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Summary Survey

SALES finance companies are specialized financial institutions which extend instalment credit through retail dealers to consumers. The exact number of such institutions in existence today is not known but it is probably more than a thousand, and nearly all of these have been established since 1915. Their rise has been both a cause and a result of the enormous growth of retail instalment selling that has taken place in this country since the end of the World War.

SALES FINANCE COMPANIES AS CREDIT AGENCIES

The primary activity of sales finance companies is the purchase of retail instalment contracts from dealers who have made instalment sales. This type of credit is extended principally for the purchase of consumer goods, though it is used also for the purchase of such producer goods as business vehicles, agricultural implements or appliances for use in business. In addition to their retail financing, however, most companies engage also in wholesale financing, thus supplying the dealer with the funds he needs for the purchase of goods from the manufacturer; without supplementation by financing of this type instalment selling could not be carried on in its present volume. Some companies also discount open accounts receivable or engage in the business of making small loans or conduct still other types of business activity. At the end of 1937 these latter types of activities accounted for about 6 percent of the outstandings of a representative sample of sales finance companies; wholesale financing accounted for 15 percent; and the remaining 79 percent was retail financing, of which nearly seven-eighths was for automobiles.

The significance of sales finance companies in the entire retail instalment system can be only roughly estimated. In 1937 retail dealers extended nearly $4,300,000.000 in instalment credit, including finance charges, and about half of this amount appears to have been handled by sales finance companies; over $2,000,000,000 of the total was extended by motor vehicle dealers, and in this field the participation of sales finance companies was probably as high as 75 percent. The paper not handled by such companies was carried by dealers themselves or was financed through banks or other agencies.

The total amount of instalment buying in 1937 was higher, however, than these figures would suggest, for they do not include the purchases made by means of cash loans, repayable at regular intervals, which are also to be regarded as instalment credit. The principal agencies engaged in this kind of business extended in that year over $1,600,000,000 in cash loan credit (including interest or finance charges), though of course only a part of this was used for the purchase of retail commodities. If the volume of credit extended by retail dealers is reduced to $3,700,000,000—in order to allow for the probable amount of paper covering the retail purchase of producer goods—it would appear that a total of well over $5,000,000,000 in instalment credit, including cash loans, was extended to consumers in 1937.

In addition to the private agencies of retail instalment financing there is an agency of the federal government, the Electric Home and Farm Authority, which has been engaged in financing instalment sales of electric appliances since 1934. Its activities are financed from capital and surplus and from short-term bank borrowing, and it provides credit services on a somewhat more liberal basis than do the private companies. Another government agency, the Federal Housing Administration, has had an indirect connection with sales financing through its insurance of real estate "modernization" loans made by approved financial institutions. Most of the institutions participating in this insurance arrangement have been commercial banks, but about 2 percent were sales finance companies in the building materials field. These finance companies handled about one-fourth of the total number of notes, and a little more than one-fifth of the total amount, insured by FHA during the period from August 1934 to April 1937.

ORGANIZATION AND FINANCIAL STRUCTURE

Although a few sales finance companies are organized under the partnership or individual form of business enterprise the great majority of them are corporations, some of the largest ones comprising a number of operating companies controlled by a holding company. Some companies handle only automobile paper; others accept only "diversified" business, that is, they finance instalment purchases of various articles other than automobiles, such as electric appliances, radios, furniture or industrial equipment; and some companies handle both automobile and diversified paper. Sales finance companies may be classified also according to their relationship with manufacturers. Of the companies handling passenger automobile paper only one, at present, is factory-controlled; until recently there were two others that had preferential relations with manufacturers, but these relations were terminated by consent decrees in 1938. Factory relationship is more frequent in the diversified field, but in both automobile and diversified financing there are a great many independent companies, having no affiliation with, or preference from, any particular manufacturer.

There are three sales finance companies whose operations are national in scope, and five large regional companies, each having offices in eight or more states. The remainder are known as local companies, although a few of them cover as much as several states. At the end of 1937 the assets of the nationals were more than seven times as great as those of the regionals, and nearly nine times as great as those of forty of the largest local companies: in that year the nationals handled roughly seven-tenths of the retail and eight-tenths of the wholesale automobile credit extended by sales finance companies. Available evidence indicates, however, that since 1929 the locals have generally maintained their competitive position as well as, and in some years notably better than, the larger companies.

The extremely rapid growth of sales finance companies in this country could not have taken place if there had not been highly developed capital and credit markets which were both able and willing to make funds available to these new institutions. In the period 1924-39 equity funds averaged roughly one-third of sales finance companies' total assets—a figure that is decidedly higher than the typical capital ratio of comparable institutions such as banks and mortgage companies. Since sales finance companies seldom own physical property in any large amount the greater proportion of these equity funds was used for financing receivables. Throughout this period the national companies' proportion of equity funds to total assets was lower than that of regionals or locals, and in most years their proportion of funds borrowed to funds owned was higher—evidence of their preferred position in the national money markets. The equity fund percentages varied considerably, of course, from one year to another, and though this variation was due largely to variation in trade volume there are indications that as the business has matured it has been able to rely more than formerly on borrowed funds.

