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Volume Title: Sales Finance Companies and Their Credit Practices

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Volume Publisher: NBER

Volume ISBN: 0-870-14461-8

Volume URL: http://www.nber.org/books/plum40-1

Publication Date: 1940

Chapter Title: Credit Procedure And Credit Losses

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Chapter URL: http://www.nber.org/chapters/c5658

Chapter pages in book: (p. 104 - 131)

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Credit Procedure and Credit Losses

THE market for the services of sales finance companies is tapped in the first instance by the seller of the commodity rather than by the sales finance company. The loan and credit procedure of the finance company is thus more complicated than credit procedure involving only two parties.

Since financing the instalment sales of automobiles dominates the field, the practices of companies engaged in such financing may be reviewed first; the important procedural differences between automobile and diversified financing may then be summarized.[1] The aim of the chapter is to follow credit procedure through to the completion of the transaction, and therefore credit loss experience in sales financing is also discussed, together with practice in the handling of such losses. There is of course variation in practice among individual companies in the financing of any commodity, and some variation as between commodities, but it is possible to give a general description and merely point out differences where they seem important.

LEGAL INSTRUMENTS IN AUTOMOBILE FINANCING

The relationships between the finance company, the dealer and the purchaser are given form and made specific by legal

[1] The material on credit procedure presented in this chapter has been assembled largely from interviews with finance company executives.

instruments. The most important of these are a conditional sales contract, chattel mortgage or bailment lease and, in most cases, a promissory note. When signed by the buyer these instruments evidence the sale and the credit arising from it.

The exact form of the instrument is determined principally by state laws. Conditional sales contracts and chattel mortgages are most common, except in Pennsylvania where the bailment lease is used. National companies prepare instrument forms, each designed to meet the requirements of a particular state or, where possible, a group of states.

The contract is designed to protect the finance company's claim to the collateral until payment has been made in full, and typically it contains provisions intended to guard the finance company's interest in almost every situation which might lead to loss. The promissory note sets forth the unpaid balance due (including the finance charge), and serves to make the contract easily negotiable. Some companies find that a properly designed contract serves both purposes, and dispense with the promissory note. One or both underlie and to some extent define the various relations discussed below. Dealer franchises have, at times, contained clauses relating to financing, and where formal contracts between finance companies and dealers exist, they obviously affect the relations between the parties concerned. Such contracts vary so greatly, however, and their use is so irregular that significant generalization is not possible.

RELATIONS BETWEEN DEALER AND PURCHASER IN AUTOMOBILE FINANCING

The dealer or his salesman is the first to negotiate with the potential user of instalment credit. If the purchaser needs credit in order to buy his car the debt may be handled through one of several channels. It is possible that he himself will make arrangements with a bank, loan company

or other source of funds, but ordinarily the dealer performs this service for him. In the latter case the dealer may direct the credit to one of the various financing institutions, or he may finance it with his own resources. Ordinarily the dealer is not in a position to handle the financing requirements of his customers and, except in those communities where commercial banks or industrial banking companies actively compete for this business, the predominant institution for the purpose is the sales finance company.

At the time the sale is made a contract is drawn covering the finance charge (and sometimes a "pack" for the dealer), the type of insurance, the down payment and the number of instalments; the purchaser signs the legal forms and fills out a "purchaser's statement." The dealer determines the finance charge on the basis of a "plan" or a rate chart furnished him by the finance company; in automobile financing the charge often includes insurance coverage as well as the charge for instalment financing. A standard minimum down payment and a standard maximum number of instalments are conventionally indicated by the finance company, and the dealer is strongly pressed to influence the purchaser to agree to terms within these limits. Substandard terms may be agreed upon, but in such cases the finance company may not accept the contract, or if it does it may require the dealer to endorse it with full recourse.

The customer's statement or credit application contains detailed information concerning the car and terms of sale as well as his financial status, employment, family relations and references. After the sales transaction has been arranged the dealer, before negotiating with the finance company, may verify the credit standing of the purchaser, either making the investigation himself or using the services of a credit bureau;[2] or he telephones the complete information

[2] A dealer's check before getting in touch with the sales finance company is important when he has a recourse arrangement with the company, under

on the customer's statement to the finance company's credit department, which is usually able to verify it and to make any additional checks that are considered necessary in order to give a decision on the deal within an hour or two, or at most a day. Non-recourse companies, especially when considering used-car deals, may send out an investigator to examine the collateral. This is considered necessary by many companies since the year and model number of a used car do not bear any exact relationship to its value as collateral. An investigator is often able to determine whether the car has been abused, whether it is a repainted taxi or whether for any other reason it is not a good risk. In actual practice very few deals submitted are refused by finance companies, not because they are indiscriminate in accepting paper, but because dealers have learned to refuse poor risks and to submit only acceptable ones, and because the competitive situation makes it necessary for the companies to stand ready to accept all reasonable paper of reputable dealers, even if its terms are considerably out of line with those that are customary. It is also true, of course, that paper which would otherwise be refused can be strengthened—by the requirement of a cosigner, for example—in order to make it acceptable.

