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CHAPTER 2

Consumer Finance Companies

CONSUMER finance companies engage primarily in making personal loans to consumers and are identified and defined by their operations under state small-loan laws. Although these laws differ in detail from state to state, they are similar in content and scope. They provide for the licensing and supervision of small-loan operations and specify many of the terms and conditions of the loans. Licensing requirements include proof of the character, fitness, and financial responsibility of the applicant and frequently call for evidence that the proposed office will result in "convenience and advantage" to the community. The regulatory provisions of these laws set maximum rates of charge, usually scaled downward as the size of the loan increases; regulate fees; establish ceilings on loan size; and frequently specify the methods that can be used in computing finance charges and many of the operating details of extending and collecting credit.

Consumer finance companies held $3.3 billion in consumer loans at the end of 1959. They ranged from large nationwide companies with hundreds of millions of dollars in loans to single-office operations with only a few thousand dollars in loans. This study covers nine large companies that were willing and able to provide the detailed cost data. They do not necessarily represent all segments of the industry. The companies included, however, held 70 per cent of the loans of all consumer finance companies at the end of 1959 and represented a sizable segment of the industry. The sample is described in greater detail in Appendix A.

Extent of Specialization

Although consumer finance companies operate primarily under state small-loan laws, most of them have diversified their operations to some extent, and nearly all of them now provide credit life insurance, purchase sales finance paper, or make additional loans under other state laws. Some of these activities may be handled by a subsidiary or by the parent or operating company. All of the companies covered by the study engaged in some activities other than lending under small-loan laws. Most of them made other types of loans or purchased automobile or appliance paper. They all provided credit life insurance for their borrowers.

The companies included in the study invested 87 per cent of their assets in consumer credit receivables in 1959 and 1 per cent in other earning assets of all types (Table 1). The proportion of consumer lend-

TABLE 1

USES OF FUNDS BY CONSUMER FINANCE COMPANIES, END OF 1959
(per cent)

Item	Mean Distribution	Range of Ratios[a] Maximum	Range of Ratios[a] Minimum
Earning assets, net	87.7	94.6	82.0
Consumer credit	86.5	94.4	80.0
Automobile paper	1.8	15.7	0
Other consumer goods paper	6.8	21.5	0
Personal loans	77.9	94.3	53.7
Other	1.2	5.8	0
Cash and bank balances	9.0	14.6	2.7
Other assets	3.3	4.5	2.2
Total	100.0	--	--

Source: Nine-company sample.

[a]Components in columns for maximum and minimum ratios are not additive as ratios for individual items were taken from statements of different companies.

ing varied slightly from company to company, but in all cases dominated their lending activities. The company most engaged in other activities had only 6 per cent of its funds invested in nonconsumer credit or in other earning assets at the end of 1959.

Consumer credit receivables of the companies surveyed were highly concentrated in personal loans. Such loans on an average accounted for 78 per cent of total assets and nine-tenths of their consumer receivables in 1959. However, one company reported only 54 per cent of its assets and three-fourths of its consumer receivables in personal loans.

Gross Finance Charges

Gross finance charges averaged $24.04 per $100 of outstanding credit at the nine sample companies in 1959.[1] At individual companies, average charges ranged from a high of $31.58 to a low of $20.02. Nearly all of this amount was received by the consumer finance company in the form of finance charges or fees. A small amount, estimated at 17 cents per

[1] Weighted averages based on the dollar amount of loans outstanding at each company show slightly different levels and changes (see Table 35).

$100, was credited to retailers under dealer participation agreements in connection with purchases of instalment contracts.

Although these charges cover all types of consumer credit held by these companies, they do not differ greatly from the average for personal loans. Gross finance charges on personal loans at consumer finance companies averaged $24.89 per $100, or less than a dollar higher than the average for loans of all types. Charges on other types of loans were not computed separately because the outstanding amount of such loans varied so widely over time that reliable rates could not be computed from averages of year-end figures.

Finance charges at consumer finance companies declined steadily during the eleven years covered by the study (Chart 1). From 1949 to 1959, the average charge decreased by $2.03 per $100, or 8 per cent. This decline followed a longer-run trend that began in the midthirties. The gross finance charges at the two largest companies, as measured by the ratio of total earnings to average receivables, declined from $35 per $100 in 1933 to $30 in 1941 and to $21.74 by 1959.[2] Data for another group of companies show a similar trend, but completely comparable data are not available for an accurate comparison.