The national companies have made fairly extensive use of long-term money markets and the regionals have used this source of funds to a moderate extent, but local companies have had to rely on the short-term money markets for practically all of their borrowed funds, and for all companies short-term debt has constituted on the whole the most important source of funds, mainly because of the need for rapid expansion or contraction, in accordance with changing conditions. Banks supply the greater part of sales finance companies' short-term funds, but open-market facilities are also used to a considerable extent, especially by the larger companies. By 1937 all of the bank debt of the national companies, and practically all that of regional companies, was incurred on an unsecured basis, but four-fifths of the bank debt of local companies was secured by pledge of collateral. Available information indicates that most short-term bank credit is for 6 months, but maturity requirements range widely—from a demand basis to 24 months or longer; interest is predominantly 1½ percent but here too there is considerable variation, the rates ranging from 1 to 12 percent, with the national companies receiving the most favorable terms. On open-market borrowing terms are as favorable as, usually more favorable than, those received from banks.

A rule of thumb standard commonly applied by bankers as a test of a sales finance company's general liquidity is its theoretical ability to liquidate all debts within 6 months merely by letting its existing instalment receivables mature, and there appears to be a fairly general adherence to such a standard; many banks, however, favor a more liberal period. Leading creditor banks obtain regular reports on the contract terms that are being granted by sales finance companies, and occasionally they have been instrumental in checking what they regarded as unwise liberalization of down payment and maturity requirements.

THE MARKET FOR SALES FINANCE CREDIT

An important factor in the great expansion of retail instalment financing that took place between 1915 and 1929 was the invention and manufacture of certain new commodities, such as the automobile and various durable electric appliances, which had a strong appeal to consumers and which manufacturers widely promoted as available on instalment terms. Also, a concurrent increase in real incomes gave consumers sufficient purchasing power to meet instalment obligations as they came due. Data available from several sources give some indication of the economic circumstances of retail instalment buyers in general, and of sales finance company customers in particular.

Estimates from an extensive survey of consumers indicate that nearly 5,900,000 non-relief families—nearly one-fourth of the total—had a net change in retail instalment debt during the year 1935-36; the proportion was greater in the Pacific region and less in the North Central. In the $1500-2500 income groups nearly one family out of three reported a net change in debt for instalment purchases, and even in the upper income brackets—$5000 or more—15 percent of the families came under this classification. The great majority of the debtor families were urban dwellers, most of them residents of large cities, though not of the great metropolitan centers. For nearly a third of the debtor families the changes in instalment debt resulted from furniture purchases, for two-fifths they resulted from purchases of electric equipment, for one-fifth from automobiles. The distribution of the volume of debt change was quite different, however: of the net dollar increase in instalment debt automobiles were responsible for almost three-fifths, electric equipment for a little less than one-third, furniture and miscellaneous purchases for the balance. The families indebted for automobiles were concentrated mainly in the $1000-4000 income levels, whereas those indebted for other commodities were concentrated mainly in the $500-2500 levels, although refrigerator debtors were relatively infrequent in the income groups below $1000.

Only 12 percent of the non-relief families having a net change in instalment debt during 1935-36 were farm families, though farming was the principal source of income for more than twice that high a proportion of all non-relief families. Of all wage-earning non-relief families 30 percent came under the category of debtor families, as used here, and of those in other non-farm occupations, 26 percent. Among wage-earners debt frequency was above average in all income levels between $1000 and $4000, and among other non-farm occupations in the $1000-3000 levels.

These data depict the market for retail instalment credit in general. Only from two sources—a large private sales finance company and the Electric Home and Farm Authority—are figures available on the economic circumstances of sales finance company customers. The data are admittedly not wholly reliable but they may serve roughly to fill out the picture already sketched.

The figures on the private company's customers suggest that nine-tenths of sales finance company automobile customers are drawn from the $500-4000 income groups, three-fifths from the $1000-2500 groups, used-car customers, of course, having lower incomes, on the whole, than new-car buyers. These data indicate also that between 1919 and 1934 there was a conspicuous increase in the proportion of automobile instalment customers coming from lower income groups; this is probably attributable mainly to the substantial decrease in the prices of cars, both new and used. Automobile purchasers with higher incomes bought higher-priced cars and committed themselves for larger unpaid balances and higher monthly payments than did lower-income purchasers; but the ratios of these items to income, that is, the financial burden which they represented, declined consistently as income increased.

The EHFA data pertain to electric appliance customers, and they suggest that about nine-tenths of such buyers come from the $500-3000 income levels, seven-tenths from the

$1000-2500 levels. Appliance customers, like automobile customers, are concentrated less in the lower income levels, and more in the intermediate income levels, than are non-relief families in general.

The question whether there are significant differences between cash and instalment buyers in regard to economic circumstances is difficult to answer accurately, but certain suggestions as to the answer, in regard to automobile buyers, are to be found in a small random sample of family expenditure schedules for the year 1935-36. Analysis of this sample indicates that cash buyers had higher incomes, on the average, than instalment buyers—substantially higher in the case of new-car buyers. The latter were slightly older, on the average, than used-car buyers, and in both groups cash buyers were somewhat older than instalment buyers. A higher proportion of cash than of instalment buyers were families whose principal breadwinner was engaged in business pursuits; wage-earning families who bought new cars, and professional and clerical families who bought used cars, were more predominant among instalment than among cash purchasers. It is interesting to note that the families that bought new cars for cash were more preponderantly childless than any other type of buyer. Home ownership was reported by a greater proportion of cash buyers than of instalment buyers, and by a greater proportion of new-car than of used-car buyers. In general, these findings confirm the commonsense inference that the economic circumstances of families purchasing on instalment terms are generally less favorable than those of families in a position to purchase for cash, but the fact remains that the differences between cash and instalment buyers are less striking than the similarities.

