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THE QUALITY OF CONSUMER LENDING

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THE QUALITY OF CONSUMER LENDING

When debt is large, the quality of lending calls especially for candid examination. This is true of credit in general, and of bank credit in particular. Bank credit is one of the most vital elements in our economic system. In managing this credit, bankers direct a flow of purchasing power into the areas of greatest need and demand. For instance, the consumer credit that you administer influences the demand for consumer goods. By and large this influence is salutary; generally speaking, what is good for consumer banking is also good for the economic system. This is true, however, only if financial institutions acquire their consumer paper from those dealers who remember their proper function is to sell real goods that satisfy people's wants, rather than to sell credit terms. Also the general welfare is enhanced only if direct consumer loans are to those consumers who provide assurance of repayment. Before discussing the quality of consumer instalment credit, I shall review briefly its past growth and its prospects.

Developments Affecting Quantity of Credit

In recent decades the role of consumer instalment credit has increased markedly. In 1929, it amounted to 4 per cent of disposable income; in 1940, 7 per cent; and today it is 11 per cent. Repayments took 6 per cent of income in 1929, 10 per cent in 1939, and 13 per cent now. For the half of our citizens who have such debt, at least one-fifth of their incomes is devoted to repayments. The present level of outstandings and contractual payments may be approaching a limit relative to income that is dictated by the prudence both of lenders and borrowers.

About 9 per cent of our income is probably being devoted to servicing the debt incurred to buy durable goods. The proportion of income used to service this debt can be increased only if the proportion used to buy nondurable goods is cut. If purchases now paid for out of current income are made on a revolving account basis, or with the proceeds of cash loans, an increasing portion of income would be devoted to the servicing of debt. However, the kind of purchases made would not necessarily be disturbed.

In the 1920's when consumer instalment credit was experiencing its first great growth, it was an exceptionally expansive force in the economy. Also during most of the 1930's, its role increased relatively. During World War II, however, it fell to very low levels with the suspension of production of consumer durables and the increasing liquidity of the consuming public. Its great growth since the war was in part a reaction to its wartime atrophy, and in part a continuation of its secular growth. Is this rapid postwar growth nearing an end? If consumers have now built up their stock of durable goods to a desired relation to income, and if the liberalizing of terms is approaching a practical limit, the consumer debt may grow little faster than income.

One of the most interesting credit developments in recent years has been the revolving credit account, used primarily by the department stores. While revolving credit has made a rapid growth in the past few years it is not yet a large percentage of total consumer credit. It is estimated that the receivables on revolving credit plans at department stores and mail order companies currently amount to between $300 and $400 million. This is about 20 per cent of all outstanding department store credit but less than 1 per cent of total consumer credit. These estimates do not include revolving credit plans at other types of retail stores. No separate information is available for them.

Revolving credit is statistically and conceptually included with "other consumer goods paper" though some of it might erroneously be reported as charge accounts. In either case neither of these categories has been very dynamic in the past few years. Charge account credit has increased 6 per cent during the past year compared with 5 per cent increase in national income. Instalment credit for the purchase of consumer goods other than autos increased 5 per cent. The development of revolving credit has apparently not been a major factor in the expansion of total instalment credit during the last three or four years.

Closely related are the instalment cash loans that have been growing, during the past two years, at an annual rate of about 14 per cent. Their growth has been more rapid than that of other types of instalment credit and now equals 2.6 per cent of disposable income. The rapidity of this rate of growth raises interesting questions as to the cause and probable duration. Personal cash loans, as well as revolving credit, may be used to postpone the payment for purchases that have usually been paid for in the past out of current income. To the extent that they are used for such postponement of payment rather than for emergencies or purchases of exceptional size they merit a critical review. Financing of the purchase of items to be consumed shortly after acquisition cannot be supported by the same reasons used to explain the use of credit for buying expensive durable goods.

Another factor is the changing age distribution of the population. Consumer credit seems to be used especially by young families when they are getting established and building up their stock of durable goods. Just as rapid family formation during the postwar period has helped expand consumer credit, its expansion during the next few years may be dampened by the low birth rate of the 1930's. But when the higher birth rates of the war and postwar years are reflected in higher family formation the rapid expansion of instalment credit may be resumed.

Some rather striking changes have occurred since 1939 in the distribution of consumer credit among various classes of holders. Most marked has been the decline in the portion of credit held by retailers from nearly a third at the end of 1939 to about 12 per cent at the present time. As a reciprocal, of course, the financial institutions have increased their holdings from 68 per cent to 88 per cent. Sales finance companies and small loan companies are holding 29 and 10 per cent respectively much the same as in 1939. Credit Unions have increased their share from 3 to 7 per cent. Commercial banks have increased their holdings most strikingly from 24 to 38 per cent. The percentage held by commercial banks has been rather stable for about 10 years and there is no apparent reason why it should change substantially in the near future.

