INSTALMENT NOTE GUARANTEES BY SURETY COMPANIES

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The sale of commodities on the instalment plan has grown to enormous proportions. It is estimated that 70% or more of all automobiles sold at retail are sold on the instalment plan; and a large percentage of graphophones, washing machines, vacuum cleaners, and the like, are sold under the same plan.

These sales are made on the basis of a certain amount in cash and the balance payable in twelve or more equal monthly instalments, the deferred payments being represented by promissory notes. Banks, as a rule, do not accept notes having maturities beyond six months, so that banks have, for the most part, been unwilling to accept this class of paper directly from dealers. The result is that a large number of finance companies have been formed throughout the country for the purpose primarily of discounting or purchasing this class of paper; and in many cases the manufacturer finances the instalment sales of its product.

The margin of profit that can be made by a finance company on a single transaction is so small that if it were able to use only its own capital, it could hardly make enough money, in the aggregate, to pay operating expenses and a reasonable return on the capital invested. The finance companies, therefore, always seek to do a certain amount of refinancing, that is to say, rediscounting instalment notes which it has purchased or borrowing money, using the instalment notes as collateral. When a manufacturer undertakes to finance the instalment sales of its product, it is almost always necessary for the manufacturer to arrange rediscount facilities, as very few, if any, manufacturing companies have sufficient working capital to handle any substantial volume of instalment notes in addition to carrying on their operations.

The large finance companies like the General Motors Acceptance Corporation, Commercial Credit Company and Commercial Investment Trust Company, are able to obtain all the rediscount facilities they desire without the aid of the surety

*This paper presented by invitation of the Committee on Program.

companies; and almost all of the finance companies are able to obtain some rediscount facilities at their local banks. It is a fact, however, that most of the small or moderate-sized companies have need for, or could use, additional facilities if they were available, and while perhaps only a small percentage of the finance companies actually use surety company facilities, there is no doubt that if these facilities were available on terms that would leave the finance company a margin of profit, they would be used to a very large extent.

The question that confronts the underwriters in this connection is whether the surety companies can safely provide these facilities and, if so, on what basis.

The surety companies have been providing this service to a greater or less extent for a number of years, and it may be appropriate at this time to review the more important plans by which this service is provided—

1. Where the money is borrowed by the finance company or the manufacturer, from a bank and where the bank takes the notes of the finance company or the manufacturer secured by an equal amount of instalment notes, and the surety company furnishes a bond to the bank by which the surety company, in effect, guarantees to the bank, payment of the instalments as they mature. The surety company usually requires a margin of at least 15% in the form of certificates of deposit which represent all or a part of the compensating balance which the finance company or the manufacturer is required to maintain at the bank. This is the plan under which most of the business is handled.

2. Where the purchasers' notes are deposited with a trustee or the surety company as collateral security for the issuance by the finance company or the manufacturer of its own promissory notes which are usually known as collateral trust notes. The surety company, in that event, may either guarantee to the trustee, for the benefit of the holders of the collateral trust notes, payment of the purchasers notes which are held by the trustee or may directly guarantee payment of the collateral trust notes. In either event a margin of collateral is required and this may be in the form of an excess of purchasers notes (a ratio of 120 or 115 to 100) or it may be in the form of cash or certificates of deposit, or partly in the form of an excess of purchasers notes and partly cash or certificates of deposit.

3. Where the purchasers' notes are made payable directly to a bank and where the surety company guarantees to the bank the payment of the notes and where the bank is required to deduct from each note discounted an agreed percentage which constitutes a loss fund and out of which all losses are paid. This bond is in effect an excess policy—a guarantee that the losses in the aggregate will not exceed the specified percentage or, if they do, that the surety company will pay the excess.