From the beginning there has been considerable disagreement on the desirability of the diversion of purchasing power that is brought about by instalment selling. Proponents of the system have contended that if consumers were not making payments on automobiles, furniture, mechanical refrigerators and the like—all useful and relatively durable commodities—they would probably be spending their odd dollars on goods and services which could give them only temporary enjoyment. Others have held that this diversion of purchasing power warps the structure of production and adversely affects standards of consumption by encouraging extravagant or unwise expenditure. The foregoing data afford some evidence for judgment as to whether the possibility of instalment credit attracts buyers who should not purchase at all, but the ultimate answer must of course remain in the realm of opinion, for statistics cannot indicate what is prudent or imprudent for a buyer to afford. The customary criticism implies also, however, that buyers are induced by instalment terms into purchasing a good of a higher price-quality class than they would otherwise feel justified in buying, and this contention can be empirically tested, though only for automobiles.

The data pertinent to this question are for the year 1935-36, and they suggest that it is only in the used-car market, where prices range widely and may mean considerable differences in quality, that the possibility of instalment credit induces people to buy higher-priced cars than those bought by cash buyers of the same income level. Among new-car buyers it appears that in no income group did instalment buyers purchase significantly higher-priced cars than cash buyers; in fact, above the $2500 income level they bought notably lower-priced cars.

CREDIT PROCEDURE AND CREDIT LOSSES

The consumer who wishes instalment credit sometimes makes his own arrangements with a bank, loan company or other source of funds, but usually he leaves this to the dealer. The dealer may finance the transaction with his own resources, or may direct the credit to a commercial bank or industrial banking company, but at least in automobile financing he ordinarily discounts the note with a sales finance company. He determines the finance charge on the basis of a rate chart furnished him by the finance company; in determining the amount of down payment and the number of instalments he has a certain amount of leeway, but on these matters certain standards are usually stipulated by the finance company and he must stay reasonably close to them, especially in automobile transactions, if he wishes the company to accept the paper under the customary arrangement. The exact form of the legal instrument which evidences the sale and protects the finance company's interest in the collateral is determined principally by state laws, conditional sales contracts and chattel mortgages being the most common; most transactions include also a promissory note for the amount due. The investigation of the customer's credit standing is usually completed within an hour or two, or at most a day, and after the contract has been accepted the dealer endorses it, delivers it to the finance company and receives his check for the amount of the note minus the finance charge and the insurance charge, if any.

In automobile financing, insurance is practically always required, and it is usually placed by the finance company, very often through affiliated insurance companies. In diversified financing, however, insurance is less customary, and even when required it is customarily placed by the purchaser, though there is an increasing tendency for the company itself to assume the risk of loss from fire, theft and the like.

If the purchaser makes his payments with reasonable promptness the finance company makes no effort to establish personal contact with him, but if he becomes delinquent his account receives special attention, ranging from form notices to the sending out of a special representative. Delinquency in automobile financing is considerably less than in cash instalment lending: among a group of leading sales finance companies retail balances over 60 days delinquent averaged, during 1935-39, only about 1 percent or less of total retail receivables outstanding. If the representative is unable to obtain prompt payment he may adjust the difficulty by arranging to have the contract extended or rewritten to allow of smaller payments, the finance company in this case either charging interest or assessing a flat charge or a new finance charge; in ordinary years, according to the experience of one large company, approximately one out of every twenty retail automobile contracts is adjusted or refinanced, and in depression years one out of every five to eight. Or the purchaser may be influenced to refinance his debt through some other institution, such as a small loan company.

If no other solution of an overly delinquent account is possible the finance company resorts to repossession of the collateral; according to the experience of a large sales finance company about three-fifths of the cases of excessive delinquency in automobile transactions eventuate in repossession, this solution occurring three to seven times more frequently among used-car than among new-car transactions. In many cases the purchaser surrenders the collateral voluntarily, but if he does not the representative takes possession by self-help or, if the purchaser resists, the finance company resorts to court action.

Not only the purchaser's but also the dealer's financial reliability is an important consideration with the finance company, partly because it may be extending him credit for his wholesale purchases, partly because he usually has some degree of liability in cases of repossession on retail transactions. His liability in such instances is determined by the "plan" governing his relations with the finance company. Under some plans the dealer endorses his customers' contracts "without recourse," and in these cases his liability usually ends when the finance company purchases the contract. Occasionally a "full recourse" endorsement is required of him, usually on substandard contracts, and then he is responsible for full payment of any remaining balance. In automobile financing the greatest volume of business is conducted, however, under what is known as a repurchase agreement; under this plan too the dealer is subject to recourse for the settlement of any defaulted balance, but he is granted certain stipulated modifications of his liability. 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; this is payable to him periodically if he has fulfilled his obligations. Diversified financing is typically conducted on a full recourse basis, though sometimes, especially in regard to refrigerator paper, the dealer's responsibility is limited, except in specified contingencies, to the span of the first four or six instalment payments.

Estimates of the average losses incurred in sales financing have only slight significance, partly because there are so many reasons for variation, partly because there are great differences of opinion as to what constitutes a loss and as to how losses and loss reserves should be handled in accounting procedure. With this reservation, however, certain partial estimates may be attempted. During 1935-39 the average retail losses sustained during each six-month interval by a group of large companies handling mainly automobile paper ranged from over ½ percent to nearly 2 percent of the retail paper liquidated during that interval. Credit losses of sales finance companies vary, of course, according to whether their retail volume is composed mainly of recourse or non-recourse business. In the period 1929-37 one large company's losses on repurchase-agreement automobile financing ranged, on new cars, from 0.02 to 0.34 percent, and on used cars from 0.25 to 1.02 percent of the total retail paper purchased during the year in which the loss paper originated. These figures pertain mainly to losses from conversion, confiscation and collision, and to some losses arising out of contract readjustments and fraudulent deals. Losses on non-recourse transactions are of course substantially higher.