The dealer now endorses note or contract, delivers it to the finance company, along with the purchaser's statement, and receives his check for the amount of the note minus the company's scheduled finance charge and the insurance charge. In the majority of cases he is now out of the picture; only in cases of serious delinquency or repossession does the dealer again become involved, and then in greater or

which he assumes responsibility for loss. For such a check dealers rank credit bureau reports first, personal investigation second and other mercantile credit agencies third, according to reports received from 56 automobile dealers responding to a questionnaire survey conducted among its members by the National Retail Credit Association in cooperation with the National Bureau of Economic Research (Financial Research Program), July and August 1939.

less degree depending both on the type of endorsement and on the policy or "plan" of the finance company for that particular type of deal. In retail financing, further credit relations are ordinarily between company and purchaser.

RELATIONS BETWEEN FINANCE COMPANY AND PURCHASER IN AUTOMOBILE FINANCING

After the various data on the contract have been verified, and the check issued to the dealer, a "welcome letter" or notification is sent to the purchaser, along with a coupon book or record-of-payment card. The notification informs the purchaser that the finance company has bought his contract from the dealer, and instructs him how to make payments. If a coupon book is used the purchaser merely mails his payment, with a coupon, on each instalment date. Some finance companies prefer a record-of-payment card; the purchaser uses this as a record form and sends with his payments a memorandum of the account number.

Occasionally insurance is placed by the purchaser, and in a few states it may be placed by the dealer, but in automobile financing this is usually done by the finance company, providing protection against loss due to fire, theft, collision, conversion and confiscation. Collision insurance is usually of the twenty-five or fifty dollar deductible type. Sometimes, on small and therefore low-risk contracts, collision and, more often, conversion and confiscation insurance is carried by the finance company itself through its loss reserves. A great many finance companies own their own insurance companies, but some of them place their business with independent insurance companies with which they have contractual relations.

The finance company may purchase either single-interest or double-interest insurance, that is, it may cover only its own interests or it may cover both its own and the pur-

chaser's interests; the latter type is more usual. Also, insurance may be issued in two ways: a blanket policy may be made out to the finance company, which in turn issues certificates of insurance to the purchaser; or individual policies may be issued by the insurance company and delivered to the purchaser, either by the insurance company or by the finance company.

As long as the purchaser makes his payments with reasonable promptness the finance company makes no effort to establish personal contact with him. All accounts are reviewed daily, and when one becomes from 2 to 5 days delinquent it receives special attention. Most finance companies have a series of form notices of delinquency which are mailed at follow-up intervals of a few days, the period depending upon the time required to receive an answer. If these are not successful in bringing payment the account is removed from the normal collection file and assigned to a credit man for personal attention. The type of attention it receives is dependent on the history of the account, the original creditworthiness of the deal and the number of payments that have been made. Since three out of four repossessions, generally speaking, are made on contracts that become delinquent before five payments are made, delinquencies on any of the first four payments receive particularly close attention. Often personally signed form letters are sent, followed by specially dictated letters or telephone calls.

By this time 15 to 25 days have passed, and if payment is not forthcoming more positive action must be taken. A representative with rather broad authority to act makes a personal call on the delinquent purchaser. His job is to get prompt payment of the account, to adjust it so that payment will be possible or to repossess the collateral. It is usually to the advantage of the finance company to make every effort to adjust the difficulty with the purchaser without resorting to repossession, since the average repossession

TABLE 20

RETAIL AUTOMOBILE BALANCES OVER 60 DAYS DELINQUENT OWED TO 24 LEADING SALES FINANCE COMPANIES, 1935–39, IN PERCENT OF TOTAL RETAIL OUTSTANDINGS[a]

Date	*Average*	*High*	*Low*
December 31, 1935	.77%	9.49%	None
June 30, 1936	.43	1.73	.008%
December 31, 1936	.50	2.68	None
June 30, 1937	.40	1.23	.008
December 31, 1937	.56	2.01	.06
June 30, 1938	1.30	4.80	.16
December 31, 1938	.90	3.29	.05
June 30, 1939	.80	2.47	.06

[a] Based on special surveys by the First National Bank of Chicago, covering 2 national companies, 3 regionals and 19 locals; of these, 17 companies reported for all dates, 7 only for some dates. For each date delinquencies are expressed in percent of total retail receivables outstanding during the preceding six-month period.

means a loss either to the finance company or to the dealer, and perhaps to both. On the other hand, as the delinquency lengthens, the collateral is depreciating in value, even though the unpaid balance of the note remains constant; therefore quick action is deemed necessary. The problem of the finance company's representative is to settle the matter without resorting to repossession if at all possible, but to act quickly if, in his opinion, the purchaser is unwilling or unable to pay and repossession is necessary.

As a result of this procedure delinquency is kept at a relatively low level in automobile financing, much lower than is typical among certain cash loan instalment credit agencies, particularly personal loan companies.[3] Illustrative of this tendency are the figures in Table 20, showing retail

[3] See National Bureau of Economic Research (Financial Research Program), *Personal Finance Companies and Their Credit Practices,* by Ralph A. Young and Associates (1940) Table 17, p. 74.

balances over 60 days delinquent, in percent of total retail receivables outstanding. During 1935-39 the averages for all companies reporting ranged from a low of 0.4 percent to a high of 1.3 percent. The highest percentage reported by an individual company was 9.5, and there were companies reporting no accounts at all that were over 60 days delinquent. Practice in reporting delinquencies varies, however, among different companies, some companies including in "delinquencies" not only overdue instalments but also outstanding balances due on cars that have been repossessed but not yet liquidated.

