CHAPTER 26

Finance Companies

Preview

Suppose that you are graduating from college and about to start work at that high-paying job you were offered. You may decide that your first purchase must be a car. If you are not mechanically inclined, you may opt to buy a new one. The problem, of course, is that you do not have the $20,000 needed for the purchase. A finance company may come to your rescue. Most automobile financing is provided by finance companies owned by the automobile companies.

Now suppose that you have gone to work and your first assignment is to acquire a new piece of equipment. After doing some math, you may decide that the company should lease the equipment. Again, you may find yourself dealing with another type of finance company.

Later, you are asked to see what you can do to increase your company's liquidity. You may again find that finance companies can help by purchasing your accounts receivable in a transaction called *factoring*.

It is clear that finance companies are an important intermediary to many segments of the economy. In this chapter we discuss the different types of finance companies and describe what they do.

History of Finance Companies

The earliest examples of finance companies date back to the beginning of the 1800s when retailers offered **installment credit** to customers. With an installment credit agreement, a loan is made that requires the borrower to make a series of equal payments over some fixed length of time. Prior to installment credit agreements, loans were usually of the single-payment or balloon type. A **balloon loan** requires the borrower to make a single large payment at the loan's maturity to retire the debt. Installment loans appealed to consumers because they allowed them to make small payments on the loan out of current income.

Finance companies came into their own when automobile companies began mass marketing. In the early 1900s, banks did not offer car loans because cars were considered consumer purchases rather than productive assets. Many people wanted to buy cars but found it difficult to raise the purchase price. The automobile companies established subsidiaries, called *finance companies*, to provide installment loans to car buyers.

Soon many other retailers adopted the idea of providing financing for consumers who wanted to buy their goods. They found not only that sales increased but also that the subsidiary finance company was profitable.

Eventually, banks recognized the value of consumer loans and began offering them too. By offering lower interest rates, banks rapidly gained the larger part of the consumer credit market. By the beginning of 2010, banks held $1,177 billion in consumer loans, compared to $684 billion by finance companies.[1]

As the proportion of credit offered by finance companies to consumers declined, the proportion offered to businesses in the form of sales and leasing increased. At the end of 2006, for example, finance companies held $478 billion of business loans.

Purpose of Finance Companies

Finance companies are money market intermediaries. Recall from Chapter 11 that the money markets are wholesale markets. This means that most securities that trade there have very large denominations. The minimum investment of $100,000 makes it impossible for individuals and most small companies to trade in this market. A second obstacle is that consumers and small companies lack the credit standing necessary to borrow in the money markets. These factors exclude consumers and small businesses from being able to take advantage of the low interest rates available on money market securities.

Finance companies allow smaller participants access to this market by selling commercial paper and using the proceeds to make loans. (In Chapter 11 we noted that finance companies were the largest sellers of commercial paper.)

The financial intermediation process of finance companies can be described by saying that they borrow in large amounts, but often lend in small amounts—a process quite different from that of commercial banks, which collect deposits in small amounts and then often make large loans.

A key feature of finance companies is that although they lend to many of the same customers that borrow from banks, they are virtually unregulated compared to commercial banks and thrift institutions. States regulate the maximum amount they can loan to individual consumers and the terms of the debt contract, but there are no restrictions on branching, the assets they hold, or how they raise their funds. The lack of restrictions enables finance companies to tailor their loans to customer needs better than banking institutions can.

Finance companies exist to service both individuals and businesses. Consumer finance companies that focus on loans to individuals differ from banks in significant ways. First, consumer finance companies often accept loans with much higher risk than banks. These high-risk customers may not have any source of loans other than the consumer finance company. Second, consumer finance companies are often wholly owned by a manufacturer who uses the company to make loans to consumers interested in purchasing the manufacturer's products. For example, all U.S. automobile companies own consumer finance companies that fund auto loans. Often these loans are made on very favorable terms to encourage product sales.

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[1] http://www.federalreserve.gov/econresdata/releases/statisticsdata.htm.

Business finance companies exist to fill financing needs not served by banks, such as lease financing. Manufacturers of business products often own finance companies for the same reasons as automobile companies: Sales can be increased if attractive financing terms are available.