Another way of looking at consumer debt is as an investment outlet for saving. Although most saving finds outlets as business capital or as government debt, some is invested in consumer debt and in consumer durable goods. This last outlet for saving has been quite important for the past 12 years. After the war, stocks of goods needed to be replenished; then people wished to improve their physical well-being. Now that stocks of goods in the hands of consumers have reached their present high level, whether measured in relation to income or to total wealth, it may be that this type of investment and debt will cease to rise at a rate greater than that of other investment and other debt.

The expansion of instalment credit has been aided by progressively longer maturities and lower down payments. Over a period of 30 years standard maturities on new auto paper have grown from 12 to 24, then to 30, and now to perhaps 36 months. In 1955 when the use of the 36-month maturity first became frequent, it was not clear just when and how the progressive liberalization of maturities might end. But the good judgment of lenders did stabilize maximum maturities at 36 months; for two years now little inclination to exceed this limit has been evident. Despite the increasing proportion of business done at the maximum terms, no evidence has appeared as yet that delinquencies, repossessions and losses have been greater on this long-maturity paper than on short when careful quality standards are used and adequate downpayments are obtained.

While average maturities on new car paper appear to have continued to increase, the amount of credit granted in relation to car value seems to have stabilized. In 1955 a sizable proportion of loans were large relative to the value of their security. After the great splurge of 1955, the proportion of these very liberal loans was reduced somewhat, and has since remained stable. Time may disclose that too many loans are still being made in excess of automobile wholesale value, but the business judgment of lenders will doubtless inhibit any considerable volume of such liberal loans from being made again. Mr. Homer Jones of the Board's staff holds the view that loans which are extremely large in relation to value of the security have proved more risky than have those with extended maturities, provided the borrower has a reasonable equity. This experience since the summer of 1955 may explain why loans that are large relative to value have declined in volume, whereas the proportion of 36-month maturity auto loans has steadily increased.

Liberalization of terms seems to have been associated in recent times with the increase in amount of credit granted and outstanding. When terms were lengthened markedly in 1952, credit outstanding rose rapidly. When maturities lengthened and loan ratios were liberalized in 1954-55, outstandings mounted again. The rate of increase in 1956-57, though more gradual, has still been about 8 per cent a year, and considerably greater than that of income. This gain of the past two years has been made possible by the increased proportion of paper written on a 36-month basis. With stabilization of average maturities and with reasonable business and price stability, the rate of growth in credit outstanding may decline.

The Quality of Credit

Experience with these more lenient terms appears to have proven reasonably good. The American Bankers Association series on delinquencies has remained at a low level; repossessions and losses have not presented a problem so far. However, some lenders may have been suffering repossessions that, in view of the strength of the used car markets, have not resulted in substantial losses. But if incomes should decline, or if prices of used cars should fall, the repossession rate would be likely to increase and the loss per car to rise.

How the present volume of consumer credit might fare in a downward movement of business activity or of prices might well be pondered. Consumer credit has had a favorable experience in past recessions, notably in 1929-33. In fact the experience with it has been better than with most other kinds of credit. However, in 1929 instalment credit outstanding amounted to only 4 per cent of disposable income; today it is 11 per cent. At that time, maturities on durable goods paper seldom exceeded 12 months; now 36 months is not uncommon. Down payments then were doubtless more substantial; the buyer's equity in the goods purchased, larger. The proportion of their incomes that consumers devoted to the servicing of instalment debt was much smaller then than now. In no field of finance have the volume and terms so altered since 1929. But it is possible that the good experience of the past may have led to volume and terms that are imprudent. It would indeed be unfortunate if this type of credit, which is such an integral part of the economy, should now prove less safe. These are not conclusions but questions. There must be some prudent limit to the maturities of loans made to buy rapidly depreciating goods, and to the amount of loans in relation to the value of security. It may be relevant to ask whether the limits of prudence have been exceeded and whether the long run interests of the consumer lending business and of the economy call for analysis of the trends.

The soundness of the practice of lending more than the new car cost the dealer may be open to question. Not only are lenders likely to experience losses larger than they care for, but if their experience should turn unfavorable they may then become unduly restrictive in their lending policies and thus injure the sale of durable goods unnecessarily. The practice of making loans in excess of the dealer cost of the collateral might be eliminated in the long run interest of both lenders and of the economy.

You probably have seen or heard about the study of consumer credit completed by the Board's staff earlier this year. As a result of this study, the Board concluded that "special peacetime authority to regulate consumer instalment credit is not now advisable. The Board feels that the broad public interest is better served if potentially unstabilizing credit developments are restrained by the use of general monetary measures and the application of sound public and private fiscal policies." This conclusion was reached because the Board believed that, with adequate control of total bank credit, and with the following of reasonably prudent policies by lenders, the terms and volume of consumer credit would be kept on a sound basis. Your group, being directly concerned with consumer credit has a special obligation in this regard.