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Comparison of Cost of Providing Consumer Credit at Four Types of Financial Institutions

THE variation in average finance charges on consumer credit among institutional groups is impressive.¹ Average annual charges in 1959 varied from \$9 to \$24 per \$100 of credit outstanding among the four types of institutions studied (Table 29). Averages for individual companies showed a range from \$7 to \$31 per \$100. These differences reflect many variations in amount and type of credit extended as well as alternative cost factors faced by different institutions.

A substantial part of these differences can be traced to the handling and operating costs of the type of lending performed by the institutions. The lender's decisions on the maturity, size, and type of loan to be made, as well as the character of the credit risk he assumes, determine the general level of his costs. His individual operating procedures and efficiency establish his own particular pattern of costs.

Other differences in charges stem from the legal, tax, and institutional framework within which the lender operates, and are of special interest because they determine the ability of lenders to compete in similar markets and because they have implications about the economic effects of legislative action. Perhaps the sharpest difference among the institutions studied occurs between the federal credit unions and the other three types. Credit unions are owned by the users (borrowers and savers), while the other types of institutions are owned by stockholders.

Table 29 gives a breakdown of the expenses of providing credit at each type of institution and indicates the importance of each cost component in the gross finance charge. Annual operating expenses, which include all the day-to-day costs of handling accounts, ranged from \$3.30 per \$100 of credit outstanding to nearly five times that amount, or \$14.25 per \$100. The cost of money varied from \$3.92 to \$6.89 per \$100, and the costs of income taxes varied from zero to \$2.73 per \$100.

The distribution of costs also varied widely. Operating expenses and payments to dealers accounted for from 48 to 64 per cent of total finance charge at the three types of stockholder-owned institutions. The cost of nonequity funds, provisions for income taxes, and profit made up the remainder. With the exception of credit unions, the cost of funds (interest and profit) was not the major element in total cost to the consumer; it was 29 per cent of the cost for consumer finance and for sales

¹ See note a, Table 29.

TABLE 29
 COMPONENTS OF GROSS FINANCE CHARGES ON CONSUMER CREDIT,
 BY TYPE OF LENDER, 1959
 (dollars per \$100 of average outstanding credit)

Item	Stockholder-Owned Institutions			All Federal Credit Unions
	Nine Consumer Finance Companies	Ten Sales Finance Companies	Nine Commercial Banks	
Gross finance charges ^a	24.04	16.59	10.04	9.13
Dealer's share of gross finance charges ^b	.17	2.95	.62	0
Lender's gross revenue	23.87	13.64	9.42	9.13
Operating expenses	14.25	7.74	4.17	3.30
Salaries	6.45	3.47	2.33	1.77
Occupancy costs	1.09	.43	.23	.06
Advertising	.89	.31	.34	.07
Provision for losses	1.98	1.46	.28	n.a.
Actual losses ^c	(1.70)	(1.11)	(.15)	.38
Other ^d	3.84	2.07	.99	1.02
Nonoperating expenses	9.62	5.90	5.25	5.83
Cost of nonequity funds	3.97	4.02	1.50	.12
Income taxes	2.73	1.07	1.33	0
Cost of equity funds (lender's profit or net income) ^e	2.92	.81	2.42	5.71
Dividends	2.31	.48	1.49	4.00
Retained	.61	.33	.93	.98
Services to owners ^f	--	--	--	.73

Source: Data for all types except federal credit unions are based on averages of individual company ratios. Ratios for federal credit unions are based on tabulations for all federal credit unions.

^aIncludes all finance charges and fees collected on consumer credit activities. Charges for insurance are not included and the cost of free insurance provided to the borrower was deducted from the gross finance charge.

^bRepresents the estimated difference between the gross finance charges and the charges which accrue to the financial institution that purchases the credit contract. The estimates of the dealer's share are based on data from four large sales finance companies on new- and used-automobile contracts. No quantitative information was available for estimates of the dealer's share on nonautomotive contracts, hence no estimate of this was included. This share is known to be considerably less important than that on automobile contracts and in some cases the dealer does not receive a share of the charge.

^cNet of recoveries.

^dIncludes a wide variety of expenses such as travel, office supplies, legal fees, etc., that could not be obtained on a separate and uniform basis from all the sample companies.

^eBecause of differences in ownership and objectives, the term net profit is usually not used for credit unions. The term net income has been used instead.

^fIncludes estimate of cost of servicing share accounts and cost of free life insurance provided shareholders.

COMPARISON OF COST OF CREDIT

finance companies, 39 per cent for commercial banks, and 64 per cent for credit unions. That is to say, 71 cents of the consumer's cost-of-credit dollar go for expenses other than the cost of money in the case of consumer finance and sales finance companies, 61 cents in the case of banks, and 36 cents in the case of credit unions. The cost of equity (lender's profit) came to 5 per cent of the total for sales finance companies, 12 per cent for consumer finance companies, 24 per cent for banks, and 63 per cent for credit unions. These results depend considerably, as is brought out below, on the relative amounts of equity funds used by the different types of lender.

