CHAPTER III

GENERAL POLICIES AND PRACTICES OF FINANCE COMPANIES IN MALAYA

In this Chapter, the general policies and practices of the three types of finance companies will be discussed.

A. Hire purchase finance companies

Hire purchase finance companies in Malaya deal mainly in consumer durable goods like motor-cars, refrigerators, television-sets and so on. For our purpose, only car financing is taken as an illustrative example.

The Form of hire purchasing financing

Generally, in Malaya, hire purchase of cars takes the following form. A prospective customer wishing to purchase a car, but who cannot afford to pay cash for it approaches a finance company for a loan. Alternatively, he may be recommended by the car dealer to a certain finance company. When the terms of the transaction have been agreed upon by both the finance company and the customer; the finance company will buy the car from the car dealer and hire it out to the customer. The ownership of the vehicle rests with the finance company, which only hires out the car to the 'hirer' (i.e. the customer). The hirer will use the car and continues to pay the finance company the regular rentals. The hirer remains only as a hirer of the vehicle; though it is registered in his name. He only becomes the legal owner of the car, after the last payment is made together with the 'option to purchase' fee.

The agency feature in hire purchase financing

Finance companies dealing in cars, usually do not deal direct with the customer. The customer seeking financial assistance is required to complete the hire purchase agreement form, which is supplied by the agent, i.e. the car-dealer company. When all the particulars in the agreement form are completed, the agreement form is sent to the finance company to be approved.

The reasons why finance companies in Malaya operate through such agents are:

Firstly, the agents are required by the finance companies to stand as guarantors to all sums payable to them. For example, if a hirer fails to pay up the remaining rentals, the vehicle will be repossessed and the agent must buy the vehicle from the finance company for such a sum as shall be equal to the total amount of all the remaining rentals and other moneys which the hirer would have had to pay if the hiring had continued until the hire purchase price had been paid in full. This type of hire purchase financing, when a third party is held responsible for full payment of all debts due to the financing company is called financing through a 'recourse plan'

Secondly, by having agents, the finance company would not have to maintain additional staff to complete the various documents involved in the initial stages of the transaction, (e.g. the hire purchase agreement forms, insurance documents, etc.).

Thirdly, the agents have to be responsible for collecting the monthly rentals from the hirers. And on the prescribed dates of each month, the agents have to remit to the finance company concerned, the amount of rentals due from the hirers. The agents have to remit the amounts due, whether or not the hirers are punctual or default in their payments.

For performing these functions the agent receives a 3% commission (calculated on the amount borrowed by the hirer from the finance company). In addition, the agent may forfeit the 5% prompt payment rebate, which is allowed by the finance company to the hirer if he is not prompt in his payment.

<u>Policies influencing the amount of loan, the rate of hiring charge and the period of repayment.</u>

The three factors, the amount of loan that can be granted, the hiring charge rate and the period allowed for repayment of a loan are important considerations in hire purchase financing. The policies affecting these three factors are discussed below.

a) <u>Amount of loan or deposit determination</u>. It is a policy of finance companies not to advance the full price of the vehicle. The remaining portion of the price, has to be paid either in cash and or in the form of a 'trade-in', by the person wishing to borrow from the finance company. This amount is known as the deposit, or the down payment for the goods.

The principle of requiring the customer to pay the deposit is explained by these arguments:-

i) The customer should have a substantial stake in the goods, in order that he will make considerable efforts to pay all his rentals. He is much less likely to risk losing what he has paid for (in the form of the deposit) than if his stake is little or nil.

ii) The goods should stand in the finance company's books at an amount which would permit it to sell without loss in the event of repossession. Therefore, the deposit is so determined (as well as the instalments) that the amount of rental received at any date exceeds the probable depreciation of the good.

The actual amount of deposits required by finance companies are seldom fixed. Some finince companies are willing to lend up to 80% of the Total Cash Price of the vehicle. The usual amount averages two-thirds of the cash price for most finance companies in Malaya. This figure of two-thirds is taken as the guide to deposit-payment as the deposit of the remaining one-third to be paid by the hirer is assumed to be an adequate amount of equity interest of the hirer, that will make him think twice if he decides to terminate his Agreement before maturity.

