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The Rise of Finance Companies as Commercial Paper Borrowers

Finance Companies in the Early 1920's

Sales finance and personal (i.e., "small") loan companies were already important suppliers of consumer credit by 1920. Nugent found that there were at least twenty-five sales finance companies operating in the automobile, piano, and appliance fields in 1917, and that the number increased rapidly after World War I.¹ Personal loan companies had been thriving for some time; there were many multi-office firms and hundreds of single-office firms as early as 1910.² Business finance companies were also active in 1920.

The sources of funds of sales finance companies at this time have been described in several contemporary accounts.³ High leverage was

¹Rolf Nugent, *Consumer Credit and Economic Stability*, New York, Russell Sage Foundation, 1939, pp. 80-81.

²*Ibid.*, pp. 73 ff. Nugent cited other agencies engaged in consumer credit at that time: credit unions (142 in 1920), industrial banks (94 in 1922), commercial banks (perhaps 30 making instalment loans in 1920), retailers, and manufacturers.

³Harold G. Moulton, *The Financial Organization of Society*, Chicago, University of Chicago, 1921, Ch. XX; "Finance Companies," *Federal Reserve Bulletin*, January 1923; J. A. Estey, "Financing the Sale of Automobiles," *Annals*, November 1924; Henry G. Hodges, "Financing the Automobile," *Annals*, November 1924; William A. Grimes, *Financing Automobile Sales*, Chicago, A. W. Shaw, 1926; and Roy A. Foulke, *The Commercial Paper Market*, New York, Bankers Publishing, 1931, Ch. VI. See also Wilbur C. Plummer and Ralph A. Young, *Sales Finance Companies and Their Credit Practices*, New York, National Bureau of Economic Research, 1940, Ch. 2; and Ralph A. Young and Associates, *Personal Finance Companies and Their Credit Practices*, New York, National Bureau of Economic Research, 1940, Ch. 1.

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already a common phenomenon, with debt-to-equity ratios of four- or five-to-one for the largest firms and one- or two-to-one for smaller firms.⁴ Apparently, nearly all borrowings were short-term and came from banks in one form or another.⁵ To a minor extent these bank borrowings were made on unsecured notes under negotiated credit lines. Another very minor portion may have come from unsecured notes placed with banks through commercial paper dealers. However, this type of borrowing was rare in 1920, if it existed at all.

By far the largest part of the short-term funds (and therefore total funds) of sales finance companies was borrowed on collateral trust notes, either with or without the assistance of a commercial paper dealer. These notes were fully secured by finance-company receivables that were assigned to a trustee. Notes were drawn in even amounts from \$500 to \$100,000. Maturities of four to six months were usual, although both shorter and considerably longer maturities were also common. Frequently, the notes were discounted with banks at which the issuer had obtained lines of credit, but sales finance companies were placing collateral trust notes through commercial paper dealers at least as early as 1922. In addition, many firms were actively canvassing banks other than those at which they had credit lines, insurance companies, individuals, and others in their search for funds through this medium.

Except when placed with line banks, collateral trust notes closely resembled commercial paper. Insofar as they were placed through dealers they have been included in the volume of commercial paper outstanding. Unfortunately, the amount of this paper that was placed directly is unknown, and my estimates of directly placed and total commercial paper outstanding are therefore understated by an unknown amount.

Personal loan companies have never relied as fully as sales finance companies on borrowed funds, and commercial paper has always been a minor portion of their total debt. Furthermore, Nugent estimated that receivables of personal loan companies were much smaller than those of sales finance companies in 1923, and the same was probably true in 1920.⁶ It is therefore quite clear that personal loan companies were

⁴Grimes, *Financing Automobile Sales*, p. 66. Plummer and Young, *Sales Finance Companies*, Table 7, show ratios of 3.0 for the "big three," 1.4 for four regional companies, and 1.6 for thirteen local companies in 1924.

⁵*Ibid.* (Table 7) shows no long-term debt for any of their three groups of companies in 1924.

⁶Nugent, *Consumer Credit*, Tables 8 and 9.

