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Summary Survey

ONE of the most noteworthy developments in contemporary commercial banking has been the rapid expansion of consumer instalment credit activity. Although banks have long participated indirectly in consumer lending by making commercial loans to agencies which specialize in instalment financing, their current interest is in the establishment of their own personal loan and time-sales departments. Through these departments large numbers of commercial banks now extend cash instalment loans directly to consumers, finance instalment purchases on a direct-to-consumer basis and purchase retail instalment paper from dealers. This movement toward direct consumer financing appears to be attributable largely to the need for an outlet for bank funds which may yield higher returns than are available in other fields.

QUANTITATIVE IMPORTANCE OF CONSUMER INSTALMENT FINANCING BY COMMERCIAL BANKS

It is estimated that by the end of 1938, 1,500 commercial banks had functioning personal loan departments. Since many banks have been operating branches through which consumer instalment loans are made, the total number of banking offices now engaged in personal lending probably approaches 3,000. It is estimated further that commercial banks had consumer instalment loan outstandings of $500,-000,000, inclusive of sales finance paper, at the close of 1938, and that during the year their services were used by 1,000,000 to 1,500,000 people.

Commercial banks reached the position just described after a relatively short period of intensive growth in consumer credit operations. Out of approximately 1,200 known personal loan departments, 80 percent were established after 1931. In addition, reports from 100 banks show a combined increase of almost 200 percent in year-end consumer loan outstandings over the five-year period 1934-38.

Despite this rapid rise in outstandings, consumer loans constitute only a small proportion of the total earning assets of commercial banks. That proportion, however, is tending to increase. Thus for the group of 100 reporting banks, consumer loans rose from .8 percent of total loans and investments in 1934 to 1.9 percent in 1938. These figures, moreover, are an inadequate expression of the importance of instalment loans, since the gross return on such transactions is higher than that yielded by most other earning assets.

Comaker notes, averaging $217 in size, comprised more than half the total volume of consumer loans made by 520 reporting banks in 1938. Secured loans were second in importance; those backed by conditional sales contracts, bailment leases, etc., averaged $274 and those secured by savings passbooks, life insurance policies, etc., $255. Probably most of the former were sales financing transactions while the latter were cash loans. Loans made on a single-name basis tended to be smallest, averaging about $200. As for the time-sales activities of commercial banks, available information indicates that automobile financing is the most important source of business and that the financing of household appliances ranks second.

LEGAL STATUS OF CONSUMER CREDIT ACTIVITIES OF COMMERCIAL BANKS

National and state banks engaged in making cash instalment loans do so in most states under general banking laws that contain no specific reference to loans repayable in instalments. Special legislation covering such credit grants has been enacted in only 10 states, and even these laws show little uniformity. Four states require a bank to obtain permission from state authorities before it may establish a personal loan department. In some states the legal maximum rate is specified and in a few states provision has been made for charges in addition to interest. One state, New York, prohibits charges other than discount except for fines, court costs and insurance premiums. Only seven states place a maximum limit on the amount to be advanced to a single customer, and in four of these the upper limit is $1000. Four states have set a maximum length of contract for personal loans. While there has been some attempt to promote a uniform statute to regulate instalment lending, the movement has not yet produced any notable effect on state legislation.

There is even less regulation of time-sales financing: only Indiana, Michigan and Wisconsin have enacted laws applicable to these activities of commercial banks. Here also there is considerable variation. The Indiana law, which is the most comprehensive, requires that financing agencies be licensed, and stipulates in detail the information that must appear on the written contract. The Indiana Department of Financial Institutions is empowered to establish schedules of maximum legal charges and delinquency penalties and to regulate time-sales practices.

Certain features of the general banking statutes likewise affect the instalment credit activities of commercial banks. Provisions concerning the setting up of branches, insofar as they place limits upon the territory in which banks may operate, have a marked influence on consumer financing policies. In this respect the commercial bank is handicapped in comparison to some of the other consumer credit agencies which are permitted to operate on a national basis.

