

GOVERNMENT FINANCING OF PRIVATE ENTERPRISE

By

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PREFACE

THIS study is an attempt to fit together and analyze the various aspects of a problem which has been the subject of controversy in banking, business, and Congressional circles for many years. It was undertaken originally as a doctoral thesis for the Graduate Council of The George Washington University, and the advice and assistance of faculty members, as well as permission of the University for publication in this revised form, are gratefully acknowledged. Special acknowledgment is due Dr. Gerhard Colm for his valuable suggestions and criticisms and for his general guidance. I wish also to thank the numerous individuals in government departments, Federal Reserve banks, the Reconstruction Finance Corporation, and private banks, who have contributed generously with their experience and advice. The opinions expressed and recommendations made are, of course, solely my personal responsibility.

DOUGLAS R. FULLER

CHICAGO, ILLINOIS
September 1948

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Chapter I

STATEMENT OF THE PROBLEM

• PROPOSALS have come from many sources in recent years that public participation in the financing of private business, especially small business, be adopted by the federal government as a normal tool of fiscal policy. The purposes are stimulation of competition, promotion of economic expansion, and the maintenance of full employment. Since 1933, in fact, more than one hundred bills have been introduced in Congress to provide for general financial assistance to business by the government. Nearly all recent plans for economic development which provide for aid to small business or for some spur to private enterprise have included public or quasi-public financial assistance.¹ Among the types of such assistance most frequently stressed are direct loans to business organizations by existing agencies such as the Reconstruction Finance Corporation or the Federal Reserve banks, guaranties or insurance by such agencies

¹ Among typical proposals, note the following publications.

Bernard M. Baruch and John M. Hancock, *Report on War and Post-war Adjustment Policies* (Washington, D.C.: Government Printing Office, February 15, 1944), pp. 25-26.

Ernest G. Draper, "Supplying the Credit Needs of Business in the Transition and Early Postwar Period," *Federal Reserve Bulletin*, XXXI (May 1945), 419-22.

Malcolm P. McNair, "The Full Employment Problem," *Harvard Business Review*, XXIV (Autumn 1945), 13, 21.

United States Department of Commerce, "Report of Small Business Advisory Committee to the Secretary of Commerce" (Washington, D.C.: press release dated May 15, 1945), p. 18.

United States Congress, Senate, Special Committee to Study Problems of American Small Business, *Future of Independent Business*, Senate Committee Print No. 16, 79th Cong., 2d sess. (Washington, D.C.: Government Printing Office, 1947), pp. 84-85.

Committee for Economic Development, "Meeting the Special Problems of Small Business" (Washington, D.C.: press release dated June 12, 1947), pp. 40-44.

of loans granted to businesses by private lenders, and the creation of new, specialized public financial institutions designed to provide risk capital as well as long-term loans.

Even many of those who do not concede the wisdom of intervention by the government in this field have urged the establishment of new private financial institutions to perform similar functions. Significant examples are the co-operative bank-credit pools sponsored by the American Bankers Association² and the local investment companies proposed by the Investment Bankers Association of America.³

Why are these proposals put forward? What are the alleged gaps in our private financial system which they propose to fill? How serious may these gaps be? Which specific type of proposed action promises to fill them most satisfactorily? What degree of success is the action likely to have if adopted? In view of this prospect, is its adoption desirable? These and related questions are the subject of the present study. In order to limit the study to manageable proportions, the term "business" will be employed to refer only to manufacturing industry and domestic trade, thereby excluding consideration of government financing of farming, of housing, of export trade, and of shipping, the railroads, and other public utilities, except to cite pertinent techniques employed, and the general pattern of experience gained, in these fields. Actually, as we proceed, we shall find our field of inquiry narrowing further to concentration upon the financial problems of small business.

It is fortunate that the questions propounded here need not be dealt with solely upon a theoretical basis. Unlike so many problems in the field of economic or fiscal policy, where new ideas cannot normally be subjected to test upon a significant scale before adoption, some aspects of the present subject can be exam-

² American Bankers Association, *Progress Report, Post-War Small Business Credit Commission* (New York: American Bankers Association, March 1945).

³ Investment Bankers Association of America, *Capital for Small Business* (Chicago: Investment Bankers Association of America, April 5, 1945).

ined in the light of actual experience in government financing of private business in this country. This experience has been accumulated under the conditions of the depression years of the 1930's and the war years of the 1940's, but the diverse successes and failures afford a useful foundation for judgment on the principal problems involved, the relative merits of the various techniques of operation which are available, the hazards to be avoided, and the possible benefits to be gained.

Before proceeding to the examination and appraisal of experience, however, it will be helpful to sketch in the necessary theoretical background, and outline the general reasoning which has been most commonly advanced in support of proposals for government financial assistance to private enterprise.

Chapter II

THEORETICAL BASIS FOR GOVERNMENT FINANCIAL ASSISTANCE

• THE POINTS advanced in favor of providing financial assistance to private business as a normal public function are various, reflecting the viewpoints of their individual proponents. Some, it is true, represent little more than the ancient complaint of borrowers against lenders. Others probably reflect a latent desire to see key economic functions concentrated in the hands of the government. The substantial body of reasoning, however, is an attempt to remedy certain alleged gaps or deficiencies in the private financial mechanism which are said to render it incapable of fully meeting the present-day needs of business, and especially the needs of small enterprises.

APPREHENSION THAT FUNDAMENTAL ECONOMIC FORCES HAVE WEAKENED

Underlying these proposals, along with other current suggestions for the extension of government economic activities, there appears to be a general apprehension concerning the ability of our economic mechanism to function satisfactorily without active intervention by the federal government. Experience in the depression years fostered the widespread feeling that fundamental, dynamic forces of expansion in private enterprise have weakened in recent decades to such an extent that governmental action is now necessary to stimulate or to supplement them. Two factors

in this weakening of the forces of expansion have received special stress: namely, the increasing maturity of our economy, and the growth of monopoly.

Increasing economic maturity has been evidenced by a slackening rate in population growth, the disappearance of geographical and industrial frontiers, and the achievement of a high degree of industrialization, all of which tend to limit the opportunities for profitable employment of capital in expansion or mechanization of business, and thus restrain net new investment. Such restriction of opportunities for new investment, with the high rate of savings accumulation which has been characteristic of our economy, has a deflationary effect upon economic activity and may create unemployment.¹ However, at the present stage of development, actual saturation of the demand for capital is probably of less importance as a deflationary influence than are certain other aspects of maturity.² One such aspect is the growth of large, monopolistic enterprises. Another, of particular importance to our present discussion, is the changing institutional character of capital supply. Although savings are large in total, we find them increasingly concentrated in the hands of institutions searching for maximum safety and liquidity, and unable or unwilling to channel them into riskier fields where they may be needed to finance expansion.

The growth in our economy of large areas of monopoly and monopolistic competition has frequently been cited as a major factor in weakening the forces of expansion. It has supposedly led to the restriction of both new investment and current output,

¹ See Alvin H. Hansen, *Fiscal Policy and Business Cycles* (New York: W. W. Norton & Co., 1941), chaps. xvi-xvii. Also J. M. Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace & Co., 1936), pp. 307-9; and Alan Sweezy, "Secular Stagnation," *Post-War Economic Problems*, ed. by Seymour Harris (New York: McGraw-Hill Book Co., 1943), pp. 67-82.

² See the analysis of economic maturity by Willford I. King in "Are We Suffering from Economic Maturity?" *The Journal of Political Economy*, XLVII (October 1939), 609 ff., and the reply by Gerhard Colm, *ibid.*, XLVIII (February 1940), 114 ff.

and to excessive prices, thus restraining expansion of the economy as a whole. By increasing profits, monopoly, in theory, increases savings at the same time that it restricts the outlet for them.³ The continuing increase in the size of individual business enterprises also makes it more and more difficult for new and small businesses to compete effectively, and restrains the important, dynamic force which has, in the past, been represented by the establishment and growth of innumerable new and small enterprises. Small business has rightly been characterized as the seed-bed of our economic system, a vital place of incubation of new products, new technologies, and new entrepreneurial talent.⁴

The problems facing small businesses, as a consequence of these adverse influences, have often been examined from a social and political instead of an economic point of view. On grounds of equity and of social policy, action by the government has been urged to equalize the competitive positions of small and large businesses, to provide the small man with a fair opportunity, and to develop, through multiplication of small entrepreneurs, the desirable social qualities of self-reliance, initiative, and leader-

³ Alvin H. Hansen, *op. cit.*, pp. 363-64, and in "Stability and Expansion," *Financing American Prosperity*, ed. by Paul T. Homan and Fritz Machlup (New York: The Twentieth Century Fund, 1945), p. 218, n. 23.

⁴ United States Congress, Senate, Special Committee to Study Problems of American Small Business, *Senate Small Business Committee—Its Record and Outlook*, Sen. Report 47, 79th Cong., 1st sess. (Washington, D.C.: Government Printing Office, 1945), pp. 1-5. What constitutes "small business" cannot be precisely defined, for the reason that the size and nature of operations vary so greatly between industries. The Temporary National Economic Committee, in its study of small business, employed the term arbitrarily to mean all business units having less than \$250,000 in assets. Other studies have employed various standards, including number of wage earners and volume of sales. A distinction is often made between manufacturing, where an enterprise employing less than one hundred people may be said to be small, and trade, where a typical small retail store may have possibly three or four employees. However, whatever definition is used, it is generally agreed that an overwhelming proportion—at least 90 percent—of total business units, both in trade and manufacture, falls in the small-business category. See the discussion and statistics in Ernest J. Hopkins, "Long-term Needs of Small Business," in *Private Capital Requirements* (Washington, D.C.: Board of Governors of the Federal Reserve System, September 1946), pp. 40-53.

ship as widely as possible.⁵ It is even declared that "the health of small-scale enterprise—the opportunity for every American to establish his own business, and the maintenance of economic conditions which will permit such businesses to grow and prosper—is essential to the preservation of our free society."⁶ Support for various types of subsidization of small business on grounds of its contribution to social and political well-being has become an increasingly strong factor in legislation, and the subsidization of financing is no exception. Thus, in discussion of the purely economic aspects of such financial assistance, the importance of its other aspects should not be forgotten.

We may question the heavy emphasis which many economists have placed upon the adverse implications of trends toward maturity and monopoly. The growth of wartime and postwar industrial and scientific developments has considerably diminished the specter of maturity (in the sense of saturation of demand for capital), which we now realize was a rationalization of depression-born fears.⁷ Likewise, not only is the existence of a pronounced trend toward monopoly questioned by some students,⁸ but others minimize its adverse effects.⁹ However, there can be no gainsaying the fact that weaknesses have existed in the general

⁵ See United States Congress, Senate, Temporary National Economic Committee, Monograph No. 17, *Problems of Small Business* (Washington, D.C.: Government Printing Office, 1941), p. 257. Also Theodore N. Beckman, "Large Versus Small Business after the War," *The American Economic Review*, XXXIV, Supplement (March 1944), 104-6.

⁶ Investment Bankers Association, *Capital for Small Business* (previously cited), p. 7.

⁷ See Richard Bissell, "Postwar Private Investing and Public Spending," *Post-War Economic Problems*, ed. by Seymour Harris (New York: McGraw-Hill Book Co., 1943), pp. 83-110, and Sherwood M. Fine, *Public Spending and Postwar Economic Policy* (New York: Columbia University Press, 1944), chap. iv.

⁸ Donald H. Wallace, "Industrial Markets and Public Policy: Some Major Problems," *Public Policy*, ed. by C. J. Friedrich and E. S. Mason (Cambridge: Harvard University Press, 1940), pp. 73-74.

⁹ A. A. Berle, Jr., *Memorandum to the Temporary National Economic Committee* (Washington, D.C.: The Kiplinger Washington Agency, 1938), pp. 4-6, and J. M. Clark, "Toward a Concept of Workable Competition," *The American Economic Review*, XXX (June 1940), 241-56.

areas described. Over a long period, monopolistic developments have threatened small enterprises, and, whether or not as a consequence of maturity, the over-all growth of our economy suffered a disastrous setback, accompanied by a shriveling up of new investment, in the decade before World War II.

WEAKENING OF FORCES OF ECONOMIC EXPANSION AGGRAVATED BY FINANCIAL GAPS

These unsatisfactory economic developments were the product of many different forces. No one pretends that insufficient availability of financing is the sole factor; few consider it to be even one of the more important. Nevertheless, it is reasoned that both weaknesses have been aggravated by gaps existing in our financial machinery. Numerous economists have claimed that we have no adequate institutions to furnish business with certain types of credit and capital, and that, for other types, the cost is excessive.¹⁰ The machinery is held to be particularly inadequate to meet the needs of small business. In his annual message to Congress on January 14, 1946, President Truman summarized and endorsed this point of view when he declared, "Many gaps exist in the private financial mechanism, especially in the provision of long-term funds for small- and medium-sized enterprises."¹¹

¹⁰ A. A. Berle, Jr., testimony in United States Congress, Senate, *Investigation of Concentration of Economic Power*, Hearings before Temporary National Economic Committee, United States Senate, 76th Cong., 1st sess., pursuant to S. Res. No. 113 (75th Cong.) May 16-26, 1939 (Washington, D.C.: Government Printing Office, 1940), Part IX, pp. 3810-24.

Lincoln and Therese Filene Foundation, *A Memorandum on Semi-Fixed and Permanent Capital for Small Business* (Boston: Lincoln and Therese Filene Foundation, December 1939).

Woodlief Thomas, "The Banks and Idle Money," *Federal Reserve Bulletin*, XXVI (March 1940), 194.

Donald Wilhelm, Jr., "How Small Business Competes for Funds," and Walter C. Louchheim, Jr., "The Problem of Long Term and Equity Capital," *Law and Contemporary Problems*, XI (Summer-Autumn, 1945), 220-47, 248-73, respectively.

¹¹ *The Budget of the United States Government for the Fiscal Year Ending June 30, 1947* (Washington, D.C.: Government Printing Office, 1946), p. xxxiv.

NEED FOR FINANCIAL ASSISTANCE TO SMALL BUSINESS

The basic problems posed by the adverse economic influences we have noted are two: how to stimulate new investment and activate the forces of economic expansion, and how to reduce monopoly and promote free competition. A direct and obvious point of attack upon both problems is encouragement of small business, or, in other words, strengthening the ability of existing small units to compete and to expand, and assisting in the formation of new units. It is at this point of attack that agitation for governmental financial assistance to private business is presently concentrated.¹² Use of government credit is proposed to fill any significant gaps in the financial mechanism which may operate to deny capital or credit to worthy small businesses. Financing is not only to be made more readily available to small business, but is to be offered on a cost basis more nearly comparable to that enjoyed by big business. Such strengthening of the competitive position of small enterprises, by equalizing the availability and the cost of financing, is urged upon social and political as well as economic grounds. Economically, however, it has attraction both as a means of curbing monopoly and as a means of stimulating new investment.

STIMULATION OF ECONOMIC EXPANSION IN GENERAL

At the same time, broader proposals are advanced for the stimulation of general economic expansion by making credit and capital for all business enterprises, large and small, more readily available and cheaper, especially for new or risky ventures.¹³

¹² See, for example, Rudolph L. Weissman, *Small Business and Venture Capital* (New York: Harper & Brothers, 1945).

¹³ A. A. Berle, Jr., "A Banking System for Capital and Credit," in United States Congress, Senate, *Investigation of Concentration of Economic Power*, *op. cit.*, Part IX, pp. 4066-79. See also J. Franklin Ebersole, "Government Can Help Banks Make More Jobs," *Harvard Business Review*, XXII (Winter 1944), 167-77.

What is envisaged in these proposals is a frontal attack upon the problem of lagging new investment in the face of heavy savings, rather than a plug for gaps in the existing financial mechanism. Prior to the 1930's, the large volume of new investment so necessary to a progressive economy was obtained by the lure of large profits, regardless of a scarcity of capital and a high cost of financing. These proposals hope to accomplish the same end, notwithstanding the fact that there is a much more limited prospect of profit, by offering the favorable financing terms made practical by the existence of an abundance of capital. The latter type of inducement is by nature much the weaker, and other considerations, such as the degree of risk involved and the prevailing rate of taxation of profits, are likely to be dominant in the decision of the entrepreneur. However, it is deemed essential to push business into substantial new investment by one means or another if we are to have continued growth, and to increase investment or to curtail savings if we are merely to have full employment. These accomplishments would be facilitated by creation of new governmental machinery for spreading or subsidizing some of the risks so that financing may be offered more liberally and more cheaply.

OTHER POSSIBLE APPLICATIONS OF GOVERNMENTAL FINANCING OF BUSINESS

Although the reasoning we have outlined demonstrates current and predominating approaches to the subject, it does not exhaust the possible beneficial applications claimed for governmental financial assistance to business. In the past, such financial assistance has taken a variety of forms, usually being associated with a relatively narrow objective, such as, for example, the subsidizing of a particular industry. Now, instead of stimulation of a particular industry or small business or new investment, it may be desirable to stimulate regional economic development, either expansion in new areas or the development of balance in older

areas.¹⁴ Government financial assistance has also been advocated as a lever useful in smoothing out cyclical economic fluctuations. Employed as an adjunct of tax and debt management and direct spending, in a unified fiscal policy, a business-credit program of a flexible character might offer a measure of control of the business cycle.¹⁵ At the least, proponents argue, it might reduce the severity of cyclical swings by making credit easier or tighter at appropriate times. Such an instrument might be used in two ways: as a temporary measure to resist deflation or stimulate expansion on specific occasions, and as a flexible permanent measure, to be made more or less liberal from time to time, with the aim of helping to stabilize business activity.

Adoption of governmental financial assistance as a fiscal tool may be urged regardless of whether significant gaps are believed to exist in the private financial mechanism. Assuming, for illustration, that entirely adequate credit were available, at a low price, for all legitimate business purposes, a national administration imbued with a desire to control economic trends closely might choose to subsidize superfluous or excessively cheap credit for its inflationary effect. Or, conceding that existing private financing institutions were performing all necessary functions satisfactorily, such a government might still wish to possess a financing institution of its own; such an instrument could be used to reward political friends or force private institutions to continue to employ their credit powers in a manner acceptable to the government. However, as already indicated, advocacy of the current proposals for government financial assistance to business is

¹⁴ Note the proposed "Industrialization of Underdeveloped Areas Act of 1945" under which the Department of Commerce would recommend loans to government lending agencies to help finance regional industrial development, *The Wall Street Journal* (New York: September 12, 1945). See also William H. Beveridge, *Full Employment in a Free Society* (New York: W. W. Norton & Co., 1945), pp. 175-78, and the exposition of the state of Mississippi's B.A.W.I. (Balance Agriculture with Industry) subsidy plan in Ernest J. Hopkins, *Mississippi's BAWI Plan* (Atlanta: Federal Reserve Bank of Atlanta, 1944).

¹⁵ Beveridge, *op. cit.*, p. 157.

based mainly upon the premise that significant gaps do exist in the private financial system. The merit of the proposals is dependent upon the validity of this premise, and upon the further assumption that private financing institutions are incapable of filling the gaps by themselves.

WHAT IS A FINANCIAL GAP?

Before we proceed farther, it will be necessary to make clear what we mean by a financial gap. One might be led to assume, for example, that if financing is not available for a transaction or enterprise which appears to have a reasonable chance of success, this alone is proof of the existence of a gap in the financial mechanism. Yet, if the supply of and demand for funds are equal at prevailing rates of interest, how can the failure of a given enterprise to secure financing be said to constitute a gap? Is it not, rather, an indication that other competing uses for the funds are preferable economically? The functions of the rate of interest are (1) to equate the supply of and demand for loanable funds and (2) to allocate the supply appropriately among the various competing demands. Some flexibility is introduced by the power of banks, within certain limits, to create deposits, but the functions of the rate of interest are not altered. Unless, at the same time, the total supply of loanable funds was increased sufficiently to lower rates to a point economical for the enterprise in question, action to provide that business with funds would bring about misallocation of capital, leading to a shortage of funds for other, worthier users.

It seems apparent, also, that the fact that a small borrower must pay a relatively high rate of interest does not necessarily demonstrate that an institutional gap exists. Many factors of cost and risk limit the supply of funds available for small loans and thus make for high rates. If the government, for reasons of social benefit, were to make small loans available at rates which would

be unprofitable to private lenders, it would then be a question of subsidization of small borrowers, not one of plugging a gap in the private financial mechanism.

What then do we mean when we speak of financial gaps? The key is to be found in the wide variety of different rates which go to make up "the" rate of interest, and in the similar complexity of the demands and supplies which are to be equated. In brief, the problem is one of institutional maladjustments within this complex structure, which may serve to defeat successful operation of the normal functions of the interest rate.

For example, although a large volume of savings accrued in the years prior to World War II, it was concentrated, as previously noted, in institutional hands, and for the most part was available only for highly conservative employment, that is, for investment in securities offering both a high degree of safety and ready marketability. Limited availability of savings for hazardous or illiquid investments reflected, in large part, statutory restrictions existing upon the investments of life insurance companies, savings banks, and other increasingly important institutional suppliers of capital. It also reflected a general desire on the part of investors to obtain first of all an assured return, and to confine their holdings to securities enjoying a ready market. At the same time, the demand for new capital for the safer types of employment, and by those large organizations whose securities commanded a broad market, was small, owing to their accumulation of internal resources and to a general concern over the long-term trend of profits and taxation. Thus, though the excess supply of funds forced interest rates down, this lower level of rates did not stimulate significant new demand of a type acceptable to suppliers. Further, the surplus of savings, because of its qualitative characteristics, did not then spill over into more speculative employment or into small, local situations with poor markets. True, the demand for funds for speculative employment at this time was also weak, but it did not receive the stimulus which might

have been present had the holders of savings been able and willing, for a price, to accept substantial risks or to revise their financing methods sufficiently to promote hazardous or small, local enterprises on a sound basis. The absence at that time of adequate institutions for converting savings that were striving for assured returns into a capital supply available to risky or small ventures was a serious handicap to the successful functioning of the economy. We shall use the term financial gap to describe institutional inadequacies of this character.

THREE GENERAL TYPES OF FINANCING REQUIRED

The private financial mechanism, if it is to be considered adequate, must provide private business enterprise with three general types of financing: equity capital, loan capital, and short-term credit. The lines between these general types cannot always be drawn sharply, but recognition of their basic differences is essential if we are to avoid confusion in appraising the gaps which may exist. Equity capital is, of course, ownership investment, whether it be simply proprietorship or partnership net worth or in the form of capital stock and surplus. In addition to financing a part of the assets of the business on a permanent basis, equity capital serves the important function of a cushion to absorb possible losses and thereby limit the risk assumed by creditors, who are asked to supply the balance of the financing required.

Loan capital, or medium-term and long-term debt, consists of borrowed funds employed for capital purposes to supplement the permanent capital supplied by the owners of the equity. Such borrowings are employed either because additional equity funds are not available on a reasonable basis or because the owners expect to profit by obtaining a portion of the necessary capital at a fixed rate of interest which is less than the rate of return they hope to make from use of the funds. Normally, loan capital is expected to be replaced gradually by profits accumulating from

the operations of the business. Much debt of this type, particularly that running for periods of less than ten years, carries a fixed schedule of installment repayments.

Short-term or commercial credit includes a wide variety of loans and book credit extended for periods of less than one year. Generally, such credit is used to supplement capital funds in order to meet seasonal or temporary requirements and to permit a greater volume of business by limiting the period of time the borrower's capital funds need be tied up in inventory and receivables. Commercial loans are typically set up for the financing of specific seasonal or other short-term requirements; they are self-liquidating in the sense that, when the operations financed are complete, the proceeds are available to retire the loan. Book or trade credit is extended most commonly on a thirty-day basis by vendors, although substantial variations exist, and suppliers of equipment frequently provide three- to five-year installment credit which is properly considered in the capital-loan category.

These three principal types of financing are supplied, generally speaking, from different sources, in consequence of the different hazards presented and the varied circumstances and objectives of the owners of savings and creators of credit. This should be borne in mind in all of the discussion which follows.

A corresponding distinction, which we must bear in mind upon the side of demand, is that between the different types of business to be financed. Business enterprises may be large, small, or medium-sized; well-established, newly organized, or somewhere in between; and operating in a relatively safe or in a more or less hazardous field. If a small enterprise is unable to obtain capital or credit because of smallness per se (perhaps its requirements are so small that existing financial institutions, after allowance for necessary costs, cannot profitably handle them), the problem is entirely different from that of denial of financing attributable to excessive risks involved. Separate treatment of the problem of financing new enterprises is also advocated on the theory that such

financing is both the most difficult to obtain and the most desirable economically. However, conceding these points, from the financial point of view, newness in an enterprise is merely another aspect of risk, and there would seem to be little practical basis for attempting to segregate it from the numerous other aspects.

Equity Capital

The major source of equity capital in the past has been earnings ploughed back into the business, supplemented by surplus funds invested directly by friends of the entrepreneur or by other individuals, and by funds obtained from all types of investors through the medium of investment bankers. Generally speaking, small business enterprises have had access only to the first two sources, for the greater part of the investment-banking business has never been geared for the profitable flotation of small issues.¹⁶ Because of the proportionately high cost of preparing and handling, the difficulty of maintaining adequate markets afterward, and unfavorable experience with the admittedly greater risks involved in small enterprises, investment bankers have tended to avoid such issues.¹⁷ In this, in recent years at least, the bankers have echoed the desire of their customers, who also have not had good experience with small, inactive issues of the securities of obscure businesses, and are not inclined to purchase them.

In former years, if we may judge by the tremendous expansion of American industry and trade, both in total size and in number of individual enterprises, this system of equity investment

¹⁶ The primary importance in the past of growth financed through earnings retained in the business is argued convincingly by Alvin H. Hansen in *Fiscal Policy and Business Cycles*, chap. xviii, and in J. Keith Butters and John Lintner, *Effect of Federal Taxes on Growing Enterprises* (Boston: Graduate School of Business Administration, Harvard University, 1945), chap. v.

¹⁷ See Investment Bankers Association, *op. cit.*, pp. 7-12. These factors, together with the added costs and problems involved in registration of new issues with the Securities and Exchange Commission, have also tended to restrict new capital issues by medium-sized business enterprises, that is, those with assets of \$250,000 to \$1,000,000.

worked reasonably well despite the general unavailability of the investment-banking machinery to small businesses. However, new conditions have arisen which make it uncertain whether these sources will, in the future, be adequate to supply needed equity capital, even for many of those businesses large enough to enjoy the services of the investment bankers. These changed conditions relate primarily to the very large increase in income tax rates, both personal and corporate, beginning in 1932, which has not only greatly impaired the ability of entrepreneurs to retain earnings in their businesses but has reduced the incentive for well-to-do individuals to undertake risky investment of any sort. Many investors, of course, had already become reluctant to make equity investments as a consequence of painful personal experience in the great deflation following 1929, and, later, others had become apprehensive about prospects for future profits under changing economic and social conditions.

An additional development particularly adverse to local investment in small enterprises has been the increasing urbanization of the nation, which has eliminated to a large extent the personal relationships of capitalists with local businessmen in need of funds, and has substituted, as an outlet for investment funds, the far more liquid market afforded by the securities of large, well-known corporations traded upon the principal stock exchanges. Another factor, mentioned before, has been the increasing concentration of capital in the hands of life insurance companies, trust companies, savings banks, and other institutional investors who are required, by the nature of their obligations and the compulsion of regulatory legislation, to invest only in the safest type of security, often only in the debt of large concerns.¹⁸

¹⁸ It is interesting to note that investment-trust companies, unhampered by regulation of their investments, have shown no more interest than other large institutional investors in the financing of small enterprises, either through equities or through debt. In this policy, the physical problem of supervision of numerous small businesses and the lack of ready marketability of their securities have probably received more weight than have the greater risks involved.

Despite this latter problem, little evidence has been introduced to indicate that new equity investment in large corporations is hampered significantly by institutional inadequacies. It has been demonstrated, rather, particularly in the investigations of the Temporary National Economic Committee, that the requirements of large corporations for new equity capital from investors were for many years prior to the war comparatively modest, in part as a consequence of easy access to substantial internal sources of funds in the form of accumulated profits and depreciation and amortization reserves. When such companies need outside funds, investment-banking machinery distributes securities in issues large enough to command broad markets. At the same time, it appears that the shrinkage in sources of equity capital available to small businesses has contributed to the development of a serious financial gap. Virtually no disagreement exists. The following was concluded by the Lincoln and Therese Filene Foundation in 1939:

There is no disagreement among economists, business men, and bankers whose statements are here reviewed, that small business lacks adequate capital. There is little or no disagreement that our financial mechanisms are not set up so as to provide equity capital for the smaller business units.¹⁹

This conclusion was corroborated in 1945 by the Investment Bankers Association of America in the following summary:

As a general rule, the existing investment banking machinery does not, and cannot be expected to handle capital issues in such small amounts [less than \$100,000]. No other institutional machinery is now in existence to fill this gap.²⁰

Loan Capital

With respect to loan capital, a distinction is necessary between long-term loans, which we shall arbitrarily define as loans run-

¹⁹ Lincoln and Therese Filene Foundation, *op. cit.*, pp. 2-3.

²⁰ Investment Bankers Association of America, *op. cit.*, p. 1.

ning for ten years or longer, and medium-term loans, running for one to ten years. As for long-term loans, small business seems to face a gap in the private financial mechanism very similar to that just described. In fact, in view of the high degree of risk and instability usually present in small businesses, their senior obligations have many of the characteristics of equities.²¹ For the same reasons we have outlined above, investment-banking facilities are inadequate, and wealthy individuals, formerly a highly important source for such loans, have become a far smaller factor. Additional sources of long-term loan capital exist, notably the large pools of capital represented by the life insurance companies and savings banks, but except for residential and farm-mortgage loans these sources have not been important to small borrowers in the past. With the life insurance companies this appears to have been due not merely to the risks involved and the restrictions limiting their investments, but also to the administrative impracticability of handling a volume of small loans large enough to constitute a significant fraction of their tremendous assets. Extension of long-term loans has never been considered a proper commercial-banking function in this country, for the reason that commercial-bank liabilities are payable upon demand or upon short notice, and bankers are naturally apprehensive about freezing their assets in long-term commitments.

Traditionally, medium-term and long-term loans were classed together as unsound commitments for commercial banks. In consequence, for many years the sources of the two types of loans did not differ greatly, although medium-term credit was provided for many businesses through the device of bank loans nominally

²¹ Charles L. Merwin in *Financing Small Corporations* (New York: National Bureau of Economic Research, 1942), p. 4, points out: "The susceptibility of these small corporations to discontinuance provides the logical explanation of the infrequency of long-term debt among their obligations. Only the owners, whose ownership enables them to have a job and to reap the gains of prosperous years, dare take the risks involved in investing long-term funds."

short-term, but in practice automatically renewed at maturity. More recently, however, there has been a strong trend toward the provision of medium-term loans by commercial banks as a normal operation, on the theory that a limited proportion of their assets can be safely committed to obligations maturing in installments over a period of several years and intended to be retired from profits. This trend has been fostered by a shortage of other acceptable loans, and by the favorable experience of certain banks and other institutions, such as finance companies that pioneered in such lending in a small way. It has been restrained, on the other hand, by timidity caused by losses during the depression years and the need for meeting the strict standards of bank examiners. These standards have been relaxed somewhat in recent years, but the attitude of the examining authorities remains adverse to the acceptance of loans of such a term and degree of risk that they tend to become, in reality, participations in ownership.

There is a school of thought which would have the commercial banks move deep into the risk sector of the economy, thus filling the vacuum left by the reduction in the normal flow of venture capital. It has been argued that this process will save our society of free enterprise. . . . However, the economic scene at the present time is not such as to persuade the Office of the Comptroller of the Currency to acquiesce in this doctrine.²²

The prevalent opinion with respect to medium-term loans is that in this field, also, a gap exists, at least to the extent that the small business has less ready access to loan capital than does the larger concern. However, many of the complaints registered by small entrepreneurs in this connection may be discounted by the fact that the complainants all too frequently are desirous of borrowing when sound financial management would require the securing of additional equity capital. Such entrepreneurs may be reluctant to admit new equity capital which would lessen the

²² "Eighty-Second Annual Report of the Comptroller of the Currency, 1944" (Washington, D.C.: Comptroller of the Currency, press release dated August 24, 1945), p. 6.

degree of their control over the business, or they may merely wish to profit from a greater pyramid of debt. Understandably, commercial bankers are unwilling in such instances to incur what are, in practical effect, equity risks. Even where the request for loan financing is clearly justified, the cost of setting up and servicing small term loans is substantial, for a thorough preliminary study and continued close attention after the loan is made are essential.²³ Charges have had to be high in order to cover expenses and return profits commensurate with the risks. Term loans to small businesses have as a class been judged particularly hazardous, because of the typically short life-expectancy of such businesses and their usual heavy dependence upon one or two individuals.²⁴ Finance companies and industrial-banking companies which share this field with the commercial banks have recognized the risk and cost factors in their heavy charges.

Short-Term Credit

Short-term credit is the traditional field of the commercial banks, and alleged inadequacies in this field have been particularly controversial. On the one hand, bankers emphasize their desire to make such loans—it is, after all, their business—and reiterate that no creditworthy undertaking need go without their assistance.²⁵ Beyond dispute, strong, established enterprises are serviced well in this respect. On the other hand, testimony has indicated that many small businessmen consider the usual bank-

²³ Neil H. Jacoby and Raymond Saulnier, *Term Lending to Business* (New York: National Bureau of Economic Research, 1942).

²⁴ For statistics setting forth the unfavorable life-expectancy of such businesses, see the Temporary National Economic Committee Monograph No. 17, *op. cit.*, chaps. i-iv.

²⁵ The American Bankers Association, *op. cit.*, p. 4, states the policy of its members to be that "every competent individual, firm or corporation in the United States that needs bank credit will get it if the money is to be used for some constructive purpose that will serve the private enterprise economy of this country." This policy has been reiterated many times by individual banking institutions in newspaper advertisements and by bank officers in public addresses and testimony before Congressional committees.

ing interpretation of "creditworthy" to be unduly strict.²⁶ In support of this point of view, the rapid growth and favorable experience of finance companies as a supplemental source of such credit are cited.

It is true that an increasing volume of short-term financing of business has been handled by finance companies and by specialized sources such as factors, and that wide use has been made of book or trade credit beyond customary terms, notwithstanding the heavy charges ordinarily made by finance companies and factors, and the serious loss of bargaining power and independence of decision associated with excessive reliance upon trade credit. It is also true that finance companies, in particular, have developed techniques, such as accounts-receivable financing, which have been well adapted for supplying credit to small businesses in weak financial condition. Nevertheless, the overwhelming preponderance of short-term business credit continues to be advanced by the commercial banks, and statistics indicate that the size of the average credit granted is relatively small.²⁷ In recent years, opinion appears to have been steadily shifting to the view that a significant gap does not exist in the general availability of short-term credit.²⁸

The situation in many individual localities is less satisfactory.

²⁶ United States Congress, Senate, Special Committee to Study Problems of American Small Business, *Small Business Loans and Risk Capital*, Sen. Committee Print No. 8, 77th Cong., 2d sess. (Washington, D.C.: Government Printing Office, 1942), pp. 15-33. See also Temporary National Economic Committee Monograph No. 17, *op. cit.*, p. 267.

²⁷ A survey as of November 20, 1946, indicated that member banks of the Federal Reserve System had outstanding 673,000 loans to business concerns, of which 514,000 were classified as loans to small businesses. Of the latter, 401,000 had original maturities of not more than one year. The typical small-business loan was stated to be between \$1,000 and \$5,000 in size. Member banks include about one-half of all commercial banks, but over 80 percent of commercial-bank resources. See Albert R. Koch, "Business Loans of Member Banks," *Federal Reserve Bulletin*, XXXIII (March 1947), 253, and Charles H. Schmidt, "Member Bank Loans to Small Business," *Federal Reserve Bulletin*, XXXIII (August 1947), 963.

²⁸ See A. D. H. Kaplan, "Free Enterprise—National and International," in *Proceedings of the Academy of Political Science*, XXII (May 1947), 272.

The depression of the 1930's cut the number of banks drastically, and a great many small communities have been reduced to reliance upon a single bank, or in some cases, none. This reduction in the number of banks has undoubtedly had a beneficial effect upon operating costs of the remainder, but reliance upon a single financing institution clearly tends to restrict the availability of credit, since the community's leading merchants or manufacturers, some of whom are usually represented upon the board of directors of the bank, are naturally cautious in assuming risks to finance new competitors.

Since the late experience of government lending agencies has tended to disprove the existence of any general unsatisfied demand for short-term credit on the part of businesses which offer a reasonable prospect of repayment, the attention of critics in this field has centered increasingly upon the subject of relative costs to large and small borrowers.²⁹ It is argued that prevailing interest-rate differentials are seriously prejudicial to small or weak businesses. Wilhelm, for example, concludes that small business is at a marked competitive disadvantage, for "small concerns generally obtain short-term bank loans only on terms considerably more onerous and expensive than large concerns can secure the same type of funds from banks or in the commercial money market."³⁰ Care should be taken, however, to distinguish between soundly capitalized small concerns, which often receive very favorable rates, and the weaker enterprises. In addition, many observers feel that whether a business pays 2 percent or, let us say, 5 or 6 percent for its short-term credit is usually a minor consideration in determining its ability to operate profit-

²⁹ The survey of business loans of member banks of the Federal Reserve System, in November 1946, disclosed a range in average rates charged from 1.9 percent on loans to borrowers with \$5,000,000 and more of assets to 5.2 percent on loans to borrowers with under \$50,000 of assets. The average rate charged on loans of \$1,000 to \$5,000 to small businesses was 5.7 percent. See Richard Youngdahl, "The Structure of Interest Rates on Business Loans at Member Banks," *Federal Reserve Bulletin*, XXXIII (July 1947), 818, and Charles H. Schmidt, *op. cit.*, p. 975.

³⁰ Donald Wilhelm, Jr., *op. cit.*, p. 245.

ably. Indicating the opinion of entrepreneurs in this respect, a study of extensive case files conducted by Professor J. Franklin Ebersole arrived at the thesis that "the interest rate is not viewed as an important problem by business management; the interest rate is seldom considered as a factor in the entrepreneurial decisions of business to expand or contract, and is a controlling factor in a negligible number of instances."³¹

Nevertheless, though the added risk and greater expense involved in lending to small borrowers are very real factors, it is generally conceded desirable to narrow the differentials in rates by devising new techniques to reduce risks and costs of servicing. With the proposal to accomplish this end by means of a subsidy from public funds, however, a multitude of new problems arise. Who is to say, for example, that the stocking and operation of a new store on Main Street should be subsidized at the expense of undermining the financial stability of other stores already established there?