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distinctly minor commercial paper borrowers in the early 1920's. Business finance companies, on the other hand, have more closely resembled sales finance companies in their use of commercial paper. However, it is not known whether business finance companies used collateral trust notes in the 1920's, nor to what extent they borrowed on the commercial paper market. Since only nine finance companies of all types borrowed through dealers in 1922, business finance company borrowings could not have been an important part of total commercial paper.

Thus, the finance company share of outstanding dealer paper was probably very small in the early 1920's. Foulke estimated that in the mid-1920's 20 per cent consisted of "the obligations of finance companies, cattle loan companies, warehouse companies, grain elevators, and cotton dealers," all of this paper being collateral trust notes or two-name paper.⁷ He also believed that "during the last few years, when the development of specialized finance companies has become so marked, the percentage of collateral trust notes and two-name paper has increased from about 8 to around 20 per cent."⁸ One can reasonably conclude that finance paper, excluding directly placed notes, was less than 4 per cent of total dealer paper outstanding in 1920 and no more than 15 per cent in 1925. Inclusion of directly placed paper would raise these figures somewhat, but finance-company paper would still be a minor part of total commercial paper.

Changes Since the Early 1920's

COMPOSITION OF BORROWERS

The trend toward fewer commercial paper borrowers since 1920, noted in Table 2, has been accompanied by an equally striking shift in the composition of borrowers. The most conspicuous aspect of this shift has been the rising importance of finance companies in the commercial paper market.

In 1922 only nine finance companies, or 0.4 per cent of all 2,259

⁷ Foulke, *Commercial Paper Market*, pp. 7-8.

⁸ *Ibid.*

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borrowers, used commercial paper (Appendix B).⁹ By 1927, 85 of the 2,490 borrowers (3.4 per cent) were finance companies. Between 1927 and 1933 the number of finance-company borrowers fell, but so did the total number of borrowers, and finance companies made up 4.4 per cent of all borrowers in the latter year. Since that time there has been a pronounced and fairly steady rise in finance-company borrowers as a percentage of total commercial paper borrowers (see Chart 4). This figure was 37.5 per cent in 1961. Except for finance companies, every major group of borrowers has declined numerically since 1922. Furthermore, except for a small increase among producers of tobacco products, only finance companies have increased numerically as commercial paper borrowers since 1935 and since 1950 (Appendix B).

Even within the universe of finance companies there have been changes in the composition of borrowers. Finance-company borrowers can be classified among the three functional types only for the period since 1949. In every year except 1954, sales finance borrowers outnumbered personal loan borrowers, and in all years the latter outnumbered business finance-company borrowers (Table 10). Nearly all of the increase in finance-company borrowers since 1949 has taken place among sales finance companies.

Finance companies can also be classified as "independents" or subsidiaries. Gradually but definitely throughout the postwar period, finance subsidiary paper borrowers have been rising in importance relative to independent finance-company borrowers. While apparently only three subsidiaries were using commercial paper in 1948, the list had grown to eighteen by late 1961 (Table 11).