CUSTOMERS OF PERSONAL LOAN DEPARTMENTS

Statistical data on the customers of personal loan departments are by no means adequate but they do point to certain broad characteristics. It is apparent, for example, that people who borrow from personal loan departments have relatively high incomes. Although 35 percent of all families in the United States have annual incomes of less than $1000, only about 5 percent of the personal loan department customers in our sample were in this income class; the majority received between $1200 and $3000. This income distribution is close to that of borrowers from industrial banking companies and somewhat higher than that of personal finance company customers.

The bulk of the personal loan department customers covered by our data were between 25 and 40 years of age. Three-fourths of the borrowers were men, two-thirds were married and two-thirds had one or two dependents. A quarter of the borrowers had maintained the same residence for at least 10 years and a still larger proportion had been at the address given at the time of the loan application from 2 to 10 years. Personal loan departments appear to draw less of their customers from the wage-earning groups than do personal finance companies. About 30 percent of the commercial bank borrowers were wage-earners, some 45 percent were employed in clerical occupations and another 20 percent were classified as managers, superintendents, foremen and proprietors.

The economic and social stability of personal loan department customers is evidenced further by the facts that over one-third of the borrowers studied had held the same job 10 years or more, that 80 percent of them had life insurance and that about one-half had some sort of bank account.

The sums borrowed ranged from $100 to $1000, but most of the advances were between $100 and $200. For almost one-half of the borrowers the loan amounted to less than 10 percent of annual income and for about 10 percent it came to 20 percent or more.

It is difficult to make a precise analysis of the uses to which the borrowed funds were put. Most frequently borrowers stated that they intended to apply the loan to the payment of debts already incurred. Another common incentive to borrowing is the desire to purchase an automobile or to acquire household goods; some banks attributed almost half of their personal loans to such purposes.

OPERATING PROCEDURES AND POLICIES

In developing their loan volume commercial banks employ advertising techniques similar to those of other consumer credit agencies. Nevertheless the most productive sources of new business are not advertising media but the recommendations of former or current customers. In addition commercial banks have worked out a number of special promotional plans. Some of them by prearrangement offer the employees of certain commercial and industrial firms the use of the bank's financing services; others make personal loans for the payment or consolidation of debts to patients of doctors and dentists and to customers of retail stores. Some banks have sought to attract borrowers from the professional classes by granting them particularly favorable terms.

Commercial banks obtain their time-sales financing business either through dealers or directly from consumers. Reports from 164 banks show that automobile financing for both new and used cars accounted for slightly more than half of their time-sales paper in 1938 and that it was originated by dealers and purchasers in about equal proportions. Retail purchasers supply more household appliance business than dealers, whereas the latter provide most of the paper covering time sales of furniture, soft goods, house-heating equipment and miscellaneous items. Banks which obtain a large volume of sales finance paper through dealer contacts commonly extend inventory loans to the dealers as well.

In the larger personal loan departments the procedure for handling credit applications has become highly systematized. The credit investigation generally involves a verification of the information submitted by the applicant. The most important items pertain to the borrower's identity, his income and employment, his current indebtedness, his assets and his previous payment record. Questionnaire replies indicate that banks reject between 1 and 25 percent of the applications they receive. When the credit is granted, the borrower receives a cashier's check for the stipulated amount and directions for making instalment payments. The payments are usually made monthly and either applied directly to the loan or placed in a special deposit account which is used to retire the loan at maturity.

The procedure followed in the extension of sales finance credit differs from the method described above in that the bank must evaluate the collateral which serves as security. In addition, when the dealer carries some liability on the customer's note, the bank must also investigate his credit standing.

Commercial banks commonly establish certain standards regarding the sizes and maturities of instalment loans. With respect to the size of cash loans, the most frequently reported maximum was $1000, and the most typical minimum $50. The most usual maximum contract length was 12 months.