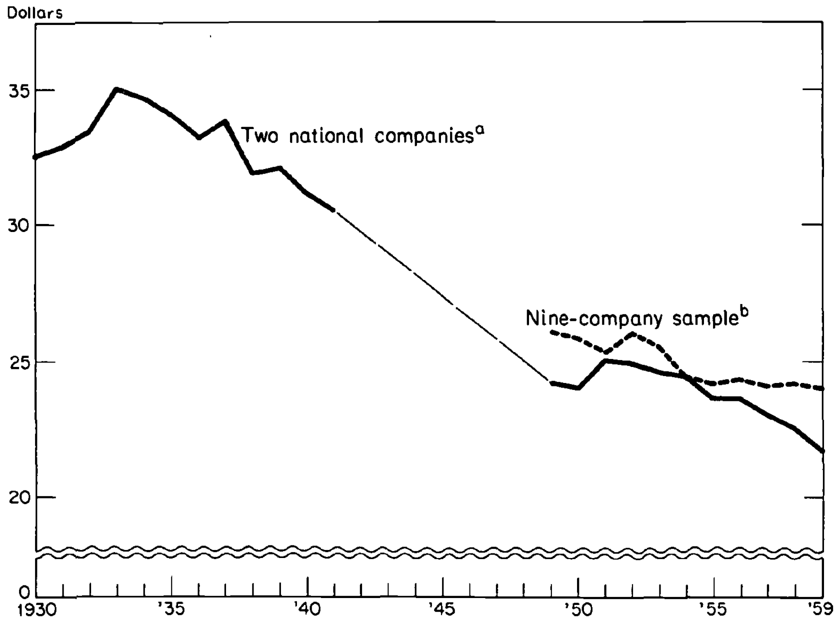
The increase in the average size of loan probably played a major role in the decline in finance charges at these companies. The increase was 2.7 times from 1939 to the end of 1959 and 70 per cent between 1949 and 1959.[3] This expansion in loan size reflected both an increase in legal ceilings and the demands of borrowers. The larger loan size permitted a reduction in the per dollar handling costs and, in states with graduated rates, resulted in changes in the applicable legal maxima. Since graduated rate ceilings are scaled downward as the size of the loan increases, an increase in the average size of a loan reduces the average maximum charge. Although the scale of rates varies from state to state and was altered by numerous legislative changes during the period covered, the following example for the State of Colorado indi-

[2] The ratio of total income to average consumer credit receivables is not as accurate a measure as the more refined ratio of consumer credit income to consumer credit receivables used for recent periods. The difference in these ratios was small for the two largest companies, however. The average ratio of total earnings to consumer credit receivables for these companies in 1959 was $21.74 per $100 compared with the ratio of consumer credit income to consumer credit receivables of $21.62 per $100. Data for the period before 1949 were obtained from Ernst A. Dauer, *Comparative Operating Experience of Consumer Instalment Financing Agencies and Commercial Banks, 1929–41,* New York, NBER, 1944, p. 84.

[3] *The Consumer Finance Industry,* National Consumer Finance Association, Englewood Cliffs, 1962, Table 4-3, p. 59.

CHART 1

Gross Finance Charges on Consumer Credit at Consumer Finance Companies, 1930–41 and 1949–59
(per $100 of average outstanding credit)



SOURCE: Data for two national companies for 1930–41 obtained from Dauer, *Comparative Operating Experience of Consumer Instalment Financing Agencies and Commercial Banks, 1929–41.* Data for 1949–59 from information collected from sample of nine companies are reproduced in Appendix Table B-4.

[a] Ratio of total income to average consumer credit receivables.

[b] Ratio of consumer credit income to average consumer credit receivables.

cates the way in which charges are reduced as the size of the loan increases. The maximum charge on a $300 loan in Colorado is 3 per cent per month, while the maximum charge on a $700 loan is 3 per cent for the first $300, 1.5 per cent for the next $200, and 1 per cent for the remaining $200. Thus, the $700 loan costs $2.00 per $100 in the first month and the $300 loan costs $3.00 per $100.

The number of lending institutions offering services competing with those of consumer finance companies increased steadily as new credit unions were formed and as banks expanded into the personal loan field. The existence of strong competition in personal lending is widely recognized, but the impact of this competition on finance charges is not clear.

Individual companies may meet competition by rate adjustments, by changing the nature of the loans, or by improving services and customer relations.

Changes in the composition of the loans of consumer finance companies played only a minor role in the changes in average charges. Personal loans dominated the loans of these companies throughout the period studied so that changes in sales financing were not large enough to alter the over-all trend in average charges. Since the proportion of sales financing done by the nine sample companies from 1949 to 1959 declined fractionally, any effects from the shift in the type of business would be to raise average charges as sales finance contracts typically carry lower rates.

Components of Finance Charges

Gross finance charges cover the total expenses of the lender, including the cost of the owners' funds used in the business (lender's profit) and the share of the total charge paid to dealers. The distribution of these components for the nine sample companies in 1959 is shown on Table 2.

The principal expense items in consumer credit lending are investigating credit applications, maintaining records, seeking new business, and collecting loans. These operating costs differ widely from one company to another and depend upon the type of business conducted by the company, the type of service rendered, and the efficiency and skill of the management. The operating expenses of the sample companies amounted to three-fifths of the total finance charge and averaged $14.25 per $100 of outstanding credit. They ranged from a minimum of $11 per $100 to a maximum of $20 per $100 at individual companies.

The cost of the funds used in lending to consumers accounted for about 30 per cent of total finance charges. Funds were provided by the owners and obtained from the public or other financial institutions. The total cost of funds in 1959 averaged $6.89 per $100 of outstanding consumer credit. Of this amount, $2.92 was paid to stockholders or retained by the company for use as equity funds.

Operating Expenses

Salaries and the related expenses of personnel accounted for nearly half of all operating expenses of consumer finance companies in 1959 and amounted to $6.45 per $100 of outstanding credit. The importance of salary costs reflects the personalized service offered by the consumer finance industry with its multiple offices and direct lending operations.