CREDIT STANDARDS AND TERMS

Dealers and sales finance companies have evolved a more or less defined set of standards which guide them in evaluating the prospective customer's ability and willingness to meet his obligations. The relative importance attached to these various standards varies from one company to another, and varies even more as between the different types of articles financed. Factors relating to collateral security, for example—such as the cash selling price, durability and resale value of the commodity purchased—are given more weight in automobile than in diversified financing, and factors relating to the customer's reliability—such as income, credit record, age and occupation, character, employment record—are typically given most emphasis in diversified financing, where there is less possibility of reselling the collateral promptly at an assured price. The size of the down payment that the customer is willing to make, and the length of time that he needs in order to repay his debt, are also important considerations, especially in automobile financing, and both these factors have to be considered in relation to the purchaser's income.

Down payment and contract length are dependent not only on what the customer will agree to but also on what the finance company will accept. In most transactions, especially in automobile financing, the down payment consists at least partly of an allowance made for a trade-in; eight out of ten new-car sales and more than six out of ten used-car sales involve trade-ins, according to the experience of one large company. In automobile financing a standard down payment of one-third of purchase price for new cars and 40 percent of purchase price for used cars, and a standard contract length of 12 months for all cars, were decided upon in 1924. For a number of years there was substantial adherence to these standards, but in 1934, during recovery from the depression, considerably easier terms appeared, especially in metropolitan areas. In 1936 and 1937 the two trade associations in this field adopted resolutions favoring another standardization of terms—a down payment of one-third of purchase price on all cars, and a contract length of 18 months on all except used cars more than two years older than current models, on which the contract should be no more than 12 months—and these proposals have since been reaffirmed by resolution. Possibly because of this action there was a change toward more conservative terms, evident on down payments after 1936 and on contract lengths after 1937, but there is some indication of a renewed tendency toward more liberal terms since the end of 1938.

In diversified financing there have been attempts to establish standard terms for different commodities, and individual companies sometimes set up their own standard terms, but practice is in general considerably more flexible than in automobile financing. As a rule, the larger the down payment the longer the contract may run, but the down payment is typically a much lower percent of purchase price than it is for automobiles; in 1938 it averaged 10 percent for most commodities. Contract length necessarily varies widely—from 12 to 36 or perhaps even 48 or 60 months—in accordance with the amount of original cash selling price. In this field too contract terms appear to have been liberalized considerably in the years of business expansion in the middle 1930's, and here too trade associations have made an effort to establish tighter terms. Contracts financed by the Electric Home and Farm Authority have tended to be of shorter duration, and to carry larger down payments, than were characteristic during the Authority's first years, but EHFA terms are still somewhat more liberal than those of private companies.

REPOSSESSION EXPERIENCE: AUTOMOBILES

Probably the commonest and most easily understandable measure of unfavorable credit experience in sales financing is the repossession ratio—the average number of repossessions per hundred articles financed. This measure gives no indication of the actual losses involved, but variation in accounting procedures and differences between recourse and non-recourse transactions make it almost impossible to arrive at accurate averages regarding losses. A body of data covering over 4,000,000 passenger-car contracts financed at retail during 1933-36 by a single large sales finance company, while not altogether typical of automobile sales financing, may be regarded as indicative of the general pattern of repossession experience in this field.

These data indicate that about half of new-car, and seven out of ten used-car, repossessions occur before four payments are made, and that nine-tenths of the former and practically all of the latter come before the tenth payment. The reason for the trade's interest in standard contract terms is evident in the pattern of the repossession ratio when related to these factors. For both new and used cars it declines sharply and consistently as down payment increases—being average or higher than average unless down payment is more than 40 percent of cash selling price. Also, it is lower on shorter contracts, though this is true only in regard to new cars. The used-car repossession ratio varies inversely with length of contract, but the reason for this is that the comparatively few customers receiving the longer contracts on used cars are selected with special care, and that contracts on the lower-priced, higher-risk used cars are conspicuously shorter than on those that are more costly; as used-car prices increase to $500 there is a distinct tendency for repossessions to diminish.

It is difficult to analyze repossessions from the point of view of the circumstances that made it necessary for the purchaser to relinquish his car, because such circumstances are not readily susceptible of generalization. With such classifications as are possible, however, it appears that about half of all automobile repossessions are due to financial or personal reverses suffered by the purchaser, and that nearly one-third befall customers who overestimated their ability to pay, or found car upkeep too high for their income; most of the remainder appear to be caused by breach of contract on the part of the customer.

REPOSSESSION EXPERIENCE: ELECTRIC APPLIANCES

The second major field of sales finance company operations is electric appliances. On this type of financing the most complete available data on repossessions pertain to a body of about 16,000 contracts financed by the Electric Home and Farm Authority from January through June 1937. These data show that appliance repossessions and automobile repossessions have much the same general pattern, but in regard to appliances it is possible to consider the significance of a further factor—the customer's income—as a possible indicator of the likelihood of repossession.

A special tabulation of EHFA contracts financed in the first quarter of 1938 shows a pronounced tendency for the repossession ratio to decline as purchaser's monthly income increases; the ratio is less than average for the purchasers—nearly three-fifths of the total—who received over $125 a month, and decidedly worse than average for those whose monthly incomes were less than that amount. An even more significant factor than absolute income is the related one of monthly payment in percent of monthly income; the repossession ratio is roughly twice as high when the monthly payment is 5 to 10 percent of the monthly income as it is when the payment is less than 5 percent, but this factor appears to be more important in regard to those receiving incomes of less than $125 than it is in regard to those receiving incomes higher than that.

