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Washington's Changing Economy

Consumer Should Also Shop for Credit

By Philip S. Brown

THE head of one of the largest consumer financing firms in the country once admitted to the writer that he had never bought anything on installment credit. "There are cheaper ways of borrowing" was his comment. And so there are.


Brown

A person who can easily borrow from a bank, on his personal note or by putting up collateral, need pay only 5 or 6 per cent a year for a few thousand dollars needed to buy a car, or a boat or furniture. He can avoid the cost of not paying cash—all the bookkeeping and overhead that account for 60 to 70 per cent of the expenses of most finance companies. With cash he can buy where he pleases. If he buys a car, he is not obligated to insure through a particular dealer or finance company and may do better through his own agent.

On the other hand, a person who has little net worth and needs a cheap car, or a small loan to meet pressing bills, often has to take credit where he can get it. He is a poorer risk and an old-model car is not very good security. Furthermore, a small loan is expensive to process. It costs $20 or so to interview an applicant, inquire about his credit, set up a loan account and make collections over a year or so.

But these borrowers are not typical of the tens of thousands of area residents who borrow each year to buy cars, TV sets, furniture and clothing, or who simply buy "on time."

Shopping for Credit

Most people have to agree to repay on an installment basis if they borrow or buy "on time," but they have certain choices. They can shop around for short-term credit, or they can even postpone incurring debt if they think the servicing charges are too high.

Apparently many people do neither. They have only the vaguest idea what credit is costing them. This is reflected in advertisements which mention only the down payment, or state only the monthly payment without mentioning the number of months required to complete payment. Sometimes the cost of credit is hopelessly entwined with the price of the article itself, with a trade-in, delivery costs, and insurance.

Some people will shop for days and weeks, comparing prices at various auto dealers or appliance stores. Then they will buy "on time" without knowing exactly what credit is costing them. Yet the potential savings in financing costs from shopping about may be in some instances, almost as great as in the price of the commodity itself. The interest charge is often a major cost. On a new Ford or Chevie, it is likely to run about $400.

There is great variation in the cost of consumer credit—more even than is indicated by the accompanying table. One large store in Washington charges only 6 per cent; a few charge over 20 per cent. Automobile loans vary from 7½ to 12 or 15 per cent on new cars and much more on used cars. Generally, the more lenient the terms, the more expensive the credit. But, there is a lot of variation from one store to another, and from one bank to another, for credit on the same terms.

Advice From a Lender

"One with good credit standing is stupid to put himself in a class with poor credit risks" is the comment of one lender. Yet this is what often happens.

The writer knows of one big used-car dealer (not in Washington) whose repossessions have been running about 40 per cent of sales—yet the company handling this dealer's paper is not losing money. Why? Because the financing charges (including insurance) are high enough to allow for this. This finance company operates on the principle that every risk has its price. When the repossession rate on its paper in any area falls much below 10 per cent, it realizes that it is being too strict and passing up too many deals that might be profitable.

A conscientious person with good credit standing would be foolish to finance his car through such a firm if he has to pay the same charges that others do who are not greatly concerned about meeting their payments promptly and who may at any time let their cars be repossessed if they are pinched or feel that their equity isn't enough to make it worth-while to keep paying.

"There's no reason for not hiring money as cheaply as one possibly can". This requires putting oneself in a class with good credit risks. And this, in turn, may take some initiative.

Any embarassment one may have in asking a bank or finance company about the availability and precise cost of credit is not justified. Lenders are in business to lend money at a profit. There's no charity or favor involved, though their manner may on occasion suggest this.

A person who borrows, or buys "on time" is entitled to know whether there are any extra charges and whether or not he will get a rebate if he decides to pay off his indebtedness ahead of schedule.

Sales Credit Easier

A personal loan from a bank is usually less expensive than buying "on time," but often a bank loan takes more time to arrange and it may involve greater scrutiny of one's financial position.

At a department store, a customer can go along for years on a revolving credit basis, without ever reapplying for credit. No Washington bank offers any such credit arrangement.

Also, it's easier—and often more convenient—to accept the financing arrangement suggested by the auto or appliance dealer, or furniture store, where one has decided to buy. Instead of asking for credit, one is offered credit.

Some banks may not loan quite as much, or stretch the payments over as long a period as auto and appliance dealers will when their profit margins justify greater leniency. Also, most banks will not finance a car that is more than three years old. (Some will allow the buyer to pledge an old-model car as security for a person loan and this may be advantageous in that the buyer is spared the necessity of costly collision insurance.)

However, a bank can sometimes provide welcome advice, as well as cheaper credit. For example, if one has not already consulted one of the published guides to new and used car prices, a banker can look up for him the factory invoice price of a new car, or the average wholesale price of a particular model of used car.

Cost of Personal Loans

Most Washington banks make small personal loans at a 6 per cent discount. If a borrower signs a note for $600 to be repaid at the rate of $50 a month, the bank withholds $36 for itself and gives the borrower $564. This is equivalent to an interest charge of a little more than 11 per cent on the unpaid balance. But in order not to violate the District's 1940 statutory prohibition against an interest rate of 8 per cent on contractual loans, the monthly payments are called deposits and assigned to the bank for the period of the loan. When sufficient deposits are accumulated, they are used to retire the loan in a lump sum or, if the borrower wishes, he can use other funds to pay the loan, retain his deposits and receive interest thereon.

Most of us find it difficult to understand the all-important legal distinction between this type of loan and a straight installment loan. But all District banks, except Riggs, take advantage of this legal procedure (essentially that of the old Morris Plan Banks), so that the 8 per cent simple interest limitation is not an effective restriction.

But even at 11 per cent, most small short-term loans are not profitable, since it costs $15 to $20 to set them up and send out payment notices. Consequently, some banks frankly discourage small loans. Others make them freely to customers and non-customers alike, with the thought that small borrowers may be big borrowers some day and that such borrowers will be encouraged to use other banking services.

Other Lenders

For those who are eligible, credit unions provide small loans at rates comparable with those of commercial banks and far below those of the small loan companies. At the close of 1956, District credit unions alone had over 178,000 members and $38 million of loans outstanding.

Nevertheless, there is still plenty of business for the small loan companies that operate in the Maryland and Virginia suburbs. The cash they provide is sometimes urgently needed to prevent repossession, or to tide a family over a period of sickness. Some of these borrowers would probably be turned down by banks, even though the loss ratio of small loan companies as a whole is surprisingly low—less than 1 per cent of the amount loaned. Other patrons of small loan companies "just don't like the idea of going to a bank."

Actually the charges of these finance firms on very small short-term loans are not out of line with the costs of making such loans, and they are certainly moderate compared with the charges exacted by illegal loan sharks, in the early 1900's, before the adoption of the Uniform Small Loan Laws, beginning in 1911.