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Testimony of C. Canby Balderston,

Vice Chairman, Board of Governors of the Federal Reserve System,

before the Subcommittee on Small Business of the

Senate Committee on Banking and Currency,

May 11, 1955.

The inquiry with which your Committee is concerned is one of vital public interest. The long-run health of the economy requires the continual fostering of young enterprises. With full appreciation of what large companies contribute to the standard of living through their creation of mass markets, through the economies of mass production, and through their ability to finance and carry on research, the economy needs the flexibility of companies that are small. They are flexible enterprises in that they can change direction and policy quickly. Their existence permits the adventure in risk-taking which is so necessary to a dynamic, free enterprise economy. Such small businesses are well suited to many types of production and service activity, and they provide millions of job opportunities for labor.

The general question of the adequacy of financing facilities for small business is a large one, and at the outset a word of caution may be appropriate. This relates to the mistake sometimes made of evaluating the adequacy of financing facilities from the comments or complaints of disappointed applicants for credit. It is the nature of a free enterprise system that many individuals should work in small businesses and should wish to expand. In general, they will be applicants for financing. In general, too, the sum total of their applications will exceed the supply of loanable funds available to them.

Even if the question of adequacy of facilities cannot be measured reliably from the response of unsatisfied applicants for credit, there are two complementary approaches to an analysis of it. One approach is to judge whether or not the organization of our financial institutions is set up in a way to foster adequate credit for small business. The other approach is to gauge adequacy on the basis of the number of small business loans that are actually made by these institutions. From the standpoint of both of these tests, the American economy is distinctive in the adequacy of its facilities for short- and intermediate-term loans.

Concerning the test of financial organization, this country can be said to be unique in the world in that its banking services are provided, not by a handful of large branch-banking systems, but by fourteen thousand banks. Most of these are small and tied to their respective localities. These small unit banks, scattered over the length and breadth of the land, are a significant source of short- and intermediate-term credit for small borrowers. In addition, the lending activities of large banks are directed, in part, to serving the financing needs of small firms. However, these big banks also serve the needs of larger businesses that small banks are not equipped and cannot aspire to accommodate. Thus, it is certainly true that, to the extent the financial needs of small business are suitable for commercial bank lending and investing, our banking system is well designed to meet them.

With respect to the second test--that is, the number of loans to small business actually made,--the Federal Reserve System in late 1946 made a survey of the business loans of its member banks. The survey showed both a broad participation in the small business loan market by banks of all sizes and a wide variety of loan patterns designed to meet the special financing problems of small firms. Since that survey was made, there have been significant developments in the business lending activities of commercial banks. They have expanded their business lending considerably, created new patterns of lending, and some large ones have modified their organizations to stimulate lending by establishing specialized small-business loan departments. Because of the importance of these changes, the Federal Reserve System is planning another survey of member bank business lending, probably to be undertaken this coming fall. The careful preparatory work which is necessary for the conduct of such a survey is already in process.

One of the bills before your Committee, namely, S. 383, would have the purpose of making short- and intermediate-term credit facilities more generally available by providing for the insurance of loans to small business under such terms and conditions as the Federal Reserve Board of Governors may prescribe. We doubt that there is sufficient real need to supplement existing short- and intermediate-term business financing facilities with Government-sponsored insurance.

Banking institutions, which are the principal source of short- and intermediate-term credit to small business, are encouraged by income tax regulations and by bank supervision to maintain loss reserves against loan portfolios. In this way, banks themselves are providing a form of self-insurance against normal loss expectancies. Such loss reserves are in addition to the capital and general reserve protection that is essential in the banking field to prudent risk assumption. If a bank considers its loss reserves to be adequate, it is not going to seek additional risk protection through a national insurance fund. Thus, the incentives for the participation of lenders in small business loan insurance protection are not strong.

It can be argued that a small business loan insurance program is still needed to help strengthen credit availability to marginal or high-risk small business borrowers, especially newly established enterprises of uncertain prospects. But an insurance loan fund limited in operation to such risks would present difficult actuarial problems. Certainly, the premium charge for the insurance would need to be very high in order to be commensurate with the high average risk of insured loans. The short- and intermediate-term business credit field differs in important respects from the home repair and modernization field where short- and intermediate-term loan insurance has already been experimented with. For one thing, it is a much less standardized credit field; in fact, its diversity would present many problems from the standpoint of risk insurance.

If the financial facilities for small business are inadequate, the inadequacy, it seems to us, is not in the bankable credit area, but rather in the area of capital requirements--either long-term loan or equity capital. From experience, we know that the smaller the size of the business, the greater its difficulty in raising long-term capital. The reason is not hard to find. It takes time and effort to investigate an applicant for long-term capital and, if the decision is made to undertake the financing, to place the resulting securities. The inescapable costs of this operation are very large in relation to amounts of the size that small businesses need. Accordingly, there is some reason to conclude that a gap does exist here in the financing facilities.