It is sometimes possible to adjust the delinquency by extending the contract for 30 or 60 days, or the contract may be rewritten to allow smaller payments and more instalments. The latter method is not uncommon; in ordinary years, according to the experience of a large company financing automobile sales, approximately one out of every twenty new- and used-car retail contracts purchased is adjusted or refinanced, and in depression years one out of every five to eight. On extended or rewritten contracts some companies charge interest and some assess a flat charge or a new finance charge comparable to the original one.

Another possibility is to influence the purchaser to refinance his debt through some other institution. If he is able to do this at all it is likely to be through a small loan company. A number of finance companies, as pointed out earlier, have established small loan or industrial banking subsidiaries in recent years, which seem to have been organized in part at least to handle such cases within the legal boundaries of the small loan or industrial banking acts.[4] These

[4] The refinancing data of the company cited above indicate that renewal or refinancing as a means of adjusting delinquent contracts was relatively infrequent before 1929. This conclusion seems to be confirmed by the fact that most small loan or industrial banking affiliates of sales finance companies have been established since that year.

various methods of adjustment are most often effective when the purchaser is only temporarily embarrassed or when he has a substantial equity in his car and therefore a strong incentive to complete his payments.

If contract readjustment fails as a means of settling an overly delinquent account, repossession follows as the final solution. In the experience of a large company financing automobile sales, about three-fifths of the cases of excessive delinquency eventuate in repossession, though the proportion may be smaller in years of receding business activity and employment;[5] repossession cases occur three to seven times more frequently among used-car than among new-car transactions.

Several methods of repossession may be resorted to by the company's representative. In many cases the purchaser has lost hope of keeping possession and surrenders the car voluntarily. If he does not, the representative takes possession by self-help—which usually means "lifting" the car from the street[6]—provided he can manage this without resort to force. If the purchaser resists, the finance company must resort to action of replevin or of claim and delivery. In the ordinary case, where the finance company has a clear right to repossess, either voluntary surrender or lifting the car may be desirable for the purchaser as well as for the company. Court action results in costs estimated variously at from $2.50 to over $20;[7] these are chargeable against the account of the purchaser, and the finance company may or may not be able to collect them.

There are occasional instances of conversion of collateral

[5] This is the proportion of repossessions to repossessions plus renewals.

[6] The contracts typically contain clauses allowing the finance companies to repossess without resort to formal legal processes.

[7] M. W. Adelson, "The Mechanics of the Installment Credit Sale" in *Law and Contemporary Problems*, published by Duke University, vol. 2, no. 2 (April 1935) p. 236; also Joseph G. Myerson, "Practical Aspects of Some Legal Problems of Sales Finance Companies," *ibid.*, p. 245.

by the purchaser, and of confiscation by public authorities of financed cars used for illegal purposes. The term "conversion" has here a more limited meaning than in ordinary legal usage. It applies to those cases, known to the trade as "skips," in which the customer disappears with or fraudulently sells or otherwise disposes of the collateral. Such cases are specifically excluded from the theft policies; the latter protect only against loss from pilferage by outside parties. Confiscation is not so frequent now as it was during prohibition, when cars bought on instalments were sometimes used for illegal transportation of liquor and were subsequently seized by public authorities.

RELATIONS BETWEEN DEALER AND FINANCE COMPANY IN AUTOMOBILE FINANCING

The relations between the dealer and the finance company encompass the granting and liquidation of wholesale credit as well as the financing of retail deals. The financial reliability of the retailer is therefore of considerable importance to the finance company. It is also of some importance in the retail finance business, when repossession is necessary. Even where the business is on a non-recourse basis the dealer has made certain warranties about the validity of title and the like that may make him financially responsible in case the purchaser defaults, and there are few if any non-recourse companies that do not do some recourse business.

For these reasons an important part of the work of the finance company's credit department is to make a careful original investigation of the dealer and to keep in touch with the changes in his financial position. Not only are the usual investigations made through financial statements, credit reporting agencies and references, but once a credit line has been established, the dealer's own payment record on his

wholesale financing and the record of the accounts purchased from him are watched closely, and statistical records of varying completeness are kept of the trend of his business. Either delinquency on his own wholesale financing or a large percentage of delinquencies in deals purchased from him has a bearing on the credit line extended, and in extreme cases might be a reason for discontinuing the purchase of his notes.

Another phase of credit supervision is the discovery and investigation of signs of irregularities, such as the receipt of instalment payments direct from the dealer. This may be merely a reflection of the financial habits of purchasers in the particular community served by the dealer, but in the past it has been evidence that a financially unsound and unscrupulous dealer has defrauded the finance company by selling it paper covering "phantom" transactions. Other fraudulent practices sometimes engaged in by dealers are duplicate wholesale financing, whereby the dealer borrows money from different finance companies, pledging the same security in each case, and the discounting of retail paper to a company other than the one that has made the wholesale loan on the car, failing to pay off the wholesale loan. Such practices are rare in comparison with the total number of transactions handled, but they are common enough to be a serious source of loss, especially since the dealer who engages in them usually does so on a large scale. In the early days of sales financing a filing bureau was organized in New York, and a few years later another was organized in Chicago, for the purpose of preventing such losses. Early in 1940 the two bureaus were amalgamated, and the Galloway Service of Chicago now provides a filing service for the entire country. Finance companies subscribing to the service notify the bureau of the identification of each car financed either at wholesale or at retail, and notify it also when the transaction

has been closed. The bureau is thus able to detect instances of double financing and to notify the companies involved.[8]