Variations in Operating Expenses

Comparison of the operating expenses for each type of company (Table 29) indicates that variations in these expenses account for the largest part of the differences in gross finance charges among the four types of institutions. A number of factors can be identified that contribute substantially to differences in operating costs among lenders: (1) the method of acquiring business, whether directly from the public or indirectly through dealers; (2) the character of the risks assumed; (3) the average size of contract; and (4) the type of credit; and (5) institutional differences. Differences in the type of credit based on a purpose or collateral classification seem to contribute to differences in costs, but are difficult to disentangle from elements of size and risk.

Consumer finance companies reported the highest average operating cost per \$100 of credit and showed the highest average cost in every listed category of expenditures (Table 29). At the other extreme, credit unions showed the lowest average cost on every item of expenditure except bad-debt losses and miscellaneous expenses. Commercial banks showed the lowest bad-debt losses and miscellaneous expenses.

METHOD OF ACQUIRING BUSINESS

Sales finance companies purchase most of their credit contracts from automobile dealers (indirect paper), while consumer finance companies and credit unions deal directly with the borrower (direct paper). Commercial banks obtain their receivables from both sources. The expenses incurred in the two methods of acquiring paper are very different.

Indirect financing frequently involves an arrangement whereby the dealer obtains a share of the finance charge. This share, which represents a part of the finance charge in automobile financing, amounted to an estimated 18 per cent of the gross charges at sales finance companies

and 6 per cent at commercial banks.² The difference in importance of the dealer's share at these two types of institutions reflects differences in the proportion of their receivables in automobile credit and the share acquired indirectly.

The income received by dealers from finance charges may be used to cover their costs in initiating the contract or the risks that they assume. It also gives them some flexibility in their pricing and, under competitive market conditions, the dealer's share of the finance charge may be returned in part to credit buyers in the form of lower automobile prices. Thus gross finance charges shown in the first line of Table 29 may overstate the effective finance charge to this extent.

The dealer's finance income may be offset in part by a reduction in the financing agency's operating expenses. The dealer absorbs part of the risk on recourse contracts, which carry the highest dealer finance charge share. The dealer also absorbs some of the cost of originating and accepting the application. However, separate data on operating expenses of direct versus indirect operations suggest that the savings in handling costs on indirect paper are relatively small. Expense data from a subsample of banks covered by the study showed only minor differences between the costs of direct and indirect automobile paper. This evidence is supported by data collected by the American Bankers Association that show a differential of only 10 to 15 per cent between the acquisition costs of an automobile contract purchased from a dealer and one acquired directly.³ These data show an average acquisition cost of \$12.75 per contract on direct loans and \$11.50 on indirect paper in 1957.

Direct lending agencies, such as consumer finance companies and banks, must attract business from the public. This involves more advertising and a different promotional approach from that used in acquiring paper from dealers. The sample consumer finance companies spent 89 cents per \$100 of loans on advertising while commercial banks spent 34 cents per \$100. The sales finance company figure, which was only slightly below that for commercial banks, includes some advertising for direct loans, as 20 per cent of their business was conducted directly with the public. The sales finance company with the largest advertising expense also had the largest direct loan operation.

² See note b, Table 29.

³ Mimeographed material distributed by the Instalment Credit Commission of the American Bankers Association to their membership.

COMPARISON OF COST OF CREDIT

Direct lending agencies must also provide facilities that are convenient for the borrower. This not only requires additional offices but frequently more expensive locations. Consumer finance companies with loans of more than \$100 million had an average of 500 offices per company in mid-1960, while sales finance companies in the same group averaged 200 offices per company.⁴ Occupancy costs amounted to \$1.09 per \$100 of consumer credit at sample consumer finance companies and to only 43 cents per \$100 at sales finance companies.

Although the sample banks obtained 75 per cent of their consumer credit business from the public, they reported lower average occupancy costs than sales finance companies. This difference may reflect the ability of the bank to spread the cost of occupancy among its many functions. Most finance companies must allocate nearly all the cost of quarters to their consumer credit business.

The extremely low occupancy cost at credit unions reflects the free space that is frequently provided by the sponsors of these organizations and the nominal space requirements associated with part time operations.

RISK

Some of the costs arising from risks are indicated by losses charged off and by provision for losses. These measures differ from year to year, with provisions for losses exceeding actual losses in all but very bad years, but they show the same pattern of costs over time. Neither of these measures includes losses sustained by dealers under recourse agreements, nor do they reflect differentials in costs of investigation and collection associated with variations in credit quality. They are, therefore, an incomplete measure of total costs of risks, and they understate the cost differential associated with different degrees of risk.

Loss figures, however, suggest the wide range of risks among lending institutions, as well as among individual companies. Actual losses charged off (net of recoveries) in 1959 varied from 15 cents per \$100 of credit at commercial banks to more than ten times that amount, or \$1.70 per \$100 at consumer finance companies. Sales finance companies showed losses of \$1.11 per \$100, and credit unions of 38 cents per \$100.