TABLE 2

COMPONENTS OF GROSS FINANCE CHARGES ON CONSUMER CREDIT
AT CONSUMER FINANCE COMPANIES, 1959
(per $100 of average outstanding credit)

Item	Mean Distribution		Range of Ratios[a] (dollars)	
	Dollars	Per Cent	Maximum	Minimum
Gross finance charges[b]	24.04	100.0	--	--
Dealer's share of gross finance charges	.17	.6	--	--
Lender's gross revenue	23.87	99.4	31.58	20.02
Operating expenses	14.25	59.3	20.30	10.87
Salaries	6.45	26.9	7.90	4.95
Occupancy costs	1.09	4.5	1.57	.77
Advertising	.89	3.7	1.68	.27
Provision for losses	1.98	8.2	2.92	1.20
Other[c]	3.84	16.0	9.17	3.63
Nonoperating expenses	9.62	40.0	11.75	8.30
Cost of nonequity funds	3.97	16.5	5.49	2.94
Income taxes	2.73	11.4	4.46	2.06
Cost of equity funds (lender's profit)	2.92	12.1	4.35	1.55
Retained	.61	2.5	2.19	-.79
Dividends	2.31	9.6	3.79	1.22

Source: Nine-company sample.

[a] Components in columns for maximum and minimum ratios are not additive as ratios for individual items were taken from the statements of different companies.

[b] Includes all finance charges and fees collected on consumer credit activities. Charges for insurance are not included and the cost of free insurance provided to borrowers was deducted.

[c] Includes a wide variety of cost items, such as supplies, legal fees, insurance, etc., for which separate information could not be obtained from all companies.

Individual companies showed variations in salary costs from $5 to $8 per $100 of consumer loans.

Provision for losses was the next largest item of expense. Since these provisions represent the company's estimate of anticipated losses rather than actual losses, they are not an effective measure of costs in any particular year. During a period of expanding volume such as the 1950's, provisions for losses usually exceed actual losses because they represent estimates based on expanding volume. In every year covered by the study, provisions for losses were larger than actual losses charged off (Table 3), but the relationship may be reversed in recession years or in years of large unanticipated losses. During the period covered by the study, provisions for losses averaged 13 per cent of total operating expenses, or nearly $2 per $100 of outstanding credit. Actual losses averaged only $1.45 per $100 during the same period.

Actual losses charged off (net of recoveries) varied widely from year to year with changes in economic conditions and the experience and policies of individual companies. The range of losses among different companies was large and apparently reflected differences in credit standards and collection policies. In 1959 actual losses among sample companies ranged from $.95 to $2.60 per $100 of outstanding consumer credit. In some years the highest loss rates were five to six times the lowest charge-off rate (Table 3).

TABLE 3

LOSSES AND PROVISION FOR LOSSES ON CONSUMER CREDIT AT CONSUMER FINANCE COMPANIES, SELECTED YEARS (dollars per $100 of average outstanding credit)

Year	Provision for Losses	Net Losses Charged Off	Range of Ratios in Net Losses Charged Off	
			Maximum	Minimum
1929	--	1.53	--	--
1933	--	3.61	--	--
1936	--	3.04	--	--
1949	2.03	1.47	2.73	.50
1950	2.13	1.42	2.71	.53
1951	1.88	1.51	3.01	.51
1952	1.86	1.38	2.07	.61
1953	1.81	1.43	2.16	.60
1954	1.79	1.50	2.17	.73
1955	1.84	1.39	1.86	.50
1956	1.70	1.15	1.62	.45
1957	1.72	1.39	2.20	.58
1958	2.02	1.71	2.78	.77
1959	1.98	1.70	2.60	.95

Source: Data for 1929-36 are based on tabulations of sample of 153 companies from Dauer's Comparative Operating Experience, Appendix B, p. 205. Data for 1949-59 are based on our nine-company sample.

Rent and maintenance of quarters for the multiple offices required by consumer finance company operations averaged $1 per $100 of outstanding consumer credit in 1959 and throughout the eleven years of the study. Individual companies reported variations between $.77 and $1.57 per $100 in 1959.

Advertising, an important element of cost in any business that must attract customers from the public, averaged 6 per cent of total operating costs, or 89 cents per $100 of outstanding loans in 1959. One company spent $1.68 per $100 of outstanding loans on advertising while another spent only 27 cents per $100.

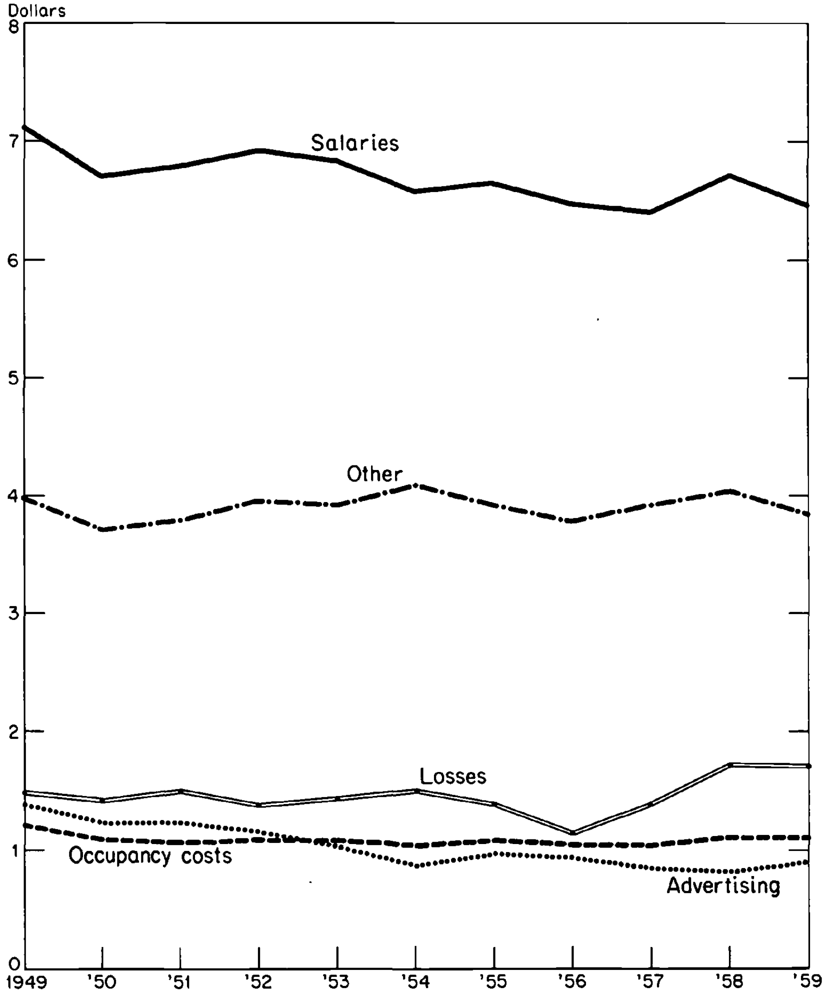
The miscellaneous costs of lending operations were sizable and averaged $3.84, or 27 per cent of operating expenses. They included a wide range of items that had to be combined because comparable detail could not be obtained from all companies. The following detail from the accounting records of one company illustrates the nature of these costs: telephone and telegraph, postage and express, collection and appraisal, credit reports, printing and stationery, dues and subscriptions, legal and auditing, insurance, provision for depreciation, donations, taxes and license fees, and equipment and rental.

