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CHAPTER 1

Introduction and Summary

THE \$63.5 billion of consumer credit outstanding at the end of 1962 was supplied by a wide variety of retail and financial institutions, ranging from small cooperatives to million-dollar financial organizations. It varied in form from small unsecured loans to long-term contracts of thousands of dollars protected by valuable collateral. Some of it was advanced directly to consumers and some of it was purchased from retailers in large-volume operations. As might be expected, the cost of providing this credit differed with the type of credit extended and with the conditions under which it was supplied.

The need for better information about the cost of granting consumer credit arises from many social and economic problems. Large differences in the finance charges paid by consumers for credit prompt questions about the reasons for such differences and, at times, about the "fairness" of the charges. Answers to economic questions about the growth and cyclical behavior of consumer credit depend on the extent of our knowledge of the cost of lending to consumers and the factors affecting these costs. An understanding of the consumer credit industry—its organization, structure, and forms of competition—requires knowledge about the nature of costs and the relationship of these costs to the size and institutional structure of the participants. The purpose of this study is to develop information that will give some insight into these questions.

The study is based on information from four major types of financial institutions engaged in extending credit to consumers: commercial banks, sales finance companies, consumer finance companies, and federal credit unions.¹ These institutions together held 70 per cent of all consumer credit and 90 per cent of all instalment credit outstanding at the end of 1959.² Commercial banks held the largest share of outstanding instalment credit—38 per cent; sales finance companies held 26 per cent; and consumer finance companies and credit unions each held slightly less than 10 per cent.

Data were obtained for nine commercial banks, ten sales finance companies, nine consumer finance companies, and all federal credit

¹ The study supplements and brings up to date an earlier study of consumer credit cost conducted by Ernst A. Dauer for the National Bureau and entitled *Comparative Operating Experience of Consumer Instalment Financing Agencies and Commercial Banks, 1929-41*.

² Outstanding instalment credit at the end of 1959, the last year covered by the study, amounted to \$39 billion.

unions.³ The agencies included held one-fifth of all instalment credit outstanding at the end of 1959 and one-fourth of the credit held by the type of institution they represented. Although the samples covered a relatively small number of companies, they accounted for more than half of the consumer credit in their segments of the industry, except the sample of commercial banks which held only 7 per cent of the consumer credit held by all banks. A description of the samples and of the processing of the data is presented in Appendix A.

The institutions covered by the study operated in very different legal and institutional environments. None of these companies engaged solely in lending to consumers. All of them made other types of loans, provided insurance, or engaged in other activities. In some cases, consumer credit was a relatively small part of their total business.

The integration of consumer credit with the other activities made it difficult to isolate the cost of consumer credit operations. The scope of the investigation was necessarily limited by the availability of accounting information and by the difficulties and perplexities of standardizing the information from various sources. In many cases, cost accounting records had to be used to separate the cost of consumer credit operations, and, in some cases, estimates of certain types of costs had to be prepared.

The word "cost" means many different things to different people. The lender views cost as the part of the finance charge that has to be used to cover expenses. The economist views cost as including "normal profit," which is defined as the return on capital that is essential to the retention of funds in the industry. In a competitive industry, extraordinary profits or less than normal profits exist only during the short run either for the individual company or the industry as a whole. Extraordinary profits attract new funds and less than normal profits lead to the withdrawal of funds. For purposes of this study, the lender's profit was regarded as an element of cost although profits are shown separately as well.

Companies that engage in providing joint services or products have some freedom in their pricing policies. As a result, the profits on any one type of joint activity, such as consumer credit, may be more or less than those required to produce a "normal" return on the company's net

³ Credit unions that are chartered under state laws and are nearly as numerous as those under federal charter were not covered by the study because uniform data on costs were not obtainable.

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worth. High earning on services sold with consumer credit, such as credit life insurance or insurance on the collateral, may permit the lender to offer lower rates on credit. In such cases, part of the cost of consumer credit (normal profit of the lender) may be absorbed by other activities. Or the opposite may be the case: part of cost of related activities may be absorbed in charges on consumer credit. The possibility of substitution of this type makes it necessary to examine the profits on consumer credit in conjunction with the over-all profits of the company.

Most of the tabulations in the study were developed from annual income and expense data and from end-of-year balance sheets. Averages of beginning- and end-of-year balance sheet data were used in all ratios of income and expense data to balance sheet data. Most of the ratios dealing with the cost of consumer credit are expressed in dollars per \$100 of credit receivables while ratios reflecting the over-all operations of the companies are expressed in percentages.

