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Summary Survey

IN A little more than twenty years the financing of consumers on an instalment basis grew from what was probably an unimportant amount into a 6 billion dollar business in 1941. The major share of this business was handled by specialized types of agencies, rather than by commercial banks. These specialized agencies may be classified into two groups, according to the character of activity in which they predominantly engage. The first includes sales finance companies, which typically engage in the financing of consumers' purchases of goods through the acquisition of instalment contracts from retail dealers; the second group includes personal finance companies, industrial banking companies, and credit unions, which typically engage in the direct extension of personal cash loans to borrowers.

The original development of the specialized agencies, and their subsequent garnering of the major share of the consumer instalment business, was at least partly due to lack of competition from commercial banks for this type of paper. There were a number of reasons why commercial banks, as a whole, had not entered this field.

First, the average commercial bank had profitably employed its facilities in financing agriculture and business enterprises; second, commercial bankers were traditionally reluctant to grant credit for "non-productive purposes"—a category in which the financing of consumption was generally included; and third, the extension of consumer credit was regarded by banks as unprofitable and uneconomic because loans for small amounts entail high operating costs, generally in excess of the rates of charge permitted banks under the usury laws.

The specialized agencies found the business profitable, however, for they were enabled to exceed the legal usury rates, either by receiving specific legislative authorization to charge higher rates, or by avoidance of the limitations in the usury statutes through the benefit of favorable judicial decisions or the use of technical devices.

In 1929 consumer instalment paper, held almost exclusively by retailers and the specialized agencies, amounted to 3 billion dollars.

With bank earnings during the 1930's at lower levels than in earlier years, commercial banks entered the field in considerable numbers, and acquired a substantial share of the business. At the end of 1941 the total amount of consumer instalment outstandings was distributed as follows:

Sales finance companies	33 percent
Commercial banks	26 percent
Retail dealers	19 percent
Personal finance companies	10 percent
Industrial banking companies	6 percent
Credit unions	4 percent
Others	2 percent

In spite of commercial banks' rapid acquisition of a considerable share of the consumer instalment credit business, this type of financing, except in relatively few banks, still represented only a small portion of their activity. Their loan operations remained typically those of an agency engaged primarily in the financing of business enterprises.

In this study the operations of the specialized agencies, engaged almost entirely in financing consumers, are contrasted with the operations of commercial banks. Specific data on banks' consumer instalment lending activities are either not available or inadequate. In this field their cost of operations and rate of operating profit probably do not differ materially from those of insured industrial banks, but because of lack of information no attempt has been made to compare the operating results of their consumer financing with those of the specialized agencies.

In the analysis of operating characteristics in this study, reliance was based chiefly upon summary balance sheet and profit and loss statements. For the most part, assets of individual companies were classified into the four major categories: loans, securities, cash, and miscellaneous assets; liabilities were classified as borrowings or miscellaneous liabilities, while all capital accounts were classified as net worth. Profit and loss accounts of individual companies were classified into the following broad categories: income; cost of operations, including taxes, losses and all expenses except interest;

interest payments or the cost of borrowed funds; and net profit, including dividends and interest paid on equity capital.

The term, operating profit, designates the difference between total income and the cost of operations, and the term net profit designates the difference between operating profit and interest payments or the cost of borrowed funds. The rates used in the analysis are expressed as percent per annum. The rate of income on loans (income received during the year in percent of loans) represents the gross return from the funds lent; the rate of operating profit (operating profit during the year in percent of total assets) reflects the degree of success of the business in utilizing the total funds at its disposal; while the rate of net profit (net profit during the year in percent of net worth) represents the degree of success of the business in utilizing the owners' investment.

The results of this study may be summarized in five main points. *First,* there is a sharp contrast between the character of assets, operating methods and activities and sources of funds of the specialized agencies, on the one hand, and of commercial banks on the other. *Second,* with respect to each of these operating characteristics, however, differences exist among the various types of specialized agencies; among individual companies within each type of agency; and among individual commercial banks. *Third,* significant differences in rates—of total income, costs of operations, and operating profit—among types of agencies and among individual companies and banks, are traceable to differences in character and typical size of loan; they do not appear to be traceable to size of enterprise, as such. *Fourth,* significant differences in cost of borrowed funds—among agencies and individual units—result from variations in sources of funds, and from variations in activities and in character of assets which accompany variations in size of enterprise. *Fifth,* important changes in total income, costs, profits and dividend records over the period 1929-41 reflected severe business recession, subsequent recovery, and the growth to maturity of the specialized agencies.

CONTRASTS IN OPERATING CHARACTERISTICS: CONSUMER AGENCIES AND COMMERCIAL BANKS

An outstanding characteristic of the consumer instalment financing agencies, as a group, was their ability throughout the period under

review to maintain from 80 to 90 percent of their assets in the form of loans, predominantly in small amounts to consumers. Enterprises of this type have normally needed to keep only a low proportion of their total assets in the form of cash, for the regularity of the flow of repayments gives them a high turnover of funds, and their cash needs are limited to uses incident to current and new business operations. Ordinarily, too, they do not invest in securities, except as an alternative to holding cash when they cannot readily adjust sources of funds to changes in volume of activity. Miscellaneous assets, including real estate, furniture and fixtures, and repossessions, have also been a negligible percentage of total assets.

