The Financing Of The Auto Business

BY H. G. HODGES

From the figures obtained by an ssociation of the larger automoile finance companies, allowing for n additional fair estimate of the usiness done by the unassociated ompanies, it seems reasonable to conclude that there were in the eighborhood of two million automobiles financed in this country ast year. With an average financed amount of $500, we secure vision basis of our particular phase of the subject when we realst that $1,000,000,000 worth of reail financing was done by these ompanies in 1923. This amount is ncreased by approximately $150,00,000 advanced to the automobile ealer. These loans to the dealer ave much shorter maturities than he notes of the retail purchaser.

FINANCING THE DEALER

Automobiles are shipped by the manufacturers to the dealers, or to heir large distributing agencies, with drafts attached to the bills of ading, through the local banks, which collect and remit to the manufacturers. If the dealer can inance himself or secure sufficient redit from his local banks, he does ot deal with finance companies so ar as his own purchases are conerned. If, however, his credit faciities are limited, as they often re, the dealer looks to the finance ompanies for assistance supplementary to that obtained from the anks. This is particularly true uring the three winter months when his stock must be large if he s to be in position to make prompt eliveries to the spring and summer trade. The usual plan is to ave the finance company advance rom 75 percent to 85 percent of he dealer's cost of the automobile nd to take title to the automobile o secure the loan. The average harge for this accommodation is bout 3½ percent to 4 percent for hree months, which charge include he cost of fire and thrift insurance n the car. The policy is held by he finance company to protect its nterest in the security. This plan nables the dealer to prepare for uture business to an extent that he usual banking facilities will ot provide. The automobile which he dealer as "bailee," for display urposes—the so-called "Foor Plan"—or is stored in a bonded warehouse in the name of the finnce company.

THE RETAIL TIME SALE

In an even larger percentage of ases the retail buyer needs help n buying his car. This figure has een generally accepted as 70 perent of the number of cars sold, nd in the case of the cheaper cars he average is much higher. When he amount of business was small he dealer could probably take are of his notes receivable through is bank. But as the business grew, hese customer notes went far beond the dealer's ability to disount. The finance company was alled into existence by the insistnt desire for an increased distriution. For this phase of the busiess the finance company supplies he dealer with all the necessary orms and instructions. The retail urchaser's note is made out dirctly to the finance company or to he dealer and assigned or assignd and endorsed by him to the enefit of the finance company hich discounts the note. The retail uyer pays from one-third to onealf the selling price of the car. o the balance is added the finance ompany's charges. This total is ivided into from six to twelve onthly payments, which are made irect to the finance company by he retail purchaser. Included in he charges are interest, service harge covers the credit investigaon and the cost of collection. hese items are of the same general ature as those of a commercial banking transaction, but they are pursued more thoroughly and in a detail commensurate with the risk involved. The cost of collection is considerably more than is the case in the ordinary banking transaction. The investment is being paid for out of earnings; there are a number of monthly installments; the borrower often is a considerable distance from the lender; the lender has an insurable interest in the security and must become the active party in the event of an insurance adjustment. The insurance item depends on the plan of the finance company, but always includes fire, theft, transportation, and a fraudulent conversion bond. In many instances there is, in addition, collision insurance against losses in excess of $100.

In addition to these precautions against possible loss, at least two of the larger companies have insured themselves against loss on "repossessed" cars. This rate is fixed by private arrangement between the insurance company and the finance company, and is usually a flat charge per car. It is a foregone conclusion that the insurance company must charge the "probable loss" in addition to overhead and a profit. So it is generally understood that finance companies using this method of insurance do so to increase their own borrowing capacity. Large finance companies can carry his risk more cheaply than the insurance companies can carry it for them. The loss ratio on this class of business does not average more than ½ percent of the volume in carefully managed companies. In the smaller companies the loss ratio will have a much wider range. It will depend more directly on the caliber of the personnel, simply because the spread is smaller. In some of these smaller companies the loss ratio is as low as one-ten percent, while in others it has forced liquidation.

THE FINANCE COMPANY

The popular conception of the finance company is coming more true to form every year, as a growing clientele "partake of its blessings." It has been viewed by many as a pawn-shop plan of unthrifty automobile purchasing. The picture includes a poor working man, buying something that he cannot afford, at the solicitaion of a prevaricaious salesman, with an unscrupulous finance company in the back-ground, ready to add disaster to an already impossible situation. The several elements in this picture must be subjected to softening tones to bring hem to a fact basis, and produce the true picture of blending interests in place of the contrasting selfishness of the other. As a matter of fact the business man, who can well afford the first cost and operating expense of $5,000 to $8,000 car, seldom has the cash lying in bank to cover this purchase. He gives his promissory note to the dealer who has it discounted through the buyer's bank, or he has his own note discounted and pays the dealer with borrowed cash. Reductions on his note are in effect installment payments. Furthermore, these reductions are met with surplus income, the same general scheme carried out in the case of the popularly known "financed" car. The only difference is that the "business man" buyer has access to regular banking credits for this purchase, as well as his business transactions, while the "financed" buyer does not have such a commercial banking opportunity.

