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INSTALMENT CREDIT - OPPORTUNITY OR PITFALL

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I

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 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. Since April of this year, the total has exceeded that peak.

The very rapidity of the increase in consumer credit has caused some question as 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 <u>any</u> 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 provide the banks of this great Nation with amazing opportunities for service, for sound public relations, and, incidentally, for profit. 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 -- business and consumers alike. Failure to do so has resulted in nationalization of banks in some foreign countries.

Opportunity always brings responsibility with it. The opportunity is presented to you, as bankers, to participate fully in the increase in consumer instalment credit that can be foreseen, and in the unknown future quantity of instalment credit to small and large business. It is your responsibility to see that every sound credit is extended and that every individual credit extended is a sound one. If credits are not soundly extended, instalment credit can prove to be a big pitfall for an individual bank and a catastrophe for the nation.

With this in mind, let us question ourselves, to see if our instalment credit activities are sound -- first those of a consumer character, then those of a non-consumer or business character.

II

Let us refer first to direct lending to consumers. You are aware, I believe, that it has taken someone on the order of a genius to sustain losses on such loans in recent years. In fact, our records show that for the country as a whole recoveries on loans of all types were greater than charge-offs on such loans in insured commercial banks in each of the last four years, 1943, 1944, 1945, and 1946. Such a long period without net charge-offs has never occurred before. In the future, an alert management will be required to scrutinize credits so that charge-offs may be kept at a low level. In recent years, charge-offs were kept at a minimum with little effort as a result of the continued high rate of national income and full employment. Therefore, I should like to have you ask yourself, whether prosperity has caused you to become lax in recent years? 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 bankers have expected the greatest opportunities in the field of consumer credit to be in instalment sale credit. In the past that fluctuated the most widely, and 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 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 were 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 how great a pitfall that could be. You realize, I am sure, 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 may be no shift in business, and the only result is a smaller gross income for everyone.

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 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 result 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. 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.

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.

In radios, refrigerators, and other electrical and gas appliances there are similar pitfalls to be avoided. Anticipated sales indicate opportunity for acquiring a significant 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. Business may be stimulated by the tempting slogan attributed to a Grand Rapids furniture store: "Feather your nest with a little down." However, there is a sobering thought in the cartoon which read: "$1 down and $1 when you catch me!" That clearly emphasizes that a reduction in down payments quickly reaches the point of unsoundness.

In addition, the appliance field is probably the best illustration of another type of pitfall. 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 no other field have there been as many new manufacturers, as in the appliance field, so that here particularly there is the added danger of failure of manufacturers, leaving "orphan" merchandise behind them, for which there will be little sales value.

A particularly good opportunity for profitable activity appears to exist in the repair and modernization field. Since the average size of such paper is substantial, the income in dollars is sufficiently high so that this paper -- even with low volume -- can be profitable. Repair and modernization loans insured under the Federal Housing Act more than doubled between V-J Day and the end of 1946; by October of 1946 they exceeded the 1941 peak. On such insured loans, an unknown contingent loss has been replaced by a fixed expense. On uninsured loans, losses have been abnormally low in recent years. To keep them as low as possible, it is important on this -- more than 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 and 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. Are you avoiding this pitfall by thoroughly investigating your dealers and contractors?

In concluding our remarks on consumer credit, let us re-state a few of the fundamentals which we have developed with respect to individual products. The determination of the credit standing, ability, and willingness to pay of the borrower, or of the purchaser of goods, is 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 the determination of 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 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.

III

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. This is in part a question of the selling capacity of the dealer with changing business conditions, in part, a question of prices.

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 years, 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 specific 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. We have already mentioned the pitfall in the appliance field with respect to merchandise of little known manufacturers, namely, the danger of taking possession of "orphan" merchandise after the manufacturer has failed.

IV

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. It seems appropriate, therefore, for us to review briefly the fundamental problems involved in the financing of the purchase of equipment for business enterprises.

The best way for us to start, is to consider the operation of the railroad equipment trust -- the proto-type of all equipment financing. Under 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, and cannot 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.

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

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 recognize 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.

Now we could, in turn, discuss trucks financed for truckers, refrigeration equipment for food stores, air conditioning for general stores, 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.

(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?

I have purposely left until last, one form of equipment financing in which the bankers of America's Dairyland are intensely interested -- agricultural equipment. Such equipment has been sold "on time" by International Harvester for over a century. This can be a field of opportunity for you, or a pitfall. Let us apply the generalizations which we have just considered.

The farmer buys a farm machine to lighten his labor, reduce his costs, increase production or improve the quality of his products. He believes that the machine will return him a profit or he would not buy. It is an important function for the banker to review the farmer's calculation, and to determine the probable accuracy of those calculations in the individual case.

Payments should be arranged with due regard to the fluctuation in the farmer's income, and, on the average, should be equal to or slightly exceed the expected depreciation in value. If the payments are too burdensome, the likelihood that the farmer cannot continue the payments is increased; if payments are too lenient, the risk of loss on repossession is greater. An adequate down payment should be required to provide a margin of safety.

We recognize that the failure of the farmer will ordinarily result in liquidation of his assets. In anticipation of that event or of earlier default, the bank must look to repossession. It will be preferable, as in all cases of movable equipment, if the bank has taken title originally from the manufacturer. If the paper in question was acquired with recourse from the dealer, the bank can look to the dealer, or the dealer's reserve; if not, the farm equipment, being standard in character, ordinarily has resale possibilities comparable to those of a used car. It is reassuring to know that, in spite of theoretical defects, International Harvester has sustained losses on such transactions of less than 1 percent per year over a forty-year period.

V

In conclusion, if it appears that I have emphasized the problems and the potential pitfalls in instalment lending, that is because those are the matters which I believe you want discussed. You <u>are</u> recognizing the opportunity in instalment credit. Following the motto on the Great Seal of your Great State, you are going "Forward", aggressively merchandising credit to consumers and business. Many of you are applying the techniques to business loans which some of you have only recently learned in the consumer field.

Those techniques have been previously used by specialized credit agencies. None of those specialized agencies, however, have had the opportunity to practice those techniques on as wide a scale. The insured commercial banks alone can bring _all_ banking facilities to _all_ the people and to _all_ business. Through serving the needs of the masses, the insured banks can show that the free enterprise system makes unnecessary, and unwise, the nationalization of banking facilities.

You have the opportunity to provide mass banking facilities and thereby to strengthen and preserve the private banking system. You have an equal responsibility -- shared with the Federal Deposit Insurance Corporation and other banking agencies -- to see that your expansion into new fields is soundly conceived and applied. For only thus can the private banking system and free enterprise flourish and contribute to the greater welfare of this great State and of these United States.