The operating expenses of consumer finance companies declined from 1949 to 1959 at about the same rate as the decline in gross finance charges, i.e., by about 10 per cent or $1.50 per $100 of outstanding credit, and continued to account for about 60 per cent of the gross finance charges. The downward trend in operating expenses during the 1950's was apparently a continuation of a longer-run trend. Data for 153 companies in a sample collected by the Russell Sage Foundation for the period 1929–39 showed a ratio of operating costs to outstanding consumer loans of 19 to 23 per cent, compared with ratios for the nine-company sample of between 14 and 16 per cent during the 1950's.[4] Separate information on the expenses of the two major companies lends supporting evidence of a decline in the per dollar costs of handling outstanding credit from the 1930's to the end of the 1950's.

The decline in total operating costs from 1949 to 1959 reflected decreases in all major expense items except provision for losses (Chart 2). The relative importance of various cost items to the nine consumer finance companies remained quite constant, except for expenditures on advertising, which dropped from 9 to 6 per cent of total expenses from 1949 to 1959.

[4] Dauer, *Comparative Operating Experience,* p. 201.

CHART 2
Operating Expenses on Consumer Credit at Consumer Finance Companies, 1949–59
(per $100 of average outstanding credit)



SOURCE: Nine-company sample.

Nonoperating Expenses

Nonoperating expenses, which include the cost of equity and nonequity funds and income taxes, made up 40 per cent of the gross finance charge at consumer finance companies in 1959. Although these expenses are part of the cost of providing credit to consumers, they are not exclusively related to consumer credit operations. They reflect the over-all organization and financial structure of the lending institution.

Nearly three-fourths of nonoperating expenses, or about $7 per $100 of outstanding credit, went into payments for the money used in the lending operations. About $4 of this total was paid to banks and other creditors and about $3 was paid out to stockholders or retained by the company.

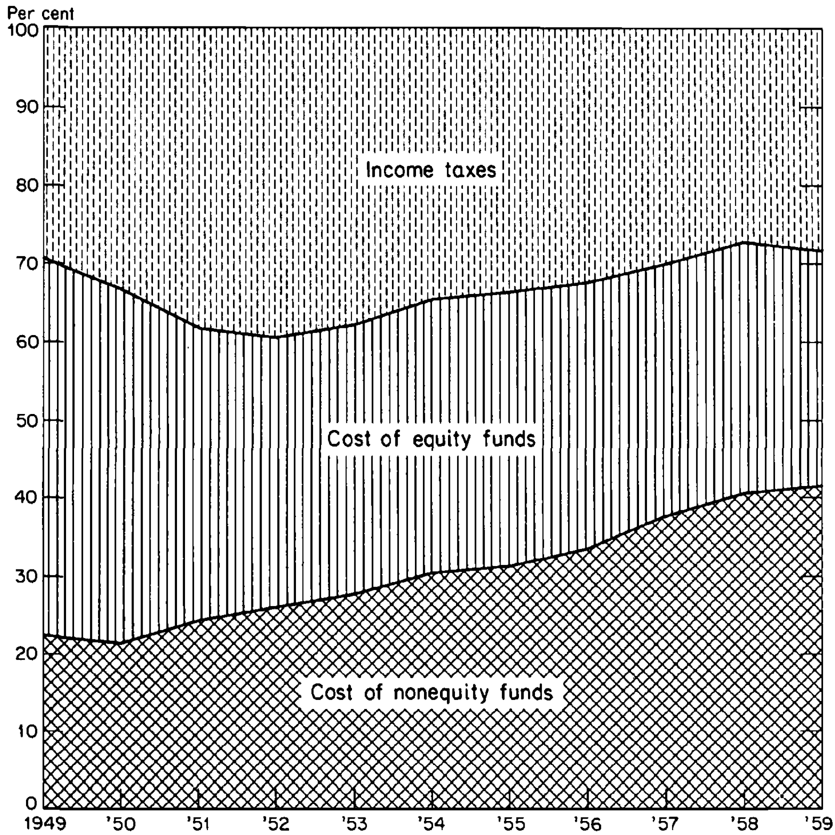
Total nonoperating costs declined roughly in proportion to the decline in the gross finance charges and accordingly their share in the total remained relatively constant over the period under study. There were, however, some fundamental changes in the components of nonoperating expenses. The proportion paid for nonequity funds rose from 22 per cent in 1949 to 41 per cent in 1959 (see Chart 3). The share going to equity and to income taxes declined accordingly. This shift reflected in large part the increase in interest rates during this period and the greater dependence on nonequity financing.