The more or less informal agreements or understandings between the finance company and the dealer are of equal importance with the legal instruments in determining the nature and extent of the business relationships. Many local companies make these understandings with each dealer to meet a particular competitive situation; in such cases they vary considerably from dealer to dealer or even from one deal to another. The better established companies are likely to have more consistent policies, often printed in folders or booklets which are distributed to dealers. These are known to the trade as "plans." All companies have a wholesale plan and at least one retail plan. The retail plans can be classified generally into non-recourse and recourse, or repurchase agreement, plans. This distinction has been of importance in the competitive situation which will be discussed later, and is of interest here since it broadly determines the relationships between finance company and dealer after repossession.

If a contract has been endorsed by the dealer without recourse, and if there is no repurchase agreement, the dealer's liability almost always ceases at the time the contract is purchased by the finance company. Only in the unusual case where he is liable under the warranty in the contract or endorsement is this not true. Ordinarily the finance company makes the repossession, disposes of the repossessed collateral and assumes the loss, if there is one. The dealer may be in-

[8] In 1932, according to information received from Galloway Service, the number of duplication reports was as much as 16.8 percent of the number of registrations. Since that year the percentage has been lower, as follows: 13.3 in 1933; 11.1 in 1934; 9.7 in 1935; 12.2 in 1936; 10.9 in 1937; 10.7 in 1938; 10.2 in 1939. Some of these cases of double financing are paid off, of course, by the time the report reaches the subscriber. About 4 to 5 percent of registrations are found to be incorrect or incomplete descriptions of the collateral on which money has been advanced, but it is estimated that the figure would be as high as 10 percent if it were possible to check all inaccuracies of this type.

formed of the delinquency, and may even cooperate with the finance company in its attempts to collect, but this is done to improve relations with the finance company and as a guide to possible future relations with the purchaser.

Endorsement by the dealer with full recourse[9] is somewhat unusual today, but may be found occasionally, usually on what are regarded as substandard contracts. In such cases the dealer is responsible for full payment to the finance company of the unpaid balance on the contract. If the car has to be repossessed he is obligated to pay the finance company the remaining balance, and he then recovers what he can by sale of the car, if it is recoverable, and possibly by subsequent action against the purchaser.

The dealer's liability is today ordinarily modified to some extent by the provisions of the repurchase agreement plan. Under such plans the dealer's liability derives not from his specific endorsement of the individual contract, but from a separate agreement in which he assumes responsibility for payment of the unpaid balance in the event of default and repossession. The difference between specifying the liability of the dealer on each contract and specifying it in a general repurchase agreement covering all or some contracts, is of course merely a matter of form, but the repurchase agreements also contain certain stipulations that modify the dealer's liability. The plans of individual companies differ but they usually include such provisions as allowance for costs of repairs due to proved collisions, protection against loss from conversion or confiscation by allowing relief from liability if the car is not repossessed within an agreed time, and delay of the request to remit the unpaid balance, in order that the dealer may have time to sell repossessed cars. The

[9] There are intermediate types of endorsements between those made with and without full recourse. These may be classed as endorsements with "partial recourse," but they are a small percentage of the total. An example is the case in which the dealer, through his endorsement, guarantees payment only for the first few months.

dealer may make the repossession, but more commonly the finance company does this and may even assume the expense, if it has not been unusually heavy. If there is evidence of fraud the finance company will take action against the purchaser and attempt to obtain a deficiency judgment.

Not only is the dealer's liability thus specifically limited in most cases, but also he receives from the finance company a certain amount of material protection against repossession losses. In business taken with recourse the finance company usually sets aside a "dealer's reserve" of 1 to 3 percent of the original amount of the contract, depending on the size of the contract and on whether the car is new or used. This reserve is payable to the dealer periodically if his liability on the contracts from which it arose has been discharged.

PROCEDURE IN DIVERSIFIED FINANCING

The broad outlines of the loan and credit procedure sketched for automobile financing fit the procedure in diversified financing, but certain differences should be pointed out. These arise for a number of reasons. The products sold, ranging all the way from inexpensive electric appliances to oil burners, have in general much lower prices than automobiles. The collateral underlying the credit becomes a part of the home or furnishings of the purchaser, and is not traveling about the country as the car is. While an automobile dealer's principal business is selling automobiles, and some three-fifths of them on the instalment plan, the dealer in diversified products is likely to sell many articles that are not sold on the instalment plan, and therefore does a larger proportion of his business for cash. Electric appliances, for example, are sold not by electric appliance dealers alone, but by a large variety of retailers ranging all the way from the corner drugstore to the electric power company.

The legal instruments for diversified financing are the

same as those for automobile financing, except for certain details which are not important for the purposes of this discussion.

The relations between the dealer and the purchaser are quite similar, with a few exceptions. While dealers are urged to obtain as large a down payment and as short a contract life as possible when negotiating the sale with the customer, this appears to be a less important problem than in automobile financing. Customary terms are more liberal and the original selling price is lower than in the case of passenger cars, and therefore down payments and monthly instalments are smaller in relation to the purchaser's income.

