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Types and Institutions of Instalment Credit

DETAILED descriptions of the various types of consumer instalment credit, and of the institutions that extend it, are not necessary here. Such descriptions are presented in the other volumes of the series to which the present study belongs. As an introduction to the following chapters it will be sufficient to delimit the field of inquiry, define a few important concepts and outline the institutional framework of the credit agencies concerned.

MEANING OF CONSUMER INSTALMENT CREDIT

Consumer instalment credit, as the term is employed in this series of studies, is characterized as follows: first, it signifies credit that is used for consumption purposes; second, it is repayable in regular, prescheduled amounts; third, it carries a charge for the financing service rendered; fourth, its stipulated period of repayment is a relatively short or intermediate interval of time; and finally, it is attested by a negotiable instrument providing for legal action in case of default on repayment.

With the term defined in this way two important types of consumer credit are excluded from consideration: open book or charge account credit extended by merchants; and real estate mortgage credit for the construction or alteration of private homes. Charge account credit does not entail a specific finance charge, is not customarily paid off in a series of regular instalments, and is not attested by a negotiable credit instrument. In all three respects it differs significantly from

the types of credit we are examining, although much of the present analysis is applicable to charge account credit too. Consumer real estate credit conforms with the adopted definition in all respects except its long period of repayment.[1] Home mortgage financing has been excluded from the present series of studies because it is conducted by quite different agencies, under quite different legal requirements, from those characterizing the other types of consumer financing, and serves a somewhat higher-income market. Again, however, much of the economic reasoning in the following pages applies to real estate credit as well as to consumer instalment credit in the narrower sense.

The distinction between consumer and producer credit may be worth elaborating, even though the latter has been categorically excluded from consideration. This distinction rests primarily on how the debtor spends the funds: while consumer credit finances expenditure on consumption, producer credit finances investment, that is, the purchase or hire of goods or services used in the process of production.[2] After the money has been spent it melts into the general money stream and is spent and respent on consumer and producer goods, or not spent at all. In fact, money originally issued through credit channels becomes indistinguishable from money originating from other sources.

Producer credit is intended to be, and usually is, productive. Creditor and debtor expect the proceeds to be used in such a way as to bring about an increase in the debtor's future receipts, thus enabling him to repay the loan with

[1] Not all home real estate financing is conducted on an instalment basis, but in recent years the instalment amortization mortgage has widely supplanted the earlier single payment type.

[2] In a highly abstract, theoretical sense the distinction between consumer goods and producer goods can be entirely eliminated, or at least reduced to a difference in degree. If consumption is defined as the "flow of satisfaction" (Irving Fisher's "psychic income"; see also the theoretical writings of Frank H. Knight) then consumer goods, non-durable as well as durable ones, are of the same nature as producer goods: they are all goods in process at different distances from final consumption. We can, however, maintain a sharp, theoretical distinction between consumer and producer credit, for in principle it is well established where the yield of goods is calculated no longer in dollars and cents, but in terms of psychic satisfaction and utility.

interest and still have a surplus (net income) as a reward for assuming the risk connected with the borrowing and investment. Consumer credit too may be productive, and in precisely the same way. The purchase of a washing or sewing machine on credit may reduce expenses for laundry and domestic service, or may release members of the family from household duties and enable them to earn more money; this may cover the cost of the credit and leave a surplus. Or a loan spent for medical service, for a vacation trip, for educational purposes, may so improve earning power that it is productive in terms of dollars and cents. In fact, in such cases one might even speak of producer credit, though this would run counter to well-established usage because it is not usual in private or social accounting to list personal capacities at their capitalized earning power among productive assets.

It is frequently difficult to decide whether credit is productive or unproductive in regard to earning power, but undoubtedly a large part, probably the larger part, of consumer instalment credit is not productive in this sense. Most instalment credit serves only to enable the debtor to effect his consumption earlier than would otherwise be likely, or to buy a more expensive, better looking commodity than he would otherwise buy, and does not improve his earning power or increase his money income. If a person buys a car or a radio now, instead of saving sufficiently and buying it later, his consumption is advanced in time and, because of the cost of the credit, his aggregate (undiscounted) consumption over the whole period of the contract is reduced, in terms of money, but ordinarily we should not expect his earning stream to be thereby changed.[8]

[8] Even if credit is unproductive in regard to earning power and money income, it is not necessarily "irrational" or "unwise." When, for example, a person borrows in order to keep his consumption on a more constant level during a temporary drop in income, the loan may be unproductive but it certainly need not be regarded as irrational. (The loan would have to be characterized as productive if without it the drop in consumption would be so severe as to impair earning power and future earnings.)

It should be noted that the term "unproductive" may be used in other senses. For instance, it is frequently said that instalment credit is unproductive because it induces people to save less. See Chapter 2 and Appendix A.

