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What's Different about Banks—Still?

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New financial instruments, new information technologies, and a new regulatory environment have blurred the distinctions between commercial banks and nonbank financial intermediaries in the U.S. in recent years. Furthermore, just as many nonbank financial institutions have increased their use of securitization, commercial banks also have shifted their emphasis from on-balance sheet to off-balance sheet activities (Boyd and Gertler 1994).

With all these changes in the competitive landscape, it seems appropriate to revisit a question posed by University of Chicago economist Eugene Fama (1985): "What's different about banks?" That is, why don't finance companies, for example, beat out banks for the same business, since banks face regulatory costs and finance companies do not? Some economists have addressed the question by examining how specialization in certain business and consumer loans could allow banks and finance companies to cater to different clienteles. This specialization results directly from the different informational advantage each possesses regarding either the borrower or the collateral backing the loan. The relative value of this loan-specific information could determine how market shares for business and consumer loans between banks and finance companies evolve in the future.

This *Economic Letter* examines Fama's question after looking at the evolution of finance companies since the early 1960s and the extent to which they have penetrated the commercial loan market in particular. This market had traditionally been dominated by the commercial banking industry and has been less affected than either the real estate or consumer loan markets by the trend toward securitization.

Trends in finance company and commercial bank lending

In 1960, finance companies tended to be relatively small—total accounts receivable were just \$25 billion,

and their focus was generally on small consumer (often cash) loans. In the early 1960s, commercial banks competed aggressively for this business, and from 1960 to 1979, finance companies' share of total consumer lending fell from 28% to 15%, while depository institutions' share rose from 48% to 73%. (Nonfinancial businesses, including retailers and gasoline companies, once dominant players in consumer lending, have seen their share steadily erode to less than 10% today.) But finance companies were not languishing. Instead, they were taking advantage of the rapid growth in the commercial paper market in the late 1960s and shifting their lending activities away from consumer loans and toward business lending. By 1975, the volume of business lending by finance companies exceeded their consumer lending for the first time.

This trend has continued unabated to the present. In 2000, total owned and managed receivables in the industry surpassed the \$1 trillion mark versus approximately \$3.8 trillion in total loans in the U.S. commercial banking system. However, this activity is highly concentrated: according to a survey conducted by the Federal Reserve and reported by August, et al. (1997), of 1,250 finance companies identified, the largest 20 firms accounted for three-quarters of the total accounts receivable in the industry.

This growth in business lending by finance companies outpaced the growth in commercial and industrial (C&I) loans at commercial banks. While the ratio of total assets in the banking system to GDP has held steady since 1975 (after experiencing a dip in the early 1990s), the share of total assets in domestically chartered U.S. banks that is allocated to C&I loans has edged down from nearly 16% to 14.5% today. This decline was due in part to the surge in commercial lending in foreign bank affiliates during the 1980s (McCauley and Seth 1992). However, finance companies, which once played a very minor role in business lending, have now captured a very significant market share. Today, their volume of non-securitized business loans is roughly equal to one-half that of domestically chartered U.S. banks, and perhaps as much as one-third that of the banking industry, once foreign bank affiliates are included in the count.

How are commercial banks different?

Fama offered the following observation on the uniqueness of banks' commercial lending activities. Bank loans represent a short-maturity funding source that requires frequent renewal. Therefore, banks are on the front line of establishing and continually reevaluating the creditworthiness of firms. A bank's willingness to lend to a firm is a valuable signal that is readily observed by the capital markets and by other potential creditors to the firm, as well as by the firm's clients and suppliers. Fama notes that it is common practice for many firms to incur the cost of establishing a line of credit with a bank, even though they may never intend to use it, in order to ensure that this signal is being sent. Bank loans play a similar role in establishing the creditworthiness of households. But why are banks especially well positioned to perform this monitoring activity? Several of the reasons below focus on the unique ability of a bank to offer demand deposits.