FINANCIAL GAPS IN THE PROVISION OF EQUITY AND LOAN CAPITAL FOR SMALL BUSINESS

To summarize prevailing opinions, there is general agreement that gaps exist in the present-day private financial system with respect to the provision of equity capital and long-term loan capital to small businesses. That institutional gaps in these respects appear to have existed for many years,³² and that their

³¹ "The Influence of Interest Rates upon Entrepreneurial Decisions in Business—a Case Study," *Harvard Business Review*, XVII (Autumn 1938), 39.

³² Edward E. Brown, a prominent Chicago banker, in testimony before a Congressional committee, declared in 1939 that "in my opinion, it has always been difficult for small businesses to get risk capital. I think the difficulties today, for a variety of causes, are greater in getting proprietary risk capital for small- and moderate-size businesses, and even for large businesses, than was the case in former years." United States Congress, Senate, *To Provide for the Insurance of Loans to Business*, hearings before a subcommittee of the Committee on Banking and Currency, United States Senate, 76th Cong., 1st sess., on S. 1482 and S. 2343, May 31-June 29, 1939 (Washington, D.C.: Government Printing Office, 1939), p. 119.

present prominence is a consequence of increasingly heavy taxation and other developments which have reduced former private or internal sources of financing, rather than a result of changing policies of financial institutions, does not alter the fact of their presence and the challenge that they offer.

As for other parts of the financing mechanism, few generally accepted opinions may be formulated at this point, despite indications that no significant general gap exists in the provision of short-term credit. In particular, although numerous private and public surveys and investigations have been made, and many Congressional hearings have been conducted, there is as yet no agreement upon the extent of the deficiencies which may exist in the availability of short-term credit and medium-term capital loans to small business. In practical effect, this is another way of saying that no satisfactory, objective test has as yet been devised to indicate whether a given small-business loan is suitable for a commercial-banking institution. It is natural for a businessman who has been denied credit to claim that the banking system is inadequate, even though he may have asked the bank to accept a dangerous risk or have refused to agree to a loan on terms necessary to protect the bank. Similarly, the banker who wishes to avoid the effort required for supervision on a sound basis of numerous small and somewhat hazardous loans may simply lean back and declare that the risks are excessive or that the bank examiners would criticize such loans. After review of the experience presented in subsequent chapters, we shall be in a better position to form a satisfactory judgment in these controversial areas.

Granted that gaps of some types exist in small-business financing, one might argue that it is a mistake to be concerned about how serious and widespread they actually are; that we should leave no tool of governmental assistance untouched if its use might stimulate the economy toward maintenance of a high level of employment. On the other hand, it is certainly possible that unless the gaps concerned are truly serious the remedy might be

worse than the disease. Consideration must obviously be given to the possible adverse repercussions upon other aspects of private initiative and investment, should government credit become available to all small enterprises at a low rate. It would accomplish little to plug gaps in the availability of capital and credit, and, by so doing, contribute to such a shrinkage in the total demand for funds that their availability would have no meaning. It should not be forgotten that the established system worked well for a long time, and that, in consequence, an effort at repair may be preferable to an ambitious new design. With this in mind we shall investigate the possibility of modifications in existing private financial institutions which would serve to fill the significant gaps adequately without resort to governmental assistance. Judgment on this question will likewise have to be deferred until after both the gaps and the efforts made by private institutions to fill them in the past have been reviewed.

Finally, should a government subsidy be employed to reduce the interest paid by small businesses to rates comparable to those paid by large concerns, a troublesome question would immediately arise. Why should only borrowers be subsidized, and the weakest most of all, when the action would penalize small entrepreneurs risking adequate capital of their own? Following logically would be the further question why other competitive handicaps of many small businesses, such as, in some cases, a high cost of production, should not likewise be equalized through subsidy. If followed any distance, such an approach would make a travesty of the free-enterprise system and the whole concept of competition as a means to greater productivity.

TYPES OF ACTION PROPOSED

Varied objectives and many shades of opinion on the controversial issues we have outlined are reflected in the long list of specific proposals for action to fill financial gaps. For conveni-

ence, however, the major proposals of recent years for governmental financial assistance may be classified into three main groups: (1) those involving direct advances by government agencies, (2) those involving government insurance or guaranty of advances made by private institutions, and (3) those involving the establishment of regional investment banks, usually with some private participation. The precise details of the individual proposals are of limited significance for our purposes, and only the general pattern of a few typical plans will be indicated at this point.

Direct Advances

Establishment of new institutions for direct governmental financing of business enterprises has not been a frequent subject of legislative proposals in recent years. This is probably in recognition of the existence of the Reconstruction Finance Corporation, actively engaged in such lending and with virtually unlimited resources. Proposed revision of this agency's authority and lending practices is, however, common. An interesting recent proposal for a new institution was the bill introduced by Representative Randolph, which provides for a permanent Small Business Finance Corporation to be owned by the government and operated through the Federal Reserve System.³³ This corporation, to be provided with \$125,000,000 of capital by the Treasury, and enjoying borrowing privileges up to several times this amount, would be authorized not only to make direct loans and to purchase preferred stock of businesses, but to guarantee private financing institutions against loss upon loans or purchases of preferred stock. Maturities of loans could not be less than one year nor more than ten. Preferred stock purchased would be retired within ten years, with a possible extension for ten more years. Both loans and preferred-stock investments would be reduced gradually by installment payments. To assure limitation

³³ H.R. 2994, 79th Cong., 1st sess., April 23, 1945.

of this assistance to small enterprises, the maximum outstanding to one business at any time would be restricted to \$250,000; and no more than 50 percent of the Corporation's funds currently outstanding could be invested in loans and preferred stock aggregating more than \$50,000 per individual business.

Guaranty by the Government

Several proposals for the establishment of systems of guaranty or insurance of loans made by private institutions have received widespread attention, though here, too, the existence of the Reconstruction Finance Corporation, already making guaranties of private loans in considerable volume, has operated to hold back new legislation. Even the Wagner-Spence bill,³⁴ most prominent among recent proposals of this type, merely suggested adding to existing guaranty powers of the Federal Reserve banks by removing all restrictions upon the type, size, or maturity of business loan which they may guarantee (up to 90 percent). The Small Business Advisory Committee of the Department of Commerce has recommended similar legislation, vesting power in an unspecified federal agency to guarantee loans to small or new businesses on an extremely liberal basis.³⁵ This proposal would permit guaranty up to 90 percent of loans three times as large as the borrower's own capital investment. Loans to be guaranteed would be limited in maturity to fifteen years, and the interest charges could not exceed 6 percent. A fee would be charged the financing institution for the guaranty. A feature would be a flexible plan of repayment, so that borrowers would not be embarrassed by cyclical fluctuations in their earnings.

Regional Investment Banks

Proposals for regional investment banks or investment companies to supply long-term capital financing to small or medium-

³⁴ S. 511, 79th Cong., 1st sess., February 12, 1945.

³⁵ United States Department of Commerce, press release dated February 21, 1946.

sized business enterprises have recurred frequently in recent years, but agreement has not yet been reached upon legislation. The new institutions proposed have been public, quasi-public, or merely public-sponsored. When provision of equity financing has been proposed, the plan has required that private interests contribute junior capital to the institution. Incentives proposed for private-capital contributions have included the use of large funds to be loaned by the government, various tax-exemption privileges, and in one case, guaranty by the government of a minimum return.

Among the more prominent proposals is that of the Investment Bankers Association of America, which provides for the organization of local investment companies by private capital, under charters to be granted by the Board of Governors of the Federal Reserve System.³⁶ The local investment companies would be authorized to borrow, by sale of their twenty-five-year debentures to the Federal Reserve banks in their districts, a sum equal to three times their own invested capital. The funds required by the Federal Reserve banks would be supplied by the Treasury, which would make available sums paid by the Reserve banks to the Treasury for stock in the Federal Deposit Insurance Corporation. The local investment companies would be authorized to purchase all classes of securities of business enterprises and to make loans to business enterprises. The maximum to be invested in any single business at any one time would be \$100,000. As an equitable means of spreading risks, all enterprises availing themselves of funds would be required to invest 10 percent of the proceeds in Class B stock of the investment companies. The Class A shares, owned by the original investors in the investment companies, would have preference in liquidation, but not in dividends. The companies would have the right to redeem Class B shares, at par value, out of net earnings.

Another interesting proposal is made by Rudolph L. Weiss-

³⁶ *Op. cit.*, pp. 3-6.

man.³⁷ This contemplates organization of a Federal Reserve Investment Corporation, its stock capital to be paid in by member banks of the Federal Reserve System in proportion to their capital funds. No direct government capital or guaranties would be involved, although the Corporation would be entitled to borrow from the Federal Reserve System and would be quasi-public in nature. Broad powers to lend or to purchase preferred stocks would be granted, but common-stock investment is not envisaged. An interest maximum of 5 or 6 percent would be supplemented by a 2 or 2½ percent fee when engineering or other services were rendered to the borrowers. While the purpose is avowedly to supply capital for small enterprises, individual investments up to \$1,000,000 would be permitted.

Other Proposals

By no means all proposals for action to fill financial gaps call for governmental financial assistance. Various programs have been outlined for liberalization of private lending practices,³⁸ and for purely local financing of local industries.³⁹ In addition, many proposals do not even entail provision of capital or credit, but attempt instead to remedy deficiencies by indirect and presumably less disruptive measures. Typical of these are proposals to lessen the risks of small business through the provision of technological or other assistance to management, and proposals to revise taxes, thereby promoting the expansion of small businesses from retained earnings or stimulating equity investment generally. We shall have occasion later to consider such types of action at some length.

³⁷ *Small Business and Venture Capital*, pp. 88-94.

³⁸ See, for example, the program of the American Bankers Association presented in *Progress Report, Post-War Small Business Credit Commission*, previously cited.

³⁹ See the discussion of community financing plans in chap. iii, *infra*.

Chapter III

GENERAL HISTORICAL BACKGROUND

• NOTWITHSTANDING the strong tradition of *laissez faire* in the United States, government financial assistance to private enterprise is by no means a recent development. Numerous examples may be cited, covering a period of more than one hundred years. Outstanding beneficiaries during much of the nineteenth century were, of course, the railroads. However, such financial assistance, which embraced the provision of loans and of equity capital as well as direct subsidies and grants, was, until World War I, of a nature fundamentally different from that now advocated.

During this early period, loan and equity financing were in effect employed by federal and state governments as subsidies, to stimulate more rapid expansion and development of key industries and of geographical areas. Such financing was closely akin to subsidies in the form of land grants or of tariff protection, and only distantly related to the now-prevalent concept of a general banking operation designed to fill in the gaps of an imperfectly functioning private financial system. True, where it emphasized regional or general expansion, in contrast to the promotion of individual industries, it had the same goal as many present-day proposals, yet the underlying philosophy of its application was very different. In large part, the differences in application symbolize our economic growth from a debtor nation, with large natural resources to develop, to the mature, creditor nation of the present day.

STRESS UPON ASSISTANCE TO SMALL BUSINESS IS NEW

The heavy stress now placed upon financial assistance to small business enterprises is of comparatively recent origin. In their financial aspects, the special problems of small business received only scattered attention prior to the depression of the 1930's. The continued rapid growth of the economy obscured such problems as were known to exist, and seemed to offer evidence that, if financing were inadequate, the deficiency could hardly be of serious proportions. Significantly, the idea of assistance to small business was not emphasized in the numerous business-financing measures introduced in Congress in the 1930's until the second half of the decade.

This does not mean that the problems of small-business financing had not impressed some observers, or that no private institutions undertook to meet these problems. After 1910 a steady growth occurred in finance companies which developed accounts-receivable financing, installment-equipment financing, and other services particularly adapted to the needs and hazards of small businesses.¹ Increasing numbers of commercial banks also broadened their traditional lending policies to include these new instruments of finance. However, it should be emphasized that banking practice in the United States had never actually remained within the narrow confines of commercial-banking theory. Confidence in the continued expansion of the national economy had led a great many bankers to make capital financing available in the form of nominally short-term loans; "nominally," in that loans were not liquidated at maturity and borrowers anticipated periodical renewals by the banks whenever required.² This practice

¹ See William H. Grimes, "Distribution and the Finance Company," *Harvard Business Review*, XVIII (Winter 1940), 199-201.

² An analysis by Harold G. Moulton indicated that in 1916 half of the loans made by banks and trust companies were devoted to intermediate- or long-term investment purposes. Including its investments in securities, the commercial-banking system was said, in reality, to be extending two-thirds of its credit for fixed- rather than

was hazardous in the long run, but was nevertheless helpful to those smaller enterprises with limited access to the capital markets.

Many of the larger banks also established affiliated security companies which floated capital issues and made loans and investments of a type unsuitable for bank portfolios. In view of modern criticism of banks for their unwillingness to assume risks, it is interesting to recall widespread criticism in the past on the opposite grounds. In 1912, the Pujo Committee of the House of Representatives attacked such security affiliates with the charge that the banks concerned were exceeding their charter powers by "acting as promoters, underwriters, and houses of issue for the securities of railroad and industrial corporations." In 1933, following the excesses of the 1920's and the resultant losses, Congress required abandonment of security affiliates by the banks.

COMMUNITY FINANCING PLANS

Among early attempts to provide more adequate means for the financing of small or new industries were a number of so-called community financing plans. Local organizations interested in community industrial development undertook the establishment of a pool of funds available for capital loans to industry. Numerous community funds of this type have been organized in recent years. Since the primary, underlying motive of such funds has been industrial expansion, or retention of existing industries important to the community, no stress has been placed upon obtaining a direct profit from the financing. Frequently, the profit-and-loss aspect has been considered of little consequence, the financing made available being viewed as a subsidy. The Industrial Corporation of Baltimore, organized in 1915, and the Louisville Industrial Foundation, organized in 1916, are leading exam-

working-capital purposes ("Commercial Banking and Capital Formation," *The Journal of Political Economy*, XXVI [May-November 1918]).

ples of successful community financing plans. Offsetting these and other successful undertakings, however, have been many failures of similar plans due to excessive eagerness for local industrial expansion, in disregard of financial risks assumed, or to dissipation of funds in subsidies.³

The Industrial Corporation of Baltimore originally made small investments in business enterprises which it had investigated and approved, in the expectation that, on the strength of this endorsement, additional private funds would be forthcoming. Ultimately, it found its own financial participation to be of little importance, its most useful financial function being operation as an intermediary in the securing of necessary funds from a variety of private (and later, governmental) sources. The corporation therefore has developed into what is essentially a service organization, covering its expenses from fees received for investigations of the prospects of applicants and for locating sources of investment funds. It looks upon its intimate knowledge of local conditions and its ability, on the basis of long experience, to provide sound managerial and financial advice to small businesses as its principal assets.⁴

The Louisville Industrial Foundation, on the other hand, has operated as a revolving capital-loan fund, directly supplying the financial requirements of promising businesses. Its selection of the type of ventures to be financed has been guided by a design for the rounded industrial development of the community. Investigations before commitments of funds are thorough, and the Foundation maintains a close advisory relationship with the borrower after the loan is disbursed. Three principles of operation

³ Chamber of Commerce of the United States, "Community Industrial Financing Plans" (Washington, D.C.: Chamber of Commerce of the United States; Mimeographed [1939]).

⁴ See testimony of G. Harvey Porter in United States Congress, House of Representatives, *A Study and Investigation of the National Defense Program in Its Relation to Small Business*, Hearings before Select Committee, United States House of Representatives, 79th Cong., 1st sess., on H. Res. 64, March 20-May 17, 1945 (Washington, D.C.: Government Printing Office, 1945), Part I, pp. 32-43.

responsible for the Foundation's favorable over-all results are flexibility in the arrangements made for repayment of loans, continuing participation with borrowers in working out nonfinancial as well as financial problems, and the individual approach to each situation that is feasible for a local institution.⁵

That the special financial problems of small businesses were recognized in many quarters in 1928 and 1929, at the height of that boom period, is indicated by an interesting survey of bank activities conducted, at the time, for the New England Bankers' Committee and the New England Council. The findings were summarized as follows:

The small company which has made good on a small scale and which wants to grow probably always has been and always will be a difficult problem. It often has no security except its own future possibilities to offer. . . . It needs additional capital for expansion of plant or operations and feels that it is entitled to capital. Nevertheless, the furnishing of such help is considered in many quarters as outside the bank's function, making it necessary for the company to go without the needed capital or to sell stock, or to find additional private capital. If it chooses to sell stock, it often pays a prohibitive price for its capital; if it succeeds in interesting private capital, this ordinarily necessitates surrendering control of the business—in many cases into hands less expert in its actual management.⁶

The conclusions of this survey were in general confirmed by the opinions of executives of a large number of New England banks and investment houses who were circularized shortly thereafter. In consequence, in 1929 a group of leading businessmen organized New England Industries, Inc., as a special institution to supply capital to established businesses "which require long-term funds or permanent capital not ordinarily within the sphere of commercial bank accommodation, but whose requirements are too small to secure underwriting by investment houses."⁷ Because

⁵ Ernest J. Hopkins, *The Louisville Industrial Foundation* (Atlanta: Federal Reserve Bank of Atlanta, 1945).

⁶ Report of Freeland & Warren, Inc., printed in *Hearings on S. 1482 and S. 2343*, p. 259.

⁷ *Ibid.*, p. 264.

of the stock-market collapse, the subscribed capital was not called in and this company did not function.

As a matter of fact, those who criticized the private financial system most effectively for its deficiencies in the period prior to 1930 paid little attention to the general field of business as we have here defined it. Discussion, for a long while, centered upon other problems, notably the instability of the banking system, the inadequacies of the mechanism for farm credit, and the excessive cost of personal loans.

EARLY EXPERIENCE IN THE UNITED STATES

Before World War I, the different concepts underlying governmental financial assistance to industry rendered experiments of little direct application to the present problem. It need only be noted that the early ventures of the state governments in the financing of canals, turnpikes, banks, and railroads in general had most unfortunate results. Reckless enthusiasm for the rapid development of new areas and for the benefits of "modern progress" brought large losses that seriously impaired the credit of many states. Likewise, though with much less serious results, the federal government found its ventures costly and unsatisfactory.⁸ This unhappy experience with the practical hazards of financing business had led, by the end of the nineteenth century, to a situation in which restrictions prevailed against the extension of public credit to anyone. The maintenance of such restrictions also reflected the prevalent anti-interventionist economic theories, holding governmental assistance to business both undesirable and unnecessary, a position which appeared to be amply supported by the great industrial and commercial expansion then in process.

With the twentieth century, as the problems associated with

⁸ Warren M. Persons, *Government Experimentation in Business* (New York: John Wiley & Sons, 1934).

this expansion became more widely recognized, a gradual trend toward intervention set in. In the field of credit, the first moves were toward the assistance of agriculture. However, with the nation's abrupt shift into a war economy in 1917, financial strains developed in such magnitude that traditions of nonintervention in business financing were brushed aside. By Act of October 6, 1917, the Secretaries of War and of the Navy were authorized to provide working capital for contractors by making advance payments, in amounts not exceeding 30 percent of contract prices. For this purpose, the Secretary of War established the War Credits Board in the War Department as a central authority to consider applications forwarded by the procuring bureaus and to arrange financing terms for those advances approved by it. The Board's policy was "to approve advances only in cases where the contractor was unable to secure funds from private sources, to assist the contractor in securing loans from private agencies, to adjust rates of interest to the market conditions in the contractor's locality, and to require the highest character of security for advances."⁹ Liquidation was to be effected through delivery of the goods contracted for. Collateral security was obtained in so far as was possible, and was of many types, including mortgages on fixed assets, mortgages on residences, pledge of securities, and pledge of life insurance.¹⁰ The usual rate of interest was 7 percent. The Board authorized total advances of approximately \$269,000,000, of which \$248,000,000 was actually advanced. The Navy Department also advanced funds, but upon a much smaller scale and with a less formal organization. Losses experienced in connection with these wartime advance payments were

⁹ United States Department of War, Historical Branch, War Plans Division, General Staff, *A Handbook of Economic Agencies of the War of 1917* (Washington, D.C.: Government Printing Office, 1919), p. 492.

¹⁰ Homer J. Dodge, in "Financing the War Industries," *Journal of the American Bankers Association*, XI (August 1918), 64-67, indicated that collateral to the value of \$450,000,000 had been taken to secure \$253,571,004 of advances made through June 30, 1918.

negligible in amount, although in some instances negotiations dragged on for years before final settlement was made.

Similarly, the Emergency Fleet Corporation was called upon during this period to finance a substantial volume of shipbuilding contracts through advance payments. Few restrictions were included in this agency's earlier contracts, and contractors were allowed to use advances for plant extension as well as for the construction of vessels. In later contracts, emphasizing the unfortunate experience suffered in certain cases, a number of requirements were imposed to make sure that funds advanced were properly applied. To protect the government's interest, trustee bank accounts subject to countersignature were employed, or surety bonds were obtained.¹¹

THE WAR FINANCE CORPORATION

Considerable criticism of advance-payment financing stemmed from bankers, as well as the Secretary of the Treasury, who objected to the fact that advances were made without consulting the Treasury, and who felt that weak contractors were obtaining lower rates of interest than they were entitled to receive.¹² To support the private financial system by assisting the banks in furnishing essential credit, the Congress, by Act of April 5, 1918, created the War Finance Corporation, the first, great federal lending agency. This action recognized the great strain placed on banking resources by war-loan financing and expanded industrial activity, to the point where banks were reluctant to make loans not eligible for rediscount.

Significantly, the gap aimed at by the War Finance Corporation was quantitative, not qualitative. The new Corporation was

¹¹ J. Franklin Crowell, *Government War Contracts* (New York: Carnegie Endowment for International Peace, 1920).

¹² United States Congress, Senate, *Hearings before the Committee on Finance*, United States Senate, 65th Cong., 2d sess., on S. 3714 (Washington, D.C.: Government Printing Office, 1918).

to supply credit beyond the limits of banking resources, not credit to small or particularly hazardous enterprises. In its first annual report, the Corporation stated that its enabling legislation

was inspired by a feeling that the very heavy borrowings by the government were likely to absorb so large a portion of available funds that even essential industries might find themselves unable to secure the financial means necessary for adjusting their operations to the increased demands occasioned by the War.¹³

The authority conferred upon the Corporation included powers:

1. To make advances of up to five years to banks which had extended credit through loans to or purchases of obligations of businesses whose operations were necessary or contributory to the prosecution of the war;
2. In exceptional cases, to make such advances directly to the businesses, provided funds were not otherwise obtainable by them on reasonable terms;
3. To make advances to savings institutions when deemed necessary or contributory to the prosecution of the war or important in the public interest, such advances to be limited to one year and to be secured 133 per cent by pledge of securities;
4. To buy and sell government bonds.

The first of these powers appears to have been given great weight by those framing the Act, although it was not the most important in practice. The idea underlying it was establishment of a rediscounting mechanism, and it is probable that the availability of such a mechanism had a considerable influence upon banking policy. However, the advances actually made under this provision were only thirty-four in number, totaling but \$4,718,000. Since the banks were obliged to remain directly responsible for repayment of the advances, giving their own notes secured by the obligations of the businesses, there was little incentive for them to resort to rediscounting unless they found themselves in a strained position. Further, the War Finance Cor-

¹³ *First Annual Report of the War Finance Corporation* (Washington, D.C.: Government Printing Office, December 2, 1918).

poration at first could lend only up to 75 percent of the amount of the loans pledged to it by the banks, and this margin of collateral was considered unattractive. An amendment was approved on November 21, 1918, to permit advances up to 100 percent of loans made for agricultural purposes or based on livestock.

The power to lend to savings institutions against securities was included because of fear that demands upon such institutions, in connection with the war loans, might force the sale of high-grade bonds on an unfavorable market. The availability of this source of credit, if needed, undoubtedly had a beneficial influence upon the bond market, but only three advances to savings institutions were made, aggregating \$550,000.

The power to make direct advances was intended to be limited to truly exceptional situations. In the hearings on the Act, it was denied emphatically that such loans would be used to finance enterprises that were not sound banking risks, and it was stated that operations of the Corporation would be along sound business lines, with all loans secured by adequate collateral.¹⁴ Notwithstanding the original intention to use direct loans only in emergencies, and public announcements that stressed this point, a flood of applications for such loans was received, especially from public-utility companies, which, as a group, were considered hazardous by the banks. In its first annual report, the Corporation noted that it had acted favorably upon only a small proportion of the applications received for direct loans, and went on to describe the basis for its action.

The corporation made advances only in those instances where the security appeared to be adequate in any circumstances, regardless of the duration of the war, and where there was a positive recommendation of the Government department or agency directly interested as to the necessity for the operation. Many of these applications were made upon the theory that the war would continue for a period of years and that the

¹⁴ See Woodbury Willoughby, *The Capital Issues Committee and War Finance Corporation* (Baltimore: The Johns Hopkins Press, 1934).

loan would be repaid out of profits, but the directors felt that they had no authority to absorb what may be termed "war waste," and avoided making loans which involved any speculation as to the duration of the war or where the security would be impaired by cancellation of war contracts.

By the terms of the Act, direct advances required "adequate security" equal to at least 125 percent of the amounts advanced. Further, the rate of interest charged was to be not less than 1 percent in excess of the rate of discount for ninety-day commercial paper prevailing in the Federal Reserve district where the borrower was located. The Corporation endeavored in each case to charge the going rate for loans of the class represented, which averaged somewhat higher than the minimum specified. Despite discouragement of applications and careful scrutiny of those received, the War Finance Corporation, under its war powers, made direct loans as follows: ¹⁵

To railroads	\$204,794,520
To public utilities	39,797,400
To industrial corporations	23,814,674
On warehouse receipts	25,211,500
On cattle	7,833,740
Total	<u>\$301,451,834</u>

Upon analysis of the figures above, however, the apparent volume is found to be misleading. The greater part of the railroad lending occurred while the railroads were in the hands of the government, being operated by the Railroad Administration. Of the total advanced against warehouse receipts, \$25,000,000 represented a single loan to the Food Administration. In the industrial classification, loans were only five in number, and, of the total advanced, 80 percent went to Bethlehem Steel Corporation. The livestock loans, though small in total, were by far the most numerous, with several hundred loans being granted, at the highest interest rate charged by the Corporation, 8 percent.

After hostilities ended in 1918, considerable fear was enter-

¹⁵ Sources are the annual reports of the War Finance Corporation.

tained that, due to the weakened finances of European nations, export trade might suffer seriously. To meet this problem, Congress amended the War Finance Corporation Act on March 3, 1919, granting authority to make advances, up to five years in duration, to finance exporting businesses unable to obtain funds upon reasonable terms through banking channels. These advances were likewise required to operate on a strictly business basis, with adequate collateral, but a considerable volume had been authorized by May 1920, when the Corporation's lending activities were suspended by the Secretary of the Treasury on the basis that they were no longer necessary.

The deflation and depression of 1920-21, however, affected agricultural products with particular severity, and banks in rural areas found themselves dangerously frozen, with large numbers being forced into liquidation. The resultant stringency of agricultural credit was alleviated, in part, by an amendment of August 24, 1921, which authorized the War Finance Corporation, on the basis of disruption of agricultural markets arising from the war, or of inadequacy of ordinary banking facilities to carry agricultural products until they could be sold for export in an orderly manner, to extend intermediate-term credit to agriculture in general. Loans were required to be secured by adequate security and could not exceed one year in maturity, but they could be renewed up to three years. Eligible for credit were producers of or dealers in agricultural products, foreign purchasers of United States agricultural products, and banks having made advances to such producers, dealers, or purchasers. By November 30, 1921, \$33,451,000 had been advanced for general agricultural purposes, and a similar volume of new export credit had been granted. Loans were made by the Corporation to banks, as well as directly to firms. They continued to be selected with care and were well secured, while rates of interest charged were not particularly low. Nevertheless, the psychological effect was substantial, and aided in combating the depression of 1921.

Important steps had been taken to improve the availability of agricultural credit prior to this time. Rediscounting privileges were granted by the Federal Reserve banks for agricultural paper of six-months or shorter maturity, so that commercial banks in most areas were able to meet short-term needs satisfactorily, barring severe general stringency. Long-term money was available from the Federal Land banks, established in 1917, and other institutions. However, a gap, greatly aggravated by the serious postwar deflation, was believed to exist with respect to credit ranging from six months to two or three years in length. Because of the long cycle of production in farming, such credit represented a significant share of the farmer's requirements. The War Finance Corporation had some success in remedying this situation, loaning approximately \$300,000,000 for agricultural purposes after August 1921. The Federal Intermediate Credit banks, organized pursuant to the Agricultural Credits Act of 1923, supplanted the War Finance Corporation in the agricultural field, and after December 31, 1924, its authority to make loans expired, except for such further advances as were necessary to assure orderly liquidation of outstanding loans.

Losses of the War Finance Corporation were nominal, due to the strict lending policies followed throughout. It made relatively few loans for business purposes, if we exclude agricultural credit and railroad credit; when measured against other factors, its contribution to the stimulation of exports was not important. It performed a useful emergency service in holding rediscounting privileges available, but it did not offer a type of credit to business that the banks could not adequately offer when wartime strains were past. With respect to agricultural credit, on the other hand, the lending services it initiated appear to have filled a gap in the private financial system and were continued afterward by other public agencies.

Chapter IV

EXPERIENCE IN FARM, HOUSING, AND OTHER TYPES OF FINANCING

• **DESPITE** our desire to limit discussion of non-business types of financing, the breadth of experience accumulated by government agencies in agricultural lending is so great and the force of its example such that consideration of it in some detail is unavoidable.

AGRICULTURAL CREDIT PRIOR TO 1933

Development of the elaborate, modern agricultural-credit structure under government sponsorship in the United States began pursuant to the Federal Farm Loan Act of 1916. Agitation for establishment of a credit system specifically designed to meet the needs of agriculture had been under way for a long period prior to enactment of this legislation. Although in certain preferred districts the activities of competing lending agencies and individual investors had provided adequate farm-mortgage credit, such credit was hard to obtain on reasonable terms in a large number of rural areas. Moreover, interest rates and commissions on farm mortgages were generally high, and the typical loan was of short maturity, usually five years or less, necessitating frequent renewal or costly refinancing, a source of serious embarrassment to farmers in times of financial stringency.

Specialized agricultural-credit systems, embracing government, co-operative, and private institutions, had existed in European countries, notably Germany, for many years. Two American commissions were sent abroad in 1912 and 1913 to investi-

gate and report upon practices in Europe. Extensive Congressional hearings which followed their reports led to passage of the Federal Farm Loan Act, which authorized creation of the Federal Land banks and the Joint-Stock Land banks as a compromise of opposing points of view, providing, under federal supervision, both a co-operative and a private agricultural-lending system. Both types of banks were given the opportunity to obtain funds on a favorable basis by sale of tax-exempt bonds as instrumentalities of the United States, and it was expected that, through the pooling of risks, they would be able to furnish long-term, amortized farm-mortgage loans at lower rates and on more favorable terms than had previously been available to most borrowers.

The twelve Federal Land banks, operating in separate geographical districts, were supplied by the federal government with substantial initial capital in the form of redeemable stock; the remainder of the stock was owned by local co-operative National Farm Loan Associations, by which most of the loans were made and endorsed, and, to a small extent, by direct borrowers. Each borrower from a local association was required to purchase association stock, bearing double liability, and equaling 5 percent of the amount of his loan. The association, in turn, was required to make an equal investment in the stock of the Federal Land bank, and provision was made that, as such investment by the associations grew, the stock of the federal government would gradually be retired. Proceeds of the loans were available to buy land, erect improvements, liquidate debts incurred for these purposes, or purchase livestock or fertilizer. Loans were limited to first mortgages, and were made upon a conservative basis; yet, within a few years, a very large volume was outstanding, exceeding \$1,000,000,000 by the end of 1925.

The Joint-Stock Land banks, of which eighty-eight in all were chartered, with loans aggregating \$669,000,000 at the peak in 1927, were privately owned, but subject, like the Federal Land banks, to close supervision and regulation by the Federal Farm

Loan Board. The purposes for which they could lend were less restricted by the enabling legislation, but the Board specified that lending activities should be confined within bounds similar to those of the Federal Land banks. However, certain of them were not conservatively managed, and failures, together with less favorable bond markets, led to difficulties in the sale of their bonds, which brought about gradual contraction of their activities after 1927. The Emergency Farm Mortgage Act of 1933 took away both their privilege of issuance of tax-exempt bonds and their power to make any loans "except such as are necessary and incidental to the refinancing of existing loans or bond issues or to the sale of any real estate now owned or hereafter acquired." They have since been in the process of liquidation.

The twelve Federal Intermediate Credit banks, which after 1923, as we have noted, supplanted the agricultural-lending activities of the War Finance Corporation and supplemented land-bank and other capital loans with short- and intermediate-term operating credit, were wholly owned by the federal government. They made funds available to farmers only through banks and co-operative credit associations, acting as discounting institutions for sound farm production and marketing loans of from six months to three years in length. They did not conceive their function to include the acceptance of other than sound banking risks. In 1930, loans of any maturity not exceeding three years were authorized by Congress, thus recognizing the position of the Intermediate Credit banks as a commercial-banking system for agriculture, rather than as a chain of institutions filling the gap between commercial and mortgage banks. Obtaining funds other than their initial capital from collateral trust bonds sold to the public, these banks primarily served the function of providing scattered rural areas with ready access to the principal financial markets on favorable terms.¹

¹ Frieda Baird and Claude L. Benner, *Ten Years of Federal Intermediate Credits* (Washington, D.C.: The Brookings Institution, 1933).

Specialized agricultural-credit agencies were also established during this period by a number of state governments, notably in North and South Dakota and Minnesota. These agencies made a substantial volume of mortgage loans, but in the aggregate they were never of major importance.

The early agricultural-credit institutions, established under government sponsorship or utilizing government funds, are significant in the present discussion because they were created in response to reasoning not dissimilar from that now advanced in support of government loans to business. In particular, the various proposals in recent years for creation of regional investment banks to make or discount capital loans to business envisage institutions closely akin in many respects to those we have just described. However, the special circumstances of agriculture—the simple and standardized nature of its operations, the absence of marketing problems comparable in complexity to those of industry and trade, and the homogeneity and ease of appraisal of its capital assets—limit the pertinence, for our purpose, of experience with agricultural loans.

THE FARM CREDIT ADMINISTRATION

The scope and complexity of the agricultural-credit institutions developed by the federal government during the 1930's, largely centered under the Farm Credit Administration after 1933, are such as to preclude satisfactory analysis here, and only a brief sketch of their nature will be attempted.² Though they

² For detailed description and discussion see United States Department of Agriculture, "Farm Credit Administration: Information prepared in connection with investigation of the activities of the Farm Credit Administration by Select Committee of the House Committee on Agriculture, pursuant to H. Res. 119, 78th Cong., 1st sess., as amended by H. Res. 525, 78th Cong., 2d sess." (Washington, D.C.: Department of Agriculture, 1944). See also United States Department of Agriculture, Miscellaneous Publication No. 478, *Farm-Mortgage Credit Facilities in the United States* (Washington, D.C.: Government Printing Office, 1942), and E. L. Butz, *The Production Credit System for Farmers* (Washington, D.C.: The Brookings Institution, 1944).

were built upon the framework already existing, the area covered was greatly expanded, adding to the wide variety of emergency assistance undertaken to combat the financial collapse of the early 1930's, which, with its numerous bank failures, had led to the calling of loans, as well as to inability in securing new accommodations. Acceptance of high risks in the pursuit of desirable social objectives and abandonment of former stress upon sound banking standards became the settled policy of certain of the new institutions.

In the early stages of the great depression, several new means of federal financial assistance to agriculture were made available, including the revolving fund provided under the Agricultural Marketing Act of 1929, the Regional Agricultural Credit Corporations organized by the Reconstruction Finance Corporation, and indirect assistance through loans to banks, or purchases of stock in banks by the Reconstruction Finance Corporation to bolster bank capital. The Secretary of Agriculture also had the power, extended periodically since 1918, to make emergency crop and feed loans directly to farmers in areas stricken by drought, flood, or other catastrophes. As the depression continued, several state governments offered assistance from another direction by enacting emergency debtor-relief laws or moratoria.

Among new types of farm credit developed during the depression, and still in operation, are the loans against commodities guaranteed by the Commodity Credit Corporation (1933). Primarily a subsidy and price-stabilization device, the Commodity Credit Corporation agrees, when banks and other agencies finance producers, to purchase the loans if tendered on or before a fixed date. A fixed collateral value is placed upon the pledged commodities, and recourse against the borrowers is waived. Thus, in effect, the commodity is sold by the farmer to the Corporation, with an option to repurchase.

Another special-purpose agency is the Rural Electrification Administration (an activity dating from 1935), which makes loans

to facilitate the introduction of electrical services to rural areas.

An important lending agency of the Department of Agriculture is the Farmers' Home Administration, established by the Farmers' Home Act of 1946 to consolidate and give permanent status to the lending activities of the Farm Security Administration and the Emergency Crop and Feed Loan Office. The Farm Security Administration, 1937 successor to the Resettlement Administration and its program of rural rehabilitation loans instituted in 1934 as a relief measure, was engaged in high-risk financing in order to promote the social objective of widespread farm ownership. A substantial total volume of loans of this type was made, with moderate losses which manifest the very favorable agricultural trends during the life of the program. The lending powers of the Emergency Crop and Feed Loan Office had, since 1937, provided for crop and feed loans when funds could not be obtained from any other source. The maximum permissible loan was \$400, with loans secured by lien on the crops or livestock being financed. Administrative expenses on such loans are naturally high and risks considerable, so that the substantial volume of business done has represented a partial subsidy to accomplish social objectives.

The basic government-sponsored agricultural-credit structure, however, is that of the Farm Credit Administration, operating under the Department of Agriculture. Organized in 1933 to supersede the Federal Farm Board, this agency has supervised the development, under 1933 and subsequent legislation, of a comprehensive farm-credit system supported by federal capital but based upon private co-operative ownership and operating on business principles. In each of the twelve farm-credit districts, there are four principal financial institutions, co-ordinated through a district farm-credit board of seven members.

The twelve Federal Land banks provide long-term first-mortgage credit, either directly or through co-operative National Farm Loan Associations. They have made a very large volume of loans.

with generally favorable experience, although many of the co-operative associations, during the depression years, suffered impairment of their capital. There is little doubt but that the Federal Land banks have exerted a considerable influence toward lower interest rates and the use of amortized loans, particularly in certain areas where few competitive sources of credit had existed. However, the Department of Agriculture remarked in 1942 that "the almost Nation-wide tendency of local interest rates and contract terms of mortgages to remain out of line with those of the land banks suggest that reasons rooted deeply in the nature of agricultural operations or farming practices cause many borrowers to use short-term loans and to pay relatively high interest rates."³

Since 1933, the "standard-credit" first-mortgage loans of the Federal Land banks have been supplemented by so-called Land Bank Commissioner loans, designed originally to meet emergency conditions by advancing federal funds directly on a basis which, although secured by mortgage, involved risks not normally consistent with safe private lending. Maturities of up to forty years have been permitted in some instances. A large volume of loans has been made, but it is too early to appraise the results.