It will be observed that all the plans for handling this business contemplate that the surety will have, in addition to 100% of purchasers' notes, a margin to take care of contingencies. Where the instalment notes are payable at the office of the finance company, the usual margin is 15%; and where the instalments are payable directly to the obligee bank and the bank deducts from each note discounted a certain percentage as a loss fund, the percentage deducted ranges from 3% to 5%. The average loss ratio of finance companies on automobile paper is around 1%.

It would seem that if the surety company guarantees payment of a block of instalment notes, and if it is protected not only by the endorsement of a finance company or the manufacturer, but also by a margin of collateral five or more times in excess of the normal loss ratio on that class of instalment notes, the company would be adequately protected and there would be no losses. It seems, on its face, like writing bonds with full collateral. It is a fact, however, that losses have been sustained; and in order that we may fully comprehend the risk that is assumed in guaranteeing instalment notes, it will be advisable to review these losses. There are five of them.

The first loss occurred in 1924. A certain fairly well known finance company, which was obtaining rediscount facilities at about twenty banks, was solicited by a broker to have its notes guaranteed by a surety company in order more readily to obtain rediscount facilities. The finance company consented to try it. The business was brought to a surety company which was seeking to develop this class of business. A detailed auditor's report was presented which showed receivables aggregating approximately $700,000 and liabilities of approximately $350,000. Investigation was made at fifteen or more banks and every reply was favorable. It appeared that the finance company had an excellent standing and reputation. The business was accepted and

notes were guaranteed in favor of a number of banks. In a few months the surety company was notified of defaults on the notes it had guaranteed. Within thirty days, the finance company was put in the hands of a receiver and it was found that more than 60% of its notes receivable were fictitious or valueless. The good notes were collected by the receiver and the surety company made good on all the notes that were not collected. The net loss on this guarantee stands today at approximately $60,000. It should be said, however, that the company has been reorganized and is operating, and it is probable that the greater part, if not all, of this loss will be recovered.

The next loss was brought to light in the early part of 1927, when one of the large eastern finance companies was placed in the hands of a receiver or in the hands of the surety company which had guaranteed its notes. It developed that the officers of the finance company had been permitted to sign the name of the surety company as guarantor of the notes of the finance company, that the surety company was then the guarantor on a very large volume of the notes of the finance company, and that among the notes guaranteed, were approximately $4,000,000, which were secured by liens upon taxicabs, and that these notes were not collectible and that the cabs were of comparatively small value. It is reported that the company had on its books a substantial volume of other classes of paper that could not be collected. It is reported also that the surety company had directly guaranteed the notes of the finance company and that these notes were not on a self-liquidating basis, that is to say, the finance company's notes were payable either on demand or in two, three or four months, while the underlying purchasers' notes were payable in twelve equal monthly instalments. The surety company is in charge of the affairs of the finance company and the amount of ultimate loss, if any, is not known to the public.

The next loss came to light later in the year 1927, when the finance company became embarrassed and was unable to meet its obligations. Its troubles appeared to have been due to the fact that it was handling a fairly large volume of notes of purchasers of a certain truck, the manufacturer of which went into the hands of the receiver. It appears that the managers of this finance company were not at all careful in the selection of the individual risks and, as a matter of fact, they accepted a large

number of transactions that had been rejected by another finance company which was expert in the handling of truck paper. The defaults on this truck paper, together with other defaults—due mainly to poor selection of risks—made it impossible for the finance company to meet its obligations to banks; and inasmuch as these obligations had been guaranteed by the surety company, it was necessary for the surety company to make good. It is understood that this case is now being worked out and that the amount of ultimate loss is as yet undetermined. It is understood that the surety company is on notes aggregating several hundred thousand dollars.

