AN ANALYSIS OF THE CANADIAN CONSUMER CREDIT MARKET AND OF THE COMPETITION FACING SALES FINANCE COMPANIES

by

DENNIS LESTER FRIZZELL
B.Sc., University of Alberta, 1963

A THESIS SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION in the Department of Commerce and Business Administration

We accept this thesis as conforming to the required standard

THE UNIVERSITY OF BRITISH COLUMBIA

April 1968
In presenting this thesis in partial fulfilment of the requirements for an advanced degree at the University of British Columbia, I agree that the Library shall make it freely available for reference and study. I further agree that permission for extensive copying of this thesis for scholarly purposes may be granted by the Head of my Department or by his representatives. It is understood that copying or publication of this thesis for financial gain shall not be allowed without my written permission.

Department of **Commerce and Business Administration**

The University of British Columbia
Vancouver 8, Canada

Date 3 Apr. 65.
ABSTRACT

A brief survey of the supply of and the demand for consumer credit in Canada discloses a dynamic situation. The increasing income of the Canadian population, among other factors, has brought about changing conditions in this market. One of the most significant changes may be the increased sensitivity of the consumer to finance rates and interest charges.

This increase in consumer sensitivity to finance rates may explain the past changes in shares of the consumer credit market that are serviced by the various financial intermediaries. The most significant share of consumer credit market changes have been the gains by the chartered banks and credit unions and the loss experienced by the sales finance companies. This may represent a consumer borrower switch from a higher cost lender (the sales finance companies) to lower cost lenders (the chartered banks and credit unions). This switch may be explained by an increase in consumer sensitivity to finance rates.

A model developed by P. Thomas Juster and Robert P. Shay, predicting increased consumer sensitivity to finance rates, is used to forecast future possible share
of consumer credit market that may be serviced by sales finance companies. The results are a forecasted decline in the share of a particular segment of the consumer credit market that may be serviced by the sales finance companies.

This forecast is the basis for a discussion of strategy and policy decisions that must be made by the management of sales finance companies.

Some of the alternative strategies are explored. The conclusion reached is that the sales finance companies will have a difficult time forestalling a loss in share of the consumer credit market. Their most productive competition strategy may be to concentrate their resources in particular segments of the consumer credit market that are not immediately accessible to the lower cost lenders. Sales finance companies may also find that a strategy of diversification, within and without the consumer credit area, is productive.
TABLE OF CONTENTS

ABSTRACT

LIST OF TABLES

LIST OF CHARTS

ACKNOWLEDGEMENTS

Chapter

I. INTRODUCTION

Social and Economic Bases for Consumer Credit

II. A GENERAL DESCRIPTION OF THE DEMAND FOR CONSUMER CREDIT

Introduction
Environmental Factors of Significance in the Use of Consumer Credit
Characteristics of the Users of Consumer Credit
Consumer Attitudes Toward Consumer Credit
Summary

III. CONSUMER SENSITIVITY TO FINANCE RATES

Introduction
The Traditional Model
The Juster and Shay Model
Summary

IV. SELECTED SUPPLIERS OF CONSUMER CREDIT

Introduction
Credit Unions
Chartered Banks
Small Loan Companies and Licensed
Money Lenders
Retailers as a Source of Consumer Credit
Summary

V. SALES FINANCE COMPANIES

Introduction
Retailers as a Liason Between the Consumer
and the Sales Finance Companies
Sales Finance Companies as a Source of
Consumer Credit
Summary

VI. FORECAST OF THE SHARE OF THE AUTOMOBILE
FINANCING MARKET THAT MAY BE SERVICED BY
THE SALES FINANCE COMPANIES ANNUALLY
TO 1980

Introduction
The Forecast
Summary

VII. CONCLUSIONS

Overview
Allocation Policy Decisions
Concluding Comments

BIBLIOGRAPHY

APPENDIX
LIST OF TABLES

Table                                                                                   Page

I. Growth of Selected Liquid Assets in Dollars........................................... 29

II. Chartered Bank Savings Deposits by Year and Size as a Percent of Total Number of Saving Accounts............................................. 29

III. Relative Growths of Deposits in Chartered Banks and Trust and Loan Companies on 1960 Base.............................................................. 30

IV. Population Age Distribution Changes 1960-1970........................................ 31

V. Consumer Credit Outstanding by Holder...................................................... 36

VI. Consumer Credit Held by Retailer.............................................................. 56

VII. Passenger Car Financing Broken into New and Used Car Outstandings.................. 76

VIII. Sales Finance Company Add-On Finance Rates............................................ 82

IX. Sales Finance Company Finance Charges in Annual Simple Interest on Household Appliances and Furniture................................................. 83

X. Sales Finance Company Finance Rates in Annual Simple Interest Rates on Older Used Cars................................................................. 83

XI. Sales Finance Company Finance Charges in Annual Simple Interest Rates on New Automobiles............................................................. 84

XII. Sales Finance Company Finance Rates in Annual Simple Interest Rates on Used Late Model Cars........................................................... 85
<table>
<thead>
<tr>
<th>Table</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>XIII. Components of Finance Charges</td>
<td>86</td>
</tr>
<tr>
<td>XIV. Cost of Nonequity Funds</td>
<td>87</td>
</tr>
<tr>
<td>XV. Consumer Credit Charges in the U.S.A. and Canada</td>
<td>95</td>
</tr>
<tr>
<td>XVI. Consumer Credit as a Percent of Personal Disposable Income</td>
<td>96</td>
</tr>
<tr>
<td>XVII. Projected Data on Independent Variables</td>
<td>99</td>
</tr>
<tr>
<td>XVIII. Forecasted Share of the Automobile Financing Market that May be Serviced by the Sales Finance Companies</td>
<td>101</td>
</tr>
<tr>
<td>XIX. Expenses and Net Profit of Sales Finance Companies as a Percent of Gross Revenues</td>
<td>112</td>
</tr>
<tr>
<td>XX. The Historical Data (U.S.A.)</td>
<td>124</td>
</tr>
</tbody>
</table>
# LIST OF CHARTS

<table>
<thead>
<tr>
<th>Chart</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Income and Cash Outflow Pattern and Stage of Family Life.</td>
<td>4</td>
</tr>
<tr>
<td>2. Percentage of all Tax Returns Filed with Income $5000 to $10,000 in 1960 Dollars.</td>
<td>11</td>
</tr>
<tr>
<td>3. Distribution of Sales Finance Company Customers and Composition of the Canadian Labor Force.</td>
<td>17</td>
</tr>
<tr>
<td>4. Share of Consumer Credit Market Serviced by Credit Unions.</td>
<td>40</td>
</tr>
<tr>
<td>5. Chartered Bank Outstanding Personal Loans.</td>
<td>43</td>
</tr>
<tr>
<td>6. Share of the Market for Consumer Credit Serviced by the Chartered Banks.</td>
<td>45</td>
</tr>
<tr>
<td>7. Small Loan Company Loan Volume by Type of Borrower.</td>
<td>47</td>
</tr>
<tr>
<td>8. Small Loan Company Loans.</td>
<td>48</td>
</tr>
<tr>
<td>9. Small Loan Company Regulated Loan Volume by Size of Loan.</td>
<td>49</td>
</tr>
<tr>
<td>10. Small Loan Company Loan Volume by Type of Loan.</td>
<td>51</td>
</tr>
<tr>
<td>11. Small Loan Company Share of the Consumer Credit Market.</td>
<td>52</td>
</tr>
<tr>
<td>12. Consumer Credit Outstanding Held by Retailers.</td>
<td>55</td>
</tr>
<tr>
<td>13. Share of Consumer Credit Outstandings Held by Retailers.</td>
<td>57</td>
</tr>
</tbody>
</table>

viii
<table>
<thead>
<tr>
<th>Chart</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>14. <strong>Relationship Between Down Payment, Maturity and Security Value, and Principle Outstanding</strong></td>
<td>64</td>
</tr>
<tr>
<td>15. <strong>Distribution of Sales Finance Company Business</strong></td>
<td>68</td>
</tr>
<tr>
<td>16. <strong>Volume of Consumer Retail Sales Financing by Types of Good</strong></td>
<td>69</td>
</tr>
<tr>
<td>17. <strong>Share of Consumer Credit Market Serviced by the Sales Finance Companies</strong></td>
<td>74</td>
</tr>
<tr>
<td>18. <strong>Automobile Finance Outstanding by Source</strong></td>
<td>75</td>
</tr>
<tr>
<td>19. <strong>Range of Forecasted Possible Share of the Market that May be Serviced by Sales Finance Companies</strong></td>
<td>102</td>
</tr>
<tr>
<td>20. <strong>Total Costs and Revenues</strong></td>
<td>107</td>
</tr>
<tr>
<td>21. <strong>Average and Marginal Costs and Revenues</strong></td>
<td>107</td>
</tr>
<tr>
<td>22. <strong>Total and Marginal Profit (Division B)</strong></td>
<td>107</td>
</tr>
<tr>
<td>23. <strong>Total and Marginal Profit (Division A)</strong></td>
<td>107</td>
</tr>
<tr>
<td>24. <strong>Total and Marginal Profit with Fixed Costs</strong></td>
<td>108</td>
</tr>
<tr>
<td>25. <strong>Range of Finance Charges on New Automobiles</strong></td>
<td>111</td>
</tr>
<tr>
<td><strong>Balance of $2000 over 30 Months</strong></td>
<td></td>
</tr>
<tr>
<td>26. <strong>Range of Finance Charges on New Refrigerators</strong></td>
<td>111</td>
</tr>
<tr>
<td><strong>Balance of $300 over 24 Months</strong></td>
<td></td>
</tr>
</tbody>
</table>
ACKNOWLEDGEMENTS

I would like to thank Professors B. Burke and W. Winniata for their assistance in the research and editing of this study. I would also like to acknowledge the invaluable assistance of my wife, Gloria, in the preparation of the various drafts.
I. INTRODUCTION

Consumer credit is suddenly a significant fact in our economy. In the relatively short time since 1948 consumer credit outstandings have grown almost ninefold. This represents an average annual growth of almost 50 percent over the 1948 figure.

Almost everyday the public is presented with an issue that touches consumer credit, from the collapse of the Atlantic Acceptance Company to the debate on disclosure. While several studies have been completed in the past several years, there still exists an unfortunate lack of data and information on consumer credit in Canada.

The objective of this study is to analyze the interaction of the supply of and demand for consumer credit, with a view to ascertaining the role of the sales finance company in this market. The main element about which this analysis will revolve is the finance rate and its importance to both the supply and demand side. However, other factors enter into the interaction in the market for consumer credit and therefore, as well as an emphasis on the importance of finance rates, a general survey of other aspects of importance to the consumer credit market will be undertaken.
The paper will have four main parts. The first being a discussion and description of the demand for consumer credit, with an emphasis on the consumer's sensitivity to finance rates. The second part will be a survey of the main sources of consumer credit and an examination of the competition between these sources in terms of changes in share of the consumer credit market held. This examination of competition will represent the analysis of the past interaction of the supply of and demand for consumer credit. The third element will be a forecast of possible future interactions in one particular segment of the consumer credit market--the automobile financing market.

The fourth and final part of the study will consist of conclusions based on the first three parts. These conclusions will represent a discussion of the possible implications to sales finance company management considering the possible future interactions between the supply of and demand for consumer credit.

The central theme of the study is the importance of finance rates to the interaction between the supply of and demand for consumer credit.
Social and Economic Bases for Consumer Credit

Consumer credit may be defined as the credit accepted when an individual purchases goods or services for consumption. The Dominion Bureau of Statistics includes personal loans, instalment credit, and charge accounts in their measures of consumer credit. Mortgage credit is excluded from the Dominion Bureau of Statistics definition of consumer credit. Therefore, the goods and services previously referred to exclude housing.

Consumer credit has two fundamental dimensions—the dollar amount and the time or term of the credit. Credit introduces several additional factors into exchange transactions. It adds time, risk, and interest. The addition of a time factor allows the consumer to gain more flexibility in his purchases. He can receive the use of a good or service at one time, and pay for it over subsequent periods. When this is applied to several goods, the consumer can "bunch" his purchases. This is quite different from the savings method of purchase, whereby one accumulates funds (by building savings) over a span of time, and obtains the use of the good at the end of the accumulation period.

When this ability to shift the timing of the purchase is considered with the pattern of income and cash dispersement of a family passing through the various
stages of life, the utility of consumer credit is apparent (see chart 1). During the early years of family life, cash outflows outstrip income due to the expenses of setting up a marriage, household, and family. Prior to this century, this load was handled by either the "nest egg" (saved up before marriage) or the purchases were postponed. The later years of family life see a rising income and falling cash disbursements as the family grows up, is educated and leaves home. Credit effectively shifts this cash disbursement curve, making it conform more with the income curve.

CHART 1

INCOME AND CASH OUTFLOW PATTERN AND STAGE OF FAMILY LIFE.
Consumer credit allows our mass producing industries to cultivate an orderly demand of the size necessary to support mass production. This is most graphically shown in the history of the automobile. It has been estimated\(^1\) that without consumer credit, the lowest priced automobile in the U.S.A. today might cost $7000.

At the present, as in the past, a controversy exists as to the economic effect of credit. Does it stabilize or destabilize our economy? Should consumer credit be regulated to a greater degree by government?

Consumer credit expansion, it is generally agreed, has a stimulating effect on the economy. Whether or not this is a destabilizing stimulation is unclear, and probably depends on the specific situation. Some authorities\(^2\) argue that instalment payments act as a method of forced saving and that it is therefore, a stabilizing force.

\(^1\) Jacob S. Ziegel and R.E. Olley (Ed.), Consumer Credit in Canada, Proceedings of a Conference on Consumer Credit (Saskatoon: Univ. of Sask., 1965), p. 50.

\(^2\) Wilbur C. Plummer, "Social and Economic Consequences of Buying on the Instalment Plan," The Annals of the American Academy of Political and Social Science (Jan. 1927) The instalment plan is viewed in this article as a commitment made by the consumer to pay for an item that would not otherwise be purchased. If the productive life of the item exceeds the total payment period, saving results.
Other arguments\(^3\) bring out that consumer credit encourages consumption when and where it would not otherwise occur thus giving rise to a type of anti-saving and possible overspending. These arguments view consumer credit as nonproductive and nonselfliquidating, as opposed to credit used to purchase capital goods.

However, recent arguments\(^4\) have applied traditional investment theory to consumer credit. These arguments consider investment in durable consumer goods as "productive". These investments do not normally offer the usual financial return, (although where purchases of durable goods replaces a previously purchased service, a financial return may occur) rather their return is measured in terms of utility and satisfaction. This return has been estimated\(^5\) as high as 75 percent per year over six years on a television set purchased by a family of four. Thus, an analytical parallel is established between


investment in capital goods and in consumer durables. It is upon this parallel that a consumer borrower model is introduced later.

