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Commercial Bank Consumer Loan Refinancings
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Commercial Bank Consumer Loan Refinancings

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Synopsis:

Major competitors of commercial banks frequently refinance consumer loans before maturity. They may do so either to maintain an ongoing credit relationship with a customer or to alleviate payment problems for customers experiencing credit difficulties.

From a legal standpoint, creditors who engage in refinancings often are subject to laws regulating calculations of interest rebates on prepaid obligations. In addition, occasionally, as in Maine, refinanced balances may be subject to different finance rate ceilings, etc., depending on the length of time unpaid balances are left outstanding. However, practically nothing is known about the extent to which commercial banks engage in consumer loan refinancings and whether, in fact, they need be much concerned about such laws.

Little is known, also, about the types of loans banks are most likely to refinance and of their motives for doing so (to maintain bank-customer relationships or to reduce customer payment difficulties).

This paper analyzes data on over 30,000 consumer loans made from 1965-71 in five regions of the country by banks that participated in a Federal Reserve survey of bank consumer lending practices. By analyzing the frequency with which consumer loans were paid off by refinancing and the reasons for the refinancing it provides several useful insights into bank behavior.

In particular, this analysis suggests that banks refinance only a small and declining portion of their total consumer loans. They do not appear to use refinancings as a way to maintain ongoing customer relationships; however, they refinance loans more frequently to allow customers to make new expenditures than to meet payment problems. Nonetheless, refinancings to meet payment difficulties rose consistently during the 1969-70 recession.

Data computed in this study suggests that riskier types of loans were not more likely to be refinanced than better quality types of loans however, individual bad loans were more likely to be refinanced than individual good loans. Finally, over time, possibly because of the growth of revolving credit, loans were less likely to be refinanced to allow bank customers to make new expenditures.

I. Introduction

A consumer loan "refinancing" occurs when a loan is paid off before maturity with proceeds obtained from the consumer's acquisition of another, related, loan from the same lender. Refinancings may occur either in response to customers' payment difficulties--as a means by which the scheduled maturity date can be extended or the average size of payment can be reduced--or as a means by which customers can obtain new funds to enable them to make new expenditures.

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Refinancings of consumer loans are very prevalent among banks' major competitors in the consumer loan markets. Analysis of prospectus data ([4], footnote 1) suggests that over 60 percent of the loans made by major personal finance companies are made to renew existing loan balances. In addition, monthly reports prepared by the National Credit Union Administration from data supplied by major federal credit unions, indicate that over one third of reported credit union new loan extensions are to refinance loan balances [3].

Yet little or nothing is known about the extent to which consumer loan refinancings are used by commercial banks. Some interesting questions that could be asked are: (1) Do commercial banks also use refinancings extensively? If not, is it because they shun riskier customers that might more frequently need to refinance loans as a result of payment difficulties or is it because they prefer to grant multiple extensions of credit on revolving, rather than conventional, installment credit lines? To the extent that banks engage extensively in refinancing existing debts, unless they use simple interest computations they must be vitally interested in legislation, such as a restriction on the use of the "rule of '78," that affects interest rebate calculations for loans repaid (or refinanced) prior to maturity.¹ (2) Do commercial banks that engage in consumer loan refinancings do so largely to allow consumers to avoid payment difficulties, or do they do so largely to accommodate customer demands for additional credit? (3) Are there types of consumer loans that banks are particularly likely to refinance? Such might be the case with riskier classes of loans, since a high proportion of such loans might otherwise need to be charged-off. Such might also be the case with classes of loans, such as small "other-consumer goods loans," which personal finance companies often acquire in order to attract consumers at the stage of their life cycle when they need to borrow frequently. For instance, Federal Reserve data suggest that the typical "other consumer goods loan (excluding mobile home loans)," made by finance companies is repaid so quickly (probably through refinancing) that the average implied maturity of such loans is less than nine months.² To the extent that banks also use furniture and appliance and small "other consumer goods" loans to attract new customers, one might expect a relatively high rate of refinancing to occur on such credit. (4) Do bank policies on refinancings appear to change over time? Changes in aggregate credit availability, the level of unemployment or in the availability of revolving credit options might all affect bank willingness and need to refinance existing loans.