In sales financing, terms covering down payment and length of contract are applied also, although these requirements vary for different commodities. On automobile contracts down payments range from 25 to 40 percent of the cash selling price, with the concentration at 33 1/3 percent. New-automobile paper is generally written for periods up to 18 months, whereas the standards for used-car paper are usually more severe. Household appliances and house-heating equipment are financed on more liberal terms than automobiles; contracts arising from the instalment purchases of soft goods often are of relatively short span and require no down payment.

COLLECTION EXPERIENCE

In the banks surveyed, both delinquent payments and charge-off losses on cash loans are kept down to relatively low levels. For most of the reporting banks, less than 1 percent of their loans were delinquent by 30 days or less at the end of 1938. Charge-offs in 209 banks reporting for 1938 amounted to .37 percent of their total loans outstanding at the end of that year. A smaller number of banks supplied data from which it has been calculated that in 1938 the average unpaid balance on loans charged off was $108.

A particularly interesting figure on collection experience is provided by reports to the New York state banking department by 65 state banks. These banks are required to report charge-offs and recoveries classified according to the years in which the loans were made. From these data it appears that by the end of 1938 total charge-offs (less recoveries) on loans made during the year 1936 amounted to .27 percent.

Collection experience on sales finance contracts seems from available information to be slightly more favorable than that reported for cash loans. This difference may be attributable, however, to the fact that where sales financing contracts are purchased with recourse on the dealer the losses arising out of such transactions are carried by him rather than by the financing agency.

RISK FACTORS IN PERSONAL LENDING

An important aspect of this study is the analysis of credit risks based on a random sample of 2,765 cash instalment loans made by 21 banks operating in 16 cities. This sample, selected from loans made over approximately the same period of time, was about equally divided between loans that paid out without collection difficulty and loans eventuating either in charge-off loss or in excessive delinquency. All cases studied involved actual grants of credit, so that the findings are relevant only to successful applicants for loans and not to the larger body of *potential* borrowers.

The professional group in the sample had a relatively good credit record, and the wage-earning group a relatively poor one. Classified by industrial affiliation, borrowers drawn from professional service, public service and independent hand trades appeared to be relatively good credit risks while those from the building and miscellaneous transportation trades were relatively poor risks. As for personal characteristics, credit experience improves as the age of the borrower increases, and women appear to be better credit risks than men; on the other hand, neither marital status nor the number of the borrower's dependents is significantly related to credit experience.

A study of the relation between a borrower's income and his credit record reveals that debtors in the low income groups met their obligations as punctually as did those in the high income groups and, furthermore, that customers whose notes represented a large proportion of their incomes were not, as might have been expected, less desirable as credit risks than persons whose borrowings amounted to a smaller fraction of their annual earnings.

These findings concerning the bearing upon credit experience of the number of the borrower's dependents, the size of the borrower's income and the borrower's note-to-income ratio suggest that factors of this kind, which would obviously affect a loan officer's judgment of the creditworthiness of a potential borrower, are so effectively taken into account in the selection of borrowers that they do not have any significant influence on payment records. Conversely, it appears that factors such as age, occupation and industrial attachment are not evaluated as effectively in the initial sifting of applications.

Further indications of relative credit risk are to be noted in those characteristics which reflect economic and social stability. Borrowers possessing life insurance, bank accounts and real estate or securities appear to have better records than those without such assets. On the other hand, borrowers who stated that they owned automobiles and household goods did not prove more desirable than those who did not. The good-loan sample did, however, include a larger proportion of persons who had maintained the same residence and employment for a number of years than did the bad-loan sample.

The proportion of the borrowers in the bad-loan group with charge and instalment accounts was not notably larger than the proportion of comparable good-loan borrowers. Of several other characteristics—size of note, number of comakers and intended use of funds—only the number of comakers appears to have a bearing on credit risk: notes with three or more comakers had a comparatively poor payment record.

The foregoing analysis was supplemented by questionnaires sent to bank credit officers asking them to state the borrower characteristics which they considered most important in their own appraisal of risks. The results show that the borrower's occupational and financial position receives first consideration, particularly with reference to stability of employment. Considerable weight is given also to the individual's past payment record and to facts that throw light on character or willingness to pay.