Institutionally, too, the distinction between consumer credit and producer credit is fairly clear and well established. The institutions and agencies that supply mainly consumer credit are different from those that supply mainly producer credit. But here again the distinction is not always clear-cut. Not every transaction in a consumer credit market is actually one of consumer credit in the theoretical sense. Producer credit may at times be financed by means of consumer credit instruments, and funds for consumption purposes may sometimes be raised through producer credit channels. There is no doubt that especially that part of consumer instalment credit which is extended for the purchase of commodities is frequently used for business purposes—for the purchase of a passenger automobile, for example, which is partly or wholly used in business. There are probably also instances in which consumer instalment credit serves to obviate business dissaving: in order to conserve his business capital a businessman may use instalment credit to buy an automobile for private use instead of drawing the necessary funds from his business.

Such overlapping may be expected mainly in the transactions of those groups for whom household and business are not sharply separated and who use the same goods (for example, houses, automobiles) both in the household ("consumption") and in business ("production"). These include small independent businessmen, shopkeepers, artisans, members of the professions and, above all, farmers. The latter, however, are relatively small users of instalment credit facilities; a regular repayment schedule is not well suited to the discontinuous flow of farmers' income. This does not mean that farmers do not buy consumer goods on credit, but rather that their credit needs, both as consumers and as producers, tend to be satisfied through special facilities usually classified as producer credit, or under specially arranged "farm plans" offered by consumer credit institutions. Only about 12 percent of farm families reported a net change, during the year 1935-36, in instalment debt for the purchase

of goods, whereas about 28 percent of non-farm families reported such a change; in contrast, the corresponding figures for cash loan debt are 14 and 8 percent, respectively.[4]

It is impossible to know precisely to what extent producer credit needs are satisfied through consumer credit channels,[5] or vice versa. It is believed, however, that the overlapping is not serious, and that the institutional separation of the two types of credit coincides substantially with the theoretical distinction. Moreover, most of the following arguments and deductions from the statistical data would not be impaired, even if there were a considerable admixture of producer credit transactions contained in the reported consumer credit volume; for, as will become apparent later, an expansion or contraction of consumer instalment credit affects economic fluctuations in substantially the same way as does an expansion or contraction of producer credit.

TYPES AND AGENCIES OF CONSUMER INSTALMENT CREDIT

Consumer credit, in the aggregate, is even less homogeneous in character than producer credit. There is not one sort of consumer credit, but a series of types which vary greatly, according to the average and maximum size of the individual loan, the security required from, and offered by, the debtor, the time and manner of repayment, the peculiarities of the relation between creditor and debtor, and other factors. Lending institutions have developed a considerable degree of specialization in regard to these various factors.

The most important division within the area of consumer instalment credit is that between commodity credit and cash

[4] The relative frequency of debt indicated by these aggregate figures is true also of most of the separate income levels. Data are from the Study of Consumer Purchases, undertaken by agencies of the federal government; see National Bureau of Economic Research (Financial Research Program), *The Pattern of Consumer Debt, 1935-36,* by Blanche Bernstein (1940) pp. 146, 180.

[5] See National Bureau of Economic Research (Financial Research Program), *Sales Finance Companies and Their Credit Practices,* by W. C. Plummer and R. A. Young (1940) pp. 37, 41.

loans. When a cash loan is made the borrower receives a sum of money which he may spend as he pleases. In the granting of commodity credit, on the other hand, the debtor receives no money at all; he merely buys the article he wishes, and is debited with the "time" or "credit" price, as contrasted with the cash selling price, of the commodity bought (minus cash down payment, if any). Occasionally intermediate forms of credit are encountered: a credit for a certain sum of money is opened to the debtor, and it is left to him to choose what he will buy with it, the difference from a cash loan being that he receives not money but coupons which are accepted as cash in a specified store, usually a department store. Whatever its external form, cash or credit, the transaction results in a money debt, repayable in a certain number of instalments according to a prearranged schedule set forth in some kind of contract.