The purpose of this study is to try to answer the preceding questions: The data used to answer these questions were obtained from an extensive Federal Reserve System study of the bank consumer installment lending practices conducted between 1965 and 1971. More than 20 commercial banks in five distinct regions of the country participated in that study.

II. The Nature of the Study

The cooperating banks in the Federal Reserve study randomly sampled and provided data on over 30,000 paid-off loans between 1965 and 1971. At the time a loan was paid off, the bank officer categorized it as either a "good" or a "bad" loan.³ He also reported whether it was paid off by refinancing and, if so, whether the purpose of the refinancing was to enable the borrower to "meet payment difficulties" or to "aid new expenditures." Since

¹ See, for instance, Bonker [2] and Stelson and Snyder [5].

² This statistic was calculated from August and September, 1975, data (when separate data for finance company other consumer goods (OCG) credit were still reported by the Federal Reserve Board). It was computed by, first, eliminating mobile home credit from the "other consumer goods" category and then calculating the ratio of seasonally adjusted finance company OCG credit repayments in September to finance company OCG credit outstanding in August. That ratio, called the "repayment ratio," was 20.7 percent. If implied maturities are estimated at twice the reciprocal of the repayment ratio minus one (see [1]), these data imply that finance company credit extended on non-mobile home "other consumer goods" is paid off on average, in approximately nine months.

³ For purposes of this study, the small proportion of loans that were classified as neither "good" nor "bad" were included with the bad loans, as the purposes given for refinancing such loans appeared to correspond more closely to the reasons given for refinancing "bad" rather than "good" loans.

the loans were classified both by purpose and security, it was possible to obtain a detailed picture of what types of bank loans were most likely to be refinanced and why.

Detailed totals are available for each type of loan for two separate periods with roughly equal numbers of loans: 1965 through early 1970 when economic conditions were generally good (Table 1), and mid-1970 to mid-1971 when the economy experienced the worst part of a severe recession (Table 2). In each table, Column 1 presents data on the percentage of loans of each type that were repaid. The percentage of "good" loans that were repaid is also noted in order to identify the poorer quality classes of loans. In the margin, letters indicate where subtotal classifications were tallied for each of five traditionally measured classes of consumer loans: automobile loans; small "other-consumer-good" loans; large "other-consumer-good" loans (plane, boat, and mobile home loans).-, home improvement loans; and personal loans. In addition, a separate breakout is given for "business" loans made by consumer installment loan departments, and, at the end of the table, a grand total is given for the period under consideration.

For each type of loan, Columns (2), and (3) show the number of loans refinanced to "meet payment difficulties," and to "aid new expenditures," while Column (4) shows the total number of loans refinanced. To provide analytical insights, Column (5) shows the proportion of each type of loan (segregated by "good" and "bad" loans) that were refinanced to "aid new expenditures" rather than to meet payment difficulties, and Column (6) shows the percentage of loans of each type that were refinanced. Finally, in Table 2 only, Column (7) shows how the percentage of loans refinanced (Column 6) changed from the 1966-early 1970 period to the mid-1970 -through mid-1971 period.

III. Analysis

Subject to the proviso that all conclusions must be qualified by noting that they apply with certainty only to the banks that participated in the study and that changes that occurred in the respondent bank sample over time may have affected the "over-time" comparisons, analysis of the data presented in the tables suggests that the following conclusions are warranted: (1) Commercial banks apparently do not use refinancing frequently. Refinancing was involved in only 4.68 percent of all loans paid off from 1965 to early 1970 and only 1.89 percent of all loans paid off from the mid-1970 to 1971.

(2) Banks are more likely to refinance loans to enable customers to make new expenditures than to allow them to meet payment difficulties. In the initial period, which was characterized by relatively good economic times, 88 percent of all refinancings were to aid new expenditures. In the later period, when times were worse and unemployment was high, 65 percent of all refinancings were to aid new expenditures, and 35 percent were to enable customers to meet payment difficulties.