Appliance repossessions, like those for automobiles, tend to concentrate in the early months of the span. Over a third of the total number of repossessions estimated to occur on the 1937 sample of EHFA contracts took place before three payments were made, and more than three-fourths came within ten payments; on the average about 4 payments were made before repossession, or approximately 12 percent of the total number due. And as in automobile financing the repossession ratio decreases markedly as down payment increases; this tendency appears to be irrespective of contract length, amount of note, type of appliance financed or purchaser's income.

The repossession ratio increases as the length of contract increases, but only until the contract reaches 36 months; scarcely more than one-tenth of these EHFA contracts were for more than 36 months—these being mainly for ranges and combination purchases—but the data indicate that on them the repossession ratio tended to decline as the span became longer, irrespective of either amount of note or down payment. As in regard to the similar tendency found in repossessions on used-car contracts, this finding may be partly explained by especially careful credit selection; and it may be partly explained by the fact that the great majority of those whose contracts ran 48 months or more had incomes higher than $125 a month. In general, however, it would seem that the significance of contract length in indicating the likelihood of repossession is particularly subject to misinterpretation and exaggeration.

For contracts of 24 months or less repossession experience improves conspicuously as notes become larger, but it seems probable that amount of note is not among the more significant factors that indicate the likelihood of repossession. The repossession ratio declines very clearly, however, as the dollar amount of monthly payment increases; the ratio is twice as high when monthly payments are less than $8 as it is when they are more than this amount.

Over eight-tenths of these contracts were for refrigerators, electric ranges and washing machines; the latter had the highest proportion of repossessions—10 percent of all washing machines financed—and ranges had the lowest—3 percent. This may have been because electric-range purchasers had monthly incomes averaging $158, while the incomes of those who bought washing machines averaged only $133.

FINANCE CHARGES

In used-car financing, and for some companies also in new-car financing, it is the general practice to stipulate in rate charts only the total amount of note, and its division into monthly payments, with no indication of the respective amounts to be allocated to the cost of financing service and of insurance protection; the amount of the note and the size of the monthly payments which it necessitates are stipulated separately for each original unpaid balance and each contract length. Insurance on used cars is such a variable item, even within a single territory, that it is considered impracticable to compile a schedule of exact rates to be employed as a basis for a separate statement of insurance charges. In new-car financing, however, it has since 1935 been the practice, especially of the national companies, to state the insurance charge separately, in standard territory schedules, and to compute the finance charge as a percentage rate on the insurance plus the original unpaid balance. As in used-car financing, it is customary to state in rate charts not the amount of finance charge but only the total amount of the note and its division into monthly payments, but at least one national company now specifies charges as well as instalment payments.

The rate used in computing finance charges on new cars is usually about ½ percent a month (of the original unpaid balance plus insurance), 6 percent on a 12-month contract, but no percentage rate is mentioned either in rate charts or in sales finance company advertising. After the "6 Percent Time Payment Plan" was introduced by General Motors Acceptance Corporation, in the fall of 1935, it was widely adopted by other companies, and widely advertised as a reduction and simplification of finance charges, but the Federal Trade Commission ordered that percentage terms could not be publicized unless they referred to simple interest. The 6 percent plan involved an interest rate considerably higher than 6 percent, because the charge was figured on the full amount of the account originally financed, regardless of the fact that the account is regularly amortized by monthly payments, but the plan effected a considerable reduction in prevalent charges and made it possible for the customer to detect any overcharge that may have been added by the dealer.

The amount that the customer actually pays is not always the same as that indicated in the rate chart: sometimes the dealer inflates the quoted charge by adding a "pack" for himself; sometimes he makes an error in computation; sometimes there are deceptions or special circumstances which lead to deviations from the normal charge.

The constituent items in the total charges actually paid by the customer are primarily the finance company's provision for expenses and profit, the retail insurance premium, the dealer's reserve or bonus and sometimes also a dealer's pack. Insurance is ordinarily required by, and also placed by, the finance company, but in most cases it covers the purchaser's as well as the company's interest; according to a large sample of automobile transactions occurring in 1936-38 insurance costs average 40 to 50 percent of the total charge on new cars, and 25 to 35 percent of that on used cars. The dealer's loss reserve (customary in recourse financing) and the dealer's bonus (allowed mainly in non-recourse financing, as a bid for business) amount to about 10 percent of the average total charge on new-car transactions, and to somewhat more on used-car transactions. The dealer's pack, which is forbidden by some companies, averages roughly 2 percent of new-car total charges, and a higher proportion in used-car transactions. The remainder of the total charge—somewhat more or less than half—is kept by the finance company for its expenses and profit. The finance company usually, however, derives some profit also from the insurance premium, either in the form of commission or in the form of dividends or income from an associated insurance company.

According to samples of automobile transactions compiled by the Federal Trade Commission, finance charges, expressed in annual percentage rates on declining credit balances, ranged in the years 1935-38 from less than 12 to nearly 20 percent on new-car transactions, the variation arising from differences in company practices and from differences in contract lengths. From an economic point of view this is the proper basis for an expression of charges, in spite of the fact that from a legal point of view sales finance company charges are not generally regarded as interest. In relation to original unpaid balance plus insurance—the basis generally used in the sales finance business—the charges on these transactions ranged from 6 to 10 percent on 12-month contracts. The charges of the factory-controlled company were consistently lower than those of the other companies during this period, and the charges of the independent companies were highest. As a result of the introduction of the 6 percent plan the finance charges of all companies were conspicuously lower in 1938 than they had been in 1935.