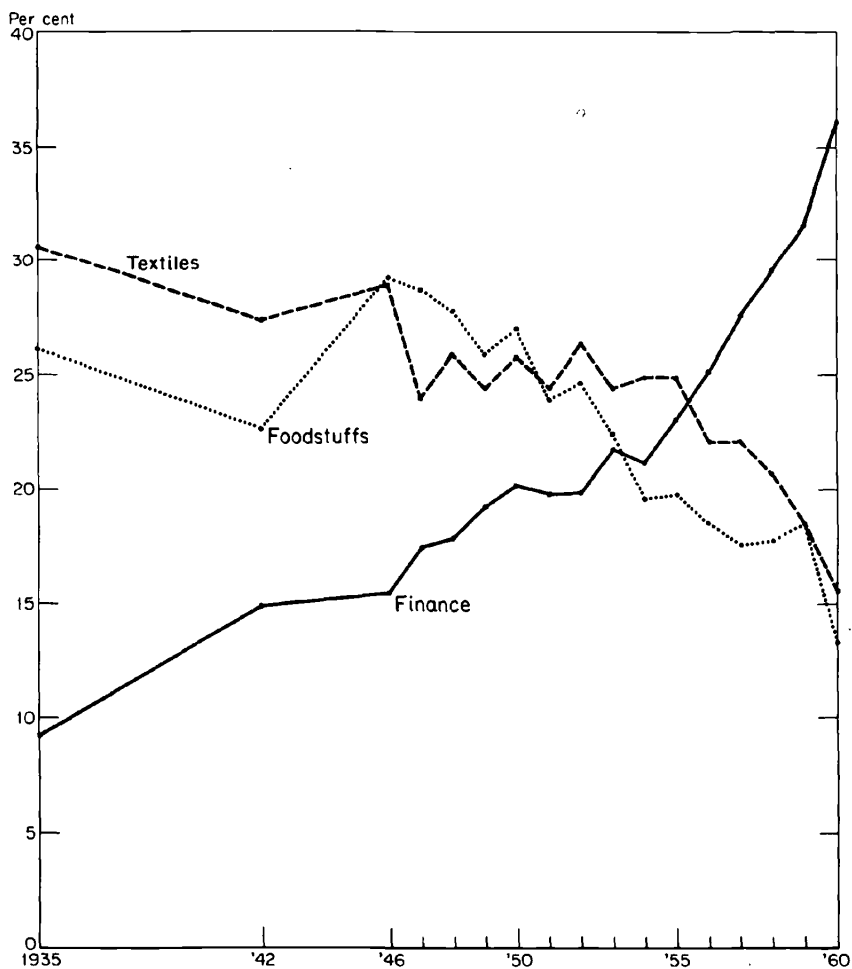
COMPOSITION OF OUTSTANDING PAPER

The current leading position of finance companies in the commercial paper market is far greater than data on the number of borrowers alone suggest. All of the directly placed paper reported by the New York Federal Reserve Bank is finance paper, and nearly all of it is consumer paper. At the end of 1960 this paper amounted to nearly \$3.1 billion, or

⁹The president of Ashwell & Company claims to have "pioneered in the role of independent finance company notes in the open market" in the mid-1920's (John W. Ashwell, address before American Finance Conference, Chicago, Ill., November 6, 1958). The claim is not consistent with National Credit Office statistics on commercial paper borrowers, but it does suggest that finance-company paper was still a novelty in the early 1920's.

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CHART 4
Borrowers in Selected Industries as Percentage of All Commercial Paper Borrowers, 1935, 1942, and 1946-60



Source: Appendix B.

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TABLE 10

**FINANCE-COMPANY BORROWERS OF COMMERCIAL PAPER FUNDS,
BY TYPE OF COMPANY, 1949-61
(number)**

Year	Sales Finance Companies	Personal Loan Companies	Business Finance Companies	Total
1949	40	24	13	77
1950	43	24	13	80
1951	44	21	14	79
1952	45	21	17	83
1953	49	23	15	87
1954	36	38	21	95
1955	40	31	25	96
1956	43	31	17	91
1957	42	31	19	92
1958	68	25	18	111
1959	59	33	14	106
1960	69	30	19	118
1961	84	29	18	131

SOURCE: *Commercial Paper*, National Credit Office releases.

69 per cent of total paper outstanding. Most of the remaining 31 per cent that was placed through dealers was also finance paper. Eighty-six sales finance and personal loan companies used the dealer market in 1960, and their end-of-year outstandings were in the neighborhood of \$465 million, or another 11 per cent of total paper outstanding.¹⁰ Thus, it appears that sales finance and personal loan companies accounted for about 80 per

¹⁰This estimate was developed in the following manner. Forty-six of the eighty-six companies have reported their 1960 outstanding paper to the National Bureau of Economic Research; the total for these firms was \$331 million (Table D-1). Crude estimates of outstandings of the forty other firms were then made: all eighty-six firms were classified by five net worth classes, and the average paper outstanding in each class of the forty-six reporting firms was applied to the corresponding class of the forty nonreporting firms; sales finance and personal loan companies were taken separately in this operation. The resulting estimate of outstanding paper of the forty nonreporting firms was \$135 million.