The credit investigation is much the same for purchasers of diversified products as for automobile buyers, although in this field a heavier responsibility for the investigation falls on the dealer, because the business is typically conducted on a recourse basis. Also, since the down payment is lower, somewhat less reliance is placed on the collateral and somewhat more on the willingness and ability of the purchaser to pay. Consequently dealers make extensive use of reports from retail credit bureaus and often check the customer's past payment record with other mercantile agencies.[10] Not infrequently the dealer's investigation includes a personal

[10] In the questionnaire survey mentioned above (footnote 2) returns from 688 retail establishments (like those from automobile dealers alone) indicate that reports from credit bureaus are considered to be the most important source of information, some retailers relying entirely on this source. The types of stores surveyed, and the number of replies, were as follows: department stores, 176; furniture stores, 134; clothing stores, 116; dealers in automobiles, tires and accessories, 56; jewelry stores, 45; lumber dealers, 43; coal and fuel dealers, 37; miscellaneous (including, among others, hardware stores, home appliance dealers and music stores), 81. By grading their answers according to a point system, allowing 3 points to a source ranked first in importance, 2 to one ranked second, and 1 to one ranked third, credit bureau reports received a total of 1,936 points, personal investigation 833 points, and reports from other mercantile agencies 579 points. In addition to the types of credit information listed on the questionnaire, one or more retail stores mentioned as being important a personal interview with the applicant, information from employer, information from relatives, a banking reference.

interview and possibly a visit to the neighborhood of the buyer's residence in order to determine the kind of house in which he lives and perhaps to make inquiries at the corner store or tavern.

In signing the contract the purchaser, as a rule, agrees to assume the risk of loss from fire, storm, theft and other special causes, and in some cases to insure the collateral against such losses, though the dealer and the finance company usually take no part in the placing of the insurance. Sometimes, however, the sales finance company will itself assume the risks of such losses;[11] in fact, reports indicate that there is at present an increasing tendency for diversified finance companies to follow this practice.

In diversified financing, since the dealer usually assumes the main responsibility for the repayment of the credit, the finance company has a less clearly delineated interest in its dealings with the purchaser in the event of delinquency and repossession. As a general rule, the finance company furnishes the dealer with periodic lists of delinquencies, and is more inclined to wait for him to take the initiative in readjustments, repossession or settlement of the note than it is in automobile financing.

Efforts to rehabilitate the account are similar to those in automobile financing, but they often extend over longer periods. Frequently outside agencies are recommended to the purchaser as aids in refinancing, though the possibility of losing customer goodwill may deter a dealer from urging their use. Questionnaire reports on this subject from all kinds of retail establishments reveal that of 688 reporting stores 70 percent suggest to customers the use of outside

[11] This is the practice of certain national companies that conduct diversified financing, and also of the Electric Home and Farm Authority. The latter's repurchase agreements with its dealers stipulate that they will be relieved of their repurchase obligation on any contract "with reference to which and to the extent in which the property securing the contract is damaged from fire, lightning, flood, cyclone, windstorm, earthquake, tornado, or theft."

agencies for refinancing.[12] Roughly three-fourths of the clothing and furniture stores and automobile dealers reported this practice and, at the other end of the scale, slightly over half of the jewelry and miscellaneous stores. The personal loan departments of commercial banks were the agency most frequently recommended and, except in the practice of department stores, industrial banking companies were a very close second; automobile dealers recommended these two agencies in the same proportion, and lumber dealers gave a slight preference to industrial banking companies. By all types of stores personal finance companies were recommended less frequently than the other two agencies, and comparatively few references were made to "other agencies" of consumer instalment credit.

If rehabilitation or readjustment of the contract fails, the dealer and the finance company find it to their interest to cooperate closely in making repossessions, and in some cases the finance company will take the action itself. Repossessions are ordinarily made at the end of 60 days of delinquency. While contracts often provide for the possibility, repossession by self-help is not usual, since the collateral is likely to be in the home, where it is difficult to "lift" it without trouble. More often than in the case of automobiles the collateral is voluntarily surrendered, and it is only occasionally necessary to resort to replevin action.

Although dealer recourse is customary in diversified financing, some companies offer a limited recourse plan, whereby the dealer's liability is limited to the period of the first four—or, more usually, six—instalment payments, provided they are met promptly. Under such plans, however, there are usually so many special stipulations and exceptions that the finance

[12] These reports were received in response to the questionnaire survey mentioned above (footnotes 2 and 9). Approximately the same results were obtained from a test questionnaire conducted in April 1939 in cooperation with the National Retail Dry Goods Association and the National Retail Furniture Association.

company is able to construe the transaction as full recourse, if it so desires. Such limited recourse business is typically conducted under agreements with the manufacturer, and the latter, in cases of repossession by the finance company, provides a market for the merchandise.

CREDIT LOSS EXPERIENCE

This survey of general procedures indicates, incidentally, what are the sources of loss in sales financing: delinquency accounts that eventuate in repossession; conversion of collateral by the purchaser, known in the trade as "skip"; confiscation of collateral by a public authority; damage to the collateral from accidental causes not covered by insurance; fraud on the part of the dealer; and readjustment of contracts to accommodate purchasers and dealers. The relative importance of these sources of loss varies from one retail instalment field to another (conversion, confiscation and collision, for example, are important only in automobile financing), and varies also among different dealers and finance companies, in accordance with the effectiveness of procedures and the nature of credit policies.