Financial ratios for banks and finance companies were calculated from these statements for each company and simple arithmetic averages of all sample companies were computed to represent each type of financial institution. Thus, each company receives an equal weight in the average of financial ratios, regardless of its size. This system of weighting the sample companies as units instead of by dollar volume of credit was adopted to avoid domination of income and expense relationships by the largest firms in samples of nine or ten companies. Weighting each company equally, on the other hand, gives the smaller companies greater weight in the averages than is justified by their size. Since the finance company and bank samples were drawn primarily from large firms, the unit weighting was considered a better representation of the rate-cost relationships characteristic of the institutional framework. In certain instances, notably those dealing with average charges, alternative calculations are given with each company weighted by its receivables in order to illustrate differences attributable to the method of weighting.

Financial ratios for credit unions, on the other hand, were available only from aggregate data which give each credit union a weight according to the dollar amount of each item included. The differences involved in a comparison of credit union averages with those of other institutions with different unit weights are minimized by two considerations. First, the credit union sample is large and representative since it includes all federally chartered credit unions, and, second, variations in size among credit unions are less than among banks and finance companies.

Summary

Average finance charges on the consumer credit provided by the four types of institutions studied varied from \$24 per \$100 of credit outstanding for one type to \$9 for another in 1959. Most of the variation in finance charges was attributable to differences in operating expenses, rather than to differences in nonoperating expenses including the lender's profits. The profits of the stockholder-owned institutions averaged 9.9 per cent of net worth, which was within the range of profits recorded by manufacturing corporations.

Among the four types of institutions, operating expenses, which ranged from \$3.30 to \$14.25 per \$100 of outstanding credit, were found to vary directly with finance charges. Many factors contributed to the spread in costs. The method of acquiring business, whether obtained directly from the public or indirectly from dealers, caused variations in advertising and occupancy expenses. Differences in the character of risks were reflected in loss ratios ranging from 15 cents per \$100 of outstanding credit at commercial banks to a figure eleven times as large at consumer finance companies. Variations in the size of credit contracts resulted in differences in the number of contracts that had to be handled for a given dollar volume of credit and in the cost per \$100 of credit outstanding. It was estimated that in 1959 the sample consumer finance companies, which had the smallest average contract size, handled twenty-three contracts for each \$10,000 of new business while commercial banks handled less than half that number. Legal provisions controlling operating practices and assistance provided by members and sponsors of credit unions added to cost differentials.

Smaller, but still significant, differences in the cost of providing consumer credit were traced to the methods of financing and to variations in income tax provisions. The four types of institutions obtained equity and nonequity funds from many different sources. The cost of nonequity funds ranged from 1.2 to 4.6 per cent. The effectiveness with which they were able to use resources and the extent to which they were able to obtain debt financing affected the cost of money used in providing credit to consumers.

The study revealed several trends in finance charges among the sample companies during the rapid growth of credit in the 1950's. First, the average finance charge at both types of finance company and federal credit unions declined during this period. Sales finance companies experienced the largest decline. Second, the average finance charge at

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commercial banks increased during the last five years of the 1950's, reflecting both an increase in rates by type of credit and an increase in the proportion of personal loans included in the average. A third trend, reflecting in part the first two, was a decrease in the spread in rates between the highest-cost and lowest-cost institutions.

These trends developed during a period when all segments of the industry were participating in a threefold expansion of outstanding instalment credit. The share of the total held by commercial banks and both types of finance companies showed little change, but the share of credit unions increased from 3.8 to 8.4 per cent of the total during the 1950's.

The sample finance companies and federal credit unions were able to reduce operating expenses per \$100 of outstanding credit during the 1950's despite increases in wage rates and other prices. This reduction was possible in part because of an increase in the average contract size and in the accompanying decline in per dollar handling costs. In contrast, operating costs at commercial banks increased slightly during the last half of the decade, despite increasing contract size.

Only minor changes in the composition of costs were observed. Advertising costs decreased slightly at consumer finance companies but increased at sales finance companies and banks. Other operating costs varied with changes in total expenses.

The sharp rise in general interest rates during the 1950's added to the cost of nonequity funds used in instalment lending. The impact of this change was particularly strong at both types of finance company and resulted in a reduction in their profits. They were able to mitigate the effects of rising interest and other expenses on profits by increasing the proportion of debt to equity financing; by using resources more efficiently, i.e., by reducing the proportion of assets held in nonearning forms; and by improving their earnings from activities other than consumer credit.

The cost of nonequity funds increased at both commercial banks and credit unions as a result of higher interest rates. But the effects were much less important than in the case of finance companies. Commercial banks were affected by rising rates only as they paid more for time deposits. Nonequity funds were of minor importance to credit unions and they were more than able to absorb the increased cost of these funds by a reduction in the cost of their nonearning assets. At both commercial banks and federal credit unions, the increase in general interest rates provided a higher return on the nonconsumer assets which more than offset the effects of higher costs of funds on their over-all return.