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Definition of Equipment Financing

IN THE DECADE PRECEDING the present war a number of important innovations were made in methods of financing industry and trade. In some cases these changes consisted of variations upon older procedures of financing while others were applications of well-established techniques to new and wider fields of use. Occurring in many parts of the American financial system, these changes represent attempts to make the functioning of financing agencies conform to new conditions underlying the demand for credit services. It is the purpose of this study to examine in detail the development of one of these adaptations, namely, instalment equipment financing or, more briefly, equipment financing. As an emerging type of credit extension equipment financing is an example of a technique, well established in more limited fields, enjoying a rapidly widening application in other areas.

Its rapid development in recent years would alone recommend equipment financing as a subject for special study but, at this time, an equally important reason is its potential role in postwar reconversion. In the ten years preceding the war instalment equipment financing served as a convenient and flexible method for making possible acquisitions of fixed assets by business concerns. That this was especially true of smaller concerns augurs significantly for the use of the instalment credit technique in the reconstruction period.

There are such close similarities between instalment equipment financing and other financing methods that we must begin with a careful definition of the field of credit to be covered. As a first approximation we may say that this will include all arrangements in which (a) the purpose of the financing is to make possible the acquisition by business enterprises, including farms, of income-producing equipment, (b) the financing agency retains title to, or

holds a lien on, the equipment acquired, and (c) the purchaser contracts to pay off the obligation on an instalment basis. Since this definition marks off a field of financing arrangements which, in the actual market, merge into others of closely similar features, certain exclusions must be made. In order further to clarify the area of the study, therefore, the remainder of this chapter is devoted to a definition of income-producing equipment and to brief descriptions of the types of arrangements included in, and excluded from, the field of equipment financing.

Distinguishing Features of Equipment Financing

The first and principal distinguishing characteristic of equipment financing is that it makes possible the acquisition of *income-producing* machinery or equipment, which we may define as machinery and equipment used by business enterprises for business purposes. There are two principal qualifications, however, that must be made. First, although the definition obviously is meant to exclude consumer goods, some commodities serve both business and personal needs and cannot be readily classified in one group or the other. For example, heating equipment of the very same kind may be used for both homes and business places. In all such cases it is the predominant use of the equipment financed that must serve to distinguish between business and consumer credits.

Second, while real estate financing is also excluded from the study (because a separate set of credit standards, credit appraisal methods and financing institutions are involved) it will be necessary to include the financing of certain installations that become, at least in part, permanent and immovable fixtures and thus real estate. Some of these installations (for example, air conditioning and sprinkler systems) may become so permanently a part of the real estate that they cannot be removed for purposes of repossession without damaging other property; only the fact that they can be rendered unproductive by the removal of certain parts (for example, the removal of nozzles from a sprinkler system) has made them the subjects of equipment financing. Thus, so far as our study deals with such equipment as installations and fixtures, it covers only those that are partly movable, though it must be admitted that this point of difference is not always clear.

It will be seen, then, that our definition of income-producing

equipment embraces both the use to which the property is put, and the character of the property itself. The principal purpose of these limitations is to reduce the financing area covered to one in which credit standards and credit appraisal techniques are roughly homogeneous.

The two other distinguishing features of equipment financing are the use of the specific equipment acquired as security for the credits extended,[1] and the repayment of obligations in instalments. Again, in limiting our study to such credits, we exclude certain other financing arrangements, as follows: (1) sales of equipment on open-book account, (2) unsecured cash loans, even where the proceeds are used to acquire equipment, (3) cash loans secured by equipment already owned by the debtor, and (4) cash loans secured by the purchased equipment but not repayable in instalments. Again, these further restrictions on the scope of the study are made for the purpose of limiting the discussion, as nearly as possible, to a homogeneous set of financial arrangements.[2] Finally, in order to limit ourselves to financial techniques of relatively recent development as contrasted with more conventional methods, we shall exclude equipment trust certificate financing, even though in many cases this may be closely akin to instalment equipment financing.

Types of Equipment Financing Arrangements

Within the equipment financing field there are three main types of financing arrangements; each of these will be dealt with in our study. First, equipment may be sold by a manufacturer or distributor on an instalment payment basis without any separate outside financing agency being involved in the transaction. This constitutes an extension of trade credit by the vendor but is distinguishable from open-book credit in two main respects: the buyer contracts to make instalment payments rather than a single deferred payment and title to the goods sold is retained by the vendor, whereas title goes to the buyer on an open-book credit

[1] This does not preclude the taking of additional security.

[2] While this definition sets off a kind of financing in which credit appraisal problems are substantially alike, no limitations can produce a *completely* distinct area. The financial system is such that types of credit extension grade into one another and thus the isolation of any particular field is necessarily somewhat arbitrary.

purchase. Since the manufacturer does not discount the instalment obligation which arises out of this transaction we may say that in such cases the seller "carries his own paper." The vendor may borrow, of course, in order to provide sufficient working capital for his needs but this debt is often contracted without any formal relation to the instalment receivables held. Where the volume of business is sufficiently large, a special subsidiary may be set up to handle the credit transactions but this does not alter fundamentally the distinctive character of this type of arrangement.

The second type of equipment financing consists of the discounting by the vendor of instalment receivables with some outside financing agency or the borrowing of funds on the assignment of the instalment receivables. In these cases a commercial finance company or commercial bank is brought into direct relationship with the instalment sales transaction.

The third type of arrangement involves the making of cash loans by financial agencies, usually commercial banks, where the proceeds are used to purchase equipment, where the loans are secured by liens on such equipment and are repayable in instalments. In this case the vendor of the equipment is in the position of having made a cash sale and has no immediate relation to the financing transaction.

These three main types of financing arrangements exclude certain others that are closely related to equipment financing and that have been subjects of special study by the National Bureau of Economic Research: namely, consumer instalment financing, open accounts receivable financing and term lending. The grounds on which consumer instalment financing and open accounts receivable financing can be distinguished from equipment financing are quite clear; the distinction between equipment financing and term lending is necessarily less clear.

The difference between equipment financing and term lending turns on the character of the relationship between borrower and lender. Where instalment receivables are discounted by the vendor with a financing agency, or are used by the vendor as collateral security for a loan, only an *indirect relationship* is established between the financing agency and the purchaser of the equipment; since the term loan involves a *direct relationship* between borrower and lender we have here a clear distinction between equipment

financing and term lending. However, there is a question of overlapping where we have cases of term loans which are made by purchasers of equipment for the purpose of financing these acquisitions and where the loans are secured by the purchased equipment and are repayable in instalments. Such credits may be classified either as equipment financing or as term lending. Satisfying all the criteria of equipment financing, the arrangement may also have all the distinguishing marks of a term loan,[3] that is, it is a *business* loan, involves a *direct* relation between borrower and lender and is repayable, at least in part, after the passage of one year. In this study, however, we shall treat such credits under equipment financing, understanding that they may be classified, with equal accuracy, as term loans.

[3] See National Bureau of Economic Research (Financial Research Program), *Term Lending to Business*, by Neil H. Jacoby and R. J. Saulnier (1942) pp. 10-12.