6Juster and Shay, pp. 10-17.
II. A GENERAL DESCRIPTION OF THE
DEMAND FOR CONSUMER CREDIT

Introduction

The importance of consumer credit in the structure of our economy, as discussed in the last chapter, is reflected by a large demand for consumer credit. The actual magnitudes of outstanding consumer credit will be stated in chapter four. However, the various general characteristics of demand are of interest as a preparation for discussion of the interaction of the supply of and demand for consumer credit.

This chapter will discuss briefly three aspects of the demand for consumer credit. The first aspect is a description of several environmental factors affecting the use of consumer credit (discretionary income, the age composition of the population and other factors). The second aspect of demand concerns the characteristics of the use of consumer credit. Questions such as "What age group and income group uses consumer credit most intensively?" will be dealt with briefly. The third aspect will be the consumer's attitudes towards consumer credit.
The objective of this chapter is to briefly describe in a general way the demand for consumer credit.

**Environmental Factors of Significance in the Use of Consumer Credit**

**Discretionary Income**

One of the most significant trends observable today is the steady increase in the proportion of consuming units with discretionary income. Various writers have defined discretionary income, in the U.S.A., as that income in excess of 4000 to 5000 dollars per year. For measurement purposes, an upper limit of 10,000 to 15,000 dollars per year is placed on the discretionary income bracket.

The quantitative description derives from the concept of discretionary income as income in excess of that required to satisfy the consuming unit's need for the necessities of life such as food, clothing, shelter, medical bills, and perhaps transportation.

The growth of discretionary spending exerts a definite influence on the market for consumer goods and services. Manufacturers find that their major problems are not only cost reduction and product improvement, but include problems of predicting the fads and whims of the

---

1 Sanford S. Parker and Lawrence A. Mayer, "The Decade of the Discretionary Dollar" *Fortune* LIX (June 1959), p. 136.
consumer. Advertising, packaging, and other methods must be employed to attract the consumer and entice him to buy the product.

Thus, discretionary income is a source of power to the consumer. He has the power of discretion. His choices include whether to buy, when to buy, and what to buy. He can spend on durables, invest in the stock market, spend on leisure, save for his children's education, or a host of other alternatives. He controls to a greater extent the rate of spending and can bunch his purchases.\(^2\)

In this manner, the consumer's thinking and decisions become of great importance to the business world and to the total economy. Fluctuation in consumer spending is now recognized as a significant force in the business cycle.\(^3\)

The growth of discretionary income also has a direct effect on the consumer credit market. Technology has provided durables such as the automobile and household appliances. These, the consumer has deemed worthy of his discretionary dollar. However, many of these items, including the two mentioned above, are of relatively high value. This fact has resulted in the birth of the several forms of consumer credit required to finance the

\(^2\)Katona, p. 245.

\(^3\)Ibid., p. 3.
purchase of these items. Discretionary income, consumer behavior and consumer credit have been interdependent in the past and may continue to be related in the future.

Discretionary income growth has a possible additional implication in the area of consumer sensitivity to finance rates, but a discussion of this will be postponed.

The magnitude of the growth in discretionary income is reflected in the *Canadian Taxation Statistics*. The steady increase in the percentage of the wage earners earning from 5000 to 10,000 dollars per year is indicated in chart 2. This chart displays the increasing percentage of tax returns stating income in this range.

**CHART 2**

PERCENTAGE OF ALL TAX RETURNS FILED WITH INCOME $5000 TO $10,000 IN 1960 DOLLARS

Source: *Canadian Taxation Statistics*, various years.
Several additional facts reflect this trend but are not shown in the above mentioned chart. The ten thousand dollar and over per year income group is also growing as indicated by personal income tax returns.

Another fact that reinforces the growth in discretionary income is the increasing number of married women entering the labor force. In 1950, there was approximately 1 out of every 10 married women working, as compared to 1970, when 3 out of every 10 married women are expected to be in the labor force. Families, whose head has a lower income, provide a greater incentive for the wife to work. The additional income may place the family in the discretionary income group.

Changing Age Composition of the Population

A second trend of importance to the consumer credit market is the change in age characteristics of the population. The number of people in the 20 to 24 age group is expected to increase by 33 percent between 1965 and 1970. The growth is expected to be even greater in the 1970 to 1975 period. This change is in part due to the depression of the nineteen thirties and in part

---


5 Ibid., p. 33.
to the second world war. It has been called the post war baby boom.

The general expectations are that over 1 million people will be added to our labor force from 1965 to 1970. This represents a 30 percent increase—the greatest increase of any industrially advanced country in the western world. The proportion of people in the over 30 age group will decline slightly from 1965 to 1970.  

Various types of consumer credit are concentrated in different age groups. Therefore, population age shifts are important to the consumer credit market.

Other characteristics, as stated by the Federal Reserve Board of Governors, that have affected the use of consumer credit are:

1) trends toward asset accumulation by the household; away from the renting and purchase of services.
2) greater uniformity of consumer characteristics and behavior, allowing mass production to cultivate and serve a mass market.
3) reduction in the work week and growth of leisure time.
4) increased proportion of the population married at a young age before savings or the "nest egg" is built up.

---

6Ibid., pp. 32-36.

5) continuing flow of new consumer goods from our rapidly changing technology.

Characteristics of the Users of Consumer Credit

Financial Characteristics

Income.-In general all studies have concluded that the majority of consumer credit is outstanding to persons having an income in the 5000 to 10,000 dollar per year range.\(^8\) As mentioned previously, this is approximately the discretionary income range. For the most part a wage below this amount is indicative of a poorer credit risk. Of course incomes above 10,000 dollars have a reduced need for credit. Consumer credit is concentrated in the middle and upper middle income brackets.

Income Expectations.-Studies\(^9\) have shown that major consumer credit fluctuations precede major swings in the economy. These studies have tended to uphold the belief that the demand for consumer credit is tied very closely to the purchase of durables. Consumer durable demand reacts to expectations\(^10\) and, along with consumer

\(^8\)Report of the Royal Commission on Banking and Finance (Ottawa: Queen's Printer, 1964) Table 2-1 p. 17.


\(^10\)Robert Ferber, Factors Influencing Durable Goods Purchases, University of Illinois Bulletin No. 79 (Urbana, Ill.; 1955) p. 27.
credit, precedes swings in the economy.

**Actual Changes in Income.**—The consumers reaction to actual changes in income depend on the size of the change, its permanence and other conditions surrounding the change. In general, the secular gradual increase in incomes has been accompanied by increased durable goods purchases and increased debt loads. The increase in debt has continued into the middle and upper middle income levels. The debt load has declined above the upper middle income level.  

**Liquid or Semiliquid Assets.**—A substantial number of families using consumer credit, have savings large enough to cover the purchases. Surveys in the U.S.A. have found that the proportion of instalment borrowers with savings was as high as 50 percent. These figures are quoted as an indication of the probable significance of the segment of Canadian borrowers with savings. Unfortunately, there is no information immediately available to demonstrate that the segment of borrowers with savings is increasing.

**Non Financial Characteristics**

**Age and Stage of Family Life Cycle.**—It is quite

---


12Katona, p. 235.
evident that instalment credit is used by the "young marrieds". The expense of setting up a new household, coupled with the low initial income of the household head, helps to explain this observation.

Specifically, it is true that in Canada (as in the United States) instalment debt is most common in families with children whose head is 20 to 35 years of age. Mortgage debt is concentrated in the 30 to 45 years of age range. All surveys agree, in general, on the above two facts.

Occupations.—Chart 3 is the result of a survey of users of all types of purchase credit at one Canadian sales finance company. It may be representative of the whole. It shows occupations of Canadian borrowers by percentages. Also shown is the make up of the Canadian work force. As can be seen, skilled and semiskilled workers are the largest occupational class of borrowers. However, they are also the largest group in the labor force. Farmers, fishermen, and lumbermen, as an occupational group, seem to use sales finance company purchase credit less than other occupational groups. In


14 The unanimity can be seen in Katona, p. 231, and in Board of Governors of the Federal Reserve System, Consumer Instalment Credit, p. 97.
CHART 3

DISTRIBUTION OF SALES FINANCE COMPANY CUSTOMERS AND COMPOSITION OF THE CANADIAN LABOR FORCE


Percent of Canadian labor force shown by left bar. Percent of total sales finance company customers shown by the right bar.
general, there seems to be no occupational pattern with the exception of the above mentioned class.

**Consumer Knowledge of Charges.** - A traditional characteristic of consumer credit users has been their almost total ignorance of finance rates. The findings in the studies done by the Survey Research Center at the University of Michigan are typical. The results indicate that consumers have very little rate knowledge and consistently underestimate finance rates charged.

The study also found that higher income groups and those more highly educated were no better informed and, if anything, less informed.

**Consumer Attitudes Towards Consumer Credit**

**Attitudes Towards Borrowing.** - Studies in the U.S.A. have shown that a secular shift has occurred in consumer attitudes away from an unfavorable view of credit. Katona has discovered that the number of favorable attitudes toward the use of credit dropped off in older age brackets and the "drop off" ages differed over time. In a 1950 survey, the drop off in favorable responses occurred in the 45 to 50 years of age group; in 1960, the drop off occurred in the 50 to 60 age group. This

15 Katona, pp. 238-241.
16 Ibid., pp. 232-233.
may indicate that favorable attitudes are not completely lost with age.

Favorable reactions toward the use of consumer credit, with or without qualifications, have been growing in the U.S.A. (from 50 percent in 1950 to 60 percent in 1960 according to Katona's survey).

Attitudes and reasoning of consumers concerning consumer credit can be summarized as follows: 17

1) favorable
   a) without credit one would have to do without the article.
   b) it appears reasonable to pay for an article while using it.
   c) automobiles and certain durables should be paid for from income and not from savings, which are for a special purpose such as old age.

2) conditional
   a) depends on size of debt—both large and small.
   b) depends on the goods and their purpose—it is not acceptable to borrow for purchase of clothes and jewelry.

3) unfavorable
   a) moral arguments.
   b) leads to excessive spending and difficulty of making payments.

17 Ibid., pp. 232-234.
c) cost of the debt.

Katona also found that the following reasons were given to substantiate the use of consumer credit when the consumer held enough liquid assets to cover the purchase:

1) savings were earmarked for another purpose.
2) establishment of a credit rating.
3) instalment buyers get better service.
4) difficulty of replacing savings.

Summary

This chapter has indicated several factors that affect the demand for consumer credit. The environment in which consumer credit has thrived was described and was shown to be in a state of change.

Several characteristics of the use of consumer credit were stated. Consumer credit is concentrated in the younger families and in those families with middle and upper middle incomes. Beyond these observations, this chapter also discussed other factors affecting the use of consumer credit.

This chapter has provided a partial brief general description of the demand for consumer credit. The next chapter will deal with another important factor regarding the demand for consumer credit and should complete the treatment of the demand side.
III. CONSUMER SENSITIVITY TO FINANCE RATES

Introduction

In the consideration of the demand for consumer credit, the past chapter considered financial and demographic factors that bear on this demand. The most important factor in the interaction of the supply of and demand for any commodity or service is the price.

In the interaction of the supply of and the demand for consumer credit, this price is the finance rate or interest charge which the consumer must pay for credit.

This chapter will consider this most important factor, as it relates to the demand for consumer credit. The consumer's sensitivity to finance rates will be discussed from the traditional viewpoint and from a different viewpoint. This different viewpoint consists of a consumer model developed in a study by F. Thomas Juster and Robert P. Shay. The model, as developed in the Juster and Shay study, depicts a user of consumer credit, and attempts to explain the demand for consumer credit.

The study is an attempt to modify traditional thinking regarding the consumer's sensitivity to finance rates. It also attempts to explain the rapid growth of
the commercial bank and credit union in the consumer credit field.

**The Traditional Model**

The traditional thought has held the consumer to be highly unresponsive to changes in finance rates. In contrast to this inelasticity, the borrower is believed, in traditional studies, to be highly sensitive to changes in the size of monthly payments. These conclusions were arrived at chiefly as a result of three factors.

1) deductive reasoning.
2) scattered observations.
3) observed lack of consumer knowledge of the rates and charges.

**Deductive Reasoning.** The effect of a change in interest rates on the size of monthly payments is negligible compared to the effect of a change in down payments or maturities. If one assumes that the consumer is concerned with the size of his aggregate monthly payment, then it is relatively simple to demonstrate an insensitivity with respect to changes in interest rates. It is useful to note that this argument has two critical elements.

---

1) It assumes the consumer is constrained by or sensitive to his monthly payment—that he is borrowed to a sufficient extent that any further increase in his size of monthly payment would mean some alternate meaningful sacrifice.

2) The relative elasticity of demand with respect to finance rates may be less than that with respect to down payment or maturity changes.

Informal Observation.—Comparisons have been made between the actual results occurring when rates have been altered, and when down payments or maturities have changed. The significant changes in demand, occurring with altered maturities and/or down payments, have completely overshadowed any results shown when rates are changed.

Lack of Consumer Knowledge.—Several studies have shown that the consumer is ignorant of the finance rates charged. From this, it is assumed the consumer is unconcerned about rates and therefore is insensitive to changes in the rates of charge.

The Juster and Shay Model

Juster and Shay propose a consumer model to attempt to explain the recent swing to "low rate" lending agencies

---

2Board of Governors of the Federal Reserve System, Consumer Instalment Credit part 1 chapter 7.

3Katona, p. 238.
and yet remain compatible with the previously mentioned three observations.

The proposed model divides the borrowing consumers into two classes and labels them rationed and unrationed. This division is necessary for analytical purposes. In reality the groups are separated by a continuum.

The groups are identified by their supply of credit. The rationed borrower is unable to obtain combinations of higher interest rate and longer maturity from primary lenders, even if he wishes to do so. He is therefore constrained by the size of his monthly payment. His only method of increasing his quantity of debt outstanding is through a lengthened maturity or by turning to a secondary lender. For this reason the rationed borrower is sensitive to maturity changes and down payment changes but insensitive to finance rate changes. He is, in this sense, the traditional consumer credit user.

The unrationed borrower is one who is not constrained by his total monthly payment—to increase his total monthly payment would not work hardship on him. The question then posed is "What is his significant constraining factor?" The answer is interest rates. His level of borrowing is determined by the satisfaction he gains from the goods obtained through credit and the interest rates charged for this credit. This consumer
is not sensitive to maturities or down payment but is more sensitive to finance rates.

The conclusions of the Juster and Shay study\(^4\) are based on the predictions of the model and on an empirical investigation and test of these predictions. A summary of these conclusions follows.

1) Consumers are not homogeneous with respect to their sensitivity to finance rates. A certain segment may be more sensitive to rates than the other. This segment is the unrationed group and they are not constrained by the size of their aggregate monthly payments.

2) The responsive or unrationed group can be characterized by a greater degree of wealth and a limited demand for durable goods. Three probable traits of a spending unit in this particular situation may be:
   a) relatively larger income.
   b) relatively larger liquid (or semiliquid) asset reserves.
   c) relatively later stage of family life.

The model and conclusions proposed by Juster and Shay are assumed valid for the Canadian consumer credit situation. The Juster and Shay model will be used to

\(^4\)Juster and Shay, p. 2.

