INSTALLMENT FINANCING OF CAPITAL ASSETS

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One of the most significant developments in the lending practices of commercial banks in recent years concerns the adaptation of the installment payment loan to the financing of long term credits of a capital nature on a constantly and quite rapidly increasing scale. This reflects an important change of attitude toward capital loans as commercial bank investments which warrants thorogoing consideration on the part of both bankers and bank supervisors. Such installment payment capital loans, more commonly referred to in banking parlance as "term loans", have not attracted widespread attention owing to the fact that they are centered primarily in the larger banks in metropolitan areas. This is due to the size and character of the advances. Such credits are devoted not only to financing the purchase of capital assets but are resorted to in an important degree for the refinancing of other long term indebtedness, principally bonds, and the supplying of working capital.

While the trend toward this form of financing by commercial banks is of comparatively recent origin, it had nevertheless gained sufficient prominence by 1940 that the National Bureau of Economic Research conducted a special study of term loans and in 1942 published an exhaustive and highly informative treatise on the subject under the title "Term Lending to Business". Indicative of the rapid increase in such lending is the growth in term capital loans by commercial banks which according to that study increased from $217,000,000 in 1938 to $2,162,000,000 by the end of 1940. The study further revealed that in 1940 term loans comprised 22% of the total loans in 50 of the larger commercial banks of the country and in five of the largest banks such credits comprised 30% of the loan total. Furthermore it is to be borne in mind that these figures were compiled prior to our entry into the war and are not colored by war time financing. Current information submitted by the largest bank in New York as to the volume of term capital loans presently carried indicates that as of 12-31-45 such credits comprised 25% of its loan account and 5% of its total resources.

A significant feature of such lending activity is its highly specialized character which entails the preparation of elaborate loan agreements tailored to the individual requirements of each situation. The preparation of such loan agreements is a highly technical function entailing exhaustive preliminary studies and investigations requiring not only the highest order of credit knowledge and experience, but also a knowledge of other specialized fields such as engineering and technology and a broad familiarity with this form of financing. It is readily apparent, therefore, that the number of banks possessing the trained personnel necessary to a proper administration of this highly specialized form of financing is limited and is confined to the larger institutions. It does not necessarily follow, however, that banks not so equipped will refrain from engaging in this form of lending and the greater hazard lies in that direction as will be noted a little further on.

The study conducted by the National Bureau of Economic Research previously referred to, reveals considerable variation in the period of time over which such credits extend but maturities from 5 to 10 years bulk heavily in the total with very few exceeding the latter limit. The report also shows considerable variation in the amortization of such loans and while equal installment payments over the life of the loan is the predominant plan of amortization, the "balloon" type note is reported employed to the extent of 29% of the dollar volume. Lenders quite generally recognize the additional hazard which attaches to the use of the balloon type contract, but such fact has not been a deterrent to a rather liberal use of this form of note in the granting of term loans. It is also well to note that it has not been the practice to establish specific reserves against loans of this type, either individually or as a group, but rather to rely upon unallocated general reserves to absorb any losses which may develop in such credits.

The marked trend in recent years toward long term financing of business requirements may be attributed in a considerable degree to the compulsion under which banks in general have been to find profitable sources of employment for an excess of loanable funds arising out of a constantly expanding deposit volume and a drying up of the demand for short term credit. The fact that well over 50% of the amount advanced on term capital loans by commercial banks at the end of 1940 was for refunding of other long term obligations, principally bonds, is quite significant and would seem to support the belief that the lending banks have not only welcomed but have strongly encouraged this form of financing. In this connection it is well to note that the higher yield received on term capital loans over that received from the ordinary commercial loan is an important factor in the growth of such credits. It is also well to observe that the somewhat higher interest rate on such loans is, nevertheless, often less than t e interest rate on the bonds refunded by this means, thus the borrower also stands to benefit by the transaction. A further factor which has lent impetus to this form of financing is the means thus afforded of escaping the requirements imposed under the Securities and Exchange Act which are avoided in the employment of direct bank credit in such borrowing operations.