One of the bills before you, S. 381, is directed at filling this gap. The general approach for this purpose is, in our opinion, on the constructive side, although we do not favor all of its provisions.

This bill would authorize the organization of National Investment Companies to engage in long-term capital and equity financing for small business. These Investment Companies would supplement and work through the commercial banking system. Commercial banks would be permitted to participate in their ownership, and these participating banks could help minimize the costs of investigating the worthiness of applicants for long-term capital. Because of their experience in providing short- and intermediate-term credit to small firms, they could recommend to an

Investment Company worthy applicants for long-term capital with less out-of-pocket cost for essential investigation than anyone else. They would also be in a better position to warn small enterprises against expansions that might prove unsound.

We are sympathetic to the approach in this bill of providing for the Federal chartering of the Investment Companies, for examining and supervising them to see that they are soundly run, and for special tax treatment of them. Financial institutions to serve the long-term capital needs of small business may not have developed spontaneously in this country because our business laws and tax legislation have operated inadvertently to make the effort unprofitable.

Federal taxes make a significant impact on the availability of long-term credit and equity capital to small business in an even more important way. Small businesses rely most heavily on the personal savings of the owners and on retained earnings to start and expand their firms. High individual and corporate tax rates tend to reduce the supply of personal and corporate savings available for investment. In the present world situation with national security expenditures equal to 65 per cent of the budget, it is probably impossible to lower tax rates enough for taxes not to impinge significantly upon the supply of savings.

Tax changes in 1954, however, did help to make more equity funds available to small business, and this fact must be considered in any current evaluation of additional means of improving financing facilities for smaller enterprises. Lower individual income tax rates and expiration of the excess profits tax reduced the rates applicable to all unincorporated businesses and to some small and expanding corporations, and allowed retention of more after-tax income. Liberalized depreciation also makes possible more funds from internal sources and facilitates the financing of new plant and equipment. In addition, provisions of the new law relative to reasonable accumulation of corporate profits, payment of estate taxes, certain aspects of the dividend-credit feature, the option granted some partnerships to be taxed as corporations, and a two-year carryback of operating losses are other changes which promise particularly to ease the long-term credit and equity capital problems of small business. Lowering of certain excises and granting the right to deduct research and development expenses were additional tax changes generally helpful to small as well as other business.

Our particular concern about this bill relates to the responsibilities it assigns to the Federal Reserve System in organizing, supervising, and investing in the National Investment Companies. We would suggest that the System's role be eliminated entirely. The System's present responsibilities, namely, trusteeship for the nation's monetary mechanism, are very different from the responsibilities that would be associated with the activities of the Investment Companies. To mix the responsibility for monetary management with responsibility for promoting the provision of adequate capital to small business would be like mixing oil and water. True, both responsibilities would have to do with credit and finance. It is also true that oil and water are both liquids. They still do not mix.

In S. 381, two functions are envisaged for the Federal Reserve, one allocated to the Federal Reserve Board and the other to the Federal Reserve Banks. One function relates to the chartering, examination, and general supervision of Investment Companies, activities generally comparable to those performed by the Comptroller of the Currency with respect to national banks in the area of commercial banking. This is clearly a governmental function. If the decision is made to go ahead with the Federal chartering, examination, and supervision approach, we would suggest that this responsibility be assigned to some other Federal agency, such as the Securities and Exchange Commission, instead of to the Federal Reserve Board.

The other incompatible function given to the Federal Reserve is that of stimulating the organization of Investment Companies by permitting individual Federal Reserve Banks to subscribe for their stock, provided that they look forward to the ultimate disposal of such stock to banks and other investors. We cannot recommend this promotional function for the Federal Reserve Banks. They are established for entirely different purposes.

Neither can we recommend diversion of the capital funds of the Federal Reserve Banks into the capital of the proposed Investment Companies.

Private capital will come forward to finance these companies, just as it did for national banks, if the legislation providing for them is soundly drawn and if the economic need for them is real.

The proposed legislation would repeal Section 13b of the Federal Reserve Act, which authorizes the Federal Reserve Banks to make loans for working capital purposes to established businesses when credit is unavailable on a reasonable basis from usual sources. This authorization was put into the Federal Reserve Act during the depression of the thirties, and has now largely accomplished the purposes for which it was enacted. Therefore, the Federal Reserve would favor its repeal now. Such repeal would release to the Treasury some 27 million dollars which has been tied up in connection with Section 13b.

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