Risk in Finance Companies

Like other financial institutions, finance companies face several types of risk. The greatest is **default risk,** the chance that customers will fail to repay their loans. As mentioned earlier, many consumer finance companies lend to borrowers who are unable to obtain credit from other sources. Naturally, these borrowers tend to default more frequently. Finance company delinquency rates are usually higher than those for banks or thrifts. Finance companies recoup the losses they suffer from bad loans by charging higher interest rates, often as much as twice that charged by banks. When economic conditions deteriorate, finance company customers are often the first to be unemployed, and defaults cause losses.

Another type of risk finance companies face is **liquidity risk.** Liquidity risk refers to problems that arise when a firm runs short of cash. For example, a bank may have a liquidity problem if many depositors withdraw their funds at once. Finance companies run the risk of liquidity problems because their assets, consumer and business loans, are not easily sold in the secondary financial markets. Thus, if they are in need of cash, they must borrow. This is not difficult for larger finance companies because they have access to the money markets and can sell commercial paper, but borrowing may be more difficult for smaller firms.

Offsetting the lack of a secondary market for finance company assets is the fact that none of the firm's funds come from deposits, so unexpected withdrawals do not occur. The greater problem is that a change in the perceived risk of the finance company may make it difficult to **roll over** its short-term debt instruments. The term *roll over* means to renew the debt each time it matures.

GO ONLINE

Access Federal Reserve releases of financial companies at www.federalreserve.gov/Releases/G20/current/default.htm.

Interest-rate risk is a major problem for banks and thrifts but not of great concern to finance companies. Recall that interest-rate risk refers to a decline in value of fixed-rate loans when market interest rates rise. Banks and thrifts hold more long-term loans than finance companies do and hence are subject to greater interest-rate risk. Finance companies can be affected by changing interest-rate levels because their assets (loans) are not as interest-rate sensitive as their liabilities (borrowings).

Types of Finance Companies

There are three types of finance companies: business, sales, and consumer. Figure 26.1 shows the distribution of loans for finance companies. Consumer loans are the most common type. Note that loans secured by real estate can be made to both businesses and consumers but more often result when consumers obtain second mortgages on their homes. (Second mortgage loans are discussed in Chapter 14.)

Business (Commercial) Finance Companies

In the early 1900s, commercial banks were reluctant to lend money secured by a company's accounts receivable (funds owed to the company by other businesses and individuals) because the Federal Reserve discounted or bought only promissory notes that were related to productive purposes, such as financing for a factory. Not

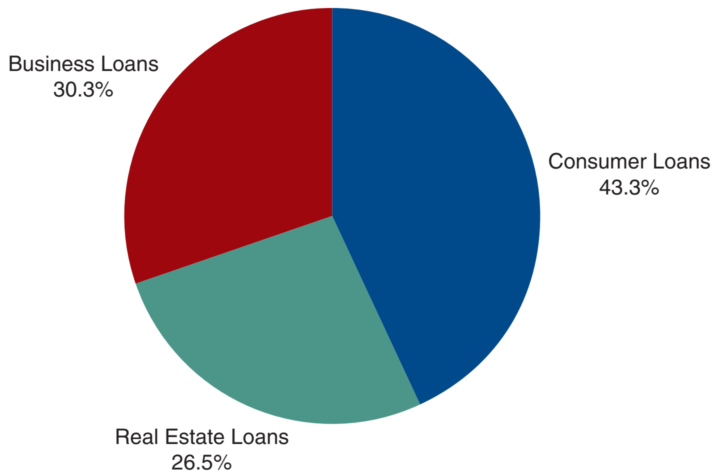

FIGURE 26.1 Types of Loans Made by Finance Companies, 2010

Source: Federal Reserve Bulletin, Table 1.51.

until after the Great Depression did commercial banks begin competing for loans secured by accounts receivable. By this time, finance companies were offering to make loans that were secured by equipment and inventory to businesses as well. Finance companies gained the reputation of being more innovative than banks at finding ways to finance small businesses. One reason they could be more flexible was their near-total absence of regulation. Because there are no depositors to protect, the government has never found the need to restrict the activities of these types of firms. Figure 26.2 reports the different types of business loans made by finance companies. Equipment lease financing is the most prevalent. Loans secured by motor vehicles, which include loans to buy autos for business use and for resale, are also common.

