**Solutions for End-of-Chapter Questions and Problems: Chapter Three**

1. What is the primary function of finance companies? How do finance companies differ from depository institutions?

The primary function of finance companies is to make loans to individuals and corporations. Finance companies do not accept deposits, but borrow short- and long-term debt, such as commercial paper and bonds, to finance the loans. The heavy reliance on borrowed money has caused finance companies to generally hold more equity than depository institutions for the purpose of signaling solvency to potential creditors. Finally, finance companies are less regulated than depository institutions, in part because they do not rely on deposits as a source of funds.

2. What are the three major types of finance companies? To which market segments do each of these types of companies provide service?

The three types of finance companies are (1) sales finance institutions, (2) personal credit institutions, and (3) business credit institutions. Sales finance companies specialize in making loans to customers of a particular retailer or manufacturer. An example is General Motors Acceptance Corporation. Personal credit institutions specialize in making installment loans to consumers. Business credit institutions provide specialty financing, such as equipment leasing and factoring, to corporations. Factoring involves the purchasing of accounts receivable at a discount from corporate customers and assuming the responsibility of collection.

3. What have been the major changes in the accounts receivable balances of finance companies over the 35-year period from 1977 to 2012?

The biggest change in the accounts receivable balances of finance companies over the last 35 years is that the amount of consumer and business loans has decreased from 95.1 percent of assets to 58.0 percent of assets. Real estate loans have replaced some of the consumer and business loans and are now 16.8 percent of assets.

4. What are the major types of consumer loans? Why are the rates charged by consumer finance companies typically higher than those charged by commercial banks?

Consumer loans include motor vehicle loans and leases, other consumer loans, and securitized loans, with motor vehicles loans taking the largest share. Other consumer loans include loans for mobile homes, appliances, furniture, etc. The rates charged by finance companies typically are higher than the rates charged by banks because the customers are considered to be riskier.

5. Why have home equity loans become popular? What are securitized mortgage assets?

Since the enactment of the Tax Reform Act of 1986 only loans secured by an individual’s home offer tax-deductible interest for the borrower. Thus, these loans are more popular than loans without a tax deduction, and finance companies as well as banks, credit unions, and savings institutions have been attracted to this loan market.

Securitized assets refer to those assets that have been placed in a pool and sold directly into the capital markets. In the case of mortgages, the resulting capital market asset is a mortgage-backed security which (1) reflects a small portion of the total pool value; (2) can be traded in the secondary market; and (3) generally carries considerably less default or credit risk than the original mortgage or equity line because of the effects of diversification. However, as seen during the financial crisis of 2008-2009, these mortgage-backed securities can, at times, create significant risk for financial institutions of all kinds.

6. What advantages do finance companies have over commercial banks in offering services to small business customers? What are the major subcategories of business loans? Which category is largest?

Finance companies have advantages in the following ways: (1) finance companies are not subject to regulations that restrict the types of products and services they can offer; (2) because they do not accept deposits, they do not have the extensive regulatory monitoring; (3) they are likely to have more product expertise because they generally are subsidiaries of industrial companies; (4) finance companies are more willing to take on riskier customers; and (5) finance companies typically have lower overhead than commercial banks.

The four categories of business loans are (1) retail and wholesale motor vehicle loans and leases, (2) equipment loans, (3) other business assets, and (4) securitized business assets. Equipment loans constitute almost half of the business loans.

7. What have been the primary sources of financing for finance companies?

Finance companies have relied primarily on short-term commercial paper and long-term notes and bonds. While bank credit has been a major source of funds, the use of bank credit has been declining, as finance companies have become major issuers of commercial paper, often with direct placements to mutual funds and pensions funds. Almost 60 percent of finance company funding comes from debt due to parents and debt not elsewhere classified.

8. How do finance companies make money? What risks does this process entail? How do these risks differ for a finance company versus a commercial bank?

Finance companies make a profit by borrowing money at a rate lower than the rate at which they lend. This is similar to a commercial bank, with the primary difference being the source of funds, principally deposits for a bank and money and capital market borrowing for a finance company. The principal risk in relying heavily on public debt as a source of financing involves the continued depth of the commercial paper and other debt markets. As experienced during the financial crisis of 2008-2009, economic recessions can affect these markets more severely than the effect on deposit drains in the commercial banking sector. In addition, the riskier asset customers may have a greater impact on the finance companies.

9. Compare Tables 3-1 and 2-6. Which firms have higher ratios of capital to total assets: finance companies or commercial? What does this comparison indicate about the relative strengths of these two types of firms?

Table 3-1 indicates that finance companies had a ratio of capital to total assets of 14.3 percent in 2012. Commercial banks (Table 2-6) have 11.5 percent of total capital to total assets. The difference may be partially due to the fact that the commercial banks have FDIC insured deposits. This insurance makes the debt safer from the depositors’ and stockholders’ perspective. As a result, commercial banks can take on more debt than the uninsured finance companies.

The higher amount of capital for finance companies serves as a cushion for their own solvency and as a possible signal to the market place regarding their ability to borrow funds.

10. Why do finance companies face less regulation than do commercial banks? How does this advantage translate into performance advantages? What is the major performance disadvantage?

By not accepting deposits, the need is eliminated for regulators to evaluate the potentially adverse safety and soundness effects of a finance company failure on the economy. The performance advantage involves the avoidance of dealing with the heavy regulatory burden, but the disadvantage is the loss of the use of a relatively cheaper source of deposit funds. However, because of the impact that non-bank FIs, including finance companies, had on the U.S. economy during the financial crisis and as a result of the need for the Federal Reserve to rescue several non-bank FIs, regulators proposed that non-bank FIs receive more oversight.