The use of commodity credit is much more widespread than the use of cash loans,[6] and its volume is greater, though in recent years the volume of cash loan credit has expanded at a much higher rate than that of sales credit. There are various reasons for this difference. One is that the promotion of commodity credit is a part of the marketing process, and is carried on by thousands of intensely interested commodity dealers; many of these, by selling the paper to a specialized credit agency, wholly or partly relieve themselves of the financial risks and responsibilities involved in the credit extension that they encourage. Another reason for the greater use of commodity credit is that most people feel less hesitation about buying on credit than about borrowing cash. In arranging for commodity credit they are more conscious of the buying aspect of the transaction than of the credit aspect, for they regard an instalment purchase (even more so the use of a charge account, or open book credit with a retailer) as merely a more convenient method of payment, rather

[6] In the year 1935-36 about 24 percent of non-relief families had a net change in commodity debt while only 9 percent had a net change in cash loan debt; see Bernstein, *op. cit.*, pp. 124, 173.

than as a debt transaction. Consumers' psychological attitudes toward instalment debt are of considerable importance in determining the structure of demand for credit and the cyclical pattern of its fluctuations, as will be shown in later chapters. But it may be remarked at this early point that, with certain qualifications that will be discussed in due course, an expansion or contraction of commodity credit[7] has all the objective attributes and consequences of an expansion or contraction of credit in general in stimulating and retarding sales and production, even if the individual consumer is entirely unconscious of the debt implications of the transaction and looks upon it solely as a more convenient method of paying for his purchases.

Cash loans and commodity credit are not equally available to all consumers, and are to a considerable degree extended by different types of agencies. Cash loans are made by personal finance or industrial (including Morris Plan) banking companies, commercial banks' personal loan departments or credit unions. Commodity credit is extended by dealers and producers and, through them, by sales finance companies, which are frequently more or less closely connected with certain dealers and producers. To an increasing extent, however, commercial banks and industrial banking companies are sharing in the financing of commodity purchases; they do this either by purchasing retail instalment paper from dealers, as do sales finance companies, or by arranging personal loans for the express purpose of financing the purchase of durable goods, especially automobiles. Both these agencies, and to some extent sales finance companies too, operate also in the field of producer credit, thus forming a link between the two types of credit.

It is true that these various types of agencies serve the same general purpose. A consumer who wishes to borrow cash may, if he meets the requirements, obtain his money from any of the four cash-lending agencies; and if he wishes to buy an article on the instalment plan he may obtain

[7] The same is true of charge account (non-instalment) credit.

credit from the dealer, who, in turn, may pass the transaction on to a sales finance or industrial banking company or a commercial bank, or the consumer may borrow money from any of the cash lenders and pay cash for the article he wants. In general, however, competition among the different types of institutions is not so perfect as this would suggest. Even within any particular field competition among the various lenders, although they may be quite numerous, is far from perfect.

The imperfection of competition among the agencies of consumer instalment credit is due to many factors.[8] One of the most important is that the finance charges of the various agencies are not quoted in a way that makes them readily comparable; the reasons for this situation, and its implications, will be discussed presently. Other factors are the varying requirements concerning the credit standing of the debtor, and the security to be offered; the geographic distribution of the lenders; differences in the legal regulations and restrictions in different states, and in the same state as regards different types of agencies; the personal relationship which to some extent must exist between debtor and creditor; the ignorance of many consumers regarding the existence of different opportunities for borrowing; the embarrassment felt by many persons when borrowing for purposes of consumption, an attitude that keeps them from shopping around for the cheapest sources of supply. These factors, however, are becoming less significant, and imperfections are tending to diminish. Education of the borrowing public by various institutions and organizations, agitation for more, and better unified, legal regulation, and the spontaneous competitive forces of the business community, are contributing to this effect.

One of these competitive forces has been the entrance of commercial banks into the field of consumer lending. This has occurred only recently, especially since 1934, when the

[8] See the analysis of this question by T. O. Yntema in American Academy of Political and Social Science, *Annals* (March 1938) pp. 79-85.

commercial banks were experiencing a slack in their traditional business, and unutilized reserves were piling up. Moreover, by that time the potentialities and soundness of the instalment credit business had been clearly demonstrated by the financial success of the agencies operating in the field; these had weathered the storm of the great depression better than the banks themselves. And from 1934 on, the banks' own success in handling home improvement loans insured by the Federal Housing Administration suggested to them the desirability of a continuation and expansion of instalment lending to consumers.

There are special features of consumer instalment lending which explain why it was first developed by special institutions other than the already existing short-term credit agencies that supply producer credit. First, in the consumer instalment credit business the operating costs per loan and per dollar loaned are very high as compared with those of producer credit and mortgage credit.[9] This is due to the small size and large number of these loans, and to the fact that repayment is made in small and numerous instalments, entailing heavy investigation, bookkeeping, collection and other expenses. Second, for the successful conduct of consumer instalment financing special skill, experience, organization and procedures are required, different from those needed in the old-established business of short-term lending to producers, as traditionally conducted by commercial banks. These special requirements are due to the fact that instalment credit serves mainly the lower income classes—persons who as a rule cannot pledge stocks, bonds, insurance policies or real estate as security for their debts—and therefore necessitates principles of risk selection quite different

[9] For the understanding of many problems connected with consumer credit it is important to keep this firmly in mind. In the general theory of credit and banking the "mechanical" cost (as against "interest" cost) of lending has been neglected, or regarded merely as a factor setting a lower limit to the fall in interest rates—a limit without practical importance. It is only in recent years that the persistence of very low interest rates has led economists to pay more attention to this factor. In the field of consumer instalment credit, however, it has always been a factor of great importance.

from those customary in lending to business concerns. Constant vigilance must be exercised by the lender to avoid excessive losses. This situation has made it necessary for the banks entering the field to develop special departments for handling personal loans (or, less often, for extending commodity credit), with specially trained personnel and with officers who devote their full time to this particular business.