On used cars financed by these companies (1936-38) charges were considerably higher than on new cars, the annual percentage rates ranging from about 18 to 37 percent for the different types of companies and the different contract lengths. When expressed in relation to original unpaid balance plus insurance the finance charge on 12-month used-car contracts ranged from nearly 13 percent (for the factory-controlled company) to 18 percent (for the independent companies).

It should be borne in mind, however, that these are average percentages, and that there is wide variation in the finance charges on individual transactions. A dealer's error in computation, an intentional overcharge of one kind or another, accounting irregularities or some other special circumstance may result in a charge that is notably higher or lower than average. Finance charges on individual 12-month transactions in the Federal Trade Commission samples ranged, in annual percentage rate, from a low of minus 8 percent to a high of 80 percent on new cars, and from a low of minus 7 percent to a high of 132 percent on used cars.

Another point to be remembered is that the finance charge, although it is in most cases separate from the insurance charge, is computed by the company on the insurance coverage which is required of the purchaser as well as on the original unpaid balance of his purchase. The cost of this insurance varies widely in different transactions—according to the type and price of car, the territory in which it is bought, the practice of the finance company (most companies provide protection at conference rates, but the factory-controlled company writes insurance at rates about one-fourth less than standard), the amount of coverage provided, and sometimes according to other circumstances of the particular transaction. Although these variations may make significant differences in the dollar amount the purchaser pays, such differences are not reflected in the rate of finance charge. The inevitable variations in the cost of insurance make it impossible, however, to express this item accurately in percentage terms for purposes of comparison. The most accurate base for a percentage expression is original cash selling price, and on this basis insurance on the Federal Trade Commission samples of 12-month contracts averaged roughly 3 percent or a little more on both new-car and used-car transactions, being somewhat lower for the factory-controlled than for the other companies. In percent of original unpaid balance plus insurance (the same base as that used for the finance charge) insurance costs are still more approximate, but on this base too they appear to have been generally lower, on the average, for the factory-controlled than for the other companies.

There are no data on the trend of automobile finance charges over a period of years but it is possible to construct indices showing relative variations of the insurance and finance charges on a single hypothetical transaction during the period 1924-38. These indices show that in the area selected (Albany, New York) combined insurance and finance charges rose sharply in 1926 and thereafter continued at a fairly even level until their abrupt fall and still more abrupt upswing in the depression years 1931-32. They have subsequently declined irregularly to levels approximating those that prevailed in the middle 1920's, in spite of the fact that since 1931 they have included a broader insurance coverage than they did before. In fact, the fraction of the combined charge that is represented by insurance shows a fairly steady increase during this period.

A significant feature of these data is that even wide swings in the index of combined charges make but a small difference in the index of gross time price (cash selling price plus insurance and finance charges). In other words, even large percentage changes in charges make but small percentage changes in the total price the purchaser pays, and this fact appears to have been of considerable importance in the attitude of consumers toward rate changes, and thus in the attitude of sales finance companies toward rate competition.

In diversified financing, as in automobile financing, charges are usually quoted as a dollar cost in relation to specified original unpaid balances, though for some commodities a straight ½ percent a month, figured on original unpaid balance, is usual. In diversified financing it is not customary to impose on the purchaser a special charge for insurance protection.

The quoted charges of twelve private companies and the Electric Home and Farm Authority for the years 1936-38 indicate that for all amounts of unpaid balance and for all contract lengths EHFA showed very nearly the same annual percentage rate, and that in all categories this rate was lower than that of any private company. The differential between EHFA and the private companies was considerably smaller, however, on larger balances and on longer contracts.

ABUSES IN RETAIL INSTALMENT FINANCING, AND THEIR REGULATION

For many years the retail instalment system has been attacked for ambiguous, sometimes exorbitant finance charges, and for various deceptive and misleading practices. Regulative legislation has been proposed in several states, but so far only four states—Indiana, Maine, Michigan and Wisconsin—have taken legislative action specifically regulating retail instalment financing. The Indiana law applies to the whole field of retail instalment financing, but those of the other three states apply only to motor vehicles. The Maine law is primarily a licensing act, those of Indiana and Wisconsin provide not only for licensing but also for regulation and supervision, and the Michigan law contains no licensing feature but provides for regulation.

There have been various attempts, however, both within and without the trade, to regulate various sales financing practices. Trade associations have devised lists of approved practices, and proposals have been studied in regard to a new uniform conditional sales act and a uniform licensing law, both such laws to apply not only to sales finance companies and retail merchants but also to any other institutions that engage in the financing of instalment sales. Also, the Federal Trade Commission has been instrumental in drafting proposals regarding fair trade practices in automobile instalment sales, although in general the trade favors self-regulation, without government participation.

A requirement that finance charges be stated in terms of simple interest—that is, as a percentage rate on the declining credit balance due—has been favored by various consumer groups and also by various state supervisory and legislative committees. Spokesmen for sales financing interests deny the desirability of this form of quotation, however, contending that it is unnecessary and inappropriate; they hold that there is a fundamental distinction between a time sale and a loan, and the courts have generally agreed that a discount transaction is not an interest transaction. No legislation thus far enacted attempts to stipulate the form in which the finance charge should be quoted to the consumer, but the Indiana, Michigan and Wisconsin laws require that the consumer be apprised in some detail regarding the various terms of the transaction, including actual insurance and the finance charge.