With these attitudes of the general public, the dealer, the time-payment automobile buyer and the banker, it may be realised, without any undue stretch of the imagination that such finance companies as operate successfully in this new field for a period of five years, let us say, have had many obstacles to overcome. With the survivors doing an increasing and successful business, we must look for the cause in some form of service not included in the casual conception of their function in our financial structure. We must admit that many companies have done and are doing considerable harm to an industry that sorely needs the best attention of capable minds, due to its infancy and size. A pertinent side-glance at the mortality of the finance companies is suggested in a quotation from the *Eastern Underwriter*, an insurance journal:

A list of finance companies was made up not long ago and they numbered 600. This paper asked an authority on this subject how many of these would rank as permanent going concerns with a sound financial foundation. The answer was fifty.

ECONOMIC FUNCTIONS

It is distinctly a service that the finance company has to sell. This service, we will try to point out, maintains a nice balance among the manufacturer, the dealer, the bank and the ultimate consumer, in a system which would never have grown so rapidly, on such a firm basis, if it were not for the interposition of this service-adjuster. In the first place it is fair to assume that the manufacturer of automobiles would not be able to finance the dealer during the unseasonable selling period. If he did, he would be compelled to carry for three or four months an enormous stock of finished cars awaiting the dealer's spring demand, or he would have to ship to the dealer on open book account during this period. In either case the problem for the manufacturer would be the same, and one which he would not be able to cope with. It is certainly safe to say that no manufacturer could successfully solicit bank assistance to carry an unsold stock of finished cars, on a year-round production basis, for a period of four months. It is within recent memory that even the Ford Motor Company was credited with "dumping" its entire finished product on its dealers in a dull selling period, due to financial pressure. Finance companies all over the country relieved the dealers of the pressure caused by this dumping transfer of frozen credits.

The banks do not look with favor on automobile financing for the dealer, except as his known business ability or tangible assets warrant extension of a credit which is certainly limited. This would be the natural consequence in any new line when estimated by our most conservative appraisers—the bankers. The very circumstances of the case created a need for some new credit medium, and the new financ companies supplied it. If they had not filled the need at this point, and the manufacturer found it impossible to carry the frozen assets of stored automobiles, there would be just one answer. Production would be kept down to meet the seasonable demand conditions, with the consequence that the price of the automobile to the consumer would be kept at the high price of five or ten years ago. Thus it was that the finance companies bridged the gap and made possible the continuous and increasing production of cars, which was responsible for their continually decreasing cost. The manufacturer can base his year's production on the estimates contained in his dealers' contracts, and spread that production evenly throughout the year. He can ship cars to his dealers as they are made and not as they are sold by the dealer. The finance companies absorb the credits which the manufacturers cannot carry.

In the same way the dealer is, in his turn, helped in the distribution of the credits demanded of him by the retail purchaser. The banks will not take the paper and the dealers cannot. By handling these retail credits in large groups the finance company not only relieves the dealer, but the loss ratio is distributed as between localities, dealers and makes of cars. In this phase of the work the finance company not only absorbs what would otherwise be a frozen credit in the hands of the dealer, but it performs another important service by the credit and collection facilities it brings to the assistance of the dealer. The banks are not prepared for this service from the standpoint of training or equipment. These new agencies made this work their business, and necessity compelled a rapid and thorough training for those that would survive. Leaving out of account the economic desirability of the automobile purchase by the consumer, the note which is a part of the purchase is to be met from his current income. It therefore becomes important to get information on this phase of the note-giver. The finance company goes even beyond that. It considers the intrinsic value of the automobile itself, as well as the financial responsibility of the manufacturer and the dealer. All these items have a direct bearing on the value of the notes offered. Such a searching examination is not only a benefit to the finance company involved, but it is a benefit to the entire automobile industry, since it acts as a continual weeder of those on the margin, both among the manufacturers and the dealers. This process always operates to the benefit of the purchaser. He is more likely to have an automobile which will continue to be manufactured at a reasonable price, together with service from a dealer who will continue to be a dealer. Nothing about our present banking system would lead us to believe that we could expect from it such a co-ordinating benefit.

