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Captive Finance Companies: Are They Cost Competitive?

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Financing the purchase of agricultural inputs used to be a fairly simple process without a lot of options. The implement or input was purchased from a dealer and then financed at the local bank or Farm Credit System lender. This straightforward process became much more complex as agricultural product suppliers (nontraditional lenders) began offering credit lines to farmers who purchase their products.

The increased competition for agricultural loans has brought about several positive changes for borrowers including: 1) the convenience of "one stop shopping" for virtually any size purchase, 2) interest rate competition much like what has been seen in the automobile market, and 3) increased credit availability to marginal borrowers who may not qualify for credit from traditional sources.

This market has grown from being virtually nonexistent a decade ago to an estimated \$13 billion in 1992. While the changes in the credit market have been mostly beneficial to farmers, other questions remain.

Lender Objectives

Some of these questions relate to the different objectives the two types of lenders bring to the credit relationship. A traditional lender's main goal is to provide financing. Machinery dealers, cooperatives, and input suppliers all have the primary objective of selling a product.

As nontraditional lenders, the latter can utilize the extension of credit for two different purposes. The dealer may provide credit as if it were simply an additional product to customers at a profit. Or credit may be utilized as a marketing tool which can increase sales by subsidizing the interest rate of the loan from the additional profits earned on increased sales. In addition to these primary differences, nontraditional lenders, such as captive finance companies, have a different fund source, regulatory requirements and delivery system.

The problem traditional lenders currently face is determining what types of

loans they will be competitive in providing, and how to structure their credit process to compete with nontraditional lenders. Nontraditional lenders also face the problem of identifying credit risks and imposing the strategies necessary to control them.

How individual firms can and will behave in their respective markets will depend to a significant degree on their cost advantage or disadvantage relative to the competition. The cost advantage captive finance companies and other nontraditional lenders have in extending credit will be the topic covered in this article.

Subsequent articles will examine the profitability of subsidizing the interest rate offered to borrowers through the additional sales that may result from offering credit, and the strategic implications of being a nontraditional lender.

Cost Data Sources

Cost information for captive finance companies was collected by a mail survey of nine companies who offer formal credit terms (as contrasted with dealer credit with terms such as payable within 10 days at a 3% discount, net 30). Several types of

Table 1.

Credit Expenses by Lender Category

Function	Traditional Lenders		Nontraditional Lenders			
	Time	Exp.	Less than \$50,000		Greater than \$100,000	
			Time	Exp.	Time	Exp.
Fill out or help complete loan app. ^a	.91	25.00	.23	5.39	.63	16.00
Review app. and financial stmt. ^a	1.51	42.00	.46	12.39	1.75	44.56
Monitor progress and inspect collateral ^a	1.99	55.00	1.00	14.21	4.13	72.75
Maintain and update loan file ^b	1.15	32.00	.56	10.72	1.38	26.25
Loan collection ^b	.73	20.00	.62	16.29	3.56	82.13
Credit checks and courthouse visits ^b	.74	20.00	.90	15.55	1.10	25.38
Other	—	—	.19	15.26	3.17	84.33
Support Staff Salary/Ben. ^c	7.15	143.02	—	—	—	—
Data Services Expense	—	100.12	—	38.03	—	62.33
Direct Time/Exp. for an Existing Customer ^d	14.1	\$433.12	2.90	\$108.65	15.00	\$392.14
Average loan size		\$71,513		\$29,708		\$139,059

^a Directly comparable between traditional and nontraditional lenders.

^b Not directly comparable – traditional lender data does not include staff time; nontraditional does.

^c Data represents commercial bank information only.

^d May not be total of function because not all firms provided data for all functions.

Sources: Henrickson, Bill. *An Analysis of the Competitive Position Nontraditional Lenders Hold in the Agricultural Credit Market*. Unpublished MS Thesis. Purdue University, May 1995.

Kalbus, J.H. *Credit Subsidies and Transaction Costs: A Policy Perspective for Two Agricultural Credit Programs in Ohio*. Unpublished Ph.D. Thesis. Columbus: The Ohio State University, 1994.

Ellinger, P.N. and P.J. Barry. "Agricultural Credit Delivery Costs at Commercial Banks," *Agricultural Finance Review*. (51)(1991): 64-78.

captives were surveyed — they included crop input suppliers, equipment dealers, and livestock feed dealers which serve farmers in the central Midwest.

Generally these firms are some of the largest suppliers of nontraditional credit. Each firm returned a questionnaire that documented their time and expenses for extending credit as well as the additional costs that are incurred with problem loans. An estimate of the bad debt experienced in the companies loan portfolio was also requested. This information then was compared to similar, existing information on traditional lenders obtained from studies completed at Ohio State University and the University of Illinois.

Comparison of Expenses

An interesting and unexpected result from the survey of nontraditional lenders was that the lending programs had credit extension expenses that were significantly different as a function of loan size. Five of the nine programs surveyed had an average loan size less than \$50,000, and four programs reported an average loan size greater than \$100,000.