In sharp contrast to the typical specialized agency, commercial banks as a group have in recent years held less than 30 percent of their total assets in loans, with securities exceeding loans at nearly 40 percent of total assets, and cash equaling loans. This asset distribution is partly the result of the peculiar position of commercial banks in our monetary structure, for banks have rarely been in a position to hold loans in excess of 65 percent of total assets. Their function of providing a circulating medium through the demand deposit, and their use as a means of effecting the transfer of funds, make it necessary that they maintain reserves in cash, and in balances with a central bank and with correspondents—reserves that are not required of the consumer agencies.

The figures for commercial banks as a whole are dominated, however, by those of the largest banks in the large centers, which have experienced the most marked increase in deposits in recent years. One out of every four banks still holds half its total assets in the form of loans. In general, banks in the western and southern states, regions dominated by agricultural and extractive industries, hold larger proportions of loans than banks in states that are dominated by manufacture and trade.

Many commercial banks—about 1,500, or one-eighth—still hold no consumer instalment loans, and the extent to which others have entered the field varies widely. It might be expected that banks in the largest centers, where the growth in deposits has been greatest, would have had the strongest incentive to enter the consumer instalment financing field. Actually, however, there is much diversity in this respect. The largest banks in these centers, accustomed to dealing with the largest business borrowers, have developed the

consumer instalment business the least, but other banks in the same centers have extended a larger proportion of consumer loans than have those in the small centers.

Banks in the smallest centers have not developed a significant volume of instalment loans to consumers, because the regular repayment basis is not suited to the needs of the dominant type of borrower in such communities; but in significant proportion their loans—extended to farmers, workers, tradesmen and small manufacturers—are otherwise similar to the typical consumer instalment loan. The small amount of the note, the use of chattels as security, the low net worth of the borrower, are all characteristic also of instalment lending to consumers.

Although all the specialized agencies have been engaged predominantly in the extension of consumer credit in small amounts, repayable on an instalment basis, they have differed widely in the sources from which they have derived their funds. This variation arises from differences in the creditworthiness attributed to retail instalment paper and cash loans; differences in the degree of seasonal and cyclical fluctuations to which these two types of paper are subject; differences in the size of individual enterprise—and also from certain peculiarities of borrowing practices, particularly those of industrial banks. The latter, alone, have derived a significant proportion of funds from depositors, as a result of which they are, in fact, an intermediate type, between the other specialized agencies and commercial banks.

In all the specialized agencies except industrial banks, the proportion of funds represented by net worth has been materially higher than in commercial banks. In the latter, the net worth proportion has decreased materially and is now at its lowest level since the formation of the national banking system, amounting to less than 9 percent of total funds. This continued reduction has been largely due to forces beyond the control of the individual banks, chiefly to the large increases in United States government securities and in demand deposits occasioned by the financing of the recovery and war programs.

A consumer instalment financing agency derives its income mainly from loans, in the form of interest or discount or special types of fees, or charges arising from the extension or collection of loans. The proportionate amount of income from other sources depends

upon the diversification of the activities of the individual company.

In commercial banks, on the contrary, income from loans accounts for somewhat less than half of total income. Interest and dividends on securities account for somewhat more than one-quarter, and the remainder is derived mainly from commissions and fees for services performed, from service charges on deposit accounts, trust department income and rent from real estate and safe deposit vaults.

The effective rate of income on loans differs significantly for each type of agency, and also for different companies within each type. These variations may be attributed in large measure to the difference in charges against different types of loans (particularly as regards security and size) rather than to the difference in rates charged on loans of a comparable nature and size.

In all the specialized agencies the effective rate of income on total loans has been materially higher than that received by the typical commercial bank on its total loans. Here again, the difference reflects a difference in type of loan. On the average, the loan income of banks has amounted to less than 4½ percent of average outstandings, and income on securities about 2 percent. Thus income on earning assets has amounted in recent years to a little over 3 percent in commercial banks, as compared with from 9 to over 30 percent in the specialized agencies.

There is no evidence to indicate that the internal distribution of operating costs (that is, all expenses except interest on borrowed funds) varies materially among the different agencies: except in credit unions, operating costs absorb about the same proportion of total income in all the specialized agencies and in commercial banks. Although rates of operating costs have been considerably higher among consumer instalment financing agencies than among commercial banks, the indicated rate of loss in some of the specialized agencies has been less than, and in others has not greatly exceeded, the average loss ratio of commercial banks on all their loans. In both consumer agencies and commercial banks charge-offs on loans have characteristically absorbed only a small proportion of total income.

In regard to rate of operating profit, therefore, the agencies *as types* may be ranked, on the average, in the same order as for rate of total income. That commercial banks' rate of operating profit has

been consistently below that of the specialized agencies may be attributed not only to their lower rate of income on loans, but also to the inherent inability of banks to invest as high a proportion of total funds in earning assets.

The burden of interest payments is primarily dependent upon the proportion of borrowed funds and on those factors determining creditworthiness which are now characteristic of individual enterprises rather than types of agencies. The rate of interest on such funds has been less than the rate of operating profit, so that the average net profit has consistently represented a high rate of return on capital funds in each type of specialized agency. The same has been true of commercial banks because of the large volume of funds represented by demand deposits upon which no interest is paid.

