

22

Finance Operations

CHAPTER OBJECTIVES

The specific objectives of this chapter are to:

- identify the main sources and uses of finance company funds,
- describe how finance companies are exposed to various forms of risk,
- identify the factors that determine the values of finance companies, and
- explain how finance companies interact with other financial institutions.

Finance companies provide short- and intermediate-term credit to consumers and small businesses. Although other financial institutions provide this service, only finance companies specialize in it. Many finance companies operate with a single office, while others have hundreds of offices across the country and even in foreign countries. Consumer finance operations can be conducted by an independent finance company or a unit (subsidiary) of a financial conglomerate.

TYPES OF FINANCE COMPANIES

Finance companies have more than \$1 trillion in assets. In aggregate, the amount of their business is similar to that of savings institutions. Some finance companies are independently owned, while others are subsidiaries of financial institutions or other corporations. For example, some very large finance companies are subsidiaries of General Motors, Ford Motor Company, Citigroup, American Express, Capital One, and General Electric.

Finance companies are commonly classified into the different types described below according to the specific services that they offer. Some finance companies could fit in every category because they offer all types of services.

Consumer Finance Companies

Consumer finance companies provide financing for customers of retail stores or wholesalers. For example, a consumer finance company can sponsor a credit card for a retailer so that the retailer can offer its own credit card for its customers. The customers can purchase products there on credit, which is provided by the finance company.

Many consumer finance companies also provide personal loans directly to individuals to finance purchases of large household items. Some consumer finance companies also provide mortgage loans.

Business Finance Companies

Business finance companies offer loans to small businesses. For example, they may provide loans to finance inventory. The business uses the loan to purchase materials that are used in the production process. Once the products are manufactured and sold, the business uses the revenue to pay off the loan. Business finance companies also provide financing in the form of credit cards that are used by a business's employees for travel or for making purchases on behalf of the business.

Captive Finance Subsidiaries

A **captive finance subsidiary (CFS)** is a wholly owned subsidiary whose primary purpose is to finance sales of the parent company's products and services, provide wholesale financing to distributors of the parent company's products, and purchase receivables of the parent company. The actual business practices of a CFS typically include various types of financing apart from just the parent company business. When a captive is formed, the captive and the parent company draw up an operating agreement containing specific stipulations, such as the type of receivables that qualify for sale to the captive and specific services to be provided by the parent.

The motive for creating a CFS can be easily understood by considering the automobile industry. Historically, automobile manufacturers were unable to finance dealers' inventories and had to demand cash from each dealer. Many dealers were unable to sell cars on an installment basis because they needed cash immediately. Banks were the primary source of capital to dealers. However, banks viewed automobiles as luxury items not suitable for bank financing and were unwilling to buy the installment plans created from automobile sales. For this reason, the automobile manufacturers became involved in financing.

The number of CFSs grew most rapidly between 1946 and 1960 as a result of liberalized credit policies and a need to finance growing inventories. By 1960 more than 100 CFSs existed.

Advantages of Captive Finance Subsidiaries There are several advantages to maintaining a CFS. A CFS can be used to finance distributor or dealer inventories until a sale occurs, making production less cyclical for the manufacturer. It can serve as an effective marketing tool by providing retail financing. It can also be used to finance products leased to others.

A CFS allows a corporation to clearly separate its manufacturing and retailing activities from its financing activities. Therefore, analysis of each segment of the parent company is less expensive and easier. Also, when lending to a CFS rather than a division of the parent company, the lender does not have to be so concerned about the claims of others. Unlike commercial banks, a CFS has no reserve requirements and no legal prohibitions on how it obtains or uses funds. Furthermore, a firm with a CFS can gain a competitive advantage because sale items such as automobiles and housing may depend on the financing arrangements available.

CFSs have diversified their financing activities to include more than just the parent company's product installment plans. General Electric Capital Corporation (GECC) has been the most innovative of all the CFSs. Its financing includes industrial and equipment sales, consumer installment credit, and second mortgage loans on private residences.

SOURCES AND USES OF FUNDS

Finance companies are distinctly different from commercial banks and savings institutions in that they do not rely heavily on deposits. Their sources and uses of funds are described next.