Many of the costs of handling higher-risk loans cannot be segregated from the rest of operating expenses. If all the costs associated with variations in risk could be isolated, risks would undoubtedly play a

⁴ F. R. Pawley, "Survey of Finance Companies, Mid-1960," *Federal Reserve Bulletin*, October 1961, pp. 1154-1155.

substantial part in explaining differences in operating costs among lenders.

CONTRACT SIZE

The volume of work required in handling and processing instalment contracts is more closely related to the number of contracts than to the dollar amounts involved. A subsample of banks, for example, handled thirty appliance contracts for every \$10,000 in volume but only five automobile contracts for the same dollar volume.⁵ The cost of handling \$100 of appliance paper was accordingly much higher than the cost of handling the same dollar volume of automobile paper. Cost figures from these banks showed operating expenses of \$7.40 per \$100 for appliance paper and \$3.09 per \$100 for indirect automobile paper.

The average size of contracts acquired during the year varied among institutions from \$436 at consumer finance companies to \$1,031 at commercial banks (Table 30). These averages reflect the type of business conducted, as well as the size of contract by type of credit. The estimated average personal loan contract acquired by finance companies was only \$431, compared with the average indirect automobile contract of \$1,875 at commercial banks. The latter estimate includes both new- and used-car credit contracts.

Both the cost of acquiring new contracts during the year and the cost of servicing and handling old contracts are intermingled in the annual expense data obtained in this study. As a result, dividing annual expenses by the number of contracts acquired does not give a very good measure of the costs of acquiring an individual credit contract. Nor does dividing annual expenses by the number of outstanding contracts give a very good measure of the cost of handling and servicing credit contracts. However, such averages do give some indication of the influence of size of contract on costs. Estimates of the cost per outstanding contract, shown in the last column of Table 30, reveal that the percentage range of costs among different types of institutions is greatly reduced when costs are expressed per contract.

The high dollar cost per \$100 of credit of consumer finance companies is clearly related to the small average size of contract. The differences between operating costs at consumer finance companies and other lenders are sharply reduced when the comparison is based on the cost per outstanding contract rather than on cost per \$100 of credit. Consumer finance company costs per \$100 of credit are three and a half times

⁵ These figures are based on data from a subsample of five of the total bank sample.

TABLE 30
ANNUAL OPERATING EXPENSES BY TYPE OF INSTITUTION
AND SELECTED TYPES OF CREDIT, 1959
(dollars)

Type of Institution	Cost Per \$100 of Credit Outstanding ^a	Average Size of Contract		Cost Per Contract Outstanding ^d
		Acquired ^b	Outstanding ^c	
ALL TYPES OF CREDIT				
Nine consumer finance companies ^e	14.25	436	346	49.30
Ten sales finance companies ^e	7.74	896	700	54.18
Nine commercial banks ^e	4.17	1,031	723	30.15
All federal credit unions	3.30	593	553	18.25
SELECTED TYPES OF CREDIT				
Nineteen finance companies:				
Automobile contracts	5.26 ^f	1,768	1,149	60.44
Personal loans	14.42	431	341	49.17
Five commercial banks:				
Automobile paper, indirect	3.09	1,875	1,181	36.49
Automobile paper, direct	2.84	1,692	1,066	30.27
Modernization loans	3.49	1,403	909	31.72
Personal loans	4.36	714	468	20.40
Other goods paper	7.40	335	220	16.28

Source: Based on samples described in source to Table 29.

^a

Data for group totals from Table 29, line 4.

^b

Obtained by dividing the dollar volume of contracts acquired by the number of contracts acquired during the year.

^c

Obtained by dividing the amount outstanding (average of beginning and end of year) by the number of contracts outstanding (average of beginning and end of year).

^d

Obtained by multiplying the cost per \$100 of credit (col. 1) by the average outstanding contract (col. 3); equivalent to total operating expenses divided by average number of contracts outstanding at beginning and end of year.

^e

Average balances of contracts acquired and outstanding were obtained by weighting the average balances by type of credit by estimates of the number of contracts acquired and outstanding.

^f

Estimates of the cost of automobile contracts and of all other contracts were obtained by assuming that the cost per \$100 for automobile contracts was the same at both consumer and sales finance companies and that the cost per \$100 for all other contracts (largely personal loans) was also the same at each type of institution. That is, it was assumed that the over-all average costs per \$100 differ only because of the difference in the proportions of auto and other contracts outstanding. If a is the cost per \$100 of automobile contracts and b the cost per \$100 of other contracts, and these are weighted by the relative proportions of amounts outstanding, then $.019a + .981b = \$14.25$ (for nine consumer finance companies), and $.729a + .271b = \$7.74$ (for ten sales finance companies). Hence $a = \$5.26$ and $b = \$14.42$.

those of banks and nearly twice those of sales finance companies but their costs per outstanding contract are only one and a half times those of commercial banks and are smaller than those of sales finance companies.