These findings are necessarily subject to certain qualifications. In the first place, since the charge-off loss on personal loans is generally less than 1 percent, a particular class of borrowers may show a relatively bad credit record and yet be worth retaining. In the second place, credit experience is much more important with respect to some groups than to others: a good record is most significant when it applies to a group representing a large segment of the entire body of borrowers. The analysis of credit risk is useful, therefore, primarily as an indication of the characteristics which have proven worthy of more careful consideration.

CUSTOMER CHARGES

Commercial banks customarily quote interest charges on cash instalment loans as a certain rate of discount on the face amount of the note. In addition, banks may charge a credit investigation fee, exact a fine on delinquent payments, and require the borrower to carry group life insurance to cover the unpaid balance of his loan. In any computation of costs to the borrower, these charges must all be considered, as must also the amount of rebate when a loan is repaid before maturity.

Since charges are quoted in many combinations it is extremely difficult to compare aggregate costs to the consumer. Questionnaire returns from a large number of banks indicate, however, that 6 percent per annum is the most frequent discount; that most banks do not charge a credit investigation fee; that the insurance premium is usually 50 cents per $100 of original unpaid balance; and that in the event of prepayment some rebate, varying in amount, is granted the borrower.

Discount rates vary with the type of loan, the region of the country and the size of the bank. Rates are about equal for comaker and single-name loans (averaging 6.4 and 6.5 percent discount, respectively) and are slightly lower (averaging 6.1 percent discount) for loans secured by savings passbooks, life insurance policies, etc. On loans of all types rates appear to be lowest in the New England and Middle Atlantic states and highest in the West South Central states. Finally, the rates quoted by the larger banks, for all types of loans and in all regions of the country, are lower on the average than those offered by smaller banks.

Most banks which charge the borrower a credit investigation fee quote it as a flat dollar amount, commonly $1. Delinquency fines are usually levied as a stipulated percentage of the delinquent payment. Although "6 percent discount and no credit investigation fee" was the most frequently reported combination of charges on comaker loans, the range went all the way from a flat 4 percent discount with no other charges to 12 percent discount with a $2 fee for credit investigation. The bulk of the loans carried 5 to 8 percent discount with no credit investigation fee; this range accounted for about 70 percent of 543 banks reporting, while about 45 percent of all reporting banks quoted a rate of 6 percent and no credit investigation fee.

From a study of these charges it may be concluded that for a personal loan of $100 running for 12 months, the cost expressed as true annual interest on declining balances would range from 7.7 percent to 30 percent. The bulk of the reporting banks made loans at rates amounting to annual interest of 12 to 17 percent on declining balances. Since the large banks tend to charge the lowest rates it can be inferred that the bulk of the consumer loans carry rates close to the lower limit of this range. In a few large metropolitan banks, which make loans at 4 percent discount or less, the cost to the consumer in terms of true annual interest would be 7.7 percent or even lower.

An analysis of sales financing costs shows that rates for automobile financing quoted by banks which obtain contracts directly from consumers tend to be slightly lower than those quoted by banks whose business is secured through dealers.

Direct-to-consumer financing of new cars is usually offered at a rate of 5 percent whereas new-car paper discounted for dealers generally involves a rate of 6 percent. Used-car paper is discounted for both consumers and dealers at a rate slightly above that quoted on new-car paper. When financing is transacted through a dealer the bank commonly establishes a reserve to cover losses incurred on paper purchased; any reserve remaining after losses is returned to the dealer.

INCOME, EXPENSES AND PROFITS

Interest or discount accounted for more than 94 percent of the income from grants of consumer credit for all banks reporting to the National Bureau, and for 90 to 95 percent of the gross income of banks reporting to the New York state banking department. The remainder came principally from credit investigation fees and delinquency fines. For a majority of the banks, gross income from personal loans amounted to $8 to $12 per $100 of loan account in 1938.