A highly significant aspect of such refunding operations is the opportunity presented of converting securities carrying a substandard rating into term loans which assume the status of approved bank credits without any fundamental change in the credit quality of such obligations. While there are no available statistics to indicate the extent to which substandard securities have been converted to term capital loans, recognition is given to the existence of such practice in a treatise on term lending prepared in 1944 by Irvin L. Porter, Vice President of The First National Bank of Chicago, an exponent of term capital loans for a number of years. While no fixed conclusions can be drawn in this direction it can be safely stated that the opportunity for conversion of substandard securities into what may be considered approved credits in the form of term capital loans is present to such degree as to warrant serious reflection on this phase of the matter.

As previously stated long term lending of the character under discussion is confined primarily to our larger commercial banks which in the main furnishes assurance of a generally high order of supervision both as to the origination and subsequent administration of such credits. Furthermore, the great bulk of such loans have been to larger businesses with long records of successful operation which tends to materially lessen the risk inherent in long term lending.

While the experience to date with term capital loans may be said to be on the whole eminently satisfactory, it is to be recogniz ed that the history of such credits covers a span of hardly more than one decade all of which has been in a period of an expanding economy and therefore such credits have not undergone the test of unfavorable economic conditions. This latter fact is well recognized by the more conservative operators in this field of financing and has caused special consideration to be given to the distribution of risk through the formation of "credit groups" or "credit pools" among many of the larger banks in the metropolitan centers thus enabling the associated banks to participate jointly in the financing of large term loans. Such action not only reduces the risk to each institution but also results in a greater degree of diversification in such credits. There are other important advantages to such cooperative action aside from the principal objective of distribution and diversification of risk, one of which is the additional scrutiny to which advances so originated are subjected by virtue of the fact that they must meet the credit standards of all the participating banks. Furthermore, it enables the undertaking of financing on a scale which would be outside the scope of any one institution, and proved particularly helpful in supplying the enlarged credit needs of industry growing out of the war program.

Our discussion up to this point has largely concerned itself with the history and development of term capital loans and the experience with this form of lending during this period of its infancy which results in a generally favorable picture. Furthermore, it sould seem from the experience to date that this method of financing has contributed importantly to the development and support of the business economy and may under proper limitations and adequate safeguards represent a field for the satisfactory employment of a limited portion of commercial bank funds in those banking areas which are well equipped by training and experience to administer such credits.

However, the danger of over employment of commercial bank funds in long term capital loans even under most competent and experienced management cannot be over emphasized and there is by no means a uniformity of opinion even among the highest banking authorities as to the appropriateness of commercial banks engaging in this form of financing on any important scale. In this connection I wish to cite the diametrically opposed pronouncements on this point which were recently issued by the heads of two of the larger New York banks both of whom are recognized authorities in the banking world of the very highest ranking.

The head of the Chase National Bank, Winthrop W. Aldrich, indicates the favorable attitude of his institution toward term capital loans in the following statement:

> "It is apparent that the bulk of the credits sought by many large industrial companies will be utilized in the form of term loans, covering a period of several years and repayable in serial installments. This development confirms and accentuates a trend which started about ten years ago. It presents a major change in commercial banking practice. The Chase National Bank has been active in this new field of lending since its inception and has been employing a substantial amount of funds in medium-term loans to borrowers with a strong financial background."

In direct contrast to such viewpoint is the unequivocal statement of Percy H. Johnston, who at the date of his recent retirement as head of the Chemical Bank and Trust Company, New York, made the following significant pronouncement:

> "We view with grave apprehension the tendency of large commercial banks to invade the Investment Banking field by making long-time loans and commitments. It is our belief that such policies are unsound and, if generally followed, will bring about a non-liquid and frozen position of such institutions."