The twelve Federal Intermediate Credit banks, which constitute the second major division of the Farm Credit Administration, are wholly owned by the government and have operated actively and successfully upon business principles in the supply of short-term funds through discounts and loans to local lending institutions. Their most important customers are now other Farm Credit Administration institutions, the Production Credit Associations, and the Banks for Co-operatives.

The twelve Production Credit Corporations, wholly owned by the federal government, organize, provide capital for, and supervise a network of co-operative Production Credit Associations whose function is to supply short-term credit for agricultural purposes. When the Production Credit System was authorized in

³ *Farm-Mortgage Credit Facilities in the United States*, p. 168.

1933, much stress was placed upon need for a source of low-cost short-term credit adapted to small farming units, and available during depressions as well as in good times. The system has obtained an important volume of loans, nearly half of them in the \$250-to-\$1,000 range, and usually maturing within one year, though renewals are anticipated in connection with the purchase of heavy machinery or other items of a capital nature. Its most notable contribution has probably been its leadership in emphasizing "budgeted" loans which stress ability to pay rather than chattel security. Such loans had been made before by many bankers, but the Production Credit Associations gave a strong impetus to broader adoption.

The fourth major division of the Farm Credit Administration embraces the twelve Banks for Co-operatives and the Central Bank for Co-operatives, created in 1933 with government capital (which is still preponderant) for the purpose of financing farmers' co-operative associations, and handling farm products, farm supplies, or furnishing farm-business services. Credit has been made available in substantial volume for short-term, secured commodity loans; for short-term operating capital loans, usually collateralized; and for facility loans financing construction or acquisition of buildings and machinery.

The most important effect of this experience with agricultural credit, in so far as it is pertinent to the present study, appears to have been a material competitive stimulus to private lending institutions. That the largest segment of farm lending, both mortgage and short-term, still remains in private hands is evidence that public competition has been met, at least in part. The private segment has increased in importance during recent years.⁴ Loss experience of the governmentally sponsored institutions has, to date, been favorable. However, in the light of the highly favorable

⁴ See comparative data in "The Balance Sheet of Agriculture, 1946," *Federal Reserve Bulletin*, XXXII (September 1946), 985, 988, and survey reported in *The Wall Street Journal* (September 22, 1947), p. 11.

trends in agricultural income in the past decade, judgment in this respect must be reserved where the newer institutions are concerned. A final point worthy of comment is the general division which has grown up in farm credit between those publicly sponsored institutions, such as the Federal Land Bank System, which are privately owned or ultimately to be privately owned and which operate upon business principles, and the direct governmental lending agencies responsible for Land Bank Commissioner loans and those loans now consolidated under the Farmers' Home Administration, where above-normal risks are assumed by the government in the furtherance of social objectives.

HOME-MORTGAGE CREDIT

A second major field in which extensive new credit institutions were developed under government sponsorship during the great depression was that of home-mortgage lending. The disastrous liquidation of mortgage credit during the early years of the depression made obvious the unsoundness of existing lending practices in which short-term, unamortized mortgages, especially second mortgages, played so important a part. It also directed attention to the need for a reserve source of credit to support mortgage-lending institutions during periods of deflation. Development of the new institutions during the 1930's accorded recognition to these facts. In addition, however, there was a growing desire to stimulate revival in housing-construction activity and employment. In attacking a problem already complicated by diverse sources of mortgage funds in the United States, these different underlying motives caused the development of what are really two separate systems of mortgage financing. A considerable measure of conflict and duplication in their operations has been unavoidable.⁵

⁵ See Miles L. Colean, *American Housing: Problems and Prospects* (New York: The Twentieth Century Fund, 1944), chaps. ix-x. Also, David M. French, "The Contest for a National System of Home Mortgage Finance," *American Political Science Review*, XXXV (February 1944), 53-69.

The essential framework of the first of these systems was established in 1932, on the basis of principles under discussion for many years, by legislation creating twelve regional Federal Home Loan banks, supervised by the Federal Home Loan Bank Board (since 1942 known as the Federal Home Loan Bank Administration). The Federal Home Loan banks do not lend to individuals, but serve as a credit reserve for member savings and loan associations, savings banks, insurance companies, and other institutions engaged in making long-term home-mortgage loans. In practice, membership has consisted chiefly of savings and loan associations. The funds of the Home Loan banks are obtained from capital stock subscribed by the government and by member institutions, from debentures offered to the public, and from the deposits of members. Advances are made to member institutions upon a secured or unsecured basis, subject to conservative standard requirements which always include pledge of stock in the Home Loan bank owned by the borrowing institution.

The Federal Home Loan Bank Administration also supervises the lending activities of the local, private Federal Savings and Loan Associations, and liquidation of the loans of the Home Owners' Loan Corporation. This rescue agency, active from 1933 until 1936, employed public funds to make long-term, amortized mortgage loans to distressed non-farm home owners and to re-finance home mortgages held by others. The primary purpose of this corporation, which made more than a million loans aggregating over \$3,000,000,000, was to protect small home owners from losing their property due to the depression, and abnormal risks were willingly assumed.

THE FEDERAL HOUSING ADMINISTRATION

The second general system of government-sponsored home-mortgage financing is that of the Federal Housing Administration, an agency created to administer those insurance provisions

of the National Housing Act of 1934 which attempted to stimulate activity in building construction and repair. This agency was unique at the time of its creation in that it was not designed to provide any credit directly, but instead to insure loans made by private institutions. Title I of the National Housing Act provided for the insurance of lending institutions against loss on loans made for modernizing or repairing real property. At the start, no premium was charged for this insurance; it was not until 1939 that a fee of $\frac{3}{4}$ percent per annum of the net proceeds of the loan was instituted. Under the plan originally established, the government insurance was limited to 20 percent of the total of such loans financed by each institution. In 1936 the maximum coverage was reduced to 10 percent but, since this is calculated on a cumulative basis, a bank which has made a good volume of loans over a period may have built up very substantial protection against new risks. Claims on defaulted loans are payable in cash upon presentation of evidence of default and transfer of the note to the agency administrator.

Loans under Title I are usually made on a discount basis, with regular installment amortization payments. Restrictions governing the types, amounts, and maturities of loans insured have been changed frequently, starting originally with a limitation to loans for repair or modernization not in excess of \$2,000 in amount or five years in length. Financing of readily detachable equipment has been excluded, except for a period during 1935 and 1936, when experience proved unsatisfactory. Neither down payment nor security was required in connection with most of the loans insured, until April 1948, when a 10 percent down payment was specified. An aggregate of nearly \$3,000,000,000 of insured Title I loans had been made by the end of 1947.

The major operations of the Federal Housing Administration, however, have been under Title II of the Act, which provided for the insurance of approved lending institutions against all losses on amortized mortgages on specified types of residential

property through the establishment of a mutual mortgage-insurance system. Restrictions as to types, amounts, and maturities of loans, and as to permissible charges, have been changed from time to time, but, on small homes, loans up to 90 percent of appraisal value and up to twenty-five years in maturity have been included. The insurance premium was first set at $\frac{1}{2}$ percent per annum of the original amount of the mortgage, later reduced to $\frac{1}{2}$ percent per annum in advance on outstanding balances. A Mutual Mortgage Insurance Fund was established, with an initial government investment of \$10,000,000, into which the premiums are paid. If default occurs, the property is foreclosed and title is transferred to the agency administrator; the mortgagee then receives debentures of the Fund equal in amount to the unpaid balance of the loan, plus net expenses of the mortgagee for taxes, special assessments, and insurance, bearing interest at the current long-term government rate and maturing three years after the original maturity date of the mortgage.

The use of insured mortgages under Title II developed slowly, but has grown to very large proportions, particularly in relation to the restricted field available. Mortgages held by individuals and by many institutions, including the Home Owners' Loan Corporation, are not eligible. The aggregate volume of Title II loans insured by the end of 1947 was in excess of \$5,700,000,000, of which sum approximately half was currently outstanding. The mortgages insured have been small on the average, and a generally high ratio of borrowing to appraisal value has existed. It appears fair to say that, although insured mortgages have been popular with lenders and borrowers alike, and loss experience has been good, borrowers have been able to secure more favorable terms elsewhere when the ratio of borrowing to appraisal value was on a relatively conservative basis.

In order to stimulate private low-cost housing construction in areas of wartime housing shortage, a Title VI was added to the National Housing Act in 1941, and liberalized by amendment

a year later. Operations under Title VI were looked upon as higher-risk emergency financing, and a separate War Housing Insurance Fund was established to protect the Mutual Mortgage Insurance Fund from possible dilution by extraordinary losses. Later, in 1946, loans for veterans' housing were made eligible under Title VI. Roughly \$2,600,000,000 of insurance under Title VI had been written by the end of 1947.

That the new credit institutions developed by the government in the home-mortgage field have stimulated lending and have exercised a beneficial influence in other respects is beyond question. This influence has been summarized by one authority as follows: "These activities of the federal government have not only made the long-term, amortized mortgage the accepted type of instrument, but have lowered interest rates, improved methods of appraisal, advanced marketing knowledge and given aid to technical research." ⁶

Criticism of the government's activities has been centered around duplication in functions and contradiction in basic policies existing between the Federal Home Loan Bank Administration and the Federal Housing Administration, which have continued despite the integration of the two organizations under the authority of the Federal Loan Agency in 1939 and under the National Housing Agency in 1942. This criticism probably does not take into full account the degree to which such lack of co-ordination is unavoidable as long as mortgage lending remains a function of institutions so different in character as, for example, savings and loan associations and commercial banks. The government, rather than attempting to concentrate mortgage lending in the hands of a single type of institution, has chosen to develop agencies capable of promoting sounder lending within the framework of the varied institutions which actually exist. The Home Loan banks have been trying to develop a specialized mortgage-

⁶ Miles L. Colean, *op. cit.*, p. 269. See also Leo Grebler, "The Home Mortgage Structure in Transition," *Harvard Business Review*, XVIII (Spring 1940), 362-72.

banking system, with the details of lending policy left to the member institutions. The Federal Housing Administration is operated centrally, with insistence that loans be subject to its own appraisal, inspection, and other standards. It insures each mortgage loan separately, and has tended to promote long-term mortgage lending within the commercial-banking system.

SHIP-CONSTRUCTION LOANS

Government financing of shipping and shipbuilding constitutes a specialized field which we shall note here only for purposes of a rounded presentation of the general background. Because of their special importance to national well-being, these industries have been the recipients of subsidies in this as well as other countries over a long period of years. Provision was made in the Merchant Marine Act of 1920 for a federal construction-loan fund of \$25,000,000 to encourage the construction or reconditioning of vessels in United States yards. This fund was increased in 1927 and 1928, and a substantial volume of loans was made, exceeding \$145,000,000 by the middle of 1931. Then, world depression in shipping halted new construction. Only \$2,800,000 of loans were authorized during the succeeding five years. Loans were made for as long as twenty years, on an amortized basis and at low interest rates.

This financing was continued in a modified form by the Merchant Marine Act of 1936, which authorized the United States Maritime Commission not only to subsidize construction costs but to guarantee "preferred ship mortgages" of private financing institutions up to 75 percent of costs at the time a ship was completed or reconditioned. The volume of these amortized mortgage loans was unimportant, amounting to roughly \$8,000,000 through the middle of 1946, at which time none remained outstanding.

THE EXPORT-IMPORT BANK

Still another type of governmental financing of private enterprise, at which we shall glance briefly, is the financing of export trade by means of loans to American exporters or to foreign purchasers. Such lending may be considered a facilitating device, a subsidy if necessary, for the promotion of American exports and thereby American economic activity, or it may be employed for advancing our political interests abroad. From either approach, a thorough discussion of the problem would introduce a multitude of complex issues relative to exchange rates, the balance of payments, and international politics, which are not germane here.

It will be recalled that export credit was made available to business in 1919-20 by the War Finance Corporation. Likewise, agricultural exports were financed by the War Finance Corporation and, later, by the Reconstruction Finance Corporation. For a long while government guaranties of export credits have been employed by European countries, the best-known system being the British, embodied in the Export Credits Guarantee Department. This Department was established in 1921 with the original purpose of facilitating exports to the Continent for rehabilitation purposes. It has operated at a profit in guaranteeing the solvency of foreign purchasers, the payment in sterling of commercial debts held in foreign currencies, and the repayment of medium-term credits extended to foreign purchasers.⁷

Recent American activity in this field began with the establishment of the Export-Import Bank of Washington on February 12, 1934, entirely with government funds, pursuant to Executive Order 6581, as a phase in the general program of encouraging economic recovery. It was intended to operate solely in the financing of trade between the United States and Russia, which was expected to be large following our diplomatic recognition of the

⁷ Joseph H. Barkmeier, "Britain's Export-Credit Guarantee System Today," *Foreign Commerce Weekly* (July 15, 1944), p. 3.

U.S.S.R. A second such bank, to facilitate trade with Cuba, was organized on March 9, 1934, also under Executive Order. The second bank soon extended its activities to include all countries except Russia, and, when it became evident that no loans for Russian trade were going to be made, the two institutions were combined, the second bank going out of existence on June 30, 1936.

At an early date the Bank stated that opportunity would be given to private banks to participate in loans, and that its intention was "to supplement rather than compete with existing sources of export and import credit." It indicated that short-term credit would be granted only under unusual circumstances, and that its main field would be the financing of transactions requiring medium-term credits or involving blocked funds which many private banks refused to accept.

Until 1939, the Bank kept to these purposes but was comparatively inactive. Beginning in 1939, and continuing during the war years, a shift occurred in the nature of its business, with the political aspects growing rapidly in importance. During this period, its principal operations were in Latin America, as a governmental instrument promoting our defense program and, later, the prosecution of the war. Large term loans were made, for example, to Latin-American governments, or to their government-sponsored development corporations.⁸

This shift in character was recognized by the Export-Import Bank Act approved on July 31, 1945, which increased the capitalization of the Bank from \$175,000,000 to \$1,000,000,000, gave it the right to borrow from the Treasury an additional amount not at any time in excess of \$2,500,000,000, and authorized it to lend or make commitments "for the purpose of aiding in the financing and facilitating of exports and imports and the exchange of commodities between the United States or any of

⁸ See Gardner Patterson, "The Export-Import Bank," *The Quarterly Journal of Economics*, LVIII (November 1943), 65-90.

its Territories or insular possessions and any foreign country or the agencies or nationals thereof.”⁹ The Act provided further that, “It is the policy of the Congress that the Bank in the exercise of its functions should supplement and not compete with private capital, and that loans . . . shall generally be for specific purposes, and, in the judgment of the Board of Directors, offer reasonable assurance of repayment.”

A general policy statement issued by President Wayne C. Taylor on September 11, 1945, stressed that loans and guaranties would be made only: (1) to promote the export and import trade of the United States, (2) for specific purposes, (3) where reasonable assurance of repayment is offered, (4) to finance purchase of American materials and services as distinguished from outlays made in the borrowing country or other countries, and (5) when not in competition with private capital, but supplementing and encouraging it. It was pointed out, despite 4 above, that the trade of the United States would be promoted indirectly as well as directly, through the financing of development projects and programs which would “assist in building up the economies and raising the levels of income in foreign countries, which thereby become better markets for American products and better suppliers of imports to this country.”¹⁰

Large loans were granted to foreign governments in 1945, 1946, and 1947. It appears that, although the Bank proposes to make only those loans which can be justified from an economic standpoint, it is at present primarily an institution for implementing governmental policy, and only secondarily an agency for making financing available for the promotion of private foreign trade.¹¹

⁹ Public No. 173, 79th Cong., 1st sess.

¹⁰ *Federal Reserve Bulletin*, XXXI (October 1945), 1000-1005.

¹¹ Despite the Bank's expressed preference for the latter function, there remains some uncertainty as to how the field of long-term development loans will ultimately be divided with the International Bank for Reconstruction and Development established pursuant to the Bretton Woods agreements.

In its financing of export trade, the Bank has stated its preference for guaranteeing or participating in privately arranged loans rather than making direct loans, because of the economies to be obtained through use of the established technical facilities of the commercial banks. However, direct loans have been more common. In connection with recent large loans to foreign governments, the Bank has made participations available to private banks. A few of these participations have been fully guaranteed by it, with the private institutions receiving a part of the interest, and the balance going to the Bank as a fee for its commitment to take over the banks' shares of the loans upon thirty days' notice. It is now indicated that, in the future, banks will be asked to take such participations without recourse.

VETERANS' ADMINISTRATION GUARANTEED LOANS

A war-born government-loan guaranty program of interest, in too early a stage for useful appraisal, is that provided pursuant to the Servicemen's Readjustment Act of 1944, as amended on December 28, 1945.¹² This program was designed as a benefit for war veterans, and probably should not be examined other than incidentally, from the standpoint of commercial credit. Briefly, the Act provides for guaranty or insurance by the Veterans' Administration, free of charge, of loans to eligible veterans to purchase or construct homes, or to purchase farms or business property, within ten years after the termination of the war.¹³ It does not provide for direct loans by the government, but permits guaranty of loans made by persons, firms, associations, or corporations, and insurance of loans made by lenders who are sub-

¹² "G.I. Bill of Rights," Public No. 346, 78th Cong., amended by Public No. 268, 79th Cong.

¹³ See D'Alton B. Myers, "Small Business for Veterans," *Law and Contemporary Problems*, XI (Summer-Autumn, 1945), 349-52, and United States Veterans' Administration, *Outline of General Administrative Procedure and Policies, Title III, Servicemen's Readjustment Act of 1944* (New York: American Bankers Association, 1946).

ject to examination and supervision by public regulatory agencies.

Business loans are subject to different regulations than are farm and home loans. The 1945 amendment made guaranties or insurance available for almost any business purpose, but it is required that (1) the loan be used in the bona fide pursuit of a specified gainful occupation, (2) the property to be purchased be useful in and reasonably necessary for the efficient and successful pursuit of the occupation, (3) the ability and experience of the veteran be such that there is a reasonable likelihood that he will succeed, (4) the purchase price of the property and the cost of construction or alteration be not in excess of reasonable value as determined by an appraiser designated by the Administrator. If these conditions are met, business loans may be guaranteed or insured by the Administrator up to the amount of \$2,000 (\$4,000 for real-estate loans). There is no limit placed upon the total size of the loan, but if insurance of a loan over \$15,000 is desired the prior approval of the Administrator is necessary.

For guaranties, the guaranteed amount may not exceed 50 percent of the total loans made to the veteran, but in practical effect the guaranty covers the *first* amounts lost, so that, on a small loan, the bank does not suffer unless more than 50 percent of the loan is lost. Insurance is provided instead of a guaranty, when desired, through establishment of an account on the Veterans' Administration's books in the name of the lending institution, to which is credited an amount not in excess of 15 percent of the principal of each loan. The full amount of the reserve account is available to cover losses suffered upon loans insured for the particular lender. Interest on loans is limited to 4 percent per annum, except for insured non-real-estate loans, for which the maximum is 3 percent discount or 5.7 percent interest. The Administrator pays the lender a sum equal to 4 percent of the original amount guaranteed or credited to the lender's insurance account for credit against principal or interest at the option of the veteran. The maximum permissible maturity is twenty-five years for busi-

ness loans on real estate, and ten years for non-real-estate loans. All loans over five years in length must be amortized. The lender is asked to set maturities in line with sound business practices. He is also asked to obtain first-mortgage security upon real-estate loans with strictly limited exceptions, and liens upon personalty to the extent legal and practical in connection with non-real-estate loans.

Business loans have been of much less importance than home loans in this program. In mid-1948, home loans totaled more than \$7,000,000,000 compared with business loans of \$300,000,000 and farm loans of \$180,000,000. The business loans guaranteed averaged approximately \$3,300, with the portion guaranteed amounting to about \$1,500. In addition, a substantial portion of the total of business loans was covered by insurance rather than guaranty.

Chapter V

FOREIGN EXPERIENCE

• IN MANY foreign countries the attention of governmental bodies was directed, at an earlier date than in the United States, to the possible inability of existing private banking systems to satisfy fully the financial requirements of business.

FOREIGN EXPERIENCE PRIOR TO THE 1930'S

In a few minor instances, specialized industrial lending institutions with government sponsorship or participation had been created prior to 1900 and, in other countries, central mortgage banks adaptable for the supplying of long-term capital loans to business had been established. During the first decade of the twentieth century, discussion of the subject increased and spread. In Germany, in particular, proposals were advocated strongly in 1908 and 1909 for the organization of institutions to make capital loans to small business enterprises which otherwise had no access to the capital market. Nevertheless, despite this early interest, the existing financial mechanisms worked smoothly enough that few changes of significance were undertaken until after World War I.¹

In examining the different courses of industrial and financial development in different countries, one finds a considerable variation prevailing, over a long period, in the structure and operation of their banking systems. This was especially true with respect to long-term capital loans. In Great Britain, where substantial wealth which had been accumulated in trade prior to the indus-

¹ See the comprehensive survey of this subject by Kurt Grünwald in "Industrial Credit Survey, 1919-1939," *L'Egypte contemporaine*, Nos. 203-4 (Cairo: February-March 1942). See also League of Nations, Financial Committee, *Medium-Term Credit to Industry* (Geneva: League of Nations, 1939).

trial revolution was available for investment, capital for industry was from the beginning provided by individual entrepreneurs and from reinvestment of profits. British commercial banks traditionally stressed liquidity, avoiding capital loans, and confining their advances, in so far as possible, to short-term commercial transactions. For their adherence to this practice, the banks were meeting a growing criticism prior to World War I. Actually, even the investment-banking houses in Great Britain had at this time relatively little to do with financing industry; they concentrated upon government and foreign loans instead.

In France, which did not possess the extensive capital resources of Great Britain, there was greater need for a banking system which could mobilize long-term capital for industry, and appropriate institutions developed. These included a central mortgage bank, an extensive system of savings banks, large banks which combined commercial- and investment-banking functions, and, in addition, speculative banks, such as the *Crédit Mobilier*, which furnished long-term capital for new undertakings. In Germany, and in other countries where capital was scarce and industrial development was particularly rapid, there developed "mixed banking," which became the general practice in most of Europe. The principal banking institutions combined commercial- and investment-banking functions, but stressed the latter. They undertook to supply all financial requirements of industry, and both promoted industrial enterprises and retained control of them afterward. They engaged in advance financing of future stock issues, that is, they financed undertakings whose securities they might later be able to sell to the public, and they frequently retained some portion of the securities as permanent investments. There is some indication, however, that promotional financing of this type was by no means always available to small enterprises.

During World War I, most of the European combatant governments undertook to supply capital and credit to war contractors beyond that available from private sources, to the extent

necessary to assure needed production. After the financial strains of the war and the severe inflation which followed in some countries, ruining the investing classes and depleting the resources of financial institutions, the prewar credit system no longer functioned adequately. In consequence, a number of governments moved, during the ensuing decade, to supplement private banking systems with new, specialized institutions. Generally speaking, this aid took the form of facilities for (1) medium- and long-term industrial loans or (2) small-business financing. Among the countries concerned were France, Belgium, Poland, Hungary, Rumania, Finland, Sweden, Latvia, and Germany.

As early as 1917, the French government organized a network of co-operative societies known as *Banques Populaires* for the supply of short-term credit to small enterprises. In 1923, it added the *Crédit Artisanat* which made medium-term loans of up to five years available to small businesses through the *Banques Populaires*. During the same period, the large, private French banks created several important affiliated institutions, for the purpose of supplying medium-term loans to industry which the parent deposit-banks felt they could not grant without unduly compromising their own liquidity.

In Belgium, a privately financed special mortgage bank to supply medium- and long-term agricultural, industrial, and commercial loans, the *Société Nationale de Crédit à l'Industrie*, was created under government sponsorship and control in 1919. For several years it loaned mainly against claims for war-damage compensation, but after 1924 it was able to turn to an increasing volume of normal types of capital loans to business. In 1939, two additional central institutions were created for the special benefit of small undertakings, the *Fonds de Garantie au Crédit pour l'Outillage Artisanal* and the *Caisse Centrale de Petit Crédit Professionel*.

In Germany, a variety of institutions attempted during the 1920's to supply mortgage loans to industry and trade, with

special emphasis upon the assistance of medium- and small-sized enterprises. Prominent among new institutions were the *Industrieschaften* organized in 1925 and 1926, associations of industrial credit-seekers organized in Saxony, Thuringia, and the Palatinate. The Saxon institution, which did a considerable volume of business successfully, was financed principally through debentures floated in America and in Germany, secured by mortgages and by the joint liability of borrowers up to 10 percent of their credits, and guaranteed by the Saxon state. The state bank also took part in the management, and the loans were made on a conservative basis, being limited to 30 percent of real-property values. The two other *Industrieschaften* were similar in organization and in the additional joint liability of borrowers, but they did not float debentures, borrowing instead from a mortgage bank, in Thuringia, or from the government. These two institutions suffered heavy losses during the subsequent depression.² Another institution which floated a substantial debenture loan in 1927 to finance mortgage credits to medium- and small-sized industrial undertakings was the *Deutsche Landesbankenzentrale*, a central organization of provincial public banks.

In sum total, however, despite the instances we have outlined, the financing of private business by public or quasi-public institutions remained of small importance until the 1930's. Many governments took no action in this direction at all, and many of the measures taken were so limited in scope or so administered as to be unproductive of significant results. The financing provided was generally confined to loans secured by first mortgages on a conservative basis of valuation, and it was by no means generally conceded that a gap existed which private financial institutions were unable to fill.

² Fritz Lehmann, "The Problem of Financing Small and Intermediate Industries," *Social Research*, II (August 1935), 290-94.

FOREIGN EXPERIENCE IN THE 1930'S

With the advent of the great depression, and in particular after the collapse of the Creditanstalt in Austria in 1931, the situation changed completely. Emergency governmental financial assistance became necessary virtually everywhere, in part to help business directly but chiefly to rescue the existing banking institutions. A disastrous wave of liquidation of bank credit had been set in motion upon the Continent, with particularly serious consequences to the industrial banking institutions which had to meet short-term deposit liabilities or maturing debentures despite a preponderance of long-term or frozen loans in their portfolios. The result was not only a serious impairment of the total ability of banking institutions to provide financing, but also a compelling incentive for bankers to avoid long commitments on new loans. In fact, legislation was shortly passed in many countries requiring the complete divorce of deposit- and investment-banking functions. This widespread legislation reflected a general feeling that the two activities were incompatible.

At about the time of the failure of the Creditanstalt, the Macmillan Committee's extensive *Report of the Committee on Finance and Industry*, covering investigations begun in 1929, was published in England.³ This report officially recognized the existence in England, the traditional stronghold of private finance, of a significant gap in the financial structure. The report ascertained that adequate short-term bank credit was available, that the English banks "use and have used their resources freely, sometimes too freely, in the provision of advances to industry." The availability of intermediate-term loans and long-term capital, however, was less satisfactory. The committee felt that the British financial organization might, with advantage, be more closely co-ordinated with British industry, and envisaged an institution or group of institutions on the Continental pattern which would

³ London: His Majesty's Stationery Office, 1931.

act as financial advisers to industrial companies, secure the underwriting of and issue the companies' securities to the public, arrange if necessary for the provision of temporary financing in anticipation of an issue, assist in financing long-term contracts, new developments, or entirely new enterprises, and generally be free to carry out all types of financing of business. The committee also reported that

It has been represented to us that great difficulty is experienced by the smaller and medium-sized businesses in raising the capital which they may from time to time require, even when the security offered is perfectly sound. To provide adequate machinery for raising long-dated capital in amounts not sufficiently large for a public issue, i.e., amounts ranging from small sums up to say £200,000 or more, always presents difficulties. The expense of a public issue is too great in proportion to the capital raised, and therefore it is difficult to interest the ordinary investor by the usual method; the Investment Trust Companies do not look with any great favour on small issues which would have no free market and would require closely watching; nor can any issuing house tie up its funds in long-dated capital issues of which it cannot dispose. In general, therefore, these smaller capital issues are made through brokers or through some private channel among investors in the locality where the business is situated.⁴

It was stated that private placement may often be the most satisfactory method, but in view of the increasing difficulty of such placement the proposal was made that a special financial institution be formed to devote itself to long-term capital issues of smaller industrial and commercial concerns.

As a consequence of the financial collapse accompanying the great depression, on top of the growing recognition accorded the problems of medium- and long-term and small-business financing as reflected in the Macmillan report, a large number of more or less successful experiments in financial assistance were instituted by, or under the auspices of, governments. There was hardly a country which did not take, or at least debate seriously, steps

⁴ *Report of the Committee on Finance and Industry*, pp. 173-74.

toward the supply of credit or long-term financing to industry. A few typical examples will be cited.

In Belgium, where mixed commercial and investment banking was well established, a separation of the two functions was compelled after 1934. However, at that time, new specialized institutions, utilizing government capital and guaranties of obligations, were also organized for lending to small industry. In 1937, these small-business lending activities were enlarged and extended, the several types of institutions being co-ordinated through a Conseil des Institutions de Crédit.

In Sweden, legislation in 1933 prohibited mixed banking. This was followed by the establishment in 1934, by the government and a number of private banks, of the Industrial Credits Company, an institution for medium- and long-term industrial loans, designed to assist particularly the smaller enterprises which lacked direct access to the capital market. This organization normally required real-estate mortgage security, but was willing to make financing available for renewal or enlargement of plant or for the fulfillment of long-term contracts. In Norway, in 1936, the government established an industrial bank for long-term loans, stressing the assistance of industries of small size, and also provided grants and guaranties to facilitate the development of new industrial enterprises.

In Germany, the Bank für Deutsche Industrie Obligationen, originally established in 1924 as a transfer medium under the Dawes Plan, in 1931 became a lending agency for industry, especially small- and medium-sized companies. It operated, as far as possible, in co-operation with local credit institutions. Although privately financed, it was supervised by the government.

In Great Britain, the Bankers' Industrial Development Company had been organized in 1930, under the auspices of the Bank of England, to assist in the rationalization of depressed industries unable to obtain capital because of the unpromising prospects which they offered. Its field was salvage, and its operations were

not of importance. Then, in 1934, Credit for Industry, Ltd. was financed privately as an institution designed to supply the capital needs of small industrial and commercial businesses in amounts from £100 to £50,000, with maturities up to twenty years. It usually loaned upon a secured basis, and only to established businesses, preferring not to participate in prospects.⁵

Other privately financed British companies designed to assist in the financing of small enterprise were organized in 1934 and 1935. These included the Charterhouse Industrial Development Company, Leadenhall Securities Corporation, and Industrial Finance and Investment Corporation. Only one British concern, the Special Areas Reconstruction Association, Ltd., formed to assist new or expanding enterprises in depressed areas, received direct governmental assistance, and that only to the extent of contribution of a portion of operating expenses and guaranty of 25 percent of losses on loans. The Charterhouse company, financed by an investment trust, an insurance company, and two large joint-stock banks, was the most interesting experiment. It looked to prospects instead of collateral, and made loans of maturities up to twenty years. However, it required that the borrowing business be already established, with a three-year profit record, prospects of growth, and a capable management, with money invested in the business by the managers. Available data do not indicate that any of the British companies mentioned has been called upon for any substantial volume of credit.

At the beginning of World War II, the new financial institutions created during the 1930's were still upon an experimental basis. Moreover, the extraordinary period covered by these experiments and the considerable variety among them render them particularly difficult to evaluate. Nevertheless, it must be conceded that the actual volume of lending done by them had in general disappointed their promoters, especially in so far as

⁵ A. T. K. Grant, *A Study of the Capital Market in Post-War Britain* (London: Macmillan & Co., Ltd., 1937), pp. 212 ff.

hopes were held for a large volume of loans to small enterprises. The Financial Committee of the League of Nations in 1939, after reviewing the experience of a number of countries which had established special facilities for medium-term credit, concluded that "the small volume of credit extended does strongly suggest that there is no great unsatisfied legitimate demand at the present time," and that "where gaps exist in the financial machinery [for medium-term credit], they are narrow and are gradually being closed."⁶ This committee drew a careful distinction, however, between need for short- or medium-term credit and need for capital, emphasizing that the risks of small business were such as to require a high proportion of equity capital to borrowed funds, and went on to remark that serious inadequacies appeared to be developing in the supply of equity capital available to small business.

Because this inadequacy of equity capital for small business is now rather widely conceded to exist, it is particularly significant to note that only a very few of the institutions created during the 1930's—and those few mainly in South American countries especially anxious to expand industrially—made provision for the supply of promotional credits or share capital. Most lending was limited to established businesses with reasonably clear prospects, and very generally the security of a mortgage was required. Quite apart from the numerous administrative, political, and other problems associated with equity financing by such institutions, the speculative risks involved in provision of share capital or promotional loans were considered to be incompatible with the debt structure through which the typical industrial financing institution was itself financed.

⁶ League of Nations, Financial Committee, *op. cit.*

THE CANADIAN INDUSTRIAL DEVELOPMENT BANK

Although as yet too young to permit of satisfactory appraisal of its work, the Industrial Development Bank organized in Canada, pursuant to an Act approved August 15, 1944,⁷ is organized along the lines of some American proposals. In its preamble, this Act declared its purposes to be "ensuring the availability of credit to industrial enterprises which may reasonably be expected to prove successful if a high level of national income and employment is maintained," and "providing capital assistance to industry with particular consideration to the financing problems of small enterprises." The Bank is wholly owned by the government through the Bank of Canada, which was required to provide the initial paid-up capital of \$10,000,000 of an authorized capital of \$25,000,000. Additional funds may be obtained by the sale of debentures in amounts not to exceed three times the Bank's total paid-up capital and reserve fund.

Authority granted the Industrial Development Bank is broad, and it may make direct loans, guarantee the loans of others, enter into underwriting agreements, or purchase "with a view to resale thereof" stocks or other securities of a corporation. However, only \$15,000,000 may be used for single commitments over \$200,000 and total commitments to single customers of more than \$200,000. Applicants are limited to persons or corporations "engaged in or about to engage in an industrial enterprise in Canada." The Bank must also determine that, in the opinion of its Board, "credit or other financial resources would not otherwise be available on reasonable terms and conditions," and that the amount of private capital invested or to be invested in the enterprise "is such as to afford the Bank reasonable protection."

During its first three fiscal years of operation the Bank reported that it received 1,249 applications from applicants quali-

⁷ See 8 George VI, chap. 44.

fying as industrial enterprises.⁸ Of these applications, 446 were withdrawn while in process, indicating that funds had been obtained elsewhere or that the projects had been abandoned. Of the remainder, 360 were refused, and 443 were authorized in the aggregate amount of \$26,735,000. After allowing for authorizations reduced or withdrawn and loans paid, on September 30, 1947, there were 322 authorized credits totaling \$19,758,000, of which \$13,330,000 was actually in use. The average size of the authorized credits was approximately \$61,000. Only 33 were for \$5,000 or less. Maturities averaged about five years, the shortest term being under one year and the longest fifteen years. In most cases, the loans were for capital purposes, such as the construction or enlargement of buildings or the purchase of machinery. It appeared that no equity investments had been authorized.

NEW BRITISH FINANCING INSTITUTIONS

With similar purposes in mind, two new British companies for financing postwar industry were organized in 1945, the Finance Corporation for Industry, Ltd., to finance reconstruction needs of large industries, and the Industrial and Commercial Finance Corporation, Ltd., to extend medium- and long-term loans to small businesses. The stock of both is privately controlled, though policies of the institutions are guided by representatives of the government. The Finance Corporation for Industry is owned by insurance companies, investment trusts, and the Bank of England. The Industrial and Commercial Finance Corporation is owned by the commercial banks and the Bank of England. Both corporations have authority to borrow substantial amounts to supplement their paid-in capital.

The Finance Corporation for Industry reported loan authorizations at the end of its first year of operations of £1,334,000, a

⁸ *Annual Report to the Minister of Finance, September 30, 1947* (Ottawa: December 9, 1947).

modest total in view of the large field which was believed to exist for it. This was probably due to the fact that several of the large industries requiring reconstruction were expected to be nationalized and thus could obtain financing through other means.

The Industrial and Commercial Finance Corporation, on the other hand, reported authorizations of £5,071,000 for its first year of operations. The number of individual authorizations was 133, reflecting an unexpectedly large average amount and few truly small authorizations. A substantial portion of the advances was authorized on an unsecured basis, with part of the remainder secured only by ordinary or preference shares.

Chapter VI

FEDERAL RESERVE BANK LOANS TO INDUSTRY

• NOW that we have sketched the general background, including the nature of public financial institutions developed in other fields and in foreign countries, we are in a position to turn to our special field of interest and examine the experience of governmental or quasi-governmental agencies in the United States in the area we have designated as business financing, that is, the financing of manufacturing industry and trade. Before 1930, as we have seen, the question of possible need in peacetime for the financing of business by such agencies was not seriously discussed in the United States. Virtually no recognition was given to the possibility that a problem might exist as to the availability of short- or intermediate-term credit. Many informed persons were aware of the existence of a growing problem facing the smaller business wishing to secure equity or loan capital, yet the general prosperity of the 1920's had been so great and the flow of new capital issues in the aggregate so vigorous that few efforts were made to investigate the possible need for remedial action. Moreover, what limited steps were initiated were intended to develop more adequate private institutions rather than any form of governmental intervention. Continued progress was made during the 1920's in the adaptation of existing private financial institutions to the changing needs of business, especially on the part of the finance companies. Too, the common practice of commercial banks of more or less automatically renewing so-called short-term loans served to provide, from that source, a substantial quantity of intermediate-term credit and long-term loan capital. A number of additional community-financing plans were estab-

lished during the period, but these were Chamber of Commerce funds for promotion of industry rather than efforts aimed at shoring up inadequacies in the financial system.

EMERGENCY SOURCES OF CREDIT IN 1932-33

With the advent of the great depression and the wave of liquidation which engulfed the nation's banking system after 1930, old prejudices against governmental intervention and assistance in the financing of private business enterprises were rapidly abandoned. The catastrophe became so great that only the government was competent to stem it, as was soon discovered by those bankers who endeavored through joint private action, notably in formation of the National Credit Corporation in October 1931, to support the banking system by providing necessary liquidity.¹ The first emergency lending activities of the federal government, excepting the agricultural field, were the rescue loans of the Reconstruction Finance Corporation (organized February 2, 1932) made chiefly in support of banks otherwise unable to meet demands for withdrawal of deposits, and of railroads unable to meet current or maturing obligations.²

Emergency sources of quasi-public credit for business in general were provided by two amendments of the Federal Reserve Act. The first, on July 21, 1932, empowered the Federal Reserve

¹ J. Franklin Ebersole, "One Year of the Reconstruction Finance Corporation," *The Quarterly Journal of Economics*, XLVII (May 1933), 464.