The rate of return on the capital funds of commercial banks, however, is considerably lower than that of any of the specialized agencies except credit unions. All types of specialized agencies and commercial banks show higher rates of net profits on capital funds than does corporate enterprise in general.

Income tax returns indicate that a larger proportion of commercial banks than active corporations in general has shown profitable operations except in years of deepest depression. In addition, the average rate of net profit on net worth of all commercial banks filing returns has been higher than that shown by all other types of corporations combined.

Cash dividends paid by the specialized agencies have represented relatively high percentages of net worth, particularly in the sales finance and personal finance companies. However, as a result of their relatively higher rates of net profit on net worth, dividends paid have rarely exceeded net profit, averaging about 80 percent. All these specialized agencies, and also commercial banks, appear to average higher dividend rates (on net worth) than all corporations in general.

The rate of dividends paid by commercial banks, on the other hand, though lower than the specialized agencies' rate (with the exception of credit unions) tends to be more regular. Whereas commercial bank dividends far exceeded net profit in the early thirties, since 1935 they have typically been about 60 percent of net profit. This dividend record has been more conservative than that of sales

finance and personal finance companies, and much more conservative than the average for all corporations filing income tax returns during the same period.

DIFFERENCES AMONG THE SPECIALIZED AGENCIES

Sales Finance Companies

The increased industrialization of the country accompanying and subsequent to the First World War, and the increased level of national income in the 1920's, gave impetus to the growth of the sales finance company, which provided means for a wider distribution of durable consumer goods. This type of agency is free from the jurisdiction of the usury statutes, for the courts have held that income arising from the purchase of instalment contracts—the business typical of sales finance companies—is a part of the cost of the merchandise purchased and does not constitute "interest" in the statutory sense.

Sales financing is not only subject to seasonal fluctuations, reflecting changes in the volume of retail instalment sales, but it has also shown extreme cyclical fluctuations, paralleling business cycle changes in the production of durable consumer goods. The maintenance by sales finance companies of a high percentage of total assets in the form of loans has been made possible only by their very flexible sources of funds, consisting chiefly of short-term borrowings, either from banks or in the commercial paper market.

Such funds have been made readily available to sales finance companies because of the high quality of the instalment receivables that serve as security. Repayment is, in effect, doubly or triply assured —by the borrowing sales finance company, by the retail dealer from whom the paper has been acquired (if acquired on a recourse basis), and by his customer, the purchaser of the article sold—in addition to the possibility of securing physical possession of the article itself.

In common with other specialized agencies, the sales finance company can, if necessary, effect a rapid liquidation of its short-term debt, since its credits are repaid out of the current income of the ultimate consumers. With this heavy dependence upon short-term funds, net worth has amounted to a moderate proportion, generally about one-third, of total funds (that is, of total assets). Through most

of the period 1929-41 long-term debt was found in only a few of the larger sales finance companies.

Although the credits extended are ultimately secured by the article financed, the companies have tended to refinance delinquent contracts. When repossession is resorted to they make every effort to dispose of the article, through recourse to the dealer or through sale. As a result, miscellaneous assets, including repossessions, have constituted a low proportion of total assets.

In the typical sales finance company, whose principal asset is automobile paper, the chief source of income has been the discount on such paper, and insurance commissions have been next in importance. But in some companies, particularly the larger ones, income from wholesale financing, interest on small loans, and income from factoring (the discounting of accounts receivable) have been significant sources of total income.

The average rate of income received by sales finance companies, generally in excess of 12 percent of outstanding loans, has been as high as that of any type of specialized agency except the personal finance company. Operating costs (excluding interest payments on borrowed funds, but including charge-offs) have absorbed slightly over 60 percent of total income, leaving an operating profit amounting to over 4 percent of total assets. This rate of return is materially above that shown by industrial and commercial banks, and below that shown by personal finance companies.

The rate of interest paid on borrowings has been lower, however, than the rate of operating profit, and therefore the residual net profit has represented a return of at least 10 percent on equity funds. Among the specialized agencies this rate of return has been exceeded only by the personal finance companies.

Personal Finance Companies

The personal finance company is generally engaged in but one type of activity—the extension of loans to individuals, usually not exceeding $300 in amount. Since these loans have constituted about 85 percent of total funds, the proportion representing cash, securities and miscellaneous assets (business quarters and equipment) is characteristically low.

To combat the evils of loan sharks and unregulated lenders, small loan laws have been adopted in all but a few states, granting per-

sonal finance companies specific exemption from the usury statutes and authorizing them to charge rates within stipulated legal limits. The legal maximum varies from state to state, ranging mainly from 1½ to 3½ percent a month on the unpaid balance of the loan. Actually the companies' interest income tends to be lower than the maximum would indicate, averaging about 30 percent of year-end loans. This rate of income represents, nevertheless, twice as high an average as that of the other agencies covered in this study.