\(^5\)Ibid., pp. 33, 36.
examine the interactions between supply and demand in the consumer credit market. To justify this assumed validity would require a separate study and could not be treated properly as part of this project. Readers, therefore, are referred to the Juster and Shay study.

Assuming the Juster and Shay findings are applicable to the Canadian credit situation, it is possible to view supply of and demand for consumer credit from a different perspective. This perspective places a different emphasis on the various occurrences in the consumer credit market.

The proportion of the population falling in either the rationed or unrationed borrower class is of importance to suppliers of consumer credit. Changes in these proportions may result in an unsettled market situation with certain suppliers losing or gaining shares of the market. This, in fact, may account for the changes that have occurred in the past several years in the consumer credit market distribution.

A brief look at the nature of each of the three suggested characteristics of unrationed borrowers will be made in the following pages. Changes in the size of the rationed or unrationed group of borrowers may be reflected by changes in these population characteristics.

Income.-A larger income is taken as a probable characteristic of unrationed borrowers chiefly because
of three facts. A larger income allows a spending unit to handle larger monthly payments. This tends to ease the monthly payment constraint. The consumer is unrationed if he is not constrained by his monthly payment size. Further, a large income may mean a reduced demand for credit since more goods can be purchased outright. A reduced demand for credit is more likely to be satisfied without meeting the monthly payment constraint. The final factor is that a larger income is often looked upon as a characteristic of a better credit risk. This may allow the individual to obtain combinations of higher interest and longer maturities. This may allow him to move from the rationed to unrationed group by easing the monthly payment constraint.

The earlier discussion of discretionary income indicated that incomes are rising. This may tend to enlarge the unrationed borrower group.

Liquid and Semiliquid Asset Reserves.-Savings are a probable characteristic of unrationed borrowers. Units with relatively large savings accounts, Canada Savings Bonds, and marketable securities usually have a larger income and therefore a lower demand for consumer credit. Liquid and semiliquid reserves often enable an individual

6The unrationed consumer can equate his marginal rate of time preference with the marginal borrowing rate.
to secure better credit terms. This may assist him in satisfying his credit needs and allow him to reach equilibrium without meeting the monthly payment constraint. Both of these circumstances tend to place the borrower in the unrationed class.

With respect to the trend in the size of savings per borrower, the analysis is difficult and the information incomplete. Table I shows selected liquid assets as defined (in total, per capita, and per income taxpayer). All have been increasing significantly. This trend, while a probable indication of increasing size of savings per consumer, is not conclusive. This increase could conceivably be due to increasing numbers of small savings accounts. Table II assists in clarifying this. This table displays the number of chartered bank savings accounts, by size over time. The period 1960 to 1962 shows a decrease in the proportion of larger savings accounts. The period 1963 to 1966 shows an increase in the proportion of larger accounts. The 1960 to 1962 decrease may be due to trust and mortgage company competition for savings accounts. No information on the size of trust and mortgage company deposits is immediately available. However, table III shows the success with which the trust and mortgage companies operated in the savings field in the period from 1960 to 1962.
TABLE I
GROWTH OF SELECTED LIQUID ASSETS IN DOLLARS*

<table>
<thead>
<tr>
<th>Year (end)</th>
<th>1960</th>
<th>1961</th>
<th>1962</th>
<th>1963</th>
<th>1964</th>
<th>1965</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total saving (millions)</td>
<td>12085</td>
<td>13209</td>
<td>14275</td>
<td>15657</td>
<td>17045</td>
<td>18368</td>
</tr>
<tr>
<td>Savings per capita</td>
<td>668</td>
<td>713</td>
<td>761</td>
<td>809</td>
<td>877</td>
<td>974</td>
</tr>
<tr>
<td>Savings per income taxpayer</td>
<td>2753</td>
<td>2930</td>
<td>3050</td>
<td>3178</td>
<td>3212</td>
<td>--</td>
</tr>
</tbody>
</table>

*Liquid assets defined a) chartered bank savings deposits, b) trust and mortgage company demand and savings deposits, c) credit union deposits, d) Canada saving bonds.


TABLE II
CHARTERED BANK SAVINGS DEPOSITS BY YEAR AND SIZE AS A PERCENT OF TOTAL NUMBER OF SAVINGS ACCOUNTS

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-99</td>
<td>53.5</td>
<td>54.3</td>
<td>54.5</td>
<td>54.7</td>
<td>54.5</td>
<td>53.8</td>
<td>53.3</td>
</tr>
<tr>
<td>$100-999</td>
<td>30.3</td>
<td>29.6</td>
<td>29.2</td>
<td>29.1</td>
<td>29.1</td>
<td>29.5</td>
<td>29.6</td>
</tr>
<tr>
<td>$1000-9999</td>
<td>15.4</td>
<td>15.3</td>
<td>15.3</td>
<td>15.4</td>
<td>15.6</td>
<td>15.9</td>
<td>16.0</td>
</tr>
</tbody>
</table>

Source: Bank of Canada Statistical Summaries--various issues.
TABLE III

RELATIVE GROWTHS OF DEPOSITS IN CHARTERED BANKS AND TRUST AND LOAN COMPANIES ON 1960 BASE

1960 = 100

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank savings deposits</td>
<td>100</td>
<td>106</td>
<td>110</td>
<td>117</td>
<td>124</td>
<td>135</td>
<td>142</td>
</tr>
<tr>
<td>Trust &amp; Loan Co. deposits</td>
<td>100</td>
<td>125</td>
<td>148</td>
<td>194</td>
<td>246</td>
<td>268</td>
<td>266</td>
</tr>
</tbody>
</table>

Source: Bank of Canada Statistical Summaries, Supplements, and various issues.

On the basis of these statistics, it is concluded that liquid and semiliquid asset reserves are increasing in size.

Stage of Family Life.-The later stage of family life is regarded as a probable characteristic of unrationed borrowers, mainly due to the reduced demand for durable goods. This occurs when the children of the family are leaving home and the initial household setup expenses have been met, as shown in the chart on page 4 of this paper.

An approximate indication of the proportions of the spending units, falling in the various stages of family life, can be seen in the age distribution of the population. The low birth rates during the depression of the nineteen thirties and during World War II, coupled with the drastic
The increase in births in the post-war years have changed our present age distribution in an extremely significant manner. Table IV demonstrates approximately the past and expected changes in the age distribution. The future changes will tend to reduce the proportion of the borrowers falling in the unrationed group during this decade and probably half of the next. Of course, in the period following 1975, the increase will occur in the older age group as the current flood of young adults ages.

**TABLE IV**

**POPULATION AGE DISTRIBUTION CHANGES 1960-1970**

<table>
<thead>
<tr>
<th>Segment of population</th>
<th>1960-65 % change</th>
<th>1965-70 % change</th>
<th>1960-70 % change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total population</td>
<td>10%</td>
<td>11%</td>
<td>22%</td>
</tr>
<tr>
<td>20-24 age group</td>
<td>18%</td>
<td>31%</td>
<td>55%</td>
</tr>
<tr>
<td>30-39 age group</td>
<td>1%</td>
<td>2%</td>
<td>3%</td>
</tr>
</tbody>
</table>

Source: Derived from estimates by the Economic Council of Canada, *First Annual Review*.

Over the next 10 years, the trend in the stage of family life, outlined above, will tend to act to reduce the proportion of the consumers falling in the unrationed borrower class. However, it is significant that the older
age group still occupies a large segment of our population and even a greater segment of the total consumer credit market.

Later in this study, an estimate of the overall effect of the above mentioned trends in age distribution, income, and liquid assets will be made.

**Summary**

The brief general survey of the demand for consumer credit is completed. The several environmental factors of relevance to the demand for consumer credit were discussed. Characteristics of the use of consumer credit were outlined briefly. The purpose of chapters two and three was to provide a background for further discussions regarding consumer credit.

The discussion of the consumer's sensitivity to finance rates introduced the Juster and Shay hypothesis. The finance rates importance in the interaction of the supply of and the demand for consumer credit should become more evident as this study progresses.

At this point, certain general conclusions have emerged from the survey of demand. The first conclusion that seems justified is that affluence, and not poverty, is an important factor making the use of consumer credit such an important element in our economy.
The second conclusion is that finance rates may be more important to the use of consumer credit than generally suspected.

While these two points have possibly not been totally "proven" by the last two chapters, the indications are that they hold.

This completes the first part of the study as mentioned in the introductory chapter--the brief general survey of the demand for consumer credit with an emphasis on the importance of finance rates to that demand.
Introduction

The next two chapters of this study will examine the five main sources of consumer borrowed funds. These sources are:
1) credit unions
2) chartered banks
3) personal/small loan companies
4) retailers
5) sales finance companies

The treatment of these sources will follow the same pattern in each case, where possible. The pattern will consist of three aspects.

The first aspect will be a brief general description of the source, its distinctive characteristics or areas of specialization, and its role in the consumer credit market. This will serve as a background against which the second and third aspects will be examined.

The second is the share of the consumer credit market held by the source. The examination will consist of an analysis of the recent past performance of the source in terms of market share.

The third and final aspect of supply is the finance
rates charged by the various sources.

Chartered banks, small loan companies, credit unions, and retailers will be examined briefly as suppliers of consumer credit. However, the main emphasis will be placed on sales finance companies which, as a source of consumer credit, will be treated in a separate chapter.

Prior to the discussion of sources of supply of consumer credit, it will be useful to look at the overall structure of consumer credit from 1948 to 1966. The importance of the various suppliers can be gauged from table V. Since 1948, the market has seen a changing composition. Of special interest are the increased shares of the chartered banks and credit unions.

Credit Unions

General Description

Credit unions, as a source of consumer credit, are growing in importance. They are similar to banks in that they accept deposits and make personal loans. Another similarity is that both institutions charge relatively low rates for personal loans, as compared to other sources of consumer credit. However, credit unions lend only to members, in contrast to the banks, which lend to the public at large.

Credit unions are a relative newcomer to the Canadian
TABLE V

CONSUMER CREDIT OUTSTANDING BY HOLDER
(millions of dollars)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1948</td>
<td>70</td>
<td>154</td>
<td>64</td>
<td>54</td>
<td>335</td>
<td>158</td>
<td>835</td>
</tr>
<tr>
<td>1949</td>
<td>116</td>
<td>173</td>
<td>77</td>
<td>63</td>
<td>389</td>
<td>167</td>
<td>985</td>
</tr>
<tr>
<td>1950</td>
<td>202</td>
<td>224</td>
<td>93</td>
<td>72</td>
<td>454</td>
<td>178</td>
<td>1223</td>
</tr>
<tr>
<td>1951</td>
<td>186</td>
<td>204</td>
<td>111</td>
<td>76</td>
<td>407</td>
<td>199</td>
<td>1186</td>
</tr>
<tr>
<td>1952</td>
<td>373</td>
<td>242</td>
<td>148</td>
<td>94</td>
<td>551</td>
<td>213</td>
<td>2</td>
</tr>
<tr>
<td>1953</td>
<td>516</td>
<td>308</td>
<td>176</td>
<td>129</td>
<td>623</td>
<td>225</td>
<td>3</td>
</tr>
<tr>
<td>1954</td>
<td>492</td>
<td>351</td>
<td>215</td>
<td>151</td>
<td>685</td>
<td>240</td>
<td>2</td>
</tr>
<tr>
<td>1955</td>
<td>599</td>
<td>441</td>
<td>279</td>
<td>174</td>
<td>752</td>
<td>250</td>
<td>2</td>
</tr>
<tr>
<td>1956</td>
<td>756</td>
<td>435</td>
<td>356</td>
<td>226</td>
<td>824</td>
<td>270</td>
<td>3</td>
</tr>
<tr>
<td>1957</td>
<td>780</td>
<td>421</td>
<td>362</td>
<td>258</td>
<td>856</td>
<td>295</td>
<td>4</td>
</tr>
<tr>
<td>1958</td>
<td>768</td>
<td>553</td>
<td>401</td>
<td>320</td>
<td>895</td>
<td>305</td>
<td>6</td>
</tr>
<tr>
<td>1959</td>
<td>806</td>
<td>719</td>
<td>484</td>
<td>397</td>
<td>956</td>
<td>323</td>
<td>6</td>
</tr>
<tr>
<td>1960</td>
<td>828</td>
<td>857</td>
<td>549</td>
<td>433</td>
<td>1003</td>
<td>344</td>
<td>6</td>
</tr>
<tr>
<td>1961</td>
<td>756</td>
<td>1030</td>
<td>594</td>
<td>516</td>
<td>1052</td>
<td>358</td>
<td>9</td>
</tr>
<tr>
<td>1962</td>
<td>801</td>
<td>1183</td>
<td>714</td>
<td>579</td>
<td>1088</td>
<td>372</td>
<td>13</td>
</tr>
<tr>
<td>1963</td>
<td>874</td>
<td>1432</td>
<td>810</td>
<td>691</td>
<td>1141</td>
<td>385</td>
<td>14</td>
</tr>
<tr>
<td>1964</td>
<td>1035</td>
<td>1793</td>
<td>904</td>
<td>836</td>
<td>1206</td>
<td>398</td>
<td>15</td>
</tr>
<tr>
<td>1965</td>
<td>1131</td>
<td>2186</td>
<td>1043</td>
<td>987</td>
<td>1284</td>
<td>411</td>
<td>16</td>
</tr>
<tr>
<td>1966</td>
<td>1212</td>
<td>2402</td>
<td>1170</td>
<td></td>
<td></td>
<td></td>
<td>16</td>
</tr>
</tbody>
</table>

Source: Bank of Canada Statistical Summaries, various issues.
financial scene. A form of credit union, *Caisses Populaire*, was founded in Quebec around the turn of the century and found a fertile climate for growth. However, the credit union movement did not make much progress in the rest of Canada until around 1935.

The credit union movement is based on the concept of a cooperative. It has been closely associated with groups of people with common social or economic bonds or similar needs and situations.

The credit union, as mentioned above, makes personal loans only to members. The borrowers often are required to have a savings account equal to a certain percent of the loan. Some credit unions have policies requiring the savings to be increased during the loan.¹

Personal loans granted by credit unions are secured by cosigners, and chattel mortgages; many provinces give credit unions a statutory lien on the shares and deposits of borrowers and cosigners.

Credit unions do make some unsecured "character" loans, but the amount is very small and most statutes limit the maximum amount (from $200 to $500).²

The credit union, by restricting its lending to

¹Gilles Mercure, *Credit Unions and Caisses Populaire: Report to Royal Commission on Banking and Finance* (Ottawa: Queen's Printer 1962), p. 120.

²Ibid., p. 119.
members, is in a good position to assess the borrower's credit worthiness. Usually, the individual is known to the management. This helps to offset the lack of professional credit management and the benefits of a national organization for collection. This may be one reason the delinquency rates for credit unions, as a whole, are low.

Several factors are of interest in the credit union environment. The low rates of interest are made possible by a low cost of funds (deposits). Competition for deposits and savings, such as is occurring now and has occurred in the past few years, may force these rates up.