The fourth loss has only recently come to light. In that case the surety company guaranteed to banks instalment notes of purchasers of taximeters, these guarantees having been furnished at the request of the manufacturer or seller of the taximeters. This account had been taken three or four years before when only a few thousand dollars of notes were involved. The account had grown until the surety company had outstanding approximately $175,000 of guaranteed notes when, out of the clear sky, the surety company was notified of default. It then developed that the manufacturer, having a good deal of pride in its apparent success, had started on a program of expansion, which resulted in tying up in plant such a large portion of its working capital that it was unable to meet its immediate obligations. The surety company then undertook to collect from the purchasers of the taximeters the instalments as they became due. Many of the purchasers refused to make payment; and it developed that it would cost the surety company an expense of $22 to repossess a taximeter and that, inasmuch as the owner of the taxicab could obtain a new meter upon the payment of $15, he, as a rule, let the taximeter be repossessed. It appears that the manufacturer of the taximeters had not been using the legal process of repossessing the meters, but had been resorting to rather high-handed methods, which, however, were successful, so that they saved the cost of repossession. The surety company, naturally, cannot pursue such high-handed methods, but must pursue the legal, but more expensive, way. The outcome of this case is at this time uncertain, and the amount of loss can hardly be estimated.

The fifth and last loss is understood to be quite large and may reach several hundred thousand dollars. In this case, a certain

company was manufacturing or selling vacuum cleaners and was discounting its instalment notes with a large finance company. The finance company, without the knowledge of the manufacturer, applied to the surety company for an "ultimate loss" bond. The bond was approved and the form was carefully prepared by an attorney for the company. It has developed that subsequently, and without the knowledge of the officers or underwriters of the surety company, there was attached to the bond, an endorsement which in effect made the bond a direct guarantee to the finance company of all the notes discounted for the manufacturer; and the worst of it was that the endorsement did not require notice of default and did not contain other usual restrictive provisions. When the surety company received the first notice of trouble, it was advised that the finance company held some $325,000 of notes which were in default or where the machine had been repossessed. It developed also that the manufacturer had been very careless in the examination of the individual credit risks, it appearing that the man who was in charge of sales and received a commission on all sales made was also in charge of the credits and permitted practically all transactions to pass. It is believed that the percentage of defaults will be very large and the aggregate loss will be very substantial.

What lessons can be drawn from these losses?

The first lesson is that there is a vast difference between the actual and the theoretical risk on business of this class. Theoretically, companies should be able to handle this business without any loss whatever, inasmuch as they seem to be fully protected by collateral; yet as a matter of fact, when the five trouble cases have fully developed, the loss ratio on this class of business will probably be much higher than the average loss ratio on surety business, and if the losses are as large as it is feared they may be, the aggregate losses may be much in excess of the aggregate premiums.

The second lesson is that, inasmuch as these losses appear to be due, in large part, to the failure of representatives of the companies adequately to supervise the details, it is necessary for the companies, if they hope successfully to write this class of business, to put the handling of it in charge of high-grade men and require them to check every detail in connection with the handling of the business and give them the facilities for so doing.

The third lesson is that the price to be paid for carelessness in the handling of the details of the business may be very great, inasmuch as it seems to be necessary, as a practical matter, to take a fairly large line for a single institution, so that when something goes wrong, the loss is quite substantial.

It would seem to be appropriate at this time, having in view the experience of the companies and the expressed views of the leading underwriters, to suggest the broad underwriting policies which it is believed the companies should follow if they are to handle this class of business.

1. There are many reasons for the conclusion that the companies should adhere strictly to the policy of handling this class of business only for finance companies engaged exclusively in this line. The handling of it for dealers or manufacturers involves several risks which are not involved when handling it for a finance company, namely,

> a. A dealer or manufacturer may become involved from causes which have nothing to do with the loss ratio on its instalment notes, as, for example, by unwarranted plant expansion at an inopportune time, or bad business judgment in other respects.
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> b. If a manufacturer does become involved financially, and the output of his product ceases, there is always an increased difficulty in the collection of instalment notes secured by the commodity put out by that manufacturer.
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> c. If a surety company once begins to guarantee instalment notes for a manufacturer, it may be difficult for the company to withdraw, inasmuch as the withdrawal of the service—unless replaced by the service of some other company—would very likely cause embarrassment on the part of the manufacturer, and probably a receivership.