Not only the rate of income on loans but also the rate of operating costs—averaging over 20 percent of outstandings—has been highest among the personal finance companies; this total includes charge-offs, or bad-debt expense, which have not been significantly higher than in the other types of agencies. Although total operating costs have represented a slightly higher proportion of total income, operating profit in relation to total income has been about the same as in industrial banks and only slightly less than in sales finance companies, so that in relation to total assets it has been higher than in any other of these agencies—over 10 percent.

Since their volume of cash loans has been subject to relatively smaller seasonal or cyclical fluctuation, personal finance companies have not found it undesirable to derive their funds from relatively permanent sources. The fact remains, however, that at the beginning of the period 1929-41, funds from banks and other short-term sources were not readily accessible to these companies, partly because of bankers' prejudice against small consumer loans and partly because the stigma that earlier attached to the loan shark carried over in some degree to the personal finance company. Characteristically, the bulk of funds, usually 60 percent or more, has been provided by stockholders. Long-term funds from outsiders have taken the form of preferred stock and, in some instances, the participating debenture bond. Except in the very largest companies short-term borrowings have rarely amounted to more than a quarter of total funds.

For their borrowings personal finance companies have in recent years paid only slightly higher rates than the other types of agencies. As a result of the small proportion of borrowed funds, however, net profit, averaging over 12 percent of net worth, has not been much above the rate of operating profit on total funds. Even so, the net profit rate has exceeded that of any other type of specialized agency.

Non-Investment Type Industrial Banking Companies

The non-investment type industrial banking companies may be characterized as a cross between industrial banks and personal finance companies. In their balance sheet characteristics they approximate the latter. A large percentage of their total funds—considerably over half—has been owners' equity, some from preferred stockholders; and the proportion of short-term funds has been small. In the character of their loans, however, and in their rates of income and expense, they approach the industrial banks, although some of them are not distinguishable from personal finance companies specializing in low-rate paper. As a rule they operate under industrial banking laws, which stipulate a maximum rate of charge below that specified in the small loan laws.

In some jurisdictions, where no statutory authorization exists, these companies are permitted by judicial interpretations to charge interest, at the rate prescribed in the state usury law, on the original amount of the loan for its entire term, regardless of the instalment form of repayment. In most cases their interest income is supplemented by service fees, commissions and other charges. On the average their rates of income have been slightly lower than those of sales finance companies, but higher than those of industrial banks.

In the years for which figures are available their charge-offs and total operating costs were lower than those of personal finance companies, and exceeded those of industrial banks. Though they borrowed little, their interest payments absorbed a significant proportion of income, since the rate of interest they paid on borrowings was about the highest of any of the agencies. This may have been due to the relatively small size of the typical company, and thus to difficulty in gaining access to money markets; borrowings, like those of the small personal finance company, may have been from stockholder or management interests.

With the rate of interest on borrowings only slightly lower than the rate of operating profit, and with a high proportion of total funds represented by net worth, the rate of net profit on net worth—slightly over 5 percent—was lower than that of any other type of agency except the credit union.

Industrial Banks

Industrial banks, or investment type industrial banking companies, are characterized by the use of a hypothecation device to accumulate repayments on loans, instead of applying repayments directly to reduce the unpaid balance. This device, linking a loan and a deposit or investment transaction, makes it possible to charge interest on the original amount of the loan at the legal rate for the entire period covered by the transaction. If repayments were applied directly to reduce the loan, the interest collected on the average outstanding balance would represent a rate approximately double the specified rate.

These enterprises, first developed under the name "Morris Plan," after Arthur J. Morris, the founder, were originally intended to grant cash loans to "industrial" workers. In the beginning they issued investment certificates, but with changes in state laws most of them now derive about 80 percent of their funds from depositors. Their net worth proportion, averaging between 15 and 20 percent of total funds, has been the lowest among the specialized agencies, and has approached the low level characteristic of commercial banks. The proportion of deposits was highest—and the net worth ratio lowest—in large institutions in the financial centers, where they experienced the same marked growth that has characterized deposits of commercial banks in recent years.

While most industrial banking companies are now accorded the status of "banks," including the protection of deposit insurance, the extent to which they have assumed other functions of commercial banks varies considerably; in general, this tendency has been greater among the larger banks in the larger centers. Another indication that they are veering away from the typical business of a consumer instalment financing agency is the fact that they hold slightly larger proportions of cash—particularly those that are subject to member bank reserve requirements—and of securities. Nevertheless, security holdings have remained small in comparison with those of commercial banks, and, as in the other specialized agencies, instalment loans have constituted a high proportion of total assets.

Interest and discount, service charges, investigation fees and fines on loans, at an effective rate averaging about 11 percent a

year, have constituted the main income of industrial banks. Other sources of income, which vary from one institution to another, depending on the degree of diversification of activities, include most of the sources from which commercial banks typically derive income—interest and dividends on securities, rents from real estate and from safe deposit vaults, insurance commissions, service charges on checking accounts and interest on bank deposits.

Total operating costs, other than interest payments, have averaged somewhat in excess of 8 percent of average loans outstanding. Most of this cost is attributable to expenses other than charge-offs, for the latter have characteristically been lower than in any type of agency except credit unions—averaging (net) less than 0.5 of 1 percent a year. Since operating costs have absorbed a relatively high proportion of total income, the rate of operating profit on total assets has been lower than that of any of the specialized agencies, though higher than that of commercial banks.

