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Equipment Financing: An Adaptation in Lending Practice

THE FINANCING OF INSTALMENT PURCHASES of commercial and industrial equipment constitutes but a small portion of the business credit market. Nonetheless this type of financing has considerable significance as one of the recent adaptations of the lending practices of financial institutions to changes in the demand for business credit. Other adaptations, some of which have been discussed in other publications of the National Bureau of Economic Research, are of greater quantitative amount but instalment equipment financing has certain features that merit special examination.

First, instalment equipment financing represents an adaptation of lending policy and practice in which the pioneering work was done by non-bank agencies. In this sense it is like consumer instalment financing, non-notification accounts receivable financing and lending on life insurance policies. Each of these types of lending operations constitutes a relatively new departure in commercial banking; in developing business within these categories the commercial banks, far from entering new and untried fields of finance, have come sharply into competition with well-established and specialized financing agencies. An additional parallel between the participation of commercial banks in instalment equipment financing and their interest in the financing fields listed, as well as in such newer types of credit as term loans and inventory loans made under field warehouse receipts, is that this participation represents a response of bank lending practice and policy to the pressure of unused lending capacity and declining rates of return on other bank assets. In this, as in other instances, commercial banks have entered a highly specialized credit field but only after its special credit problems had been thoroughly explored by non-bank agencies and the practicability of the operation well established.

Second, it is interesting to note a special parallel between equipment financing and accounts receivable financing. From the point of view of the trade purchaser, both provide trade credit; one of a medium-term instalment payment variety, the other of a short-term single payment type. In accounts receivable financing the buyer usually obtains a current asset while in equipment financing a fixed asset is acquired. From the point of view of the seller, both arrangements make it possible to convert the trade obligations of customers into cash or to use them as collateral security for purposes of current financing, and the nature of the receivables is such that in both cases the financing is amortized relatively quickly out of collections. Finally, in both cases there are companies that use the special financing arrangement; rather than borrow on an unsecured basis and carry the receivables themselves, mainly in order to obtain certain ancillary services that are otherwise not conveniently or economically available.

Third, equipment financing is based on one of the now well-established principles of medium-term credit, namely, repayment of debt on a prescheduled, regular, instalment basis. It is similar in this sense to credits extended in the instalment financing of consumer durable goods, to the term loans made to business enterprises, and to mortgage loans. This feature of equipment financing is an adaptation in credit extension methods calculated to make possible the repayment of loans out of income as earned. Whereas the traditional unsecured commercial loan was intended, at least in theory, to finance short-period investments in current assets and to be liquidated (over one year or less) out of the proceeds flowing from the sale of these assets, equipment financing contemplates investment in an asset having an expected service or income-generating life considerably in excess of one year and is repayable, over a period determined in large part by this service life, out of the income produced by the use of the asset itself. As in term lending, the focus of credit appraisal is mainly on the income-generating capacity of the debtor, and only to a lesser extent on the debtor's balance-sheet position.

Beyond this feature, the fact that payments are definitely prescheduled under the regular amortization principle permits and encourages budgeting of the debtor's business affairs; further, the breaking up of the full cost of the equipment into a number of small payments separated by intervals brings the purchase of expensive equipment within reach of a number of companies that would otherwise be unable to afford it. The parallel between these characteristics of equipment financing and certain features of consumer instalment credit will readily come to mind.

Fourth, equipment financing has one feature that distinguishes it rather sharply from many other forms of business credit, both new and old. This is the fact that the financing transaction is entered into for a very specific purpose, namely, the acquisition of a particular unit, or group of units, of equipment. Furthermore, the credit is secured by a lien of some description on the equipment in question. Thus, equipment financing is special purpose lending in a much more definite sense than conventional commercial lending. In this respect its closest parallel is that type of financing long available under equipment trust receipt procedures. It should be noted also that the salient features of equipment financing, including the maturity of the note, the character of the repayment schedule, the nature of the lien established in order to secure the credit, and other features, are all determined in large part by reference to the characteristics of the specific equipment purchased.