Factoring Business finance companies provide specialized forms of credit to businesses by making loans and purchasing accounts receivable at a discount; this provision of credit is called **factoring.** For example, a dressmaking firm might have outstanding bills (accounts receivable) of $100,000, due from the retail stores that have bought its dresses. If this firm needs cash to buy 100 new sewing machines, it can sell its accounts receivable for, say, $90,000 to a finance company, which is now entitled to collect the $100,000 owed to the firm.

Factoring is a very common practice in the apparel industry. One advantage of factoring is that the finance company (called a *factor* in this situation) usually assumes responsibility for collecting the debt. If the debt becomes uncollectible, the factor suffers the loss. This removes the need for the apparel company to have a credit department or be involved in the collection effort.

Factors usually check the quality of the firm's receivables before accepting them. The factoring arrangement works well because the factor is able to specialize in bill processing and collections and to take advantage of economies of scale. Besides the cost savings from reduced salary expenses, many firms like to use factors because they do not want their relationship with their customers spoiled by having to collect money from them.

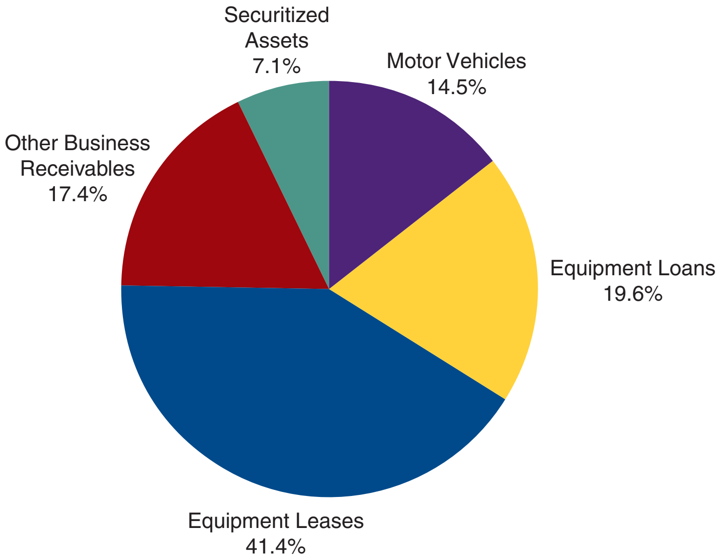

FIGURE 26.2 Types of Business Loans Made by Finance Companies (end of 2009)

Source: http://www.federalreserve.gov/releases/g20/current/g20.htm.

Finance companies also provide financing of accounts receivable without taking ownership of the accounts receivable. In this case, the finance company receives documents from the business giving it the right to collect and keep the accounts receivable should the business fail to pay its debt to the finance company. Many firms prefer this arrangement over factoring because it leaves them in control of their accounts receivable. They can work with their customers if special arrangements are required to assure payment.

Leasing Business finance companies also specialize in **leasing** equipment (such as railroad cars, jet planes, and computers), which they purchase and then lease to businesses for a set number of years. Indeed, much of the growth in finance companies in recent years has come from business leasing. Under a lease, the finance company buys the asset and then leases it to the business. One advantage of leasing is that **repossession** of the asset is easier. Repossession occurs when the finance company takes the asset back when the lessee (the firm that is leasing the asset) fails to make the payments on time. Lenders can repossess an asset under loans and lease contracts, but it is easier under a lease because the finance company already owns the asset, so no transfer of title of ownership is required.

Finance companies that are subsidiaries of equipment manufacturers have an additional advantage over banks. When a piece of equipment must be repossessed, the manufacturer is in a better position to release or resell the asset.

The owner of an asset is able to depreciate the asset over time and to capture a tax savings as a result. If the firm that plans to use the asset does not have income to offset with the depreciation, the tax saving may be more valuable to the finance company. Part of this tax benefit can be passed on to the lessee in the form of lower payments than on a straight loan. In effect, the government is supporting the equipment purchase in the amount of the tax savings. This support is lost unless a firm earning income actually owns the asset.

A final advantage to leasing is that the lessee is often not required to make as large an up-front payment as is usually required on a straight loan. This conserves valuable working capital and is often the critical factor in leasing decisions.

