

NATIONAL RECOVERY ADMINISTRATION

WASHINGTON, D.C.

M E M O R A N D U M

April 9, 1934

TO: Mr. M. S. Eccles  
Assistant Secretary of the Treasury

FROM: Nelson Slater  
Special Ass't to the Administrator

With General Johnson's approval I have had prepared the enclosed memorandum. In my opinion such a method of taxation would encourage industries to make durable goods expenditures without causing any harmful effects. The Durable Goods Committee appointed by General Johnson following the code conferences is now studying this subject and I would appreciate having your views on the matter, if you consider such a plan practical.



Nelson Slater

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N.R.A. CREDIT PROGRAM AND POLICIES

1. NRA not responsible for financial and credit difficulties of commerce and industry, but is interested in seeing that sound and adequate credit facilities are available to all American business concerns, especially the small ones, which have a legitimate basis for credit.
2. Basic credit policies:
  - (a) Avoid extension of industrial credit through official Government channels, either by direct government loans or by guaranteed loans.
  - (b) Finance private business through private credit channels, decentralized and localized as much as possible.
  - (c) Scrap all three pending intermediate credit bills and substitute measure to provide as follows:
    - (1) Intermediate Credit Corporation to handle capital financing up to, say, \$750,000, any maturity.
    - (2) Federal Reserve Banks and private institutions to subscribe to capital stock.
    - (3) Temporary authority (2 years) to handle large refunding issues which will be resold to public as soon as market develops. RFC to supply additional capital in form of preferred stock if this feature is adopted.
    - (4) Give banks or other supplier of new money for current business operations a preferential lien on all unpledged assets of a business, provided 65% of unsecured creditors so agree. This will require amendment of bankruptcy act. Small business concerns will be the chief beneficiaries of this reform, and will receive all credit to which they are entitled, through their local banks.
    - (5) Distinguish clearly between:
      - a. Working capital loans ( 2 to 5 years )
      - B. Capital loans proper ( 5 to 25 years )
      - c. Loans for current business operations only  
( 3 to 9 mos. )

Only (c) should be made by commercial banks. (a) and (b) will be handled by the Intermediate Credit Corporation in the case of medium-sized loans up to \$750,000. Larger capital loans should be handled through regular private investment banking houses.

MEMORANDUM

TO : Mr. Leon Henderson, Director of Research and Planning Division.  
FROM : W. E. Dunn.  
SUBJECT: MODIFIED PLAN FOR PENDING INTERMEDIATE CREDIT LEGISLATION.

Three credit measures are now pending before Congress, viz:

1. Governor Black's bill setting up 12 Federal Reserve Intermediate Credit Banks (80% limit).
2. Senator Glass's bill authorizing the Federal Reserve Banks themselves to extend intermediate credit as in Black bill.
3. RFC bill permitting direct government loans by RFC to replace present mortgage loan plan (75% limit).

The Glass bill should obviously be abandoned in its present form. It puts the Federal Reserve system into a type of business for which it was never intended and for which it does not have adequate capital. As such operations would be impracticable and dangerous, at best the Glass bill could only be considered as a political gesture.

The RFC bill is fundamentally unsound, as direct government lending by an official organization in which political influences inevitably appear is an unsound principle. Furthermore, the RFC does not have the type of personnel nor the administrative set-up required to handle direct loans on a thoroughly sound and efficient basis. There is too great centralization in Washington, and long delays and false hopes would result. As a political gesture, not intended to get down to the real roots of the credit problem, the RFC bill would be fine, but it is based on erroneous principles.

The Black bill is more soundly conceived than either of the other two bills,



but involves a questionable principle. By assuring commercial banks that they can get rid of 2 to 5 year paper at any time, provided they take at least 20% of any loss therefrom, banks will be encouraged to think again in long-term, non-commercial type of loans which got them into trouble during recent years. Such loans are not proper loans for commercial banks to make, and it is doubtful whether they should be encouraged to utilize their depositors' funds in such fashion even for a temporary period.

The Black bill does not cover the whole field of intermediary credit, but is limited to working capital loans of not more than 5 years' maturity. It does not solve the problem of medium-sized capital loans of longer maturity which cannot be publicly marketed. Adequate facilities for such loans have never been available in our banking system, and are badly needed. New machinery for this purpose must be created. With comparatively minor modifications, the Black bill could be adapted to this broader need.

As it now stands, the Black bill provides for direct loans only in exceptional cases, and relies on local commercial banks to handle the bulk of working capital transactions. Since such banks must assume at least 20% of the risk, present credit stringency would be relieved only in cases where a longer maturity of from 2 to 5 years is now the sole obstacle to the extension of a given loan. If they have to assume such partial risk, banks would obviously not extend any loans where lack of adequate security is or has been the real stumbling block. There is no doubt, however, that where adequate security is available but longer terms are required, the Black plan would tend to encourage bank loans, although at some sacrifice of the principle that commercial banks should not attempt to supply funds other than for current business operations.