TYPE OF CREDIT

Data for commercial banks show a wide variation in cost by type of credit (Table 30). Operating expenses on direct automobile paper were \$2.84 per \$100, compared with \$7.40 per \$100 on other goods paper. These differences reflect many elements, such as risk, contract size, the number of instalments, and others that cannot be identified from available data. Such marked cost differentials within the same institutional structure suggest that some of the variation in costs among different types of institutions can be attributed to variations in the type of credit they extend.

The cost differential on the same type of business between types of institutions is sizable. The cost of providing personal loans at finance companies was nearly \$10 per \$100 more than at commercial banks, and nearly \$11 per \$100 more than at credit unions. Part, but not all, of these differentials can be explained by differences in average size of loan. The cost per contract was higher at finance companies than at other institutions, but the percentage spread was much smaller than the range in costs per dollar.

INSTITUTIONAL DIFFERENCES

The expenses of all lenders are shaped to some extent by the legal and institutional framework within which they operate. The operating expenses of credit unions, for example, are reduced in a number of ways by their cooperative organization. Much of the clerical work is done by the voluntary help of the members, sometimes during time paid for by the sponsoring organization. Quarters are frequently provided by the sponsoring organization, and promotional expenses are usually nominal because of the limited membership. A quantitative comparison of the savings that result from these advantages is not possible. A rough indication of the nature of the differences is obtained by comparing the credit union costs with those of the sample of commercial banks. Commercial bank salary costs were a third larger, and their occupancy and advertising expenses were four times larger than those of credit unions.

COMPARISON OF COST OF CREDIT

The business conducted by consumer finance companies resembles that of credit unions in many ways. Both types of institutions deal primarily in relatively small personal loans, but their expenses differ widely. Salary expenses of consumer finance companies were three and a half times those of credit unions. Their occupancy costs were seventeen times larger, and their advertising expenses were twelve times larger.

The institutional advantages and disadvantages of other types of companies are less obvious and hence more difficult to detect. Regulations that specify operating procedures or legal restrictions that limit the size of loan may adversely affect expense ratios. The impact of regulatory provisions on consumer finance companies probably provides the best illustration of the cost differential arising from legal and administrative supervision. The adverse effect of their small loan size on expenses has already been discussed. Administrative provisions such as those requiring the issuance of new certificates and the cancellation of old ones upon the renewal of the loan and those specifying the daily computation of interest charges, add to the high cost of their operations.

INDIVIDUAL COMPANY VARIATIONS

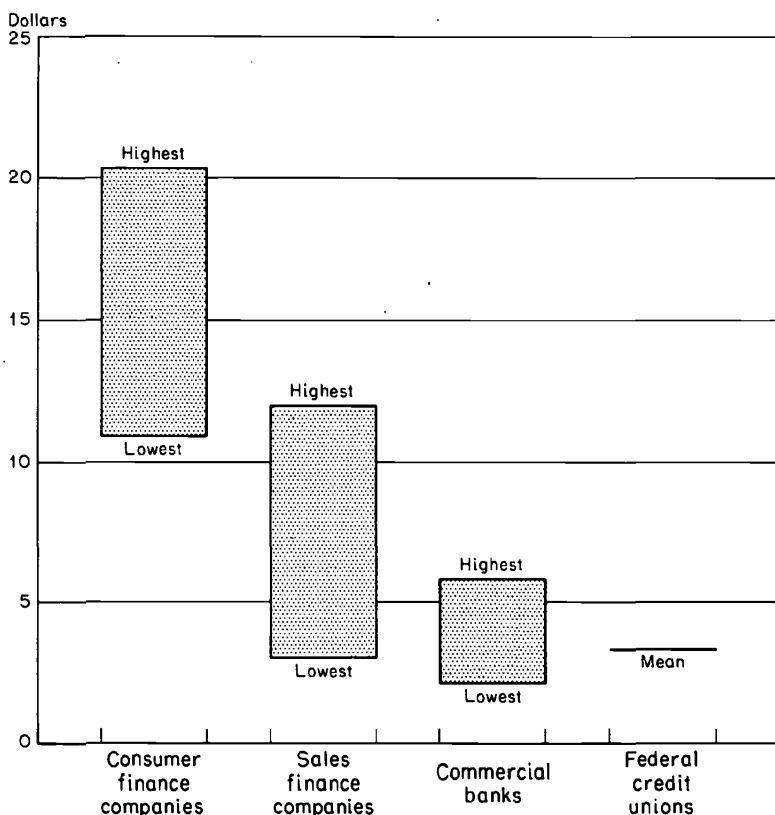
As would be expected, individual companies of each type of institution differ considerably from an average for all companies. Many of the factors explaining differences in operating expense among different types of institutions apply to individual institutions. They operate in different markets and assume different credit risks, specialize in different types of credit, and work with varying degrees of efficiency.