² This agency's activities broadened rapidly during the depression years, in directions we have no occasion to examine here, to include loans to insurance companies, savings and loan associations, drainage and irrigation districts, state and local political units, and a network of other financial transactions, especially in mortgages and agricultural loans. Its subsidiary organizations grew to include, for example, the Electric Home and Farm Authority, which contracted with retail electrical-appliance dealers to purchase from them time-payment notes executed by consumers; and the Disaster Loan Corporation, which made loans available to individuals and corporations in regions suffering from catastrophes such as earthquakes, hurricanes, and floods. Many of these activities were eliminated by an amendment of the Reconstruction Finance Corporation Act on June 30, 1947. (Public No. 132, 80th Cong., 1st sess.)

Board "in unusual and exigent circumstances" to authorize any Federal Reserve bank, during a period to be prescribed, to discount for any individual, partnership, or corporation, which was unable to secure adequate credit accommodations from other banking institutions, paper of the kinds and maturities eligible for discount for member banks, when such paper was endorsed and otherwise secured to the satisfaction of the Reserve bank. The Board authorized such discounts by all Reserve banks for the six months beginning August 1, 1932, and this authority was renewed periodically thereafter until July 31, 1936, when it was allowed to lapse because the emergency had passed and the powers were not being used. Even during the critical period to the end of 1932, only twenty-three loans aggregating \$859,000 were made under this authorization.

The second amendment of the Federal Reserve Act, on March 9, 1933, gave the Federal Reserve banks the power to make ninety-day advances to any individual, partnership, or corporation on promissory notes secured by direct obligations of the United States. A limited number of loans were made under this authority during the bank holiday, when credit was not available through the usual channels, but the total advanced was small. The amount outstanding was only \$715,000 at the end of March 1933, and was rapidly reduced thereafter, although the authority still remains.

The Reconstruction Finance Corporation received authority in 1933 to make indirect industrial loans in connection with the National Recovery Administration program, and on September 30, 1933, it offered two new types of financing. First, loans limited to six months in length were made available at a 3-percent rate to financial institutions for relending to industry at not over 5 percent in order to help industry meet the requirements of the National Recovery Administration. Second, loans limited to three years in length were made available at 4 percent to local mortgage companies or co-operative industrial groups for relending to individual businesses at not over 6 percent, against mortgage

security. Neither of these plans was successful, and the total volume of loans actually disbursed was small, amounting to only \$5,334,000 through December 31, 1934, and \$482,000 thereafter.³

DEMAND FOR NEW SOURCES OF BUSINESS CREDIT

As time passed and recovery from the depression lagged, the attention of Congress shifted from rescue measures in support of existing institutions toward the urgent need for encouraging and stimulating economic recovery. Significant new issues were raised concerning the adequacy, in this respect, of our existing economic mechanism. One such issue, keynoting the complaints of numerous businessmen, was that of the availability of adequate industrial and commercial credit through the existing banking system. Business in general had suffered a tremendous shrinkage in working capital, due to operating losses in the period 1930-33, and the sources of bank credit available to meet this deficiency had likewise been greatly reduced. Not only were banks much fewer in number and much smaller in resources, with many communities now without banking facilities at all, but credit policies had become much stricter. The bankers who survived the deflation in a reasonably liquid condition were those who had followed the strict orthodox policies which held that intermediate- or long-term working capital loans were not proper ventures for commercial banks. The remaining bankers not too frozen to be able to lend money, and the bank examiners who supervised them, were now much more conscious of the hazards involved in such financing. On the other hand, borrowers accustomed in the past to indefinite renewal of working-capital loans found it difficult to understand the new insistence upon short-term self-liquidating borrowings.

One result of the agitation which developed for new sources

³ Of these totals, \$115,000 was advanced to banks. (Sources are quarterly reports of Reconstruction Finance Corporation.)

of business credit was to call attention to some of the financial problems which, for a long time, had existed for small businesses but which had been disregarded in more prosperous days. Particular stress was placed upon need for development of a means of providing intermediate- or long-term loans to the smaller business concerns for working-capital purposes. This was the principal conclusion, for example, of the first of the numerous business-credit surveys of the 1930's, a survey conducted by the National Industrial Conference Board in the late summer of 1932.⁴ Based simply upon replies to a questionnaire, this survey offered rather unsatisfactory factual data, but the comments received and the conclusion reached were indicative of the trend of thought.

One observer wrote that the legislation in 1934 for direct industrial advances by the Reconstruction Finance Corporation and the Federal Reserve banks

was the direct outgrowth of a widespread belief among government officials that commercial banks, through fear of the Roosevelt Administration or deliberate antagonism to it, were refusing to extend loans to qualified business borrowers and that this refusal was retarding industrial recovery. Throughout 1933 it was generally believed that the commercial banks were refusing rather steadily to extend credit of any kind, whether for long or short periods and regardless of the credit rating of the applicant.⁵

However, this belief does not appear to have been, generally speaking, in accord with the facts, and gradually opinion shifted instead to the view that there existed a widespread unsatisfied demand for long-term working-capital loans which standard commercial-banking practice considered unacceptable. Statements to this effect came from many responsible sources, with the impact of the situation upon smaller businesses receiving increasing stress. Jesse H. Jones, Chairman of the Reconstruction Finance

⁴ Ralph A. Young, *The Availability of Bank Credit* (New York: National Industrial Conference Board, 1932).

⁵ James C. Dolley, "The Industrial Advance Program of the Federal Reserve System," *The Quarterly Journal of Economics*, L (February 1936), 229.

Corporation, in addressing the New York State Bankers Association on February 5, 1934, declared

I am of the opinion that banks are not extending enough new credit. . . .

There is never a day that the Reconstruction Finance Corporation does not have applications for individual and industrial loans that are perfectly sound. They are not loans that would be normally liquidated within a few months, but many of them could be made by the local banker and could be liquidated, if the borrower is given reasonable time and notice.⁶

Eugene R. Black, Governor of the Federal Reserve Board, reported on February 20, 1934, in connection with a meeting of prominent bankers composing the Federal Advisory Council of the Board:

The Advisory Council discussed the general credit situation and reported that all legitimate demands for commercial credit are being met by the banks. . . .

It was felt that there was a real demand for working capital on the part of small industries. This need was illustrated not only by the demand from all over the country for working capital but by the financial statements of the industries showing great shrinkages in working capital over the last few years, which in turn showed the need for new working capital.

It was felt that this could be best supplied through a series of industrial Intermediate Credit Banks under the jurisdiction of the Federal Reserve banks and operating through those banks and their branches in the twelve cities in which they are located.⁷

In testimony before the Committee on Banking and Currency of the House of Representatives, Mr. Black subsequently stated his personal view that "small industries have never had a chance to get working capital anywhere . . . ,” being forced to build it up from earnings, and declared further, "I would like to make it perfectly clear that in my opinion there is a real demand for this credit.”⁸

⁶ *Wall Street Journal* (February 6, 1934).

⁷ *Commercial and Financial Chronicle*, CXXXVIII (February 24, 1934), 1332.

⁸ United States Congress, House of Representatives, *Hearings before the Committee on Banking and Currency on H.R. 8717*, 72d Cong., 2d sess., May 2, 1934 (Washington, D.C.: Government Printing Office, 1934).

Not all observers agreed with the opinions expressed by Mr. Jones and Mr. Black, but it was generally felt that under existing conditions of depression no harm could come from an effort to make additional credit facilities available, and there was little opposition when several bills with this objective were introduced in Congress in February and March, 1934. Three bills received principal attention; of special import was the Administration bill which embodied the proposals of the Federal Reserve Board for the establishment, under its jurisdiction, of twelve regional Credit Banks for Industry. This bill was supported by telegraphic endorsements obtained, at Secretary of the Treasury Morgenthau's suggestion, from leading bankers and from Chambers of Commerce. The second bill was drafted by the Reconstruction Finance Corporation, and proposed to empower the Corporation to make direct loans to industry and for financing foreign trade. In explanation, Mr. Jones stated that the Corporation was merely seeking authority to do directly for smaller industries what it was already doing to a limited degree indirectly, through its loans to local mortgage companies for purposes of relending. Direct lending was expected to facilitate the making of a greater volume of loans and thereby contribute to increased employment and economic recovery. The third bill was offered by Senator Carter Glass, who proposed, as a substitute for the Credit Banks, simply granting authority to the Federal Reserve banks to make loans of up to five years directly to industry.

The legislation finally approved upon June 19, 1934, amended both the Federal Reserve Act and the Reconstruction Finance Corporation Act, to give each agency the right to make direct medium-term working-capital loans to business.⁹ The general expectation was that a very large volume of loans would result, and some criticism was leveled at the bill for limitations placed upon the amount of loans which could be outstanding at any one time to approximately \$278,000,000 for the Federal

⁹ Public No. 417, 73d Cong., 2d sess.

Reserve System and to \$300,000,000 for the Reconstruction Finance Corporation.

DISSATISFACTION WITH EARLY LENDING OPERATIONS

After lending operations pursuant to this authority had progressed for a number of months it became apparent that the volume of loans would be much less than had been contemplated. Dissatisfaction shortly arose over the somewhat strict loan requirements which had been established, and pressure for liberalization developed. This was increased by two much-publicized bank-credit surveys which were conducted during August and September, 1934, while the Federal Reserve System and Reconstruction Finance Corporation programs were just getting under way. The findings were published in 1935.

One study, undertaken by the Department of Commerce for its Business Advisory Council, was of a sketchy nature, being based upon replies to a questionnaire sent to small manufacturing firms and a rough analysis of limited financial data submitted.¹⁰ It did, however, find some indication that the smaller firms had experienced more difficulty in obtaining credit than had the larger, and it established that a substantial proportion of the firms circularized believed that no adequate sources of long-term capital were available to them.

The second study was based upon extensive field investigations in the Chicago Federal Reserve District undertaken for the Secretary of the Treasury under the direction of Charles O. Hardy and Jacob Viner.¹¹ It embraced also an analysis of the business-lending policies being developed by the Federal Reserve Bank of Chicago and the Chicago agency of the Reconstruction Finance Corporation, supported by examination of credit files and attend-

¹⁰ *Survey of Reports of Credit and Capital Difficulties Submitted by Small Manufacturers* (Washington, D.C.: Government Printing Office, 1935).

¹¹ *Report on the Availability of Bank Credit in the Seventh Federal Reserve District* (Washington, D.C.: Government Printing Office, 1935).

ance at committee meetings where cases were being reviewed. The study's findings were not adverse to these agencies, although the Corporation was criticized for the red tape and expense involved in its applications. It was found that both agencies had incurred widespread unpopularity, apparently because publicity at the outset of their programs had aroused expectations of greater liberality than was possible under the Act. A recommendation was made that the Federal Reserve banks be relieved of responsibility for direct lending, since the making of this type of loan was believed to conflict with other more important responsibilities. The conclusions which drew most attention, however, were "(1) that there exists a genuine unsatisfied demand for credit on the part of solvent borrowers, many of whom could make economically sound use of working capital"; and "(2) that the total amount of this unsatisfied demand for credit is considerably smaller than is popularly believed, but is large enough to be a significant factor, among many others, in retarding business recovery." Other findings were that small businesses had particular difficulty in obtaining credit, that the principal unsatisfied demand was for long-term working-capital loans, and "that a very large proportion of would-be borrowers are persons whose equity in the business they control is so small that any bank or individual who lends them substantial amounts is assuming a major part of the risk of the business, rather than the normal risk of a creditor."

LOANS TO INDUSTRY UNDER SECTION 13*b* OF THE FEDERAL RESERVE ACT

The 1934 amendment of the Federal Reserve Act added Section 13*b*, still in effect, which provides that, "in exceptional circumstances," when a Federal Reserve bank finds that "an established industrial or commercial business" within its district cannot secure loans "on a reasonable basis from the usual sources," the bank may make loans to or purchase the obligations

of the business, provided such loans or obligations are for working-capital purposes and have maturities not in excess of five years. The Federal Reserve bank may also participate up to 80 percent in such loans or obligations with any financing institution in its district, and may discount for or purchase such obligations from such a financial institution, make loans to it on the security of such obligations, or make commitments to it to discount, purchase, or make loans, subject in each case to assumption of liability by the financing institution for at least 20 percent of any loss resulting. The Act provides also for the appointment in each district of an Industrial Advisory Committee, consisting of from three to five members "actively engaged in some industrial pursuit," which is to pass upon all applications for credit and transmit them with its recommendations to the Federal Reserve bank for final decision.

The Federal Reserve Board implemented the Act with its Regulation S, issued on June 26, 1934. In this regulation, the Board left to the individual Federal Reserve banks the definition of "exceptional circumstances," "an established industrial or commercial business," and "working capital," explaining that definition of terms had been avoided by the Board "lest it have the effect of restricting and hampering the operations of the Federal Reserve banks under this statute." It was pointed out that security was not necessarily required, the Act stating merely that loans should be made on a "reasonable and sound basis." The Board authorized each Federal Reserve bank to establish its own requirements concerning information to be submitted by applicants, and to grant loans and make commitments without referring them to Washington. In a press release on June 28, 1934, after conferences with the Chairmen and governors of the twelve Federal Reserve banks, the Board stated: "It was agreed that these loans would be made chiefly to small and medium-size enterprises, which have the greatest need for such assistance, to whose needs primary consideration was given by the Congress,

and in the improvement of whose condition the Reserve System under this law is primarily concerned.”¹²

The lending program of the Federal Reserve System was initiated with a great deal of publicity, and, despite a lack of enthusiasm on the part of some who felt that there was no important unsatisfied demand which could be met on a sound basis,¹³ it appears that, on the whole, a vigorous attempt was made by the Reserve banks to develop a substantial volume of loans. The actual lending which resulted was small in amount, even though probably more influential in liberalizing bank-lending policies than the figures alone suggest.

Statistics

Table 1 supplies statistics covering loans authorized and outstanding. It will be noted that a rapid tapering off in applications occurred after the initial rush, to be reversed slightly in 1938 in reflection of the slump in business at that time. A subtotal is shown for loans authorized through 1939, before the defense program which commenced in 1940 might be considered to have altered normal lending relationships.¹⁴

Although the effect of expanding defense and war production is apparent in the increased amount of loans authorized after 1940, it should be noted that this increase reflects a few large loans

¹² *Federal Reserve Bulletin*, XX (July 1934), 429.

¹³ That substantial losses might be suffered was of course contemplated, in view of the marginal types of loans to be made, but the incurring of an over-all loss, i.e., a subsidy to borrowers, was not an aim of this legislation. It was believed that unsatisfied demand existed which could be filled without a net loss, and the Act specified that loans were to be on a sound basis.

¹⁴ Marriner S. Eccles, Chairman of the Board of Governors of the Federal Reserve System, in testifying in June 1940, before a Subcommittee of the Committee on Banking and Currency of the Senate (*Hearings on S. 2998 and S. 3839*, 76th Cong., 3d sess., p. 15) stated that as a result of liberalization of the business-lending authority of the Reconstruction Finance Corporation in 1938, without any corresponding amendment of the Federal Reserve Act, “the Reserve System has, for all practical purposes, for the past two or three years, I would say, been almost out of business in this particular field.”

TABLE 1
FEDERAL RESERVE BANK LOANS TO INDUSTRY *
(Amounts in Thousands of Dollars)

Date	Number of Applica- tions Received	Applications Approved			Amounts Outstanding at End of Period			
		Number	Amount	Average Amount	Loans†	Commit- ments‡	Bank Participa- tions§	Total
1934 (6 mos.)	4,386	984	49,634	50	13,589	8,225	1,296	23,110
1935	3,051	1,009	74,859	74	32,493	27,649	8,778	68,920
1936	810	287	15,336	53	25,526	20,959	7,208	53,693
1937	287	126	11,158	89	20,216	12,780	7,238	40,234
1938	584	247	24,026	97	17,345	14,161	12,722	44,228
1939	300	128	13,209	103	13,683	9,220	10,981	33,884
Subtotal	9,418	2,781	188,222	.....	.....	.....	.....	.....
1940	191	127	24,288	191	9,152	5,226	6,386	20,764
1941 . . . . .	.....	294	67,350	229	10,337	14,597	19,600	44,534
1942 . . . . .	.....	221	128,877	583	14,126	10,661	17,305	42,092
1943 . . . . .	.....	48	82,605	1,721	10,532	9,270	17,930	37,732
1944 . . . . .	.....	18	34,190	1,899	3,894	4,165	2,705	10,764
1945 . . . . .	.....	22	19,429	884	1,995	1,644	1,086	4,725
1946 . . . . .	.....	31	20,952	676	554	8,309	2,670	11,533
1947 . . . . .	.....	32	20,813	650	1,387	7,434	4,869	13,690
Total	.....	3,574	586,726	.....	.....	.....	.....	.....

* Source: *Federal Reserve Bulletin*.

† All actual advances by Federal Reserve banks, including direct loans, shares in joint loans (participations), and monies paid out under commitments to purchase.

‡ Federal Reserve bank commitments to purchase loans, plus small amounts of commitments for advances not yet disbursed.

§ Advances by banks on joint loans (participations), and those portions of advances made under commitment loans which are not covered by the Federal Reserve banks' commitments to purchase.

and not a general broadening of the lending program. After the war, in 1945 and later years, activity was negligible. For our purposes, the figures subsequent to 1940 have little significance other than to confirm that the broader lending authority granted to the Reconstruction Finance Corporation and, in 1942, to government war agencies made the Federal Reserve banks' loans unattractive. Too, the main efforts of the business-loan departments of the Federal Reserve banks were in 1942 transferred to carrying out the functions assumed by the Reserve banks as fiscal agents for the government in guaranteeing repayment of the huge volume of credit made available for financing war production.

The figures upon applications received do not reflect the full extent of interest in the program. Experience in the New York and Philadelphia districts through 1938 was that only slightly more than one-quarter of the inquiries actually developed into formal applications. On the other hand, the data upon applications approved overstate the actual amount of loans disbursed, for approximately one-quarter of this amount through 1939 covers loans not accepted by the applicants because of conditions imposed by the Reserve banks or because the applications were withdrawn after approval.¹⁵ A very common cause of withdrawal was ability to obtain the necessary funds elsewhere.

As indicated by the table, during the early years of the program only about one-third of the applications submitted were approved. The proportion of applications approved varied as between the twelve Reserve banks, but not greatly in most instances. A consistently low proportion of approvals was reported for retail-trade and service industries, and a rather high proportion for requests of industries manufacturing durable goods.

One aspect of the statistics of particular interest is the growth indicated in the average size of loan approved, from \$50,000 in 1934 to \$103,000 in 1939. In view of the presumed orientation

¹⁵ Statement of Marriner S. Eccles covering period ended May 24, 1939 (*To Provide for the Insurance of Loans to Business*, p. 113).

of the program toward small-business loans, both the average size of loan and the upward trend were the subject of much criticism. However, a detailed breakdown by size of loans approved in the period 1934 through 1937 indicated that the median size of loan fell within the \$10,000 to \$25,000 range, not a high figure for a program dealing primarily with manufacturers.¹⁶

About one-quarter of the loans approved were for \$5,000 or less. That there were no more truly small loans made does not reflect lack of diligence on the part of the Federal Reserve banks. For example, the Federal Reserve Bank of New York undertook in 1938 to follow up on names submitted to it by the Smaller Business Association for New York, New Jersey, Connecticut, Inc. as in need of credit, based upon replies received by the association to a questionnaire.¹⁷ Of the first 100 who were asked by the Reserve bank to discuss their credit needs with it, only 55 replied, and but 42 were still in need of credit. Of these, only 8 were in a condition sound enough to be invited to apply for a loan, and only one actually filed an application, which was approved. An additional 200 names were then obtained from the Smaller Business Association, but only 20 replies and one appli-

¹⁶ *Twenty-Fourth Annual Report of the Board of Governors of the Federal Reserve System* (1937) provides the following data, summarizing applications for industrial advances (including commitments) approved by the Federal Reserve banks for the period June 19, 1934, to December 29, 1937:

Amount	Total Number of Applications Approved		Total Amount of Applications Approved	
	Number	Percent	Thousand Dollars	Percent
\$ 2,500 and under.....	221	9.2	354	.2
\$ 2,501 to \$ 5,000.....	343	14.3	1,449	1.0
\$ 5,001 to \$ 10,000.....	335	13.9	2,900	1.9
\$ 10,001 to \$ 25,000.....	526	21.8	10,325	6.8
\$ 25,001 to \$ 50,000.....	418	17.4	17,060	11.3
\$ 50,001 to \$100,000.....	285	11.8	22,970	15.2
\$100,001 to \$200,000.....	144	6.0	22,802	15.1
\$200,001 to \$400,000.....	94	3.9	28,059	18.6
Over \$400,000.....	40	1.7	45,063	29.9
Total.....	2,406	100.0	150,982	100.0

¹⁷ *To Provide for the Insurance of Loans to Business*, pp. 159-60.

cation resulted. The Federal Reserve Bank of New York was led to conclude that "very few legitimate cases of unsatisfied demands for credit or working capital, which can be extended on a reasonably sound basis, exist in this District."¹⁸

An interesting trend shown by the figures in Table 1 is the shift from a preponderance of direct loans by the Federal Reserve banks in the early stages of the program toward participations in or guaranties of loans made by other financing institutions. Certain of the Federal Reserve banks stressed guaranties (commitments) from the start, in an effort to avoid competition with member banks, but the more general practice in the beginning was to loan directly. The trend toward guaranties which developed accentuated the favorable experience and gradually increasing willingness of commercial banks to enter into longer-term loans. Regularly published figures, while showing the general trend, have not furnished a satisfactory breakdown among the three types. In data supplied by Ernest G. Draper of the Board of Governors in connection with Congressional hearings, total loans authorized for the period June 19, 1934, to May 31, 1940, are shown to have been distributed as follows:¹⁹

	Number	Amount
Direct loans	1,299	\$ 53,903,000
Joint loans	472	41,601,000
Commitments	1,140	96,701,000
Total	2,911	\$192,206,000

It will be noted that the average size of direct loan authorized during this period, \$41,000, was considerably smaller than the average size of joint loan or commitment.

Worthy of comment, also, is the Federal Reserve banks' experience as to percentage of guaranty required by financing institutions in connection with commitments. Although no direct statis-

¹⁸ Federal Reserve Bank of New York, *Annual Report*, 1938, p. 21.

¹⁹ "Supplemental Statement Filed with the Colmer Committee on Post-War Economic Planning and Policy" (Mimeographed release of Board of Governors of the Federal Reserve System, 1945), p. 13.

tics are available, the data in Table 1 suggest that guaranties have averaged materially below the maximum allowable figure of 80 percent, an indication confirmed by Reserve bank officials. A substantial number of guaranties were actually made upon a basis of 50 percent.

The interest rates charged have varied with the district and with the risks assumed. In general, in the early and active years of the program, rates ranged from 4 to 6 percent upon direct advances, with 6 percent being the most common rate. The commitment fees charged by the Reserve banks to financing institutions for guaranties ranged from $\frac{1}{2}$ to 2 percent. Reductions were effected as interest rates generally declined, and the rates charged in all Reserve districts ranged from $2\frac{1}{2}$ to 5 percent as of December 31, 1945, with commitment fees ranging from $\frac{1}{2}$ to $1\frac{1}{4}$ percent in most districts.²⁰

Limited data upon earnings under the program have been published, but no adequate information on loss experience is to be had. A considerable variation in experience has existed among the individual Reserve banks. However, it is reasonably certain that, despite misgivings in the early years, the program as a whole has produced a net profit.²¹ Favorable economic trends have contributed significantly to this result, but the major factor has been recognition of the high-risk character of the loans and consequent thorough credit investigations and care in setting up and servicing loans. The Federal Reserve banks were assisted in the financing of this program by Treasury funds advanced to the extent of 50

²⁰ *Federal Reserve Bulletin*, XXXII (January 1946), 41.

²¹ In a letter dated June 24, 1940, to Senator Wagner, Chairman Eccles stated, ". . . on the basis of information now available it would appear that for the Federal Reserve banks as a whole the earnings on industrial advances and commitments will approximately offset the expenses and losses in connection with such loans" (*Hearings on S. 2998 and S. 3839*, p. 51). It is interesting to compare the comments of the Federal Reserve Bank of New York in its *Monthly Review* for August 1938, that "in general, the experience of this bank with this type of loan indicates that the income received, even at rates as high as 6 per cent, is not adequate to cover expenses and losses."

percent of requirements, with the Treasury presumably sharing 50 percent of the net profit or loss.²² In the years 1940 through 1945, the Federal Reserve banks paid to the Treasury \$1,240,000 out of earnings on the program, after provision of reserves for losses.²³

²² See *Hearings on S. 2998 and S. 3839*, pp. 26-28, where a letter from the Acting Secretary of the Treasury is reproduced stating:

"... on the basis of the aggregate funds employed, both Treasury and Federal Reserve bank funds, gross earnings, expenses, losses and reserves for losses and current net earnings, as of December 31, 1939, were as follows:

Gross earnings	\$6,817,773.77	
Less: Expenses:		
Administrative	\$3,605,259.35	
Expense for maintenance of miscellaneous assets acquired	36,629.94	
Losses charged off (other than those charged to reserves)	416,444.75	
Losses charged to reserves	319,308.39	
Reserve for loss	2,041,528.70	6,419,171.03
		\$ 398,602.74

²³ For further discussion of various aspects of Federal Reserve industrial-lending experience, see James C. Dolley, "The Industrial Advance Program of the Federal Reserve System," *The Quarterly Journal of Economics*, L (February 1936), 229-74; Lewis H. Kimmel, *The Availability of Bank Credit, 1933-38* (New York: National Industrial Conference Board, 1939), pp. 110-20; Rudolph L. Weissman, *Small Business and Venture Capital* (New York: Harper & Brothers, 1945), pp. 81-88.

See also the following unpublished studies: Federal Reserve Bank of Philadelphia, "Survey of Credit and Capital Requirements among Small and Medium-sized Business Establishments—Third Federal Reserve District," November-December, 1938; Federal Reserve Bank of New York, "The Experience of the Federal Reserve Bank of New York With Applications for Credit Under the Provisions of Section 13b of the Federal Reserve Act up to December 31, 1938" (April 1939); Glenn K. Morris, "The Loans to Industry Program of the Federal Reserve Bank of Philadelphia" (Rutgers University Graduate School of Banking: June 1940); Charles L. Merwin, Jr., and Charles H. Schmidt, "Capital and Credit Requirements of Federal Reserve Bank Industrial Loan Applicants" (New York: National Bureau of Economic Research, 1941).

Chapter VII

RECONSTRUCTION FINANCE CORPORATION LOANS TO INDUSTRY

• THE ACT of June 19, 1934, in addition to adding Section 13*b* to the Federal Reserve Act, amended the Reconstruction Finance Corporation Act by the addition of a new section, 5*d*, which authorized the Corporation to make loans to any industrial or commercial business established prior to January 1, 1934, provided credit was not available to it at banks.¹

LOANS TO INDUSTRY UNDER SECTION 5*d* OF THE RECONSTRUCTION FINANCE CORPORATION ACT

The business had to be judged "solvent," and each loan had to offer "reasonable assurance of continued or increased employment of labor." No loan could exceed \$500,000 or run for more than five years, and all loans had to be "adequately secured." The Corporation also had to be satisfied that salaries and other compensation paid by the business were reasonable. Loans could be made directly or in co-operation with banks. In *Circular No. 13*, supplying information to prospective borrowers, the Corporation interpreted the Act to permit only working-capital loans, i.e., to

¹ Other sections of the Act of June 19, 1934, authorized loans to special minor types of business enterprises which will not be covered in this discussion. Section 14 authorized loans to established businesses engaged in the mining, milling, or smelting of ores. Loans of \$7,593,000 were disbursed under this provision through December 31, 1946, on which date \$3,733,000 remained outstanding. Section 15 authorized loans, under Section 5 of the Reconstruction Finance Corporation Act, to the fishing industry. Total disbursements of only \$720,000 were made under this authority, and no outstanding balances remained on December 31, 1946.

exclude loans for fixed assets, construction or repairs, or refunding; and defined "adequately secured" to mean either a first mortgage on real property, a chattel on equipment, assignment of receivables, or a first lien on other assets acceptable to it.

Unlike Section 13*b* of the Federal Reserve Act, the Reconstruction Finance Corporation's authority to make business loans has been modified on several occasions. The first modification, upon expiration of the original lending authority on January 31, 1935, removed the limitations upon the size of individual loans and the restriction of loans to five years, permitting instead any maturity up to January 31, 1945. The most important revision, liberalizing greatly the underlying authority, was effected as of April 13, 1938, partly in response to long-standing criticism of the Corporation's policies but chiefly as a move to help in stimulating recovery from a slump in business activity.²

The 1938 revision broadened the field of eligible borrowers to include "any business enterprise," in circumstances "when capital or credit, at prevailing rates for the character of loan applied for, is not otherwise available." For the original finding as to employment of labor there was substituted the general purpose "of maintaining and promoting the economic stability of the country or encouraging the employment of labor." Limitations as to length of maturity were completely removed, as was the limit upon the aggregate amount which could be outstanding. In addition, the Corporation was authorized to purchase securities from businesses, as well as to make loans. Finally, the requirement that loans be "adequately secured" was dropped; instead, the provision was inserted that all loans made and securities purchased should be "of such sound value, or so secured, as reasonably to assure retirement or repayment." The Congressional hearings in connection with this revision found the commit-

² Apparently in the belief that direct governmental financial assistance to business was no longer needed, the President had actually, on October 18, 1937, ordered all the Corporation's lending activities to cease, except processing of applications already received. Resumption of lending had not been ordered until February 1938.

tee members uncertain as to whether this language would permit unsecured loans, but Chairman Jones of the Corporation indicated that it would not be so construed,³ and the instructions issued by the Corporation continued to require first mortgage or other first-lien security. Likewise, the Corporation did not construe the authority to purchase securities to include any securities other than bonds meeting the same conditions as those specified for loans.

The Corporation did announce, however, in the revised *Circular No. 13*, that loans would now be available for other than working-capital purposes. Permissible purposes would also include the purchase of machinery, the financing of industrial construction, the payment of existing indebtedness, and the establishment of new business enterprises or the expansion of existing enterprises into new fields.⁴ With regard to maturity, the circular stated:

Loans will not be made for a longer term than is justified by the facts of the particular case. However, the period of time so determined will be sufficient . . . to enable the borrower to make plans for the development of future business without being unnecessarily restricted by a repayment schedule which would impair the borrower's working capital during the life of the loan. For established businesses whose need is principally for shorter term credit, loans usually should be repaid within five years or less. When loans are primarily to finance capital expenditures, a longer repayment program may be considered.

In practice, it appears that a great many applicants have asked for loans of five- to ten-year maturities, while authorizations have exceeded five years in only a moderate proportion of cases.

³ United States Congress, House of Representatives, *Hearings before the Committee on Banking and Currency on H.R. 10055 (superseded by S. 3735)*, 75th Cong., 3d sess., March 29, 1938 (Washington, D.C.: Government Printing Office, 1938).

⁴ Loans of the latter types must be "sound from an economic as well as a credit standpoint. Such applicants must have a net worth proportionate to the loan requested and the new enterprise must be sufficiently beyond the developmental or promotional stage that profitable future operations can reasonably be assured." Loans would not be made to develop or purchase new inventions or to cover the cost of patents or patent litigation (*Circular No. 13*).

Partly because of publicity which raised unwarranted expectations of liberality to small businesses, criticisms of the Corporation for conservative interpretation of the Act and strict lending standards continued after the 1938 amendments; but no major change has since been made in the legislation, except for the addition and later elimination of special wartime lending powers, and restrictions placed in 1948 upon the percentage of guaranty which might be offered to banks in connection with "deferred participations."⁵ Among numerous broad and important new powers granted the Corporation in connection with the defense program and prosecution of the war was an extension of its authority for industrial lending, accomplished by an amendment of June 25, 1940, and subsequently revised. The new Section 5d(2) authorized the Corporation "To make loans to and purchase the obligations of any business enterprise, including, when requested by the Secretary of Commerce, subscription to the capital stock thereof, for any purpose deemed by the Corporation to be advantageous to the national defense. Such loans, purchases, or subscriptions shall be made under such terms and conditions and with such maturities as the Corporation may determine."⁶ The Corporation was thus able, for loans related to national defense and, subsequently, the war, to abandon, if necessary, its normal requirements of solvency and adequate security. Loans in substantial volume were made under this authority, many of

⁵ Drastic amendment of the Reconstruction Finance Corporation Act on June 30, 1947, in connection with extension of the Corporation's life to June 30, 1948, eliminated its broad wartime powers and many of its numerous other loan and investment powers dating from the 1930's, but placed no significant new restriction upon its business-lending authority other than limiting the maturity of new loans (apparently inadvertently) to January 31, 1955. This was followed by the Act of May 25, 1948 (Public Law No. 548, 80th Cong., 2d sess.), which extended the Corporation's business-lending authority to June 30, 1954, but did not change this authority significantly other than to limit loans to ten years and restrict deferred participations to 70 percent of the loan balance where the total amount was under \$100,000, and to 60 percent where it was over. This legislation also added "to encourage small business" to the purposes for which loans could be made.

⁶ Public No. 664, 76th Cong., 2d sess.

them at the request of the War or Navy Departments, although beginning in 1942 the major burden of such financing not suitable for banks was assumed by the military services themselves. The Reconstruction Finance Corporation, after guaranties from the military services became available, in general followed the practice of asking that war loans it made be guaranteed by these other government agencies.

Blanket Participation Agreements

As war financing tapered off and reconversion began to loom as an important financial problem, the Reconstruction Finance Corporation, on March 1, 1945, offered to banks under its 1938 lending authority a "Blanket Participation Agreement." In effect, the offer provided those banks becoming parties to the agreement with an automatic guaranty of up to 75 percent of any loans to business enterprises, the terms of which met certain simple conditions and which did not exceed \$250,000 outstanding at any time to any one borrower.⁷ The Corporation was obligated to take up for cash its guaranteed portion of any such loan within ten days of written demand. The loans were made upon terms and conditions satisfactory to the banks, including the Corporation's basic requirements as to solvency and security, without need for filing a loan application with the Corporation. Loans were limited to ten years in length, had to be repayable in installments aggregating each year not less than 10 percent of the principal, and could not bear interest in excess of 4 percent on the Corporation's share, or 6 percent on the bank's share. A commitment fee at the rate of $\frac{3}{4}$ percent per annum was paid if the guaranteed percentage was over 50; otherwise the fee was $\frac{1}{2}$ percent. The only feature of the guaranty not actually automatic was the pro-

⁷ See the Corporation's *Circular No. 25*, and Charles B. Henderson, "The RFC 75% Program," *Law and Contemporary Problems*, XI (Summer-Autumn, 1945), 399-403. The maximum size of loan thus guaranteed was first set at \$250,000, then raised to \$350,000 in December 1945, and later, as of December 1, 1946, reduced to \$100,000.

vision for review by the Corporation's loan agency, in advance of any final commitment, of the reasonableness of the salaries and other compensation paid by the borrower. This was a statutory requirement contained in the Reconstruction Finance Corporation Act.

The volume of loans written under Blanket Participation Agreements grew rapidly in 1945 and 1946, reaching, during 1946, a rate of 1,000 loans monthly, an activity far greater than that experienced in the Corporation's busiest prewar years. However, criticism from many sources was directed toward the automatic feature of the plan, and as of January 22, 1947, the program was terminated. In substitution, the Corporation offered a "Small Loan Participation" plan which, in essence, was a simplified form of application designed to expedite the processing of requests for guaranties of not over 75 percent of loans under \$100,000.

Statistics

Tables 2 and 3 summarize available statistics covering the Corporation's business-lending operations. Although the Corporation was somewhat less active than the Federal Reserve banks in the early stages of the program, and had handled a roughly similar volume of loans through 1937, the liberalization of its lending powers by the 1938 amendment enabled it at that time to become much the more important factor in the field. Its new authorizations nevertheless declined sharply after 1938, until loans in support of the defense program were initiated following the amendment of June 25, 1940. In Table 2, the large expansion in authorizations of agreements to purchase participations during 1945 and 1946 reflects mainly the operation of the new blanket-participation program, but the full significance of the increase in direct loans is uncertain in view of indications that a substantial volume of loans were transferred during the period from the defense to the nondefense category.

TABLE 2
RECONSTRUCTION FINANCE CORPORATION LOANS TO INDUSTRY, EXCEPT TO AID IN NATIONAL DEFENSE * †
(Amounts in Thousands of Dollars)

Year	Number of Authorizations	Amount of Authorizations						Average Amount of Authorization	Amount of Loans Outstanding, End of Period (RFC only)
		Direct Loans ‡	Purchases of Participations	Agreements to Purchase Participations	Total RFC Portion	Bank Participations ||	Total		
1934 (6 mos.)	593	26,656	3,421	492	30,566	2,457	33,023	56	6,627
1935	1,115	64,447	5,538	3,422	73,410	3,119	76,529	69	40,013
1936	535	35,568	4,111	2,368	42,047	2,471	44,518	83	63,592
1937	271	16,009	388	1,275	17,672	812	18,484	68	74,794
1938	4,396	82,766	9,038	35,508	127,312	23,540	150,852	34	107,747
1939	1,638	72,782	2,721	29,096	104,598	13,261	117,859	72	130,625
Subtotal	8,548	298,228	25,217	72,161	395,605	45,660	441,265		
1940	776	28,083	633	4,874	33,591	4,367	37,958	49	121,130
1941	336	29,958	261	6,606	36,825	4,254	41,079	122	109,383
1942	261 §	9,823	116	4,575	14,415	2,344	16,759	64	83,415
1943	86 §	5,971	101	3,008	9,079	1,654	10,733	125	55,482
1944	193 §	11,177	.....	12,234	23,511	4,372	27,883	144	30,623
1945	1,498 §	60,403	123	80,019	240,545	28,608	269,153	180	145,117
1946	11,321 §	90,848	363	345,638	436,849	128,373	565,222	50	146,925
Total	23,019 §	634,491	26,814	529,115	1,190,420	219,632	1,410,052		

* Source: Reconstruction Finance Corporation quarterly reports.

† Also excluding loans made through banks and mortgage-loan companies, loans to the fishing industry under Section 5 of the Act, and loans for the mining, milling, or smelting of ores under Section 14. The peak year-end amount of the aggregate of such loans was \$6,330,000 on December 31, 1935. At the end of 1946, no loans of these classes remained outstanding except \$3,733,000 under Section 14.

‡ Participations in these loans aggregating \$17,735,000 for the period 1934-46 were subsequently sold to banks, but are not included in the sixth column.

|| Data for 1934-37 obtained from Temporary National Economic Committee, *Monograph No. 17*, p. 299.