Since commercial banks do not employ uniform cost accounting methods, it is difficult to ascertain the profitability of personal loan operations. Of 104 reporting banks, 85 stated that their personal loan departments were not charged interest on the funds employed, and of 112 reporting banks, 62 did not allocate any portion of general bank overhead expense to such departments. Both of these findings are probably to be explained on the grounds that personal loan departments are usually integrated closely with other bank operations and that few banks have a volume of personal loans large enough to warrant an intricate cost accounting procedure. It is broadly true, however, that as departments grow in number and size the problem of cost determination becomes increasingly acute.

Information on the distribution of personal loan department costs is available only for banks reporting to the New York state banking department. These data indicate that during 1937 and 1938 salaries accounted for 40 percent of total expenses, reserves for charge-offs for 17 percent, and insurance, rent, advertising and legal fees for about 23 percent. The reports show also that the operating costs of 38 out of 65 departments amounted to less than $5 per $100 of average loan account. A comparison of data for 1937 and 1938, a period during which the volume of loans made by these reporting banks increased by 18 percent and the average amount of funds employed rose by 45 percent, reveals that additional business entailed a less than proportionate addition to expenses.

A number of banks were asked to submit estimates of the cost of making and handling individual loans. Although they were urged to take into account overhead charges as well as direct costs, there was a wide diversity in reported figures, doubtless attributable to differences in methods of calculation. The reporting banks appeared to agree, however, that the cost of collecting each instalment payment was between 25 and 30 cents. Estimates of the cost of making a loan varied from $1.50 to $3.25; thus the cost of acquiring and handling a 12-month loan may be calculated as ranging from $4 to $7.

With regard to sales financing, most banks hold that when the dealer supplies the paper the costs per unit transaction are generally lower than for personal loans, because most of the credit investigation is conducted by the seller. On the other hand this type of business entails expenses not encountered in personal lending; and when dealer reserves are established the gross income per $100 of funds employed may be less than the yield from direct cash instalment lending.

Profitability per loan tends to increase with both size of loan and contract length. If it is assumed that loans are made at 6 percent discount, that acquisition costs are $1.80, that per payment collection costs are 20 cents and that special delinquency and charge-off costs for each loan total $2.50, it is found that the break-even point on loans comes between the $100 and $125 sizes. With a slightly lower cost schedule the break-even point occurs between the $75 and $100 sizes.

From the limited data available, it appears that profits are greater on personal loans than on other earning assets. Reports on net profits of personal loan departments of New York state banks for 1938 show that 4.5 percent was earned on average loan account after reserves were set up for losses. This rate is considerably higher than that derived from total earning assets by all non-member commercial banks during the same period.

Banks were asked to estimate the minimum annual volume of business they considered necessary to render their departments profitable. It was the consensus of the responses that a department having a single full-time employee should maintain an annual volume of $75,000 to $100,000, and that those with 2 to 4 full-time employees should have an annual volume of $100,000 to $200,000.

COMMERCIAL BANK LOANS TO CONSUMER CREDIT AGENCIES

For many years commercial banks have financed consumers indirectly by making loans to various instalment credit agencies. Sales finance companies, for example, are seldom entirely free of bank debt; normally they obtain part of their working capital through commercial loans and the sale of open market paper and debentures. The dependence of sales finance companies on bank credit varies in degree from year to year. Thus in 1934 a group of 48 sales finance companies obtained nearly 50 percent of their total funds from short-term loans, of which bank debt represented about one-half, whereas in 1938 bank loans and open market paper provided about 36 percent of their working funds.

Although loans to sales finance companies represent only a small proportion of the total volume of loans made by commercial banks, the magnitude of these loans is subject to rapid change. At the end of 1937 outstanding loans to sales finance companies accounted for only 6.4 percent of the total loans of 181 large reporting banks; at the end of 1938 the proportion was 3.3 percent. It is important to note, however, that about 30 percent of the decline in all loans and discounts of these 181 banks during this period can be attributed to the drop in loans to sales finance companies.