None of the companies participating in the survey had an average loan size between \$50,000 and \$100,000; thus three groups of lenders will be compared. Traditional lenders are included in one group; nontraditional lenders with a typical loan size greater than \$100,000 are included in a second group; and nontraditional lenders with a typical loan size of less than \$50,000 are in a third group.

Table 1 summarizes the credit extension expenses by function for each of the lender categories. Both categories of nontraditional lenders exhibited less time and expense than traditional lenders for the function of filling out or helping complete the loan application. The lower costs for nontraditional lenders may result from their relationship as a product or service provider to the borrower.

With respect to reviewing the application and financial statement, captives who make smaller loans have a significant cost advantage; their time and expenses are

much lower than that of traditional lenders. Captives making larger loans use more time and report a slightly higher cost for this function than traditional lenders.

As to monitoring progress and inspecting collateral, nontraditional lenders making smaller loans use only about half the time and perform this function at a much lower cost than traditional lenders. Nontraditional lenders making larger loans use nearly twice as much time as traditional lenders to carry out this function, and thus report a higher cost. The efficiencies that nontraditional lenders were suspected to have in this area appear to be present only for those making smaller loans.

The four additional functions noted in Table 1 are assumed to involve support staff (the first three functions were assumed to be performed by loan officers only), and because time and expense of support staff was not separated by function, comparisons cannot be made on a function-by-function basis. The function of "other" was included in the survey for nontraditional lenders to capture any expenses that did not fit the identified functional categories.

The time that support staff spent per loan account was also not detailed by function in the studies of traditional lenders. The University of Illinois study reported the support staff expense to be \$143.02. For the purposes of this study, the cost per hour of support staff was estimated so a comparison of the total time each lender spends per loan account could be made. The amount of \$20.00 per hour was used as the cost of employing support staff. This figure is assumed to include total pay and benefits received by the employee.

A significant difference can be seen in Table 1 in the total time and expense for the three groups of lenders. Nontraditional lenders with an average loan size less than \$50,000 require only 21% of the time and 25% of the expense of a traditional lender to extend credit.

These results clearly indicate that nontraditional lenders extending smaller loans have a cost advantage over traditional lenders. In each of the three functions that

were compared earlier, this group of non-traditional lenders had less time and expense invested per loan account.

Nontraditional lenders with an average loan size greater than \$100,000 indicate they require 106% of the time and 91% of the expense of traditional lenders when extending credit. This group of nontraditional lenders does not have a significant advantage over commercial banks and the Farm Credit System regarding the time and expense required to extend credit.

Problem Loans

When repayment problems develop, more time is required by the lender to work out the difficulty. Information was gathered on three levels of repayment problems – delinquency, restructuring, and foreclosure. Nontraditional lenders spend 82% of the time and 66% of the expense of traditional lenders when working out delinquencies. They spend the same amount of time, but only 60% of the expense of a traditional lender when foreclosing on a borrower. Nontraditional lenders had a larger advantage when restructuring loans; they use only 60% of the time and 24% of the expense of a traditional lender.

Loan Losses

Low loan losses, by definition, is the lender's goal. But some would argue a very low loan loss figure is evidence that the lender is not being aggressive enough in their lending practices. When this is the case, some believe, a greater total profit may be earned by lending to higher risk borrowers if the additional profits from the loans are greater than the increase in loan losses.

Captive finance companies have a greater incentive to incur the additional loan losses if lending increases their sales; they receive the profit from selling the extra products and services bought with the credit, in addition to any additional profits available to a lender for increasing loan volume.

The additional profit earned by increasing sales can be great enough to offset a

loss in the lending department. This may be one of the driving forces behind product and service suppliers entering the market or increasing their current lending activity.

The survey results show that nontraditional lenders are having higher loan losses than traditional lenders; nontraditional lenders reported loan losses 435% greater than the loan losses reported in the Agricultural Finance Databook for commercial banks. Loan losses added 100 basis points to the overall lending costs of nontraditional lenders, reducing some of the advantages present because of lower credit extension costs.

Given the significant improvement in the financial position of farmers since the 1980s, nontraditional lenders may be increasing their activity during a period of relatively good financial times. Tailoring their actions to the present financial paradigm may present problems if a downturn in the agricultural economy occurs.

Currently, the additional profits earned by selling more products and services appears to more than offset the additional loan losses; in the long run this may or may not be true.

Conclusions

The data indicates that captive finance companies and other nontraditional lenders making smaller loans have significant advantages over traditional lenders in terms of credit extension expenses and costs of resolving problem loans. These cost advantages provide agricultural product and service suppliers a large incentive to offer customers credit.

The next article in this series will examine the impact nontraditional lending has on overall company profits when additional sales result from offering customers financing. The final article will summarize the strengths and weaknesses of nontraditional lenders compared to traditional lenders, and speculate on the strategic implications of these new players for the agricultural credit market.