A comparison of expense data for companies that show extremes in costs reveals considerable overlapping among types of institutions (Chart 10). The lowest-cost consumer finance company had lower operating expenses than did the highest-cost sales finance company. The lowest-cost sales finance company had lower costs than did the highest-cost commercial bank, and the bank with the lowest cost fell below the average for all federal credit unions.

Variations in Nonoperating Expenses

Nonoperating costs include the cost of nonequity funds, provisions for income taxes, and the lender's profit. Differences in costs among the four types of institutions reflect primarily different sources of funds and, in the case of federal credit unions, exemption from income taxes (Table 29). These costs contributed significantly to variations in gross

CHART 10
Individual Company Variations in Operating Expenses, 1959
(per \$100 of average outstanding credit)



SOURCE: Bureau of Federal Credit Unions and sample data obtained for study.
NOTE: Includes dealer's share of gross finance charges.

finance charges among the four types of institutions, although they were less important than operating expenses in explaining these variations.

A number of factors contributed to differences in total nonoperating costs and to the distribution of these costs: (1) the rate paid for funds, in both the equity and nonequity markets; (2) sources and uses of funds, i.e., the proportion of funds supplied by owners and the proportion of resources held idle in nonearning assets; and (3) effective income tax rates.

COMPARISON OF COST OF CREDIT

RATE PAID FOR FUNDS

The institutions covered by this study draw their funds from the entire spectrum of credit markets and attract funds with a wide range of rates and terms. They do not all have access to the same markets, however, and their costs vary accordingly.

Commercial banks have exclusive access to demand deposits as a source of funds. They do not pay interest on these deposits but they assume a substantial part of the costs of handling and servicing these accounts. In addition, they bear hidden costs that cannot be measured, such as loss of earnings that result from holding legal reserves and from the low return on secondary reserves. The cost estimates of demand deposits are based on cost accounting records, and information was not available from the reporting banks to permit a separation of the costs of handling demand and time deposits.⁶ The combined administrative cost of handling deposits at the sample banks, net of service charges, amounted to 70 cents per \$100 of deposits (Table 31).

Both commercial banks and credit unions have access to the market for savings accounts. The cost of these accounts includes interest payment, as well as handling costs. The savings market covered by commercial banks and credit unions cannot be equated, however, because of the greater security offered by the commercial banks through deposit insurance and the debt status of their deposits. Savings accounts placed in credit unions must share many of the risks of equity capital. The sample commercial banks paid an average of 2.7 per cent on their time deposits in 1959 in contrast to cash payments of 3.4 per cent by federal credit unions.⁷ In addition, the total cost of share accounts at credit unions includes the cost of servicing the accounts, retained earnings, and the costs of free insurance provided for shareholders. The total cost of the shareholders' funds in this broad view averaged 5 per cent.

All four types of financial institutions obtained some funds from various debt markets. Commercial banks borrow from other banks and from Federal Reserve banks. Since they typically pay off such borrow-

⁶ An alternate method of estimating the cost of funds to commercial banks would require estimating the opportunity cost of credit to the consumer credit department of a bank. The cost accounting approach was chosen to avoid the arbitrary aspects of an opportunity-cost estimate.

⁷ Insured commercial banks on the average paid a slightly lower figure (2.4 per cent) in 1959 (*Annual Report of the Federal Deposit Insurance Corporation for the Year Ended December 31, 1960*, Washington, 1961, pp. 154-155).

TABLE 31
 AVERAGE COST OF FUNDS BY SOURCE AND TYPE OF INSTITUTION, 1959
 (per cent of average outstanding balances)

Type of Institution	Debt and Deposits	Total Nonequity Funds	Equity Funds	
			Ratio of Net Profits (or Net Income) to Equity Funds ^a	Ratio of Dividends to Equity Funds
Nine commercial banks, total	1.3 ^b	1.2 ^b	7.6	4.5
Interest on time deposits	2.7	--	--	--
Cost of handling deposits	.7	--	--	--
Nine consumer finance companies	5.0	4.6	12.1	7.7
Ten sales finance companies	4.5	4.2	10.3	5.9
All federal credit unions	3.8	3.1	5.0	3.4

Source: Based on samples described in source to Table 29.

^a Because of differences in ownership and objectives, the term net profit is usually not used for credit unions. The term net income is used instead.

^b Includes interest on debt.

COMPARISON OF COST OF CREDIT

ings before statement dates, the data for year-end dates seldom indicate the normal extent of this type of indebtedness. Rates on funds obtained in these markets correspond closely to Federal Reserve discount rates, which ranged between 3 and 4 per cent in 1959. Credit unions borrow relatively small amounts from banks and other credit unions. They paid an average of 3.8 per cent on their debt in 1959.

Finance companies obtain their funds from banks and from public markets. The large finance companies have access to nearly all of the public markets, both long- and short-term. Some of them place commercial paper directly with financial and nonfinancial corporations, others sell their paper through dealers. They raise long-term funds in the form of either subordinated or senior debt in the capital markets and by direct placement. In 1959 the sample of sales finance companies paid an average of 4.5 per cent for their debt funds obtained in all markets, while the consumer finance companies paid an average of 5 per cent.

