Summary Survey

THE industrial banking company, which in many respects resembles other institutions engaged in financing consumers, is most readily identified by its unique combination of loan and savings functions. This characteristic has been adopted as the basis for the definition of such companies that is used in this study: they are regarded as all institutions which extend consumer loans, repayable on an instalment basis, and obtain at least part of their working funds from the acceptance of deposits or the sale of investment certificates. It is not feasible to use legal status as the basis for definition, because the laws governing industrial banking companies are often indefinite, sometimes conflicting. Nor are corporate titles a sufficient basis for identification; many of the companies use the words "Morris Plan" in their titles, but an increasing number are not affiliated with the Morris Plan system.

NATURE AND SCOPE OF INDUSTRIAL LENDING

Industrial lending began in the United States in 1910 with the formation of the Fidelity Savings and Trust Company at Norfolk, Virginia. Established by Arthur J. Morris, it marked the beginning of a Morris Plan system which at the end of 1937 comprised 94 banks and companies operating in 119 cities. Growth was rapid between 1911 and 1917; it was retarded after this country's entry into the World War, but was resumed in the period 1921-30 and again, to some extent, after 1933. Half of the 25 extra-city branches now operating were opened between 1925 and 1930. The Industrial Finance Corporation and its subsidiaries played an important part in this program of expansion. It was formed in 1914 to aid expansion of the Morris Plan system, and at the end of 1937 it had a controlling stock interest in 15 companies and minority interests in 50 others. In addition to having indirect ownership of some local banks and companies the Industrial Finance Corporation engaged in real estate and time-sales financing through subsidiaries most of which are now inactive. Its Morris Plan Insurance Society, formed in 1917 to write personal loan insurance, has been markedly successful. Other systems of industrial banking companies were established concurrently with the Morris Plan system, but with the exception of two groups organized in 1930 these are now dissolved, their surviving units operating independently.

An indication of the quantitative importance of industrial banking companies is provided by the estimate that there were 410 in operation at the close of 1938, extending between $370,000,000 and $425,000,000 in credit during that year. The scope of industrial lending is further indicated by the estimate that the services of these companies were used by approximately 1,500,000 persons during 1938.

LEGAL STATUS

Since it did not fit into any of the usual categories of corporations, the first industrial banking company was granted a general charter as a Virginia corporation. To some extent this uncertain status exists even now, but in 31 states special statutory provisions have been made for this type of agency. In a few states, even in those that have made special provisions for industrial banking companies, these institutions operate under regular bank charters; in other states they conduct their business under special sections of the small loan law.

Most industrial lending laws prescribe the steps that must be taken before a charter can be issued, stipulate minimum capital requirements and give the charter-granting authority the right to refuse an application if, in its opinion, the "convenience and advantage of the community" would not be served by the establishment of the proposed company.

Almost all state laws give industrial banking companies extensive lending privileges. Regulations as to the maximum size of note, rarely set at less than $1000, are generally much more liberal than small loan law limitations. Restrictions, when they exist, are usually limitations on, or outright denials of, the right to make real estate loans; there are also maturity regulations, and restrictions on the type of investment securities that can be held as assets.

Sections of industrial loan statutes pertaining to maximum rate of charge apply only to cash loans; except in Indiana the sales-financing activities of industrial banking companies are virtually unregulated. In general, statutes permit loans to be discounted at from 6 to 8 percent. Other charges usually permitted are a credit investigation fee, frequently not to be collected unless the loan is made, a fee for the provision of group life insurance and fees for the preparation of necessary documents. Many laws also provide for delinquency fees, and stipulate maximum and minimum total charges.

Most industrial banking company statutes permit either the acceptance of deposits or the sale of investment certificates, thus enabling companies to acquire loanable funds. Deposits, when "hypothecated," and certificates of investment, when sold on an instalment basis, are often used as collateral security for a loan made simultaneously with the opening of the savings account, although most laws state that when this is done the two transactions are to be considered as separate and distinct. Thus while the loan-repayment and certificate-purchase periods may be equal in length, and while the fully-paid certificate may be used to retire the loan at maturity, the form of the contract separates the two transactions and considers the loan as paid in full in one payment. This arrangement makes it possible to regard the rate of discount as the annual effective rate of interest, whereas the effective rate is approximately twice the rate of discount on a loan formally repaid in equal instalments.

Other features of state statutes concern branch banking, dividend payments and reserves to be held against accounts receivable, deposits and unhypothecated investment certificates. Examinations and reports to supervisory authorities are also provided for by law, and legislation makes certain companies eligible for membership in the Federal Reserve System and for insurance of deposits under the Federal Deposit Insurance Corporation. In recent years proposals for a uniform industrial banking law have been under consideration.

FINANCIAL STRUCTURE

In having the greatest proportion of their assets in consumer loans and discounts industrial banking companies are notably different from commercial banks; but their major reliance on deposits and investment certificates as a source of funds distinguishes them from other agencies of consumer instalment credit. Savings deposits in institutions with deposits insured by the Federal Deposit Insurance Corporation have shown a tendency to increase in average size, rising from $189 in 1934 to $357 in 1938.