However, the actual amount of deposit determined, to any customer is wholly the outcome of negotiations between hirer and dealer, and several other factors which are:

i) The credit-standing of the customer, or popularly known amongst finance circles as the "3 C's" i.e. Character, Collateral and Capacity of the customer. For example, essential questions like, "Who is the customer", "What occupation" and "type of security offered", will be asked by the finance company.

ii) Type and year of make (i.e. the model) of the goods. For cars, used-cars usually demand a higher deposit and compared to other cars, used Japanese makes are not favoured. For used-cars, more than three years old, a one-third deposit is usually required and for a car more than six years, a 5[illegible] deposit is usual. This policy is consistent with the principle of requiring the borrower to have an appropriate equity interest in the article he wants to buy. A car depreciates at a decreasing rate (with highest depreciation-rate after the first year).

A popular make, Austin 7 "850" Saloon priced at $4,690/-[1] loses 34% in its first year and 8%, 13%, 15%, 9%, for the second, third, fourth, fifth years consecutively. Compare these figures with the depreciation rates of an expensive Jaguar E-type Fixed Head Coup'e which costs $17,845 new. It depreciates 49% in its first year and only 9% in the second year.

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[1] Figures are based on the "New & Used-Vehicles Price-Guide", published by Malayan Industrial Finance Corporation Ltd."

Therefore, we see that when buying used-cars, the amount advanced by a motor finance company depends primarily on the model and type. A sports car usually has poor used-value while used Japanese cars (even the popular Toyota series), are subject to negotiation on application of loan, and most finance companies do not usually finance used Japanese cars as a matter of policy, because of the heavy depreciation rate and hence resale price (in case of repossession) is very low. This is important because as one company claims, "The value of the car is the greatest protection for the company ..."[2]. Take for example the Nissan Cedric "1900" which costs $8,450 when new, depreciates by 45% during its first year and is not normally accepted for financing if it is more than two years old. This is true for most Japanese makes including Toyota, Datsun, Isuzu, the British Rover and Humber and the Swedish Saab, which are not popular makes and used ones are not favoured by finance companies. The Volkswagon has remained by far one of the most popular makes in Malaya and most finance companies do not mind if deposits of hirers are less than the normal stipulated percentage. For example it depreciates very constantly after its first year's rate of 23% (one of the lowest in the market) and 9%, 9.5%, 10.0%, 11.7% consecutively in the second, third, fourth, fifth year.

We could summarise by saying that finance companies' policies on maximum amount of loan (alternatively the minimum amount of deposits) depends on the popularity of the make or model. This in turn takes into account factors like fuel-consumption, resale-value and such considerations.

Only in very special cases down-payment is not required, e.g., a government servant who could produce a 'guarantee-note' from his head.

b) Rate of Hiring Charge. The hire charge is very commonly referred to as the interest charged, which is technically wrong. Firstly, the customer does not actually borrow money from the finance company. What he does is really hiring the goods from the owner (finance company) and is paying monthly rentals for the use of the goods. It is only by virtue of the payment of the 'option to purchase fee' that he buys the goods and ultimately becomes the legal owner. The customer is actually renting the goods. He does not borrow a lump sum of money from the finance company, hence he pays no 'interest' - as interest is the 'payment for the use of money', the definition as used by Keynes.

Secondly, even if we assume that a finance company 'advances' credit to the customer, by purchasing outright from the dealer, the goods concerned and allows the customer the privilege of 'hire-purchasing'

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[2] As quoted by Eu Tong Sen Finance (M) Ltd.

it by equal instalments, the so-called interest rate consists of other elements apart from 'payment for the use of money'.