(3) The types of loans more likely than average to be refinanced in both periods included personal loans (particularly debt consolidation, vacation, and other or unclassified loans) and business loans made by installment loan departments.

(4) There was no evidence that loans for small other consumer goods were used by banks, as they are by finance companies, to attract new loan business. In both periods, these loans were less likely to be refinanced than was the case for installment loans in general.

(5) In the aggregate, "bad" loans of all types were more likely to be refinanced than "good" loans in both periods.

(6) It was not consistently true that loans that belonged to loan categories characterized by a higher proportion of "good" loans were less likely than other loans to be refinanced. The "debt consolidation" loan category was, as might be expected, characterized by a lower-than-average proportion of "good" loans and by a higher-than-average ratio of refinancings in both periods. However, the vacation loan category, which was

among the loan categories with the highest proportion of "good" loans, was also among the loan categories with the highest proportion of refinancings. Thus, no general statement can be made that riskier types of loans are uniformly more likely to be refinanced than less risky types of loans, even though it can be said that "bad" loans are more likely to be refinanced than "good" loans.

(7) Between the earlier and later periods of the study, bank willingness to refinance loans apparently diminished substantially, as money became tight, economic conditions deteriorated and bank revolving credit became more readily available. While the overall percentage of "bad" loans refinanced rose from the earlier to the later period, as banks evidently tried to ease customer payment burdens during the recession by refinancing bad loans more frequently, this trend was more than offset by a sharp cutback in the number of loans refinanced to fund new expenditures. Therefore, since more refinancings were made to "aid new expenditures," total bank loan refinancings fell sharply between periods.

IV. Summary

Analysis of extensive data on bank loan refinancings for the 1965-71 period suggests that commercial banks are far less likely than their major competitors to refinance consumer, loans. Further, no evidence was found that banks use refinancing of particular types of new loans as a way to gain new consumer loan business. However, the data did suggest that most bank consumer loan refinancings are to allow their customers to finance new expenditures rather than to meet payment difficulties.

Over the period of the study, either because of greater loan officer caution during recessionary times or because of the growing availability of revolving credit, the proportion of bank loans refinanced to facilitate new expenditures fell sharply. However, probably because of high unemployment in the later stages of the recession, the proportion of "bad" loans refinanced rose over time. Overall, the increase in refinancing of "bad" loans was not sufficient to offset loan officer's apparent increased reluctance to refinance loans in general , so total refinancings declined over time even though unemployment rose during the period studied.

Table 1 : Refinancings by Type of Loan--mid 1965 - early 1970

Type	Total Paid-Off Loans			Refinancings			(5) % of Refn. To aid new exp.	(6) Total refin. As % of total loans ⁶
	Rating	Percent Good ⁵	#	(1) To "meet Payment problems"	(2) To "aid" new expends	(3) Total Refin.		
New Auto	Good	94.3	3,671	3	84	87	96.6	2.37
	Bad or? ⁷		221	2	3	5	60.0	2.26
	Total		3,892	5	87	92	94.6	2.36
Used Auto	Good	90.9	2,574	12	107	119	89.9	4.62
	Bad or ?		259	8	9	17	52.9	6.56
	Total	90.0	2,833	20	116	136	85.3	4.80

⁵ Total paid-off loans include all loans made to males or females that installment loan officers reported as "paid-off" during the period indicated. The "percent good" column indicates the percentage of those loans that loan officers classed as "good" loans.

⁶ Column 6 indicates the percentage of total loans that were paid off by refinancing.

⁷ The "Bad or ?" category largely includes paid-off loans classed as bad loans by loan officers. The ? category, which was very small , was also included here as loan officers failed to classify such loans as either good or bad and their (meet payment problem vs. aid new expenditure) refinancings composition tended to be more like bad" than "good" loans.