Another aspect is the continued growth of credit unions. One investigator forecasts a continued growth (in spite of some regional signs of faltering), but qualifies this forecast with a "continued favorable environment". A comment on the environment is in order. The credit union has traditionally thrived upon a community type of environment. Its patrons are persons with a common bond or similar circumstance.

The current trend in the Canadian society seems to be towards mobility—a trend towards a population with no roots. Can the credit union adapt itself to a mobile population? The national structure of credit unions is

\[ \text{3Ibid., p. 139.} \]
an organization of highly autonomous, small operations. The credit unions have no "branches" to send a moving customer to, and without much improved coordination, credit unions could not obtain this type of referral service. The above mentioned prophesy of continued rapid growth may be questionable.

Share of the Market

Competitively, credit unions have the advantages of lower interest charges, combined saving and borrowing functions, and the cooperative appeal. Being faced with a demand they have not been able to meet, they have expanded in the past to the limit of their funds. However, as mentioned above, they do not have the national organization (with its coordination) that the large sales finance companies, chartered banks, and consumer loan companies possess. Being confined to local operation may begin to restrict the credit union's growth.

Chart 4 shows the share of the market held by credit unions. The share has been steadily increasing from under 11 percent in 1961 to 14 percent in 1965.

In 1962, credit union membership ranged from 6 percent to 15 percent of the population by province. The national average was approximately 10 percent.

Considering the late start and the relatively well developed financial structure of the economy, the credit
union record is very impressive.

CHART 4

SHARE OF CONSUMER CREDIT MARKET SERVICED BY CREDIT UNIONS

Source: Bank of Canada Statistical Summaries, various issues.

Rate of Charge

The rates of charge for personal loans granted by credit unions vary among provinces, and in some cases within a province. The normal or average effective annual rate is 8.5 percent to 11 percent, but some rates are as
low as 6 percent. The recent development in deposit competition will probably force these rates up. However, credit unions are definitely one of the lower cost suppliers of consumer credit.

Chartered Banks

General Description

A personal instalment loan was first offered by a chartered bank in 1936. However, not until the middle of the nineteen forties did any of the chartered banks enter the personal loan field formally. The Canadian Bank of Commerce was the first to set up a separate personal loan plan. Most of the loans required cosigners. This tended to reduce the attractiveness of the source. In spite of this, by 1949, the banks were the major supplier of consumer credit in terms of consumer credit outstanding.

A significant change in this pattern occurred in 1954 with the revision of the Bank Act. Prior to 1954, as stated above, the general rule was to require cosigners. Personal credit was advanced as a convenience to customers and for purposes of goodwill. The 1954 revision of the

4 Ibid., p. 127.

Bank Act allowed banks to take chattel mortgages on household property. This new security marked the turning point for several banks, allowing them to compete more aggressively for personal loan business. 6

The first aggressive step was taken by the Bank of Nova Scotia in 1958. 7 This bank granted normal direct personal loans and in addition began discounting dealer paper. This step brought the Bank of Nova Scotia into direct competition with the sales finance companies. A comment has been made to the effect that while the results of the scheme are secret, they have undoubtably been favorable. 8

As well as the type of loans discussed above, the chartered banks provide two other types of personal loans. These are loans fully secured by marketable securities and loans to finance home improvement. While the loans for home improvement may be considered consumer credit, in many cases the fully secured loans could not be so classified. These have not been included in the "chartered bank's supply of consumer credit" for purposes of this paper. As a matter of interest, the importance of these

---

6 Ibid., p. 52.


8 Ibid., p. 86.
two types of loans are shown in chart 5.

CHART 5

CHARTERED BANK OUTSTANDING PERSONAL LOANS

![Chart showing outstanding personal loans]

- Personal loans against marketable securities
- Home improvement loans
- Personal loans on household property

Source: Bank Of Canada Statistical Summaries, various issues.

Recently, certain other chartered banks have begun to discount dealer paper on a decentralized basis.9 There is some speculation that some of the banks are considering entering this area on a more formal basis. The 1967 Revisions to the Bank Act could have a bearing on this decision. The consumer credit industry should be prepared for the future formal entry of the banks into

---

9Based on conversations with various bank managers.
Share of the Market

In 1949, the chartered banks reluctantly held over 20 percent of the market for consumer credit. This share fell to approximately 16 percent in the mid nineteen fifties as can be seen in chart 6. This fall was due mainly to the increased competition from sales finance companies, small loan companies, and credit unions. The last ten years have seen a rapid rise in the bank's share of the market. The banks have accounted for almost 44 percent of the growth in consumer credit from 1960 to 1965. In 1965, the chartered banks held approximately 39 percent of the noncharge account consumer credit.

Rate of Charge

Chartered banks are charging 9.5 to 11 percent on consumer personal loans.10 These rates are essentially the same as those that existed before the 1967 revision to the Bank Act. A survey of local branches was made shortly after the revision (June 1967). A comparison six months later showed no substantial changes in rate structure, in the area of consumer loan.

However, it was speculated that in January 1968, when the ceiling on interest rate charges is lifted,

10A survey of local chartered bank branches.
all rates may tend to move upward. Comments were made to the effect that the chartered bank's personal loan departments are experiencing a profit squeeze. Cost of funds is the main cause of this pressure. The future may see a rise in interest rates charged on personal loans.

However, the advantage of deposits as a low cost source of funds should assist the banks in maintaining their position of a low cost lender. The analysis in this study will assume that the banks will remain as low cost lenders.

CHART 6

SHARE OF THE MARKET FOR CONSUMER CREDIT SERVICED BY THE CHARTERED BANKS

Source: Bank of Canada Statistical Summaries, various issues.

Conversation with various bank managers.
Small Loan Companies and Licensed Money Lenders

General Description

Small loan companies and licensed money lenders make cash loans under the Federal Small Loans Act. These sources serve a particular segment of the consumer credit market. It has been stated\(^\text{12}\) that the majority of small loans are made for emergency reasons such as medical, legal, and funeral expenses, and for consolidation of monthly payments (a form of refinancing). These reasons tend to define the small loan company customers as a distinct segment of the market for consumer credit.

Chart 7 shows another aspect of this market. A significant amount of the small loan company loans are to current or previous borrowers. Chart 8 shows that a significant percentage (almost half) of the small loans made are applied to current balances. These two facts further increase the definition of this segment of the market.

Another feature of the small loan market is depicted by chart 9. This shows that small loan companies may be moving into larger ($1000 to $1500) loans. This is probably the result of borrower demand and not at the instance of the small loan companies. Regulations are

\(^{12}\text{A.E. Gedge, p. 84.}\)
such that the rate of return on smaller loans is higher than on larger loans. In some instances, small loan companies have been accused of dividing a large loan up among several companies. In this way, the amount of the loan can be held within the greater return range. These charges have been denied by small loan companies.

CHART 7
SMALL LOAN COMPANY LOAN VOLUME BY TYPE OF BORROWER

Source: Annual Reports to the Superintendent of Insurance by the Small Loan Companies and Licensed Money Lenders.

The above suggests three characteristics of the market served by small loan companies. The majority of small loans are made to current borrowers. This means that once a customer borrows from a small loan company, he will probably remain on their books for several years. His loan may be refinanced two or even three times. The second characteristic is an indication that a relatively large portion of previous customers will return eventually, to borrow again.
The third characteristic is the upward movement in loan size. Consumers appear to be demanding larger amounts.

These three characteristics assist in establishing the character of the small loan market, and in distinguishing it from other markets.

Small loan company credit is made on both a secured and unsecured basis. Security usually consists of the following:
1) chattel mortgages

Source: Annual Reports to the Superintendent of Insurance by the Small Loan Companies and Licensed Money Lenders.
2) endorsed notes.
3) wage assignments.
4) miscellaneous types of security.

The characteristics of the small loan business allow the small loan company to utilize standard procedures and methods in the processing and handling of loans. The small loan companies seek efficiency through techniques of mass production in the making of small loans.

Share of the Market

The outstandings by type of loan are shown in chart 10, and the share of the total consumer credit market is shown in chart 11. It can be seen that small loan companies and licensed money lenders have succeeded, only to a small degree, in increasing their share of the market over the past few years.

It may be significant that (of the total small loan companies' outstandings) over fifty percent are held among four major firms (with one firm holding twice as much as the other three). The other 50 percent of the market is shared by approximately 85 other firms.

Rates of Charge

Maximum rates of charge are specified by the Federal Small Loans Act. Specifications differ between small

CHART 10
SMALL LOAN COMPANIES LOAN VOLUME BY TYPE OF LOAN

Source: Bank of Canada Statistical Summaries, various issues.

Loan companies and money lenders. For small loan companies the maximum rates of charge permitted are:

<table>
<thead>
<tr>
<th>Charge</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2% per month</td>
<td>not exceeding $300</td>
</tr>
<tr>
<td>1.5% per month</td>
<td>from $300 to $1000</td>
</tr>
<tr>
<td>.5% per month</td>
<td>$1000 to $1500</td>
</tr>
</tbody>
</table>

There are also restrictions regarding terms and rates but these are the basic rates.
Retailers as a Source of Consumer Credit

General Description

Retailers have entered the credit field in part as a convenience to customers. Historically, retailers were among the first sources of consumer credit. Originally, credit was granted by the general store and other merchants on an informal basis.

The types of credit offered by retailers are infinite in their variations, but there are basically three
types. The most common form of credit is the 30 day charge account. This plan is characterized by a term of 30 days. There is no carrying charge in this period, and one payment is necessary. In most cases, this plan is used for low value items such as clothing and gasoline. No down payment is made. If the account is not paid within 30 days, a service charge is sometimes levied. One study found the consumer generally did not consider that purchasing with a charge account was a use of credit. This was probably reinforced by the absence of a service charge. However, it is undoubtably true that the cost of providing 30 day credit is included in the prices of the merchandise.

In addition to the charge account, or sometimes combined with it is a revolving credit feature. This allows a consumer a certain maximum credit in relation to the size of monthly payment—the larger the monthly payment, the greater the available credit. The features of a revolving charge account are midway between the formal charge account and instalment purchase plans. A service charge is levied, regular payments are required, a conditional sales contract may be attached, and a term.

---

15 The features of each type of credit are condensed from Robert H. Cole, Revolving Credit, (Urbana, Illinéis: Bureau of Business Management, 1957).

16 Katona, page 237.
is implicit in the available credit-payment relationship. No down payment is required. This type of credit is used to purchase both low and intermediate value items. Thus, the revolving charge account is a combination of the charge account and the regular instalment credit plan.

The third type of credit is the instalment purchase plan. This type of credit is characterized by down payment, fixed term, regular payments, interest charges, and security in the form of a chattel mortgage or a conditional sales contract. This type of credit is used for high value items such as automobiles, furniture, and appliances.

The majority of the consumer credit granted by retailers is of the charge account type, as shown in chart 12. In this chart, outstandings are classified as department store or nondepartment store credit. Nondepartment store credit is broken into instalment and charge types. The majority of nondepartment store credit is held by furniture, appliance, radio and television dealers as shown in table VI. The greater portion of it is in the form of charge accounts. The other classification is department store credit which is not broken down any further. However, main providers of revolving credit plans are department stores and mail order houses. Revolving credit plans (as compared to other types of credit plans) are experiencing very rapid
growth in the U.S.A.\textsuperscript{17} This may also be true of this type of credit in Canada. Although department store credit is not classified by type of credit plan, it is evident that department stores have experienced very rapid growth with respect to consumer credit.

CHART 12

CONSUMER CREDIT OUTSTANDING HELD BY RETAILERS

\begin{center}
\begin{tikzpicture}
\begin{axis}[
    title={CONSUMER CREDIT OUTSTANDING HELD BY RETAILERS},
    ylabel={Dollars},
    xlabel={Year},
    xmin=1960, xmax=1965,
    ymin=400, ymax=1200,
    legend pos=north west,
]
\addplot coordinates {
};
\addplot coordinates {
};
\addplot coordinates {
};
\legend{Department store credit, Nondepartment store credit, Nondepartment store charge account credit}
\end{axis}
\end{tikzpicture}
\end{center}

Source: Bank of Canada Statistical Summaries, various issues.

TABLE VI
CONSUMER CREDIT HELD BY RETAILERS
(in millions of dollars)

<table>
<thead>
<tr>
<th>Type of Retailer</th>
<th>1960</th>
<th>1963</th>
<th>1966</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dept. Stores</td>
<td>368</td>
<td>456</td>
<td>603</td>
</tr>
<tr>
<td>Furniture and appliance dealers</td>
<td>195</td>
<td>198</td>
<td>216</td>
</tr>
<tr>
<td>Others*</td>
<td>397</td>
<td>434</td>
<td>445</td>
</tr>
</tbody>
</table>

*does not include oil company credit cards

Source: Bank of Canada Statistical Summaries.

Share of the Market

As can be seen from chart 13, credit held by retailers has declined in terms of share of the market. The instalment type of credit declined as a percentage of the credit held by retailers over the past five years.

Share of the market considerations are complicated by the fact that only a portion of the credit granted by retailers is retained. The rest is sold to other sources. While little of the charge account credit is passed on in this way, the majority of sales finance company consumer credit holdings are obtained from dealers. The decline in the proportion of instalment paper held by retailers does not necessarily mean a reduction in instalment paper volume, since part of their volume is displayed as sales.
finance company outstandings. However, since both retailers and sales finance companies have lost ground in terms of share of the market, there is some evidence that consumers are turning from this type of credit (purchase credit) to other types.

**CHART 13**

SHARE OF CONSUMER CREDIT OUTSTANDINGS HELD BY RETAILERS

![Chart showing the share of consumer credit outstandings held by retailers from 1957 to 1966.](chart)


**Charges**

Charges on extended charge accounts and revolving credit accounts range from 1 percent per month to 1.5 percent per month on the unpaid balance. Instalment

---

18 Based on a survey of local retail credit plans and information provided by Federated Council of Sales Finance Companies.
contract rates are in the 20 percent to 30 percent per annum range. While it is not always true, in many cases the 30 day charge accounts and credit card accounts levy a 1 percent per month (beyond 30 days) charge while the revolving credit plans and budget charge accounts charge a higher rate of approximately 1.25 percent to 1.5 percent per month. The above places the retailer among the more expensive sources of credit.

Summary

This chapter has displayed the supply of consumer credit (except for sales finance companies). A general description of share of the market performance and an examination of the finance rates was undertaken.

It is possible to rank those institutions discussed in terms of cost of consumer credit. The following arrangement places the various sources such that the more expensive sources are nearer the top:

1) small loan companies
2) retailers
3) chartered banks
4) credit unions

Admittedly there may be cases where this ranking is different but on the average the levels of finance rates appear to suggest this order.

The share of the market performance cannot be so
easily classified. Both credit unions and chartered banks have made impressive gains in share of the consumer credit market. Small loan companies have succeeded in holding their share of the market or increasing it slightly. Retailers have lost share of the market for consumer credit.