The proper term to be used is 'hire charge' and this includes:[3]

i) Initial cost of negotiating the hire-purchase agreement.

ii) Interest cost as determined by ruling market rate (the finance company invariably has to borrow money or pay interests on deposits to be used as its operating-funds).

iii) Administration, and collection expenses, which may continue for anything up to thirty-six months.

iv) Provision for 'bad debts' in defaulting cases.

In view of the various elements which constitute the 'hire charge' it is not surprising then, it tends to be comparatively higher than 'interest rates' of say, commercial banks, which charge 9% per annum (in 1965).

Hiring-Charge as 'flat rate': Another point to note is the method of calculating of hire charge. Finance companies in Malaya and Singapore (for that matter Malaysia) use the 'flat-rate' basis for charging customers. Flat-rate as opposed to the reducing-balance rate (as used in bank-overdrafts) is assessed on the amount to be financed on the agreement, at the beginning of the hire-period, i.e. assessed on the original amount financed, and therefore is not affected by what the hirer has repaid or reduced the outstanding balance of of the amount financed. Compared to the 'true or reducing balance rate, it is slightly less than twice the rate. (E.g. 10% flat is equivalent to 18.4% actual on a 12-month hire purchase agreement).

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[3] N.W. Birdsey, "Hire purchase", one of the articles in "Radio Talks", Series 4, published by Lembaga Gerakan Pelajaran Dewasa, S'pore., 1965, p. 56.

Hence, the usual hiring charge of 13% less 3% would become 26% less 6% and 39% less 9% in a 2-year and 3-year agreements respectively. Therefore, a hirer involved in a 3-year agreement and loses his prompt payment rebate has to pay nearly 40% hiring charge in addition to the amount financed. As the hiring-period increases, the true hiring charge rate increases as well. Thus a 10% flat rate rises to 19.49% over an instalment period of thirty-six months.[4]

Hire Charge rates in Malaya. As mentioned hire charge rates in Malaya for motor vehicles tend to be uniform. For new motor-cars the rate is 13% per annum less 3% for prompt payment rebate.[5] The 3% prompt payment rebate is only allowed if the hirer is prompt or punctual in all his payment of rentals. A week's grace is allowed after a payment date is due. If the hirer fails to pay up after the period of grace, he is liable to forfeit his 3% rebate. However, this is not the rule strictly adhered to by finance companies. The rebate is usually forfeited only when the hirer is a 'persistent-late' payer. The rebate, if allowed, is payable after the last rental payment, calculated on the amount financed. A 3% rebate on a $4,000/- loan for 1 year comes to $120. Sometimes, the rebate is in the form of a deduction from the last payment due.

Some finance companies, notably foreign-owned ones[6] charge lower hiring rates. It ranges from 6% to 12% 'flat'. However, conditions are more stringent and suspected bad risks are not entertained. A case was cited of such a company charging only, 10% flat, instead of the normal '13% less 3%', in Penang.

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[4]N.W. Birdsey, Ibid. p. 56
This can be worked out by using formula,

$\frac{R \times 24}{N+1} = P$, where P = True per annum rate
R = 'flat-rate'
N = Number of instalments.

$$\frac{30 \times 24}{36+1} = \frac{720}{37} = \underline{19.49\%}$$

[5]Or 16.25% less 3.75% (15 months), 19.5% less 4.5% (18 months), 26% less 6% (24 months).

[6]Credit Corporation (M) Ltd. is an example, wholly owned and controlled by Chartered Bank, Australian Guarantee Corporation and Sharikat Permodalan Kebangsaan Ltd.

<u>Rates charged for Used Cars:</u> The normal rate charged is 16% 'flat' per annum less 3 3/4% for prompt payment rebate.[7] Rates are higher because a used car has depreciated in value and a 'third-hand' car is not very favourable in the used car market, hence resale in case of repossession is quite difficult. The service life of a used car is moreover shortened and therefore the hiring charge must be so calculated that the amount paid at any given time will exceed the depreciation. A certain company in Kuala Lumpur however, charge the same rate for old or new cars i.e. the normal charge of 13% less 3%. However, to strengthen the security in this case, the maximum period of hire is shorter for used than new cars.