In addition to this service which goes before, there is the very important service which comes after the sale of the car. For this the dealer and the bank is even more unfitted than for those functions outlined in the preceding paragraph. The note usually covers ten or twelve monthly payments. This is a longer period than is customarily allowed on time paper by the banks. Again, the maker of this paper is not accustomed, usually, to banking practices, and the banker is not trained to collect this type of installment note. Such a situation potentialises a friction which will court loss to all concerned, and particularly to the

(Continued on Page 4)

The Financing Of The Auto Business

(Continued from Page 3)

dealer. Delinquent payments must be followed up with machinelike punctuality, but with a peculiar adjustment of the human element that will protect the dealer's future business. Then if it becomes necessary to repossess the car securing the account, an organisation to handle resales must be at the command of the financing agency. Here again the impossibility of the bank doing justice to the collection of this type of account suggests itself.

An excellent graphic illustration of the absorption of credits by the finance company is borrowed from an explanation of the subject by Emlen S. Hare.

REDISCOUNTS

It is not customary for the finance company to operate entirely on its own capital. In fact, when an efficient operating organisation has been whipped into shape and has produced results, more business will flow to the company than it can usually take care of from its capital investment. At this point the organisation is able to take on additional business with an increasing net return, if outside capital can be had at reasonable rates. The finance companies turn to the banks. There are probably numerous ways of obtaining this additional working capital, but three methods are commonly employed. The company may have its own corporation notes discounted directly, or it may sell its commercial paper, with varying maturities, through commercial paper houses which sell to banks. This type of commercial paper pays an attractive rate, and is considered a safe, temporary investment for the bank. Some of this paper pays as high as 7 percent.

Again, the finance company may give its corporation note secured by its retail-purchaser and dealer notes receivable. Often the bank is made trustee for these receivables, the finance company agreeing to substitute other notes of equal or larger amount, or cash, for any note taken from the trustee bank. These substitutions occur whenever any customer of the company liquidates an account. The bank may agree to advance the company from 50 percent to 75 percent of the total balance due on its trustee notes. In view of the fact that there is more than an ordinary service in this bank loan, a rate is fixed, through the carrying of cash balances by the company, which will adequately compensate the bank for its loan and service.

A THIRD METHOD

The third method is for the finance company to arrange for a straight rediscount rate on its customer notes with a bank in the territory where these notes originate. In this case the original maker of the note is notified by the rediscounting bank to make payments to it direct. The bank thus acts as a receiving agency for the finance company. In its understanding the finance company agrees that, in event of any installment not being paid on the day on which it is due, such installment shall be subtracted by the bank from the finance company's balance. Then the company must get on the job as the collecting agency—a detail which the bank is not prepared to handle. In this case the bank renders a small item of the service included in the finance company's work, and is compensated accordingly. Sometimes there is a flat amount allowed the bank, in addition to the interest, on each note so handled. Another plan is to allow the bank a preferential rate as high as 9 percent—to cover interest charges and the cost of receiving the installments. The margin to the company in this transaction comes from the fact that, whereas the bank figures "simple interest" on each installment for the time it is to run, the company figures its interest rate on the face of the note. Under this plan the company benefits from the possible turn-over of the installments. From the margin it must get its operating expenses and profit.

It is evident, therefore, that the greater the volume of this rediscounting the company can arrange for, the smaller will be its overhead spread on each account handled, and the greater the net profit on its own capital investment. If the company was restricted to it own capital and had a theoretically perfect turn-over, that turn-over would occur twice each year. As a matter of fact the actual turn-over on its capital will be a little better than this, due to anticipations on some of its customer notes. But with the rediscounting methods here outlined, the turn-over on capital may be pushed to twenty or thirty times a year, or even more. One well-known company did a busines of nearly $33,000,000 in 1923 on a capital and surplus of $1,600,000.

At this point it is interesting to note the percentage of delinquent payments on this type of installment note. In a well-managed company it will not be in excess of the delinquencies on mortgage interest payments. In actual practice the ratio is about the same. The collection of mortagage interest by trust companies and other agencies has been of such long standing that age itself has lent a feeling of security as to the relative promptness of these interest payments. But ask the officer in charge of such collections at some institution with which you are familiar. Doesn't it speak well, therefore, for the methods practiced by the better finance companies, when we realise that their ratio of delinquent collections is not appreciably worse than mortgage interest payments? We must realise that age has given force to the idea of prompt, mortgage interest payments, which occur twice a year, while the installment notes, secured by the financed automobile, is a comparatively new thing and the payments must be made monthly.