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TABLE 11

FINANCE SUBSIDIARY BORROWERS OF COMMERCIAL PAPER FUNDS,
SEPTEMBER 1961

Companies
Allis Chalmers Credit Corporation
Appliance Buyers Credit Corporation
B-W Acceptance Corporation
Caterpillar Credit Corporation
Clark Equipment Credit Company
John Deere Credit Company
Ford Motor Credit Company
General Electric Credit Corporation
General Motors Acceptance Corporation
International Harvester Credit Corporation
Montgomery Ward Credit Corporation
Motorola Finance Corporation
Philco Finance Corporation
RCA Credit Corporation
Redisco, Incorporated
Sears Roebuck Acceptance Corporation
Westinghouse Credit Corporation
Yellow Manufacturing Acceptance Corporation

SOURCE: National Credit Office.

cent of all commercial paper at the end of 1960. In addition, business finance companies, including such large borrowers as A. J. Armstrong, Walter E. Heller & Company, Standard Financial Corporation, James Talcott, and Yellow Manufacturing Acceptance Corporation, probably accounted for another \$300 million or more of commercial paper at the end of 1960, raising the figure for all finance companies to the neighborhood of \$3.8 billion, or nearly 87 per cent of the total.¹¹

¹¹The recent Federal Reserve survey of finance companies gives a figure of \$4.6 billion for "commercial paper and other short-term notes" of all finance companies as of mid-1960 (see *Federal Reserve Bulletin*, October 1961, pp. 1154-57). A minor portion, perhaps \$100 million, of the discrepancy between this figure and

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It is difficult to trace the rising importance of finance paper in the commercial paper market. For the period prior to 1934 figures are available for only one company, General Motors Acceptance Corporation. This company's paper was less than 4 per cent of total paper in 1924; but by 1929 it accounted for over 20 per cent of all paper; and by 1931, for over 28 per cent. By the latter year it is possible that finance paper was approaching the 50 per cent mark.

Beginning in 1934 there is somewhat better information. An earlier study of the National Bureau of Economic Research obtained year-end balance sheet data from forty-eight sales finance companies over the period 1934-38.¹² These firms included most of the large commercial paper borrowers among sales finance companies. Their outstanding paper in 1934 amounted to \$150 million, compared with total commercial paper of \$301 million. If the paper of other sales finance companies, personal loan companies, and business finance companies is added to the \$150 million, finance paper apparently made up 55 to 65 per cent of all commercial paper by 1934. At the end of 1937 the same group of companies had \$308 million outstanding, or nearly 56 per cent of the total; perhaps two-thirds of all commercial paper and one-third of dealer paper was paper of finance companies by that date.

Let us turn to the postwar period. Chart 5 shows outstanding paper at year-end of seventy finance companies, 1946-60.¹³ Forty-two of the seventy are sales finance companies, including all of the direct borrowers except International Harvester Company. The \$432 million of outstanding paper of these seventy firms in 1948 provides a minimum estimate of total finance paper then outstanding. This amount is nearly 65 per cent of total paper, \$666 million; it implies finance-company outstandings of perhaps 75 per cent of the total paper then in existence. At the end of

the one given in the text reflects the seasonal fall-off in December. It seems unlikely that all of the remaining \$700 million can be attributed to inclusion of "other short-term notes" in the Federal Reserve estimate. I therefore regard the estimate in the text as a minimum figure. (For distribution of the \$4.6 billion by type and size of company, see Tables D-4, E-3, E-4, and F-1, below.)