The rate of interest paid on deposits by industrial banks has been subject to the same influences as the rate paid by commercial banks, though in centers of comparable size it has been somewhat higher. In industrial banks, however, the net worth proportion has become so low that these institutions have been able to earn a rate of net profit on net worth averaging more than 10 percent a year. This return is smaller than that earned by personal finance companies but higher than that of either non-investment type industrial banking companies, commercial banks or credit unions.

Credit Unions

The credit union is a cooperative association, usually of individuals who have some tie, industrial, cultural or religious. Since credit unions are mutual institutions, practically all of their funds are provided by members' purchases of shares, and only an insignificant proportion by borrowings, chiefly from other credit unions. The charter under which all credit unions operate contains restrictions on investment and lending activities. As a result their assets, other than loans to members, are generally limited to high-grade securities and cash.

Although these organizations have been in existence for about thirty years the only comprehensive figures on their income and expenses are those covering federal credit unions, first organized

in 1934. The present analysis is therefore limited to these data. In the first few years after the establishment of federal credit unions, entrance fees of 25 cents per member represented a significant proportion of total income; in subsequent years, however, more than 90 percent of total funds has been derived from interest and fines on loans.

Federal credit unions have received an average income on loans amounting to about 10 percent of average outstandings—as compared with a legal maximum of 12 percent, or 1 percent a month on the unpaid balance. This rate is much lower than that charged by personal finance companies on loans of comparable size. Credit unions' operating costs, too, have been particularly low, partly because of their cooperative form and partly because of the lower investigation and collection costs entailed on loans made exclusively to members.

Charge-offs of federal credit unions have been negligible, amounting to less than 0.07 of 1 percent of the loans made since the organization of the system. With such very low operating costs the average rate of operating profit—about 5 percent of total assets—has been higher than that of any type of agency except the personal finance company. Since there has been essentially no trading on equity the rate of net profit has only fractionally exceeded the rate of operating profit. At about 5 percent of net worth it has been lower than that of any of the other institutions, including commercial banks.

INFLUENCE OF CHARACTER OF PAPER ON INCOME, COSTS AND PROFITS

In each type of agency there was a great deal of variation in the rate of income on loans, and there was substantial overlapping among the types. As between commercial banks the variation was greater than within any single type of specialized agency, an indication of the high degree of diversification in their activities; among the specialized agencies it was considerable in personal finance and sales finance companies, and it was least in industrial banks.

In commercial banks the variation, ranging from less than 2 to more than 20 percent, reflected chiefly the influence of differences

in the character and size of loans made by different banks—though it was due in some degree to geographic differences in interest rates, and to differences in competitive conditions. The lowest rates are received on the largest loans, made primarily to the largest firms, and involving a minimum of risk and a minimum of service. On smaller loans, to smaller firms, involving a greater proportionate amount of service, and perhaps a greater risk, the charge is higher.

The highest rates—in the form either of interest alone, or of interest in combination with service charges and fees—are obtained on retail instalment loans, on personal instalment cash loans or on cash loans that are practically the same as consumer instalment credit except for regular instalment repayment. These loans are small in amount; most of them are for less than $100, and many are for less than $50. Many of the very smallest are made to factory employees and other workers, and provide for complete repayment within periods as short as 15 or 30 days, at minimum charges of 50 cents or more; others, made to farmers and local businessmen, are frequently secured by chattels, and call for repayment in unequal instalments at the convenience of the borrower.

Among sales finance companies there was wider variation in rates of income than in any other type of specialized agency. Companies that received higher-than-average rates probably concentrated on the financing of used rather than new durable goods; those that received lower-than-average rates may have charged less on comparable paper, to meet competitive conditions, but they probably also held a high proportion of wholesale or other low-rate paper.

Among personal finance companies those that received the lower rates probably extended relatively more of the larger loans, rates of charge being generally graduated inversely according to size of loan. Also, they may have specialized in certain types of lower-rate transactions—in endorsed as contrasted with unsecured loans, or in loans to selected types of customers, such as teachers.

These differences in the character of the predominant type of paper and in the size of the average loan held—expressed in the varying rates of income among types of agencies and among individual enterprises within each type—account for differences in

operating cost and profits. The data on commercial banks indicate that differences in the proportion of total assets represented by loans have also had an important influence on costs and profits.

In all the types of institutions a pronounced relationship was found between rate of total income and rate of total operating costs, indicating that rates charged customers and the rate of operating cost are dependent on the character and quality of the loans extended. Paper bearing a higher-than-average rate of income was also in general paper which involved higher-than-average costs for acquisition, servicing and collection as well as other operating costs, and also showed a somewhat higher, but not proportionately higher rate of charge-offs.

Higher rate loans were not higher risk loans in that they resulted in a materially higher rate of loss. The losses sustained on these loans, while higher than on the lower rate loans, nevertheless absorbed a smaller proportion of total income. Thus the higher costs and charge-offs did not eliminate the advantage accruing to the companies from the higher rate of income, for they showed higher-than-average rates of operating profit. The charges made on high-rate paper therefore appear to have been higher than required to cover the higher losses and other operating costs on such paper.