Relatively high credit losses are not necessarily unprofitable, nor do relatively low credit losses necessarily lead to profits. High credit losses may be compensated as an expense item by greater income from a larger volume of financing, obtained by less stringent procedures and more liberal credit policies. Low credit losses, on the other hand, may be more than offset by unusually high collection expense. Credit losses are costs of doing business, and as long as they are covered by charges for the service some credit agencies are not concerned about them. But while it is true that many credit agencies conduct a highly profitable business with relatively high credit losses, it is also true that many of them have caused only difficulties and embarrassment for them-

selves, their customers and their creditors through extending easy credit.

Probably the best general index of credit loss experience in retail instalment financing as a whole—not merely in the business of sales finance companies—is the proportion of "bad-debt" losses incurred by retail dealers in the extension of instalment credit. Such losses are those that result from net charge-offs, that is, from the unpaid instalment receivables charged off as worthless over a given period minus recoveries on repossessions and on charge-offs of previous periods. The net charge-offs of a period are ordinarily computed as a percentage of the face amount of instalment paper handled in that period, or as a percentage of the total amount of instalment sales made during the period. For published reports dealers generally prefer loss percentages computed in the latter manner, since they are necessarily lower than those computed against the volume of instalment paper handled (sales minus down payments).

Bad-debt loss percentages (in relation to instalment sales) over the period 1929-38 are presented in Table 21 for a small sample of retail dealers, covering four types of stores: automobile, department, furniture and jewelry. The percentages are shown to run lowest for automobiles, somewhat higher for the commodities financed by department stores, higher still for those financed by furniture stores, and highest for the instalment financing of jewelry stores. From year to year, whatever the general business conditions prevailing, this ranking is consistent. It cannot be inferred that this variation in credit loss experience has one simple explanation, as for example the character of the products financed. This may indeed be partly the explanation, but the variation arises also from differing credit procedures and policies and from the differing economic groups from which customers are principally drawn.

TABLE 21

CREDIT (BAD-DEBT) LOSSES ON INSTALMENT SALES OF SELECTED RETAIL DEALERS, 1929–38, IN PERCENT OF TOTAL INSTALMENT SALES[a]

Year	*Automobile Dealers*	*Department Stores*	*Furniture Stores*	*Jewelry Stores*
1929	..	1.48	3.11	7.13
1930	..	1.85	3.89	8.91
1931	..	2.68	6.19	12.88
1932	..	3.92	10.08	18.77
1933	0.46	2.97	5.32	13.44
1934	0.35	1.44	2.66	6.72
1935	0.28	1.01	1.71	4.94
1936	0.23	0.81	1.29	3.77
1937	0.23	0.81	1.38	3.51
1938	0.42	1.13	1.46	4.17

[a] Based on United States Department of Commerce, Bureau of Foreign and Domestic Commerce, *Retail Credit Survey* (1930-38). Bad-debt loss is the total of accounts determined to be uncollectable in a given period, minus recoveries during the same period on old accounts previously charged off. This amount is here taken to be an index of credit loss since the latter is composed primarily of "bad-debt" loss.

Each issue of the *Retail Credit Survey* presents the experience of an identical group of stores over a two-year period (the year of issue and the previous year). From these data the percentage changes in the bad-debt loss figures from one year to the previous year were calculated for each type of outlet; the percentage changes were then calculated against the 1938 bad-debt loss figure to derive the figure for each year. Because of the very small sample of jewelry stores reporting during the 1929-32 period, jewelry bad-debt loss figures for these years were adjusted in the light of department store experience.

In the business of a sales finance company a credit loss percentage figured on the basis of the total amount of retail instalment sales would not be relevant, though one reckoned on the face amount of retail instalment paper handled would be. The trade, however, commonly employs as an index of credit loss experience the percentage of retail losses during a given period to the retail paper liquidated during that period. Table 22 gives such figures for six-month intervals

TABLE 22

RETAIL CREDIT LOSSES OF LEADING SALES FINANCE COMPANIES, 1935–39, IN PERCENT OF RETAIL RECEIVABLES LIQUIDATED[a]

Date	*Average*	*High*	*Low*
December 31, 1935	.75%	1.49%	.21%
June 30, 1936	1.08	1.41	None
December 31, 1936	.92	2.10	.005
June 30, 1937	.64	1.31	.09
December 31, 1937	.89	1.77	.06
June 30, 1938	1.87	4.01	.16
December 31, 1938	1.70	3.37	.74
June 30, 1939	1.06	1.46	None

[a] Based on special surveys by the First National Bank of Chicago, covering 24 companies handling mainly automobile paper—2 nationals (omitted from this tabulation), 3 regionals and 19 locals; of these, 13 companies reported for all dates, 9 only for some dates. For each date losses are expressed in percent of retail paper liquidated during the preceding six-month period.

over the period 1935-39, covering twenty-two companies handling mainly automobile paper. The average retail credit losses of all companies reporting ranged from a low of 0.64 percent (June 30, 1937) to a high of 1.87 percent (June 30, 1938); the highest loss figure reported by any one company was 4.01 percent, and the lowest was no losses at all. Credit loss percentages so reckoned are necessarily higher than those figured from total retail instalment sales or from face amount of instalment paper handled.