2. There is considerable doubt as to the wisdom of guaranteeing notes representing deferred payment on a product in connection with which the percentage of defaults is unusually large, as, for example, taximeters, vacuum cleaners, household furniture, and the like, particularly if the product is of comparatively small value and the cost of collecting the instalment or repossessing the article is relatively large. If one or more of these classes constitute only a small part of the business of a finance company whose other lines are satisfactory, there may be no objection, but if it constitutes the sole business of the manufacturer or finance

company which makes the application for the guarantee, the desirability of the account seems open to serious question.

When we come to consider guaranteeing automobile paper for finance companies, it is believed that the following underwriting principles should be applied—

1. That only notes of the ultimate purchaser at retail should be guaranteed, all dealers' notes being eliminated. If dealers' notes are to be considered, they should be treated as a separate class and should be underwritten on a different basis.

2. That notes representing the deferred payments on taxicabs should not be considered, as this is manifestly a substandard class of paper on which the percentage of defaults is very large.

3. That notes representing the deferred payments on trucks (except the so-called light or delivery trucks) should be considered as a separate class, and this class of business should not be accepted from the ordinary finance company. Farmer & Ochs Company have handled a large volume of this business and have used the guarantee of the surety companies, but they have specialized in this line, having in all cases the endorsement of the manufacturer; and the average finance company is not able to obtain this business on that basis.

4. That notes representing the deferred payments should be guaranteed only if the cash payment represents not less than 33⅓% of the time selling price on new cars and 40% of the time selling price on used cars, and if the balance is to be paid in not more than twelve equal monthly instalments.

5. That a finance company should not be permitted to borrow in the aggregate more than four times its net paid in capital and surplus; and this ratio of 4 to 1 should be permitted only to take care of what is known as the "peak load" during the late spring or early summer months. A well conducted finance company can make a good margin of profit even if limited to a ratio of 3 to 1; and in practice the better managed companies do not exceed this ratio.

6. That if collateral trust notes are to be guaranteed, they should be issued on a strictly self-liquidating basis so that the maturities of the collateral trust notes correspond with the maturities of the instalments of the underlying purchasers' notes. It is customary to list the purchasers' notes on a schedule so as to show the aggregate instalments maturing during each calendar

month and then issue collateral trust notes to mature at the end of each month, each note being for an amount not in excess of the aggregate instalments for the corresponding month. If the collateral trust notes are being issued in a ratio of 100 to 115 or 120 of purchasers' notes, this ratio should be maintained with regard to each of the monthly notes.

It is not particularly difficult to lay down and follow sound underwriting principles like those above suggested. Assuming this to be done, it seems to me that the real problem which confronts the underwriters is to make sure—

1. That all the notes which the company guarantees, as well as all the other notes in the portfolio of the finance company, are genuine notes, each note being actually made by the person whose name appears on the note, as the maker, and that the sale has been made in good faith and the car described in the papers actually delivered to the maker of the note; in other words, that each transaction is in all respects what it purports to be; and

2. That each purchaser has been suitably investigated and is in fact a reasonably good credit risk and able, except under some abnormal condition, to make the monthly payments required.

If these two features are adequately covered and if the other underwriting principles above suggested are applied, and if the details are carefully handled so as to avoid serious "accidents," it is believed that the automobile note guarantee business for finance companies can be handled without any loss whatever. In order to check the two items above mentioned, as well as to cover adequately the necessary underwriting features, it is deemed essential that the finance company be required to present the report of a detailed audit by an audit company or a firm of certified public accountants, who are not only reliable but who are experienced in this particular class of auditing. The audit should embrace not only the making up of the complete balance sheet with appropriate schedules, but should include a check of a sufficient percentage (say 10% to 20%) of the original papers covering individual transactions to satisfy the accountants and the surety company that the transactions checked are representative of the entire volume of business on the finance company's books. The original papers should be investigated to determine—

1. The percentage of cases in which an inquiry was sent by the finance company to the original purchaser to verify the genuineness of the transaction and the percentage of cases in which a reply was received.