Variations in the rate paid for total nonequity funds depend on the credit rating of the individual institution, the sources used, the mix between long- and short-term funds, and the importance of noninterest-bearing liabilities. The average rate paid by individual sales finance companies varied from 3.7 to 4.7 per cent and that paid by consumer finance companies varied from 4.0 to 5.6 per cent.

Since most banks require finance companies to maintain compensating balances, the average rate on finance company indebtedness understates the total costs. The added cost appears in this study as part of the costs of idle funds, since the compensating balances are included as bank balances.⁸ This treatment is consistent with that used for bank reserves against deposits.

Equity funds used by banks and finance companies are obtained from local and national markets. The rate that must be earned on the book value of equity funds to attract new funds and the dividends that must be paid depends on the investor's attitude toward a particular company or type of business. The ratio of net profit to equity funds varied from 12.1 per cent for the sample of consumer finance companies to 7.6 per cent for banks (Table 31). Individual company variations in the return on equity were sizable.

⁸ The cost of nonequity funds expressed as a percentage of consumer receivables (Table 29, line 12) reflects the cost of compensating balances, in that the total cost of funds is related to the proportion of funds that is actually invested in receivables.

SOURCES AND USES OF FUNDS

The proportion of total resources obtained from nonequity sources has an important impact on both the total cost of funds and upon the return to the lender. The percentage of nonequity funds used varied from 90 at commercial banks to 3 at credit unions (Table 32). The sample sales finance companies obtained 84 per cent and the consumer finance companies about 75 per cent of their funds from nonequity sources.

Since a share of the funds used in any lending operation must be allocated to cash balances and other nonearning assets, the cost of such funds reduces the return available from earning assets. Many accountants deduct the amount of nonearning assets from the total debt in computing the effective rate paid for funds used in their lending operations. Since the proportion of idle funds differed so widely from one type of institution to another, the costs of nonearning assets were treated in this study as a separate item of expense. In many cases, however, part of the expense of nonearning assets could be treated as a cost of non-

TABLE 32
SOURCES AND USES OF FUNDS BY TYPE OF INSTITUTION, 1959
(per cent)

Item	Nine Consumer Finance Companies	Ten Sales Finance Companies	Nine Commercial Banks	All Federal Credit Unions
Sources:				
Nonequity	74.6	84.2	90.2	2.6
Equity	25.4	15.8	9.8	97.4
Total	100.0	100.0	100.0	100.0
Uses:				
Earning assets, net	87.2	88.0	77.1	92.2
Nonearning assets	12.8	12.0	22.9	7.8
Total	100.0	100.0	100.0	100.0

Source: Based on averages of beginning- and end-of-year dates for samples described in source to Table 29.

COMPARISON OF COST OF CREDIT

equity funds. The large legal reserves required of banks could be considered in part as a cost of deposits, and the compensating balances that banks require of finance companies could be considered as part of the cost of borrowing.

The proportion of resources held in nonearning forms varied from 23 per cent for the sample of banks to 8 per cent at federal credit unions. Finance companies of both types held about 12 to 13 per cent of their resources in nonearning forms (Table 32).

COST OF NONEQUITY FUNDS

The cost of nonequity funds used in consumer credit varied between \$4.02 per \$100 of credit at sales finance companies to 12 cents per \$100 at federal credit unions (Table 29). These differences reflected variations in the rates paid for these funds, in the proportion of nonequity funds used for consumer credit, and in the burden of nonearning assets.

The average cost of nonequity funds to lenders fell within a relatively narrow range except for commercial banks (Table 31). Finance companies and credit unions paid between 3.1 and 4.6 per cent, whereas the banks paid an average of 1.2 per cent.

The cost of nonequity funds used in consumer credit includes the burden of providing part of the funds used in nonearning forms. Many companies deduct their nonearning assets from nonequity funds in computing the effective rate paid for funds used in lending operations. When nonearning assets take a relatively large share of total resources, the effective cost of money will be considerably higher than the rate paid for the funds. The cost of nonearning assets is relatively most important at commercial banks, where idle funds add about 40 per cent to the effective cost of money used in lending (Table 33).

Since the average cost of nonequity funds used in consumer lending also depends on the extent to which these funds are used, the proportion of nonequity to equity funds affects the total cost of such funds as a percentage of consumer receivables. The extremely low cost of nonequity funds at credit unions merely reflects the minor importance of such funds in their total resources, while the high cost at finance companies reflects the importance of nonequity funds.