§ Data for 1942-46 are for number of new borrowers, numbers possibly 20 percent smaller than those for authorizations.

Loan volume declined sharply in 1947 after abandonment of the blanket-participation program, but was nevertheless large by prewar standards. During the first ten months of 1947, there were 2,623 authorizations totaling \$89,425,000 made under the Small Loan Participation program.⁸

TABLE 3

RECONSTRUCTION FINANCE CORPORATION LOANS TO INDUSTRY, TO AID IN
NATIONAL DEFENSE *

(Amounts in Thousands of Dollars)

Date	Amount of Authorizations			Amount Outstanding, End of Period (RFC Only)
	RFC Portion	Bank Participations	Total	
1940.....	42,543	1,458	44,001	7,306
1941.....	162,589	3,581	166,170	106,127
1942.....	640,677	33,596	674,273	257,015
1943.....	417,494	31,380	448,874	326,624
1944.....	313,862	27,094	340,956	369,568
1945.....	156,497	11,169	167,666	140,022
1946.....	5,855	948	6,803	78,933
Total	1,739,517	109,226	1,848,743	.....

* Including loans on rationed articles and commodities (\$67,766,000 total authorizations), but excluding an aggregate of \$2,214,000 of loans authorized for mining, milling, and smelting of ores.

(Source: Reconstruction Finance Corporation quarterly reports.)

Full data on applications received are not published by the Reconstruction Finance Corporation. However, figures made available to the Temporary National Economic Committee indicated that, up to February 29, 1940, 59 percent of the applications received under Section 5d had been approved. A relatively high proportion (about one-third) of the direct business loans authorized by the Corporation before initiation of the defense

⁸ United States Senate, *Inquiry into the Operation of the Reconstruction Finance Corporation and Its Subsidiaries*, hearings before a special subcommittee of the Committee on Banking and Currency on S.Res. 132, 80th Cong., December 3, 1947-January 22, 1948 (Washington, D.C.: Government Printing Office, 1948), p. 213.

program was never disbursed. As with the Reserve banks, this appears to have been due, in part, to the availability of other financing once it was clear that the Corporation felt the loan to be satisfactory, and to unwillingness of borrowers to accept the terms of the loans authorized.

The Corporation, like the Reserve banks, has loaned principally to manufacturers. Although prior to 1938 its authorizations averaged about the same size as those of the Reserve banks, the considerable volume of small loans it processed in 1938 resulted in an over-all prewar record of authorizations more heavily weighted with the very small loans, i.e., those under \$5,000. These loans amounted to 36.6 percent, in number, of all loans to business enterprises made by the Corporation for other than defense purposes through December 31, 1944.⁹ In 1946 the low average authorization of \$50,000 was reported. Of loans made under Blanket Participation Agreements, 90 percent were stated to be under \$100,000.

A trend toward guaranty of loans made by banks, at the expense of direct loans and direct participations, was evident prior to the war, on the basis of Table 2, and it was greatly accelerated

⁹ A tabulation submitted to the Senate Committee on Commerce by Federal Loan Administrator Jesse H. Jones (*Hearings on S. 375*, 79th Cong., 1st sess. January 1945, pp. 57-58) gives the following breakdown by size of all loans and commitments authorized to business enterprises by the Reconstruction Finance Corporation through December 31, 1944 (including certain minor classes of loans not covered by Section 5d, which were omitted from Table 2):

Amount	All Authorizations Except for Defense		Total Authorizations	
	Number	Percent	Number	Percent
\$ 5,000 and under	3,947	36.6	6,952	31.6
\$ 5,001 to \$ 10,000	1,715	15.9	3,414	15.5
\$ 10,001 to \$ 25,000	2,091	19.4	4,552	20.7
\$ 25,001 to \$ 50,000	1,243	11.5	2,761	12.5
\$ 50,001 to \$ 100,000	876	8.1	2,121	9.6
\$100,001 to \$ 200,000	463	4.3	1,034	4.7
\$200,001 to \$ 500,000	323	3.0	697	3.2
\$500,001 to \$1,000,000	71	.6	218	1.0
Over \$1,000,000	63	.6	259	1.2
Total	10,792	100.0	22,008	100.0

by the blanket-participation plan. The authorizations in the column headed "agreements to purchase participations" are what the Corporation has usually referred to as "deferred participations," the Federal Reserve banks have called "commitments," and are now commonly known as "guaranties." The trend toward guaranties was assisted by a favorable schedule of commitment fees,¹⁰ as follows:

Bank's Participation (Portion of Loan Not Covered by Guaranty)	Annual Fee on Portion Guaranteed by RFC
10 percent up to 25 percent	1 percent
25 percent up to 50 percent	$\frac{3}{4}$ percent
50 percent or over	$\frac{1}{2}$ percent

Thus, under rules which have prescribed a 4-percent interest rate on the portion guaranteed by the Corporation, in the event of a 90-percent guaranty, the bank received 3 percent for the use of this amount of its funds, with the privilege of calling upon the Corporation to convert this portion of the loan into cash at any time upon ten days' notice.

Originally, the Corporation charged interest at the rate of 6 percent on all its business loans. This was reduced to 5 percent on May 15, 1935, and since April 1, 1939, most loans have been on a 4-percent basis. Banks, however, are permitted to charge up to 6 percent upon those portions of loans which represent their participations. An interesting aspect of the Corporation's interest rate is that it appears to be applied uniformly, regardless of the size or relative soundness of the borrower.

Adequate data upon loss experience have never been published by the Reconstruction Finance Corporation. However, in June 1940, Chairman Jones presented certain estimates of losses on business lending to the Senate Committee on Banking and Currency, as follows:

We have foreclosed 306 loans, aggregating \$18,535,801. Now on those loans we will lose at least one-half. The security that we took, the plants,

¹⁰ Reconstruction Finance Corporation, *Circular No. 15*.

et cetera, will not liquidate more than half the loans, probably not quite half.

We have something over 900 loans aggregating approximately \$25,000,000 that are in default. A good many of those will have to be foreclosed.

We estimate that on all of our industrial loans the losses will average at least 10 percent. Banks just cannot make loans where they are going to have a 10-percent loss. We could not do it except that we make a little something on the other loans and that will take care of our losses, but we will lose something like 10 percent on those loans.¹¹

In the same testimony, Chairman Jones indicated that administrative expenses were very heavy, stating that "business loans take two-thirds of the time of the executives and the board."

In January 1945, however, Mr. Jones, then Federal Loan Administrator, made an entirely different report, writing in the *Washington Star* as follows:

RFC's experience in making industrial loans has clearly shown that, had the banks been energetic enough and taken the trouble to make the loans and nurse some of them, they could all have been made. This is proven by the fact that RFC's losses on such loans have averaged less than 1 per cent. This percentage of loss can be taken from a reasonable rate of interest and still leave a proper profit for the bank.¹²

It is possible to reconcile such diametrically opposed statements only by reference to two factors, both of which deserve weight. In the first place, the wartime industrial boom after 1940 undoubtedly eliminated or reduced many prospective losses. Secondly, and probably more important, it appears that Mr. Jones's estimate in 1940 was a highly conservative guess as to experience in the long run, based upon knowledge that hazardous loans had been made. The estimate did not even at that time coincide with actual loss experience.

Relatively few sources may be cited for more detailed information concerning the Reconstruction Finance Corporation's

¹¹ *Hearings on S. 2998 and S. 3839*, p. 49.

¹² January 7, 1945.

business-lending operations.¹³ The information disclosed by the Corporation has been limited, and, moreover, the operations under 5*d* have been so dwarfed by the Corporation's manifold general operations that many of the figures published are of little use for analysis.¹⁴

APPRAISAL OF EXPERIENCE UNDER 13*b* AND 5*d*

The two emergency business-lending programs inaugurated in 1934 undoubtedly produced certain social benefits in that they helped to promote business recovery by supporting, or assisting in the expansion of, numerous businesses which were fundamentally sound but whose financial resources had been exhausted or whose banking relationships had been disrupted by the depression.

From all points of view, however, the most impressive fact which stands out from the prewar experience of the Federal Reserve banks, under 13*b*, and the Reconstruction Finance Corporation, under 5*d*, is the small total of loans actually made. Some analysts have concluded from this experience that no really significant unsatisfied demand for loans existed; others have suggested that the loaning standards employed must have been excessively strict. In so far as the Federal Reserve System is

¹³ The best source is *Inquiry into the Operation of the Reconstruction Finance Corporation*, already cited, especially pp. 455-69. Brief studies are presented in Lewis H. Kimmel, *The Availability of Bank Credit, 1933-1938* (New York: National Industrial Conference Board, 1939), pp. 105-10; Ernest M. Klemme, "Industrial Loan Operations of the Reconstruction Finance Corporation and the Federal Reserve Banks," *The Journal of Business*, XII (October 1939), 365-85; Hal B. Lary, "Analysis of Applications for Business Loans Rejected by Reconstruction Finance Corporation," Department of Commerce, 1939 (reproduced in *Hearings on S. 1482 and S. 2343*, pp. 408-14); Temporary National Economic Committee, *Monograph No. 17*, pp. 228-31, 234-36; Jacoby and Saulnier, *op. cit.*, pp. 59-62, 86-87, 102-12, 122-25; Weissman, *op. cit.*, pp. 74-81.

¹⁴ Progress has been made in improving the Corporation's reports, but see the comments of the General Accounting Office, *Inquiry into the Operation of the Reconstruction Finance Corporation*, pp. 100-116.

concerned, the Board of Governors has in large part attributed its low volume, particularly in comparison to that of the Reconstruction Finance Corporation since 1938, to the restrictive provisions of Section 13*b*, which limit the Reserve banks to loans made to established businesses for working-capital purposes, with maturities not in excess of five years.¹⁵

An explanation of the small total volume of loans made by both agencies was sought in numerous surveys and Congressional hearings prior to the war, and in more recent research, yet the answer remains controversial. This appears to be because of the intangible elements of judgment introduced in the attempt to decide whether a given business is "creditworthy." No purely statistical or quantitative measure will suffice, and, an item too often overlooked in surveys employing questionnaires, neither will the opinion of the prospective borrower. In addition, as indicated before, a fundamental difference exists between those who seek to interpret "creditworthy" as meaning "worthy of assistance in the interest of net social benefit," and those who interpret it to mean "offering reasonable assurance of repayment of a loan."

Despite this apparent controversy, it is possible to trace with some assurance the major reasons for the small volume of business loans made by the two governmental agencies prior to the war, and thereby to clarify the issue. As already suggested, two general reasons may exist: that is, there may have been a lack of demand for loans, or the terms and conditions under which they were offered may have restricted volume.

A general lack of demand for credit on the part of concerns in sound financial condition was, in truth, characteristic of the

¹⁵ In the *Hearings on S. 2998 and S. 3839*, Chairman Eccles testified (p. 16) that "the law pretty generally confines the Reserve System to the type of lending that the banks would make without the Reserve System." Some evidence of the restrictive effect of the limitation to working-capital purposes is supplied by Jacoby and Saulnier in *Term Lending to Business, op. cit.*, where (p. 65) they state that "Less than 16 percent of the original amounts of all term loans held by commercial banks at mid-1941 were intended to be used by borrowers exclusively to augment working capital."

period under review. Presumably, the same lack of confidence in business trends and the discouraging effect of high tax rates on new investment, holding back expansion on the part of the sounder concerns, were at least factors in the plans of the weaker. Probably much more important in restricting demand for loans from governmental agencies was the growing willingness of private financing institutions to make credit available for other than short-term, self-liquidating purposes.¹⁶ By 1940, the criticism leveled at bankers and bank examiners in the report of Hardy and Viner in 1935 was no longer pertinent, for the recommendations of that report had been carried out and medium-term working-capital loans to sound borrowers were freely available.

This increased liberality on the part of lenders was the product of three general influences. First, the end of the great depression and subsequent development of a measure of prosperity helped to unfreeze bank capital and to increase confidence in the ability of business enterprises to operate profitably. Second, the active lending campaigns of the Federal Reserve banks and the Reconstruction Finance Corporation served as a competitive spur to private banks, and also helped to educate many institutions in the possibilities and procedures of successful operation in the field of medium-term business loans.¹⁷ Finally, as a result of these facts and of a number of other important influences, the new so-called "term loans," which are in essence

¹⁶ In its annual report for the year 1938 the Federal Reserve Bank of New York remarked (p. 23) that the quality of applications received for industrial loans was not as good as in preceding years, and commented that "the reason for this appears to be that it is now easier for prospective borrowers, whose condition and prospects appear to be reasonably satisfactory, to obtain working capital from other sources. Commercial banks have increasingly engaged in the practice of making loans of 1 to 5 year maturities. . . ."

¹⁷ Jacoby and Saulnier, *op. cit.*, state (p. 24) that it would be incorrect to say that the two governmental agencies originated term lending, but that "indubitably the actions of these agencies educated many commercial banks in the techniques of making term loans." The operations of the two agencies were thus much more influential than the direct volume of their loans suggests.

medium-term working-capital or equipment loans to be amortized out of future profits, became a generally accepted type of bank credit. Among these other influences were a lack of other types of loans coincident with the growth of excess reserve funds in the hands of banks, new confidence with respect to the threat of deposit withdrawals by virtue of the existence of the Federal Deposit Insurance Corporation, revised bank-examiner practice which looked favorably upon loans reasonably certain of payment even though not of short maturity, and a vigorous campaign on the part of the Association of Reserve City Bankers and the American Bankers Association to promote term lending.¹⁸

The qualification must be made that, on the whole, term loans by commercial banks have been employed to finance comparatively large businesses, much larger on the average than those financed by the two government agencies. The activities of a few private institutions which have stressed term loans to small enterprises do not affect the validity of this general statement. The larger costs of investigation and loan administration per dollar advanced, and the extra risks inherent in term lending to small business (the instability of profits and heavy dependence upon the ability of only one or two men) have discouraged the making of term loans of less than \$50,000 or \$100,000. Banks have been reluctant to charge, or barred by statute from charging, the rates

¹⁸ Jacoby and Saulnier, *op. cit.* See also the *Report on Term Loans* prepared in 1938 for the Association of Reserve City Bankers by the Institute of International Finance of New York University (Chicago: Association of Reserve City Bankers). This study stressed the opportunities for bankers in term loans, noting that the depression had brought an important change in the character of the credit needs of business, particularly small business, and referring to the loosening of bank-examiner and rediscount regulations in this respect as "a change in banking philosophy of far-reaching importance" which substituted the criteria of soundness and assurance of ultimate repayment for the old criteria of liquidity and marketability.

A recent pamphlet continuing the Association of Reserve City Bankers educational campaign is *Term Lending by Commercial Banks* (Chicago: Association of Reserve City Bankers, 1945), which refers to the term loan as "probably one of the most important of the innovations in commercial banking practice of the last fifteen years."

necessary to insure profitable handling of the really small loans. On the other hand, it should be recognized that many small businesses receive almost the equivalent of term-loan accommodation, at lower cost, through short-term notes which are renewed periodically as long as the business remains in sound condition.

The second general reason suggested to explain the modest volume of lending done in the 1930's by the Federal Reserve banks and the Reconstruction Finance Corporation was that loans may have been offered under unduly onerous terms and conditions. It is obvious enough, in view of the number of applications rejected, that the strict lending standards of the agencies held down their volume. However, no trustworthy evidence has been introduced to prove that the standards applied were appreciably stricter than was necessary to conform with the instructions of Congress that loans were only to be made when reasonable assurance of repayment existed.¹⁹ The policy established in the legislation is, as a matter of fact, not a great distance removed from that now followed by private banks, since term loans have become generally acceptable. It is perfectly true that the public agencies have in general made loans which were substandard from a commercial viewpoint (including term loans before they were generally accepted), but such loans were made with appropriate security; the agencies have had the benefits of diversification of risks and no necessity for earning profits.²⁰ In a survey made by the National Industrial Conference Board in 1938, 107 of 115 concerns experiencing difficulty in obtaining credit stated

¹⁹ Note the statement of Chairman Jones of the Reconstruction Finance Corporation in 1939 (*To Provide for the Insurance of Loans to Business*, p. 415) that "there is not a little-business man in the United States that is entitled to a loan, *with a reasonable expectation of being able to repay it*, that cannot get a loan, whether it is for \$500 or \$5,000, if he will come and apply for it." (Italics added.)

²⁰ These agencies have required certification by the borrower that credit elsewhere has been refused, and they have frequently offered prospective loans or participations therein to banks. Further, if a substandard borrower succeeds in improving its position, an effort is usually made, according to agency officials, to get a bank to handle subsequent financing.

that they believed the credit standards of the two public agencies to be as rigid as, or more so than, those of commercial banks.²¹

Nevertheless, if the credit standards applied by these agencies are to be criticized, it appears that such criticism should be directed at the instruction of Congress to require reasonable assurance of repayment rather than at its administration. A study made by the Department of Commerce in 1939 of 330 dockets chosen at random from the Reconstruction Finance Corporation's files, covering applications rejected subsequent to February 1938, endorsed the policies followed by the Corporation in this respect practically without reservation.²² The investigators concluded that the field for sound loans of a type which would have been rejected under standards applied by the Corporation was extremely narrow. The fact that loss experience of both agencies appears to have been favorable need not invalidate this conclusion, for the highly favorable economic trend of the past decade was an external factor upon which lending agencies could not safely rely.

In short, the two agencies, one operating entirely with public funds and one in part with private, tried sincerely to grant rather than to deny loans, so long as reasonable assurance of repayment existed. Moreover, they were, in a measure, competitive, each anxious to do the greater volume of business. The basic reason for the small volume of business done prior to the war must have been that unsatisfied demand for the type of credit they had to offer was lacking. The agencies offered loans, not equity capital,

²¹ Kimmel, *op. cit.* The collateral requirements of the Reconstruction Finance Corporation, in particular, have been frequently criticized as excessive or burdensome. On the other hand, it may be pointed out with justice that since these agencies were supposed to lend only to borrowers unable to obtain normal private accommodations it should not have been possible for them to make loans "of sound value" without especially careful provision of security. Moreover, it is true that a considerable number of Reserve bank loans and a few Reconstruction Finance Corporation loans have been advanced upon an unsecured basis. For a detailed discussion of the type of security ordinarily required by these agencies, see Jacoby and Saulnier, *op. cit.*, Hal B. Lary, *op. cit.*, and Merwin and Schmidt, *op. cit.*

²² Hal B. Lary, *op. cit.*

and they offered a business transaction set up to provide reasonable assurance of repayment, not a subsidy to cover heavy risks or to prolong the operation of a business probably doomed to failure.

To what extent this conclusion should be altered, as a result of the large postwar activity of the Reconstruction Finance Corporation under the blanket-participation plan, is not clear. Despite the brief life of this program, Blanket Participation Agreements were approved with 5,253 banks, of which 2,422 actually made loans under the agreement. The total number of loans authorized was 11,057, in the aggregate amount of \$525,000,000, of which \$381,000,000, or 72.6 percent, represented the Corporation's commitment for deferred participation (its guaranty).

Some of this large lending activity under the blanket-participation program doubtless reflected the sharp, general increase in demand for credit which was evident during the period, especially in the term loans for fixed assets such as predominated under the program. But the reduced volume of the Small Loan Participation plan which succeeded it suggests that the nature of the blanket-participation arrangement itself had a strong appeal.

The automatic character of the arrangement proved popular, for example, with many small banks which could avoid filing long application forms as well as the chance that guaranty might be refused; too, by virtue of the guaranty, they were enabled to handle loans much larger than their legal loaning limit would otherwise permit.²³ These banks were not only thus able to increase their earnings without added risk, but avoided the loss of

²³ The advantage of this feature to bank earning power was recognized by the Corporation, and stressed in its literature. In a booklet prepared in 1944 to promote the guaranty ("deferred participation") then being offered, it underscored the following statement: "The effect is to permit banks through this arrangement to increase their earnings without increasing their risks beyond the amount of the participation." However, in the *Hearings on H. Res. 64, op. cit.*, p. 1188, John W. Snyder, Federal Loan Administrator, expressed the point somewhat differently: "The effect of the agreement is to permit banks to make loans in excess of their loan limit and to take more risks than they would ordinarily take."

customers, a hazard which might have been present if other banks were called in to share in setting up large credits. On the other hand, the larger banks, with extensive correspondent relationships, were generally critical of the arrangement; for, with these loans, the Corporation took the position that, in view of the bank participation, it was not obligated to investigate whether the entire credit requested might be available from other sources. The American Bankers Association went on record in opposition to the program as superfluous, and as leading toward socialization of banking by eliminating the risk-taking function that is at the basis of private banking.²⁴ From the standpoint of the Corporation it is too early to appraise possible loss experience in connection with the blanket-guaranty arrangement, but a material saving in the expense of authorizing loans naturally resulted.

One qualification of our conclusion regarding prewar lending activities of the two government agencies is important in connection with small businesses, and probably has some bearing upon the popularity of the Blanket Participation Agreement. Loans to small businesses by these agencies were restricted not merely by careful lending standards, but by cumbersome and expensive procedures in application, approval, and closing.²⁵ Comment to this effect has come from many sources, but especially from small businesses, which often have readily available neither the mass of information required by elaborate application forms nor the time of principals necessary to prepare it; in addition, they are usually dismayed by the complicated loan agreements employed. A typical criticism by a banker is the following:

²⁴ See the address by Robert M. Hanes, chairman of the American Bankers Association Small-Business Credit Commission, published in *The American Banker* (September 26, 1946).

²⁵ We have not mentioned the financial stigma often attached to businesses, large and small, that are forced to rely upon public agencies for financing. No small deterrent for many concerns during the period under review, fear of this stigma was usually heightened by knowledge that liens would have to be filed or notices of assignments given, thus advertising the borrower's weak condition. However, if a businessman is really in need of funds he is likely to swallow his pride.

My own feeling as a result of this experience is that the present routine in handling small loans through the Reconstruction Finance Corporation is so cumbersome that the average small concern cannot wait for the final result. In addition, it is so expensive because of all the documents involved, usually including special legal and accounting fees, that the small firm feels it cannot afford to make an application on a speculative basis. The net result of both these conditions is that unless there is some definite feeling that the loan will be consummated most small borrowers are discouraged at the outset.²⁶

One who reviews the complicated application forms and typical loan agreements of the two agencies will probably sympathize with these complaints, even though he may realize that such agencies inevitably must require more information in connection with an application than does a local banker who is intimately acquainted with his customers, and a more complex loan agreement than does a local banker who may be able to follow a loan personally from day to day, if necessary. Moreover, thorough financial and other data are particularly essential when entering into a commitment spreading over a period of years, with future profits the major source of funds to repay the loan. Administrative expenses of the agencies have been high for similar reasons, and especially in relation to the income obtainable from small loans. Careful credit investigations have been required, and frequently a continuing effort to assist the management.

Delays encountered by applicants in the processing of applications have been related to the procedures followed, which have, with both agencies, involved screening committees of local businessmen who must pass upon all applications submitted. Most investigators have considered the Industrial Advisory Committees set up by the Federal Reserve banks under the terms of the 1934 Act to be superfluous. Decentralized operations, however, permitted the Federal Reserve banks to establish a better record for speed in processing than that of the Reconstruction Finance Corporation, which until 1942 centralized all lending decisions in

²⁶ Howard Markel, quoted in *American Banker*, March 12, 1941.

Washington. Applications to the Corporation were processed through an examiner in one of its thirty-odd agencies, the agency advisory committee of local bankers and businessmen, and the local manager; they were then forwarded to Washington, where they had to pass an examiner, a review committee, and finally the Board of Directors of the Corporation. When the burden of wartime lending became heavy, this complicated system was superseded (February 19, 1942) by a delegation of authority to all agency managers to approve direct loans up to \$100,000 and loans with bank participation up to \$250,000 without reference to Washington. Significantly, however, it was required that all *denials* (i.e., all denials of formal applications) be forwarded to Washington for review and possible reversal.

In general, the experience of the Federal Reserve banks and the Reconstruction Finance Corporation in business lending confirms the belief that the principal unsatisfied demand for financing has been a need for equity capital. The most common source of credit denial has been lack of adequate capital in the business. Without provision of additional equity capital in such instances, any sort of credit offered can be of only temporary benefit. Even among the concerns deemed worthy of credit, review of the experience of the New York and Philadelphia Reserve banks indicated that nearly one-quarter of the borrowers were found subsequently not to have been helped by the loans.²⁷ These borrowers, obviously, were suffering from weaknesses other than insufficient working capital, and the loans merely postponed the day of reckoning.

The extent of the field actually offered for the investment of equity capital in concerns of the type which have been denied credit by the two public agencies is problematical. Chairman Jones of the Reconstruction Finance Corporation, in speaking of loans refused in 1938 after liberalization of the Corporation's authority had brought in a horde of would-be borrowers, stated:

²⁷ See Weissman, *op. cit.*, pp. 85-86.

The great majority of these inquiries and applications for business loans come from applicants with promotional ideas, with no successful record of business experience, and little prospect of success or earnings. In most cases there was no economic justification for the loan sought, and which if made would only have had the effect of aiding one business at the expense of another.²⁸

Similarly, the Federal Reserve Bank of New York in 1938 undertook a review of approximately 750 applications for working-capital loans which had been denied because the business really needed permanent capital. The conclusion was that an overwhelming proportion of the cases reviewed had poor prospects, even for purposes of equity investment.²⁹ In only a small percentage of the cases did it appear that the investment of equity capital would be justified.

²⁸ *To Provide for the Insurance of Loans to Business*, p. 406.

²⁹ Federal Reserve Bank of New York, *Annual Report*, 1938, p. 21.

Chapter VIII

WARTIME FINANCING OF BUSINESS BY PUBLIC AGENCIES

• WE HAVE now surveyed American experience with public financing of private business enterprise under the conditions existing prior to and immediately after World War II. Experience under peacetime conditions must naturally be given fundamental weight in arriving at answers to the questions we are investigating. Nevertheless, it represents only one part of the evidence available, and it can profitably be supplemented with a review of experience under the abnormal conditions prevailing during the war years, when former credit standards were abandoned and all other considerations subordinated to the goal of maximum production of war materials. Recognizing the abnormal influence of wartime necessities upon the types of credit risk assumed, the average size of loan made, and the aggregate volume of credit extended, we shall focus our attention upon certain important innovations in lending techniques which were developed.

FINANCING THE DEFENSE PROGRAM

Government executives, from the beginning of the defense program in 1940, were considering means of assuring adequate financing for the expansion in manufacturing capacity and in production which was being undertaken; the problem, however, had less attention than it would have received had officials been able to conceive of the immense proportions which this expansion would later attain. At the start, it was believed that the existence of the industrial lending powers of the Federal Reserve banks

and the Reconstruction Finance Corporation would simplify the financing problem, yet, as we have indicated, these agencies were accustomed to lending only upon a basis of sound value that inevitably excluded much of the financing which soon became necessary.

Among direct measures taken promptly by the government in 1940 in order to provide additional financial assistance to business were: (1) the Act of June 25, noted in the preceding chapter, which broadened the lending powers of the Reconstruction Finance Corporation for defense purposes; (2) the Acts of June 28 and July 2, which authorized the Navy and War Departments to make advance payments to prime contractors "in the interest of National Defense";¹ and (3) creation of the Defense Plant Corporation, a subsidiary of the Reconstruction Finance Corporation, with authority to erect plants and lease them to manufacturers engaged in defense production.

Three indirect measures taken in 1940 to facilitate defense financing through the private banking system were also of prime importance: namely, (1) provision in the Second Revenue Act of 1940 to grant, in connection with construction of new facilities for defense production, "Necessity Certificates" which authorized amortization for tax purposes of the entire cost of approved facilities against earnings over a five-year period; (2) passage on October 9 of the Assignment of Claims Act of 1940, which permitted the assignment of payments upon a government contract to a bank or other financing institution; and (3) approval on October 18 of the Emergency Plant Facilities Contract, under which standard form of contract the government agreed to reimburse contractors, by means of equal monthly installments over a period of five years, for the full cost of defense facilities constructed with private funds.

¹ The Navy Department already had authority under an act of 1911 (37 Stat. 32) to make "progress payments" to contractors, not in excess of the value of the work done, and protected by a lien upon the articles being produced. This was the standard method of financing ship-construction contracts.

Each of these measures contributed substantially during 1940 and 1941 to the successful financing of the defense program, a very important portion of which involved the construction of facilities for expanded production.² A major share of plant facilities, in particular those of very large size or highly specialized type, was constructed for the account of the Defense Plant Corporation. Of special importance in making private bank credit available in borderline situations, both for plant facilities and for working-capital purposes, was the Assignment of Claims Act. This Act removed a century-old prohibition of the assignment of claims arising under contracts made by the United States and established a method of assignment to a financing institution of all amounts payable under a government contract providing for payments aggregating \$1,000 or more.³

Although commercial banks made liberal provision of credit for defense purposes,⁴ and total bank loans for such purposes are estimated to have reached \$1,300,000,000 by the end of 1941,⁵ there was a considerable segment of the new munitions industry which clearly did not present bankable risks. A large number of small enterprises, in particular, found themselves with backlogs of orders utterly out of proportion to their net worth, and with production schedules and employment rising at a rate which made the maintenance of proper production and cost controls impossible. Frequently, the new orders were for types of production in which the manufacturer had had little or no experience. Thus, for example, a machine shop with net worth of

² Roy A. Foulke, *Credit Problems in a War Economy* (New York: Dun & Bradstreet, 1942).

³ Loans to finance Emergency Plant Facilities (EPF loans), though not large in relation to other facilities financing, were handled almost entirely by commercial banks.

⁴ Commercial banks offered more-than-liberal provision in some areas, such as the Pacific Coast, where greatly overextended businesses in the aircraft and shipbuilding industries soon were the rule.

⁵ Gerald M. Conkling, "Loans for War Purposes," *Federal Reserve Bulletin*, XXXI (November 1945), 1102.

\$10,000 or \$20,000 might require a loan of \$100,000 or more to fill a \$500,000 contract for high-precision ordnance parts, or a builder of small yachts with a total capital investment of less than \$50,000 and nominal working capital might, if favorably located, be granted large government facilities and contracts for ship construction amounting to \$10,000,000 or more. Obviously, such ventures did not provide a satisfactory basis for private bank credit.⁶

Working-capital financing for seriously overextended prime contractors was supplied during this period of defense preparations through the medium of advance payments (and, in the case of shipbuilding, progress payments). Advance payments made under the 1940 legislation were limited to 30 percent of the contract price, and "adequate security" was required. The security obtained was usually a surety bond. A large volume of credit was made available through this means, and prime contractors were on the whole adequately financed, even though the use of advance payments against individual contracts was a cumbersome process for those who had numerous contracts, especially when the contracts were with more than one Service or more than one procurement branch of a Service.

Advance payments did not, however, meet the problem of financing overextended subcontractors (and sub-subcontractors, et cetera), who were not eligible for direct advances; frequently they were unable to obtain advances because their prime contractors were unwilling to assume any liability in connection with such financing, or because of the extremely complicated arrangements involved in passing on advances to subcontractors

⁶ An important class of enterprises with nominal net worth but large government facilities and supply contracts consisted of subsidiary companies organized by large corporations, in response to requests by the military services, for the sole purpose of specialized munitions production. These subsidiaries could have obtained private financing if supported by their parents' guaranties, but one purpose in their organization as separate entities usually was to limit any liabilities in connection with their activities, and it was provided in many cases that all necessary working capital would be supplied by the government by means of advance payments.

below the first tier.⁷ Some financing for the less seriously extended subcontractors was available through direct loans by the Reconstruction Finance Corporation. By the middle of 1941, however, it was evident both to the military services and to many bankers that continued expansion of the production program and extension of the subcontracting principle (whereby thousands of small firms were being brought into the program) might seriously jeopardize essential production if a more flexible type of governmental financing were not devised—one in which the military services could assume the extraordinary risks which might be involved in financing essential but financially weak subcontractors. The possibility of some form of joint financing participated in by the Services and private banks was discussed.

ACTION PURSUANT TO THE FIRST WAR POWERS ACT

With the entrance of the United States into the war, broadened financing powers were promptly made available under the First War Powers Act, approved December 18, 1941.⁸ This Act provided, under Title II, that

. . . the President may authorize any department or agency of the Government exercising functions in connection with the prosecution of the war effort . . . to enter into contracts and into amendments or modifications of contracts . . . and to make advance, progress and other payments thereon, without regard to the provisions of law relating to the making, performance, amendment, or modification of contracts whenever he deems such action would facilitate the prosecution of the war. . . .

The first step to implement these provisions of the Act was taken in Executive Order 9001, issued on December 27, 1941, which authorized the War and Navy Departments and the Maritime Commission to make advance, progress, and other payments upon

⁷ The Services could, when essential, use the prime contractor purely as a conduit for getting funds to subcontractors by specifically relieving the prime of any liability, but this was not a satisfactory approach to other than exceptional cases.

⁸ Public No. 354, 77th Cong.

their contracts of any percentage of the contract price whenever, in their judgment, the prosecution of the war would thereby be facilitated. The decree provided that advance payments should be made "only after careful scrutiny to determine that such payments will promote the national interest." Similar powers were delegated to the Treasury Department by Executive Order 9023 on January 14, 1942, and, later, to the Office of Scientific Research and Development.

Executive Order 9001 made more liberal advance payments available, and dispensed with the requirement of security, but it did not touch upon the problem of financing subcontractors. This problem grew increasingly troublesome as (1) active prosecution of war required large and rapid increases in production, which rendered more and more well-established companies marginal as credit risks, and (2) the necessary extension of subcontracting put essential production more and more in the hands of weak and inexperienced enterprises which were ineligible for advance-payment financing. Moreover, even with respect to prime contractors, certain shortcomings of advance-payment financing became increasingly apparent, especially its cumbersomeness in cases where a contractor had numerous contracts, and in the administrative burden on the Services when reliance for security was not placed solely upon a surety bond.

On the other hand, granting the troublesome nature of the problem which was developing in the financing of subcontractors, we should caution against overstressing its gravity. Several procedures not involving loans or advances were available to the government for the purpose of minimizing the financial burdens and hazards of both prime contractors and subcontractors. For example, materials and subassemblies could be (and were) purchased by the government directly from suppliers and provided to prime contractors as government-furnished material, thus reducing the financing necessary for the prime and eliminating much subcontracting. Or, the funds required and the hazards in-

volved in financing weak contractors could be greatly reduced, and private financing possibly made feasible, by the writing of cost-plus-a-fixed-fee contracts and subcontracts. The former procedure, however, threw large extra burdens upon already overburdened government procurement staffs, while the latter threatened to be extremely wasteful in terms of ultimate cost.

Rapid payment for delivered items, curtailing the "float" of unpaid accounts receivable, was another obvious method open for reducing the financial requirements of contractors. Unfortunately, due to the vast increase in the volume of payments made, the government agencies during the early stages of the war fell far in arrears on their disbursements. Substantial assistance, however, was provided to prime contractors and, through them, to subcontractors, through the medium of progress payments, i.e., payments on account of progress actually made in the performance of the contracts. Frequently, they totaled up to 90 or 100 percent of costs incurred. Such payments were, in fact, the principal financing vehicle employed by the Maritime Commission. They were important in financing the construction of ships for the Navy, as already noted, and were eventually widely used for certain other types of contracts. This type of financing, being free of interest charges and of other restrictions excepting a lien upon the work in progress, was attractive to prime contractors able to finance themselves from their own funds, tax reserves, or accounts payable during the period that the progress payment was being vouchered and paid.⁹

⁹ In this connection, it is pertinent to observe that Great Britain was able to finance its greatly expanded production for World War II through reliance upon rapid disbursement of progress payments. Contractors received monthly progress payments of up to 90 percent of "expenditures incurred," and an effort was made to make these payments within a week of the submission of the invoice. The commercial banks were asked to provide any additional financing needed. If the banks denied credit, the situation was investigated by the government to see if the borrower's position could be strengthened by improvements in accounting or in production. If the government was satisfied with the concern's ability to perform its contracts, prompt payments were arranged, and the banks were instructed to make the loan. The govern-

Despite the existence of these various means of alleviating the financing problem, the rapid increase in subcontracting which was under way, and which promised greatly to increase over-all production, called for bolder action. Production was the goal, and the beneficial effect of adequate financing upon production could not be overlooked. The effort consumed by business management in carrying on hand-to-mouth financing operations was obviously detrimental to its other activities, especially when managerial talent was already spread so thinly in most small concerns. Therefore, following a crisis reached late in February 1942, when an Army subcontractor essential to the aircraft program was unable to secure necessary working capital, it was agreed by those charged with responsibility for procurement that provision of a more adequate method for financing subcontractors could be no longer delayed.

On March 5, 1942, the Chairman of the Maritime Commission, in a letter to the Chairman of the War Production Board, suggested that the latter consider the creation of a new agency or the utilization of an existing agency to be charged with the responsibility for making over-all advances to war contractors in behalf of the Army, Navy, and Maritime Commission. On March 15, 1942, a War Department memorandum proposed in detail a "Plan for Financing Subcontractors."¹⁰ Shortly thereafter a conference between the interested agencies, including

ment continued to assist through periodic checks, with appropriate reports to the banks, as to whether the materials produced were satisfactory and being delivered on schedule. The assurance of payment by the government upon delivery was enough for the banks if they also could be sure that the contractor was capable of filling the order and was proceeding on schedule. *The Economist* remarked on November 16, 1940 (Banking Supplement, p. 4), that "in many cases the help given by the banks in such directions has involved loans that would have been deemed thoroughly unsound by customary banking standards. Small firms engaged on Government contracts have been granted loans rising to quite fantastic ratios to the firms' own resources."

¹⁰ Memorandum for the Undersecretary of War, signed by Major Paul Cleveland, published in *Bulletin of the Robert Morris Associates*, Special Supplement No. 1 (November 1942), pp. 27-28.

representatives of both the Board of Governors of the Federal Reserve System and the Reconstruction Finance Corporation, resulted in agreement upon a proposal along the lines of the War Department memorandum, and Executive Order 9112 was signed by the President on March 26, 1942. This directive, based on the authority of the First War Powers Act, authorized the War and Navy Departments and the Maritime Commission to make or guarantee loans, discounts, or advances for the purposes of financing any contractor, subcontractor, or others engaged in any business or operation deemed by these agencies to be necessary, appropriate, or convenient for the prosecution of the war. It appointed the Federal Reserve banks fiscal agents for the three government agencies designated for the purpose of carrying out the Order.¹¹

In a statement accompanying the Order, the President declared that it was "aimed at curing a situation which has interfered with the all-out participation of many small business enterprises in war production," and added:

The basic purpose of the Order is to put working capital financing on a war basis. Up to now peacetime restrictions on banks and credit agencies have made it difficult for them to finance war production although the banks have been anxious to use their resources for prosecution of the war.