For their relatively insignificant proportion of funds obtained through bank loans industrial banking companies pay rates varying from 2½ to 6 per cent; the rates paid for funds raised through deposits and the sale of investment certificates range mainly from 2 to 4 percent, though as a rule, funds obtained through the sale of certificates prove more costly than funds obtained through savings deposits. Data on insured industrial banking companies indicate that the average interest paid on deposits has tended to decline somewhat since 1935.

SERVICES AND CHARGES

The present diversification of industrial banking company business is in marked contrast to the earlier practice of these firms. Originally they dealt almost exclusively in comaker loans, and while this type of lending is still important in their business nearly all of the companies now make single-name loans, and most firms make loans on collateral security. Also, many have developed a substantial proportion of sales finance business, developed either through dealer contacts or by appeals made directly to individuals. Commercial lending, too, has grown considerably in importance; at the end of 1938 nearly 12 percent of the total loans and discounts of insured industrial banking companies were "commercial and industrial loans" made to businessmen on a non-instalment basis. Comaker and single-name loans now provide about 50 percent of the volume of all loans, collateral loans roughly 10 percent and sales finance paper from 15 to 20 percent; the remainder is mainly in loans on real estate, loans insured by the Federal Housing Administration, and commercial loans.

The greater liberality of the laws governing them enables industrial banking companies to make larger loans than personal finance companies. Their market, however, is limited mainly to persons with annual incomes of $3000 or less, and thus few of them make many very large loans. Reports by members of the American Industrial Bankers Association show average loan sizes ranging mainly from $175 to $210. Data on 10 relatively large Morris Plan companies show that the average size of loan fell from $271 in 1929 to $228 in 1933, rose to $317 in 1937 and fell again to $288 in 1938. Cash loans made by industrial banking companies may run for as short a period as 3 months but usually they are for 12 or 15 months. On sales financing business maturities are similar to those offered by other agencies, contracts ranging from 12 to 18 months for most goods, longer for the more expensive commodities.

Competitive conditions have resulted in customer rates about equal to those offered by commercial bank personal loan departments and sales finance companies, rates that are in many instances lower than the legal maximum. Loan costs are customarily quoted as a rate of discount plus a charge for credit investigation, and the discount rate usually varies according to the size of the loan and often also according to the type of security. These variations, in addition to those dependent on company practice and local conditions, make it very difficult to generalize about typical charges. Rates may be as low as 3 1/3 percent discount, plus a credit investigation charge of 50 cents per $100, or as high as 6 or 8 percent discount plus charges. On loans repayable in equal monthly instalments over a 12-month period, the effective rate of interest on average unpaid balances may be calculated as approximately double the rate at which the loan is discounted.

Most industrial banking companies attempt to offer their customers saving as well as lending services. In those states where existing legislation gives such firms the status of banks they are able to offer complete banking facilities, but the majority of industrial banking companies receive savings and deposit funds through the sale of investment certificates.

OPERATING METHODS AND COLLECTION EXPERIENCE

Although all the standard advertising techniques—direct mail, newspaper, radio, and billboard—are used by industrial banking companies, the bulk of their loan volume is obtained through repeat borrowing and through the recommendations of old customers. Sales financing, if conducted in volume, is necessarily developed through dealer contacts; some banks, however, have developed business by arranging to finance accounts receivable originated by retailers, and many companies finance consumer purchases directly.

Office organization varies according to the size of the firm, 300 loan accounts per employee being regarded as a rough standard of operating efficiency. Loan applications are received and investigated in a manner typical of all consumer credit agencies. In small offices all loans may be passed by one person; in larger institutions it is common practice for a loan committee to review applications. The proportion of rejections varies widely but as a rule it is probably about 25 percent of all loan applications received.

Losses are consistently low, when expressed as a percentage of total credit extended, but they represent an important part of the total expenses of operating an office. During the period 1929-38 the net charge-offs of 10 relatively large Morris Plan companies were consistently less than 1 percent of total loan volume, being highest in 1933, lowest in 1935; during the same period year-end outstandings on delinquent loans ranged from 4.4 percent of total loans outstanding at the end of 1932 to 1.2 percent at the end of 1937. For the entire group of insured industrial banking companies net charge-offs, in percent of year-end outstandings, fell from 1.3 in 1934 to 0.1 in 1936, rising somewhat in 1937 and 1938; on assets other than loans, however, their net losses rose from 1.9 percent of security holdings at the end of 1934 to 5.5 in 1937, and fell considerably in 1938. On the whole these insured industrial banking companies had lower net losses on loans than did comparable commercial banks; on assets other than loans there was no consistent relationship, in the years 1934-38, between the two types of institutions.