SOURCES OF FUNDS

The total cost of funds as well as the distribution of payments between equity and nonequity sources depends in large part upon the financial structure of each company. The owners of the nine sample companies provided an average of 25 per cent of the funds used for their lending in 1959 and obtained the remaining 75 per cent from banks and the public (Table 4). The importance of equity funds, which had provided nearly a third of total resources in 1949, declined during the 1950's as the need for funds rose.

Banks were the principal source of short-term funds and provided 26 per cent of the total resources used by these companies. The proportion of bank borrowing varied widely, however, among individual institutions, ranging from a high of 42 per cent to a low of 7 per cent. Other short-term sources, principally commercial paper, accounted for about 7 per cent of the total resources. A few companies obtained small amounts from their employees in the form of thrift accounts or issued investment certificates.

CHART 3
Distribution of Nonoperating Expenses on Consumer Credit at Consumer Finance Companies, 1949–59



SOURCE: Nine-company sample. Based on data in Appendix Table B-4.

About 38 per cent of all funds was obtained from long-term sources—in the form of either senior or subordinated long-term obligations. The importance of long-term debt varied from 55 per cent at one company to 8 per cent at another. Subordinated debt was used by all but two of the companies and accounted for 15 per cent of the total resources of one company.

Senior long-term debt replaced bank loans as the principal source of nonequity funds during the 1950's. At the end of 1949 senior long-term obligations provided only 11 per cent of total resources and bank loans

TABLE 4

SOURCES OF FUNDS FOR CONSUMER FINANCE COMPANIES, END OF 1959
(per cent)

Item	Mean Distribution	Range of Ratios[a]	
		Maximum	Minimum
Debt, total	70.8	77.7	63.1
Short-term to banks	26.2	42.4	6.8
Other short-term[b]	7.1	20.4	0
Senior long-term	28.3	55.3	8.3
Subordinated	9.2	14.7	0
Dealer reserves	.3	1.3	0
Other liabilities	4.1	5.1	2.7
Total nonequity funds	75.2	82.8	70.1
Equity funds, total	24.8	32.3	17.2
Reserves	3.2	5.5	1.8
Preferred stock	3.7	5.2	0
Common stock and surplus	17.9	24.6	8.9
Total	100.0	--	--

Source: Nine-company sample.

[a] Components in columns for maximum and minimum ratios are not additive as ratios for individual items were taken from statements of different companies.

[b] Includes small amount of certificates of deposits and thrift accounts of employees.

provided 37 per cent. By the end of 1959, senior long-term debt provided 28 per cent of the total and bank loans 26 per cent.

A small proportion of the total funds available to consumer finance companies came from temporary sources such as dealer reserves or accounts payable. Although these funds are usually interest free, they add to the resources available to the company.

COST OF NONEQUITY FUNDS

The sample consumer finance companies paid an average of 5.0 per cent for interest-bearing debt outstanding in 1959. When accounts payable and other noninterest-bearing sources of funds are included, the average rate paid for nonequity funds was 4.6 per cent (Table 5). These rates understate the total cost of borrowing, however, when com-

TABLE 5

COST OF NONEQUITY FUNDS AT CONSUMER FINANCE COMPANIES, 1949-59
(per cent of average outstanding balances)

	Ratio of Dollar Cost of Nonequity Funds to			
Year	Debt	Total Nonequity Funds	Nonequity Funds Minus Nonearning Assets	Consumer Credit Receivables[a]
1949	3.0	2.8	3.7	2.3
1950	3.0	2.8	3.5	2.3
1951	3.2	3.0	3.7	2.5
1952	3.7	3.4	4.3	2.8
1953	3.8	3.5	4.4	2.9
1954	3.8	3.5	4.4	3.0
1955	3.7	3.4	4.3	3.0
1956	4.2	3.9	4.8	3.4
1957	4.6	4.3	5.2	3.8
1958	4.7	4.4	5.4	3.8
1959	5.0	4.6	5.6	4.0

Source: Nine-company sample.

[a] Based on the dollar share of total cost of nonequity funds allocated to consumer credit receivables by the ratio of consumer receivables to total earning assets.

pensating balances are required in connection with bank lines of credit. Banks customarily require finance companies to maintain a given percentage of their line on deposit with the bank. This requirement reduces the funds available to the finance company from the loan and increases the effective rate on the net amount obtained from the bank. The size of the required balance is set by individual agreement between the bank and finance company. Since the actual cost of compensating balance requirements cannot be calculated accurately because of the difficulty in estimating the change in working balances held, no attempt has been made to include these costs as part of the rate paid for funds. They are included here as part of the cost of nonearning assets.

The full cost of nonequity funds used in consumer lending includes part of the burden of providing funds used in nonearning forms, including compensating balances. This cost can be approximated by the ratio of interest paid for nonequity funds to total nonequity funds minus nonearning assets (Table 5, column 3). In 1959, nonearning assets added approximately 1 percentage point to the average cost of funds used in consumer lending.