The next chapter will examine the sales finance companies' share of market performance and finance rates and attempt to fit the sales finance company into the above reference.
V. SALES FINANCE COMPANIES

Introduction

Sales finance companies purchase certain types of credit granted by retailers. The sales finance company discounts this credit (referred to as paper) to obtain its profit. In this way, the sales finance company is more or less an indirect supplier of credit. This gives rise to a complicating stage between the consumer and the supplier of funds. The sales finance company must work through the retailer. This adds another dimension to the credit transaction. The following section will depart from the pattern previously followed and will explore the relationship between the sales finance company, and the retailer before examining the sales finance company as a source of consumer credit. This is necessary to gain an understanding of the operations of the sales finance company, since retailer relations are a crucial and fundamental part of these operations.

Retailers as a Liason Between the Consumer and the Sales Finance Company

The retailer has three choices in the sales of his merchandise.

1) He can sell only for cash or by charge account.
2) He can sell on instalment and retain the contract.
3) He can sell on instalment and then, sell the contract to a sales finance company (or in some cases to a chartered bank).

This study is interested in the third alternative and in the following section will examine the factors bearing on the retailer's decisions and the effect of those decisions on the sales finance company.

Finance Charges

If the retailer has no intention of holding the paper, the decision regarding interest rate does not have the usual basis—that is to cover cost of funds, risk, and administration expenses. If the intention is to sell the paper, rates may be based upon factors such as sales stimulation, the rate of discount, and the weight of the dealer reserve.

Finance rates may be low to stimulate sales if the customer shops for financing. The retailer may expect no profit on the sale of the paper. However, this is found most often when the retailer holds his own paper, since it may be difficult and costly to discount paper with an unusually low finance charge.

---

1 The dealer reserve is the seller's or retailer's share of the finance charge. It is accumulated by the sales finance company and dispersed periodically to the retailer.
In other cases, sales may be stimulated by high finance rates which are meant to subsidize low prices. Prices may be subsidized through profit on the sales of the paper and through the dealer reserve.²

The rate of discount and the extent of dealer participation in finance earnings may effect the dealer's decision with respect to finance rates.

Down Payment

Down payments are of vital importance to the sales finance companies. The down payment is a major determinant of the risk assumed. The down payment is the borrower's initial equity in the collateral. It may have a bearing on his efforts to meet the contract and it definitely provides a cushion for the sales finance company in case of default.

The retailer can use low down payments as a sales stimulant as in the case of low finance rates. Lower down payments make more consumers eligible to purchase the item. Thus, the retailer may manipulate the size of the down payment. Beyond this, a further complication arises when the down payment is a "trade in". The retailer

²U.S., Board of Governors of the Federal Reserve System, Consumer Instalment Credit, part 2, p. 427. This study found that, in some cases, high finance rates and the dealer reserve were the major source of profit for retailers.
may allow larger than normal trade in values, adding the excess to the purchase price. This is effectively a decrease in the size of down payment. Even without this, the complication of having to know the price of used models places an additional load and risk on the lending institution. The trade in may depreciate before sale. This affects the "cushion". The item financed may also depreciate. In the case of automobiles, this is very important due to the rapid first and second year depreciation of new cars. In many cases this depreciation is faster than the rate at which the debt is amortized. Repossession in this situation can be very costly to the sales finance companies.

Maturities

Maturity or term of the loan, in conjunction with principle, determines the size of the instalment payments. The past fine record of borrowers has led to a lengthening of maturities in car purchase contracts. The sales finance companies have been the initiators of this trend.

However, there is a safety relationship between down payment and maturity, as mentioned above. The longer the maturity, the larger the down payment should be. One of the major factors in this relationship is the depreciation rate of the item purchased. In the case of automobile financing, the sales finance companies would be particu-
larly vulnerable during the first year or two of the contract if the down payment was not increased. Chart 14 is intended to illustrate this point.

CHART 14

RELATIONSHIP BETWEEN DOWN PAYMENT, MATURITY AND SECURITY VALUE, AND PRINCIPLE OUTSTANDING

The first number refers to the down payment in percent of new car values, the second number (bracketed) refers to the term in years (e.g., 30(4) = 30% down payment, 4 year contract).

Dealer Reserve and Risk Control

The retailer also has control over the selection of customer to whom he grants credit. He can be selective or nonselective. The sales finance companies devised
the system of dealer reserves to gain a measure of control in this area. This system gives the retailer a share of the financing profits and (in some cases) a share of the liability of bad accounts.

Thus, the rate of dealer participation\(^3\) is probably importantly influenced by the:

1) liability of the retailer for losses incurred.
2) repayment record of the retailer's customers.
3) interest rate on the loan.
4) amount of competition for the paper.

The sharing of liabilities and profits gives the retailer a motive for selective credit granting. The retailer often is in a better position to assess the customer's credit worthiness. The retailer has facilities to resell a repossession and a motive for getting the top price. Therefore, a system of dealer reserves was created.\(^4\) The reserve is held by the sales finance company until it reaches a certain level at which point all or a part of it is paid out to the retailer. Default losses may be taken from the reserve. This, as mentioned above, spreads and reduces the risk.

It is interesting to note that the concept of dealer

\(^3\)Ibid., pp. 433-434.

\(^4\)In some cases there is also a reserve set up for the dealer for insurance if this is sold as a part of or in conjunction with the credit contract.
reserves has introduced a dimension, favorable to the retailer, into the retailer-sales finance company relationships. The retailer has found that the extent of his participation in charges is a bargaining tool. The pressure on the sales finance company to increase retailer participation may result in increased charges to the consumer.

Floor Planning

The freedom of the retailer to sell his retail paper to whom he pleases allows him to negotiate another favor from the sales finance company. The retailer usually requires a substantial inventory. Durables are typically of high unit value (especially the automobile). The retailer requires funds to finance this inventory. The term floor planning applies to this financing. The sales finance company supplies the retailer with wholesale financing for his inventory in order to obtain his retail paper. One study indicated that this financing was done at a loss by the sales finance company.\(^5\)

The basic elements of the sales finance company-retailer relationship have been stated. It should be clear by now that the nature of these elements lend

themselves to negotiations and bargaining. Each party
to the negotiations attempts to obtain the most profitable
arrangements for its firm. The retailer may or may not
have the initiative in setting finance charges, down
payments, and maturities. He has the choice as to the
level of risk he is willing to accept in a financed
customer. The sales finance company has created and
offered the retailer dealer reserves, floor planning,
and general advice in an effort to obtain the retailer's
paper and exert a certain degree of influence on the
above mentioned variables.

The sales finance companies must compete with one
another on these bases for the retailer's paper.

Sales Finance Companies as a Source of Consumer Credit

General Description

Sales finance companies operate in three main areas.
The principle area of operation and that area of interest
to this paper, is the underwriting of retail sales by
the purchase of the instalment paper held by retailers.
Sales finance companies also provide retailers with
wholesale financing of inventories, and provide loans
on a commercial and industrial basis. The wholesale
financing operation is usually intimately related to the
retail sales financing aspect, as was pointed out earlier.
Commercial and industrial loans are normally not directly connected to the other areas of operation.

The relative importance of each of these aspects of sales finance company business can be gained from chart 15.

CHART 15
DISTRIBUTION OF SALES FINANCE COMPANY BUSINESS

Source: Bank of Canada Statistical Summaries, various issues.

It can be seen that there may be a slight trend towards a decreased importance for the retail financing business.
A further breakdown of the retail consumer instalment paper operation can be seen in chart 16. The chart shows new and used automobiles as the main durables financed. Recently, new automobiles have grown in importance.

CHART 16

VOLUME OF CONSUMER RETAIL SALES
FINANCING BY TYPE OF GOOD

Source: Dominion Bureau of Statistics, various years.
In 1962, 45 percent of sales finance companies total retail business was in new automobiles. The following examination of the sales finance company methods of operation will be restricted to automobile financing. The automobile is one of the most expensive durables financed, and also constitutes the bulk of the consumer financing business done by sales finance companies.

Concentration in the sales finance industry is of interest. Estimates have placed the total number of firms in this field at 200 or more; however, more than half of the business is concentrated in the hands of four larger firms.

The procedure upon agreement to purchase an automobile on instalment can vary. The buyer signs a conditional sales contract. It may or may not have reference to a sales finance company. The contract may then be held or sold by the automobile dealer. Usually, the contract refers to a specific sales finance company, to which payments must be made. The automobile dealer may offer the customer a choice of sales finance company contracts, or he may select one if the customer is unaware of a choice and does not inquire. In some cases, the dealer may deal with only one sales finance company, giving the

---

6Royal Commission on the Cost of Borrowing Money, Cost of Credit and Related Matters, p. 190.
buyer no choice regarding source of on-premise financing. This may be more common among smaller dealers.

The contract itself is usually a form of conditional sales contract with an annexed promissory note. The promissory note has importance in terms of security, as will be noted later.

The contract may or may not have recourse features against the dealer. Recourse can operate to affect the quality of customer that is granted credit. Policies regarding recourse seem to differ among different sales finance companies. The percent of paper without recourse on the books of the major firms appears to vary from almost nil to 50 percent.\(^7\) The actual effect, on the dealer's credit screening process, arising from the recourse feature is difficult to ascertain. It probably does help to maintain low delinquency rates.

The customer can, in some cases, (if he choses) obtain, in conjunction with the contract, liability and life insurance. This is an important service, not provided by the forms of "off-premises" financing.

With respect to the security and risk of the contract, several aspects should be mentioned. The contract states that the sales finance company is not responsible for satisfactory performance of the dealer's obligations

\(^7\)Financial Statements and supplementary data of major firms, 1966.
to the customer. The promissory note has relevance here. The promissory note is a contract separate from the conditional sales contract. Even if the transaction between dealer and consumer is nullified by some aspect, such as fraud, the promissory note is still valid. The consumer has legal recourse against the seller, but not against the sales finance company. This situation has given rise to a certain amount of criticism of sales finance companies. 8

If a customer is unable to meet his payments, sales finance companies may refinance the purchase over a longer period of time, if possible. In the event of default by the borrower, the recourse feature may be implemented. This recourse may be in the form of a dealer endorsement of the contract, repurchase agreement, or deferred credit. In addition, default may affect the dealer reserve.

If the automobile is repossessed by the sales finance company, a portion of the debt may be recovered. If the dealer participates in the repossession, the sales finance company may obtain a larger recovery, and the dealer is not plagued with "sacrifice sale" competition. Sources of credit other than sales finance companies do

8Royal Commission on Cost of Borrowing Money, Cost of Credit, and Related Matters, p. 194.
not seem to have as well organized and efficient repossession procedure. 9

The above provides a brief description of the methods of operation of sales finance companies at the consumer-retailer level. This is provided because an analysis of the competitive situation will require a knowledge of the operating characteristics of the sales finance company.

Share of the Market

The percentage share of the market being serviced by sales finance companies is displayed in chart 17. It can be seen that the period from 1957 to 1963 saw a drastic reduction in the share of the market serviced by sales finance companies. During this period, the sales finance companies lost 10 percent of the market for consumer credit.

While the sales finance companies have lost their proportionate share of the market, relative to that of 1957, the chartered banks have gained substantially. A large portion of the chartered bank gain occurred in loans to individuals on the security of automobiles. The relative movements in the sales finance company and chartered bank loans on automobiles are shown in chart 18.

The recent growth in new car sales has created a

9Ibid., p. 200.
A growing market for new automobile financing. The chartered banks have expanded into this market. The sales finance company loans on new automobiles did not keep up with the expansion in sales.

An examination of the importance of new car financing in the sales finance company business discloses an additional fact. Table VII shows that, new automobile financing has increased in importance since 1957.
and that used automobile financing has decreased in importance.

CHART 18

AUTOMOBILE FINANCE OUTSTANDING BY SOURCE

Source: Bank of Canada Statistical Summaries, various issues.

This fact can be combined with the previous indication that sales finance companies are losing new automobile business to the banks to produce an apparent paradox. The sales finance companies appear to be concentrating their business in an area in which they are

\(^{10}\) See chart 18.
at a competitive disadvantage. However, a possible explanation can be offered. It is possible that the growth in new car sales has resulted in a relative stagnation in the used car market. This decay or stagnation may have led to a relative reduction in the used automobile financing business. There is some indication that used cars are falling from favor with the consumer. 11

**TABLE VII**

**PASSENGER CAR FINANCING BROKEN INTO NEW AND USED CAR OUTSTANDINGS**

<table>
<thead>
<tr>
<th>Year</th>
<th>New Car Financing</th>
<th>Used Car Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>56.5%</td>
<td>43.5%</td>
</tr>
<tr>
<td>1961</td>
<td>58.7%</td>
<td>41.3%</td>
</tr>
<tr>
<td>1962</td>
<td>59.6%</td>
<td>40.4%</td>
</tr>
<tr>
<td>1963</td>
<td>61.0%</td>
<td>39.0%</td>
</tr>
<tr>
<td>1964</td>
<td>63.0%</td>
<td>37.0%</td>
</tr>
<tr>
<td>1965</td>
<td>64.6%</td>
<td>35.4%</td>
</tr>
</tbody>
</table>

Source: Dominion Bureau of Statistics, 63-211, various years.

The particular development described above (the concentration of sales finance company business in new car contracts) may represent a vulnerable position. An increase in aggressiveness by the chartered banks,

11A comparison of new and used car sales figures indicate this may be true.
with respect to consumer loans, would have a greater impact on new car financing than on used car financing.

**Finance Rates and Share of the Market.**—There is more or less unanimous agreement on the conclusion that a majority of the chartered bank's recent gains in share of the market has been due to the lower cost of their consumer credit. It is probably true that the potential market for this low cost credit has existed for some time and that the banks are expanding into it with little or no resistance.

Several possible reasons may be given for the banks uninhibited gain in share of the market. In the past, sales finance companies have lowered their rates, or rather, have added lower rates to their rate structure. This has presumably been in answer to the bank's competition. However, public knowledge lags with regard to these rates and therefore the public may believe rates to be higher than they really are. A fact that may have added to the public's misconception in the past is the association of consumer loan companies and sales finance companies. Each has diversified into the other's business and the sales finance rate may have become associated with the generally higher small loan rate.

In addition, the obvious fact that sales finance

\[ \text{See page 44 and 82 of this paper.} \]
rates are higher than bank consumer loan rates assists the bank expansion. However, the point made above is that this difference may have been exaggerated by the consumer.

**Interest Rate Disclosure.**—Interest rate disclosure is now a fact of business. One can assume that effective legislation requiring finance rate disclosure in terms of total dollar cost, and an annual effective interest rate will exist in all jurisdictions in Canada within the near future.

There was some concern regarding the sources of consumer credit that were exempt from provincial legislation. However, regulations governing chartered banks became effective October 16, 1967. In this discussion, it will be assumed that all consumer credit sources will disclose interest rates and charges on a comparable basis.

The following are aspects that are relevant to a discussion of the effects of disclosure.

1) Consumer borrowers are quite ignorant of finance rates paid as an effective rate.