We could summarise by saying that the actual rates charged for new and used cars are uniform throughout the country with only slight variations. The important factors influencing the hiring charge rates are the make and model, as well as the age of the vehicle.

c) <u>Period of Repayment</u>. Periods of repayment allowed vary from company to company slightly. Some may adopt a more stringent policy of a maximum of twnty-four months, while others allow a hirer thirty-six months to pay up.

Normally, shorter repayment periods are allowed for used cars. A typical example would be twenty-four months for cars which are more than three years old and only twelve months when they are between three to six years old. As a matter of interest, finance companies offering credit-facilities for commercial vehicles and consumer durables including motor-scooters allow shorter periods of repayment. This is logical enough, because on the one hand commercial vehicles are considered a greater risk and depreciates faster and on the other, household appliances ... and motor scooters since they cost much less than a car, repayment periods need not be long as say thirty-six months. The security-nature of these

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[7] 19.5% less 4.5% (15 months)

goods to the finance company is such that the company deems them unfavourable because of the limited market for such used-goods, in cases of repossession. Another point to note is that since these goods do not cost very much relative to cars, hence if repayment period is stretched longer still, the flat hiring charge rate would be extremely inflated, in proportion of its price.

Usual periods of repayment for cars are twelve months, fifteen months, eighteen months, and twenty-four months. Obviously from a finance company's viewpoint, the shorter the period, the better it would be because it would mean:

i) A faster turnover for them, thereby permitting them to have more cash to do a greater volume of business.

ii) It represents a security-factor for the company assuming everything is the same, a hirer A, who has to repay within twelve months, and B, who is allowed thirty-six months to pay the same amount; at the end of say ten months, A's equity or interest in the goods would be more than B. Hence, A, is less likely to give up payment for fear of losing his greater equity in the goods.

iii) For the hirer he will pay less hire charges for the total hiring-period if the period is shorter than longer, as the difference between twelve months and twenty-four months, would mean paying 13% or 26% hire charges.

<u>Factors affecting period of repayment</u>:
These factors are:

i) How much the hirer can afford to pay monthly. If his budget is tight, negotiations may lead to a longer period. However, this is usually the starting point for a potential bad credit-risk. Over ambitious 'selling' usually results in bad debts.

ii) The age of the vehicle. The older the vehicle, the shorter is the period allowed. This is following the principle of keeping the current value of the vehicle over and above the outstanding debts. (in case of resale). This difference is termed the "safety margin"[8] which serves as the guidepost for finance companies to formulate its terms of business vis. the amount advanced, the hiring charge and the period of hire.

iii) Other factors include the type of car, where unpopular makes or models are not usually allowed generous terms.

Some General Considerations for approval of Application for Hire Purchase Financing[9]

The terms of hire, any finance company decides upon mainly, depend on the "3 Cs " of financing - Character, Capacity and Collateral of the hirer. We shall discuss this aspect first, before we proceed to other important variables like Deposits, Credit-Checks, Recourse etc., which all determine whether application is approved or not, the terms of hire and help to formulate broad operational policies of the company.

Character. Important considerations are:

- Period of residence.
- Period with present and past employer.
- The type of occupation.
- Married/single.
- Does he have a bank account and the amount?

It is believed, if he has stayed for ten years or more in the present residence, and has consistently been with the same employer, then it denotes stability. Married men are considered more stable than unmarried ones. Does he come from a bad "credit-area", where the public is known to be bad credit-risks? The type of job which spells stability and offers security is a Government post, perhaps in one of the ministries. Every finance company favours such jobs, and such customers.

Capacity. The capacity is the hirers ability to meet the proposed payment. This depends on several factors:

- His type of occupation.
- His salary and wages.
- Is he a stable customer?
- Any previous experience with him?

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[8] N.W. Birdsey, op. cit., p. 58.

[9] The writer is indebted to Mr. Shrives of Credit Corporation Malaysia for his personal treatment of this discussion.