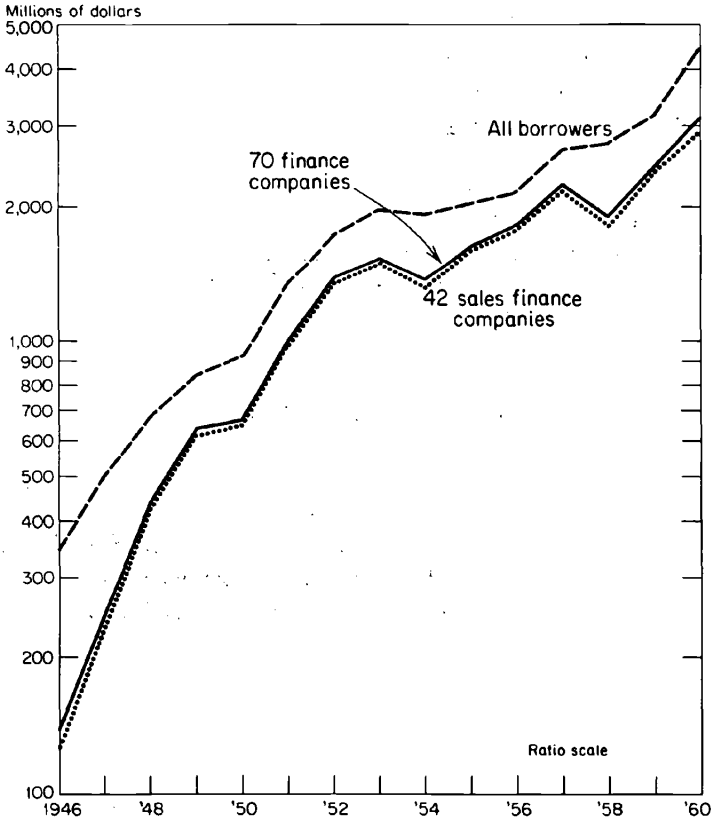
¹² John M. Chapman and associates, *Commercial Banks as Agencies of Consumer Instalment Credit*, New York, National Bureau of Economic Research, 1940, p. 198.

¹³ These companies constitute the National Bureau's finance-company sample described in Chapter 4.

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CHART 5

Commercial Paper Outstanding, End of Year, 1946-60



Source: Appendixes A, D, and E.

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1953, the seventy companies had outstanding paper equal to 77.5 per cent of all paper. By 1959, the minimum finance-company share was even higher, 80 per cent, although it receded to 72 per cent in 1960.

Finally, let us examine the distribution of outstanding finance paper by type of company. The bulk of finance paper is issued by sales finance companies, of course, and this has long been the case. This is obvious for recent years since directly placed paper alone (nearly all of it sales finance paper) has far outweighed total dealer paper, including the very substantial sales finance portion of dealer paper. In addition, the forty-two sales finance companies shown in Chart 5 far outweigh the twenty-eight personal loan companies included in the data for seventy companies. At the end of 1960, sales finance paper probably constituted 80 to 82 per cent of total paper. And it was shown above that even in 1934 sales finance paper was over half of total paper. Business finance paper has exceeded personal loan paper recently and probably in most past periods as well, despite the small number of borrowers (see Table F-1). This group of companies includes one of the direct borrowers and another large company that is generally regarded as the largest dealer account.

It was noted above that finance subsidiaries have been rising in importance in the last decade or so. These companies were large borrowers even in 1948, when they accounted for 35 per cent of total paper outstanding.¹⁴ At the end of 1960 the share of subsidiaries had risen to 44 per cent, or about half of all finance company paper borrowings.

Why the Market Has Changed

It will be useful to conclude the discussion in Chapters 2 and 3, which has dealt with changes in the commercial paper market since 1920, by considering the underlying factors responsible for change. Broadly speaking, the over-all period falls into two rather different parts. One, extending from 1920 to the early 1930's, was a period of declining size

¹⁴ Outstanding paper of a comprehensive sample of finance subsidiaries is given in Victor L. Andrews, "Captive Finance Companies: Their Growth and Some Speculations on Their Significance," *Industrial Management Review*, Fall 1961, Table 2.

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and few innovations. The other period, roughly 1933 to date, has been characterized by impressive growth and sweeping transformations.