Floor Plan Loans Some auto manufacturers require that dealers accept auto deliveries throughout the year, even though sales tend to be seasonal. To help dealers pay for their inventories of cars, finance companies began offering **floor plans.** In a floor plan arrangement, the finance company pays for the car dealership's inventory of cars received from the manufacturer and puts a lien on each car on the showroom floor. When a car is sold, the dealer must pay off the debt owed on that car before the finance company will provide a clear title of ownership. The dealer must pay the finance company interest on the floor loans until the inventory has been sold. Floor plan financing is most common in the auto industry because cars have titles that the finance company can hold to secure its loans. Floor plan financing exists in other industries where assets with titles are involved, such as construction equipment and boats.

A close relationship usually evolves between the finance company and the dealer. Consider that each sale requires correspondence between the firms. As a result of the close relationship, it is common to find that the same finance company also provides retail financing for the dealer's customers. The help that an aggressive finance company can provide by financing weak credit customers also helps the finance company's floor loans get paid.

Note that banks also provide floor plan financing; however, such loans tend to be high-maintenance. The unregulated, lower-cost structure of finance companies often makes them the preferred intermediaries.

Finance companies enjoyed growth in business loans in the mid to late 1990s, but the growth has leveled off since then (see Figure 26.3).

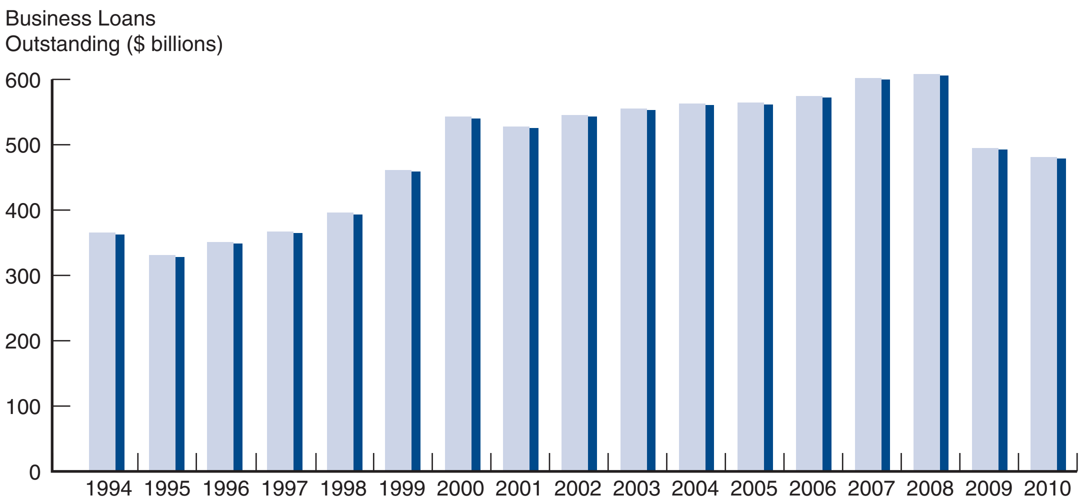

FIGURE 26.3 Finance Company Business Loans, 1994–2010

Source: http://www.federalreserve.gov/releases/g20/current/g20.htm.

Consumer Finance Companies

Consumer finance companies make loans to consumers to buy particular items such as furniture or home appliances, to make home improvements, or to help refinance small debts. Consumer finance companies are separate corporations (like Household Finance Corporation) or are owned by banks (Citicorp owns Person-to-Person Finance Company, which operates offices nationwide). Typically, these companies make loans to consumers who cannot obtain credit from other sources due to low income or poor credit history. Finance companies will often accept items for security, such as old cars or old mobile homes, that would be unacceptable to banks. Because these loans are often high in both risk and maintenance, they usually carry high interest rates.

There are two exceptions: Finance companies are becoming more active in making home equity loans, loans secured by a second mortgage on the borrower's home. The Tax Reform Act of 1986 ended the ability to deduct most consumer interest from income when computing taxes. Unchanged, however, was the right to deduct interest paid on loans against a principal residence.[2] This lowers the effective interest rate by a factor of 1 minus the tax rate.