2) Consumers have an institutional knowledge of finance rates, knowing that one type of source charges a higher rate than another source.

---

13 Ziegel and Olley, p. 150.


15 Katona, p. 239.
3) Rate information, prior to disclosure legislation, was provided in the form of dollar cost, discount and add-on rates.

Consumer ignorance will probably be reduced by disclosure. The discount or add on-rates advertised prior to disclosure legislation may become less common, the consumer may be presented with fewer rates, and, as a result, be less confused as to the true finance rate.

The annual effective interest rate does allow the consumer to compare similar institutions and their rates of charge. For example, a consumer attempting to compare two sales finance company contracts of different maturities, or payment rate, will be assisted by disclosure.

With respect to different types of consumer credit sources, and a comparison of their rates, the effect of disclosure will depend on several factors. One of these factors concerns the consumer's awareness of rate differences. This was earlier called institutional knowledge. If consumers believe that rate differences between banks and sales finance companies are larger than they are in fact, disclosure may assist the higher cost lenders. In any event, disclosure will assist the consumer in comparing institutions and their finance rates.

The fact that cost information, prior to the
disclosure requirements, was in the form of discounts and add-on may magnify the effects of disclosure. This can be demonstrated by an example. Consider two sources of finance, one charging an annual discount rate of 6 percent, the other charging a discount rate of 8 percent. In terms of discount, the difference is 2 percent. In terms of effective annual rate the figures are roughly doubled becoming 12 and 16 percent. Under this comparison the spread may approach 4 percent. The difference in finance rates is increased. This doubling effect may also have an initial effect on the demand for consumer credit as borrowers and would-be-borrowers find out that they are paying unexpectedly high rates.

The Juster and Shay study concludes that long run borrower reaction to disclosure will differ between rationed and unrationed borrower groups. They conclude that while rationed borrower reaction may be quite small, unrationed borrowers may reduce their demands for credit. It is further concluded that overall reaction will be quite small.

In summary, the effects of disclosure will probably be a short run contraction or reduced expansion in demand for credit, with little or no long term effect.

---

16 This is a rough approximation but it serves to demonstrate the point.

17 Juster and Shay, p. 72.
It is possible that no significant share of market disturbances will result from disclosure.

Finance Rates

**Gross Charges.** Along with conditional sales contracts, the sales finance companies provide the retailers with finance rate tables. These rate tables set the various charges for different levels of risk, security, and term of financing. A working classification with which to examine finance rates is by item purchased, as follows:

1) new automobiles.
2) late used automobiles.
3) older used automobiles.
4) other consumer products.

A study in July 1966, by the Federated Council of Sales Finance Companies provides a few examples of finance company charges. Each company sampled entered one or more rates for each of the four classes of contract. For the 10 companies sampled, the average was two rates per company per type of contract. Thus, approximately 20 different rates were obtained for each contract class. These rates have been averaged and a range stated as shown in table VIII. The rates are shown as annual "add-on" rates since no terms or principles were stated. This precludes conversion to effective interest rates. Due to this, the averaged
figures are only approximate indicators of rates charged. However, a general idea regarding the rates charged by sales finance companies can be gained.

TABLE VIII
SALES FINANCE COMPANY ADD-ON FINANCE RATES

<table>
<thead>
<tr>
<th>Contract Classification</th>
<th>Average Rate</th>
<th>High Rate</th>
<th>Low Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>New car</td>
<td>8.5</td>
<td>9.7</td>
<td>6.6</td>
</tr>
<tr>
<td>Late model used car</td>
<td>9.6</td>
<td>11.8</td>
<td>7.0</td>
</tr>
<tr>
<td>Older used car</td>
<td>12.3</td>
<td>18.6</td>
<td>8.6</td>
</tr>
<tr>
<td>Other consumer goods</td>
<td>9.8</td>
<td>13.0</td>
<td>4.5</td>
</tr>
</tbody>
</table>

Source: Federated Council of Sales Finance Companies Instalment Finance Operations Questionnaire.

A more comprehensive, although less recent study, was done in the Province of Nova Scotia. In this study, rates, terms, principles, and security were also stated. The various methods of stating finance charges (add-on and discount) were converted into a common annual effective interest rate. A further breakdown of the rates is shown in table IX to table XII.

Royal Commission on Borrowing Money, Cost of Credit, and Related Matters.
TABLE IX
SALES FINANCE COMPANY FINANCE CHARGES IN ANNUAL SIMPLE INTEREST RATES ON HOUSEHOLD APPLIANCES & FURNITURE

<table>
<thead>
<tr>
<th>Amount Financed</th>
<th>Finance Charges</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Term (months)</td>
</tr>
<tr>
<td>$100</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>12</td>
</tr>
<tr>
<td>200</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td>300</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td>500</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>36</td>
</tr>
<tr>
<td>1000</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>36</td>
</tr>
</tbody>
</table>

TABLE X
SALES FINANCE COMPANY FINANCE RATES IN ANNUAL SIMPLE INTEREST RATES ON OLDER USED CARS

<table>
<thead>
<tr>
<th>Amount Financed</th>
<th>Finance Charges</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Term (months)</td>
</tr>
<tr>
<td>$500</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td>1000</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td>Amount Financed</td>
<td>Term (months)</td>
</tr>
<tr>
<td>-----------------</td>
<td>---------------</td>
</tr>
<tr>
<td>$500</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>36</td>
</tr>
<tr>
<td>1000</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>36</td>
</tr>
<tr>
<td>2000</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>36</td>
</tr>
<tr>
<td>3000</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>36</td>
</tr>
</tbody>
</table>
### TABLE XII

SALES FINANCE COMPANY FINANCE RATES IN ANNUAL SIMPLE INTEREST RATES ON USED LATE MODEL CARS

<table>
<thead>
<tr>
<th>Amount Financed</th>
<th>Term (months)</th>
<th>Finance Charges</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>High</td>
</tr>
<tr>
<td>$500</td>
<td>12</td>
<td>25.0</td>
</tr>
<tr>
<td></td>
<td>24</td>
<td>24.9</td>
</tr>
<tr>
<td></td>
<td>36</td>
<td></td>
</tr>
<tr>
<td>1000</td>
<td>12</td>
<td>21.4</td>
</tr>
<tr>
<td></td>
<td>24</td>
<td>21.6</td>
</tr>
<tr>
<td></td>
<td>36</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>12</td>
<td>21.3</td>
</tr>
<tr>
<td></td>
<td>24</td>
<td>21.5</td>
</tr>
<tr>
<td></td>
<td>36</td>
<td></td>
</tr>
<tr>
<td>3000</td>
<td>12</td>
<td>21.3</td>
</tr>
<tr>
<td></td>
<td>24</td>
<td>21.5</td>
</tr>
</tbody>
</table>


Note: The above were the figures available to the Commission in Nova Scotia in 1962.

Components of the Finance Charge.- The various components of gross finance charges are displayed in table XIII. This breakdown was obtained from 4 major finance companies in the year 1955 and from a broader study in 1965.

The diversified nature of the major finance companies and the inclusion of smaller firms in the 1965 survey,
make the two series not perfectly comparable. However, indications are that since 1955, nonequity funds expense may have become a larger component of finance charges, especially in the past few years.

**TABLE XIII**

**COMPONENTS OF FINANCE CHARGES**

<table>
<thead>
<tr>
<th></th>
<th>1955</th>
<th>1965</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total revenue from operations</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Costs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dealer reserve</td>
<td>16</td>
<td></td>
</tr>
<tr>
<td>General and Administrative</td>
<td>19</td>
<td></td>
</tr>
<tr>
<td>Bad Debts</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td><strong>Total Costs</strong></td>
<td>44%</td>
<td>35%</td>
</tr>
<tr>
<td><strong>Interest and discount expense</strong></td>
<td>25%</td>
<td>45.5%</td>
</tr>
<tr>
<td><strong>Net profit before taxes</strong></td>
<td>31%</td>
<td>19.5%</td>
</tr>
<tr>
<td><strong>Taxes</strong></td>
<td>15</td>
<td>8.1</td>
</tr>
<tr>
<td><strong>Net Profit after taxes</strong></td>
<td>16%</td>
<td>11.1%</td>
</tr>
</tbody>
</table>


Sales finance company capital structure has remained relatively constant over the past 10 years. Therefore, it is assumed that any increase in the interest and discount expense is probably largely due to higher interest rates. Cost of nonequity funds can be seen in

19As shown by *Bank of Canada Statistical Summary* data.
Table XIV.

TABLE XIV
COST OF NONEQUITY FUNDS

<table>
<thead>
<tr>
<th>Year</th>
<th>Demand Bank Loans</th>
<th>Short Term Secured Notes</th>
<th>Long Term Secured Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1957</td>
<td>5.75</td>
<td>5.5</td>
<td>5.5</td>
</tr>
<tr>
<td>1966</td>
<td>5.6-6.5</td>
<td>6.0</td>
<td>6.5</td>
</tr>
<tr>
<td>1967</td>
<td>6.0-6.3</td>
<td>6.0-6.8</td>
<td>6.5-7.0</td>
</tr>
</tbody>
</table>

Summary

The discussion of the supply of consumer credit is now completed. The question posed at the end of the last chapter has been answered. The complete ranking of sources of supply of consumer credit, in terms of cost of consumer credit, is as follows:

1) small loan companies
2) retailers
3) sales finance companies
4) chartered banks
5) credit unions.

The most expensive sources are nearer the top.

With respect to share of the consumer credit market performance, sales finance companies have lost share of the market as "impressively" as the credit unions and chartered banks have gained share of the market.
The discussion of the historical interaction between the supply of and demand for consumer credit, as it is reflected in changes in shares of the consumer credit market held by various institutions, is completed. The next step concerns the future interactions between the supply of and the demand for consumer credit. This question is treated in the following chapter.
Introduction

The preceding analysis has left the implication that the sales finance companies may face a declining share of the market in the future. This tentative conclusion is mainly based on the bank's aggressive action in the field of consumer credit, and the difference in finance rates between the sales finance companies and the chartered banks. The conclusion necessarily assumes this situation will continue.

To support this conclusion, the Juster and Shay model will be used to generate a prediction of the sales finance companies' future share of a particular segment of the consumer credit market.

The Forecast

The Variable to be Predicted

The variable to be predicted will be the share of the automobile financing market that may be serviced by sales finance companies and chartered banks, in Canada, annually to 1980. The share of the market will be measured in terms of outstanding credit at year end.
The selection of the automobile financing market as the variable is based on two reasons. The first reason is that the automobile financing market is a finite market almost completely divided between one higher cost lender (the sales finance company) and one lower cost lender (the chartered bank). The amount of automobile financing done by other lenders is insignificant. The second reason for the selection of this particular variable is the availability of data.

The automobile financing market is the main element in the sales finance companies' retail credit portfolio. Therefore, the changes in the automobile segment of their business control (to a large extent) the fortunes of the entire portfolio.

The automobile financing market may or may not be representative of the total consumer credit market. It is possible that because of the nature of the automobile market, occurrences in the automobile financing market may lead (to a significant extent) changes in other consumer credit markets. However, many of the forces acting on the automobile financing market also bear on the other segments of the consumer credit market.

The Hypothesis

The Juster and Shay study addressed itself to the consumer's sensitivity to finance rates. Juster and
Shay states that consumers may in the future become more sensitive to finance rates, that is the unrationed group of borrowers may grow as a proportion of the population. It is assumed that the unrationed consumer will seek lower cost credit, while the rationed consumer may be forced to seek credit from the higher cost lenders.

The three characteristics of unrationed borrowers mentioned previously and the above assumption lead to the hypothesis. It is hypothesized that the change in the lower or higher cost suppliers' share of the consumer credit market can, in the future, be predicted by changes in the proportion of the population falling in the unrationed class. Changes in this proportion are reflected by changes in the age characteristics of the population, and by certain financial characteristics of the population.

The hypothesis consists of two fundamental proposals. The first is that the changes in share of the market can be predicted by changes in the proportion of the population that is unrationed with respect to its supply of credit. The second is that changes in this proportion can be predicted by changes in population characteristics.

The method of prediction will actually skip the

\[1\] Juster and Shay, p. 46.

\[2\] see page 25.
intermediate step and forecast changes in share of the market from changes in the characteristics of the population.

Technique of Forecasting

The technique will be to obtain rough measures of the sensitivity of the automobile financing market to changes in certain population and financial characteristics. This will be accomplished by means of a regression of past share of automobile financing market data onto the above characteristics.

Establishment of the Relationships-Problem

A brief look at the past performance of chartered banks, in the field of automobile financing, identifies a problem in the establishment of the relationships.

A revision of the Bank Act, in 1954, allowed the banks, for the first time, to take chattel mortgages on household property as security for personal loans. It is subsequent to this date that chartered banks became active in the automobile financing market. Their presence has been felt to a significant degree only in the past 10 years. This represents a statistically inadequate time span upon which to establish relationships between share of the market and population characteristics. This is especially true considering the
distance into the future that the variable will be predicted. An additional problem is the fact that the likelihood of a valid relationship existing in the above time period is remote. The chartered bank's share of the market was, during that time, influenced significantly by their aggressiveness and capacity. The potential market for lower cost consumer credit may have existed in the past. The banks merely expanded into this market.

The difficulties mentioned above have led to the decision to use past U.S.A. data regarding sales finance companies and commercial banks, in order to establish the relationships. The U.S.A. data is usable, with some small exceptions, from 1939 to date. The commercial banks have been in the field since 1939. Therefore, a greater likelihood exists that the share of the market data will reflect the relationships proposed in the hypothesis.

The assumption will then be made that the relationships established on the U.S.A. data are applicable to the Canadian automobile financing situation. A forecast of the future share of the automobile financing market that will be serviced by the sales finance companies will be constructed, using these relationships.

It is admitted that the nature of the assumption made above, damages the credibility of the forecast.
In an effort to restore some of this lost credibility, a digression in the form of an examination of the assumption will be made.

Fundamentally, the assumption is that Canadian borrowers will, in the future, exhibit the same reactions (in terms of source of credit selection) in accordance with their changes in age and income characteristics as U.S.A. borrowers did in the past. The elements of this assumption are as follows:

1) It assumes that credit sources in Canada are similar to those in the U.S.A. with respect to difference in finance rates.

2) It assumes that the cultural and social foundations of each country give rise to a similar demand for credit.

The first element, that of similar institutional finance rates, can be evaluated by table XV.

The second element is far more intangible and difficult to evaluate. Table XVI shows the similarity between the U.S.A. and Canada data regarding consumer credit as a percentage of personal disposable income.

The parallels in history that can be established between the U.S.A. and Canada are numerous. Both countries were developed by European immigrants. Both countries suffered a common depression and were involved in the
same major wars. It is common knowledge that our economies are closely linked and tend to move together.