It is important to distinguish between credit losses that are an expense to the dealer and those that are an expense to the sales finance company. Previous discussion has made it abundantly clear that the instalment sale may or may not involve a finance company, but that when it does, contractual arrangements with the dealer may provide for a sharing of credit losses.

For this reason sales finance company credit losses alone

are no measure of the amount of credit loss to which retail instalment transactions give rise; they indicate only the credit losses which for competitive or other reasons the finance company is unable to avoid or shift to dealers. It necessarily follows that credit losses of sales finance companies vary according to whether their retail volume is composed predominantly of recourse or non-recourse business. On recourse deals finance companies generally accept responsibility for losses arising from the readjustment or refinancing of contracts and, in automobile financing, those arising from collision, conversion and confiscation; their losses include also those resulting from dealer fraud. On non-recourse deals, however, finance companies assume all credit losses, including those from repossession. The business of some companies is exclusively recourse, and that of others is mixed, but no company, according to the trade, does an exclusively non-recourse business.

As to loss experience on recourse deals, data from a large sales finance company engaged in recourse financing, presented in Table 23 for the period 1929-38, may be taken as illustrative for the automobile field. This company's retail losses in automobile financing, like those of other recourse companies, comprise mainly losses from conversion, confiscation and collision, and also some arising out of contract readjustments and fraudulent deals. Under the terms of its financing arrangements responsibility for such retail losses is assumed by the company under most conditions, but in specified circumstances it is either shared with or assumed by the dealer. The table shows losses in percent of total retail paper purchased during the year in which the loss paper originated, and it indicates that the maximum loss was 0.34 percent on new cars and 1.02 percent on used cars (both in 1930); the minimum loss (disregarding 1938, for which year data on volume are incomplete) was 0.02 percent on new

TABLE 23

NET RETAIL CREDIT LOSSES OF A LARGE SALES FINANCE COMPANY ON REPURCHASE-AGREEMENT AUTOMOBILE FINANCING, 1929–38, IN PERCENT OF TOTAL RETAIL PAPER PURCHASED DURING YEAR IN WHICH LOSS PAPER ORIGINATED[a]

Year[b]	*New-Car Paper*	*Used-Car Paper*	*All Cars*
1929	.28	.71	.43
1930	.34	1.02	.62
1931	.24	.82	.47
1932	.18	.62	.37
1933	.07	.38	.19
1934	.05	.33	.15
1935	.04	.26	.12
1936	.02	.25	.10
1937	.03	.26	.13
1938	.01	.01	.07

[a] Based on data supplied by the company. Net credit losses are gross charge-offs (resulting principally from collision, confiscation and conversion) minus recoveries; since they are here related back to the year in which the loss paper originated, the loss data on 1938 volume are incomplete.
[b] Year in which loss paper originated.

cars and 0.25 percent on used cars (both in 1936). Total credit losses on retail passenger car business ranged from a high of 0.62 percent to a low of 0.10.

Data illustrative of sales finance company credit losses on non-recourse financing are not available from any company operating principally on that basis, but the magnitude of at least repossession losses in non-recourse automobile financing is suggested by tabulations published by the National Association of Sales Finance Companies. Table 24, which presents estimates on such losses for 1929-38, shows a range from a low of 0.58 to a high of 2.42, expressed in percent of the total retail paper that was purchased during the current year.

These figures are of course but approximations of re-

TABLE 24

AVERAGE LOSS PER REPOSSESSED CAR ON NON-RECOURSE AUTOMOBILE FINANCING OF REPORTING SALES FINANCE COMPANIES, 1929–38, AND ESTIMATED AVERAGE RETAIL REPOSSESSION LOSSES ON SUCH FINANCING IN PERCENT OF TOTAL RETAIL PAPER PURCHASED DURING CURRENT YEAR[a]

Year[b]	*Reported Loss Per Car*[c]	*Estimated Loss Percent*[d]
1929	$63	.58
1930	65	.85
1931	47	1.03
1932	59	1.74
1933	42	.70
1934	50	.72
1935	55	1.08
1936	51	.65
1937	52	1.19
1938	62	2.42

[a] Based on data presented in the National Association of Sales Finance Companies' leaflet, *Composite Experience of Sales Finance Companies and Automobile Dealers, 1938*; the data pertain to repossessions on both new and used cars.

[b] Year in which repossession occurred.

[c] Reported by finance companies in replies to questionnaires sent out by the National Association of Sales Finance Companies, and pertaining only to non-recourse deals.

[d] Estimated as follows: for each year the number of cars financed (as found by the United States Department of Commerce and reported in the Association's leaflet) was multiplied by the percent of cars repossessed (as found by the Association in response to questionnaires); the resulting number of repossessed cars, times the average dollar loss per repossessed car on non-recourse deals, gave an estimate for the total repossession loss in dollars, and this was then expressed in percent of the total dollar volume of retail paper handled in that year by companies reporting to the Department of Commerce. In the conclusion that the resulting repossession loss percentage fairly estimates relative losses on non-recourse deals it is necessarily assumed that recourse and non-recourse paper is repossessed in approximately the same proportion.