“?” ⁸ Auto	Good		380	0	13	13	100	3.42
	Bad or ?		42	0	0	0	0	0
	Total		422	0	13	13	100	3.08
A. Total Auto	Good	92.7	6,625	15	204	219	93.2	3.31
	Bad or ?		522	10	12	22	54.5	4.21
	Total		7,147	25	216	241	89.6	3.37
Furn & Appliance	Good	91.6	1 083	2	41	43	95.3	3.97
	Bad or ?		99	2	0	2	0	2.02
	Total		1,182	4	41	45	91.1	3.81
Radio, TV, Hifi	Good	91.5	248	1	10	11	90.9	4.44
	Bad or ?		23	1	1	2	50.0	8.70
	Total		271	2	11	13	84.6	4.79
B. Total small consumer	Good	91.6	1,331	3	51	54	94.4	4.06
	Bad or ?		122	3	1	4	25.0	3.28
	Total		1,453	6	52	58	89.7	3.99
C. Plane, boat, mobile home	Good	92.2	378	0	9	9	100	2.38
	Bad or ?		32	2	1	3	33.3	9.34
	Total		410	2	10	12	83.3	2.93
D. Home improvement	Good	92.7	1,890	2	55	57	96.5	3.02
	Bad or ?		148	2	2	4	50.0	2.70
	Total		2,038	4	57	61	93.4	2.99
Medical dental, funeral	Good	91.0	282	3	23	26	88.5	9.22
	Bad or ?		28	3	0	3	0	10.71
	Total		310	6	23	29	79.3	9.35
Debt consolidation	Good	90.8	1,143	20	107	127	84.3	11.11
	Bad or ?		116	5	9	14	64.3	12.07
	Total		1 259	25	116	141	82.3	11.20
Education	Good	92.3	156	0	0	0	0	0
	Bad or ?		13	0	0	0	0	0
	Total		169	0	0	0	0	0
Vacation	Good	94.6	298	1	12	13	92.3	4.36
	Bad or ?		17	1	2	3	66.7	17.65
	Total		315	2	14	16	87.5	5.08
Tax Payments	Good	95.4	186	0	16	16	100	8.60
	Bad or ?		9	0	0	0	0	0
	Total		195	0	16	16	100	8.21
Other	Good	92.2	1,973	11	104	115	90.4	5.83
	Bad or ?		168	8	5	13	38.5	7.74
	Total		2,141	19	109	128	85.2	5.98
Unclassified ⁹	Good	88.6	279	0	30	30	100	10.75
	Bad or ?		36	1	2	3	66.7	8.33
	Total		315	1	32	33	97.0	10.48
E.Total "Personal" ¹⁰	Good	91.8	4,317	35	292	327	89.3	7.57
	Bad or ?		387	18	18	36	50.0	9.30
	Total		4,704	53	310	363	85.4	7.72
F."Business"	Good	89.9	143	0	8	8	100	5.59
	Bad or ?		16	0	1	1	100	6.25
	Total		159	0	9	9	100	5.66
G-Grand Total	Good	92.3	14,684	55	619	674	91.8	4.59
	Bad or ?		1,227	35	35	70	50.0	5.70
	Total		15,912	90	654	744	87.9	4.68

⁸ Security for "?" Auto loans was either not ascertained or was not solely either a "new" or a "used" auto

⁹ No loan purpose was specified for these loans

¹⁰ These "all other consumer loan" categories are commonly called "personal loans."