TABLE XV

CONSUMER CREDIT CHARGES IN THE U.S.A. AND CANADA

<table>
<thead>
<tr>
<th>Institution</th>
<th>Average</th>
<th>High</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Sales Finance Co.</td>
<td>15%</td>
<td>20%</td>
<td>11%</td>
</tr>
<tr>
<td>Commercial Banks</td>
<td>10%</td>
<td>15%</td>
<td>6%</td>
</tr>
<tr>
<td>Canadian Sales Finance Co.</td>
<td>15%</td>
<td>30%</td>
<td>12%</td>
</tr>
<tr>
<td>Chartered Banks</td>
<td>11%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: The Canadian data are estimates based on various sources. The U.S.A. data are based on Wallace P. Mors, *Consumer Credit Finance Charges*, NBER 1964.

It is submitted that these points will tend to support the view that similar demand characteristics for consumer credit (as far as elasticities with respect to finance rates are concerned) may exist.
TABLE XVI
CONSUMER CREDIT AS A PERCENT OF PERSONAL DISPOSABLE INCOME

<table>
<thead>
<tr>
<th>Year</th>
<th>Can.</th>
<th>U.S.A.</th>
<th>Year</th>
<th>Can.</th>
<th>U.S.A.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1948</td>
<td>7.5</td>
<td>7.4</td>
<td>1958</td>
<td>14.2</td>
<td>14.5</td>
</tr>
<tr>
<td>1949</td>
<td>8.3</td>
<td>8.9</td>
<td>1959</td>
<td>15.4</td>
<td>15.4</td>
</tr>
<tr>
<td>1950</td>
<td>9.6</td>
<td>10.1</td>
<td>1960</td>
<td>16.0</td>
<td>15.8</td>
</tr>
<tr>
<td>1951</td>
<td>8.0</td>
<td>10.1</td>
<td>1961</td>
<td>16.6</td>
<td>15.8</td>
</tr>
<tr>
<td>1952</td>
<td>10.1</td>
<td>11.3</td>
<td>1962</td>
<td>16.8</td>
<td>16.4</td>
</tr>
<tr>
<td>1953</td>
<td>11.7</td>
<td>12.3</td>
<td>1963</td>
<td>17.8</td>
<td>17.4</td>
</tr>
<tr>
<td>1954</td>
<td>12.6</td>
<td>12.5</td>
<td>1964</td>
<td>19.5</td>
<td>17.9</td>
</tr>
<tr>
<td>1955</td>
<td>13.8</td>
<td>14.2</td>
<td>1965</td>
<td>20.2</td>
<td>18.6</td>
</tr>
<tr>
<td>1956</td>
<td>14.2</td>
<td>14.7</td>
<td>1966</td>
<td>NA</td>
<td>18.6</td>
</tr>
<tr>
<td>1957</td>
<td>14.0</td>
<td>14.6</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


It is submitted that these points will tend to support the view that similar demand characteristics for consumer credit (as far as elasticities with respect to finance rates are concerned) may exist.

Independent Variables

Juster and Shay describe the unrationed borrower as being in a later stage of family life and having a larger income.

These characteristics will be measured as follows.

Stage of Family Life. - The ratio of the number of
people in the following age groups.³

\[
\frac{\text{Number of persons 20 to } 3\frac{1}{4} \text{ years of age}}{\text{Number of persons 35 to } 5\frac{1}{4} \text{ years of age}}
\]

This variable is assumed to reflect the stage of family life characteristics. A later stage of family life is reasonably well indicated by the 35 to 5\(\frac{1}{4}\) years of age group. The age variable is a ratio of the two age groups because of the problems in forecasting future size of age groups as a percentage of total population. In addition, the variable expressed as a ratio generally covers the entire age group using consumer credit, and is therefore, a better indicator of the stage of family life of the potential consumer credit market.

**Median Income of Family Units.** This variable may represent the income characteristics of the population. Median income was chosen on the basis of the availability of data. The family unit was chosen because a borrower's credit need and potential payment ability is usually based on the income of his family. This income may be larger than the income of the head of the family if the wife works.

³Since U.S.A. data is to be used to establish the relationships the number of persons in the 20 to 3\(\frac{1}{4}\) age group will be modified as follows: The data for the years 1942 to 1946 is reduced by the number of persons in military service during this period in excess of the 1941 figure. The 1951 to 1961 data are similarly modified over the 1950 military strength.
In addition, Juster and Shay described the unrationed borrower as having greater liquid assets, however the difficulty of obtaining data on the size of liquid assets, combined with the high degree of intercorrelation between saving and income, makes it difficult to utilize this variable. Therefore, it will be ignored as an explanatory variable. This is not to suggest that the size of liquid assets is not a possible valid distinction between rationed and unrationed borrowers.

Establishment of the Relationship

The data used to establish the relationships is U.S.A. data and is shown in the appendix on page 123.

The regressions were approached from two ways. The first approach was to perform a routine least squares regression on the data referred to above. The results are shown in the appendix on page 123.

The second approach was to perform an approximate graphical regression. This regression was premised by the Juster and Shay model. The age ratio regression coefficient was restricted to a positive value, and the income regression coefficient was restricted to a negative value. The results are shown in the appendix on page 125.

The two approaches provided different results and this problem is discussed in the appendix.
The Forecast Results

The regression equations obtained from the above were used to generate a series of predicted shares of the automobile financing market going to sales finance companies. Canadian data was used for the projections, as shown in table XVII.

<table>
<thead>
<tr>
<th>Year</th>
<th>Age ratio of 20 to 34 yr. olds to 35 to 54 yr. olds</th>
<th>Median Family Income (t-1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1966</td>
<td>.842</td>
<td>$ 5998</td>
</tr>
<tr>
<td>1967</td>
<td>.849</td>
<td>6299</td>
</tr>
<tr>
<td>1968</td>
<td>.891</td>
<td>6613</td>
</tr>
<tr>
<td>1969</td>
<td>.908</td>
<td>6947</td>
</tr>
<tr>
<td>1970</td>
<td>.937</td>
<td>7291</td>
</tr>
<tr>
<td>1971</td>
<td>1.961</td>
<td>7655</td>
</tr>
<tr>
<td>1972</td>
<td>1.002</td>
<td>8031</td>
</tr>
<tr>
<td>1973</td>
<td>1.037</td>
<td>8441</td>
</tr>
<tr>
<td>1974</td>
<td>1.071</td>
<td>8862</td>
</tr>
<tr>
<td>1975</td>
<td>1.104</td>
<td>9306</td>
</tr>
<tr>
<td>1976</td>
<td>1.133</td>
<td>9771</td>
</tr>
<tr>
<td>1977</td>
<td>1.159</td>
<td>10260</td>
</tr>
<tr>
<td>1978</td>
<td>1.184</td>
<td>10772</td>
</tr>
<tr>
<td>1979</td>
<td>1.204</td>
<td>11311</td>
</tr>
<tr>
<td>1980</td>
<td>1.217</td>
<td>11876</td>
</tr>
</tbody>
</table>

These projections were obtained as follows:

1) The age ratio projection was obtained from an
2) The projected median family income was obtained by using an arbitrary compounding factor of 5 percent annually and projecting the 1961 median family income at this rate.

All equations except the one for the period 1939 to 1964 (which includes the war years) predict a falling share of the market for sales finance companies. The equation for the period 1939 to 1964 is not considered relevant due to the economic dislocations that occurred in the war period 1942 to 1945 in the U.S.A.

The various forecasts generated by the equations are shown in table XVIII.

The profile of the share of the automobile financing market that may be serviced by the sales finance companies in Canada, to 1980 is shown in chart 19.

Summary

The forecast generated in this chapter lends some support to the tentative conclusion drawn from the examination of the sales finance companies' place in the consumer credit market, contained in the last chapter. The sales finance companies may lose share of the automobile financing market in the future.

This forecast assumes that the chartered banks will

---

TABLE XVIII
FORECASTED SHARE OF AUTOMOBILE FINANCING MARKET THAT MAY BE SERVICED BY THE SALES FINANCE COMPANIES:

<table>
<thead>
<tr>
<th>Year</th>
<th>1939-41</th>
<th>1946-64</th>
<th>1951-64</th>
<th>1953-64</th>
<th>1953-64</th>
</tr>
</thead>
<tbody>
<tr>
<td>1966</td>
<td>45.3</td>
<td>46.0</td>
<td>46.6</td>
<td>47.9</td>
<td>50.8</td>
</tr>
<tr>
<td>1967</td>
<td>42.5</td>
<td>43.3</td>
<td>44.1</td>
<td>45.5</td>
<td>49.2</td>
</tr>
<tr>
<td>1968</td>
<td>38.9</td>
<td>39.8</td>
<td>41.1</td>
<td>43.0</td>
<td>48.0</td>
</tr>
<tr>
<td>1969</td>
<td>35.9</td>
<td>37.0</td>
<td>38.4</td>
<td>40.3</td>
<td>46.0</td>
</tr>
<tr>
<td>1970</td>
<td>32.2</td>
<td>33.5</td>
<td>35.3</td>
<td>37.5</td>
<td>44.4</td>
</tr>
<tr>
<td>1971</td>
<td>29.7</td>
<td>30.1</td>
<td>32.2</td>
<td>34.5</td>
<td>42.5</td>
</tr>
<tr>
<td>1972</td>
<td>24.1</td>
<td>25.8</td>
<td>28.5</td>
<td>31.5</td>
<td>41.2</td>
</tr>
<tr>
<td>1973</td>
<td>19.7</td>
<td>21.5</td>
<td>24.7</td>
<td>28.1</td>
<td>39.2</td>
</tr>
<tr>
<td>1974</td>
<td>15.2</td>
<td>17.3</td>
<td>21.0</td>
<td>24.7</td>
<td>37.3</td>
</tr>
<tr>
<td>1975</td>
<td>10.7</td>
<td>13.0</td>
<td>17.1</td>
<td>21.1</td>
<td>35.1</td>
</tr>
<tr>
<td>1976</td>
<td>6.3</td>
<td>8.8</td>
<td>13.2</td>
<td>17.4</td>
<td>32.6</td>
</tr>
<tr>
<td>1977</td>
<td>1.9</td>
<td>4.6</td>
<td>9.3</td>
<td>13.6</td>
<td>29.9</td>
</tr>
<tr>
<td>1978</td>
<td>0</td>
<td>0.3</td>
<td>5.2</td>
<td>9.6</td>
<td>26.9</td>
</tr>
<tr>
<td>1979</td>
<td>0</td>
<td>0</td>
<td>1.2</td>
<td>5.4</td>
<td>23.6</td>
</tr>
<tr>
<td>1980</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1.1</td>
<td>19.8</td>
</tr>
</tbody>
</table>

*dates are inclusive.

continue to aggressively seek consumer credit business, and that they will remain lower cost lenders than the sales finance companies.

While this chapter was not completely successful in applying the Juster and Shay model to explain past market changes, certain critical areas in the forecast were indicated. The main area that requires more investigation is the specification of the age variable.
This particular area is suggested as a possible fruitful area of investigation for further study.

The possible implications of a forecasted loss of share of market to the management of sales finance companies will be considered in the following chapter.
VII. CONCLUSIONS

Overview

The last five chapters have examined the market in which the sales finance companies operate. Several demand factors were briefly examined. The various aspects of the competition in the market for consumer credit were also examined. The forecast in chapter six predicts a future consumer population having an increased sensitivity to finance rates. This prediction leads to a forecasted decline in the potential share of market that may be serviced by the sales finance companies.

With this expectation, how should the competitive strategy of the sales finance companies be determined? Should the sales finance companies adopt a retreat posture, or should they increase their competitive strength in an attempt to hold share of the market?

The sales finance industry consists of basically two types of firms. One type is the large diversified company, offering several types of financial and other services to the economy. These firms do the majority of the sales financing business. The other type of firm is the small company. There are a great number of this type, although they do only a small amount of business.
They are usually not as diversified as the larger firms.

Future changes in the market for consumer credit will have a different impact on each of these two types of firms. The smaller firms may suffer the initial effect of the chartered banks' expansion in the consumer credit field. This possibility was stated recently by a sales finance industry spokesman.\(^1\) The spokesman predicted fewer, larger, and stronger finance companies in the future.

The comments contained in this chapter will be directed at the large, diversified firm. These comments may or may not be applicable to the smaller firms.

**Allocation Policy Decisions**

The following section will deal with the allocation of resources within a diversified finance company. There are two different approaches that may be used to conceptualize the decision making process regarding the allocation of resources within a diversified finance company.

The first method is to visualize the various areas of operation requiring the firm's resources as elements in an investment portfolio. Each element in the portfolio has an expected return and a risk factor. The portfolio

\(^1\)The Financial Post, October 14, 1967, p. 5.
is optimized when the expected return is maximized for a risk level consistent with the risk preferences of the investor. The main objective of diversification under this reasoning is to minimize risk.

Viewing a diversified firm as a portfolio has several complicating factors.

1) The rate of return on a particular element may depend on the amount invested or the resources allocated to it.

2) The variability (risk) of the return may be difficult to obtain, and/or predict.

3) Diversification within a firm may stem from reasons other than a desire to reduce risk.

These factors complicate portfolio analysis greatly and make it difficult to apply.

The second approach to the allocation of resources within the diversified finance firm is based on marginal analysis. It may be termed the theory of the firm approach. The disadvantage of this approach is that it ignores risk, although it does have the advantage of simplicity.

Consider a firm with two divisions called A and B.

2Note that it may be possible to argue that the individual shareholder will diversify within his portfolio, in line with his own risk preference. Therefore, the firm should govern its actions only in terms of profit maximization. Risk reduction may not be an objective in the diversification decision within the firm.
Division A is the sales finance division. It is assumed all costs are variable in both divisions. Charts 20 to 24 show the total, average, and marginal costs and revenues for each divisions as well as total and marginal profit. By marginal analysis, resources would be allocated such that marginal profit was equal between divisions. This can be seen on charts 22 and 23. Assume that only a limited amount of resources were available for allocation and that this amount was less than x+y, but greater than x or y. These resources would be allocated such that marginal profits were equal (for instance at points r and s). This allocation would be optimal. This can be demonstrated by taking one unit from either division, allocating it to the other division, and noting the effect on total profit. By definition, the reduction in profit for one division by the mis-allocation would exceed the increase in profit gained by the other division. Therefore, the allocation is optimal.

The overall optimum operation is with x+y resources. At this optimum, marginal profits from both divisions are zero. It is interesting to note that as resources exceeded the x+y level, it would pay to diversify further and reallocate the resources among three divisions. However, this reasoning is complicated in the short term by fixed costs. With fixed costs, the profit curves
1) Marginal values in these charts would be in terms of quantity of resources allocated to the division, rather than units of sales.

   e.g. \( MC = \frac{dC}{dQ} \) where \( C \) equals cost and \( Q \) is a measure of the quantity of resources allocated to the division.

2) The following conditions must apply for the optimal allocation of resources as discussed in the text:

   \( Q > x \)
   \( Q > y \)
   \( Q < x+y \)


would appear somewhat like chart 24. In this case, diversification would result only when funds exceeded some point \( x+y+e \).
This model can be used in an examination of the diversified finance company allocation of resources. Funds would be allocated such that equal Marginal profit existed between divisions.