. . . These guarantees will support the operations of the banks, the Federal Reserve System, the Reconstruction Finance Corporation, and other credit agencies. They will not be made under peacetime credit rules. They will be made by production men, wherever additional financing is essential for additional production. Peacetime restrictions on credits cannot hold up production of war supplies needed by the armed forces.¹²

General instructions on procedures to be followed in guaranteeing loans were set forth by the Board of Governors of the Federal Reserve System in its Regulation V, issued April 6, 1942. In consequence, the loans guaranteed pursuant to the regulation were soon commonly referred to as "V Loans." The regulation in-

¹¹ *Federal Reserve Bulletin*, XXVIII (April 1942), 299-301.

¹² *Ibid.*, p. 299.

structed the Federal Reserve banks to arrange necessary war-production financing, where practicable, without the assistance of the three government agencies. Where private financing was not feasible, guaranties by the agencies were to be preferred to loans or participations. Rates of interest and fees were to be prescribed by the Board of Governors after consultation with the three agencies, and maturities were to be "consistent with the needs of the borrower for the fulfillment of the contracts or orders for which the financing is provided," but were limited to five years.¹³

A large volume of guaranteed loans developed rapidly after the promulgation of Regulation V, and this type of financing grew steadily during the following two years. It soon became evident that such loans were attractive to prime contractors as well as subcontractors, and in many instances to strong businesses as well as weak. Several reasons existed for this interest in V loans, in addition to their special suitability for subcontractors and the convenience they offered to contractors with numerous contracts. One reason of considerable importance was that the original form of guaranty agreement which was adopted provided special protection both to the financing institution and to the borrower in the event of cancellation of contracts for the convenience of the government. This wartime hazard had particularly concerned many banks and borrowers, who feared that, in such event, the government might not allow all costs incurred by the borrower in good faith, and might be extremely slow in effecting settlement. It was provided in the agreement that, in the event of important cancellations, the borrower would receive, through suspension of maturity of a portion of the loan, financing of its claims against the government, and the bank would receive, by means of a step-up of the guaranty, protection against the extra hazards which might be involved in connection with the settlement of the claims.

¹³ *Ibid.* (May 1942), pp. 424-27.

Guaranteed loans were also encouraged by the adoption of somewhat more restrictive policies in connection with advance payments. In April 1942, the Navy instituted interest charges of $21\frac{1}{2}$ percent per annum upon advance payments, except for advances under no-profit contracts, and in June the Army did likewise. Previously, most advances had been interest-free, although the Navy had followed the general practice, when advances were requested after the award of a contract (so that the benefits to the contractor of interest-free financial assistance had not been considered in negotiation of the profit to be allowed), of making an interest charge, at first 6 percent and later 4 percent.

ADVANCE PAYMENTS¹⁴

Despite the institution of interest charges and the adoption of increasingly restrictive provisions to safeguard the funds advanced, advance payments remained, throughout the war, in terms of aggregate volume outstanding, a more important form of war-production financing than were guaranteed loans.¹⁵

¹⁴ A general description of advance-payment policies of the principal procurement agencies is available in Roy A. Foulke, *Government Guaranteed Production and Termination Loans* (New York: Dun & Bradstreet, 1945), pp. 5-8. However, both this section and the succeeding discussion of guaranteed loans are based heavily upon conversations with officials responsible for these lending programs and upon inspection of unpublished files and statistics.

¹⁵ The largest source of governmental financing of business during the war was, in a very real sense, the Treasury Department. The huge unliquidated tax liabilities continually outstanding, by virtue of the fact that taxes were, on the average, not due for more than a year after the profits taxed had been earned, were an extremely important source of working capital to many businesses. For an estimate of the relative magnitudes of the different types of governmental assistance in financing production as of June 30, 1943, including government-furnished equipment and stock-piles, and government-owned inventories under cost-plus-a-fixed-fee contracts, see Charles C. Abbott, *The Financial Situation of Industry after Two Years of War* (Boston: Graduate School of Business Administration, Harvard University, 1944), p. 16.

The following table, based upon a Securities and Exchange Commission statistical release of December 5, 1945 ("Working Capital of 1228 Registered Corporations"), gives pertinent data relative to sources of working funds for 388 manufacturing cor-

However, this large dollar volume of advance payments reflected a small number of very large advances, especially to firms in the aircraft industry. The V-loan program, after a few months of operation, was financing a greater number of individual businesses than were being financed through advances. Although adequate statistics are not available, the total of advance payments actually disbursed by the Army, Navy, and Maritime Commission may be estimated with sufficient accuracy at more than \$9,000,000,000, extended to possibly 2,200 contractors. A considerably larger total sum was authorized than was disbursed. For the peak period in the use of advance payments, the autumn of 1942 to the summer of 1943, outstanding advances actually in use averaged over \$2,500,000,000, possibly reaching \$3,000,000,000. Army advances were approximately \$2,000,000,000 at the peak, and Navy advances somewhat over \$700,000,000. In each case this was higher than the peak amount of credit actually in use under guaranteed loans.

Advance payments under the 1940 legislation were at first authorized by the Army and Navy in a more or less perfunctory manner. Requests for advances not in excess of 30 percent of the contract price, to be secured by payment bond, were generally being approved without question. As the volume of advances increased and some of the contractors so financed ran into difficul-

porations in war industries. These are large corporations, but the relationships indicated were also reasonably typical of smaller concerns in war industries.

SOURCES OF FUNDS IN WAR INDUSTRIES
(Amounts in Millions of Dollars)

Date	Bank Loans	Government Advances and Prepay- ments	Trade Credit	Federal Income Taxes Accrued	Provisions for Renegotia- tion Liabili- ties	Other Taxes	Other Current Liabili- ties
12/31/39...	62	25	530	202	.....	172	427
12/31/41...	152	527	982	1,990	.....	305	781
12/31/43...	640	1,449	1,884	3,685	927	451	946
12/31/44...	716	1,266	1,889	3,266	539	460	945
6/30/45....	627	1,067	1,581	3,152	377	486	986

ties, there was a gradual shift toward consideration of advances in a different light. It became apparent that, because of the overextended or weak financial position of most applicants, the advances made should be properly regarded as direct government loans for the operation of the contractor's business, rather than as advances on contracts. This was recognized after the Army and Navy abandoned the practice of relying upon surety bonds¹⁶ and undertook to supervise the use of the funds advanced by disbursing them through controlled bank accounts requiring supervision or countersignature by a Service representative.

Although advance payments were thus looked upon as similar to direct loans, experience with them has only limited significance to our general subject.¹⁷ Not only were underlying economic conditions extraordinary, but the Services were engaged in financing their own customers when there was virtually no limit to the production which was required, or to the funds which were available to pay for it. Moreover, the Services had resident inspectors and other technical men available to see that production met specifications. It was always possible, if deemed necessary in the prosecution of the war, to alter the original delivery schedule or to increase the price of the contract. In consequence, the

¹⁶ Several factors contributed to this decision, not the least being the fact that, in the case of producers essential to the prosecution of the war, the Services would be reluctant to collect under a bond at the risk of impairing continued production. Further, while a surety bond might insure repayment of the advance, it did not assure application of the advance to performance of the contract. Too, the cost of the bond, often substantial, was usually reflected in the price which the Services had to pay for procurement. Legal problems were raised by the need to obtain consent of the surety for every modification of the contract and the risk that some step might be taken which would relieve the surety from liability. Both of these points argued for the Services becoming their own insurers. Finally, the liability of bonding companies on advance payments made by the Army and Navy was, by the spring of 1942, in excess of their total combined capital, and for this reason it was becoming difficult to obtain the bonds necessary to cover new advances.

¹⁷ Actual direct loans were authorized under Executive Order 9112, although never employed by the Navy or Maritime Commission, and only very rarely by the Army. In view of their lack of facilities for handling collateral, assigned payments, et cetera, these government agencies found it more desirable, when emergencies arose, to employ 100-percent guaranteed loans.

fact that total losses (before allowance for interest received or operating expenses of the financial arms of the Services) have been held below 1/20 of 1 percent on the huge volume of such "loans" has little bearing upon the soundness of such a public financing operation in normal times.

Two classes of advance payment were of special importance, the first in terms of volume, and the second in number.¹⁸ The first class consisted of large advances made for the purpose of supplying the entire working capital required to finance operations under major contracts given to aircraft manufacturers or other similarly overextended concerns, or to subsidiaries or divisions of large corporations where the operation concerned had been established, usually employing government facilities, solely to produce a certain product requested by the Services. The second major class of advance represented, in general, credit risks so poor that commercial banks were unwilling to finance the operation even with a guaranty to cover 90 percent of the possible loss. It was these concerns which caused advance-payment financing to be referred to as "banking in reverse," in the sense that one factor qualifying a war contractor for advance payments was evidence that his financial position was such that no bank could lend to him. Of course, such risks were not assumed by the Services without strong certification from the procurement officers concerned that the production involved was essential to the prosecution of the war and could not be obtained elsewhere without prejudicial delay.

With respect to concerns strong enough to obtain bank credit but who preferred advance payments, policies wavered. Efforts

¹⁸ The following discussion relates to the experience of the War and Navy Departments. Comparatively, advances made by the other agencies were not large. The Maritime Commission used advance payments only occasionally, relying chiefly upon progress payments and guaranteed loans. The Treasury Department Procurement Division followed the policy of securing its advances with surety bonds, rather than controlled bank accounts. The Office of Scientific Research and Development, advancing funds to universities for research and development projects, required no security, though it did require that the funds advanced be segregated from other funds.

were made by the Services from time to time to avoid making such advances, and the Navy in particular denied numerous requests. Gradually, however, after new requests for advances began to taper off in 1943, policies in this respect were relaxed.

In order to protect the government's interest it was imperative in many of the weaker situations to add certain restrictive terms and provisions to the agreement governing the advance payment. The character of these provisions included subordination of other debts, endorsement by the principals, agreement not to pay dividends or increase salaries, or a limitation upon expenditures on capital assets. Gradually, this practice spread until it became standard in the Navy to impose such conditions on top of the basic security of disbursement through a bank account controlled by countersignature, lien upon funds in the controlled account, and lien upon work in process financed from the controlled account.¹⁹ Although the Army followed a similar trend, its practices were somewhat more lenient, owing to the difficulty of implementing a stringent policy with any uniformity through the numerous offices in the Army with authority to make advance payments.²⁰ Under the Army's decentralized setup, instituted December 31, 1941, authority was delegated by the Advance Payment and Loan Branch in the Office of the Fiscal Director to the chiefs of the eight supply services to make advances of up to 50 percent on

¹⁹ These basic provisions were included in standard advance-payment forms developed by both the Army and the Navy. The standard forms provided not only that the advance payments would be made into a controlled account, but that this account would serve as a revolving fund, being replenished by deposit of all other payments (or, in the case of the Army, a percentage of all other payments) made under the contract. Withdrawals from the account were to be made only under countersignature of a Service representative (the Army did not specify countersignature in advances to strong contractors, but reserved the right to require it) and were usually limited to direct labor, material, and indirect expenses necessary for the performance of the contract.

²⁰ The Army did, however, insert in all advance-payment contracts a provision to the effect that "if at any time the Under Secretary of War deems the security furnished by the Contractor inadequate, the Contractor shall furnish such additional security as shall be satisfactory to the Under Secretary of War." The War Department interpretation of this provision gave it very broad powers.

contracts not in excess of \$5,000,000. This authority was in turn redelegated by them to their district offices (forty-five at one time) with respect usually to advances up to 30 percent on contracts up to \$1,000,000. In the Navy Department, all advance payments after May 1942 were authorized centrally by the Finance Division, Office of Procurement and Material, in Washington, and after January 1943 all advances were also negotiated by that office.

No discussion of advance payments during the period under review can avoid reference to the considerable paper work and administrative burden placed upon the Services, whether operations were centralized or decentralized. This was a real factor in discouraging further extension of advances once guaranteed loans became generally available. The negotiation of an advance by an officer unfamiliar with local conditions, and the attempt afterward to control the financing from a distance through the agency of a technical inspector who was not likely to be versed in financial matters, led to many complications. In addition, because of the fact that advances had to be made against, secured by, and liquidated from the proceeds of specific individual contracts, there were numerous accounting complications affecting the countersigner and the contractor. Necessary segregation of materials and work in process often presented a baffling problem when the contractor was engaged in both civilian and war-production business, in contracts from several Services or branches thereof, or in numerous small contracts. In some cases, advances against several contracts could be pooled and used to finance any of the contracts through a joint "pool account." This eliminated some problems of segregation, but added new ones, such as that of determination of the amount which might properly be withdrawn as profit upon a contract when it was completed.

THE GUARANTEED-LOAN PROGRAM²¹*V Loans*

Contrary to the impression in some quarters, the War and Navy Departments, at least, never intended that guaranteed loans should generally supplant advance payments.²² The primary purpose of the Regulation V program was clearly to provide credit for certain areas of production which, because of high risks and a lack of direct contractual relationships, were impracticable to finance adequately through previously existing procedures. The fact that small businesses were especially important in these areas was an added incentive to provide assistance. As we have noted, the President's statement accompanying Executive Order 9112 stressed the need to assist small business enterprises in achieving maximum war production, and that peacetime credit rules should be abandoned where necessary in the interest of production.

From the start, emphasis was placed upon the urgency of getting funds to contractors with a minimum of delay, and upon the willingness of the government to assume large financial risks to obtain essential production. The risk factor was secondary to that of production. In the original instructions of the War Department to the Federal Reserve banks, it was stated that, although the Department's liaison officers and the Federal Reserve banks were to protect the agency as far as possible against loss, guarantees or loans were not to be denied or substantially delayed because of the difficulty of arranging adequate protection. At the same time, it was not originally intended to employ these lending powers unnecessarily. This was made plain by Regulation V,

²¹ A comprehensive summary of this program is presented in "Financing War Production and Contract Terminations under Regulation V," *Federal Reserve Bulletin*, XXXII (March 1946), pp. 240-48.

²² Cf. Charles C. Abbott and Walter G. O'Neil, *The V and VT Loan Arrangement and Termination Financing* (Boston: Graduate School of Business Administration, Harvard University, 1944), p. 31.

which instructed the Federal Reserve banks to arrange necessary war-production financing, where practicable, without the assistance of the government. The principle that guaranties would not be granted if adequate private financing was available without guaranty was reiterated frequently in memoranda and correspondence in the early days of the program.

Though supplanting advance payments by guaranteed loans was not a major consideration in framing the V-loan program, the War and Navy Departments and the Maritime Commission were aware of the possibility and of certain advantages which it offered. A basic factor in the decision to employ guaranties, rather than direct loans to subcontractors, was the desire to utilize the established credit machinery and facilities of the private banking system, rather than to construct a duplicate government organization. This was true not only with respect to the making, but also the subsequent servicing and policing, of loans. The government agencies were also assisted by the experienced personnel of the Federal Reserve banks in arranging credits and in supervising administration of the program. Too, it was expected that the banks, through their unguaranteed exposure, would have an adequate incentive to follow the loans carefully, and, in the event of loss, the government would not suffer the whole amount. Finally, it was recognized that many industrial concerns which would be willing to arrange private bank loans, supported by a government guaranty, were extremely reluctant to borrow directly from the government and expose themselves to the bureaucratic interference in their affairs which this might entail.

As previously remarked, in terms of aggregate volume, outstanding guaranteed loans remained secondary in importance to advance payments, although their volume was large by any standard, as reflected in Table 4, and declined less during 1944 than did advances. Probably the biggest factor in the continued popularity of advance payments was the preference of numerous large contractors for liabilities which could be directly offset against

monies owed to them by the government, rather than bank loans which were owed to third parties and had definite maturity dates. Many concerns were reluctant to show large bank loans upon the

TABLE 4
LOANS GUARANTEED UNDER REGULATION V, BY PERIODS *
(Amounts in Thousands of Dollars)

Dates	Loans Authorized		Loans Outstanding, End of Period			
	Number	Amount	Total Credit Available	Credit in Use	Percent of Credit Available in Use	Average Percent of Government Guaranty†
4/10-6/30/42...	565	310,680	218,996	81,108	37.0	85.9
7/1-12/31/42...	2,100	2,377,717	2,233,841	803,720	36.0	78.7
1/1-6/30/43...	1,552	2,030,421	3,644,306	1,428,253	39.2	80.8
7/1-12/31/43...	1,130	1,844,230	5,060,326	1,914,040	37.8	83.6
1/1-6/30/44...	1,086	1,483,624	5,875,115	2,064,318	35.2	84.1
7/1-12/31/44...	1,001	1,263,910	6,189,556	1,735,970	28.1	85.5
1/1-6/30/45...	988	838,733	5,081,469	1,386,851	27.3	86.0
7/1-12/31/45...	335	190,085	1,476,865	510,270	34.6	85.3
1/1-6/30/46...	14	4,618	212,884	70,267	33.0	85.7
7/1-12/31/46...	0	0	40,449	18,025	44.5	92.4
Total.....	8,771	10,344,018	.....	.....	.....	.....

* Including so-called V, VT, and T loans, guaranteed by War Department, Navy Department, and Maritime Commission. See Table 5 for separation by type of loan. Between agencies the division of authorizations, in dollars, was roughly 77 percent War Department, 21 percent Navy Department, and 2 percent Maritime Commission. (Source: *Federal Reserve Bulletin*.)

† On credit in use.

liability side of their balance sheets, whereas it was possible to treat advance payments merely as deductions from current assets.

The basic document covering guaranteed loans was the guaranty agreement, a contract between the financing institution²³

²³ Normally a commercial bank, of which approximately 1,400 participated, but occasionally included were finance companies, factors, and at least one life insurance company. In larger credits, it was customary for several banks to participate. In the General Motors \$1,000,000,000 credit, there were nearly 400 banks.

and the guaranteeing government agency, executed for the agency by the Federal Reserve bank, as fiscal agent, in whose district the financing institution was located. Three principal standard forms of guaranty agreements, dated May 14, 1942, April 6, 1943, and September 15, 1944, were used for production loans.²⁴ Certain standard amendments were also authorized from time to time. The essence of the agreement, which was retained in each form, was (1) the obligation of the guarantor to purchase the guaranteed percentage of the outstanding amount of the loan on ten days' notice from the financing institution, irrespective of the borrower's possible default; and (2) agreement of the guarantor to share losses with the financing institution, in accordance with the respective interests of each in the loan.²⁵ Other provisions of the agreement spelled out details of administration of the loan and the collateral, reports, fees, and other matters, some quite complicated.

Notably complicated were Sections 5 and 6, conferring, in case of cancellation of war contracts for convenience of the government, the benefits already mentioned: namely, the right of the borrower (Section 6), in the event of cancellation of 25 percent or more of its war-production orders, to request suspension of maturity and waiver of interest upon a similar percentage of its loan, and the right of the financing institution (Section 5), in the event of such cancellation, to have the unguaranteed portion of the loan decreased by the same percentage. Unlike the borrower, the financing institution could avail itself of this right only once. During the period while interest was waived, the govern-

²⁴ The 1942 guaranty agreement was published in *War Production Loans*, American Bankers Association Special Bulletin No. 85 (New York: American Bankers Association, June 1942), and the 1943 agreement in *War Loans*, American Bankers Association, Bank Management Publication No. 101 (New York: American Bankers Association, June 1943).

²⁵ On the basis of these provisions, an opinion was obtained in April 1942, from the Comptroller of the Currency, that the guaranteed portion of a V loan extended by a national bank need not be considered for purposes of the statutes imposing a legal lending limit. Similar rulings were obtained from other banking authorities.

ment would pay interest to the financing institution on the suspended portion of the loan, at the net rate (after deduction of guaranty fee) the company formerly received, or at $2\frac{1}{2}$ percent, whichever was less. There was originally some uncertainty as to the desirability of including these sections, for though they eliminated a hazard which had been disturbing to many contractors and bankers, there was doubt as to whether such a purpose could be construed as within the limits of the Executive Order. Too, it was pointed out that Section 6 would have the undesirable effect of attracting many applicants with sound credit, who might otherwise be satisfied with private financing. However, in the end, this protection was provided to allay the fears expressed by both contractors and bankers. The two sections proved definitely appealing to borrowers and banks, but they also became, because of their complexity, the source of endless problems and disputes, involving a great volume of paper work. When the Contract Settlement Act of 1944 provided other means of financing cancelled contracts, both sections were eliminated from the new standard form of guaranty then prepared; when contract cancellations came in volume in 1945, numerous borrowers, entitled to suspensions under their old-form agreements, elected not to exercise their rights, using instead the vastly simpler protection afforded under the Contract Settlement Act. Only rarely did banks avail themselves of the step-up of guaranty under Section 5.

War Department procedure in authorizing guaranties differed from that of the Navy, which made all decisions in Washington upon the basis of applications submitted through the Federal Reserve banks. The Army maintained liaison officers in each of the twelve Federal Reserve banks and in two of their branches, a practice suited to its decentralized procurement setup.²⁶ These

²⁶ Maritime Commission procedure was similar to that of the Army, in that the Commission delegated authority to its regional field representatives (not attached to the Federal Reserve banks) to certify loans to the Federal Reserve banks for guaranty, provided the total loan did not exceed \$250,000, the guaranteed portion \$100,000, or the guaranteed percentage 90 percent.

representatives were given responsibility for determining whether the product was necessary to prosecution of the war, whether the contractor had the technical ability to produce and was in need of additional funds to produce, and whether the prices of the contracts were such that he could hope to produce without a crippling loss. Because of the presence of these liaison officers, the Federal Reserve banks were authorized to commit the War Department to loans not in excess of \$100,000, provided that the liaison officer first certified to the above-named points and concurred with the decision to make the loan. On September 15, 1944, this authority was increased to \$250,000, provided the guaranty requested was not over 90 percent. This action by the War Department resulted in cutting red tape and reducing delays on small loans. It contributed to more amicable relations with the financing institutions, because of the opportunities for explanation of policies, and because loan agreements were tailored to the War Department's wishes before negotiations had crystallized to a point where modifications were embarrassing to the bank. On the other hand, decentralized operation made maintenance of uniformity in policies more difficult, and the presence of a direct Army representative as an active participant in preliminary negotiations probably led the Reserve banks to assume less responsibility than would otherwise have been the case.

The maximum interest rates and commitment fees to be charged borrowers upon guaranteed loans, and the guaranty fees to be paid by the banks to the guaranteeing agencies were prescribed by the Board of Governors, after consultation with the agencies. Interest rates were limited originally to 5 percent, and reduced to $4\frac{1}{2}$ percent in September, 1944. The maximum rates were the most common, as might be expected in view of the risks presumed to exist, but rates as low as 2 percent were set in some instances. The commitment fee charged by banks was limited to $\frac{1}{4}$ of 1 percent except for the so-called "VT loans," where $\frac{1}{2}$ of

1 percent was permitted.²⁷ Commitment fees were not always charged; in fact, they were uncommon in several Federal Reserve districts. Loans in certain areas were habitually extended upon an unfirm basis, i.e., the bank did not commit itself unequivocally to advance the funds when requested, so that commitment fees were not appropriate.

The prescribed schedule of guaranty fees was revised on two occasions, the final simplified and reduced schedule being put into effect on September 15, 1944, as follows:

Percentage of Loan Guaranteed	Guaranty Fee Percentage of Loan Interest Rate
Up to 80.....	10
85.....	15
90.....	20
95.....	30
100.....	50

The guaranty fee was calculated only with respect to the guaranteed portion of the loan. The proceeds of guaranty fees were used, first, to reimburse the Federal Reserve banks for their expenses, and, second, to establish reserves against losses. In the end, large surpluses accumulated in these reserve accounts. Losses appear to have been confined to less than 1/20 of 1 percent of the total loans authorized.²⁸

Guaranteed production loans were designed to supplement working capital, and were intended to be self-liquidating, in the sense that they were to be liquidated from the proceeds of the contracts—some running for two years or more—which they were provided to finance. The position of the guaranteeing agencies

²⁷ With VT loans the guarantor shared in the commitment fee as well as in interest paid.

²⁸ The War Department as of December 31, 1945, had received \$23,720,000 in guaranty and commitment fees, which, after the Federal Reserve banks' expenses of \$2,474,000, and estimated ultimate losses of \$3,369,000, left \$17,877,000 net income before allowance for administrative expenses incurred by the Department. The Navy Department and the Maritime Commission had similarly favorable net income in their much smaller operations (*Federal Reserve Bulletin*, XXXII, 247).

from the start was that adequate other means were available for financing any necessary facilities, other than incidental items whose inclusion under a guaranteed loan would not change its essential nature.

The most controversial question in the program was perhaps that of who should be financed. Although, as noted, the intention had originally been to guarantee loans only where such a guaranty was needed for a war contractor with production "necessary, appropriate or convenient" for the prosecution of the war to obtain adequate financing, in practice, this line was difficult to draw. The issue was soon joined with two opposing interpretations of Executive Order 9112. One asserted that the holder of a war contract was entitled to governmental financial assistance for that reason alone, whether he was very strong financially or completely irresponsible, and whether or not his production was really needed; the other maintained that the government should not spend any more money in procurement than necessary, that it was essential to enforce reasonable credit standards except for truly urgent procurement, and that private banks should assume the risk of financing such enterprises as could meet conservative banking standards. Strangely, criticism was centered around the refusal of the Navy and the Maritime Commission to guarantee loans to enterprises which were sound credit risks, well able to obtain unguaranteed financing.²⁹ It appeared that these government agencies were far more anxious that they abstain from unnecessary competition with private banking than were many bankers.

The War Department agreed in theory with the policies expressed by the Navy and the Maritime Commission, but was inclined to follow what it considered the more practical course of a liberal interpretation of the Executive Order, based upon the belief that the government could not lose by financing strong

²⁹ See Roy A. Foulke, *Government Guaranteed Production and Termination Loans*, p. 10. Criticism stressed that the government agencies were withholding from strong companies the benefits of contract-termination protection made available to others.

companies, and would, in fact, gain the guaranty fees. Its policy might be expressed in terms of two questions: "Is the contractor good for the loan?" and "Does he need it?" If the answer to either question was yes, the financing would usually be provided, subject only to certification of the military necessity of the procurement, which was rarely refused in the early years of the war.

As a matter of fact, few applications for loans were denied. Of 9,605 total applications received through December 31, 1945, only 847, or less than 9 percent, were denied. Of the three agencies, the War Department denied only 5 percent, the Navy, 17 percent, and the Maritime Commission, 27 percent.

A second field of controversy had to do with the size of the credit made available and the length of the loan. In keeping with the announced intention of supplementing the working capital of contractors rather than freeing it for nonwar purposes, the guaranteeing agencies attempted to hold loans down to amounts appropriate to the financing of the war contracts on hand at the time of application. To this end they usually required cash flow sheets or budgets showing need for the size of loan requested. However, under the conditions of rapid expansion into new fields which prevailed, projection of loan requirements was often extremely difficult, and the agencies were anxious to provide amply for any legitimate need. It was also believed that the loan formulas employed would adequately limit the credit in use without need of a restrictive ceiling. It is not surprising, therefore, that many amounts were authorized which proved far in excess of actual needs. This situation is reflected in the over-all statistics presented in Table 4. Here again, some differences in policy should be noted, with the War Department generally imposing less strict limitations upon amounts than did the other two agencies.³⁰

With respect to maturity, a similar divergence existed. Loans

³⁰ See the Navy Department memorandum of February 29, 1944, covering its policy on VT loans, quoted by Foulke, *Government Guaranteed Production and Termination Loans*, pp. 16-17.

in general averaged a year to eighteen months in maturity, depending upon the length of time required to perform the contracts held. Even if the guaranteeing agency was confident that the borrower could perform without difficulty, and was likely to continue in war work, there was reluctance to commit funds for a long period when preponderance might easily shift to another Service in the meantime. Borrowers, and even banks, troubled by the complexities of arranging new loans, were often desirous of obtaining longer maturities than those granted. In some cases, where continued need for the supplies was apparent and finances were sound, the agencies permitted maturities up to three years, even though not supported by the existing backlog of orders. The War Department was considerably more liberal in this respect than were the other two agencies.

A third subject of controversy was the question of what was an appropriate percentage of guaranty. From the beginning, the guaranteeing agencies urged that financing institutions take exposures commensurate with the risks involved in the particular cases, rather than endeavor to obtain maximum protection. This was urged in order to lessen the liability assumed by the government and to provide the financing institution with an incentive for careful servicing. A genuine financial interest in the loan on the part of the bank was basic to the partnership relationship contemplated by the program. Here also, the policies of the Maritime Commission and the Navy were somewhat the stricter, the War Department feeling that no real risk was involved in the stronger situations, and that, if the banks insisted upon a high percentage of guaranty, it simply meant a more favorable guaranty fee for the government.

In practice, there was only a small correlation between the percentage of guaranty and the strength of the loan. A number of situations with 50-percent guaranties were very weak, the low guaranty indicating primarily that the bank had been heavily involved in the business at the time of the application. The guaran-

teeing agencies endeavored to avoid "bail-outs" of banks. On the other hand, 90-percent guaranties were requested for many of the strongest credits. The financing institution, for example, might offer the borrower an interest rate of only $2\frac{1}{4}$ percent, yet, at the same time, would insist upon a 90-percent guaranty from the government. The fact that the banks financing General Motors Corporation were able to obtain a 90-percent guaranty was long used in support of arguments for high guaranties of the obligations of other borrowers.³¹

In point of fact, although much clearer to hindsight than it was when the problems of war financing first arose, a bank obtaining a 90-percent guaranty in connection with a business not already on its last legs could hardly lose. Its servicing of the loan was based more upon good faith and jealousy of its reputation than upon any incentive to avoid loss. The risk assumed, in the last analysis, was that of the contractor's ability to perform. In any event, a very severe loss would be 50 percent of the loan, yet the bank would, in this case, be liable for a loss of only 5 percent, a sum which would be less than its interest income if it had held the loan for, say, eighteen months with a gross rate of 5 percent and a net rate of 3.65 percent, on the basis of a 30-percent guaranty fee.³² The bank also would be protected, in the event of bankruptcy of the borrower, by the government's priority as a creditor.

On the whole, guaranties averaged high percentages, as indicated in Table 4. The figure of 90 percent was certainly the most common, and it should be noted that a considerable proportion of

³¹ This \$1,000,000,000 credit guaranteed by the War Department was arranged in October 1942, to run to February 1946. The need for a substantial guaranty was evident when the size of this commitment was compared with the estimated aggregate lending limit, on an unsecured basis, of all commercial banks at that time of approximately \$575,000,000. Strictly speaking, also, this guaranty might not be classified as 90 percent. On *total* borrowings up to \$250,000,000 the guaranty was 50 percent; between \$250,000,000 and \$500,000,000, 75 percent; between \$500,000,000 and \$650,000,000, 85 percent, and above that amount, 90 percent. Actually, only \$100,000,000 of this credit was used (Foulke, *Government Guaranteed Production and Termination Loans*, p. 11).

³² See Abbott and O'Neil, *op. cit.*, p. 34, n. 1.

those below 90 percent were so only because the guaranteeing agencies had refused to agree to the percentage originally requested. Guaranties below 70 percent were rare, and below 50 percent, practically nonexistent. At the other extreme, guaranties were as high as 100 percent, when truly essential subcontractors could not be financed otherwise. With prime contractors, under similar circumstances, advance payments were normally employed. With 100-percent guaranties, special controls were usually established, such as, for example, countersignature of all disbursements by a government representative.

A fourth controversy revolved around the necessity for the rather elaborate restrictions and negative covenants which eventually came to surround most guaranteed production loans. A formal loan agreement was negotiated between the borrower and the financing institution.³³ Often, because of the complicated nature of the four-party (borrower, bank, Federal Reserve bank, and guarantor) relationship and the special conditions associated with assignments, loan formulas, termination calculations, et cetera, the loan agreement became extraordinarily lengthy and complex. All parties concerned were unhappy about this development, but reluctant to abandon the machine they had created, for the substantial sums involved made it desirable to spell out rights in detail in a large proportion of the cases, and many reasons argued for a considerable degree of standardization. In addition, as time went on, the banks, Federal Reserve banks, and guaranteeing agencies gradually added new standard covenants to guard against recurrence of unfortunate experiences. Being in the position where they had to finance essential production, almost regardless of the financial difficulties and maladministration of contractors, the government agencies wished to forestall the more common sources of difficulty, such as excessive expenditures for fixed assets, excessive dividends or withdrawals, and excessive salaries. They did this by inserting negative covenants prohibit-

³³ For an example of such an agreement see *War Loans, op. cit.*, pp. 142-52.

ing such action or requiring the guarantor's prior consent.³⁴ In due course, fairly standard lists of desirable restrictions were built up, and, to avoid charges of favoritism, the guaranteeing agencies attempted to employ restrictions uniformly, except in the strongest cases. The result was that the agencies, on the one hand, were accused of meddling in relationships between the borrower and his bank, and on the other, found banks omitting reasonable restrictions in order to avoid friction with customers, apparently with the confident expectation that the Federal Reserve banks or the guaranteeing agencies would impose them.

Although the complex nature of the loan agreements resulted in frequent delays while the lawyers for the several parties debated changes in the language (especially in those cases where several banks were involved), it does not appear that this feature interfered unduly with the eventual consummation of the loans. Instances of approved applications under which guaranty and loan agreements were never executed were fairly frequent, but for the over-all program averaged less than 10 percent.

It is interesting to note the average size of loan guaranteed during the war years. An even distribution by size classes was characteristic of loans under Regulation V.³⁵ The smallest loan

³⁴ The gradual addition of restrictions indicated the change in procurement emphasis as the war progressed, from the obtaining of additional production in a hurry and almost regardless of cost, to the maintenance of a level of production already attained, permitting more careful attention to cost factors.

³⁵ Draper, *op. cit.*, p. 20, supplies the following tabulation of loans guaranteed under Regulation V through March 31, 1945.

Maximum Loan Guaranteed (In thousands of dollars)	Number of Borrowers with Total Assets in Thousands of Dollars				Total Borrowers*
	Less than \$50	\$50- \$500	\$500- \$5,000	\$5,000 and Over	
Less than \$25.....	423	128	4	.....	559
\$ 25-\$ 50.....	208	238	4	.....	452
\$ 50-\$ 100.....	119	495	33	.....	658
\$ 100-\$ 250.....	46	542	157	2	763
\$ 250-\$ 500.....	21	314	334	3	690
\$ 500-\$1,000.....	5	104	333	16	461
\$1,000-\$5,000.....	3	28	356	152	552
\$5,000 and over.....	.....	2	14	160	194
Total.....	825	1,848	1,235	333	4,313

* Including 72 borrowers with no information as to size of assets.

guaranteed was for \$400, the largest for \$1,000,000,000, and the median in the group, \$100,000 to \$250,000. In view of the war-time increase in credit requirements for such contractors, it may reasonably be assumed that this median group represented borrowers who would have required credit accommodations of from \$10,000 to \$50,000 in the period prior to the war.

VT Loans

We have already commented upon the pressure to make available to strong contractors the benefits of Section 6, which, in the event of substantial terminations, permitted suspension of an appropriate portion of the loan and waiving of interest thereon. This pressure increased after the spring of 1943 as terminations and postwar adjustments occupied more of the attention of business planners. Many corporations engaged in war production grew reluctant to assume additional war contracts in the absence of provision by the government for prompt processing of termination settlements and, thus, release of working capital at the end of the war for postwar purposes. The Navy Department proposed a new type of loan for stronger contractors, which would involve a commitment arranged in advance for lending solely against terminated contracts. Some doubts were expressed, however, as to the authority of the guaranteeing agencies to guarantee loans purely for termination purposes, and the matter was resolved on August 30, 1943 by a compromise known as the VT loan.

By this compromise guaranteed loans were made available to strong concerns for both production and termination purposes. The new type of loan for this purpose was to be made under the standard 1943 form of guaranty agreement, modified by an amendment which eliminated the bank's right of step-up under Section 5 (presumably there was no occasion for such protection in strong credits of this type), and provided for a commitment fee of up to $\frac{1}{2}$ of 1 percent in which the guarantor would share, since

the guarantor might otherwise receive little or nothing in return for its liability under the guaranty.

It was also determined that the maximum guaranty for this type of loan would be 90 percent, and that borrowings would have to be supported by a formula based upon war-production inventories and receivables. The intentions of the latter provision were (1) to assure that the amount of loan actually disbursed would be related directly to the volume of war-production business in process, even though the ceiling set on the loan commitment might be far too liberal, and (2) to provide an acceptable basis for borrowing after termination. Because of the strength of most VT borrowers, the permanent exposure accepted by the banks, and a desire to provide adequate termination protection, VT maturities were usually liberal, two to three years being common.

Although VT loans were only available for one year, a large volume was authorized (see Table 5, *infra*). With the passage of the Contract Settlement Act of 1944, on July 1, providing for the establishment of ample means of termination financing, a new and simplified form of V-loan guaranty agreement was prepared, being adopted on September 15. This 1944 form superseded both the VT and the 1943 V form. It eliminated Section 5 and Section 6, and was made simpler in other respects.

After the capitulation of Japan in August 1945, the authorization of new V loans (and advance payments) virtually ceased, because of the difficulty of certifying, as was necessary under the authority delegated by the President, that the work to be financed was "necessary, appropriate, or convenient for the prosecution of the war." A large volume of loans remained outstanding, pending settlement of claims and completion of unterminated contracts, but extensions of maturing loans were granted only for purposes of orderly liquidation. In this connection, the guarantors delegated to the Federal Reserve banks a larger measure of discretion in carrying the liquidation through to completion.

*T Loans*³⁶

The final answer to the termination problem, in so far as the guaranteed-loan program was concerned, was provided by the T loan, made available on September 12, 1944, under the authority of the Contract Settlement Act. The T loan could only partly be regarded as an extension of government credit. Rather, along with other means of termination financing, including advance and partial payments provided under the authority of the Contract Settlement Act, and pursuant to regulations stemming from the Director of Contract Settlement, it was looked upon as a rapid method of preliminary liquidation of claims owed by the government. Although credit risks obviously existed, the Director set the policy that they were to be frankly accepted as a part of the price to be paid for rapid settlement of terminations and reconversion to a peacetime economy.

Simple standard forms of guaranty and loan agreements were devised, the guaranty being along the same general lines as the 1944 V-loan guaranty. Borrowings were only to be made after termination, in accordance with a specified loan formula. Only very limited restrictions were provided, and reliance was placed upon assignment of claims or a covenant to assign the claims borrowed against, upon the incentive to policing provided by the bank's exposure, and upon the fraud statutes. The schedule of guaranty fees was the same as that inaugurated for V loans on September 15, 1944. Commitment fees of up to $\frac{1}{4}$ of 1 percent could be charged by the bank, but the guarantor did not share.