The character of typical loans appears to have been the most significant factor also in the rate of interest paid on borrowed funds. The higher the rate of income received on loans, the higher the rate of interest paid on borrowed funds. This may be partly attributed to the fact that an enterprise experiencing an active demand for loans at high rates of interest is willing to pay high rates for funds; this appears to have been true, particularly, with respect to individual commercial banks. It may have been due, too, especially in the smaller agencies, to a practice of borrowing from sources close to the management or the dominant stockholder interest. Finally, in certain of the agencies, it may have resulted from a carryover in the minds of bankers of the early prejudice against those engaged in high-rate lending.

Although the high-income-rate companies and banks paid a higher-than-average rate of interest on borrowings (and deposits) they did not use a higher proportion of total income for this purpose, since the differential between rates received and paid

operated in their favor. In addition, they tended to have a relatively small proportion of borrowed funds. It follows that institutions with loans of higher-than-average rates showed higher-than-average rates of net profit on total assets. Whether or not they showed higher rates of net profit on net worth depended largely on the net worth proportion. The latter was larger in high-rate than in low-rate institutions, but not so much larger as to offset the advantage of higher rates of operating profit. Therefore, in general, the high-rate companies showed higher-than-average rates of net profit available for owners.

INFLUENCE OF SIZE OF ENTERPRISE ON OPERATIONS

In all types of institutions, including banks, differences in size of enterprise were associated with significant differences in the proportion of funds derived from various sources, in rates of interest paid on borrowed funds and in the payment of dividends. On the other hand, there was little evidence of a relationship between size of enterprise and operating efficiency, or rate of operating profit.

Among the specialized agencies differences in sources of funds among companies of the same type are attributable almost entirely to differences in size. Increase in size, particularly when accompanied by the greater stability in operations that results from a wider geographic scope, has provided more ready access to money markets and has resulted, in general, in a larger proportion of borrowed, and a smaller proportion of equity, funds. The high net worth proportion in the smallest companies may be attributed, in part, to the existence of minimum capital requirements; among industrial and commercial banks this was of particular significance. Among the largest banks the very rapid growth of deposits has led to a decline in the net worth ratio.

The decline in the rate of interest paid for borrowed funds over the period covered by this study was felt first by the larger companies within each of the types of specialized agencies, and reflected the fact that open-market rates react more quickly to changing conditions than do customers' rates. The larger companies, having access to a greater variety of sources for borrowed funds, were able to take advantage of the decline in open-market

rates and were, thereby, probably able to exert some influence upon customers' rates.

Although most of the differential between the rate of interest paid on borrowings by large and small institutions had disappeared by the end of the period, some was still evident. Since they borrowed a larger proportion of their funds, the burden of interest cost tended to be heavier on the larger companies, though exceptions occurred in certain years, during the transition to lower interest rates.

In all types of institutions it was found that the smaller the enterprise the greater the likelihood that it retained all of its net profit and did not pay dividends. This may be laid, in part, to the greater difficulty among smaller companies in obtaining borrowed funds; moreover, in a small company, whose stock is usually closely held, the management is more willing to withhold dividend payments than in a large company, where that action might adversely influence the market value of widely held stock.

Although the payment or nonpayment of dividends appears to have been strongly influenced by size of company, except among the largest institutions, the rate paid bore little relationship to size of company. Among banks the rate of dividends paid bore more relationship to the rate of net earnings and the rate of net profits available for dividends, than to size of bank.

Among the specialized agencies there appeared to be no important differences in the distribution of assets when the companies were grouped by size. Much of the variation in rates of income with size of institution may be attributed to differences in the average size and character of the loans. This was particularly evident among the very largest sales finance companies, which held a higher proportion of wholesale and other low-rate paper.

Among commercial banks there was a strong inverse relationship between size of bank (in so far as this can be isolated from the influence of geographic location and size of center) and the ratio of loans to total assets. There was also a strong relationship between size of bank and rate of loan income, arising from differences in the average size and character of loans.

Available data show some decrease, among the specialized agencies, in the rate of operating costs—and some increase in the rate of operating profit—with increase in the size of company; but

this variation was relatively slight compared to the variation with increase in rate of income. There is no evidence that a larger volume of loan operations, beyond a certain practicable minimum, brought any marked decrease in operating costs. There is reason to believe, therefore, that the apparent size variation was, except among the very smallest companies, due to differences in the character and average size of loans—which could not be isolated in the available data—rather than to greater efficiency of the larger companies. There were no important differences in rates of operating profit among commercial banks of different size, which showed substantially equivalent rates of income from loans and percentages of loans to total assets.

CHANGES OVER THE PERIOD 1929-41

During the years 1929-41 the consumer instalment financing agencies and commercial banks showed wide changes in operating results as the economy moved from prosperity to depression and to subsequent revival. Significant changes due to other causes have taken place in the operations of commercial banks, and the specialized agencies have shown changes which evidence the growing maturity and public acceptance of the consumer instalment financing business.