The future, as suggested by the forecast, may see the nonsales finance divisions grow more rapidly than the sales finance division. Alternatively, the sales finance division may shrink in size. The results would be the same in that the sales finance division may become relatively smaller compared to the other divisions in the firm. This can be represented by a shift to the left of the profit curve of the sales finance division. The long run effect would be that the finance firm would have excess resources. The choice would then be to return the excess resources to the shareholders or to diversify under the reasoning previously stated.

This type of analysis results in the rejection of a "stand and fight" policy by the finance company. If the firm were to attempt to engage in increased price and nonprice competition, the result would be a reduction in profitability. This would be acceptable only if the reduced profitability were a short term condition. It would mean a movement down the profit curve to the right and would represent a misallocation of funds.

The logical policy in the light of the predicted loss of share of the market may be to contract the sales
finance division (relative to other divisions), and/or increase diversification.

It is possible that both the portfolio approach and the theory of the firm approach would indicate an increased diversification strategy. This strategy would originate from two main effects of diversification.
1) Reduction of overall risk by diversification.
2) Since the return from each division varies with the amount of resources allocated to that division, there may exist logical reason for diversification based simply on the desire to maximize profits as well as the risk incentive referred to in point 1.

What has the sales finance company strategy been in the recent past? From the surface, sagging profit margins and lower finance charges (charts 25 and 26) appear to indicate that sales finance companies have in general been sacrificing profits for volume. However, closer examination has shown that only in the last two or three years have operating costs begun to rise, relative to revenues. The main reason for the poor profit performance appears to have been the high cost of funds, as is shown in table XIX. This is interpreted as indicative of a policy based primarily on profit maximization and not on an index of share of market or volume.
CHART 25
RANGE OF FINANCE CHARGES ON NEW AUTOMOBILE
BALANCE OF $2000 OVER 30 MONTHS

CHART 26
RANGE OF FINANCE CHARGES ON NEW REFRIGERATORS
BALANCE OF $300 OVER 24 MONTHS

Based on Federated Council of Sales Finance Companies data.
TABLE XIX

EXPENSES AND NET PROFIT OF SALES FINANCE COMPANIES
AS A PERCENT OF GROSS REVENUES

<table>
<thead>
<tr>
<th></th>
<th>1962</th>
<th>1963</th>
<th>1964</th>
<th>1965</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Revenues</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Cost of non-equity funds</td>
<td>39.3</td>
<td>42.6</td>
<td>45.2</td>
<td>45.5</td>
</tr>
<tr>
<td>General Admin.</td>
<td>29.0</td>
<td>28.5</td>
<td>27.8</td>
<td>28.7</td>
</tr>
<tr>
<td>Bad Debt Expense</td>
<td>4.6</td>
<td>3.7</td>
<td>4.5</td>
<td>6.2</td>
</tr>
<tr>
<td>Taxes</td>
<td>12.4</td>
<td>11.1</td>
<td>9.5</td>
<td>8.1</td>
</tr>
<tr>
<td>Net Earnings</td>
<td>15.3</td>
<td>14.1</td>
<td>13.4</td>
<td>11.2</td>
</tr>
</tbody>
</table>

Source: Data supplied by the Federated Council of Sales Finance Companies.

Divisional Optimization

If the previously discussed allocation decision has been made, the competitive posture of the sales finance division would already be determined. The primary objective of the division would be a divisional maximization of profit. Any measure of volume as an objective or goal would be unacceptable since it would not automatically lead to an optimum allocation of resources and resultant profit maximization.

This section will consist of speculations regarding the suboptimization within the sales finance division.
The previous chapters may serve as a background to this speculation. An examination of the fundamental variables in the operation of the sales finance division (in competition with other types of sources of consumer finance) may provide a clearer view of some possible alternative competitive strategies regarding the future.

An examination of the various sources of supply of consumer credit was made in chapters four and five. These chapters indicated that (to a great extent) the various sources have specialized in certain segments of the consumer credit market. The credit unions, and small loan companies serve relatively distinct and separate segments of the market. In the case of the sales finance companies and the chartered banks, there appears to be an overlap of markets. The conclusion drawn from this observation is that, at the present time, the chief competition facing the sales finance companies is from the chartered banks.

Previous discussion should have indicated that the main competitive advantage that the chartered banks hold over the sales finance companies is the lower finance rates. The reason consumers are borrowing from the banks and not from the sales finance companies is that it is cheaper to do so. This may be interpreted as meaning that the consumer does not consider the additional
services offered by "on premises sales financing" worth the additional cost. This presents the sales finance company with two possible alternatives with respect to competition. The sales finance company can increase the attractiveness of the services offered (both at the point of purchase and follow-up services) or the sales finance company can reduce the cost of credit. Both alternatives may bring the value of the services offered by the sales finance company and the cost of these services, closer together in the eye of the consumer.

However, these measures must not result in a reduced profit for the sales finance company, or division. If profits fall, the measures would be incompatible with the previously discussed allocation reasoning. That is, if these measures result in reduced profit, they are not acceptable as a means of increasing the share of the market.

In all probability, both measures, employed separately or in some combination, would result in reduced profit. Increasing the attractiveness of the services offered would probably result in increased expenses. Reduced finance rates would probably result in a fall in revenues.

Therefore, both measures must be accompanied by off-setting effects. A possible area where savings could theoretically be achieved is through a reduction in
other expenses; particularly these savings might be achieved through a reduction in the cost of funds.

The foregoing is not a prescription to increase the profitability of a sales finance division. Only the practising manager can pass an opinion on whether savings in the above areas could be achieved. The above discussion is simply an effort to systematically examine the main elements in the problem of sales finance company competitive strategy determination.

If, as the preceding chapter suggests, the sales finance companies are facing a long term decline in share of the market, the main concern of management may be a redefinition of the primary services offered by the company.

The sales financing of consumer purchases will remain as an important service to consumers, in spite of a falling market share. The utility of on-premises financing of consumer purchases by sales finance companies will depend upon the services offered and the rates charged. Assuming that this utility remains approximately the same as the present level (that is that the sales finance companies can find no way of cutting charges or increasing services, without damaging their profit position) the total outstandings of sales finance companies in 1980 may be of the order of 1.5 to 2 billion
dollars. The above redefinition of sales finance company business appears to be in progress within the sales finance industry. It may be reflected by the strategy of diversification that is being pursued by most large firms. Diversification has occurred into the following fields.

1) small loan business.

2) industrial and commercial financing

3) factoring

4) mortgage lending

5) interim financing for real estate and construction projects

6) property and equipment leasing

7) mutual funds

8) miscellaneous

9) foreign investments.

In addition, some companies have working agreements with firms in other industries (e.g. with mortgage loan companies in order to provide high ratio mortgages).

Concluding Comments

This study was intended to undertake a general

\[^3\] This figure was obtained by a simple extrapolation of current growth rates.
survey of the demand for and supply of consumer credit, study the past and possible future interactions between this supply and demand, and discuss the implications of these interactions to the management of sales finance companies.

Chapters two and three dwelled on the demand for consumer credit and emphasized the consumer's sensitivity to finance rates.

Chapter four and five dealt with the supply of consumer credit and interactions in the market for this credit. Share of the market serviced by each source of credit and the particular source's range of finance charges were stated. This represents the analysis of the past interaction between the supply of and demand for consumer credit.

Chapter six disclosed difficulties in using the past market interactions to forecast future possible shares of the market but a forecast was eventually constructed showing a possible future decline in the sales finance companies share of the market (automobile financing).

Chapter seven discussed the implications of this forecast for the management of sales finance companies. The conclusions drawn indicate that the dynamic nature of the market for consumer credit, and the highly com-
petitive supply of such credit presents the management of sales finance companies with a difficult task. Added to this is a changing background of regulations and economic conditions. In total, these factors indicate that the management of sales finance companies face a critical responsibility to comprehend the nature of and changing characteristics of the demand for their resources. Their companies have a vital, unique, and necessary role to perform in the Canadian economy in the immediate future. Equally they are concerned to identify the nature and characteristics of existing and emerging sources of consumer credit and the effect of these sources on the sales finance companies' competitive position.
BIBLIOGRAPHY

Books


Articles


Articles


Annual Reports to the Superintendent of Insurance by the Small Loan Companies and Licensed Money Lenders, various years.

Other Sources

Financial Post. various issues.

Bank of Canada Statistical Summaries and Supplements.

Dominion Bureau of Statistics. various publications.

Federated Council of Sales Finance Companies. various studies.

Canadian Taxation Statistics. various years.
Regressions

This appendix is intended to state and discuss the regression results. However, it will be useful first to state the objective of the forecast and regressions. The objective is to apply the Juster and Shay hypothesis to obtain a prediction of the lower and higher cost lenders' shares of the consumer credit market. The automobile financing market was chosen for reasons previously stated.

The forecast and regressions are not intended to support or invalidate the Juster and Shay ideas. The regressions and data are considered far too unsophisticated to be used in this manner, as will be pointed out. The empirical test used by Juster and Shay in their study is considered far more useful for this purpose.

The Regression Equation

The regression equation used is of the following form. 

\[ S = K + B_1X_1 + B_2X_2 \]

where \( S \) = share of the automobile financing market serviced by the sales finance companies in percent

\[ ^1 \text{see page 125.} \]
K = a constant  

\[ X_1 = \frac{\text{number of 20 to 34 year olds}}{\text{number of 35 to 54 year olds}} \]

\[ X_2 = \text{median annual income of families and related individuals of previous year.} \]

The past U.S.A. data (table XX) was used to construct a series of forecasting equations of the form listed above.

Regression Results

A. Least Squares Regressions

1) For the period 1939 to 1964

\[ S = -70.6 + 126.8X_1 + 0.005X_2 \]

\[ R^2 = 0.54 \]

2) For the period 1939 to 1941, 1946 to 1964

\[ S = 128.6 - 56.2X_1 - 0.006X_2 \]

\[ R^2 = 0.77 \]

3) For the period 1946 to 1964

\[ S = 125.5 - 53.8X_1 - 0.006X_2 \]

\[ R^2 = 0.60 \]

4) For the period 1951 to 1964

\[ S = 112.6 - 34.3X_1 - 0.006X_2 \]

\[ R^2 = 0.81 \]

5) For the period 1953 to 1964

\[ S = 99.7 - 8.8X_1 - 0.007X_2 \]

\[ R^2 = 0.97 \]
<table>
<thead>
<tr>
<th>Year</th>
<th>Share of Auto. Fin. Market Serviced by Sales Fin. Co. in Percent</th>
<th>Age Ratio</th>
<th>Median Family Income in Dollars (t-1 years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1939</td>
<td>69.3</td>
<td>0.976</td>
<td>1100</td>
</tr>
<tr>
<td>1940</td>
<td>67.8</td>
<td>0.976</td>
<td>1231</td>
</tr>
<tr>
<td>1941</td>
<td>63.0</td>
<td>0.974</td>
<td>1348</td>
</tr>
<tr>
<td>1942</td>
<td>46.2</td>
<td>0.859</td>
<td>1500</td>
</tr>
<tr>
<td>1943</td>
<td>25.0</td>
<td>0.712</td>
<td>1700</td>
</tr>
<tr>
<td>1944</td>
<td>22.0</td>
<td>0.613</td>
<td>1950</td>
</tr>
<tr>
<td>1945</td>
<td>10.0</td>
<td>0.621</td>
<td>2388</td>
</tr>
<tr>
<td>1946</td>
<td>5.7</td>
<td>0.865</td>
<td>2445</td>
</tr>
<tr>
<td>1947</td>
<td>56.0</td>
<td>0.938</td>
<td>2548</td>
</tr>
<tr>
<td>1948</td>
<td>56.3</td>
<td>0.931</td>
<td>3033</td>
</tr>
<tr>
<td>1949</td>
<td>61.8</td>
<td>0.922</td>
<td>3140</td>
</tr>
<tr>
<td>1950</td>
<td>59.7</td>
<td>0.889</td>
<td>3107</td>
</tr>
<tr>
<td>1951</td>
<td>59.0</td>
<td>0.863</td>
<td>3319</td>
</tr>
<tr>
<td>1952</td>
<td>58.0</td>
<td>0.836</td>
<td>3709</td>
</tr>
<tr>
<td>1953</td>
<td>58.0</td>
<td>0.825</td>
<td>4889</td>
</tr>
<tr>
<td>1954</td>
<td>60.0</td>
<td>0.814</td>
<td>4223</td>
</tr>
<tr>
<td>1955</td>
<td>61.0</td>
<td>0.811</td>
<td>4197</td>
</tr>
<tr>
<td>1956</td>
<td>60.0</td>
<td>0.792</td>
<td>4420</td>
</tr>
<tr>
<td>1957</td>
<td>58.5</td>
<td>0.779</td>
<td>4788</td>
</tr>
<tr>
<td>1958</td>
<td>58.7</td>
<td>0.766</td>
<td>4978</td>
</tr>
<tr>
<td>1959</td>
<td>55.7</td>
<td>0.720</td>
<td>5045</td>
</tr>
<tr>
<td>1960</td>
<td>54.1</td>
<td>0.741</td>
<td>5417</td>
</tr>
<tr>
<td>1961</td>
<td>52.4</td>
<td>0.741</td>
<td>5625</td>
</tr>
<tr>
<td>1962</td>
<td>50.4</td>
<td>0.740</td>
<td>5744</td>
</tr>
<tr>
<td>1963</td>
<td>48.6</td>
<td>0.738</td>
<td>5910</td>
</tr>
<tr>
<td>1964</td>
<td>45.7</td>
<td>0.750</td>
<td>6265</td>
</tr>
</tbody>
</table>

B. Graphical Regressions

1) For the period 1953 to 1964

\[ S = 67.2 + 33.3X_1 - 0.0074X_2 \]

\[ R^2 = 0.88 \]

The regression equations for the period 1953 to 1964 are probably the most relevant for forecasting purposes in that they are based on data closer to the future, in time, than the other regressions. However, they are based on less data and therefore less reliable than the regressions on the other periods.

The fundamental difference between the least squares and graphical regression rests in the coefficient $B_1$. The least squares regression produces a negative coefficient while the graphical regression contains a positive one.

Conceptually this represents a conflict regarding the rationed and unrationed borrowers age description. The least squares regression seems to disagree with the Juster and Shay suggestion that unrationed borrowers are in a later stage of family life. However, as mentioned earlier, there may be inaccuracies in the particular age ratio as a measure of stage of family life distribution of the population. One of these inaccuracies may have resulted in the apparent conflict. This inaccuracy may be a result of the possible change in the spending power held by persons in the 20 to 34 years of age group.
over the 1939 to 1964 period. It is suggested that the relative spending power of this group increased over the period, as compared to the 35 to 54 year old group. This would tend to distort the historical relationships, and could produce the problem referred to above.

Unfortunately the complexity of the forces at work and the unavailability of data preclude allowing for this possible inaccuracy in the definition of the age variable, in a forecast of this nature.