The number of companies represented in the Department of Commerce reports varied during this period from 456 to 419; in volume of business these companies are said to represent about 95 percent of the total for all automobile sales finance companies. The National Association figures for the percent of cars repossessed represent a smaller number of companies; their dollar volume amounts, however, to about a fifth to a half of that of the larger group.

tail credit losses on non-recourse deals, for they include only those losses arising from repossession. Also, they are not strictly comparable to the loss percentages illustrative of recourse automobile financing, given in Table 23, as they are computed on a different basis.[13] They suffice to suggest, however, that credit losses of sales finance companies in non-recourse deals consistently and substantially exceed those in recourse financing.

HANDLING OF CREDIT LOSSES

Finance companies following conventional accounting procedure set up the estimated value of repossessed cars in an asset account to which are charged the expenses of repossessing and such expenses as may be entailed in reconditioning. When the cars are sold the selling price is credited to the same account and the loss or profit, if any, is charged to a reserve-for-losses account which has been set up out of the finance charges.

Most companies carry special insurance to protect themselves from losses caused by conversion or confiscation of the collateral and from collision losses not covered by insurance under the financing contract, but any losses resulting either from the lack of such insurance or from unsatisfactory adjustments are charged to the reserve for losses. If there is a conversion, or "skip," the defrauding purchaser is pursued if possible, and there is a sizable percentage of recoveries. The value realized from recoveries is credited to the reserve-for-losses account.

The credit losses of sales finance companies have thus far

[13] The two bases for the computation of loss percentages would give comparable results under conditions of constant volume, but loss percentages figured against current volume tend to understate credit loss experience under conditions of increasing business, and to exaggerate it under conditions of decreasing business, in comparison with percentages that are figured against the volume of paper purchased during the year in which the loss paper originated.

been discussed in terms of losses from retail automobile financing. Credit losses are incurred also on wholesale automobile financing, and although such losses are ordinarily substantially lower than retail credit losses they may attain to considerable proportions in periods of business recession with widespread dealer failures. Retail paper covering diversified lines also entails a measure of credit loss, but since such financing is done largely on a recourse basis, losses are usually very low. Finally, there are credit losses from the discounting of open-account receivables, from industrial financing, small loan financing and any other line of credit business in which the sales finance company may engage.

The usual practice, as has been said, is to charge credit losses to a reserve-for-losses account which is continually fed by a small allocation from each finance charge, but the precise meaning of such reserves and their comparability among companies is never clear. This is due partly to the sharp differences of opinion that prevail as to what constitutes a loss and as to how losses and reserves should be treated in accounting procedure, and partly to the varying proportions of retail instalment financing as against other credit business that different companies engage in.

As to the question of what constitutes a loss, one who has had occasion to review the accounting methods of some two hundred different finance companies has declared that he found among them fifty different methods of computing losses.[14] He cited in illustration a used car financed for $300 with total charges amounting to $60 and a net finance charge (after allowance is made for insurance, dealer's reserve and loss reserve) of $40, making a total note of $360; the car is repossessed within 45 days, without any payments, and sold for $315.

[14] According to a letter received by the National Association of Sales Finance Companies from one of its members; see *Time-Sales Financing*, vol. 2, no. 11 (November 1937) p. 12.

Some finance companies, according to this observer, would show a loss of $45, while other companies would prorate the overall charge to show a loss of anywhere from $5 to $45. Still other companies, he stated, would consider as profit the $15 realized in excess of cash actually advanced, or would consider that they had made a profit of that amount minus interest for 45 days and actual disbursements in connection with the deal. That various methods of accounting in actual use should produce such varying results, ranging from a loss of $45 to a profit of $15, clearly indicates a confused state of accounting practice.

Lack of uniformity in the definitions and accounting methods employed for computing and reporting credit loss experience has resulted in widespread demand in the trade for standardized usage. A committee appointed by the American Finance Conference to study this question[15] has recommended that losses on different types of business be reported separately and computed as a percent of liquidation occurring during a stated period. "Credit losses" it defined as loss on repossessed merchandise sold,[16] plus reconditioning expense and direct selling expense on such merchandise; "other losses" it defined as conversion, confiscation and collision losses, plus the premiums on insurance, and also incidental expenses.

The committee believed that a part of general overhead expenses should be included in computing repossession loss, but doubted whether any agreement could be reached con-

[15] The committee was appointed in 1936 at the suggestion of Arthur W. Newton, Vice President of the First National Bank of Chicago, and its members were: C. F. Cunningham, President of National Discount Company, South Bend, Indiana, chairman; Owen L. Coon, President of General Finance Corporation, Detroit, Michigan; and J. Frank Hudson, Vice President of Interstate Securities Company, Kansas City, Missouri. The committee's report is partly quoted in American Finance Conference, Special Bulletin no. 29 (1938).

[16] Unpaid balance at repossession, minus unearned finance charge, minus actual resale price.

cerning the determination and apportionment of overhead, since there are so many different ideas on this problem; for this reason it recommended that all but direct expenses be excluded. The committee also recognized the apparent inconsistency of charging an insurance premium to a loss account, but considered this necessary in cases where the insurance is provided and paid for by the company; the inclusion of this item by all companies was strongly recommended so that results might be comparable.