Changes in Sources and Uses of Funds

Over the last decade there has been a gradual lowering of the proportion of equity funds in each type of specialized agency. The greater ability to borrow in the last few years, and the lower rates at which funds have been borrowed, are indicative of the fact that these companies have become much more widely accepted, by banks and in the money market generally, as their sound credit character has become evident. The industrial banks in this period underwent, in addition, a change from companies dependent upon the sale of investment certificates to institutions having the status of banks.

During the depression, the decline in capital ratios was temporarily reversed, as a result of the contraction in volume of business. This affected the sales finance companies to the greatest extent, since they were better able to contract their funds, making

use of the flexibility provided by the relatively short maturity of bank borrowings and open-market paper.

In commercial banks a similar lowering of the net worth proportion had occurred over the past half century. From the formation of the national banking system until about 1895, the net worth of all national banks averaged between 30 and 40 percent of total funds. During the McKinley boom, the First World War and the recent periods 1932-36 and after 1938, the net worth ratio dropped sharply; in the intervening periods it fluctuated about the previously established level.

Each period of rapid decline in this ratio was one in which business activity and the volume of total deposits were increasing rapidly. The growth of deposits in the recipient bank could be prevented only by its refusal to accept such funds, and the decline of its net worth ratio could only be stemmed in this way or by increasing the amount of stockholder investment.

Throughout the last decade, characterized by widely varying business conditions, the specialized agencies have had sufficiently flexible sources of funds available to enable them to expand the volume of borrowings and other liabilities when desirable, and likewise to reduce them to avoid the accumulation of idle funds. The volume of operations of sales finance companies was subject to the greatest cyclical and seasonal fluctuations, but their funds were obtained from sources that permitted a ready adjustment to changing business conditions.

In contrast to most of the specialized agencies, some personal finance companies which sustained a serious decrease in loan volume between 1929 and 1933, could not, because their funds were provided principally by equity capital, reduce their volume correspondingly, and acquired securities and other more liquid forms of investment. Loans extended by industrial banking companies declined to a greater extent than those of other specialized agencies during the depression, probably as a result of lack of qualified loans coupled with a desire to be liquid in order to be prepared to meet demands for withdrawal of deposits or investment certificates.

In the early 1930's both the total dollar amount of loans held by commercial banks, and the ratio of this amount to total assets, declined sharply to about half their previous levels, and failed to

show any material increase with the subsequent recovery, up to the time of the expansion in business stimulated by the war program. The degree of decline in the loan proportion varied sharply, however, in different communities and different banks; it was greater in the financial centers than in the agricultural areas, and greatest in the largest banks in those centers, which had experienced the greatest growth in deposits.

The expansion in deposits was associated, in large part, with the purchase of gold imports by the United States Treasury and with an increase in bank holdings of federal government securities incident to the recovery and war programs, and only to a lesser degree was it associated with bank financing of expanding production, inventory accumulation and consumption, and an increase in interbank correspondent balances.

Changes in Total Income, Costs and Operating Profit

In the specialized agencies the rate of total income on loans fell with the decline in business activity after 1929, reflecting difficulties in the collection of interest, and turned upward again after 1933. Although it reattained its 1929 level in some companies, this level was not maintained, and for the period as a whole the rate showed a slightly declining trend. This decline was probably the result of voluntary rate reductions due in part to increased competition in the consumer credit field and in part to the favorable loss experience of the depression.

Among sales finance companies, in which the downward trend was most marked, the decline in rate of total income on loans may be attributed primarily to the more active competition from industrial and commercial banks for retail instalment paper, which was accompanied by an increase in the proportion of wholesale, factoring and other low-rate paper held by sales finance companies.

Conversely, the rate of operating profit did not regain its 1929 level in the post-depression years. This discrepancy was most noticeable among sales finance companies, least noticeable among personal finance companies. Reflecting the significant drop in the rate of total income on loans, the rate of operating profit of sales finance companies was less than half the 1929 figure by the end of the period.

Commercial banks' average rate of income on loans fell from

about 6 percent in 1929 to about 4¾ percent in 1933, and remained relatively stable thereafter; the average rate of income on securities declined throughout the period, from 4½ percent in 1929 to less than half that rate in 1941. These declines are indicative not of an equivalent decrease in rates on all loans and securities, but rather of the sharp decrease in rates on very large loans, and the increased concentration in federal government securities characteristic of the largest banks.

In commercial banks operating costs, other than net charge-offs, represented an almost constant proportion of total loans and investments, varying only from 2.3 to 2.5 percent of earning assets throughout the period. Fluctuations in the amount of charge-offs and recoveries on loans, securities and other assets were so extreme, however, that total operating costs showed very erratic movements from 1929 to 1941. Consequently the operating profit of commercial banks was negative or negligible in the depression years, in contrast to the maintenance of a positive operating profit by most of the specialized agencies.

Changes in Interest Payments, Net Profit and Dividends

At the beginning of the period those agencies whose borrowed funds were derived from credit agencies, through the sale of bonds, in the open market or from banks—sales finance, personal finance and non-investment type industrial banking companies—paid a rate of interest of 6 to 8 percent, or approximately twice the rate paid by those agencies whose funds were derived chiefly from depositors and the sale of investment certificates—investment type industrial banking companies and commercial banks. This sharp divergence was eliminated by the decline in interest rates after 1929, which benefited all types of institutions. By 1941 differences in the rates paid by the different types of institutions were much less significant.