In England a plan was recently announced for financing medium-sized

concerns which cannot satisfy their capital requirements through public offerings of their securities. A private banking corporation was chosen to handle these operations, the Bank of England subscribing to the largest amount of capital stock, The maturity of loans may run from 2 to 20 years.

The Black bill could easily be modified to serve a similar purpose. A new corporation could be set up, in which the Federal Reserve and Private interests would take the common stock, and the RFC, in case of necessity, could subscribe for preferred stock. Debentures could be issued by this new corporation, against sound industrial securities in its portfolio. The corporation would be under the supervision of a separate board of directors, representative of both Federal Reserve and other private interests. Preference would be given to medium-sized capital loans not to exceed \$750,000 each, but if private investment channels are to remain closed, whether due to the Securities Act or other reasons, the Corporation could be authorized temporarily to handle refunding issues regardless of size or maturities. Such issues could be sold later through regular investment channels when, as and if a market developed for them. A detailed description of the set-up of the suggested corporation has been prepared in a separate memorandum.

This plan would differ from the Black bill as follows:

1. Emphasis on medium-sized capital loans, not limited to 5 years' maturity.
2. Commercial banks not to be used to supply working capital, but to confine themselves to supplying funds for current operations.
3. Supervision by a separate Board of Directors and not exclusively under Federal Reserve Board.
4. New institution to be created, permanent so far as medium-sized

loans are concerned, temporary as regards larger refunding operations. This would be a single corporation, with as many branches and agencies as necessary.

5. RFC to supply additional funds through sale of preferred stock, if necessary to carry out temporary authorization to handle larger refunding operations in excess of \$750,000.

Loans for current business operations should be made by local commercial banks, which should have a cushion in the form of corporate working capital, where this cushion has disappeared as a result of the depression, banks cannot safely extend credit for current operations. It would be unsound for the Government to attempt to supply this missing working capital cushion, and it would be unwise for the Federal Reserve to supply it with its ordinary resources.

There are only two sound ways to relieve frozen credit situations:

1. Liquidation and bankruptcy.
2. Reorganization and subordination of claims of present creditors in favor of the new creditor who puts in new money.

The latter method is preferable. It is the basis for present RFC mortgage loans, and if RFC were entirely free of political pressure from members of Congress and had a fully competent personnel, such loans could be handled in a thoroughly sound manner. But the facts are that they cannot be so handled in such an organization as RFC is at the present time.

A partial solution might be to give the commercial banks this same cushion through subordination of prior claims when the banks supply new funds for current business operations. Loans of this character will presumably be based on profitable operations, permitting the loan to be repaid and leaving a margin of profit which will help thaw out the frozen situation of prior creditors. If



these creditors cannot be induced to subordinate, there is no sound way of relieving the present frozen condition of many business concerns.

The assent of these present creditors can be obtained by individual agreements in each case, or it might be secured through the application to American banking and business practice of a formula similar to that authorized under Section 88 of the Canadian Bank Act.

This formula would involve an amendment to the bankruptcy law giving a bank or other source of new funds for current operations a preference over all other unsecured creditors to the amount of the new money so advanced, provided 65% of such creditors agreed to the transaction. This would give the bank the cushion in many cases that is now lacking. Section 88 is virtually a device for giving a lender a blanket lien on goods remaining in the custody of the borrower, whether moveable or fixed. Whether such a plan would work in the United States is problematical. It has not been 100% satisfactory in Canada, as only by constant vigilance and high business integrity can a sound lien be had under such conditions.

It is believed, however, that such an amendment to the bankruptcy act permitting creditor adjustments with the consent of only 65% of all unsecured creditors in favor of the supplier of new operating funds would tend to encourage banks to go back to their former position as a source of current funds for their local business firms and as a friend and adviser to such firms. At any rate, it is difficult to see how such an amendment could do any harm, and it seems worth while trying it out. Clearly if banks will not supply funds for current business operation, there is no sound way in which such funds can be supplied. The passage of such legislation would give security in many cases which is now lacking.

Summary of Conclusions.

1. Modify the Black bill so as to create an Intermediate Credit Corporation (intermediate as to size of loans, not as to maturities), with as many branches or agencies as may be needed; common stock to be held by private interests, including the Federal Reserve system, insurance companies, etc., and preferred stock to be subscribed by RFC if temporary refunding feature is incorporated. Federal Reserve physical facilities might be utilized.

2. Amend the bankruptcy Act so as to permit subordination in favor of furnisher of new money when 65% of the unsecured creditors so agree, and only to the amount of such new money advanced. This will give banks a cushion now lacking, and will justify them in making many loans for current operating purposes which they are not afraid to make.

3. Working capital proper should be built up again out of business profits and not by pumping Government funds into the middle of frozen situations.

W. E. Dunn  
Liaison Officer N.R.A.-R.F.C.

April 7, 1934