Finance companies as a policy-procedure usually confirm that the hirer's monthly income after deducting expenses leaves an amount sufficient to cover the monthly instalments. It is due to over ambitious 'selling' of business that result in assuming too bad-risks and ending up with bad debts, and repossessions.

Collateral: This is the security the finance company possesses. Principally it would be the vehicle involved. To be more exact, it can be defined as the equity the buyer has in the goods being acquired. To the finance company it enjoys 'double security' - firstly in the goods, which is repossessed if the hirer defaults and secondly because of the equity the buyer has in the goods, he is not likely, normally, to default, thus losing it when the company repossesses it. This will ensure that the hire purchase agreement would be carried through till maturity. Secondly, in usual cases, where an 'agent' introduces the hire-purchase transaction to the finance company, the latter requires the agent to be the guarantor who undertakes to answer for the debt, default, or miscarriage of the hirer.

As the car, provides the principal collateral, other considerations are:

a) New Cars: The finance company must make it a point to check if there is any variation from the accepted list-price. The list-price may fluctuate according to 'extras' etc. which are not always shown in the agreement.

It must also ensure that the vehicle is carefully described in the Agreement viz., the engine number, the chassis number, registration number etc.

There were reported cases in Singapore of taxi-owners who replace old engines in a new body.

They purposely default in payment, and allow the finance to repossess it. But before this, they replace the new body with an old one and the finance company would be left with an old engine plus an old body:

b) Deposits: Character and capacity are of vital importance, because although we may set a minimum deposit of say 20%, in actual fact the true deposit is invariably less than this amount because of overtrading on deposit.

Trade-ins may be overvalued due to:

- Dealer discounting new cars because of overstocking.

- Dealer is a poor trader.

- There is factory liquidation where the dealer receives an increased discount.

Used cars provide a company with the greatest loss factor, but also a high earning rate. However, they represent a great scope for misrepresentation particularly the "loading" of deals.

Eg.	(A)	(B)
List price	$600	$495
Trade in $150) Cash $75)	225	125
Amount financed	$375	$375

In (A) and (B), the residues of $375 are the same, but (B) actually represents the true transaction. The deposit is $125 to $495 (list price) giving a ratio of one-quarter. In (A) obviously, the trade-in component of the deposit has been inflated and so is the list price, giving a favourable figure of deposit: list price ratio of > one-third.

The list price is usually a guide, and the only important variable is the deposit, especially the valuation of the traded-in vehicle and close investigation of it is necessary to prevent an overvaluation of it.

An adequate description of used cars is very important, more important than for new ones, as the price is usually a guide on new cars.

Price variation of up to $300 can exist in the same model and remembering that an average loss of $220 for car repossessed a correct description can mean the difference between a loss or break-even in the event of repossession.

c) **Credit Checks:**

i) The best and most reliable is the finance company's previous experience.

ii) The previous experience of another finance company who had done business with the customer.

iii) The banker's opinion, if customer has got a bank account.

iv) Referees.

If trade reference is required from another finance company, questions should be asked on:

- Date of commencement of contract.
- Total amount of the contract.
- The number of payments paid up to date of enquiry and the manner in which they were paid.

In the case of banker's opinion, direct and specific questions are advisable as they call forth direct and relevant replies. (Eg. If agreement calls for thirty-six payments of $100/- each, ask the bank's opinion as whether the customer is 'good' for thirty-six payments of $100/- each, thus forcing the bank for a direct answer).

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In the case of referees, reassure them of the confidential nature of enquiry and that his opinion would be treated accordingly. Positive questions should be asked on, e.g.