During 1920-33 a succession of factors, no single one of which was of great importance, adversely affected the commercial paper market. The sharp reduction in borrowers—and in some degree, in outstandings—during 1920-22 may have resulted from tightened dealer standards following the large number of defaults at that time (Table 8). This is also suggested by the increase in borrowings per account, which took place despite the marked fall in commodity prices during the recession (Table 5). Developments during 1927-33 probably reflected a falling demand for funds. Not only the number of borrowers per dealer but also the volume of borrowing per account declined. The result was a sharp fall in the size of borrowings per dealer. Under such circumstances, it is not surprising that some dealers ceased their commercial paper operations. Another factor that may have influenced dealers to abandon commercial paper during 1928-29 was the stock market boom, which was demanding more of the dealers' attention. The rising tempo of speculation had an even more significant impact on the demand for commercial paper funds, as many borrowers apparently obtained long-term financing of their working capital needs. Other adverse developments were: (1) the depressed state of the textile industry and the decline of wholesaling—these industries had long been major borrowers; (2) a general tendency toward smaller inventories; (3) a shift by some borrowers to acceptances as a source of short-term funds (acceptances outstanding rose substantially during this period of commercial paper decline); and (4) a shift by banks to bonds, particularly tax-exempt securities.¹⁵

Most of the changes that have occurred in the commercial paper market since 1933 are attributable, directly or indirectly, to the rise of finance companies which has accompanied the spectacular growth in consumer durable goods expenditures and consumer credit since then. The impact of finance companies was already evident in the earlier period—note the expanding volume of directly placed paper and the growing number of finance company borrowers. But not until the early 1930's did finance companies reach a position of predominance in the market.

¹⁵ See Benjamin H. Beckhart, *The New York Money Market*, Vol. III, Part 2, New York, Columbia University Press, 1932, pp. 218-219, for a discussion of these points.

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Finance companies are continuous paper borrowers, in contrast to most industrial borrowers; moreover, they are heavy borrowers, per dollar of net worth. Only continuous borrowers are willing to borrow over a wide maturity range and for periods determined by lenders; most industrial borrowers, it should be noted, still hold to the old four- to six-month basis. In addition, it is evident that flat per cent commissions, irrespective of maturities, were quite acceptable when maturities were kept within a fairly narrow range, but that adoption of a really wide maturity range would require some method of scaling the commission to the maturity of the note, as is now done.

Furthermore, only heavy and continuous borrowers would find it profitable to make the sizable initial investment in trained personnel necessary for direct placement of paper. As noted earlier, all direct borrowers are large finance companies. Their mean amount outstanding was well over \$200 million at the end of 1961, in comparison with the \$156.4 million average of dealer-handled paper per dealer. Even the smallest direct borrower ordinarily has outstandings of \$50 million or more.

These facts also help explain the shrinking number of borrowers and dealers in recent decades. On one hand, the growth of direct placement undoubtedly has been partly at the expense of dealer paper growth. Measured in constant dollars, the \$798 million of dealer paper outstanding at the end of 1924 was not equaled again until the summer of 1961. With less paper outstanding one would expect fewer dealers, and fewer borrowers as well. But even the smaller finance companies that borrow via dealers are relatively large firms, and they are heavy borrowers. Consequently, dealers gradually have found it advantageous to work with a few sizable and continuous finance company borrowers rather than with a large number of small and sporadic industrial borrowers. One result of this shift is that dealers have been able to watch their clients more closely, thereby contributing to the maintenance of high-quality standards. Another result is that dealers have passed on part of their cost savings to borrowers by greatly reducing commissions below the levels that prevailed in the 1920's.

It would be wrong to leave the impression that the rise of finance companies has been the only important source of change in the commercial paper market since the early 1930's. This would ignore important developments on the supply side of the market. Increasingly, nonfinancial corporations and a wide variety of other investors have displaced the

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banks as paper holders. In part this change seems to be related to the abandonment of interest payments on demand deposits, brought about by the Banking Act of 1933. Corporate treasurers and investment officers, being denied any yield on their cash balances, began to discover commercial paper as an alternative liquid asset. The existence of large corporate tax accruals since the 1930's probably also created a demand for an investment medium such as paper.

Nevertheless it is doubtful that these shifts on the supply side of the market would have been very significant if the commercial paper of the 1930's had been merely the same old paper of the 1920's. And it seems clear that the rise of finance companies has been the major factor responsible for the increased attractiveness of commercial paper in recent times.