Sources of Funds

The main sources of funds for finance companies are

- Loans from banks
- Commercial paper
- Deposits
- Bonds
- Capital

Loans from Banks Finance companies commonly borrow from commercial banks and can consistently renew the loans over time. For this reason, bank loans can provide a continual source of funds, although some finance companies use bank loans mainly to accommodate seasonal swings in their business.

Commercial Paper Although commercial paper is available only for short-term financing, finance companies can continually roll over their issues to create a permanent source of funds. Only the most well-known finance companies have traditionally been able to issue commercial paper to attract funds, because unsecured commercial paper exposes investors to the risk of default. In the past, small or medium-sized finance companies had difficulty placing unsecured commercial paper. In recent years, as secured commercial paper has become popular, more finance companies have access to funds through this market.

The best-known finance companies can issue commercial paper through direct placement, thereby avoiding a transaction fee and lowering their cost of funds. Most companies, however, utilize the services of a commercial paper dealer.

Deposits Under certain conditions, some states allow finance companies to attract funds by offering customer deposits similar to those of the depository institutions discussed in previous chapters. Although deposits have not been a major source of funds for finance companies, they may become more widely used where legal.

Bonds Finance companies in need of long-term funds can issue bonds. The decision to issue bonds versus some alternative short-term financing depends on the company's balance sheet structure and its expectations about future interest rates. When the company's assets are less interest rate sensitive than its liabilities and when interest rates are expected to increase, bonds can provide long-term financing at a rate that is completely insulated from rising market rates. If the finance company is confident that interest rates will rise, it might consider using the funds obtained from bonds to offer loans with variable interest rates. Conversely, when interest rates decline, finance companies may use more long-term debt to lock in the cost of funds over an extended period of time.

Capital Finance companies can build their capital base by retaining earnings or by issuing stock. Like other financial institutions, finance companies maintain a low level of capital as a percentage of total assets. Several finance companies have engaged in initial public offerings of stock so that they could expand their businesses.

Uses of Finance Company Funds

Finance companies use funds for

- Consumer loans
- Business loans and leasing
- Real estate loans

Each use of funds is described in turn.

Consumer Loans Finance companies extend consumer loans in the form of personal loans. One of the most popular types is the automobile loan offered by a finance company that is owned by a car manufacturer. For example, General Motors Acceptance Corporation (GMAC) finances purchases of automobiles built by General Motors. Ford Motor Company and Chrysler also have their own finance companies. Subsidiaries of automobile manufacturers may offer unusually low rates to increase automobile sales.

WEB

www.nfcc.org

More detailed information about consumer loans.

In addition to offering automobile loans, finance companies offer personal loans for home improvement, mobile homes, and a variety of other personal expenses. Personal loans are often secured by a co-signer or by real property. The maturities on personal loans are typically less than five years.

Finance company loans are subject to ceiling interest rates on the loans provided and to a maximum length on the loan maturity. These regulations are imposed by states, and they vary among the states. Because ceiling rates are now sufficiently above market rates, they normally do not interfere with the rate-setting decisions of finance companies. Finance companies are also subject to state regulations on intrastate business. If a finance company wishes to set up a new branch, it must convince regulators that the branch would serve the needs of the people in that location.

Some finance companies also offer credit card loans through a particular retailer. For example, a retail store may sell products to customers on credit and then sell the credit contract to a finance company. Customers make payments to the finance company under the terms negotiated with the retail store. The finance company is responsible for the initial credit approval and for processing the credit card payments. The retailer can benefit from the finance company's credit allowance through increased sales; the finance company benefits by obtaining increased business. Finance companies increase their customer base in this way and are accessible for additional financing for those customers who prove to be creditworthy. The specific arrangement between a finance company and retailer can vary.

The main competition to finance companies in the consumer loan market comes from commercial banks and credit unions. Finance companies have consistently provided more credit to consumers than credit unions have, but they are a distant second to commercial banks. Savings institutions have recently entered this market and are now also considered a major competitor.