Since equity sources provided part of the funds used for consumer lending, the cost of nonequity funds used in consumer lending expressed as a percentage of consumer credit receivables is less than the rate paid for funds. In 1959 about 25 per cent of funds were provided by equity sources so that the effective rate on the nonequity funds used for consumer lending was correspondingly reduced (Table 5, column 4).

The cost of nonequity funds used for consumer lending increased from 2.3 to 4 per cent of outstanding receivables between 1949 and 1959, reflecting higher rates on borrowed funds and decreased use of equity funds. The average rate paid on nonequity funds rose from 2.8 to 4.6 per cent and the proportion of equity funds used by consumer finance companies decreased from 32 per cent of total resources in 1949 to 25 per cent in 1959.

The cost of nonequity funds among the nine companies covered by the study showed a wide range both as a result of differences in rates paid on borrowed funds and differences in the proportion of nonequity funds used in their lending operations. The company with the lowest cost of funds paid an average 4.0 per cent for its nonequity funds in 1959 and obtained 70 per cent of its total funds from such sources. In contrast, the company with the highest cost of funds paid 6.2 per cent for its nonequity funds and obtained 74 per cent of its funds from such sources.

COST OF EQUITY FUNDS

The cost of equity funds used in consumer credit is a residual after other costs have been deducted from gross revenue. It represents that part of the lender's total return coming from consumer credit operations and is a real cost of credit in that it must be large enough to attract and hold risk capital in the industry. The lender's share in the total cost of consumer credit is an important element in his profit, but it is not the sole determinant. The profitability of a lending operation also depends upon the return from other earning assets, the cost of money, and the efficiency with which it is used. Consumer finance companies earned an average of $12.07 per $100 of net worth in 1959 while obtaining only $2.92 per $100 from the funds invested in consumer credit (Table 6, line 7, and Table 2, line 13).

The cost of equity funds to consumers declined from $4.97 per $100 of credit in 1949 to $2.92 per $100 in 1959. The decline was steady and

TABLE 5

FACTORS IN CONSUMER FINANCE COMPANY PROFITS, 1949-59

(per cent of average outstanding balances)

Ratio	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959
1. Net operating income from consumer credit to consumer receivables[a]	10.3	10.7	10.4	10.9	10.6	9.9	9.5	10.2	10.0	9.4	9.6
2. Net operating income to earning assets	10.8	11.2	10.9	11.5	11.2	10.5	10.4	11.0	10.9	10.2	10.4
3. Net operating income to total assets	9.1	9.5	9.3	9.8	9.6	8.9	8.9	9.5	9.3	8.9	9.1
4. Profits before taxes to equity funds	23.1	25.3	24.9	25.5	24.4	23.0	24.2	26.2	24.9	21.9	22.2
5. Net return from nonequity to equity funds (line 4 minus line 3)	14.0	15.8	15.6	15.7	14.8	14.1	15.3	16.7	15.6	13.0	13.1
6. Provision for income taxes to profit before taxes	36.8	41.6	48.9	52.3	51.1	48.5	46.9	47.0	45.7	43.4	45.8
7. Net profits to equity funds	14.5	14.8	12.7	12.2	12.0	11.9	12.8	13.9	13.5	12.4	12.1
8. Percentage of profit obtained from leverage on nonequity funds (line 5 ÷ line 4)	60.6	62.5	62.7	61.6	60.7	61.3	63.2	63.7	62.7	59.4	59.0
ALTERNATIVE DERIVATION OF LINE 5											
a. Net operating income to total assets (line 3)	9.1	9.5	9.3	9.8	9.6	8.9	8.9	9.5	9.3	8.9	9.1
<u>less</u>											
b. Cost of nonequity funds to nonequity funds	2.8	2.8	3.0	3.4	3.5	3.5	3.4	3.9	4.3	4.4	4.6
<u>equals</u>											
c. Net return from nonequity funds to nonequity funds	6.3	6.7	6.3	6.4	6.1	5.4	5.5	5.6	5.0	4.5	4.5
<u>times</u>											
d. Leverage coefficient (ratio of nonequity to equity funds)	2.2	2.4	2.5	2.5	2.5	2.6	2.8	3.0	3.1	3.0	3.0
<u>equals</u>											
e. Net return from nonequity to equity funds (line 5)[b]	13.9	16.1	15.8	16.0	15.3	14.0	15.4	16.8	15.5	13.5	13.5

[a]Equivalent to nonoperating expenses per $100 of average consumer credit receivables; see Table 2.

[b]Differences between lines 5 and e result from rounding errors introduced by alternative methods of calculation.

some decrease occurred in almost every year. The reasons for this decline can best be seen by examining the factors affecting the profits of the institution as a whole.

Lender's Rate of Profit

In addition to the return from consumer credit receivables, the lenders' profits also depend upon: the net return from other earning assets; the proportion of resources that are invested in earning assets; the financial advantage obtained from use of nonequity funds; and the applicable tax rates on net income.

RETURN ON OTHER EARNING ASSETS

All of the sample companies engaged in some activities other than lending to consumers such as providing insurance or lending to businesses. They earned 10.4 per cent on total receivables compared to an average of 9.6 per cent on consumer credit receivables in 1959 (Table 6). The higher rate of return on total receivables indicates that the average return on other assets was higher than on consumer credit receivables. Since other earning assets amounted to only 1.3 per cent of all earning assets, the average return per dollar of nonconsumer assets was obviously high. Not all of the companies in the sample showed this relationship, however. Five of the companies in the study in 1959 reported a higher return on total earning assets than on consumer credit; the other four showed fractionally higher returns on consumer credit.