Black (1975) has argued that a bank can monitor a borrower relatively cheaply by observing the way the borrower manages its demand deposit accounts—traditionally, maintaining such an account is common practice for the loan recipient. In addition, a bank provides other financial services to a corporate client, such as managing its accounts receivable or managing the risk of a portion of its asset portfolio. The sum total of these activities, often referred to as "relationship lending," gives the bank an informational advantage over finance companies. Bolton and Friexas (2000) point out that, if the borrower is in financial distress, the bank, as a "relationship lender" which has superior knowledge of the borrower's future prospects, may deem the current weakness to be transitory. In this case, the bank would choose to refinance the firm's debt rather than force the liquidation of the assets. This aspect of relationship lending is obviously of value to the firm, and it applies equally well to households.

Others have stressed the importance of the lender having superior knowledge of the "second best" use of

the collateral backing the loans, which the bank would have to liquidate if early termination of the loan were required. There are two issues here. First, borrowers know that lenders who do not have full knowledge of the “second-best” use of the collateral will be very reluctant to foreclose on a loan. Consequently, a borrower in difficulty may be able to renegotiate the loan with more favorable terms than were warranted by the level of default risk when the loan was originated. To avoid such a renegotiation, banks need a “commitment mechanism.” One commitment mechanism, discussed by Diamond and Rajan (2001), is the demand deposit contract; it requires the bank to meet withdrawals on demand. If these withdrawal demands are sufficiently high, the borrower realizes that the bank must liquidate the assets and sell off the collateral. This commitment mechanism may be somewhat less credible for finance companies, since they are unable to issue demand deposits, although a large share of their funding is from short-term commercial paper.

Second, knowledge of the second-best use of the collateral allows room for finance companies to compete with banks in commercial lending. As described below, finance companies may specialize in certain categories of loans for which they have more information than banks would about the value of a loan's collateral. This informational advantage could outweigh the information value of being a relationship lender, thus enabling banks and finance companies to coexist. The importance of relationship lending and collateral-specific knowledge also applies to the origination and monitoring of consumer loans.

How are finance companies different?

Finance companies raise funds primarily by issuing debt instruments in the credit markets consisting of commercial paper and bonds, with small percentages raised from bank borrowings and equity. These funds are used principally to finance consumer loans and business loans and, to a lesser extent, real estate loans. The focus here is on the on-balance sheet non-securitized consumer and business loans, which constitute approximately 85% of the finance companies' aggregate accounts receivable. In recent years, finance companies have securitized various pools of their assets, thus taking them off balance sheet.

An examination of the accounts receivable of finance companies reveals that, indeed, collateral-specific knowledge appears to be an important determinant of the kind of lending they do. For example, consumer lending by finance companies is dominated by auto loans and leases, many of which are originated by finance companies that are captive businesses of the large auto makers. Similarly, a significant portion of their business lending is for auto loans and leases, some of which is dealer inventory financing. However, the majority of business lending is for equipment loans and leases for which specialized monitoring by finance companies is feasible. For example, many large firms, such as Caterpillar, operate their own captive finance company through which business loans are extended for the purchase or lease of equipment produced by the parent company. This type of specialization provides expertise in assessing the true market value of the equipment and thereby reduces the cost to the finance company of liquidating the assets in the event of default.

The information advantage that accrues from specialized monitoring, which is often accompanied by collateral-specific knowledge, means that finance companies can extend higher risk loans than banks can. Consequently, the overall level of risk inherent in the typical business loan portfolio of large finance companies exceeds the risk inherent in the business loan portfolios of large commercial banks (Carey, et al. 1996).

Conclusions

In the early 1960s, finance companies in the United States were predominantly small firms that specialized in small consumer loans. Since then, these financial intermediaries have evolved into a \$1 trillion industry. Today, the volume of consumer lending by finance companies amounts to about a

fourth of that by depository institutions; their business lending amounts to about half of that by domestically chartered U.S banks and perhaps as much as a third of that by the banking industry, inclusive of foreign bank affiliates. How these market shares change in the future will depend largely on whether financial innovation, technological advances in information processing, and consolidation in the banking industry in the presence of deregulation reward or mitigate the informational advantages that have enabled these firms to compete successfully through specialization.

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