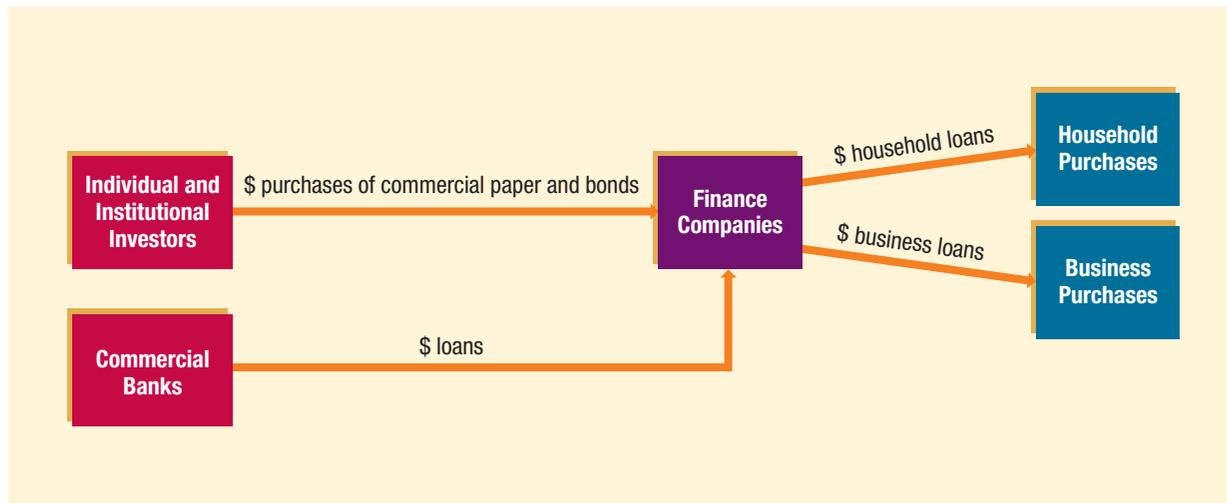
Business Loans and Leasing In addition to consumer loans, finance companies also provide business (commercial) loans. Companies commonly obtain these loans from the time they purchase raw materials until cash is generated from sales of the finished goods. Such loans are short term but may be renewed, as many companies permanently need financing to support their cash cycle. Business loans are often backed by inventory or accounts receivable.

Some finance companies provide loans to support leveraged buyouts (LBOs). These loans are generally riskier than other business loans but offer a higher expected return. In 2001, some highly leveraged firms experienced financial problems, and exposure to LBO loans received more attention.

Finance companies commonly act as **factors** for accounts receivable; that is, they purchase a firm's receivables at a discount and are responsible for processing and collecting the balances of these accounts. The finance company incurs any losses due to bad debt. Factoring reduces a business's processing costs and also provides short-term financing, as the business receives cash from the finance company earlier than it would have obtained funds from collecting the receivables.

Another way finance companies provide financing is by leasing. They purchase machinery or equipment and then lease it to businesses that prefer to avoid the additional debt on their balance sheet that purchases would require. Avoiding debt can be important to a business that is already close to its debt capacity and is concerned that additional debt will adversely affect its credit rating.

Real Estate Loans Finance companies offer real estate loans in the form of mortgages on commercial real estate and second mortgages on residential real estate. The offering of second mortgages has become increasingly popular over time. These mortgages are typically secured and historically have had a relatively low default rate.

Exhibit 22.1 How Finance Companies Finance Economic Growth

In the 2003–2006 period, however, some finance companies offered subprime (low quality) mortgage loans, which experienced a higher default rate that resulted in losses for the companies during the credit crisis.

Summary of Uses of Funds The particular allocation of a finance company's uses of funds depends on whether the company is focused on business or consumer lending. Some finance companies, such as GE Capital, provide all types of services. Exhibit 22.1 summarizes the sources and uses of funds by illustrating how finance companies finance economic growth. They channel funds from institutional investors who purchase the securities they issue to households and small businesses that need funds.

RISKS FACED BY FINANCE COMPANIES

Finance companies, like other financial institutions, are exposed to three types of risks:

- Liquidity risk
- Interest rate risk
- Credit risk

Because finance companies' characteristics differ from those of other financial institutions, their degree of exposure to each type of risk differs as well.