Because of the decline in interest rates on borrowed funds the share of total income absorbed by interest expense tended to decrease considerably during the period, in all groups, despite the increase in the proportion of borrowed funds. Nowhere was this more apparent than in the commercial banks: a decade ago over one-third of their total income was required for interest payments on deposits, but less than one-eighth in 1940.

The rate of interest *received* on loans and the rate of interest *paid* on borrowings by these institutions both represent a cost of borrowed funds but the costs are borne by different segments of the economy. Although both rates were affected by the relative availability of money, the differential in favor of these institutions increased sharply over the period.

The rate of net profit represented a high rate of return on capital funds in all the types of institutions during 1929-41. It declined sharply, however, during the depression, though in the specialized agencies it rarely reached a negative figure, as it did in commercial banks in three depression years. That all the institutions reattained a high level of net profit in the subsequent recovery, in spite of less satisfactory rates of operating profit, was due to the continued decline in the share of total funds supplied by owners and to the decline in the cost of borrowed funds.

The dividend record of the specialized agencies was that of a business growing into maturity. Of the companies that reported profitable operations a substantial proportion, in 1929, retained all of their net profit to retire borrowings or to provide additional funds for working capital, but in 1936 practically all of them paid dividends, and used a higher proportion of net profit to pay them at a higher rate than in 1929. In the interim the worthiness of these companies as potential borrowers had become more generally recognized, and the rates of interest required on borrowed funds had been reduced, with the result that the companies were no longer so dependent upon retained funds for expansion.

Commercial banks had attained a similar maturity much earlier, and the rate of dividends paid by all national banks became so stable that in twenty-three of the thirty years from 1900 to 1929 average dividends represented between 5 and 6 percent of net worth. Throughout this period the proportion of surplus and undivided profits grew substantially, and there was a concomitant increase in the rate of dividends on capital stock; it amounted to more than 10 percent of capital stock in each year from 1910 through 1931.

The continuance of dividend payments throughout the depression, though at a reduced level, combined with the heavy losses sustained on assets, resulted in a dissipation within five years of more than two-thirds of the net profit that had been retained by

the national banking system over the preceding forty-year period. In recent years dividends have been paid by from 75 to 85 percent of commercial banks, have absorbed less than 60 percent of total net profit, and have averaged less than 4 percent of net worth and about 9 percent of common stock.

War Restrictions

With the present cessation in the production, and practical elimination of the sales, of durable consumer goods, and the imposition by the Board of Governors of the Federal Reserve System of Regulation W, tightening the terms of instalment credit extensions, the rapid expansion of the consumer instalment financing agencies under consideration has been halted—and reversed.

The amount of outstanding retail instalment paper has been decreasing much more rapidly than it did during the early 1930's. From 4.1 billion dollars at the end of August 1941 it had fallen to half that amount within a year, thus creating serious problems for sales finance companies. Some of the larger companies, already holding significant proportions of factoring paper, have been spurred to diversify their activities still further; simultaneously they have been contracting total funds by repaying short-term obligations in an effort to maintain their high loan proportions, but their rate of operating costs may be expected to rise, and their rate of net profit to fall sharply.

The smaller the sales finance company, the greater the likelihood that its sources of funds are less flexible and that its lending activities have been concentrated in the financing of retail durable goods. In the absence of resourceful management able to develop other lending activities, such a company may find its most reasonable alternative to be the investment of all permanent non-repayable funds in government or other securities, for the duration of the war.

Cash-lending agencies were relatively little affected during the closing months of 1941 by the imposition of Regulation W, but during 1942 they sustained a rapid curtailment of lending activity, totaling about one-third for the year. Since cash-lending agencies are less likely than sales finance companies to be able to adjust funds easily, they will probably be forced to invest to some extent in federal government securities in the event of continued curtailment.

Total loans of commercial banks increased sharply from the middle of 1940 through the first quarter of 1942, with the expansion in business activity. During the balance of 1942 they contracted with almost equal rapidity, as demands for the financing of civilian requirements decreased. How far loan curtailment will continue is dependent to a great extent upon the degree to which private or government agencies finance war production.

In a similar manner the degree of expansion of commercial bank security holdings is dependent upon the extent to which the war program is financed by taxes and the extent to which government securities are purchased by individuals and non-banking institutions. During 1942 bank holdings of United States government securities almost doubled, the increase amounting to nearly 20 billion dollars; and they may be expected to increase by as much if not more, during 1943 and 1944.

Total income of commercial banks may be expected to increase substantially on the basis of the established pattern of interest rates on federal government securities, a moderate decrease in outstanding loans, and an assumed service income from the handling of ration coupons commensurate with the costs incurred.

Operating costs are not likely to increase as rapidly as total income even with increased federal taxes. Thus, except in the event of substantial increases in federal surtaxes above the rates in the 1942 law, operating profit will be well sustained. Moreover, since interest paid on time deposits may show a further decline, the amount of net profit may be expected to increase substantially. If, as is likely, approximately one-half of net profit is paid out in dividends and the other half is added to net worth, the rate of additions to capital from profit for commercial banks as a whole will be maintained above recent levels.