The almost automatic character of T loans, in so far as the guaranteeing agencies were concerned, is best illustrated by Regulation No. 1 of the Director of Contract Settlement, which speci-

³⁶ For general discussion see Foulke, *Government Guaranteed Production and Termination Loans*, pp. 23-24, and American Bankers Association, *Contract Termination Loans* (New York: American Bankers Association, 1944). The latter source contains copies of the standard guaranty and loan agreements and the official explanatory notes.

fied that, as long as the guaranty requested did not exceed 90 percent, the guarantor would have the right to prescribe additional conditions (beyond those arranged by the borrower and his bank) "only in exceptional circumstances and when they are clearly necessary to protect the Government's interest." In a number of cases, extra conditions were added for these reasons, but, on the whole, T loans were authorized automatically after routine verification of contracts.

At the end of 1945, a modest amount of such loans had been made. In total, the credit used under T loans was not large, and loss experience was favorable. The principal lesson afforded by T-loan experience is perhaps the ready adaptability of the guaranty device to a special purpose. The smoothness with which the T-loan operation was initiated was due to the considerable experience of the banks with comparable guaranties under the V-loan program.

Table 5 presents a breakdown of all loans under the Regulation V program through 1945, indicating the proportion of loans guaranteed under the original 1942 and 1943 V-loan agreements,

TABLE 5
LOANS GUARANTEED UNDER REGULATION V, BY TYPES,
THROUGH DECEMBER 31, 1945 *
(Amounts in Thousands of Dollars)

Type of Loan	Approved Applications, through December 31, 1945		Credit in Use, December 31, 1945
	Number	Amount	
V Loans	5,953	6,230,964	139,907
VT Loans	857	2,441,437	134,112
1944 V Loans	1,117	1,280,039	206,216
T Loans	830	386,960	30,035
Total	8,757	10,339,400	510,270

* Source: *Federal Reserve Bulletin*, XXXII (March 1946), 246.

the VT agreement, the revised 1944 V agreement, and the T agreement. Fourteen additional T loans, aggregating \$4,618,000, were guaranteed in 1946.

THE SMALLER WAR PLANTS CORPORATION

A fruit of the same concern for the unfavorable situation of subcontractors and small business generally, which contributed to the drafting of Executive Order 9112, was the Smaller War Plants Corporation, created by Act of June 11, 1942.³⁷ The approach of this legislation differed, however, in that its stress was less upon obtaining essential production than upon promotion of the welfare of small business; the legislation assured small concerns of larger participation in war production and essential civilian production. These smaller plants feared that the war-production program was bringing about an increasing concentration of economic power. The Act proposed to combat this trend by obtaining a wider distribution of war orders. The purchase of plants and equipment, for lease to small enterprises desiring to enter war production, was also stressed. In addition, the Corporation was authorized, under Section 4(f),

. . . to make loans or advances, on such terms and conditions and with such maturities as it may determine, to enable small business concerns to finance plant construction, conversion, or expansion, or to finance the acquisition of equipment, facilities, machinery, supplies, or materials, or to supply such concerns with capital, to be used in the manufacture of articles, equipment, supplies, or materials for war or essential civilian purposes, and such loans or advances may be made or effected either directly or in cooperation with banks or other lending institutions through agreements to participate or by the purchase of participations, or otherwise. . . .³⁸

³⁷ Public No. 603, 77th Cong.

³⁸ In the hearings on this Act, Senator Murray explained that the purpose in giving the Corporation lending powers rather than relying upon the Reconstruction Finance Corporation was simplification and convenience in order to avoid forcing an enterprise, once it had demonstrated its competence (as a basis for securing war contracts), to present its case again to an entirely different branch of the government.

This authority was, of course, extremely broad, particularly when "essential civilian production" was interpreted liberally. The Corporation, however, had limited funds at first, being originally established with a capital-stock subscription of \$150,000,000 subject to call from the Treasury. This was increased to \$350,000,000 by an amendment of December 8, 1944.³⁹ The Corporation, although operated as a separate entity, was in effect a division of the War Production Board, being subject to control by the chairman of that agency, who was charged with broad responsibilities for mobilizing the productive capacity of small businesses. An indication of the special nature of the lending operation authorized was afforded by Section 6 of the Act, which provided that, when the Corporation had arranged a loan or advance under the clause quoted above, it was to transfer the administration and servicing of the loan or advance to the Defense Plant Corporation, a Reconstruction Finance Corporation subsidiary, which would act as the Corporation's agent.

The lending policies adopted by Smaller War Plants Corporation were intended, and were recognized soon after it commenced operations in September 1942, to be most liberal. The Corporation was willing to accept heavy risks, and it moved aggressively to develop loans. More than 100 field offices were established to obtain contact with small businesses all over the country, and most of these offices actively solicited loans. For loans under \$25,000, it offered to banks a "Repurchase Bank Loan Plan" providing 100-percent guaranties. Moreover, in connection with the placing of war-production orders with new, financially weak suppliers, the Corporation frequently found it necessary to arrange

³⁹ Public No. 474, 78th Cong. The Corporation was also granted certain additional financing authority under Public Nos. 395 and 457, 78th Cong. This authority, not availed of substantially, included the making of loans or guaranties for interim financing of the settlement of terminated contracts (under the Contract Settlement Act of 1944), and the financing of purchases by small business of surplus property and of the acquisition, conversion, and operation of government war plants (Surplus Property Act of 1944).

direct financial assistance at the same time. Yet, the volume of loans made grew slowly and remained small throughout the war, as indicated by Table 6. The maximum amount of Corporation funds outstanding in loans, according to published figures, was approximately \$40,000,000, as of March 31, 1945.⁴⁰ To this should be added an amount of possibly similar proportions for guaranties or deferred participations covering the loans of others. One obvious explanation of the Corporation's inability to develop a larger volume of loans in relation to the considerable effort expended is that the coverage of Regulation V was so great that only a narrow fringe of cases was left to the Smaller War Plants Corporation. Since the actual number of small loans made under Regulation V, however, was not large, the Corporation's experience offers some basis for questioning the existence of any appreciable volume of legitimate unfilled needs for credit during this period.

An interesting aspect of Table 6 is the substantial average size of loan, despite the Corporation's supposed stress upon small business. In part, of course, this reflects the same factor noted in connection with Regulation V—that the average credit requirement of small manufacturing enterprises was swollen by wartime business volume. It also reflects the practice, like that employed by the Reconstruction Finance Corporation, of reporting loans on the basis of total disbursements authorized, even though the amount permitted to be outstanding at any time might be restricted to a much lower figure. Chairman Maverick indicated early in 1945 that the Corporation's smallest loan had been for \$600.⁴¹ Earlier bimonthly reports of the Corporation to Congress indi-

⁴⁰ Quarterly Treasury Statement. In view of the competitive stimulus given to private bankers, the Corporation may, of course, have played a more important part in wartime financing than Table 6 alone would suggest.

⁴¹ United States Congress, Senate, *Extending the Life of Smaller War Plants Corporation*, hearing before the Committee on Banking and Currency, United States Senate, 79th Cong., 1st sess., on S. 105, February 6, 1945 (Washington, D.C.: Government Printing Office, 1945), pp. 7, 11.

cated that several loans in excess of \$1,500,000 had been made.

Adequate data are not available upon the percentage of applications for loans rejected by the Smaller War Plants Corporation. Of 230 applications received during the first six months of operations, only 50 had been approved at the end of the period, though

TABLE 6
SMALLER WAR PLANTS CORPORATION LOANS
(Amounts in Thousands of Dollars)

Year	Loans Authorized During Period*		Average Amount of Loan Authorized	Outstanding Amount of Loans†
	Number	Amount		
1942 (4 mos.)	37	3,546	96	12,000 (June 29, 1943)
1943.....	797	44,564	56	35,000 (March 15, 1944)
1944.....	1,508	185,437	123	35,000 (Dec. 31, 1944)
1945.....	2,145	231,130	108	33,000 (Sept. 30, 1945)
Total...	4,487	464,677	103	.....

* Data supplied by Smaller War Plants Corporation. The totals shown include 314 bank loans in the amount of \$5,710,000 which were guaranteed in their entirety by the Corporation, and 1,326 "bank-participation" loans in which the Corporation's share was \$159,225,000 and the participation by banks was \$22,922,000. The latter figure is not included in the table.

† June 29, 1943, figure reported by Chairman Johnson in *New York Times* of June 29, 1943; other figures are from United States Treasury Statements, to nearest million. Last two figures are on net basis after reserves for losses. As of December 31, 1946, the Reconstruction Finance Corporation reported \$21,190,000 of these loans still outstanding, exclusive of certain liabilities under guaranties.

presumably some were still pending.⁴² From testimony presented to Congress in 1945, however, it may be inferred that applications aggregating approximately one-third of the total dollar amount of applications submitted from 1942 through 1944 were denied.⁴³ With respect to loans approved but not used, the Corporation shared the experience common to other lending agencies

⁴² Smaller War Plants Corporation, *Fourth Bimonthly Report to Congress* (February 11, 1943).

⁴³ *Extending the Life of Smaller War Plants Corporation*, p. 23.

that authorizations made were considerably in excess of amounts actually used. Data released from time to time revealed that an approximate 30 percent of the amounts authorized were never disbursed.

In its explanatory booklet, *Loans to Small Business*, the Smaller War Plants Corporation stated that "it is our policy to encourage local banks to make loans direct to small business concerns engaged in war or essential civilian production. If for some special reason a bank is unable to make a particular loan, the Corporation may arrange the loan directly and invite the bank to participate." Participations, however, were for a long time much less important than direct loans. Chairman Maverick, in February 1945, declared that 23 percent of the Corporation's loans then had bank participation, usually of from 10 percent to 25 percent.⁴⁴ By the end of 1945, however, the proportion of loans having bank participations (or made by banks and guaranteed by the Corporation) had increased materially, as indicated in the footnote to Table 6. The cumulative total of such loans then had reached 36 percent of all loans authorized, although, in terms of dollar amounts, the banks' participations represented only 5 percent of the total credit made available. The average participation by the Corporation was 87 percent. Increased interest in this type of loan caused the Corporation, in the summer of 1945, to introduce a Blanket Participation Agreement patterned after that of the Reconstruction Finance Corporation. This agreement, known as a deferred participation but the equivalent of a guaranty, covered loans to "small business concerns" (defined for this purpose as employing less than 500 people) up to \$100,000 in amount and ten years in maturity, with interest at 4 percent on the guaranteed portion and not above 6 percent on the balance, and with the bank required to take a minimum exposure of 20 percent.⁴⁵ It

⁴⁴ *Extending the Life of Smaller War Plants Corporation*, p. 6.

⁴⁵ Guaranty fees on these loans were set at $\frac{1}{2}$ of 1 percent for participations not over 50 percent, $\frac{3}{4}$ of 1 percent from 51 percent through 75 percent, and 1 percent above 75 percent.

was not actually an automatic commitment, however, for the agreement required submittal of full details concerning the credit, via the district loan agent, to the regional loan agent of the Corporation, whose written approval was required before the loan guaranty became effective.

Although the regional loan agents could commit the Corporation for loans under the blanket agreement, or for other loans up to \$100,000 in which a bank participated to the extent of 20 percent, on direct loans their limit was \$50,000.⁴⁶ Other loans went to Washington for approval. Before loan applications were forwarded from the field, they were checked by a financial man and, in many offices, by engineers or technical advisers; there was also oral checking to see whether local banks would take the loan on the basis worked out by the Corporation. The process involved a considerable lapse of time; Chairman Maverick indicated that, in early 1945, the Corporation needed from six weeks to two months to make a loan. On top of this, long delays were common in the actual execution of a loan after it was authorized, because of complications in arranging the mortgages and other documents often required.

The Corporation had broad authority as to type of loan, and loans for fixed assets were made as well as loans for working capital. Announcement was made that it would give "primary consideration to the urgent war or essential civilian need of the product to be manufactured and to the managerial and productive capacity of the small business concern," and, in published rules, the Corporation declared that it would not finance purely promotional projects, nor research or development projects, or experimental work of any kind.⁴⁷ Loans were declared in 1945 to be 80 percent for working-capital purposes, 10 percent for plant and equipment, and 10 percent for miscellaneous purposes.⁴⁸

⁴⁶ This authority was first delegated in March 1943, for loans up to \$25,000. The increase to \$50,000 was made in 1945.

⁴⁷ *Loans to Small Business* (Washington, D.C.: Government Printing Office, 1944).

⁴⁸ *Extending the Life of Smaller War Plants Corporation*, p. 11.

The bulk of Smaller War Plants wartime financing was short-term, commonly six months to one year, being geared to the performance of specific war-production contracts. Even capital loans were normally confined to five-year or shorter maturities.⁴⁹ The capital loans were amortized, either on a fixed monthly basis or in annual or semiannual installments.

As for loss experience, no adequate data are available. The Corporation's sixteenth bimonthly report, in February 1945, stressed the careful lending policy which the Corporation had followed, commenting that "this is indicated by its extremely low loss ratio of less than 1 percent." The Corporation, in view of this experience (obviously tentative with respect to longer loans), expressed the conclusion, in its reports to Congress, that private bankers, in failing to make these loans themselves, had refused the financing of propositions thoroughly sound under wartime conditions. There is a measure of truth in this contention. All bankers were not alert to the ease with which war profits could be obtained by previously inefficient concerns. Many were not willing to gamble that such profits would accrue for a period long enough to restore the weaker concerns to health. However, the soundness of the loans in question rests heavily upon hindsight. The Smaller War Plants Corporation itself was apprehensive enough over the weakness of its customers to exact mortgage security and to surround loans with restrictions until, like the Reconstruction Finance Corporation, it became unfavorably known among borrowers for its harsh terms. Further, the Corporation, with its control over the placing of contracts, through priorities and in other ways, was able to assist weak borrowers in ways not open to banks.

An important contribution to lending technique by the Smaller War Plants Corporation was its liberal use of engineers and production men in appraising the abilities and improving the operating methods and controls of small manufacturers. The

⁴⁹ *Extending the Life of Smaller War Plants Corporation*, pp. 5, 10, 11, 42.

Corporation established a Technical Advisory Service, to answer technological questions faced by small enterprises which could not afford to maintain engineering and research staffs of their own. In these activities, the Corporation was handicapped by lack of adequate trained personnel to service its widely scattered borrowers, but its stress upon the need of small businesses for technical advice and managerial assistance, rather than merely financial aid, undoubtedly contributed to a wider recognition by financing institutions of the importance of this aspect.

On December 27, 1945, with wartime procurement and financing virtually complete, the President announced the abolition of the Smaller War Plants Corporation and the transfer of its duties, effective January 28, 1946, to other government agencies. This action was taken, the President explained, because the government "must have a permanent program to assist small business to grow and prosper."⁵⁰ Lending activities of the Corporation, together with its field offices, were transferred and merged into those of the Reconstruction Finance Corporation. It was believed that elimination of the duplication between the two agencies would contribute to development of a sounder program. Similarly, the Corporation's activities in the supply of technical and other aid to small businesses were transferred to the Department of Commerce, to be consolidated with the services being supplied by that Department.

⁵⁰ *Washington Post* (December 28, 1946).

Chapter IX

APPRAISAL OF WARTIME EXPERIENCE AND EARLY POSTWAR TRENDS

• **GOVERNMENT**-guaranteed lending by private financial institutions under Regulation V proved a highly useful wartime financial tool. As we have observed, it was supplemented by similar guaranties offered by the Reconstruction Finance Corporation and the Smaller War Plants Corporation, but it greatly overshadowed both the guaranties and the direct loans of these agencies in so far as production financing was concerned. In addition to their size, the loaning operations under Regulation V have the advantage, for our purpose, of being covered by relatively complete information.

APPRAISAL OF WARTIME LENDING EXPERIENCE

In retrospect, it is clear that V loans facilitated the extension of credit to essential wartime enterprises which would otherwise have been difficult to finance. In many cases, the degree of expansion of production made possible simply could not have happened had government credit not been available. On the whole, despite the probably inevitable quota of complaints about delays and various minor annoyances, these loans appear to have been handled smoothly, to the satisfaction of banks and borrowers, and with a minimum of government personnel. Borrowers found them, notwithstanding their frequently elaborate terms and conditions, more flexible and simpler to operate under than advance payments; and the government agencies found them to be far less of a burden administratively.

At the same time, the quantitative importance of V loans should not be overstressed. The real need for them was not because the job of financing the war was too big for private sources, but because, in so far as the financing of numerous essential contractors was concerned, it was considered too risky. Irrespective of the overwhelming evidence of this, which may be built up by examination of the hazards presented by individual cases, the

TABLE 7

WAR LOANS AND OTHER LOANS OUTSTANDING, ALL INSURED COMMERCIAL BANKS IN THE UNITED STATES

(Amounts in Millions of Dollars)

Date	Total Loans	Commercial and Industrial Loans			Regulation V, Guaranteed War Loans	Percent of Total War Loans	Other War Loans*
		Total	Except for War Purposes*	For War Purposes*			
1941—Dec. 31..	21,258	9,214	7,900	1,300	.....	.....	1,300
1942—June 30..	19,920	8,867	6,600	2,250	81	4	2,150
Dec. 31..	18,903	7,757	4,800	2,950	804	27	2,150
1943—June 30..	17,390	6,887	3,650	3,250	1,428	44	1,800
Dec. 31..	18,841	7,777	4,300	3,500	1,914	55	1,600
1944—June 30..	20,729	7,406	4,250	3,150	2,064	66	1,100
Dec. 31..	21,352	7,920	4,700	3,200	1,736	54	1,450
1945—June 30..	23,376	7,501	4,500	3,000	1,387	46	1,600

* Estimated. (Source: Gerald M. Conkling, "Loans for War Purposes," *Federal Reserve Bulletin*, XXXI [November 1945], 1102-5.)

best indication of the situation is contained in Table 7. Total loans for war purposes increased but little after December 1942, while total industrial and commercial loans remained relatively stationary, although bank resources were increasing at a record-breaking pace. In particular, the period of greatest expansion in guaranteed loans reflected a pattern of transfer of unguaranteed loans to a position under the government umbrella, while the period after June 30, 1944, reflected a contrary movement, possibly

related to the development, in the fall of 1944, of adequate termination financing outside of Regulation V.

A few skeptics have remarked that no financial problem existed during the war, that the problem was simply one of production, that is, of ability to produce the materials contracted for, since a market at a fair price was assured. The element of truth in this comment should not be permitted to obscure the importance of a "cushion" to the lender should production fail, and the importance to both lender and borrower of sound financial management. Neither should the highly favorable loss experience under the V program lead to minimization, in retrospect, of the risks actually taken by financing institutions. Many of the favorable factors which developed could hardly have been taken for granted, particularly with respect to unguaranteed financing, where the government agencies had no direct financial stake in seeing that losses were avoided. For example, the long duration of the war was an important factor in many cases in amortizing the cost of imprudently large facilities. In difficult cases, a financial stake in the successful operation of an enterprise was a powerful stimulus to the guarantor involved; the latter exerted a great deal of effort to straighten out production or other problems, by active managerial or accounting assistance, by modification of delivery schedules, or even by a change in the contract price.

Analyzing wartime experience, and especially that under Regulation V, for usefulness of technique in meeting peacetime financing problems, two major qualifications emerge. In the first place, much of the smoothness with which the V-loan program operated was due to the obvious urgency of the wartime problems which had to be met. There was a continued underlying pressure toward workable compromise and prompt action, and little opportunity for bureaucratic quibbling or perfectionism, although the guaranteeing agencies were not blameless in this respect. The smoothness of operation perhaps reflected also the nature of the government personnel involved, which consisted of men in uni-

form who looked upon themselves as private citizens engaged in an important but temporary project, and probably retained more understanding of the point of view of the banks and borrowers than might be possible for a career public servant.

The second distinguishing factor of wartime as against peacetime lending was the existence of a tangible and unquestioned criterion upon which decisions as to the extension or rejection of credit could, in the final analysis, be based. This was the criterion of essentiality of the borrower's production to the prosecution of the war. In some respects this criterion was not fair as between different borrowers, for the worthiness of borrowers in other respects ordinarily did not matter greatly; the outcome was dependent upon the urgency of the contracts the borrower had been able, rightly or wrongly, to obtain. Nevertheless, the criterion was simple and easy to apply. In contrast, the criteria normally proposed for peacetime lending, such as "creditworthiness," appear vague indeed.

From the standpoint of banking practices, the wartime lending programs exerted a beneficial influence in causing increased stress to be placed upon a business' ability to produce and earn a profit; less stress to be put upon collateral. Many bankers obtained valuable experience in the budgeting of loan requirements and payments, and in the arrangement of types of security formerly not popularly employed. Experience under difficult wartime operating conditions also served to emphasize the importance of adequate technical assistance and accounting procedures to smaller borrowers. On the other hand, if we are interested in the maintenance of a private banking system, we may see cause for concern in the new respectability which wartime financing gave to leaning upon a government guaranty in order to reduce the risks accepted by bankers. If the banker does not assume risks, the usefulness of his credit powers to the community may naturally be questioned. Yet, it becomes difficult for the smaller banker, at least, to refrain from overextension after he has once

gotten, with the assistance of the government, into the swing of pyramiding his profits and limiting his risks in one and the same operation. The substantial volume developed so rapidly in 1945 and 1946 under the Reconstruction Finance Corporation's blanket-participation plan is undoubtedly symptomatic of this factor.

One obvious means of reducing reckless lending under protection of a guaranty is, of course, to require a substantial exposure by the lending bank. The negligible risk assumed by a bank with a 90-percent guaranty was noted earlier, and the maximum guaranty of 75 percent established by the Blanket Participation Agreement was a desirable step in this respect. Another useful device is establishment of a sliding scale of guaranty fees progressive enough to offer a real incentive for the bank to take a substantial exposure. Reviewing the programs now, we can see that failure to establish an adequately progressive scale of fees was a principal technical weakness of the Regulation V program. For the difference in net return offered, few banks thought it was worth while to request guaranties below 90 percent.

THE BLANKET PARTICIPATION AGREEMENT

Excepting the specialized field of small business loans guaranteed for veterans by the Veterans Administration, the only substantial postwar lending to business by government agencies thus far is that of the Reconstruction Finance Corporation, chiefly through its blanket-participation plan prior to the abandonment of that program in the face of Congressional and other pressure. As pointed out before, the large activity under the blanket-participation program in 1945 and 1946 accented a general, strong increase in the demand for credit; in particular, term loans to finance fixed-asset expenditures. Since an important segment of this demand for financing of fixed-asset expenditures came from enterprises which had grown rapidly during the war years but were untested

under peacetime conditions, it was to be expected that a substantial volume of applications for high-risk term loans might reach the Reconstruction Finance Corporation. On the other hand, the financial incentive to smaller banks to put their larger loans under a Blanket Participation Agreement was such that it is not possible to say, with any assurance, that the bulk of the loans guaranteed actually could not, if necessary, have been made through private institutions.

DEVELOPMENT OF PRIVATE FINANCING

Bank Loans

Despite a strong tendency to require the protection of a government guaranty in connection with war financing, and the considerable popularity of the Reconstruction Finance Corporation's blanket-guaranty program, it does not follow that, either during or since the war, significant numbers of private bankers have been abdicating their risk-taking function. On the contrary, there are definite indications that the transformation of banking practices to meet present-day needs, which we noted in the 1930's, is still in progress. Term loans have continued to grow in importance, and increasing though limited attention is still being paid by commercial banks to the adaptation of such loans for small business. Finance companies remain active in the latter field. Various other specialized lending techniques, particularly applicable to small business, such as accounts receivable financing, financing of inventory through warehouse receipts, and installment financing of equipment of many types, have spread widely among banks.¹

Some of the larger banks, taking advantage of the reduced handling costs and the safety factor of diversification made pos-

¹ See the studies of R. J. Saulnier and N. H. Jacoby published by the National Bureau of Economic Research (New York: *Accounts Receivable Financing*, 1943; *Financing Inventory on Field Warehouse Receipts*, 1944; *Financing Equipment for Commercial and Industrial Enterprise*, 1944; *Business Finance and Banking*, 1947).

sible by a large volume of loans, have established small-business loan divisions where extra-risk loans are granted with the conscious expectation that costs and losses will be sufficiently high to prevent any short-run profit. These lending operations are conducted in part as a community service in the long-run interest of private banking, and in part with the hope of eventually developing some of the small borrowers into profitable accounts. In connection with guaranteed loans to war veterans, several co-operative agencies were organized by local banks in an effort to provide, through specialization, a maximum of assistance to applicants. A pioneer organization of this type was the Philadelphia Agency for Business Loans to Servicemen, sponsored by thirty-six commercial banks in the Philadelphia area.²

As already observed, an important factor in the development of new lending techniques has been wartime experience under Regulation V, when banks, under the protection of guaranties, made loans freely to enterprises which they would have considered actually insolvent, or at least perilously overextended, in normal times. Daily contact with these situations has had a beneficial effect on many bankers, causing them to look at a weak statement with the thought of working the problem out rather than turning the borrower away. In fact, the phenomenally low loss ratios suffered under conditions of wartime and postwar industrial prosperity are bound to have the effect, dangerous though it may be in the long run, of rendering many bankers insensible to risks that would formerly have disturbed them.

On top of these developments, the American Bankers Association and the Association of Reserve City Bankers, troubled by the steady flow of bills in Congress proposing new government credit agencies, have been engaged since 1944 in a vigorous campaign to spur on private lending, and in particular, term loans and loans

² See "Philadelphia's Aid to the Veteran," *Bulletin of the Robert Morris Associates*, XXVIII (October 1945), 157, and "Philadelphia's Experience with G.I. Business Loans," *ibid.*, XXIX (September 1946), 109.

to small business.³ A "Post-War Small Business Credit Commission" was created to this end by the American Bankers Association, and undertook a program of education and publicity with the announced purpose of enabling every competent person or firm in need of bank credit to obtain it from the private banking system. This program has included widespread advertising to the public of the bankers' willingness to lend, as well as of the unsoundness of, and lack of necessity for, loans made directly or guaranteed by the government. Stress upon the latter point appears to be aimed mainly at other bankers, rather than at customers. Prominent bankers have assailed government guaranties, in particular, as habit-forming opiates which tend to destroy the private banking system by eliminating its basic risk-taking function.

The program of the Credit Commission has stressed the availability of correspondent banks as participants, in the event the risk in connection with any loan is greater than the lending bank cares to assume by itself. Participation in loans with correspondent banks, always of importance in handling the larger credits, was greatly stimulated during recent years by the extraordinary volume of very large loans required for war production. To facilitate the handling of participations in risky loans during the period of reconversion from war to peacetime production, the Commission actively sponsored the creation of "Bank Credit Groups," or pools, in most major financial centers of the nation. Presumably, this is a device which might prove useful in the future in supplying credit for other special purposes, including those socially desirable but individually unprofitable. So-called "commitments" to make funds available in fifty-one of these pools aggregated approximately \$750,000,000 by the end of 1946.

The largest of the pools was the Bank Credit Group of New

³ See, for example, *Term Lending by Commercial Banks* (Chicago: Association of Reserve City Bankers, April 1945).

York City. In the underlying agreement executed by the participating financial institutions, its purpose was stated to be

. . . to implement, augment and undertake the financing (through loans or other credit accommodations) of small and medium-sized business concerns in the United States during the present reconversion period . . . by participating with local originating banks in financing risks so undertaken which may be in amount, for periods or upon terms or under conditions which may make usual banking accommodations unavailable. . . .⁴

Applications to be submitted to the New York pool were expected to fall into two classes: (1) where the prospective loan was acceptable to the local bank, but beyond its lending limit in amount, and (2) where the basic qualifications of the management were looked upon favorably by the bank but, "because of the terms of the loan or its indicated length, or the fact that its financial setup does not exactly conform to traditional ratios," the bank did not wish to assume an amount as great as its legal lending limit. The procedure was for the local bank to apply first to one or more of its correspondent banks. If the correspondent did not wish to take the balance of the credit, it was to place it before the Bank Credit Group. Individual members of the Bank Credit Group were free to accept or decline portions of the risk as they might determine when it was offered.

Despite extensive publicity, indications are that small recourse has been had to these pools. It appears that nearly all acceptable loans in which the originating bank was willing to participate have been taken by the correspondent banks upon presentation. Loans simply have not reached the Bank Credit Groups. At least a factor in this experience, however, in addition to the willingness of correspondent banks to accept loans, probably was the ready availability to local banks, after the war, of the Reconstruction Finance Corporation's blanket guaranty, which involved less paper work and offered more profit.

⁴ Agreement dated September 12, 1944.

Equity Financing

In contrast with the increasing availability of bank credit from private sources in recent years, little progress has been made in developing more adequate private sources of equity financing and long-term loan capital for smaller businesses. A further, modest extension of community financing plans has occurred, but action of a truly private nature has been confined to the establishment of a number of companies interested primarily in the development and exploitation of new ideas and new inventions.

These companies are generally closely held, but an interesting exception, stock in which was offered to the public, is the American Research and Development Corporation. This concern, sponsored by a group of New England manufacturers, financiers, and university leaders, has not been operating long enough to permit satisfactory appraisal of its efforts. In its prospectus, dated August 8, 1946, filed with the Securities and Exchange Commission, the American Research and Development Corporation stated that its charter permitted it "to engage in the business of furnishing capital to industry, financing promotional enterprises, and purchasing securities of issuers for which no ready market is in existence." The prospectus continued:

It is a fundamental policy of the Company that its principal and primary activities will consist of investigation and research with respect to new or existing enterprises, processes or products and of furnishing capital to or purchasing securities of other companies primarily and principally engaged in the conduct or development of new enterprises, processes or products or the development of existing processes or products. . . . It will, however, be the Company's policy not to invest in the securities of any company principally engaged in or formed for the purpose of engaging in a new enterprise unless, in the judgment of the Company's Board of Directors, research or development work, which has already been carried on, indicates that the product or process to which the new enterprise relates is commercially practicable and embraces prospects of ultimate profit.

The assistance of small business, as such, was not mentioned as a purpose.

A particularly interesting aspect of this venture was the provision that of its \$5,000,000 of capital, all to be provided through sale of common stock, at least \$1,500,000 was to be obtained from institutional investors, including investment companies, life insurance companies, educational institutions, and research or educational foundations. This required minimum of funds from institutional investors was successfully obtained, and operations were commenced in 1946.

Chapter X

THE DESIRABLE ROLE OF THE GOVERNMENT IN BUSINESS FINANCING

• WE ARE now ready to return to the questions raised at the start and to consider what light the experience which we have reviewed may have thrown upon our problem. In the first place, how serious do the gaps in private sources of business financing now appear to be? To what extent may private action be expected to fill them? What need for governmental assistance in filling them can be demonstrated? Then, secondly, if significant gaps and need for governmental assistance do exist, what types of action promise to fill them most satisfactorily?

THE INSTITUTIONAL GAPS

In our preliminary survey we found general agreement among businessmen and financiers alike that adequate sources of equity capital or of long-term loan capital are not available to small or, in many cases, to medium-sized businesses. These deficiencies are the primary gaps in the private financial mechanism, and are closely related to each other. There were less positive but widely publicized indications that a gap exists in the availability of medium-term capital loans to small businesses. Lastly, with respect to short-term credit, there was a sharp difference of opinion, though the consensus was shifting to the view that, despite adverse conditions in some localities, no significant general gap exists in this field.

Equity Capital

No data have been presented which would modify our preliminary finding that a serious gap exists in facilities for provision of equity capital to smaller businesses, although occasional conflicting opinions may be cited.¹ No experience in this field has been included in our survey for the simple reason that public agencies have not entered the field. Neither have private agencies seriously attempted to develop the field, if we except community financing plans and a few investment companies designed to promote new ideas and inventions. The community financing plans have been small in total and have normally operated through loans, with equity capital, if provided, being offered as a subsidy. The inadequacy of the existing private investment-banking system as a source of equity capital in amounts of less than \$100,000 is conceded by the investment bankers themselves, as we have noted; others have frequently placed the figure considerably higher. Because small business risks are unattractive to most investors and small issues of securities are of limited marketability, the cost of such capital when available is undesirably high. Other private institutions from which assistance might have been anticipated, such as the investment trusts, have taken no significant part in equity financing of new or small businesses.

Thus, while higher income taxes and the other adverse influences outlined in the second chapter have operated to restrict the former principal sources of equity funds for small business organization or expansion, no new sources have been developed. At the same time, increasing mechanization of manufacturing processes and heavier advertising and distribution expenditures, in order to compete in national markets, have materially increased the capital investment required in many types of business.

¹ Cf. *Hearings on H. Res. 64*, p. 34. On the other hand, note the corroboration of this gap contained in the recent study by J. Keith Butters and John Lintner, *Effect of Federal Taxes on Growing Enterprises* (Boston: Harvard University, Graduate School of Business Administration, 1945), chap. vii.

It appears surprising, therefore, that the problem of providing equity capital for smaller businesses has received so little attention during a period when so much has been said and written and so many legislative proposals have been made in connection with the provision of bank credit and medium-term loans. Inability to secure adequate equity capital is, of course, a highly important factor in failure to obtain bank credit. One of the most common reasons for refusal of business loans by the Federal Reserve banks and the Reconstruction Finance Corporation was lack of an adequate cushion of equity funds to protect the loan. The following testimony of an experienced small-town banker was given before the Senate Committee on Banking and Currency in 1940:

. . . my conclusion is that our financial difficulties today in small business in financing themselves is not so much in the field, or is not to any great extent in the field, that can be served by loans, but it is in the field that must be served by risk capital, or share capital, or ownership money. For instance, a bank can lend a business part of its working capital, but necessarily the owner of that business must have some working capital of his own in there as a cushion between the risk of the loan money and the possible losses of the business.

Now, no machinery, no new machinery, no machinery that I have been able to conceive of, can supply those funds except on the basis of taking an interest in the business. . . .²

After further consideration, however, at least some doubt must arise as to what extent the undercapitalization so frequently noted among small businesses is due to inability to secure equity capital, and to what extent it is due to unwillingness of the entrepreneur to dilute his own equity in the earnings of the business or to jeopardize his control by accepting the capital of others. The latter factors are undoubtedly very strong, for the typical entrepreneur places a high value upon his independence and freedom of action.³ These factors probably account fully as much for the limited agitation thus far for governmental sources of equity funds as

² A. L. M. Wiggins in *Hearings on S. 2998 and S. 3839*, p. 41.

³ Cf. Butters and Lintner, *op. cit.*, p. 3.

does the more theoretical explanation that provision of risk capital by the government is recognized to be incompatible with a private-enterprise system.

Long-Term Loan Capital

As with equity capital, our survey has included no experience directly relating to long-term capital loans to business, yet there is no reason to modify our preliminary finding, which is almost unchallenged, that a significant gap also exists in the provision of this type of financing. Some small progress has been made toward narrowing this gap, both by government agencies and by private institutions, for the development of a large volume of medium-term loans has tended to push some commitments over into the long-term category. The Reconstruction Finance Corporation, for example, has made substantial ten-year commitments under its Blanket Participation Agreements. However, no lending agency thus far, public or private, has been willing to make a large volume of loans of more than ten years in length to small or medium-sized businesses, excepting occasional mortgage loans secured by real estate.

The factors contributing to this gap are basically the same as in the case of equity capital. In fact, as we noted in the second chapter, the high degree of risk and instability present in small businesses make the position of long-term loan capital in such concerns not very different from that of the equity.⁴

The basic fact is that practically all capital issues in amounts of less than \$100,000 represent genuine risk capital from the standpoint of the underwriter and investor, regardless of whether the issue takes the form of a first mortgage bond or a common stock. The difference is one of degree and not of kind.⁵

⁴ Together with the poor marketability of small issues of debt, these factors similarly make the cost of such financing relatively high.

⁵ Investment Bankers Association of America, *op. cit.*, p. 10.

Medium-Term Loan Capital

Provision of medium-term financing to small or relatively risky businesses became a primary objective of the government's experiments in public financing of private industry, beginning in 1934. At the time these experiments were undertaken, the evidence gathered in several surveys had indicated that such loans were not generally available. However, this deficiency was attributable to the depression of the early 1930's and to the banking panic. As economic conditions improved, banking restrictions were relaxed and government agencies spurred bankers on by making successful medium-term loans in borderline cases. The private institutions have turned their efforts to loans of this type and have made them in increasingly large volume.

It seems clear that no major gap now exists in medium-term financing, even for small business. The growth in term loans by private institutions and the small volume of loans made in this field by the Federal Reserve banks and by the Reconstruction Finance Corporation prior to 1945 are reasonably conclusive in this respect. The latter agencies made a strong effort to satisfy political pressures by advancing a large total of loans, especially to small business, and the meager results for so many years must indicate a lack of important unsatisfied demand for such loans. On the other hand, we have noted the large volume of Reconstruction Finance Corporation financing of this type since 1945, and a gap of minor proportions probably does exist. No one denies that small business has less ready access to term loans than do large organizations, because of the greater risks present over a period of time in small businesses, their unstable earnings experience, their limited capacity to withstand losses, and their frequent heavy dependence upon the energy and ability of only one or two individuals or upon narrow markets. Further, the costs to smaller businesses are high. Financing institutions require a greater return to offset the extra risks involved in term commitments made

to enterprises characterized as a class by instability. They also must be reimbursed for costs of investigation and continuing supervision which cannot be avoided even though the loan in question is small. In recent years, as noted at an earlier point, critics have shifted their attention from the subject of availability of term credit to the question of its relative cost to small businesses.

Short-Term Credit

Experience of the government lending agencies adds convincing evidence that no gap of consequence exists in the private financing mechanism with respect to provision of short-term credit. The total volume of short-term loans made to businesses by the Federal Reserve banks and the Reconstruction Finance Corporation was clearly insignificant. It is true that a gap of some consequence appears to have existed during the banking panic of the early 1930's. However, this condition was corrected long ago, and the banking system has regained its strength. Private banking institutions have moved aggressively to provide all types of short-term credits and gaps can be said to exist, if at all, only in a few localities where, because of limited banking facilities, local monopolies prevail.

An interesting comment with respect to the financing of retail trade is provided by Professor Theodore H. Smith, who writes:

It hardly seems likely that one of the major problems of the postwar period will be availability of credit for the small retailer. . . .

The availability of store rooms, the willingness of distributors of store equipment to sell or lease on low down payment and extended maturity, the ease with which inventories can be secured through generous extensions of mercantile credit, and the increasing ease of financing consumer receivables seem to give little support to the idea that it is difficult to embark upon a retailing career. In fact, there seems as much cause to question whether it has been too easy as whether it has been too hard.⁶

⁶ "Small Retailer Credit Sources," *Law and Contemporary Problems*, XI (Summer-Autumn 1945), 279-80.

Here, too, we must note a gradual shifting of attention from the question of availability of short-term credit to the question of its cost to small businesses. The small borrower paying 6 percent to a country bank or 10 percent to a finance company is understandably dissatisfied when he reads of large competitors obtaining funds at $11\frac{1}{2}$ percent. On the other hand, 6 percent on a \$500 loan may barely cover the costs of establishing and supervising the credit, while $11\frac{1}{2}$ percent on a \$500,000 loan may provide a satisfactory net return to the lender.

