Appendix C: Four Measures of Collection Experience: Their Characteristics and Uses

DELINQUENCY RATE

Delinquency data have one important advantage for the study of the effect of changed credit terms or other economic conditions on subsequent credit experience. The first signs of collection difficulty are likely to appear in delinquency rates. Thus the relationship between delinquencies and the terms and conditions at the time loans are made would be closer in point of time than that for any other measure of collection experience except perhaps refinancing.

One of the deficiencies of delinquencies as a measure of collection experience is that the standards utilized in declaring loans delinquent vary for different banks and finance companies. Hence it is difficult to generalize on the basis of a single firm's experience, and changes in practices can distort the figures. Also, a loan on which some sort of extension is arranged (formally or informally) will escape the delinquent category.

A classification of delinquencies by duration, e.g., 30–59 days, 60–89 days, and 90 days and over, distinguishes those that occur first from those that persist and which are likely to represent more serious problems. The longer delinquencies are, naturally, more likely to result in repossession or losses.

REPOSSESSIONS

Repossession experience has proven to be an excellent measure with which to analyze the relation of collection experience to previous changes in terms. It avoids some of the problems of definition inherent in delinquency data. It represents a rather serious economic event, both for the borrower and the lender. Furthermore, although the loss rate (discussed below) may be the best measure of ultimate credit performance as a whole, its significance is sometimes blurred by fortuitous factors, such as the sale of repossessed durables in a favorable market, or by financial arrangements that involve the shifting of losses to another creditor. Repossession data have an additional advantage relative to losses in that the repossession is recorded at an earlier date.

Repossession data, like delinquency data, can be affected by changes in the creditor's policy with regard to repossession on overdue accounts. Furthermore, an additional complication concerning repossession rates arises because some contracts are purchased by sales finance companies and banks from automobile dealers under recourse agreements whereby the dealer agrees to absorb part or all of the loss encountered on contracts he originates. Recourse or repurchase agreements, naturally, alter the ultimate significance of repossession to the lender. Presumably, a given repossession rate with recourse agreements would have a different effect on lending policy than the same rate without such agreements. Unfortunately, repossession data seldom if ever include this sort of additional information.

LOSS RATES

In his study of consumer loan losses, James P. Winchester enumerated four methods which can be utilized in reporting net loss experience.[1]

First, there is net loss related to volume by year the loan was made. This method of reporting losses is seldom utilized. One of the difficulties with it is that the loss rate with respect to a given year's volume changes more or less constantly over a long period of time as old loans are repaid or charged off.

Second, net losses can be related to current volume of loans made. While this method is fairly common among banks, according to Winchester, it is rare for sales finance companies and in any case tends to understate losses where volume is growing rapidly.

Thirdly, losses can be related to volume of loans liquidated. While rare among banks, this method is fairly common among sales finance

[1] James P. Winchester, *Consumer Installment Loan Losses and Valuation Reserves,* Cambridge, Mass., 1955, pp. 17–20.

companies and is more accurate, in general, than the first two methods because it eliminates relatively new loans which have not had the same exposure to risk as the older ones.

The fourth method is to relate losses to outstandings. While this is a common method among sales finance companies, it is rare among banks. A fairly similar measure, the ratio of losses to income and reserves, is used in this study's local area data obtained from a large sales finance company.

Net losses are significantly affected by recoveries from the resale of repossessed items. Variation in the market for such items is a factor that affects the repossession rate only indirectly (by making repossession more or less profitable) and the delinquency rate not at all. This tends to reduce the correlation between net losses and credit terms or borrower characteristics at the time the loans were made.

Furthermore, loss data present problems because losses can be split in varying degree between the lending agency and the automobile dealer, who may sell the loan paper on either a recourse or a nonrecourse basis. Hence the net losses as reported by a given lender may fail to reveal the total losses on a given volume of loans, some of which the dealers themselves bear.

EXTENSIONS (REFINANCING)

A final measure of collection experience for which some data are available is extensions or refinancing. This represents an alternative to repossession (and hence loss) for the dealer on a given loan. One might expect extensions, therefore, to vary in the same direction as delinquencies, repossessions, and losses.

The major disadvantage in the use of extensions is that they do not necessarily reflect collection or repayment difficulty. Refinancing of a short maturity may even be contemplated at the time the loan is made. Many extensions are made to permit new commitments or purchases, or to consolidate other credit obligations. Because of this ambiguity, we have not included extensions in our analysis.

Nevertheless, to the extent that extensions are resorted to as alternatives to other and more drastic types of collection difficulty considered, ignoring them means ignoring one aspect of credit experience that may be related to a prior change in credit quality.