Part of the high return on other earning assets may be explained by the difficulty of segregating the costs of handling insurance and other activities from the cost of consumer credit so that the quantitative results must be regarded with caution. The high indicated return on other activities, however, suggests the importance of these operations in the over-all profits of consumer finance companies.

COST OF NONEARNING ASSETS

The sample companies held 12.3 per cent of their assets in nonearning forms at the end of 1959. The amounts required for cash, bank balances, and other nonearning assets depend upon the number of offices, compensating balance requirements, and operating needs. The proportion of assets held in nonearning forms in 1959 ranged from 18 per cent at one company to 5.4 per cent at another.

These funds must be supplied either by borrowing or from equity sources and added to the over-all costs of the business. An indication of the costs involved can be obtained by comparing the net operating income on earning assets with the rate earned on total assets. The difference between these ratios is a measure of the loss of return that results from the incomplete employment of resources. In 1959, the sample companies showed a net operating income of 10.4 per cent on all earning assets and 9.1 per cent on total assets (Table 6).

The cost of nonearning assets varied widely from company to company reflecting differences in operating needs, in the efficiency of handling of cash balances, and in compensatory balance requirements. One company reported a spread of 2.4 per cent between the ratio of net operating income to earning assets and the rate on total assets, while the company with the smallest difference reported a spread of only 0.6 per cent.

FINANCIAL ADVANTAGE OF THE USE OF NONEQUITY FUNDS

If the lender can earn more on the funds that he invests than he pays for those he borrows, the difference increases the return on equity. This financial advantage or leverage from the use of nonequity funds is an essential part of the profits of most financing operations. The importance of income from this source to the return on equity depends upon the rate that can be earned on invested funds, the cost of nonequity funds, and the proportion of nonequity funds to equity funds.

Consumer finance companies were able to earn a net operating income of 9.1 per cent on the assets employed in the business before the cost of funds and taxes in 1959. If only equity funds were used in the business, this return would also be the return before taxes on equity funds. The net profits of these companies before taxes, however, amounted to 22.2 per cent of net worth. The difference in the return on equity and the return on total assets reflects the financial advantage of use of borrowed funds. About 60 per cent of returns before taxes could be traced to use of nonequity funds.

The part played by the cost of funds and ratio of nonequity to equity funds is shown in Table 6. Since the consumer finance companies were able to obtain nonequity funds at an average of 4.6 per cent and could clear 9.1 per cent on these funds, they were able to net 4.5 per cent on the nonequity funds used in the business. By using $3 of nonequity funds for every dollar of equity funds, they were able to earn three times 4.5 per cent, or 13.5 per cent, on equity funds by the use of borrowed funds. This return plus the normal return of 9.1 per cent on equity funds used in the business gave them a net profit before taxes of 22.6 per cent on equity funds.

INCOME TAXES

Consumer finance companies pay the regular federal income tax rates and state taxes. The information available in the financial statements of these companies indicates their provisions for taxes each year but does not show the cash payments. As a result, the data do not measure the actual payments in each year but show the impact of taxes over a period of time. Provision for taxes varied considerably from year to year and averaged 46 per cent of net operating income after interest during the eleven years 1949–59.

TREND IN LENDER'S PROFITS

The return on consumer credit receivables as measured by net operating income declined slightly from the early 1950's to 1959 (Table 6). The impact of this decline was largely offset, however, by a slight rise in return on other earning assets and by a reduction in nonearning assets. The sample companies were able to maintain a relatively stable return on total assets despite the slight decline in their principal source of income.

The major problem for consumer finance companies during this period was the maintenance of satisfactory profit levels in the face of increasing interest costs. The rate they paid for funds increased 65 per cent from 1949 to 1959. They tried to offset this additional cost by expanding their debt-equity ratios to maintain the financial advantages of the use of borrowed funds, but were only partly successful. In 1958 and 1959, the additions to profits from the use of nonequity funds fell substantially from earlier levels and profit rates declined accordingly.

Consumer finance companies typically pay a substantial part of their net profits to shareholders in the form of dividends. They paid out 60 per cent of net profits in 1959, which resulted in a return of 7.7 per cent to stockholders on the equity of the company. Since the market price of the stocks of most consumer finance companies was above the book value of the stocks in 1959, the return per share on the market value of the stock of these companies was below the return on the book value.

Comparison of Companies with Highest and Lowest Finance Charges

The number of companies that could be included in the sample was too small to permit the use of correlation analysis to examine the relationship between costs and individual factors determining these costs. A comparison of the experience of several companies showing consistently high average finance charges with those of companies showing low charges gives some indication of the reasons for the variations in charges.

To avoid the problem of unusual ratios that occur from year to year, averages of the data for eleven years were used in these comparisons. Although the two companies with the lowest charges were larger than the three companies with the highest charges, the sample was not large enough to establish a relationship between size and costs.

The finance charges on consumer credit in 1949–59 were consistently higher at three companies in the sample and consistently lower at two others. The difference between finance charges at the high- and low-charge companies averaged about 4.4 percentage points or about 25 per cent of the total finance charge (Table 7). Some of this difference probably reflected variations in the credit services to the consumer, although such differences are difficult to identify statistically.

The three companies with the highest charges apparently made more risky loans, as their actual loss ratios were 20 per cent higher than those of the companies with the lowest charges. The other costs associated with high-risk business, such as the additional attention required in screening loans and higher collection costs, add greatly to the operating expenses of companies handling high-risk loans. Every category of expense at the high-charge companies was higher except for nonoperating expenses. The principal differences occurred in salary and "other" expenses. One of the companies with low charges held a sizable amount of sales finance paper which typically carries lower rates and tends to lower many cost items. The other low-charge company, however, engaged almost entirely in personal lending, as did the three companies with highest charges.