CREDIT RISK

An important consideration in consumer instalment lending is the relative degrees of risk involved in various types of loans and various classes of customers. The present study of risk factors is based on a sample of 1,322 accepted loan applications, submitted by 2 large Morris Plan and 8 other industrial banking companies. The cooperating institutions were asked to provide random samples of about the same number of "good" and "bad" loans made over approximately the same period—the former defined as loans that paid out without collection difficulty, the latter as loans that ended in charge-off or legal action for recovery. Since the cases studied refer to credits actually extended, and experience thereon, the findings are relevant only to actual borrowers and not to the much larger group of potential customers.

Analysis of these samples reveals that certain personal characteristics of borrowers are significantly related to collection experience. Thus credit experience seems to be better on loans made to older borrowers than on those made to younger borrowers; women borrowers appear to be better credit risks than men; borrowers who have resided in the same city for a considerable period of time seem to have better records than those with shorter durations of residence. Marital status and number of dependents, on the other hand, do not appear to be significantly related to credit experience. It should be noted again, however, that these findings refer to successful loan applicants and that the results are more reflective of the care with which certain borrower characteristics are taken into account by loan officers than of the risk inherent in a particular class of potential borrowers.

The study reveals also that borrowers from professional and certain clerical occupations, and those employed in public service industries, have better-than-average credit records; borrowers from the miscellaneous transportation industries prove to have a considerably worse-than-average record of loan performance. Credit experience is better on loans to persons engaged in an occupation for a long period of time than on those to borrowers with shorter durations of occupational attachment.

Financial characteristics of borrowers that appear to be associated with better-than-average credit experience are the possession of a bank account, of life insurance or the ownership of real estate. A borrower's income and the ratio of the amount of a borrower's note to his income do not prove to be significant, doubtless because these factors were adequately taken into account in the original selection of risks.

Among the loan characteristics neither size nor maturity appears to be reliably indicative of credit experience, nor does the purpose for which the borrower intends to use his funds. In regard to loan security, however, it is found that notes carrying the names of three or more comakers have a somewhat worse-than-average record.

INCOME, EXPENSES, PROFITS

About three-quarters of the income of industrial banking companies comes from interest and discounts on loans; fees, charges and commissions amount to from 10 to 15 percent of gross income. Interest and dividends on securities seldom amount to more than 5 percent of gross income. Data on insured industrial banking companies reveal that income from interest and discounts on loans, plus fees and other charges, declined from $9.38 per $100 of average loan account in 1935 to $8.73 in 1938.

The main items of expense incurred by these companies are salaries and wages, and interest paid on deposits and certificates. The former accounts for between 30 and 40 percent, the latter for about 20 percent of gross expenses. Data on insured institutions show that, like income from loans, current operating expenses (not including charge-offs and losses on the sale of assets) have declined over the period 1935 to 1938, falling from $7.14 per $100 of average loan account in 1935 to $6.42 in 1938.

An indication of the profitability of industrial banking companies is provided by the ratio of net profits to total equity account. For Morris Plan companies this figure averaged about 10 percent during the years 1922-38. Insured industrial banking companies have shown a consistently better earnings record than insured commercial banks, despite the fact that the current operating expenses of the former, when expressed per $100 of total assets, are well over twice as high as those of the commercial banks.

COMPETITIVE AND COOPERATIVE RELATIONS

The competitive situation of industrial banking companies is unique in that the diversification of their activities brings them into direct contact with all types of consumer credit agencies. In making cash loans they compete with small loan companies, credit unions and personal loan departments of commercial banks, and in financing retail instalment sales they compete with commercial banks and sales finance companies. Morris Plan companies are so located as not to compete with one another, but there is a substantial degree of competition between Morris Plan and other industrial banking companies. The recent tendency of sales finance companies to enter the cash loan field brings a new element of competition into the market. Sales finance companies have effected this diversification of their activities by taking out licenses under small loan statutes or by incorporating or qualifying offices as industrial banking companies.

Another relatively recent development in the competitive situation is the extension of commercial loans by industrial banking companies, especially the larger ones, an activity which, like the acceptance of deposits, brings them again in competition with commercial banks. At the end of 1938 nearly 12 percent of the total loans and discounts of insured industrial banking companies were classified as commercial loans.

Measures of the extent to which there is overlapping of the markets served by these various agencies are difficult to make, but it appears that in regard to cash loans the industrial banking company market is much closer in character to that of the commercial bank personal loan department than it is to the market served by the personal finance company. The relative closeness of competition between industrial banking companies and commercial banks is indicated also by the fact that their loan charges are very nearly the same, while in many cases the charges of industrial banking companies are substantially lower than small loan company rates. Competition with sales finance companies is largely in the automobile field, which accounts for about 75 percent of the retail instalment paper purchased by industrial banking companies. This competition is not very significant, however, for the volume of retail sales financing conducted by industrial banking companies represents less than 5 percent of the total volume of this type of paper handled by all agencies combined.

Cooperative relations among industrial banking companies are effected through two associations—the American Industrial Bankers Association and the Morris Plan Bankers Association—both of which perform the usual trade association functions.