Liquidity Risk

Finance companies generally do not hold assets that could be easily sold in the secondary market. Thus, if they are in need of funds, they have to borrow. However, their balance sheet structure does not call for much liquidity. Virtually all of their funds are from borrowings rather than deposits anyway. Consequently, they are not susceptible to unexpected deposit withdrawals. Overall, the liquidity risk of finance companies is less than that of other financial institutions.

Interest Rate Risk

Both liability and asset maturities of finance companies are short or intermediate term. Therefore, they are not as susceptible to increasing interest rates as savings institutions are. Finance companies can still be adversely affected, however, because their assets are

typically not as rate sensitive as their liabilities. They can shorten their average asset life or make greater use of adjustable rates if they wish to reduce their interest rate risk.

Credit Risk

Because the majority of a finance company's funds are allocated as loans to consumers and businesses, credit risk is a major concern. Customers who borrow from finance companies usually exhibit a moderate degree of risk. The loan delinquency rate of finance companies is typically higher than that of other lending financial institutions. However, this higher default level may be more than offset by the higher average rate charged on loans. Because their loans entail both relatively high returns and high risk, the performance of finance companies can be quite sensitive to prevailing economic conditions.

VALUATION OF A FINANCE COMPANY

Finance companies (or consumer finance units that are part of a financial conglomerate) are commonly valued by their managers to monitor progress over time or by other financial institutions that are considering an acquisition. The value of a finance company can be modeled as the present value of its future cash flows. Thus, the value of a finance company should change in response to changes in its expected cash flows in the future and to changes in the required rate of return by investors:

$$\Delta V = f[\Delta E(CF), \Delta k]$$

+ -

Factors That Affect Cash Flows

The change in a finance company's expected cash flows may be modeled as

$$\Delta E(CF) = f(\Delta \text{ECON}, \Delta R_f, \Delta \text{INDUS}, \Delta \text{MANAB})$$

+ - ? +

where ECON represents economic growth, R_f represents the risk-free interest rate, INDUS represents industry conditions (such as regulatory constraints), and MANAB represents the abilities of the finance company's management.

Economic Growth Economic growth can enhance a finance company's cash flows by increasing household demand for consumer loans, thereby allowing the finance company to provide more loans. In addition, loan defaults are normally reduced in periods of strong growth. The valuation of finance companies can be very sensitive to economic conditions because they commonly offer relatively risky loans; thus, loan repayments are sensitive to economic conditions.

Change in the Risk-Free Interest Rates A finance company's cash flows may be inversely related to interest rate movements. If the risk-free interest rate decreases, other market rates may also decline, and as a result, there may be stronger demand for the finance company's loans. Second, finance companies rely heavily on short-term funds, and the rates paid on these funds are typically revised in accordance with other interest rate movements. Finance companies' assets (such as consumer loans) commonly have fixed rates, so interest income does not adjust to interest rate movements until those assets reach maturity. Therefore, when interest rates fall, the finance company's cost of obtaining funds declines more than the decline in the interest earned on its loans and investments. An increase in interest rates could reduce the finance company's expected cash flows because the interest paid on its sources of funds increases, while the interest earned on its existing loans and investments does not.

Change in Industry Conditions Industry conditions include regulatory constraints, technology, and competition within the industry. Some finance companies may be valued higher if state regulators give them the opportunity to generate economies of scale by expanding throughout the state. However, this would result in more competition, causing some finance companies to gain at the expense of others.

Change in Management Abilities A finance company has control over the composition of its managers and its organizational structure. Its managers attempt to make internal decisions that will capitalize on the external forces (economic growth, interest rates, regulatory constraints) that the institution cannot control. Thus, the management skills of a finance company can influence its expected cash flows. In particular, finance companies need skilled managers to analyze the creditworthiness of potential borrowers and assess how future economic conditions may affect their ability to repay their loans. Finance company managers may also capitalize on technology by advertising to consumers and accepting loan applications over the Internet.