Fifth, equipment financing is an example of a well developed trend in lending practices, namely, mass financing on a relatively routine basis. In this respect it can be interpreted as more than a parallel to consumer instalment financing; equipment financing, in fact, grew out of the latter type of lending. The individual contracts are frequently of relatively small size and the financing agency must acquire a large number of them in order to develop sufficient volume to make the operation profitable. Under these circumstances it is essential that the unit transactions be handled through established routines, and that credit appraisal procedures be standardized. Credit standards must be such that they can be applied to individual contracts without incurring considerable expense in individual investigations. It is necessary, of course, to make a very careful investigation of the source from which the contracts are being acquired, and to arrive at an over-all appraisal of the individual credits that are to be offered for discount, but once this has been done individual contracts must be passed upon promptly as originated, with only routine appraisal.

There is an element of insurance against loss in equipment financing resulting from this mass basis of operations, but this aspect is not as prominent as in the instalment financing of consumer durable goods where both debtors and goods are more standardized and contracts are smaller and more numerous. Nevertheless, it is substantially true that the success of equipment financing must be judged not by reference to individual contracts but by credit experience over a period of time with a large number of contracts. This characteristic of equipment financing is important both for credit administration and bank supervision. For example, the problem of establishing appropriate reserves and maintaining proper control over balances is obviously different in a mass financing operation of this type than it is in the extension of single credits such as are encountered in conventional short-term business lending and also in term lending.

Sixth, many of the features of equipment financing discussed above combine to make this form of credit extension adaptable to the needs of business enterprises of relatively small size and limited financial resources. The fact that credits are repayable over relatively long periods of time and out of the income generated by the use of the acquired asset increases the likelihood that less substantial companies can afford to make the acquisition. On the other hand, the fact that the lending agency either retains title to the equipment, or has a first lien on it, affords greater security for the lender and makes it possible for credit to be extended to such buyers. In this way the borrowing potential of smaller companies may be raised substantially and the market for business credit thereby expanded. The importance of this fact is that, like receivables financing and loans secured by specific items of inventory, commercial and industrial equipment financing represents at least a partial solution to the problem of the availability of credit to small business. This is not to deny, of course, that other features, described at an earlier point, recommend this type of financing to larger and better-established companies.

It is important also that the presence of agencies in the financial system ready to discount the instalment notes of equipment buyers and to provide thereby the credit necessary to carry these buyers over the deferred payment period minimizes the amount of capital resources that are needed by equipment distributing agencies. This fact has greatly facilitated the distribution of income-producing equipment just as sales finance companies and banks, by discounting consumer instalment receivables, have provided a large part of the capital resources necessary to operate dealer outlets and in that way facilitated the distribution of automobiles and other consumer goods. By supplying a credit service which equipment dealers would in many cases be unable to provide independently, the equipment financing agencies make financial support available not only to buyers but also to a large group of dealers constituting an important segment of small and medium-sized business concerns.

Finally, the growth of instalment equipment financing and the way this type of credit extension has spread through different types of financing institutions exemplifies a general tendency in our financial system for agencies that at one time were relatively specialized in character to diversify their operations. Many examples of this tendency can be cited. Companies that have been primarily interested in making personal cash loans now may concern themselves, either directly or through subsidiaries, with extending credit for financing purchases of consumer durable goods. Conversely, sales finance companies tend to move into the field of personal cash lending. In receivables financing we find factoring companies engaging in non-notification financing and non-notification companies acquiring direct or indirect interests in factoring. The manner in which term lending has brought commercial banks competitively closer to investment banking houses and insurance companies has been discussed elsewhere. Through their activities in consumer instalment financing, accounts receivable financing, term lending and equipment financing, the commercial banks have managed in recent years to inject themselves into fields of financing that had previously been largely the sphere of specialized agencies. Equipment financing offers another example of how a declining demand for credit on the part of business enterprises, combined with widening credit facilities and easy credit conditions, has forced financial institutions of all types to diversify their activities and to broaden their competitive spheres of operation.