2. The percentage of cases in which suitable investigation was made of the purchaser and the percentage of poor credit risks.

3. The percentage of used cars as compared with new cars, and ordinarily this percent should not exceed 30%.

4. The percentage of trucks as compared with passenger cars and the type of trucks, if any.

5. The percentage of defaults, the percentage of repossessions, the percentage of repossessed cars on hand and the loss on the sale of repossessed cars and the actual loss ratio of the finance company on business handled during the past year or two.

It is suggested also that a surety company handling this business for finance companies should not only require an auditor's report at least annually, and possibly semi-annually, but should also, at least once a year, send its own representative to the office of the finance company for the purpose of making a check of the papers in connection with a substantial percentage of the original transactions of the finance company for the purpose of making the verifications above suggested. It is believed that a check by an outside public accountant once a year, together with a check once a year by a salaried employee of the surety company, would be sufficient to detect any signs of falsity in the assets of the finance company; and if all the notes are genuine and are actually what they purport to be, there is, in my opinion, little, if any, chance of loss on this class of business, assuming the standard underwriting conditions are applied.

In this connection it should be noted that if the purchasers' notes are made payable at the obligee bank instead of at the office of the finance company, an automatic check of the genuineness of the notes is provided, for if the purchaser himself pays the first instalment, the possibility of the note being fictitious is practically eliminated. This also eliminates the chance of loss through the failure of the finance company to turn over to the bank collections actually made.

It seems to me that the two risks which are thus eliminated, constitute the real hazard on these instalment note guarantees.

When these two risks are eliminated, the risk is boiled down to losses through failure of purchasers to make the instalment payments, which of course would be reduced by such amount as might be realized from the sale of repossessed machines.

It is not difficult to obtain a sufficient margin of collateral to cover this loss, even under very adverse business conditions, and it is suggested that the surety companies make a concerted effort to obtain the business on this basis.

So much for the guaranteeing of purchasers' notes or the notes of a finance company secured by purchasers' notes.

During the past few years, there has developed a plan by which purchasers' notes guaranteed by a surety company are deposited with a trust company as collateral security for the issuance of a series of collateral trust notes, which, in turn, are guaranteed by one or more surety companies. The collateral trust notes thus guaranteed are being distributed by one of the leading commercial paper houses and many million dollars of them have been distributed, and the present market for them is said to be very good. This plan was originated by Farmer & Ochs Company, and under this plan, they have successfully handled a large volume of truck paper.

Inasmuch as the guaranteed collateral trust notes which are sold to investors are secured by an equal amount of purchasers' notes which are guaranteed by a surety company, it is apparent that the guarantors on the collateral trust notes are assuming practically no risk beyond that of the continued solvency of the guarantor of the underlying notes. The rate for this top guarantee is correspondingly low.

During the past year, two companies have been formed here in New York for the purpose of providing rediscount facilities for finance companies. Neither of these companies has made much progress, but it seems likely that within a short time there will be developed a satisfactory plan under which the surety company can, by virtue of this double guarantee, aid in providing rediscount facilities for finance companies. This is important because it is not always easy for a finance company to find a market for its notes even after they have been guaranteed by a surety company, while the market for the notes secured by the double guarantee is excellent.

Inasmuch as this plan contemplates the payment of a premium for the guarantee of the underlying notes, as well as the premium for the guarantee of the trust notes, the plan is at the present time rather expensive, but it is probable that this difficulty will in due course be overcome.

My own view, therefore, is that the surety companies can successfully operate in this field of guaranteeing instalment notes and that if they are conservative and careful, they can make some money.