Factors That Affect the Required Rate of Return

The required rate of return by investors who invest in a finance company can be modeled as

$$\Delta k = f(\Delta R_f, \Delta RP)$$

+ +

where ΔR_f represents a change in the risk-free interest rate, and ΔRP represents a change in the risk premium.

The risk-free interest rate is normally expected to be positively related to inflation, economic growth, and the budget deficit level, but inversely related to money supply growth (assuming it does not cause inflation). The risk premium on a finance company is inversely related to economic growth because there is less uncertainty about loan repayments when economic conditions are strong. The risk premium is also inversely related to the company's management skills, as more skillful managers may be able to focus on financial services that reduce the finance company's exposure to risk.

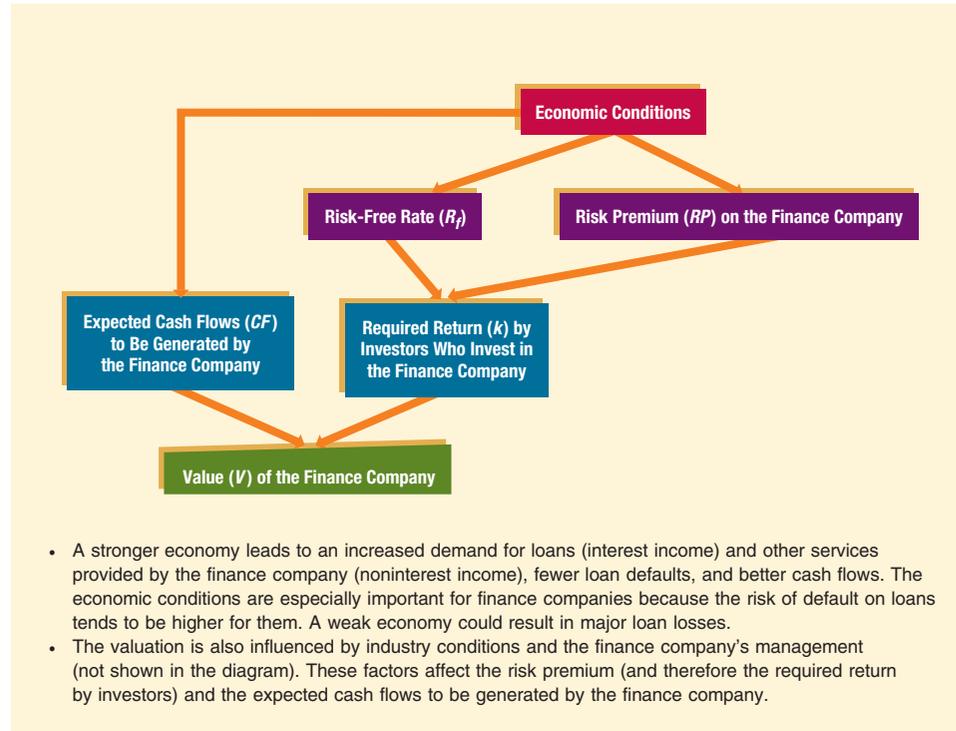
Exhibit 22.2 provides a framework for valuing a finance company, based on the preceding discussion. In general, the value of a finance company is favorably affected by strong economic growth, a reduction in interest rates, and skilled management. The sensitivity of a finance company's value to these conditions depends on its own characteristics. The higher the risk tolerance reflected in the loans provided by a finance company, the more sensitive its valuation to changes in economic growth (and therefore in the ability of borrowers to repay their loans).

INTERACTION WITH OTHER FINANCIAL INSTITUTIONS

Finance companies and their subsidiaries often interact with other financial institutions, as summarized in Exhibit 22.3. Because of their concentration in consumer lending, finance companies are more closely related to commercial banks, savings institutions, and credit unions. However, those finance companies with subsidiaries that specialize in other financial services compete with insurance companies and pension plans.

Because finance companies compete with savings institutions in providing consumer loans, they are able to increase their market share when savings institutions experience financial problems. Furthermore, some finance companies (such as Household International, Inc.) have acquired savings institutions. Before being acquired by the British-based conglomerate HSBC Holdings in 2003, Household International, Inc. acquired

Exhibit 22.2 Framework for Valuing a Finance Company



numerous branches of depository institutions across the country in an effort to diversify its services. Like many other finance companies, Household became a diversified financial services company.