- The length of trading, he had with the hirer.
- How much would the hirer pay each month.
- Does he consider the hirer to be in a position to pay.

d) General Information: Some general information on the customer are essential to rate him; such as
- His occupation (certain types are poor-credit

risks e.g. itinerant professions, cooks, showmen, odd-job man ...etc.)

e) On Recourse: Recourse plans are very advisable in Malaya where hire-purchase has not reached a desired level of sophistication yet. However, it is dependent on the dealer being able to stand up to his liability. In essence, under a 'recourse plan', the dealer guarantees the transaction. If hirer fails to pay up, we can call upon dealer to pay, regardless of whether the goods are repossessed or not. Often, dealer undertakes the repurchase of the possessed vehicle. If it cannot be located, the dealer will still finalise.

f) On Outside Guarantees: This should be the exception rather than the rule. Although the outside guarantor may be happy signing it, and it is usual to resort to legal action, when hirer defaults and it proves difficult to get them to pay.

g) On Minors (under 21 years of age): Minors legally cannot be held responsible for their actions. Hence, a finance company should make it, as a policy not to enter into agreement to do business, except when there is an acceptable adult as a joint-signature. A guarantee is useless, because if the original contract is not enforced, the guarantee likewise is not enforced also.

g) Miscellaneous: Irregular documents, should be returned promptly but it is important that all errors have been noted and that the company is goint to accept the deal.

The Acceptance Officer in the company is the company's contact with the dealer and by demonstrating his knowledge of values of trading, he can earn respect and confidence.

Following is a brief discussion of industrial finance companies and house finance companies, especially on their terms of financing. These two types of finance companies will be discussed in greater details in Chapter V.

B. Industrial Finance Companies

There are relatively fewer finance companies dealing in industrial financing than in hire purchase for cars. In many cases, financing industrial assets forms only a small part of the total business of a finance company. This is because, at present the business in car financing is very much greater than in industrial financing.

Form of Industrial Financing

Unlike hire purchase financing of cars, where most of the business is done through agents; finance companies financing industrial assets prefer direct financing. This means, a customer intending to buy industrial assets on an instalment basis approaches such a finance company direct to negotiate the terms of the loan. In cases when the deal is introduced by an agent, the transaction is invariably through a recourse plan. This is because of the greater risks involved in industrial financing. There is a less ready-market for repossessed industrial assets and also the act of repossession is more difficult in view of the fixity of the asset, which requires a lengthy legal process in order to repossess it.

In view of the greater risks involved in industrial financing, finance companies reckon that they could assess applications better themselves than by relying on agents' recommendations.

Terms of Financing

The hiring rates charged on hire-purchase financing are usually not fixed, as compared to cars. The exact rates charged will depend on factors like, the location of intended usage, the age of the asset and such risk-factors. Rates vary from a minimum of 7% to 12% flat.

Regarding the repayment periods, the average maximum period allowed is usually shorter, about twenty-four months, as compared to thirty months allowed for cars. This is again due to the greater risks involved in industrial financing.

The minimum deposits required would vary from a minimum of 20% of the cash price of the asset, to anything above 50%. Again, it depends on the risks involved and the nature of the negotiations between the finance company and the customer.

In industrial financing the terms of financing tend to be 'stiffer' as compared to those for the hire-purchase of cars and also the exact terms levied depend to an extent upon the outcome of the negotiations between finance company and the customer.

C. House Finance Companies

House financing is carried out by various institutions like the building societies, housing-development companies and some of the big finance companies.

Form of Financing

The form of financing done is direct mostly. The prospective buyer in seeking a loan for the purchase of a house approaches the finance company where the terms of the loan are agreed upon.

The form of the loan requires a deposit, and the usual repayment over a number of months.

Terms of Financing

The rates of interest charged for loans vary from 7½% to 10% usually. The rate is calculated on a yearly-rest basis i.e. it is calculated on the outstanding balance of the loan at the end of each year.

Repayment periods necessarily are longer than hire purchase of cars, as the price per unit is very much higher. Periods vary from five years to twenty years. This depends on the amount which a customer is willing to pay per instalment and the amount he has already paid in the form of deposits.

The deposits required vary from as low as 10% of the appraised value or the cost of the house to 50%. It is a practice that lower-price houses require lower deposits than higher-price units. It is due to the fact that those buying expensive houses should have a greater equity in them, to prevent defaults and in cases of repossession and resale, the finance company would not be as worse off if the deposit-payment had been less.