EXAMPLE 26.1 After Tax Effective Interest Rate

Suppose that the interest rate on a home equity loan is 8% and that the marginal tax is 28%. What is the effective after-tax cost of the loan?

Solution

The effective after-tax cost of the loan would be 5.76%.

$$\text{Effective interest rate} = \text{interest rate} \times (1 - \text{marginal tax rate})$$

where

$$\text{Interest rate} = 0.08$$

$$\text{Marginal tax rate} = 0.28$$

Thus,

$$\text{Effective interest rate} = 0.08 \times (1 - 0.28) = 0.0576 = 5.76\%$$

The reduced effective interest rates have made home equity loans very popular. Most consumers continue to obtain home equity loans through banks. However, lower-income consumers and those with poor credit histories obtain them from finance companies.

The disadvantage to home equity lending is that the lender will usually be in second position on the title. This requires the lender to pay off the first mortgage before taking ownership of the property. We discussed second mortgages in detail in Chapter 14.

Another growth area for consumer finance companies is in retail credit cards. Many retailers like to offer their customers a "private label" credit card to increase sales. Many large retailers operate their own credit card programs either in-house

[2]Interest on loans made against a second home is also deductible.

or through finance subsidiaries, but smaller retailers may contract with a finance company. When the retailers accept applications for credit cards, they pass them on to the finance company for approval. The finance company then sends the retailer's card to the customer. The finance company provides billing and collection services for the account. The consumer may never be aware that a finance company is involved in these transactions. Thus, finance companies allow smaller retailers to provide a service that only larger retailers could offer otherwise.

Sales Finance Companies

Sales finance companies make loans to consumers to purchase items from a particular retailer or manufacturer. Sears, Roebuck Acceptance Corporation, for example, finances consumer purchases of all goods and services at Sears stores. Sales finance companies compete directly with banks for consumer loans and are used by consumers because loans can frequently be obtained faster and more conveniently at the location where an item is purchased.

A sales finance company, also called a **captive finance company,** is owned by the manufacturer to make loans to consumers to help finance the purchase of the manufacturer's products. These captive finance companies often offer interest rates below those of banks and other finance companies to increase sales. Profits made on the sale offset any losses made on the loans.

Regulation of Finance Companies

As noted, because there are no depositors to protect and no government deposit insurance is involved, finance companies are far less regulated than banks and thrifts. The exception to this is when a finance company is acting as a bank holding company or is a subsidiary of a bank holding company. (Recall from Chapter 19 that bank holding companies are firms that own the stock of one or more banking institutions.) In these cases, federal regulations are imposed. Finance companies without a direct relationship to a bank are regulated by the state.

What regulations do affect finance companies are aimed at protecting unsophisticated customers. **Regulation Z** (the "truth in lending" regulation) requires that banks and finance companies disclose the annual percentage rate charged on loans in a prominent and understandable fashion. The lender must also disclose what the total interest cost of the credit will be over the life of the loan.

The Federal bankruptcy laws were revised in 2005 to tighten up on some of the abuses finance companies and banks were suffering from debtors declaring bankruptcy to eliminate loan obligations. The revisions set "means tests" that restrict debtors from declaring bankruptcy if they have sufficient income to make repayment. Other components of the law make it more difficult and costly to go bankrupt and require audits. Despite these changes, however, many borrowers find bankruptcy attractive. For example, the homestead provision allows individuals to keep the equity in their homes even after declaring bankruptcy. Though the new law sets limits on the amount of the homestead exemption, many finance company customers have low equity to begin with, so are not affected. This is a serious concern for finance companies and is one reason they usually demand adequate security before making a loan.

The level of interest rates that finance companies can charge customers is limited by **usury** statutes. Usury is charging an excessive or inordinate interest rate on a loan. The permissible interest-rate ceiling depends on the size and maturity of the loan, with small, short-term loans having the highest rates. The usury limits vary by state, but most are sufficiently high not to be a limiting factor to reputable finance companies.[3]

State and federal government regulations impose restrictions on finance companies' ability to collect on delinquent and defaulted loans. For example, many states restrict how aggressive a finance company can be when calling customers and prohibit them from calling late at night or at work. Regulations also require that certain legal procedures be followed and that the lender bear the expense of collecting on the bad debt.