The higher unit cost of extending instalment credit necessitates a higher finance charge than for other types of credit. In terms of interest equivalents, or annual percentage rates on declining balances, finance charges are in the overwhelming majority of cases much higher than the rates for producer loans, and considerably exceed the maximum contract interest rates per annum permitted by usury laws, which are still in force in most states of the Union. This situation has necessitated the passage of special laws giving cash-lending agencies exemption from usury statutes—the small loan laws and credit union legislation now enacted by the majority of states, allowing licensed personal finance companies, credit unions and in some cases industrial banking companies to charge interest in excess of the usury rates—or it has necessitated the development of special legal techniques for avoiding the usury laws. These techniques include taking interest in advance (discount), linking a savings transaction with a loan transaction, charging special fees for investigation and insurance as well as an interest charge, and imposing delinquency fines. Combinations of these methods and others are employed by industrial banking companies and commercial banks' personal loan departments. Doubts as to the legal status of bank activities in the field have been another reason why commercial banks were slow in entering the business of direct instalment lending, though for a long time they have participated indirectly in this business by extending funds to other consumer credit institutions. Only in recent years, and in a few states, have banking laws explicitly taken cognizance of the special features of small personal loans.

These legal handicaps do not apply (or apply only to a minor extent) in the field of commodity credit. Strictly speaking, an instalment purchase of a commodity can be conceived of as a sale of goods combined with a loan of funds, and therefore in economic analysis we may speak briefly of "loans" or "credit" when referring to cash loans and commodity credit together, although in everyday language the term "loan" refers usually to cash loans. From the legal point of view, however, the two kinds of credit are sharply distinguished: a debt arising from a sale of goods on the deferred payment plan is not legally a loan of money and therefore it is not regarded as subject to the usury statutes.

In view of the differing legal conditions under which the various agencies operate, it is not surprising that there is considerable difference among them in their methods of quoting charges. Personal finance companies state their charges as a monthly percent of the current unpaid balance (sometimes, however, with additional fees), and the notes they write cover only the principal of the debt. Credit unions are permitted either to charge a percent per month on the current unpaid balance or to take an equivalent discount in advance. Industrial banking companies and commercial banks' personal loan departments customarily take a flat percentage discount, in advance, from the face value of the note, and often charge one or more fees in addition. In the extension of commodity credit retail dealers differ widely in their methods of quoting charges, using practically every conceivable form, but the financing plans offered to dealers by sales finance companies usually state the charge as a dollar amount, sometimes not stipulating it separately from the principal. Thus finance charges are rarely quoted in terms of interest equivalents, except in the practice of personal finance companies and, less generally, credit unions, and even these agencies quote monthly rather than annual rates. The charges of most agencies are not easily calculable in

interest terms, and therefore comparison of the various rates is difficult for most consumers.[10]

Because of the very nature of their business the various credit agencies serve the same broad group of consumers—almost entirely those receiving less than $5000 a year, and for the most part those receiving less than $3000. There is some differentiation, however, in the markets characteristically served by the different agencies. In cash lending, commercial banks and industrial banking companies, on the whole, conduct business with somewhat higher income groups than do personal finance companies and credit unions. This tendency is not unrelated to the fact that the latter agencies are generally restricted by law in the maximum amount they may lend to any one person. For personal finance companies the maximum is $300, and loans are usually secured by chattel mortgage. For credit unions the maximum unsecured loan is $50 in most states, $100 for the credit unions operating under federal law; the credit unions' market is further restricted by the fact that they lend only to members. Requirements as to credit standing and loan security vary, of course, as between larger and smaller loans. Commodity credit customers range very widely in income, both those financed by the dealers themselves and those financed by the special credit agencies.

For many purposes the internal diversification of consumer instalment credit must be kept in mind. Especially the structure of demand, the pattern of its cyclical fluctuations and its responsiveness to changes in the terms of lending, is strongly influenced by the particular conditions surrounding different types of credit. But for many other purposes the field can be treated as a unity. Particularly as regards the broad economic consequences of expansion and contraction of credit we may satisfactorily refer to consumer instalment credit in the aggregate.

[10] Certain consequences of the various methods of stating finance charges are discussed in Chapter 4.