business. Currently, there is evidence of a great deal of interest among bankers, generally, in equipment financing. The title of the ABA Conference at St. Louis, significantly, was Consumer - Instalment Credit Conference. One-half or more of its sessions were devoted to the financing of producers' durable goods.

There are a number of reasons why industrial banks are interested in such financing. It is most closely related to consumer instalment credit. To the extent that it involves difficult financing problems, it is a "natural" for you. With your long experience in instalment lending, you have been accustomed to making loans which the average commercial bank, through inexperience, would have refused to accept until recent years. It seems appropriate, therefore, for us to review briefly the fundamental problems involved in the financing of the purchase of equipment for business enterprises.

It will be helpful at the outset to consider the operation of the railroad equipment trust -- the proto-type of all equipment financing. Under

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the so-called Philadelphia Plan, as originally developed, a railroad wishing to purchase cars and locomotives enters into an agreement with the manufacturer who builds the equipment according to specifications. When completed, title to the property is transferred from the manufacturer to a third party, a trustee, who acts as the representative of the purchasers of equipment trust certificates. This trustee leases the equipment to the railroad, for a period as long as 10 to 15 years. Over this period the railroad makes rental payments in an amount sufficient to cover interest, plus amortization at a rate somewhat in excess of the depreciation rate. To provide a margin of safety, the railroad makes an original down payment of 15 to 25 percent.

Equipment trust certificates have enjoyed an unusually fine record, in spite of the checkered history of railroad financing. In over 50 years, very few losses have occurred. In fact, the holders of only one issue suffered a loss of principal in the period between 1931 and 1938, when 21 bankrupt railroads had 120 equipment trust issues outstanding.

This extremely strong position may be explained as follows:

(1) The equipment is essential to the operation of the railroad;

(2) Even if the railroad fails, it usually continues operation and is reorganized rather than liquidated;

(3) Railroads usually do not have a surplus of equipment, a nd connot operate without the leased equipment; and

(4) It is more expensive to secure equipment from any other source than to continue payments on the leased equipment.

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If, in spite of those facts, default does occur, the trustee can take possession of the equipment and lease or sell it to another road.

The conditions we have just described produce a practically perfect type of investment security, or a practically perfect loan. For this reason, by using equipment trust certificates, even weak railroads have been able to secure funds at relatively low interest rates at a time when they had to pay a higher rate of interest on underlying mortgage liens.

To what extent do equipment instalment loans by banks fulfill the necessary conditions for a "perfect loan"? If we are honest with ourselves, we regognize that there is practically no instance in which they do.

We have a close approach in the case of loans to finance the acquisition of streetcars and buses by city transit systems; it is true to a lesser extent of inter-urban systems or cross-country bus lines. In each individual case, however, it is necessary to determine: (1) whether the continued operation of the carrier is essential to the community, and (2) whether a surplus of equipment might develop.

A weaker situation also exists in the case of instalment loans to finance the acquisition of aircraft by passenger airlines. We have not yet seen whether the Civil Aeronautics Board will facilitate the reorganization and continued operation of a large or a small airline; or whether the franchise will be transferred to a competing line in the case of a failure. It is also possible that more than one airline will find itself with a surplus of equipment, in view of the heavy purchases which have been contracted for. As you know, the operating results for 1946 and the first quarter of 1947 have been disappointing to a number of the carriers.

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Now we could, in turn, discuss trucks financed for truckers, refrigeration equipment for food stores, air conditioning for general stores, agricultural equipment for farmers, and/or any one of the endless variety of equipment or machinery which small or large businesses may wish to acquire. In each individual case, we could examine the extent to which the conditions essential to a "perfect loan" are present. Instead, let us generalize. Rarely does an economic monopoly exist in which continued operation even after failure is assured; most businesses which fail are liquidated. You must therefore satisfy yourself in any given case, with respect to two questions: First, will the purchaser in all probability pay his contract to maturity? Second, what will the consequences be if the purchaser fails to perform?

The answers to the following questions will help you, the banker, determine whether the purchaser will pay out his contract to maturity:

(1) How essential is the continued operation of the enterprise to the community? In other words, what is its prospective earning power?

(2) How essential is the equipment to the functioning of the business? Stated differently, what effect will its absence or removal have on the applicant's earning power?

(3) Is the down payment enough to establish an adequate equity on the part of the applicant?

(4) What is the probable service life of the equipment? That depends, of course, upon the extent and character of the use to which it will be subjected.

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(5) Is the length of the repayment period commensurate with that service life? If the period is too long, the purchaser's equity in the equipment will be dissipated. If it is too short, the necessary payments will be a drain on the purchaser's working capital.

If the purchaser does not pay his contract to maturity, the bank's position will depend on the answers to the further questions:

(6) Did the bank acquire clear title to the equipment directly from the manufacturer or distributor, so that it can secure possession without difficulty? Title transferred from the purchaser, as through a chattel mortgage, may be no protection if the purchaser becomes bankrupt.

(7) Was the original transaction made with recourse? If so, the burden of disposing of the property falls upon the manufacturer or distributor where it belongs; if not, the bank is in the merchandising business.

(8) If the bank has to repossess the equipment, is it a standard product? How broad is the resale market? Agricultural equipment is the only form of equipment which has a resale market comparable in breadth and scope to that of the used car market.

VI

In conclusion, I wish to mention that I have emphasized the problems connected with recent developments in instalment lending, because those are the matters which I belive you want discussed. That does

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does not mean that I am opposed in any way to greater participation in this field by adequately equipped banks, but I think it is desirable that they do so with their eyes open.

The opportunities for profit, for service, for sound public relations to consumers are unlimited. If banks are to continue to hold their franchise to serve the public, they must provide a banking service related to the needs of the masses — businesses and consumers alike. Failure to do so has resulted in nationalization of banks in some foreign countries. But if loans are not made soundly, then the day of reckoning will come surely and swiftly, and that day will find some banks "holding the bag". The FDIC does not wish to see banks left "holding the bag" as a result of unsound loans. We know, that the bigger the bank's bag, the greater the likelihood that eventually <u>we</u> will take over the load.

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