The various elements entering into the cost of nonequity funds as a part of the gross finance charge are summarized in Table 33. Although the average rate paid for nonequity funds by consumer finance companies was higher than that paid by sales finance companies, the net cost to the consumer was about the same because of the difference in the share

CONSUMER CREDIT COSTS, 1949-59

TABLE 33

COST OF NONEQUITY FUNDS BY TYPE OF INSTITUTION, 1959
(per cent of average outstanding balances)

Ratio of Dollar Cost of Nonequity Funds to:	Nine Consumer Finance Companies	Ten Sales Finance Companies	Nine Commercial Banks	All Federal Credit Unions
Total debt and deposits	5.0	4.5	1.3	3.8
Total nonequity funds	4.6	4.2	1.2	3.1
Nonequity funds minus nonearning assets	5.6	4.8	1.7	a
Consumer credit receivables ^b	4.0	4.0	1.5	.1

Source: Based on samples described in source to Table 29.

^a

Nonearning assets exceed nonequity funds at federal credit unions.

^b

Table 29, cost of nonequity funds.

of equity funds used. The low cost of nonequity funds to consumers at commercial banks, despite the importance of these funds in their total resources, reflects the lower cost of these funds to the bank.

INCOME TAXES

The most striking variation in income tax arises from the tax exemption of credit unions as cooperative organizations. The other three types of institutions are all subject to income taxes.

Among the three taxpaying institutions, the sample of consumer finance companies reported the highest tax cost—\$2.73 per \$100— and sales finance companies the lowest—\$1.07 per \$100. The differences reflected primarily their earnings before tax. The effective rate on pre-tax earnings averaged 45 per cent at all three types. The percentage varied slightly by type of institution but the differences were small and might have been caused by adjustments for over- or underaccruals in previous years or other special tax adjustments rather than by different effective rates.

COST OF EQUITY FUNDS

The cost of equity funds (lender's profit) from consumer credit ranged from 81 cents per \$100 of consumer credit at sales finance companies

COMPARISON OF COST OF CREDIT

to about seven times that amount, or \$5.71 per \$100, at federal credit unions (Table 29). These differences reflect variations in the ability of lenders to convert the return from their lending into a satisfactory return on equity and the return from consumer credit that has to be maintained to provide an adequate return on net worth to attract and hold funds in the business. The total cost of equity funds to the consumer falls well below the return on equity funds. For example, consumers paid 81 cents per \$100 for the use of equity funds at sales finance companies in 1959, yet the return on equity funds (net profits to equity funds) at these companies was \$10 per \$100. Sales finance companies earned a net operating income from consumer credit of 5.9 per cent and, after interest but before taxes, were able to earn 18 per cent on their net worth.

The principal device for enlarging the return from consumer lending lies in the financial advantage or leverage of the use of nonequity funds. If the lender can earn a higher return on his resources than he pays for the funds, the differential profit accrues to the owners and enlarges the return. This advantage permits the lender to charge the consumer less for the use of equity than he has to earn to attract risk capital into the business.

All stockholder-owned institutions depended heavily on the financial advantage of nonequity funds to produce a satisfactory return on equity from the relatively low equity cost to the consumer (Table 34). Leverage was highest at commercial banks where 83 per cent of the return on equity came from the use of nonequity funds, the next highest at sales finance companies, and the lowest at consumer finance companies where 59 per cent of the return was from this source. The high cost of equity funds to the credit union borrowers can be explained almost entirely by the absence of financial advantage from the use of debt.

All four types of institutions invested part of their resources in non-consumer activities. Commercial banks and credit unions showed a lower return from all earning assets than from consumer assets alone (Table 34, lines 1 and 2). At the sample commercial banks, the average net operating income on all earning assets was 3.4 per cent, or 1.9 percentage points less than the yield on consumer assets. At the credit unions, the net operating income on all earning assets was .5 of a percentage point below the return on consumer credit. Consumer credit activities therefore carry more than a proportionate share in the total cost of equity funds at these institutions.

The sample sales finance companies, however, earned a higher aver-

CONSUMER CREDIT COSTS, 1949-59

TABLE 34

FACTORS IN LENDER'S PROFITS BY TYPE OF INSTITUTION, 1959
(per cent of average outstanding balances)

Ratio	Nine Consumer Finance Companies	Ten Sales Finance Companies	Nine Commercial Banks	All Federal Credit Unions
1. Net operating income from consumer credit to consumer receivables	9.6	5.9	5.3	5.8
2. Net operating income to earning assets	10.4	7.2	3.4	5.3
3. Net operating income to total assets	9.1	6.3	2.5	4.9
4. Profits before taxes to equity funds ^a	22.2	17.9	14.5	5.0
5. Net return from nonequity to equity funds (line 4 minus line 3)	13.1	11.6	12.0	0.1
6. Provision for income taxes to profit before taxes	45.8	42.5	46.0	--
7. Net profits to equity funds ^a	12.1	10.3	7.6	5.0
8. Percentage of profit obtained from leverage on nonequity funds (line 5 + line 4)	59.0	64.8	82.7	0.9 ^b
ALTERNATIVE DERIVATION OF LINE 5				
a. Net operating income to total assets (line 3)	9.1	6.3	2.5	4.9
<u>less</u>				
b. Cost of nonequity funds to nonequity funds	4.6	4.2	1.2	3.1
<u>equals</u>				
c. Net return from nonequity funds to nonequity funds	4.5	2.1	1.3	1.8
<u>times</u>				
d. Leverage coefficient (ratio of nonequity to equity funds)	3.0	5.6	9.6	0.03
<u>equals</u>				
e. Net return from nonequity to equity funds (line 5) ^c	13.5	11.8	12.5	0.05

Source: Based on samples described in source to Table 29. Items 1 and 7 are based on data in Tables 29 and 31, respectively.