Only the Indiana law has attempted to set maximum legal rates of finance charge, and the constitutionality of this provision has not been finally determined. Existing legislation generally sets standard manual rates as the maximum charge for insurance, and in the last few years insurance commissioners too have concerned themselves with this aspect of sales financing, issuing rulings that rates and coverages be detailed to customers. Regulation of the dealer's participation in the finance charge, through the reserve and bonus, and prohibition of the dealer's pack, are further features of existing legislation and also of proposals regarding fair trade practices and uniform licensing legislation; in regard to such dealer payments, however, the efforts of the sales finance business toward self-regulation have been complicated by problems of competition.

Abuses in regard to delinquency, refinancing and the refunding of unearned finance and insurance charges have been widely stressed, and they are dealt with specifically in the laws of Indiana and Wisconsin; also the efforts at self-regulation and the proposals for legislative and administrative regulation give considerable emphasis to provisions regarding contract adjustment.

The instalment system has been criticized for many other business practices: hasty or peremptory repossession, accompanied by high reinstatement fees; "add-on" contracts; the requirement of extra security in the form of chattel mortgages on non-sale merchandise, endorsements of other parties, or wage assignments; and various miscellaneous deceptions and outright frauds. Abuses of these kinds are not, however, characteristic of the more reputable companies, and they have been condemned in practically all of the proposals for regulation.

A special set of problems arises in connection with insurance practices; false inflation of the insurance charge, failure to provide the insurance paid for by the customer, ambiguity as to coverage, are a serious source of criticism. Most of these insurance abuses are eliminated when there is a clear statement to the purchaser, informing him not only as to the exact cost of his insurance but also as to the insurance coverage which is provided him, and provisions regarding such a statement are contained in most proposals for regulation. Considerable improvement has been effected in this field by the recent widespread activity of state insurance commissioners, requiring exposure of rates and coverage and stipulating proper practices in regard to finance insurance.

INCOME, EXPENSES, PROFITS

The gross earnings of sales finance companies come from retail and wholesale financing, insurance placement, small loans, factoring and rediscounting the paper of other finance companies. Retail financing, which constitutes from two-thirds to three-fourths of receivables outstanding, furnishes the bulk of gross earnings. Wholesale financing constitutes 10 to 20 percent of receivables outstanding, and a much higher proportion of volume, but it accounts for scarcely more than 5 to 10 percent of gross income. This type of business is commonly transacted at the prevailing commercial interest rate, or even less, because the sales finance companies make a practice of accommodating dealers in this regard so that they may share in the retail instalment paper which the dealers handle. Income from handling the insurance required on automobiles constitutes an important proportion of earnings, but this item varies widely among the different companies.

Gross income shows considerable variation according to the scope of a company's operations, being on the whole lowest for national companies, and lower for regionals than for locals, when expressed in percent of year-end total assets; in the years 1928-39, for these three types of companies, it averaged respectively 11, 13 and 15 percent. The reason for this variation is mainly that the national companies hold a larger proportion of new-car paper, and a larger proportion of wholesale automobile and factoring paper, than do the locals; such transactions, since they entail a lower risk, carry lower rates of charge.

Operating expense, cost of borrowing and provision for taxes constitute the major categories of sales finance company expenses. Total expenses too are lowest for the national companies—about 6 percent of total assets, in 1937, as compared with 8 percent for the regionals and 9 for the locals. Over two-thirds of total expenses are for operating outlays, the proportion being a little lower for the national companies, and about one-fourth is for borrowing costs, this proportion being somewhat lower for the locals and still lower for the regionals. Data on the period 1928-39 indicate that for all companies the proportion of gross income required for operating expenses and taxes increased considerably in 1930-32 and thereafter declined irregularly, but —mainly because of increased provision for taxes—to levels substantially higher than those obtaining in 1928-29. On the other hand, the cost of borrowing, which declined considerably during the depression years, in relation to gross income, maintained its lower level during the expansion years that followed.

Since its beginning the business of instalment financing has been a highly profitable one, with a very low rate of failure among the companies engaged in it. In 1937 the net profit of a representative group of sales finance companies was about 4 percent of total assets, slightly higher for the nationals, slightly lower for the locals; in relation to owners' invested capital it amounted to 19 percent for the nationals, nearly 15 percent for the regionals and 14 for the locals, the variation being due largely to differences in the capital structures of the three types of companies. But in a consideration of the profitability of an entire business, profits are properly computed in percent of total capital employed, including borrowed funds. On this basis Federal Trade Commission data indicate that in 1937 average net profit was

7.9 percent for the independent sales finance companies (regionals and locals), 6.5 percent for those that were factory-preferred and 5.6 for the one under factory control.

One reason for the relatively high and relatively stable profit rates of sales finance companies is the fact that there has been for two decades an expanding market for their services. Their ability to reduce operating expenses and increase charges in periods of cyclical decline in volume is another reason. And a third is the low interest rates on borrowed funds that have prevailed during the past few years. But the profit rates that have persisted among sales finance companies cannot be wholly understood without consideration of the competitive conditions that have characterized this business.

COMPETITIVE RELATIONS

In the sales finance business competition takes forms quite different from what might be expected if the transaction were effected directly between finance company and purchaser, with no other interests to be satisfied. In fact, it is not primarily the consumer who has led the finance companies to compete with one another in regard to such matters as charges, which are presumably of paramount concern to the consumer. As a rule the latter is mainly interested in acquiring immediate possession of the commodity he is purchasing, and is ignorant of other, possibly more advantageous, credit arrangements, or even indifferent to credit possibilities other than those conveniently presented to him. Moreover, even if by shopping around he could find a finance charge, say, 15 or 20 percent less than the one offered him, he is likely, especially if he is not among the lowest income groups, to feel that his total investment is already so large that the resultant few dollars' saving is not worth the effort.