Participation in Financial Markets

Finance companies utilize various financial markets to manage their operations, as summarized in Exhibit 22.4. For their core business, finance companies use financial markets mainly to obtain funds. However, the subsidiaries of finance companies often utilize financial markets to invest funds or to hedge investment portfolios against interest rate risk or market risk. They may even diversify their financial services in foreign countries. As large finance companies expand internationally, they are better able to use the international bond and commercial paper markets as a source of funds.

Exhibit 22.3 Interaction between Finance Companies and Other Financial Institutions

TYPE OF FINANCIAL INSTITUTION	INTERACTION WITH FINANCE COMPANIES
Commercial banks and savings institutions	<ul style="list-style-type: none"> • Compete with finance companies for consumer loan business (including credit cards), commercial loans, and leasing.
Credit unions	<ul style="list-style-type: none"> • Compete with finance companies for consumer loan business.
Securities firms	<ul style="list-style-type: none"> • Underwrite bonds that are issued by finance companies.
Pension funds	<ul style="list-style-type: none"> • Compete with insurance subsidiaries of finance companies that manage pension plans.
Insurance companies	<ul style="list-style-type: none"> • Compete directly with insurance subsidiaries of finance companies.

Exhibit 22.4 Participation of Finance Companies in Financial Markets

TYPE OF FINANCIAL MARKET	PARTICIPATION BY FINANCE COMPANIES
Money markets	<ul style="list-style-type: none"> • Finance companies obtain funds by issuing commercial paper.
Bond markets	<ul style="list-style-type: none"> • Finance companies issue bonds as a method of obtaining long-term funds. • Subsidiaries of finance companies commonly purchase corporate and Treasury bonds.
Mortgage markets	<ul style="list-style-type: none"> • Finance companies purchase real estate and also provide loans to real estate investors. • Subsidiaries of finance companies commonly purchase mortgages.
Stock markets	<ul style="list-style-type: none"> • Finance companies issue stock to establish a capital base. • Subsidiaries of finance companies commonly purchase stocks.
Futures markets	<ul style="list-style-type: none"> • Subsidiaries of finance companies that offer insurance-related services sometimes use futures contracts to reduce the sensitivity of their bond portfolio to interest rate movements and may also trade stock index futures to reduce the sensitivity of their stock portfolio to stock market movements.
Options markets	<ul style="list-style-type: none"> • Subsidiaries of finance companies that offer insurance-related services sometimes use options contracts to protect against temporary declines in particular stock holdings.
Swap markets	<ul style="list-style-type: none"> • Finance companies may engage in interest rate swaps to hedge their exposure to interest rate risk.

Some finance companies have recently acquired insurance companies to enter the insurance business. They have also acquired commercial banks located in various states. In addition, the larger finance companies have diversified into a variety of nonfinancial businesses as well.

MULTINATIONAL FINANCE COMPANIES



Some finance companies are large multinational corporations with subsidiaries in several countries. For example, GE Money provides consumer finance services in 55 countries and serves more than 130 million customers around the world. It provides products and services in local currencies where it does business.

SUMMARY

- The main sources of finance company funds are loans from banks, sales of commercial paper, bonds, and capital. The main uses of finance company funds are consumer loans, business loans, leasing, and real estate loans.
- Finance companies are exposed to credit risk as a result of their consumer loans, business loans, and real estate loans. They are also exposed to liquidity risk because their assets are not very marketable in the secondary market. They may also be exposed to interest rate risk.
- Finance companies are valued as the present value of their expected cash flows. Their valuation is highly dependent on economic conditions, because there are more requests for loans by qualified borrowers when economic conditions are favorable. In addition, the amount of loan defaults is normally lower when the economy is strong.
- Finance companies compete with depository institutions (such as commercial banks, savings institutions, and credit unions) that provide loans to consumers and businesses. Many finance companies have insurance subsidiaries that compete directly with other insurance subsidiaries.

POINT COUNTER-POINT

Will Finance Companies Be Replaced by Banks?