^a Based on net income to equity for federal credit unions.

^b Based on unrounded data.

^c Differences between lines 5 and e result from rounding errors introduced by alternative methods of calculation.

COMPARISON OF COST OF CREDIT

age return (1.3 percentage points higher) on their total earning assets than on their consumer assets. Part of this difference may reflect the difficulty of adjusting the sales finance cost data to allow properly for the cost of nonconsumer credit. Provision was made for the cost of insurance and other nonconsumer operations, but such costs are difficult to segregate, and some of the related costs may have been underestimated.

Profitable alternatives for the use of funds permit some flexibility in the pricing of consumer credit for some companies. To the extent that the higher earnings rate on other earning assets arises from activities related to consumer lending, such as credit life insurance or insurance on the collateral to the loan, the lender can offer lower rates on credit. In such cases, part of the cost of consumer credit may be absorbed in other activities and paid for in the form of higher prices for the related items. This type of substitution is common in retail operations, where part of the cost of credit may be absorbed in the price of the article sold. The possibility of substitution makes an exact determination of the total cost of credit to consumers virtually impossible.

COMPARISON BY TYPE OF INSTITUTION

Nonoperating expenses on consumer credit were highest at the sample of consumer finance companies. Their high cost compared to other types of institutions reflected their tax disadvantage relative to credit unions; the high cost of their nonequity funds; their small ratio of nonequity funds to total resources, which, together with their high cost of funds, resulted in the lowest leverage among the stockholder-owned institutions; and the high cost of their equity funds.

At the other extreme, the commercial bank sample had the lowest nonoperating costs. They were \$4.37 per \$100 below those of the consumer finance companies and reflected primarily the low cost of their nonequity funds and their high ratio of nonequity funds to total resources, which, together with their low cost of funds, gave them the largest advantage from leverage.

Federal credit unions had the second lowest nonoperating costs. Their position relative to finance companies stemmed primarily from their exemption from income taxes and their inexpensive source of equity funds from the savings markets.

The sample of sales finance companies showed nonoperating costs of \$2.70 per \$100 less than those of the consumer finance companies, despite the many similarities in their operations. They were able to achieve this cost differential largely because: (1) they were able to

supplement their earnings from consumer credit by a high rate of return on their other activities; (2) they obtained a slightly better rate on non-equity funds; (3) they had a high ratio of nonequity funds to total resources and hence were able to show greater leverage; and (4) their cost of equity funds was smaller.

Rate of Profits⁹

The lenders' profits are a necessary cost to consumers as long as they are no larger than needed to attract and hold equity funds in the industry. The profits from consumer credit would be considered "normal" if they were similar to those of their competitors for equity funds. Such comparisons are difficult because of a wide variety of factors that enter into the market evaluation of equities. The rate that any company or any type of institution must earn depends on the investor's appraisal of the risks involved, potential growth, and his attitude toward the industry and the particular company.

The extremes in the market for equity funds are illustrated by the difference between the sources of funds for credit unions and those for consumer finance companies. Credit unions offer a high degree of liquidity with some risk, while the stock of a finance company may offer less liquidity and greater risk. Investors in the latter case must be compensated by a higher return.

The average net profit to the book value of equity funds in 1959, shown in Table 34, ranged from 5 per cent at federal credit unions to 7.6 per cent at the sample commercial banks, 10.3 per cent at the sales finance companies, and 12.1 per cent at the consumer finance companies. Although these averages vary with the gross finance charges at these institutions, this does not imply excessive profits in any case. The normal return would be expected to vary with liquidity, risk, the growth potential, and the investor appeal of the different types of institutions.

All the profit rates for the stockholder-owned financial institutions fell well within the range of rates at manufacturing corporations.¹⁰ The average profit to equity funds for the samples of stockholder-owned companies covered by the study was 9.9 per cent in 1959, compared with an average for all manufacturing corporations of 10.4 per cent.

⁹ The term "net income" has been used to indicate the return after expenses for federal credit unions instead of net profits because of differences in the ownership and objectives of credit unions.

¹⁰ *Quarterly Financial Report for Manufacturing Corporations, First Quarter 1960*, Federal Trade Commission and Securities and Exchange Commission, pp. 12-27.

COMPARISON OF COST OF CREDIT

The profit rates for a number of industry groups, including the chemical, drug, and tobacco industries, were higher than the highest rate for institutions covered by the study. These comparisons cannot necessarily establish the profits of consumer lending as normal, but they place consumer credit institutions in an intermediate position among their competitors for equity capital.