Table 2: Refinancings by Type of Loan--mid- 1970 to mid-1971

Type	Rating	Total Paid-Off Loans			Refinancings				
		Percent Good ⁵	#	(1)	(2)	(3)	(4)	(5)	(6)
				To "meet Payment problems"	To "aid" new expends	Total Refin.	% of Refn. To aid new exp.	Total refin. As % of total loans ⁶	Change in Col. (6) from 1965-early 1970
New Auto	Good	93.9	3828	2	23	25	92.0	0.65	-1.72
	Bad or? ⁷		250	4	2	6	33.3	2.40	+1.14
	Total		4078	6	25	31	80.6	0.76	-1.60
Used Auto	Good	91.2	2508	6	31	3	83.8	1.48	-3.14
	Bad or ?		242	2	8	10	80.0	4.13	-2.43
	Total		2750	8	39	47	83.0	1.71	-3.09
"?" ⁸ Auto	Good	89.3	342	0	9	9	83.8	2.63	-.79
	Bad or ?		41	2	1	3	33.3	7.32	+7.32
	Total		383	2	10	12	83.3	3.13	+0.05
A. Total Auto	Good	92.6	6678	8	63	71	88.7	1.06	-2.25
	Bad or ?		533	8	11	19	57.9	3.56	-.65
	Total		7211	16	74	90	82.2	1.25	-2.12
Furn & Appliance	Good	94.3	607	0	9	9	100	1.48	-1.83
	Bad or ?		37	2	1	3	33.3	8.11	+6.09
	Total		644	2	10	12	83.3	1.86	-1.95
Radio, TV. Hifi	Good	92.2	658	0	3	3	100	0.46	-3.98
	Bad or ?		56	0	0	0	0	0	-8.70
	Total		714	0	3	3	100	0.42	-4.39
B. Total small consumer	Good	93.2	1265	0	12	12	100	0.95	-3.11
	Bad or ?		93	2	1	3	33.3	3.23	-.05
	Total		1358	2	13	15	86.7	1.10	-2.89
C. Plane, boat, mobile home	Good	92.2	658	0	1	1	100	0.15	-2.23
	Bad or ?		56	0	0	0	0	0	-9.34
	Total		714	0	1	1	100	0.14	-2.79
D. Home improvement	Good	90.9	1541	5	14	19	73.7	1.23	-1.79
	Bad or ?		154	12	2	14	14.3	9.09	+6.39
	Total		1695	17	16	33	48.5	1.95	-1.04
Medical dental, funeral	Good	92.2	214	1	0	1	0	0.47	-8.75
	Bad or ?		18	1	1	2	50	11.11	+4.0
	Total		232	2	1	3	33.3	1.29	-8.06
Debt consolidation	Good	90.6	762	14	18	32	56.3	4.20	-6.91
	Bad or ?		79	12	3	15	20.0	18.99	+6.92
	Total		841	26	21	47	44.7	5.59	-5.61
Education	Good	95.7	111	0	8	8	100	7.27	+7.27
	Bad or ?		5	1	0	1	0	20.0	+20.0
	Total		116	1	8	9	88.9	7.76	+7.76
Vacation	Good	95.7	270	1	7	8	87.5	2.96	-1.40
	Bad or ?		12	2	0	2	0	16.67	-.98
	Total		282	3	7	10	70.	3.55	-1.53
Tax Payments	Good	92.9	183	1	2	3	66.7	1.64	-6.96
	Bad or ?		14	0	0	.0	--	0	0

	Total		197	1	2	3	66.7	1.52	-6.69
Other	Good	92.5	1955	16	32	48	66.7	2.46	-3.37
	Bad or ?		158	13	4	17	23.5	10.76	+3.02
	Total		2113	29	36	65	55.4	3.08	-2.90
Unclassified ⁹	Good	92.1	220	0	3	3	100	1.36	-9.39
	Bad or ?		19	2	2	4	50	21.05	+12.72
	Total		239	2	5	7	71.4	2.93	-7.55
E.Total "Personal" ¹⁰	Good	92.4	3715	33	70	103	68.0	2.77	-4.80
	Bad or ?		305	31	10	41	24.4	13.44	+4.14
	Total		4020	64	80	144	55.6	3.58	-4.14
F."Business"	Good	91.9	158	0	3	3	100	1.90	-3.69
	Bad or ?		14	1	0	1	0	7.14	+89
	Total		172	1	3	4	75.0	2.33	-3.33
G-Grand Total	Good	92.4	14015	46	163	209	78.0	1.49	-3.10
	Bad or ?		1155	54	24	78	30.8	6.75	+1.05
	Total		15170	100	187	287	65.2	1.89	-2.89

Note: All footnotes are the same as those in Table 1.

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