The proportion of bank loans made to sales finance companies on an unsecured basis has tended to increase over the past 15 years. The maturity terms range from demand to 24 months or longer, and interest is most frequently quoted at about 1.5 percent. National companies, moreover, are usually granted lower rates than regional or local companies. Prevailing maturities on open market paper range up to 6 months, and interest rates (varying from 1.25 to 1.75 percent) are usually somewhat higher than those on prime commercial paper.

The total bank borrowings of personal finance companies are small in comparison to those of sales finance companies. Loans to the former made by 181 reporting banks amounted at the end of 1937 to $55,000,000, whereas their grants to sales finance companies came to $440,000,000. Personal finance company loans declined during 1938 by 16 percent, but sales finance company loans dropped as much as 54 percent. Bank loans to personal finance companies are usually unsecured; their maturities tend to be shorter and they generally carry higher interest rates than do grants of credit to sales finance companies.

Industrial banking companies are even less dependent on commercial banks for working funds, in part because they obtain a large proportion of their capital either from deposits or from the public sale of instalment investment certificates. Loans to these companies are mostly unsecured, maturities seldom run for more than 6 months, and reported interest rates vary from 1.5 to 6 percent.

THE COMPETITIVE SITUATION

Although commercial banks have increased their share of the combined outstandings of all cash loan agencies in recent years, the other cash lending institutions have also enjoyed a steady rise in business volume, and for this reason the competitive situation has not thus far engendered intensive rivalry. Nor do the differences in rates charged by the several agencies invariably constitute a clear-cut competitive issue; while it is true that such differentials are often substantial, consumers tend to be influenced by other considerations.

A number of factors exert a moderating effect upon the competition between personal finance companies and the personal loan departments of banks. The rates charged by personal finance companies, when computed as a percentage of the average unpaid balance, appear to be about twice as high as those commonly set for instalment loans by commercial banks. On the other hand, the former institutions have tended to specialize in single-name loans made on the security of household chattels, whereas commercial banks have made most of their loans on a comaker basis. Again, small loan companies draw more of their customers from the lower-income, wage-earning groups than do personal loan departments, which cater largely to clerical, business and professional occupations.

In some respects industrial banking companies are the closest competitors of personal loan departments. Like the latter, they are active in both cash lending and time-sales financing and are not generally restricted by law to loans of small amounts. Furthermore, the industrial banking companies whose charters permit them to conduct a complete banking business can offer lending and deposit services equal on many counts to those provided by commercial banks. They quote their rates on the same basis as do commercial banks; their borrowers are drawn from similar income and occupational groups; and there are certain organizational resemblances between the two types of agency. The rates quoted by commercial banks are either equal to or somewhat lower than those offered by their industrial banking company competitors.

Commercial banks meet their keenest competition in the field of sales financing. Some banks have adopted the policy of soliciting business directly from consumers, usually urging their patronage on grounds of economy. In this competitive situation, however, the crucial element is the retail dealer.

With regard to organization there are considerable differences between commercial banks and sales finance companies: the former are generally non-branch units, whereas the bulk of sales finance company business is done by national companies. Banks have developed a number of techniques designed to overcome this competitive disadvantage. Available data, while not conclusive, indicate that the customer charges established by commercial banks are either equal to or slightly lower than those maintained by the larger sales finance companies.

Competition for personal loan business among commercial banks themselves is not as acute as the rivalry between banks and sales finance companies. Nevertheless there are indications that interbank competition is growing in intensity, and it is probably the cause of a number of moves on the part of banks toward reduced rates.

Cooperative relations among banks engaged in consumer credit activities were virtually non-existent until 1939. Early in that year the Bankers Association for Consumer Credit was formed. The Association initiated a monthly publication—*Time Notes*—devoted to consumer instalment credit, and organized special services for members. In 1940 the Association was merged with the newly-established consumer credit division of the American Bankers Association.