Point Yes. Commercial banks specialize in loans and can provide the services that are provided by finance companies. The two types of financial institutions will eventually merge into one.

Counter-Point No. Finance companies and commercial banks tend to target different markets for loans.

Thus, commercial banks will not replace finance companies because they do not serve the same market.

Who Is Correct? Use the Internet to learn more about this issue. Offer your own opinion on this issue.

QUESTIONS AND APPLICATIONS

- 1. Exposure to Interest Rate Risk** Is the cost of funds obtained by finance companies very sensitive to market interest rate movements? Explain.
- 2. Issuance of Commercial Paper** How are small and medium-sized finance companies able to issue commercial paper? Why do some well-known finance companies directly place their commercial paper?
- 3. Finance Company Affiliations** Explain why some finance companies are associated with automobile manufacturers. Why do some of these finance companies offer below-market rates on loans?
- 4. Uses of Funds** Describe the major uses of funds by finance companies.
- 5. Credit Card Services** Explain how finance companies benefit from offering consumers a credit card.
- 6. Leasing Services** Explain how finance companies provide financing through leasing.
- 7. Regulation of Finance Companies** Describe the kinds of regulations that are imposed on finance companies.
- 8. Liquidity Position** Explain how the liquidity position of finance companies differs from that of depository institutions such as commercial banks.
- 9. Exposure to Interest Rate Risk** Explain how the interest rate risk of finance companies differs from that of savings institutions.
- 10. Exposure to Credit Risk** Explain how the default risk of finance companies differs from that of other lending financial institutions.

Interpreting Financial News

Interpret the following comments made by Wall Street analysts and portfolio managers:

- “During a credit crunch, finance companies tend to generate a large amount of business.”
- “Some finance companies took a huge hit as a result of the last recession because they opened their wallets too wide before the recession occurred.”
- “During periods of strong economic growth, finance companies generate unusually high returns without any hint of excessive risk; but their returns are at the mercy of the economy.”

Managing in Financial Markets

Managing a Finance Company As a manager of a finance company, you are attempting to increase the spread between the rate earned on your assets and the rate paid on your liabilities.

- Assume that you expect interest rates to decline over time. Should you issue bonds or commercial paper in order to obtain funds?
- If you expect interest rates to decline, will you benefit more from providing medium-term fixed-rate loans to consumers or floating-rate loans to businesses?
- Why would you still maintain some balance between medium-term fixed-rate loans and floating-rate loans to businesses, even if you anticipate that one type of loan will be more profitable under a cycle of declining interest rates?

FLOW OF FUNDS EXERCISE

How Finance Companies Facilitate the Flow of Funds

Carson Company has sometimes relied on debt financing from Fente Finance Company. Fente has been willing to lend money even when most commercial banks were not. Fente obtains funding from issuing commercial paper and focuses mostly on channeling the funds to borrowers.

- a. Explain how finance companies are unique by comparing Fente's net interest income, noninterest income, noninterest expenses, and loan losses to those of commercial banks.
- b. Explain why Fente performs better than commercial banks in some periods.
- c. Describe the flow of funds channeled through finance companies to firms such as Carson Company. What is the original source of the money that is channeled to firms or households that borrow from finance companies?

INTERNET/EXCEL EXERCISES

1. Go to www.gmaccf.com. Describe the services offered by GMAC Commercial Finance.
2. Retrieve the annual report of American International Group (its ticker symbol is AIG), which owns a large consumer finance company, or select your own consumer finance company. To access income statement information, go to <http://finance.yahoo.com>, enter the ticker symbol, and click on "Get Quotes." Then click on "SEC Filings."

Review the consumer finance company's recent performance. Has its income as a percentage of assets increased since the year before? Explain what caused this change over the last year. How have its operating expenses changed over the last year? Discuss how the finance company's recent strategy and economic conditions may explain the changes in these components of its income statement.

WSJ EXERCISE

Finance Company Performance

Using a recent issue of *The Wall Street Journal*, summarize an article that discussed the recent performance of a particular finance company. Does the article sug-

gest that the finance company's performance was better or worse than the norm? What was the reason for the unusual level of performance?