In contrast to consumer lending, few regulations limit finance companies in the business loan market. Regulators feel that businesses should be financially sophisticated enough to protect themselves without government intervention.

Finance Company Balance Sheet

Table 26.1 presents the aggregate balance sheet for finance companies.

Assets

The primary asset of finance companies is their loan portfolio, consisting of consumer, business, and real estate loans. The largest category of loans is to consumers, currently representing 33% of total assets.

TABLE 26.1 Consolidated Finance Company Balance Sheet ($ billions, 2010)

	Billions of Dollars	Percentage of Total
Assets		
Consumer loans	616	33.0
Business loans	447	24.0
Real estate loans	387	20.7
Less reserve for loan losses	−73	−3.9
Other assets	489	26.2
Total Assets	1,866	100
Liabilities		
Bank loans	125	6.7
Commercial paper	64	3.4
Owed to parent	277	14.8
Debt not elsewhere	857	45.9
Other liabilities	314	16.8
Total Liabilities	1,637	87.7
Equity	229	12.3
Total Liabilities and Equity	1,866	100

Source: Federal Reserve Bulletin, 2010, Table 1.51.

[3]Some critics of usury laws counter that these laws do not protect consumers, but instead prevent marginal or high-risk borrowers from obtaining credit.

Because of the high risk of loans made to consumers, more loans default. To protect their income against these defaults, finance companies allocate a portion of income each period to an account to be used to offset losses, called the **reserve for loan losses.** The reason for having a reserve for loan losses is to smooth losses over time. By recognizing a set amount of loss each period, different losses in one period over another do not show up on the bottom line. Banks and thrifts also maintain a reserve for loan losses; however, it does not need to be as large as that for finance companies.

Liabilities

Because finance companies do not accept deposits, they must raise funds from other sources to fund their loans. An important source of funds is commercial paper (discussed in detail in Chapter 11). Recall that commercial paper is unsecured, short-term debt issued by low-risk companies. Its advantage over bank loans and other sources of funds is that it carries a low interest rate. Finance companies also obtain funds by borrowing from other money market sources and occasionally from banks (about 6% of assets). Captive finance companies have the option of borrowing directly from their parent corporation.

On average, finance companies have a 12% capital-to-total-assets ratio. This compares favorably to the 9% to 10% usually observed for banks and savings and loans.

Income

Finance company income derives from several sources. The primary source, of course, is interest income from its loan portfolio. Finance companies also earn income from loan origination fees. These are fees they charge borrowers for making a loan. These fees cover the processing costs involved. Many finance companies also sell credit insurance, which pays off any balance due on a loan if the borrower should die or become disabled. Credit insurance tends to generate very high profits compared to other types of life insurance coverage. Some finance companies earn additional income from expanding their operations to include income tax preparation services.

Finance Company Growth

Finance companies grew rapidly in the late 1980s and, after a pause, the 1990s. This growth was fueled by the expansive economy, which caused the demand for finance company business loans to increase. The recession of the early 1990s caused a dip in the demand for business loans, as did the growth in assets, but growth soon resumed. Figure 26.4 traces the growth in finance company assets from 1980 to 2009.