Such factors as these undoubtedly reduce the incentive of sales finance companies to engage in rate competition.

Dealers, however, have to compete strongly for consumers' business. In the automobile field the lack of standardization in the value of used cars is a special cause of retail competition, and not infrequently the dealer must make an unwise overallowance on a trade-in if he hopes to keep his customer. And he may have to allow a smaller down payment or a longer contract than he feels to be justified. This situation too is likely to be reflected in what the customer pays, for the cost of such dealer practices is partly compensated by dealer participations in the finance charge, and may be compensated also by a packed sales price for the new commodity the consumer is buying.

It is not to be denied, however, that the consumer derives some benefit from finance company competition, partly because he is learning to be more aware of comparative charges, partly because in some fields the manufacturer has an interest in the financing arrangements offered for the instalment purchase of his goods.

Manufacturer participation in retail and wholesale instalment financing has been under serious attack in the automobile field. Of the companies that finance the instalment purchase of passenger automobiles there is today only one—General Motors Acceptance Corporation—that is under factory control, none of the others having any affiliation with motor manufacturers, but formerly several other large companies were either owned by or contractually connected with factories. In 1937 about three-fourths of the total volume of automobile paper handled by sales finance companies went to the three national companies that were at that time related to automobile manufacturers. The special arrangements between manufacturer and related finance company usually provided that the latter would finance the wholesale purchases of the factory's dealers and would offer retail purchasers a relatively low-cost plan of financing approved by the manufacturer; the latter endeavored to influence his dealers to use, and to recommend to their customers, the facilities of the related finance company. There were also specific financial arrangements under which the manufacturer paid subsidies to the finance company and the latter sometimes paid to the factory a portion of its profits.

The manufacturer's interest in the financing process has operated to keep the factory-related companies' finance charges lower, on the whole, than those of the independent companies. The latter contended, however, that if competition had been allowed free play among all finance companies charges would have been reduced at least as much as they were under the preferential system. As a result of the independents' contention that some companies' relationships with manufacturers tended to create a monopoly situation, the Department of Justice instituted legal proceedings against the manufacturers and finance companies concerned. Late in 1938 consent decrees were signed with Ford, Chrysler and their associated finance companies, providing that the dealer should be left complete freedom to patronize any finance company he chooses, and that the manufacturer shall accord equal treatment to all finance companies. General Motors refused to sign a consent decree, and in the fall of 1939 a verdict of guilty was returned against the General Motors corporate defendants; this verdict they have filed notice of intention to appeal.

In these proceedings the Department of Justice hoped to reach three objectives: elimination of any existing coercion of dealers by the manufacturers and their related finance companies; elimination of any manufacturer discrimination against independent finance companies; and elimination from purchaser payments of any excess amounts intended for undue dealer participation in the finance charge. This third objective cannot be achieved until the GMAC case is settled, but the first two were covered in the provisions of the consent decrees.

Since the dealer, rather than the purchaser, is the focus of finance company efforts to obtain business, it is around the dealer that most competitive practices have developed. The financing of a dealer's wholesale purchases, for example, is not a profitable business, but it is engaged in as a lever for obtaining his retail business, the relatively low rate on wholesale financing being compensated by the relatively high rate on retail transactions. Some finance companies also, for the same purpose, make loans on dealers' stocks of used cars.

The development from full recourse to repurchase-agreement or partial recourse plans is another aspect of finance company competition for dealer business, and many smaller companies have gone even farther and offered the dealer complete freedom from responsibility in cases of purchaser default. Most companies, whether they purchase predominantly under the repurchase or under the non-recourse plan, buy some paper also under the alternative arrangement. At least in relatively prosperous times the two methods of purchasing paper have not such different effects on dealer losses as might be expected, but their development has been accompanied by highly competitive practices regarding dealer payments, and these have a direct bearing on the interests of the consumer.

Under the repurchase plan, and under the less frequent full recourse plan, a loss reserve is set aside for the dealer out of the finance charge, and often it is considerably in excess of what he needs to cover actual losses. The non-recourse companies, not holding the dealer responsible for losses, could not offer him this inducement of a generous loss reserve, and therefore they developed the practice of offering him an outright bonus for his business, this too provided out of the finance charge. Some dealers provide themselves with further income by arbitrarily "packing" the finance charge. In 1936-38, according to samples collected by the Federal Trade Commission, about one-tenth of the average insurance and finance charge on new cars—and a somewhat larger fraction on used cars—went to dealers for reserve or bonus. The various dealer participations in the finance charge create a situation that is unsatisfactory for the finance company as well as for the consumer, but attempts to remedy it have met with little success.

In recent years sales finance companies have met increasing competition from other consumer credit agencies. New institutions, particularly commercial banks and industrial banking companies, have entered the sales financing field, and new rivalry has developed from alternative methods of consumer instalment financing, such as direct cash lending. Also, especially in diversified financing, the dealer himself may undertake the financing of instalment sales, thus threatening the business of all the specialized credit agencies. The extent to which the sales finance company will withstand the rivalry of these various institutional competitors is probably dependent mainly on the extent to which it excels them in having capital resources available for a specific purpose, in having an organization geared to the procedures required, and in possessing a store of experience in regard to the intricate problems of contract terms and finance charges.