The high-charge companies reported a lower net operating income on their consumer lending than the low-charge companies despite their higher charges. Their operating costs were 50 per cent higher than those of the companies with lowest charges although they averaged only 40 per cent more on their charges.

The high-charge companies were able to obtain more income from their insurance and other earning assets than the low-charge companies. The former earned 10.3 per cent on their total earning assets compared with 9 per cent on their consumer credit receivables. The low-charge companies, however, showed only a slightly higher return on total earning assets than on consumer credit receivables (Table 7).

Although consumers had to pay more for credit at the high-charge companies, the additional charges were absorbed by higher operating expenses incurred in providing credit to consumers. The profits of high-charge companies were smaller than those of the low-charge companies;

TABLE 7

COMPARISON OF CONSUMER FINANCE COMPANIES WITH HIGHEST AND LOWEST AVERAGE FINANCE CHARGES, 1949-59[a]

Item	Three High-Charge Companies (1)	Two Low-Charge Companies (2)	Difference (col. 1 minus col. 2) (3)
DOLLARS PER $100 OF AVERAGE OUTSTANDING CONSUMER CREDIT			
Finance charges[b]	26.30	21.90	4.40
Operating expenses	17.30	11.40	5.90
Salaries	7.50	5.10	2.40
Occupancy costs	1.10	1.00	.10
Advertising	1.20	.90	.30
Provision for losses	2.30	1.60	.70
Actual losses	(1.60)	(1.30)	(.30)
Other	5.20	2.80	2.40
Nonoperating expenses (lender's net operating income from consumer credit receivables)	9.00	10.50	-1.50
SELECTED RATIOS (PER CENT)			
Total net operating income to all earning assets	10.3	10.8	-0.5
Cost of nonequity funds to total nonequity funds	3.7	3.4	.3
Nonequity to equity funds	2.6	2.7	-.1
Net profit to equity funds	12.4	12.8	-.4

[a] All data are averages of annual individual company ratios for the eleven years 1949-59.

[b] Excludes dealer share of gross finance charges.

the former averaged a return of 12.4 per cent on equity compared with an average of 12.8 per cent for the latter. The low-charge companies were able to show a higher profit largely because of the higher net operating income on their consumer credit business, and because of the greater financial advantage that resulted from a lower cost of nonequity funds and a slightly larger proportion of nonequity to equity funds.

TABLE 8

COMPARISON OF SELECTED HIGH- AND LOW-PROFIT CONSUMER FINANCE COMPANIES, 1949-59[a]

Item	Two High-Profit Companies (1)	Three Low-Profit Companies (2)	Difference (col. 1 minus col. 2) (3)
SELECTED RATIOS (PER CENT)			
Net profit to equity funds	15.4	10.9	4.5
Net operating income on consumer credit receivables to consumer credit receivables	10.5	8.9	1.6
Total net operating income to all earning assets	12.1	9.7	2.4
Net operating income to total assets	10.1	8.0	2.1
Cost of nonequity funds to total nonequity funds	3.8	3.7	.1
Nonequity to equity funds	2.8	2.7	.1
DOLLARS PER $100 OF AVERAGE OUTSTANDING CONSUMER CREDIT			
Finance charges[b]	26.6	25.5	1.1
Operating expenses	16.1	16.6	-.5
Salaries	6.9	7.8	-.9
Occupancy costs	1.5	1.0	.5
Advertising	1.1	1.1	—
Provision for losses	2.0	2.2	-.2
Actual losses	(1.3)	(1.6)	(-.3)
Other	4.6	4.5	.1
Nonoperating expenses (lender's net operating income from consumer credit receivables)	10.5	8.9	1.6

[a] All data are averages of annual individual company ratios for the eleven years 1949-59.

[b] Excludes dealer share of the gross finance charges.

Comparison of High- and Low-Profit Companies

Two consumer finance companies in the sample consistently reported a higher return on net worth than the other companies and three companies were usually at the bottom of the profit scale.[5] The comparison of these two groups of companies suggests some of the differences in the nature of operations that contributed to the profit differential (Table 8). Both of the most profitable companies were larger than the three least profitable companies, but there were larger companies with lower profits and smaller companies with better profits at both extremes.

The most profitable companies averaged a return on equity of 15.4 per cent over the eleven years. This was 4.5 percentage points or 41 per cent better than the return of the low-profit companies. The profitable companies showed better experience in nearly all phases of their operations.

The profitable companies average 1.6 percentage points better than low-profit companies on their net operating income on consumer credit receivables. A comparison of earnings and operating expenses on consumer credit indicates that this advantage reflected both higher earnings and lower operating expenses. The profitable companies had salary expenses of almost 1 percentage point below those of the less profitable operations. Their occupancy costs, however, were higher, while their loss ratios were lower.

The profitable companies supplement their return on consumer credit with a higher return on their other earning assets. They reported a net operating income of 12.1 per cent on all earning assets, as opposed to the return for the less profitable companies of 9.7 per cent, thus increasing the earning spread from 1.6 to 2.4 percentage points.

The principal factor in the profits differential was the higher net operating income achieved by the profitable companies on their earning assets. Only minor differences appeared in the cost of funds and financial structure of the two groups.

[5] Two of the low-profit companies and one of the high-profit companies were also included in the preceding tabulation of companies with the highest and lowest finance charges.