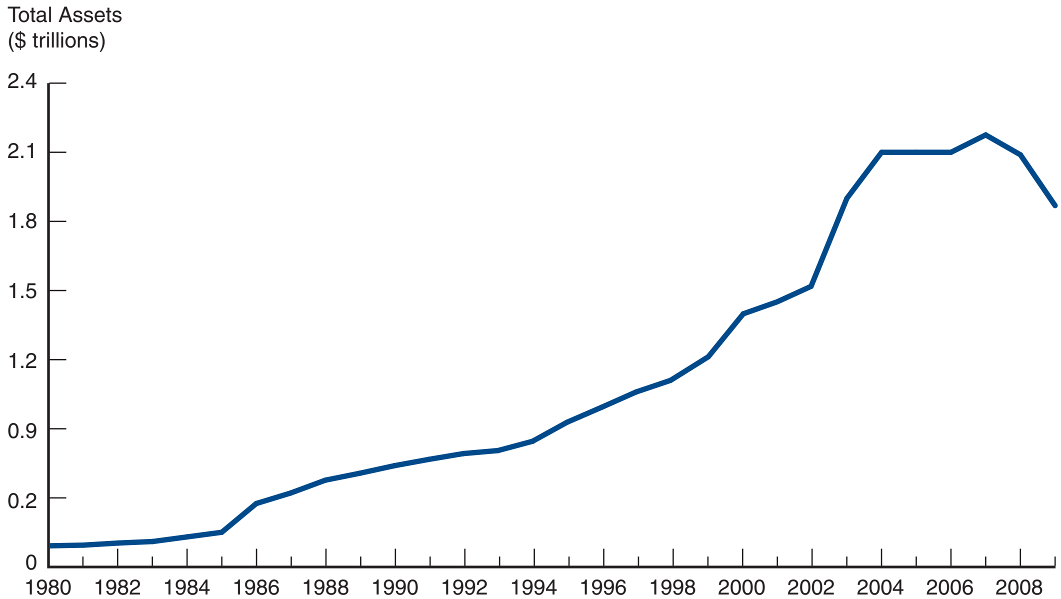

FIGURE 26.4 Growth of Finance Company Assets, 1980–2009

Source: http://www.federalreserve.gov/releases/g20/hist/fc_hist.html.

SUMMARY

1. Finance companies were initially owned by manufacturers who wanted to provide easy financing to help the sales of their products. The concept rapidly expanded when automobile financing became more commonplace.
2. Finance companies sell short-term securities in the money markets and use the proceeds to make small consumer and business loans. In this way, they act as intermediaries in the money markets. They typically borrow in large amounts and lend in small.
3. Another purpose served by consumer finance companies is servicing higher-risk customers. As a result of making these high-risk loans, default is the primary risk finance companies face. Finance companies compensate for default risk by charging higher interest rates. Finance companies also make business loans and offer leases.
4. The three types of finance companies are business, consumer, and sales. Business finance companies finance accounts receivable (often through an arrangement called factoring) and provide inventory loans and leases. Consumer finance companies make loans to high-risk customers for the purchase of autos and appliances and to refinance other debt. Sales finance companies finance a firm's sales, often through in-house credit or credit cards.
5. Because there are no deposits at risk, finance companies are less regulated than banks and thrifts. They are subject, however, to consumer regulations that limit interest rates and require disclosure of the cost of loans.

KEY TERMS

balloon loan, *p. W-27*
captive finance company, *p. W-34*
default risk, *p. W-29*
factoring, *p. W-30*
floor plans, *p. W-32*
installment credit, *p. W-27*
leasing, *p. W-31*
liquidity risk, *p. W-29*
Regulation Z, *p. W-34*
repossession, *p. W-31*
reserve for loan losses, *p. W-36*
roll over, *p. W-29*
usury, *p. W-34*

QUESTIONS

1. What is the difference between an installment loan and a balloon loan?

2. What caused finance companies to grow rapidly in the early 1900s?

3. Who are the typical customers of consumer finance companies, and why do they not go to commercial banks, where interest rates are lower?

4. How do consumer finance companies maintain their income in the face of high default rates on their loans?

5. Do finance companies face liquidity risk? Why?

6. Do finance companies face interest-rate risk? Why?

7. What is factoring?

8. What is the advantage of leasing assets to the lessor? To the lessee?

9. Many auto dealers finance their inventory using floor plan loans advanced by finance companies. What is a floor plan loan?

10. Many manufacturers own finance companies that finance the purchase of the manufacturers' products. What are these finance companies called?

11. Why are home equity loans popular?

12. Why are finance companies so concerned that their customers may file bankruptcy?

13. What does Regulation Z require of finance companies?

14. What types of statutes limit the interest rates that finance companies can charge their customers?

WEB EXERCISES

Finance Companies

1. The Federal Reserve maintains extensive data on finance companies. Go to **http://www.federalreserve.gov/releases** and find Finance Companies G.20.

a. Review the terms of credit for new car loans. What is the most recent average interest rate, and what is the term to maturity? How much is the average new car loan offered by finance companies?

b. Do finance companies make more consumer loans, real estate loans, or business loans?

c. Which type of loan has grown most rapidly over the last five years?