In the light of such forthright statements representing as they do two schools of thought in respect to the subject of our discussion, we can ill afford not to take full cognizance of the growing importance of this form of financing by commercial banks and the possible far reaching effect thereof for either good or ill upon the banking structure of the country as a whole.

In weighing the hazards which are involved in this trend toward long term financing by commercial banks it is well to note that even among larger institutions the possibility is present os such loans being fostered and administered on an unsound basis. This is well illustrated in the case of a large national bank on the west coast which exercises a dominant position through the operation of an extensive chain of branches and has inaugurated an all out effort to promote term loans to business, both large and small, on the general poemise that such credits can be originated and administered enbloc upon the same principles which apply to installment payment personal and consumer credit loans. That is to say the emphasis is to be palced on volume rather than credit quality upon the theory that the law of averages can be relied upon to limit losses to reasonable proportions as in the case of personal installment payment loans. The fallacy of such reasoning and the inherent danger in its application to large long term credits is most obvious and in a recent report of examination of this bank the examiner offers the following significant observations on this phase of the bank's loaning activities:

> "Officers express a belief that term loans will make up a large part of future lending operations, and have even outlined a campaign to push term loans to small businesses under the head of the instalment loan department. In a

> number of such advances already made they have proceeded with little or no regard for the stability or earning record of the concern, and with little more concern for the legality of security taken. If this whole idea is pushed with the determination now expressed, a serious accumulation of grief can easily result. Their thinking apparently has been warped by bank's success in handling personal loans on a bulk basis, depending on the law of averages. In this connection, from a theoretical standpoint it seems to the examiner that term loans, being usually neither real estate loans nor bond issues but partaking of the dangers of both, will need controlling by statutory restrictions before they come to form any appreciable part of bank assets."

While this represents an isolated case, it is indicative, nevertheless, of the danger and hazard which attaches to lending operations of this character in the hands of overly optimistic or inexperienced management and with the steadily widening interest being manifest in term loans it is most important that supervisory agencies should be keenly aware of the possiblities for the development of unsound and unwarranted loaning activities in this particular field. As more and more banks are attracted to this form of financing and, as banks of smaller size which are ill equipped both as to trained personnel and by experience to originate and administer such highly specialized form of credits undertake such financing operations, we may expect serious and far reaching problems to develop therefrom. The entrance of the banks of lesser size into this field entails not only the greater hazard which arises from their inexperience and lack of personnel trained in the intricacies of this highly specialized form of financing, but also embraces the further hazard which the financing of relatively small businesses entails over that involved in loans to larger nationally known businesses which occupy a secure position in our overall economy.

It is only necessary to recall the sad and costly experiences which a few years back attended the entrance of many banks without due preparation or experience into the specialized field of consumer credits, to visualize the even greater and more serious problems which might result from the embarkation of banks generally into this lending field of far greater specialization. It is needless to point out the greatly increased potentialities for loss and the more vulnerable position of such capital credits in inexperienced hands, due to the much larger amounts involved and the extended period over which the loans must be carried. It is also to be noted that large scale diversion of bank credit to long term capital loans in a period of an inflated economy such a spresently exists, tends to contribute to the inflationary spiral which so seriously threatens the foundations upon which our individualistic system rests.

Due to time limitations our discussion of this important subject has been limited to the consideration of certain of its major aspects which serves only to high-light some of the more pertinent factors involved. In summation of this limited presentation of the subject I should like to offer for your consideration two general conclusions as follows:

1. In view of the highly specialized character of this form of financing, it would seem that such long term lending by commercial banks should be undertaken only under the auspices of those who by training and experience are fully qualified to originate and administer such credits.
2. Due consideration should be given to the extent to which commercial bank funds may be properly and safely devoted to the

financing of such long term capital requirements, with due regard given to its effect upon the relative position of the individual bank concerned as well as its overall effect upon the commercial banking structure of the country as a whole.