CHANGES AND PROFITS

The average charge made by the finance company on a new car, in a transaction where the cash paid by the retail purchaser amounts to one-third of the selling price of the car, and the note is to run for one year, is from 9 percent to 11 percent of the amount financed. Second-hand cars take a higher rate. The note will call for the balance due the dealer, plus the finance charge and the cost of the insurance. The finance company also receives a broker's or agent's commission on the insurance. These company insurance accounts are considered substandard risks by the large insurance companies, on account of a number of features which may well be imagined. But from the standpoint of volume of business coming from a single source, and collection of premiums which is made monthly and promptly by the finance companies themselves, the account is a desirable one. Exclusive of this insurance item, the net profit of the finance company on the average car requiring $500 is from $5 to $10, depending on the numerous conditions under which it is operating. Some of the small companies operating in a local field with a small ovehead, if they push their rediscounts, may reach the latter figure. There are so many factors entering into the final figure that its detailed treatment is impossible in this article. It must be understood, too, that these companies lay aside considerable surpluses to protect contingent losses and to increase their own credit facilities. When profits earned on these surpluses are credited with the profits earned on invested capital, the total bears, in the case of well-operated companies, a favorable ratio to the original capital.

As we have suggested that many of the companies are below standard, this low figure of $5 is often shrunk to the other side of zero. The result is easily attainable if the dealers, the cars and the general credits are not watched closely. One authority suggests that here are about twenty makes of cars worthy of the finance company's operations, and the sooner the manufacturers and the dealers handling the balance are pushed beyond the margin by the lack of credit facilities, the better it will be for the automobile industry in particular and the public in general.

From the standpoint of profits alone the finance company must rather be contrasted than likened to a diamond mine. There are the average number of failures among these companies. Like most other business enterprises the reward is attractive to intelligent industry. Many attempts that lacked constant and far-sighted attention to details ended in disaster. This is true in both the large and the small companies. Several large losses may discourage the small company. The cost of stock promotion, large salaries to non working entrepreneurs, heavy expenses of a centralised branch-office system in distant cities, high rediscount and insurance rates, and a general inattention to the business by the holding "owners" of free, common stock in the larger companies, has furnished spicy liquidation reading for the financial page of our newspapers. These records in the hands of some bankers who do not understand the underlying plan, and hence cannot establish the proper relationship between cause and effect, have caused a mistrust of finance companies with a consequent high interest rate for rediscount accommodation. This mistrust is gradually decreasing as a large number of successful companies are establishing their credits by operations reflected through their balance sheets.

It would seem entirely fair to conclude that the finance charge and net profit on the average unit is inconsequential as compared with the total cost of the car and the direct service rendered the dealer and the buyer. When we consider these figures in relation to the general benefits to the industry and the public, as noted previously in the flow of credits, and the increased and steady production influences, we must conclude that the service is truly an economic one, since it leaves a goodly margin of benefits after the cost of its functions is subtracted.

WEAKNESSES

A mushroom company, organised on a water basis and operated with an oilwell vision, has a wonderful opportunity for spreading industrial disease. It will assist automobile manufacturers of its own ilk by advancing "Floor Plan" money to dealers who do not know the difference between gross and net profits. By maintaining these dealers for a time, it gives a portion of the public an opportunity to invest in cars that will soon be known as "orphans"—automobiles no longer manufactured. Orphans have a low intrinsic value, a very small resale value, and are an economic loss even before conception. These conditions are naturally precedent to loose retail credits. This type of dealer falsifies the cash consideration or the trade allowance on the traded-in car. He will also give false declarations as to the year model of the car to be financed, as well as any other misinformation that may serve his purposes. His "service" to the buyer is of the same general style, and that service has a decided effect on the desire of the buyer to meet his installment payments with the finance company. The circle is completed, and its undesirability and consequent loss to all concerned becomes continuously greater, as long as the combination is allowed to survive. The only saving feature in this situation is that such companies never have an ancient lineage. They are necessarily self-destroyers, and their investors' money must be used to heal the many wounds. This particular kind of commercial microbe will be less prevalent as financing business becomes more firmly established.

ADVANTAGES

1. It is a service organisation with special training and equipment for passing on the credits and collecting the payments on installment automobile accounts.

2. By gathering business from various localities and makes of cars and types of dealers, it spreads the loss ratio so that it is not felt as a burden at any one point.

3. Scientific credits in this one field inject a stabilising influence throughout the industry.

4. It hastens the weeding out process of manufacturers and dealers operating near the economic margin.

5. It relieves frozen credits for the manufacturer and the dealer.

6. It provides a safe medium for the transfer of regular commercial credits to the new automobile industry.

7. It serves as the linking credit medium as among the bank, the manufacturer, the dealer and the buyer.

8. By its providing a wider distribution it makes possible large scale production, with consequent savings in cost and selling price.

9. By providing for the distribution to dealers of the finished product during the dull season, it makes possible steady production, an important item in the cost of manufacture.

10. It makes possible retail purchase of automobiles from income rather than capital. This method has long been recognised as sound in other phases of the transportation problem, such as the railroads and water carriers.