THE NEED FOR GOVERNMENTAL ASSISTANCE

We have thus reached the conclusion that important gaps exist in the provision of equity capital and long-term loan capital to small and, to some extent, medium-sized business enterprises, and that a gap of minor proportions exists in the provision of medium-term loan capital to small businesses, but that sources of short-term credit are, on the whole, adequate. A few new private institutions, and widespread modification of the policies of existing private institutions, are moving to narrow these gaps, but too slowly to be effective for practical purposes. All of these types of financing tend to be provided to small businesses at costs substantially higher than those usually faced by large enterprises. Merely because certain gaps exist, however, and because costs are generally high, it does not follow that a need for governmental intervention can be demonstrated.

For example, we may question the fundamental desirability of this type of encouragement of small business.⁷ We find our-

⁷ Cf. Barnard Ellinger in *The City; the London Financial Markets* (London: P. S. King & Staples, 1940), p. 318: "It is a question worthy of consideration whether the idea of the encouragement of small businesses, which rests on our experience of the nineteenth century, is still sound. . . . These [large] concerns are naturally attracting into their service the best brains available . . . men who in the last century would have been the leading entrepreneurs. . . ."

selves weighing the social values of encouraging individual independence and self-reliance and of promoting equality of opportunity against the economic hazards of protecting and perhaps subsidizing inefficiency. A long-run goal of increasing the nation's productivity requires that inefficient firms be weeded out by failure. It is apparent that many small firms in all industries are inefficient, and that, in those industries where economies of large-scale operations are great, nearly all the small businesses must be classed as inefficient. However, the mass-production industries form only one segment in the nation's economy, and everyday observation reveals that, in many fields, small enterprises are able to compete with a degree of success that is convincing evidence of their efficiency. Small units are normally more flexible, more adaptable, not burdened by high overhead expenses and complicated problems of internal control, co-ordination, supervision, and employee relations.

The present case for encouragement of small business was set forth at some length in the second chapter. According to our analysis, proposals for governmental financial assistance to small business have to a large extent been founded upon: (1) a desire to stimulate new investment in order to offset a weakening of the dynamic forces of economic expansion; (2) a desire to reduce monopoly and promote free competition with the same object in mind; (3) a desire to promote the welfare of small business from the viewpoint of social and political well-being; and (4) a belief that small business is handicapped by gaps in the financing facilities available to it. If investment is to be stimulated adequately in the interest of continued active business and full employment, action should be taken to reduce the wide gaps which appear to exist in the availability of long-term small business financing (i.e., equity and long-term loan financing). Elimination of these gaps alone will not assure adequate investment, but it is an important step. In view of the continued failure to develop effective private financial assistance to small business in this area, the need

for governmental action would appear to require no further demonstration.

The type of governmental assistance which is desirable in order to narrow these gaps is another question. As will be illustrated later, consideration need by no means be limited to financial assistance through the direct or indirect loans so freely advocated. In fact, under some circumstances, such financial assistance might be a very unwise prescription. It has been amply demonstrated that making credit too freely available is no favor to the average borrower. The overbuying of inventory or overexpansion of plant facilities fostered by liberal creditors who encourage debtor businesses to accept unwarranted amounts of credit is one of the most frequent causes of failure. Furthermore, if a business has difficulty in operating profitably because of managerial or technical incompetency, the ready availability of credit, by deferring necessary adjustments, may actually hasten insolvency. Finally, it is necessary to weigh the effect of governmental financial assistance upon the *net* volume of investment. It is perfectly conceivable that excessive credit advanced to the favored business units will seriously restrict the amount of new investment undertaken by a much wider group of enterprises, which may feel themselves to be adversely affected by the strengthened competitive position of the recipients of the loans.

In the fields of medium-term loans and short-term credit, we have not found serious gaps. In the latter field the gap which may exist is clearly negligible. In the former, it is of minor importance and is being narrowed by the increasing activity of private institutions in the field of small term loans. The commercial banks, in self-defense as well as for profit, are making an effort to stretch their loaning standards to cover all reasonable loan requests. In consequence, there is no significant need for expansion of governmental assistance in these areas to fill gaps in the availability of credit. Whether it is appropriate to curtail or to end the already existing activities of government agencies in these fields, however,

is another matter. It is difficult to assess the service performed by a government agency willing to finance marginal risks as a competitive spur to private institutions, but this is a factor of some importance. Availability of government guaranties of, and participations in, private loans has also unquestionably served to extend private financing into areas of greater risk on what has to date been a sound basis. Moreover, the experience of the 1930's points strongly to the desirability of keeping available a reservoir of business credit which would not dry up in the event a depression should once again greatly restrict the power of private banks to extend credit. Need for continuance of a government agency empowered to extend short- or medium-term loans to business is indicated.⁸

At several points we have noted the problem which faces a large proportion of small businesses—the relatively high costs of financing. We have minimized the importance of this aspect, in so far as loans are concerned, on the basis of evidence that the interest rate to be charged is rarely the determining factor in the expansion plans of business, as well as calculation that interest costs in the typical business are not sufficiently great to influence appreciably its profitability or its competitive position. However, it must be conceded that an undue inflexibility exists in the rates charged by many country banks, and that the charges paid to finance companies are often very high indeed. The essence of the problem is, of course, simply the fact that the financing of small

⁸ Pertinent in this connection are the results of the poll of bankers undertaken in late 1947 by Senator Buck's committee as a step in its investigation of the Reconstruction Finance Corporation. Of 7,910 replies received from commercial banks, 40 percent expressed the belief that the Corporation was performing a useful economic function by its loans to business, even under the prosperous conditions of 1947. A negative answer was given by 38 percent, and 22 percent gave no opinion. The same bankers, however, were overwhelmingly agreed upon the usefulness of the Reconstruction Finance Corporation under conditions of depression or national emergency. The bankers answered strongly in the negative when asked whether the Reconstruction Finance Corporation made direct business loans or took participations which would have been acceptable to them. (*Inquiry into the Operation of the Reconstruction Finance Corporation*, pp. 472-522.)

business generally is characterized by greater risks and proportionately higher costs than are present in financing larger enterprises. Obviously, small businesses must pay more than large businesses for their financing if they are to be self-supporting. If we wish financing institutions to accept substantial risks in the interest of economic expansion, we must be willing to see them reimbursed accordingly. Declining rates for small loans, unless fully offset by a decline in prime money rates, tend to bring about a shrinkage in the extent of the risk which lenders can afford to assume. Except for the fact that they can, through volume and efficient procedures, reduce their costs of making loans, and, through diversification and careful (but expensive) supervision, reduce the risks involved, lenders cannot hope to reduce by much the differential between the rates charged small enterprises and those charged the prime credit risks. It is not clear that action beyond that already in process as a result of normal forces of competition is desirable in the loan field, but methods of lowering both loan and equity financing costs of small businesses, without use of a subsidy, should continue to be explored. Such exploration could well be made a responsibility of any government or private institution organized to extend financing to small business.

ASSISTANCE IN THE IMPROVEMENT OF MANAGEMENT

Our study has gradually become focused almost exclusively upon the problems of small business. The general question of public participation in the financing of private enterprise has narrowed progressively into a question of public assistance in the special financial problems of small business. Although an institutional gap does exist with respect to long-term small-business financing, and requires attention, it has become apparent that, at bottom, the financial difficulties of small business can be traced to the unstable nature of its earning power and the heavy operating risks it faces. In short, the financial problems of small business

are, generally speaking, a reflection of basic operating problems of a technological or managerial nature.

In consequence, if we really wish to assist small business, there is much to be said for a direct attack upon the fundamental problem of reducing its heavy operating risks, in preference to use of an indirect tool such as financial assistance, which does not get to the root of the trouble. Moreover, if it proves possible in some fashion to improve stability and profitability of operations, the financial problem is thereby simplified. The need for funds is likely to be reduced by more efficient operation at the same time that financial institutions and individual investors are rendered more willing to provide them.

Those experienced in the affairs of small business stress again and again that improved management is needed far more than new financial aid. In speaking of the experience of the Industrial Corporation of Baltimore, its director stated:

Thirty years of experience of our corporation, dealing with hundreds of cases has convinced us that small business needs more counsel than cash. Small business will not agree to that. It is easier to cover up your shortcomings with new cash and to stay in your comfortable management rut than to correct your practices or vary your policy—if you can get the cash; whereas, small business can many times effect more financing faster with a new policy, and sometimes personnel changes, than in any other manner.⁹

Managerial problems are particularly likely to arise in connection with growing enterprises, with the result that the small business often finds procurement of funds for expansion especially difficult. In a recent article, "Rx for Small Business," R. L. Rosenthal points out that, despite the political appeal of the view that inability to procure funds is the only thing keeping small business from becoming larger,

⁹ G. Harvey Porter, in an address before the Graduate School of Banking, Rutgers University, June 20, 1944, quoted by Joseph K. Wexman, "Financial Advice and Guidance for Small Business," *Law and Contemporary Problems*, XI (Summer-Autumn 1945), 334.

experience with smaller business and smaller businessmen indicates that availability of capital is relatively secondary compared with the primary problems and difficulties which develop because smaller business is often inadequately organized, particularly to provide proper management in all the areas vital to efficient operation. These problems and difficulties stem largely from the fact that successful smaller businesses usually owe their existence to the particular talents, dynamic but limited, of one man, who is usually the owner of the so-called smaller business. And the real dilemma arises when a successful smaller business begins to grow large enough to need the application of additional management skill, but the one-man owner does not see the need of it, or for some reason is unwilling or unable to take the steps to get it.¹⁰

In recognition of this point of view, increasing stress has been placed by many economists, particularly those concerned about the long-run consequences of direct governmental financial assistance, upon the provision of management aid to small business as the fundamental solution of its problems.¹¹ Both private and public agencies have taken steps in this direction. Banking institutions, of course, have always considered provision of financial counsel to their customer businesses to be an important function. In addition, some of them have undertaken to supply customers with technical advice and information such as that provided by the *Research Advisory Service*, which acts as a clearing house for information and inquiries about current problems. The federal government has made available various services through the Department of Commerce, but, in the absence of an adequate field staff, little was accomplished except in the field of international trade. During recent years, as already noted, the development of managerial assistance was undertaken by the Smaller War Plants

¹⁰ *Harvard Business Review*, XXIV (Autumn 1945), 22.

¹¹ Cf. Charles C. Abbott, "Small Business: A Community Problem," *Harvard Business Review*, XXIV (Winter 1946), 190. See also Ernest J. Hopkins, "Long-term Needs of Small Business," *op. cit.*, pp. 56-62; Committee for Economic Development, "Meeting the Special Problems of Small Business," *op. cit.*, pp. 25-32; and Myles L. Mace, "Management Assistance for Small Business," *Harvard Business Review*, XXV (Autumn 1947), 587.

Corporation, with industrial consultants of the Corporation's staff working closely with many small businesses in planning and organizing their wartime operations. The Department of Commerce succeeded to these activities of the Smaller War Plants Corporation and has undertaken, through its Office of Small Business, a program of assistance to small business which, however, is useful in supplying information rather than the close guidance attempted in wartime.¹²

Despite the obvious merit in an approach designed to improve managerial efficiency, we must recognize its limitations. Small businessmen in general are by no means receptive to outside advice and are frankly jealous of their managerial prerogatives. If they do listen to advice, comparatively great hazards will nevertheless remain in the operation of their businesses, and they will continue to possess only relatively small capacity to withstand losses. Finally, if a financial gap, as distinguished from merely high-cost financing, actually exists in this field, a gradual, indirect decrease in its hazards is much too mild and slow-moving a remedy. Similar comment may be made upon proposals to remedy the situation by continued efforts to break down monopolies, desirable though such efforts may be as auxiliary steps, and upon proposals directed toward a change in the general political atmosphere surrounding business, one that will make capitalists more willing to accept investment risks and businessmen more eager to expand.

Thus, the desirability of more positive action to meet the needs we have outlined is confirmed. Before turning to specific recommendations, however, it will be well to restate certain general cautions. Action taken to provide governmental financial assistance must be viewed in perspective, as one policy among many, and not the most important. If other policies, particularly those affect-

¹² Note, for example, the pamphlet, *One Hundred Questions to Be Considered in Establishing a Small Manufacturing Business* (Washington, D.C.: Department of Commerce, June 1946).

ing demand for funds, are in conflict, little benefit can be anticipated. Attention to the net effect of the particular action is also important, even though it may be difficult to trace. As Abbott observes:

A considerable doubt exists whether direct federal action could succeed in making credit and capital more accessible to small concerns without at the same time influencing adversely present banking practice and the inclination of investors toward business venturing, so that the net effect would be restrictive.¹³

HAZARDS PRESENT IN SUBSIDIES AND DIRECT FINANCING

The fundamental hazard present in any plan of governmental financial assistance was well expressed by the Temporary National Economic Committee in its final report in 1941.

We cannot continue to rely upon government expenditures, whether by way of contribution or loan, to sustain enterprise and private employment unless we are willing to invite eventually some form of the authoritarian state.¹⁴

This hazard assuredly exists in those plans which embrace subsidies of costs or risks. How do we preserve the qualities of independence and self-reliance which we value so highly in the small businessman, if we make him dependent upon public subsidy? Once we provide a subsidy in this field, what we profess to preserve is lost.

Similarly, the practice of direct financing by government agencies involves political hazards which are much more serious than those associated with indirect financing by means of public guaranty of loans arranged by private institutions. Direct financing of equity risks by the government would seem to be particu-

¹³ "Small Business: A Community Problem," *Harvard Business Review*, XXIV, 186.

¹⁴ United States Congress, Senate, *Final Report and Recommendations of the Temporary National Economic Committee*, Senate Document No. 35, 77th Cong., 1st sess. (Washington, D. C.: Government Printing Office, 1942), p. 9.

larly anomalous. It is absurd to talk of the government assuming equity risks so that business will be able to expand and contribute to a strong and active free-enterprise economy, when the government, by such entrance into the ownership of business, would be moving in precisely the opposite direction.

DESIRABLE POLICIES AND INSTITUTIONS

Bearing in mind both the needs we have found to exist and the hazards we have noted as present in governmental intervention in business financing, we find a definite pattern of recommendations taking shape. The first and most important of these have to do with the problem of reducing the magnitude of the gap in provision of long-term capital financing to small business. This problem is especially important because, the more adequately it is solved, the fewer and smaller difficulties there will be in short-term and medium-term financing.

Long-Term Capital

In attacking this problem, the most significant consideration is that the existing institutional arrangements once proved adequate to finance widespread establishment and rapid and continued expansion of small businesses, even though it be conceded that small entrepreneurs seeking equity financing or long-term loan capital have always had a difficult time. This was possible because small businesses were able to finance themselves to a very large extent from retained earnings. They also had available capital from a considerable body of well-to-do investors, usually friends or other local citizens, who wished to invest money locally and who were willing to accept large risks in hope of large returns. Both of these sources of financing have been greatly reduced in importance, the first almost entirely because of sharply increased income tax rates since 1932, and the second partly because of this factor.

It is logical, therefore, to consider the desirability of altering our tax structure to restore, in a substantial measure, these former major sources of capital. Obviously, a selective lightening of tax burdens, designed to aid small businesses in building up capital from earnings and to encourage investors to assume greater risks, is likely to have far less disturbing effects upon the smooth operation of a free economy than might develop from governmental intervention to assist specific firms through financing. The practicality of this approach has commended itself to numerous individuals and groups who have been led to make specific proposals.¹⁵ There is not space or occasion here to discuss the details of these proposals; presumably, the exact details would not matter greatly from the standpoint of the present study, although in view of the government's pressing need for tax revenues they naturally reflect problems of great complexity. However, a logical point of departure would be to revise sharply downward the lower-bracket tax rates for corporate net income. A second reform might be to permit both incorporated and unincorporated businesses to carry forward losses and apply them against subsequent profits for a period of several years.

Perhaps the most comprehensive study of the effect of tax policies upon the expansion of small business is the work of Butters and Lintner, previously cited.¹⁶ These authors reach the conclusion that "the basic financial need of small business is the ability to expand from retained earnings."¹⁷ They summarize further findings as follows:

¹⁵ Cf. Investment Bankers Association, *op. cit.*, pp. 15-16; J. Keith Butters, "Taxation and New Product Development," *Harvard Business Review*, XXIII (Summer 1945), 451-59; and Richard A. Musgrave, "Federal Tax Reform," in *Public Finance and Full Employment* (Washington, D.C.: Board of Governors of the Federal Reserve System, December 1945), pp. 32-38. The *Final Report and Recommendations of the Temporary National Economic Committee* (p. 30) concluded that "the social desirability of new enterprise and new employment is so great that Congress can well consider the advisability of material reductions in the rate of taxation on returns which come from investments in new, independent businesses."

¹⁶ *Effect of Federal Taxes on Growing Enterprises.*

¹⁷ *Ibid.*, p. 133.

1. In the development-of-the-idea stage of a new enterprise, taxes are seldom of dominant importance.
2. As a business develops beyond the "idea" stage to the point at which production appears feasible, tax considerations become progressively more important.
3. At this stage, and beyond, high corporate taxes are typically much more repressive in their effects than are high personal taxes—at least so long as capital gains continue to receive very favorable treatment.
4. High corporate taxes restrict the growth of small companies:
 - a) By greatly reducing the attractiveness of risky expansions to the managements of small companies;
 - b) By curtailing the amount of capital available from retained earnings to finance such expansions; and
 - c) By making the acquisition of outside capital on satisfactory terms much more difficult.¹⁸

We must conclude that an important step in closing the gap in long-term capital financing is adjustment of income tax rates in favor of small businesses and, if feasible, in favor of investors willing to accept substantial risks. Such revision of taxes would not only help close the gap in supply of capital, but would also assist in creating that favorable climate for business in which a demand may develop, and thus make use of the financing facilities offered.¹⁹ It would be a mistake, however, to assume that revision of taxes alone would solve our problem. It is necessarily an indirect, inexact, and slow method. We need also to consider the establishment of a direct method of filling the gap. This involves the creation of new institutions.

It is apparent, in view of the demand nature of commercial-bank liabilities, that the banks cannot safely undertake equity or

¹⁸ *Effect of Federal Taxes on Growing Enterprises*, p. 2.

¹⁹ Note the comment of the bulletin of the National City Bank of New York in December 1939 (p. 137): "After all the real difficulty, as we see it, is not so much a lack of credit, whether long or short, as it is lack of borrowers, and this reflects the reluctance of businessmen to undertake new enterprises or to expand the old. What is needed to overcome this is the creation of an atmosphere conducive to risk-taking,—in other words, emphasis upon general policies that will permit and encourage investment of private capital where the burden of risk-taking properly belongs."

long-term capital financing, especially in the hazardous field of small business. It would seem equally apparent that the government, in view of the political complications in providing what is really in either case ownership capital, should not undertake such financing. The basis for this conclusion is clear enough with respect to actual equity financing, where the absurdity of government ownership as a means of strengthening small business in a free economy is obvious. An almost identical case exists against long-term capital loans to small business enterprises. Loans of this type involve quite comparable risks, for their repayment depends upon future profits. Moreover, because of the inevitably substantial number of failures, the problem of government ownership is also posed.

If a publicly owned long-term lending institution were created with instructions to confine itself to conservative mortgage loans and to avoid the field of risk or ownership capital, as was done in a number of foreign countries, it would be of little use for our purposes. By the very nature of the gap we are discussing, that is, the inability of existing private lending institutions to convert high-security savings into risk capital, a government institution would have to employ a much more liberal appraisal of risks than that now typical of private lending institutions. Quite probably some liberalization of present private standards could be accomplished without offering an outright subsidy, but adequate liberalization to fill the gap means the assumption of ownership risks, by whatever name we call them. Governmental assistance is appropriate, for both economic and social reasons, but it should be confined to the granting of tax or other benefits to private institutions designed to handle such financing, or to the provision of capital to these institutions through the medium of well-secured senior obligations.

Exclusion of the government from direct participation in such financing is of course contrary to practices in long-term lending now in effect in the fields of farm- and home-mortgage financing.

However, there is little comparison, in terms of security, between the standardized nature and easily established sales value of farmlands or urban homes and the tremendously varied characteristics and ephemeral sales value of industrial assets. The value of retail properties is also subject to sharp variations in line with fluctuations in earning power. Farm or home properties represent an objective value, and, in case of default by the borrower, there is usually little difficulty in disposing of the property. The principal part of the value of business property, however, is dependent upon subjective factors such as the capability of the management and the course of competition; it does not have a ready sale.

It is this fundamental difference in the nature of business assets and their values from that of real property in the shape of farms or residences that makes impracticable an insurance or guaranty program covering long-term business loans made by private institutions, with the government serving only the function of an underwriter. There simply is not sufficient homogeneity in the assets which would have to serve as collateral to permit a satisfactory calculation and spreading of risk on an insurance basis.

Not only should the institutions created to assure long-term financing to small business be organized with private capital, at least in so far as a substantial equity is provided, but they should be local institutions. Many of the problems of small business are local problems, differing widely in different localities, and local men are naturally in an advantageous position to appraise the capabilities and limitations of a given management, together with the problems it faces.²⁰ The considerable success of certain community-development funds, such as the Louisville Industrial Foundation and the Industrial Corporation of Baltimore, will be recalled in this connection.

A number of proposals have been advanced for the establish-

²⁰ Cf. Abbott, "Small Business: A Community Problem," *op. cit.*, pp. 193-96. Investors may also be satisfied with somewhat lesser returns from tangible brick-and-mortar investments within their own communities.

ment of local investment companies or capital banks operating with private equity capital. Among these proposals, that of the Investment Bankers Association has much to commend it. The precise form, however, would not seem to be important. What is important is the incentive to establish the companies, the incentive to attract capital funds into them, and the philosophy of operation employed in investing the funds. It seems to be a reasonable conclusion that in view of the high cost of supervision of small loans and equity holdings, including provision of technical assistance and managerial guidance, and considering the substantial risks which must be assumed if the need is to be filled, these investment companies will have difficulty in earning large returns. The sound method of spurring such companies on to incorporate, to take risks despite a moderate return to the investors, would appear to be a carefully guarded system of tax benefits to a special type of investment company. This company could be expected to attract capital yet would be so defined as to assure, within reasonable limits, the constructive use of capital funds in the provision of equity or long-term loan financing to small businesses.

It would be preferable for the investment companies to borrow senior capital from private sources, but there appears to be no serious objection to recourse to the Federal Reserve banks or possibly the government. However, it would be essential to limit strictly the ratio of such borrowings to equity capital so that the investment companies would be able to assume the relatively heavy equity risks which we have found to be associated with smaller businesses. A possible large source of senior capital to the local investment companies would be the life insurance companies; their rapidly growing funds, earmarked, with minor exceptions, for only the safest investments, have constituted a serious problem in the eyes of many students.²¹

²¹ Cf. Howard S. Ellis, "Economic Expansion through Competitive Markets," *Financing American Prosperity*, p. 149.

Short-Term and Medium-Term Loans

Even though no important gaps presently exist in the private mechanism for short- and medium-term financing, we concluded that a government agency should be continued in this field. This recommendation was guided by two main objectives: (1) maintenance in working order of a supplementary credit mechanism which would be available, if needed, in times of business depression or in localities where the private financial mechanism proved inadequate, and (2) provision of a continuing spur, through direct loans and through guaranties, toward the assumption of borderline risks by many commercial banks which might otherwise avoid them. In addition, such an agency may possibly be helpful in the development of improved lending techniques and of methods for lowering costs to small borrowers.

Our study of the business-lending operations of the Reconstruction Finance Corporation and the Federal Reserve banks indicated that, despite the small volume of loans actually made during the 1930's, these agencies performed a useful function, both in financing individual borderline situations and in spurring the commercial banks into term lending. Of the two business-lending operations, it would appear preferable to maintain that of the Reconstruction Finance Corporation, in view of its wider scope, its greater current activity, and its direct responsibility to Congress in the event changes in lending practices were desired, particularly in times of depression when risks might be great.

A similar conclusion was reached by the Senate committee, headed by Senator Buck, which investigated the Reconstruction Finance Corporation in 1947 and 1948. This committee sponsored the legislation in 1948 which extended the life of the Corporation and preserved its business-lending powers substantially intact.²² The committee at the same time recommended rescind-

²² Public Law No. 548, 80th Cong., 2d sess.

ing the business-lending authority of the Federal Reserve banks.²³

Although urging continuation of the Reconstruction Finance Corporation's business-lending powers, the Buck Committee felt it necessary to clarify the objectives of this lending and to suggest appropriate criteria to govern its operations. This was accomplished chiefly in the committee's report; in the interest of flexibility, it was felt unwise to spell out more detailed instructions in the legislation. Three basic principles to govern the operations of the Reconstruction Finance Corporation were enunciated in the report:

First. Such activities should not be carried on in competition with private sources of credit.

Second. In deciding whether to grant a loan, the primary consideration should be the interest of the general public rather than the interest of the individual borrower.

Third. Under normal conditions the activities should be conducted so as to make them self-sustaining insofar as it is possible.²⁴

Supplementing the committee's three principles, the following proposals might be helpful in future operations of the Corporation in this field:

1. Although the Corporation should continue to avoid subsidy of borrowers and require a reasonable prospect of repayment of funds advanced, it should have the power to make unsecured loans. It might also be given the power to make loans embodying very large risks under special circumstances, when the loans are certified to it by other government agencies as essential in the public interest. Such loans might, for example, be desired in connection with regional development programs to absorb surplus labor in depressed areas.

2. The Corporation should make a strong effort to confine its normal activities so far as possible to loans supplementary to

²³ United States Congress, Senate, *Operations of the Reconstruction Finance Corporation*, Report No. 974, 80th Cong., 2d sess. (Washington, D.C.: Government Printing Office, 1948), p. 17.

²⁴ *Ibid.*, p. 9.

rather than directly competitive with the private banking system. In the first place, it should invariably make a careful exploration of loan applications to be sure that private financing is not available on reasonable terms. Secondly, it should adhere closely to a program of offering its existing loans to banks once the soundness of the loans has been demonstrated.

3. The Corporation should stress guaranties of or participations in loans, rather than direct loans. Direct lending of government funds leads to development of bureaucratic methods, political favoritism, and undue control over private business. Moreover, direct lending is costly in that it fails to make use of the experienced personnel and highly developed mechanical processes of the private banking system.

4. The Corporation should place all of its business-lending activities in a separate subsidiary corporation, so that these activities are not mixed with others and obscured, and should be required to follow this up by supplying thorough, informative reports upon the operations of the business-lending subsidiary.

Reduction of Costs of Financing

As a further step toward assuring that financial inadequacies will not hamper economic expansion, we have recommended continued exploration of methods and devices by which the costs of financing may be reduced to a minimum. Not only should financing be made available to small business, but it should be offered at prices favorable to its use. As previously noted, the cost of financing, especially the interest rate for a loan if somewhere within the conventional range, is not often the major determinant in an investment decision, but obviously it is an influence which should not be overlooked.

In recommending further study of this problem we do not mean to infer that existing costs and rates charged to small business are generally exorbitant. Numerous instances of apparently excessive charges have been cited, particularly in the flotation of

new equity financing. On the other hand, it could easily be argued that many rates quoted by commercial banks, in their current eagerness to obtain loans and to avoid unfavorable publicity, are inadequate in the long run. We must emphasize, in view of the fact that one major aspect of the unsatisfactory trend of new investment in peacetime years has been the unwillingness of investors to accept risks, that caution is needed in pushing returns down. Otherwise we may simply convince investors more thoroughly than before that they cannot afford to accept appreciable risks. Small business is better off to have 6-percent money freely available than to have a 3-percent rate nominally established but not actually effective because lenders do not feel it warrants acceptance of any but the best risks. An important reason, for example, why many types of somewhat hazardous loans have, in the past, been made by finance companies rather than by banks has been the reluctance or inability of the latter, because of sensitiveness to unfavorable publicity or because of actual legal prohibitions, to charge rates adequate to offset the expenses and risks involved.

In view of these complex influences it would appear to be mistaken policy for an expansion-minded government, desirous of stimulating full employment, to tamper directly with the internal details of the interest-rate structure. Fiscal policy should confine its direct action to the broader problem of the general level of interest rates and to the specific rates applicable to government financing. However, the admittedly high cost of equity financing and the inflexibility of lending rates in many local areas call for attention; these warrant some degree of indirect general pressure by the government. The policies and institutions we have recommended should fit readily into such a program.

Emphatically, this program should not involve a subsidy in the form of lower-than-market rates to individual borrowers. The hazards in a subsidy were stressed in the second chapter, when we raised the question of where such a policy of subsidizing the

inefficient and unsuccessful enterprises logically could be stopped. Are not nonborrowing small businesses equally worthy of our support? Are there not more serious competitive handicaps of the weaker concerns that might just as reasonably be equalized by subsidy? When such subsidies have become widespread, what has become of our free-enterprise system? There is much to be said for the banker's point of view, expressed to a Congressional committee by James H. Perkins: "Every businessman knows his toughest competition comes from an incompetent rival who does not know his costs. Subsidizing that kind of competition makes things harder for the businessman who is doing a good job."²²

Three principal avenues are open for bringing about reduced financing costs for small business within the framework of a free economic system: (1) reduction in the handling costs of financing institutions, (2) reduction in the risks attached to small business enterprise, and (3) diversification of risks to minimize their effect upon any given institution. The first avenue, that of cost-reduction through distribution of costs over a large volume of financing, efficient operating procedures, and employment of specialized skill and facilities, is the familiar approach of private business. It has been slow to spread in commercial and investment banking because of the nonstandardized nature of the commodity handled. However, considerable progress has now been made in urban centers, and competition and the urge for better profits are causing improved methods to be adopted elsewhere.

Possible means of reducing the risks prevalent in small business were discussed at some length at an earlier point in this chapter. To the degree management can be improved through general informational and technical services of government agencies, and specific advice from local organizations upon administrative, production, research, accounting, or other problems, operating risks may be reduced and the financing charges necessary to offset them likewise lowered. The local investing companies we have advo-

²² *To Provide for the Insurance of Loans to Business*, p. 182.

cated should certainly attempt to provide, for a reasonable fee, expert advisory service to their small-business clients.

Minimization of the impact of risk upon an individual institution, through diversification, depends of course upon the volume of financing the institution can develop. Various schemes for credit insurance have been advanced in the interest of diversification for institutions unable to obtain a substantial volume of such loans, but, as already remarked, the nonhomogeneous character of the risks involved stands in the way of a sound insurance plan in connection with a large proportion of business loans.

Chapter XI

SUMMARY

• OUR investigation of financial gaps has led to stress upon matters far removed from the establishment of new government institutions for business financing. In the first place, after analysis of the nature of the gaps alleged to exist, the subject narrowed to a consideration of the capital and credit problems of small business. Then, upon further examination, these problems were found to stem primarily from the heavy operating risks which are, and in fact have always been, present in the typical small enterprise, tending to make its obligations, as well as shares in its ownership, relatively hazardous and unattractive to investors. This prevalence of heavy operating risks, in turn, although reflecting a variety of factors, such as the competitive disadvantages frequently attributable to small-scale operation, appears to be most closely related to inadequacies in the management available to the average small business.

A natural first point of stress, therefore, in our consideration of appropriate action, was upon means of improving management, through provision for and dissemination of information, advice, and technological assistance. This type of assistance to small business has recently received increasing emphasis from many sources. As we have noted, the government, through the Department of Commerce, very properly has undertaken a program to this end. The program is still in an early stage, and as yet on a modest scale, but it holds promise of substantial long-run benefits, if pursued actively. Needless to say, it should be supplemented wherever possible by the activities of private agencies.

Secondly, from our review of the experience of public financing agencies, we concluded that the alleged gaps in the private

financial mechanism which have received the most attention in legislative proposals, that is, gaps in the provision of bank credit and medium-term capital loans to small business, are at most of no more than minor proportions. Moreover, private sources, led by the American Bankers Association, are working actively to further improve the availability of such funds.

Despite the satisfactory availability of credit and medium-term capital loans in recent years, we reached the conclusion that the Reconstruction Finance Corporation's business-lending authority in this field should be continued, subject to some modification of the criteria governing its operations and to adequate reporting. The Corporation serves useful purposes as a reserve source of funds in times of general contraction and as a continuing spur to private institutions. Beyond this, it might possibly also be helpful in the development of improved lending techniques and of methods for lowering costs to small borrowers.

The major deficiency of the existing financial mechanism is found to be its lack of facilities for providing small businesses with equity and long-term capital financing. Since the financing experience of public agencies did not extend into this field, and satisfactory statistics upon private activity were lacking, this conclusion rests upon our analysis and the nearly unanimous views of the authorities we have quoted. Nevertheless, it seems clear not only that the gaps in this respect are important, but that private sources have been making little progress toward filling them. On the other hand, unfortunately for the advocates of public assistance in this field, both equity and long-term loan financing of small business actually require capital to assume equity risks, and we therefore cannot, under a free-enterprise system, turn to direct financing by the government. Sharing of ownership by the government is no solution to the problem, and neither is direct subsidy by the government, with all the new problems it creates.

However, although direct government assistance in financing equity risks is ruled out, several indirect means of assistance are

feasible, and compatible with a private-enterprise economy. Action to improve management in order to reduce investment risks is one step we have advocated. A second highly important step is the adjustment of income taxes in favor of small businesses, or perhaps of business in general, in order to increase the availability of retained earnings as a source of funds for expansion. If the average small business has more difficulty today in financing its expansion than was experienced by its predecessors prior to 1930, the major factor in the difference is unquestionably the increased rate of taxation of profits.

Finally, as a special, direct stimulus, we have advocated provision in the tax laws for the organization, on a favorable basis, of private local and regional investment companies designed specifically for supplying capital financing to small business enterprises. The government could properly arrange to make senior capital available to these private institutions, if needed.

CURRENT STATUS OF THE CONTROVERSY

As this is written, much of the active agitation of recent years for increased public participation in the financing of private business, and the subsequent flood of legislative proposals, has died down. In part, this reflects a shift of emphasis from the controversial point of the availability of bank credit to a general agreement that reasonable bank credit is available, and that the financial problem of small business, beyond inadequate financial management, is one of equity capital. Further, increasing recognition is being given to the fact that equity capital has always been difficult for the small business to obtain upon satisfactory terms, and that, if the problem is more pressing now, this is attributable chiefly to increased taxes rather than to institutional changes.

To a greater extent, however, the lessened agitation currently reflects the high and prosperous level of business activity which has prevailed since the end of the war. Under these conditions,

many enterprises have found it relatively easy to obtain financing which might otherwise have been refused as unduly hazardous. In addition, those advocates of government financial assistance who were disturbed about the theoretical maturity and lack of expansion in our economy have been silenced, at least temporarily, by the extraordinary extent of the expansion which has occurred since the end of the war. One aspect of this boom has been the formation of a vast number of new small businesses, estimated at more than 650,000 in the single year 1946.

Obviously, in that the factor of general prosperity has been important, a reaction and a renewal of agitation is to be expected at such time as adverse economic trends may again become dominant. However, as already outlined, certain points have now become so well established that major targets of future agitation are likely to be somewhat different from those of the past. The brief discussion of recent developments which follows may serve to indicate the principal trends now in evidence.

TRENDS NOW IN EVIDENCE

Without arousing much public interest, active skirmishing took place during 1947 between advocates of enlarged business-lending authority for the Federal Reserve banks, supporters of the Reconstruction Finance Corporation, and representatives of the American Bankers Association. The then-Chairman of the Board of Governors of the Federal Reserve System, Marriner S. Eccles, and his associates strongly espoused legislation proposed by Senator Tobey to broaden the Federal Reserve banks' authority with respect to guaranties only. Partisans of the Reconstruction Finance Corporation pointed out that this would be merely duplication of the Corporation's existing powers, and defended the Corporation against efforts to terminate its life on June 30, 1947, and again on June 30, 1948. Both lending agencies were attacked by the American Bankers Association, which contended

that no need for their lending activities now exists. Extension of the life of the Reconstruction Finance Corporation was obtained from Congress only with some difficulty.

The recent attitude of the Congress has, on the whole, been distinctly hostile to expansion of government lending powers; the adequacy of private sources of bank credit and medium-term capital loans, under present conditions, has been reasonably well established in political as well as economic circles, despite the substantial postwar activity in Reconstruction Finance Corporation guaranties under the blanket-participation plan. On the other hand, increasing attention has been focused upon the need of small business for better access to long-term capital. Little responsible opinion has as yet advocated direct governmental assistance in this area, but the problem is widely recognized, and proposals for private action continue to be put forward.¹ A conservative statement of the recent trend of thought is given in the report of the Colmer Committee, dated December 12, 1946, which observes:²

In general, the results of the committee's studies would indicate that with the funds available in banks throughout the country, in both large and small centers, with the plans which have already been formulated by the banks to help smaller companies, the bank-credit situation for business concerns of all sizes can be considered satisfactory.

With regard to equity capital, however, small and new business is probably in a less advantageous position than with regard to bank credit. The cost of issuing securities is considerable, and the organized markets are not receptive to the issues of little-known firms.

Definitely the minority point of view at the present time, but indicative of future controversy which may develop under less favorable economic conditions, is the report of the Murray Committee, the second of the two committees of the Seventy-ninth Con-

¹ See the analysis and recommendations of the Committee for Economic Development in "Meeting the Special Problems of Small Business," *op. cit.*, pp. 40-42.

² United States Congress, House of Representatives, Special Committee on Postwar Economic Policy and Planning, *Reconversion Experience and Current Economic Problems*, House Report No. 2729, 79th Cong., 2d sess. (Washington, D.C.: Government Printing Office, 1946), p. 83.

gress which investigated the financial problems of small business. This committee did not find a lack of proper accommodation on the part of private financial institutions. However, the group considered that the collateral requirements and interest charges required to offset the hazards and expenses involved in financing small business put small business under a severe competitive handicap. It therefore proposed a new agency, the Department of Small Business, which would provide both technical and financial assistance to small businesses, and would presumably be subsidized to permit cheaper and more hazardous financing. This new agency would guarantee medium- and long-term loans to small business by a procedure similar to that followed by the Reconstruction Finance Corporation with its Blanket Participation Agreement, and would also make direct loans on an "unsecured or character basis." In addition, this committee not only proposed tax benefits to encourage equity investment in small enterprises but recommended that the new agency provide equity funds to small businesses through purchase of preferred stock or other nonvoting ownership shares.³

³ United States Congress, Senate, Special Committee to Study Problems of American Small Business, *Future of Independent Business*, Senate Committee Print No. 16, 79th Cong., 2d sess. (Washington, D.C.: Government Printing Office, 1947), pp. xix-xx, 84-88.

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