

Mr. Eccles

March 3, 1950

To: Board of Governors

From: Mr. Young

Subject: Financing problem of
small business and the O'Mahoney
bill.

The attached memorandum provides for the Board's information a background outline of the financing problem of small and medium-sized business and the principal provisions of the O'Mahoney bill. It is understood that the Board may wish to discuss the O'Mahoney bill at a meeting in the near future (next week).

RCY

March 3, 1950

FINANCING SMALL AND MEDIUM-SIZED BUSINESS

I. The Problem of Small Business Financing

- A. Evidence of Financial Need. Quantitative data are not available to show the character and magnitude of small and medium-sized business financial requirements. There is, however, a cumulative mass of circumstantial evidence, including the reports of Professors Viner and Hardy, the Temporary National Economic Committee and other Congressional Committees, and the Committee for Economic Development, which points to the existence of unsolved financing problems in the small business area. More specifically, the evidence suggests that small and medium-sized business concerns encounter great difficulty in obtaining long term credit and equity capital needed for launching new projects, expanding productive facilities, and broadening the market for their products and services, and that very small concerns often have difficulty in financing their short-term working capital requirements.
- B. Origins of the Problem. The problem of small and medium-sized business financing is not new, but it has been intensified in recent years by:
 - 1. Federal income and inheritance taxes. The present level of Federal personal and corporate income taxes reduces the amount of business earnings available for reinvestment and serves as a deterrent to individuals who might otherwise invest a portion of their savings in small business concerns. Present estate and inheritance taxes tend to force the liquidation or sale of closely-held small and medium-sized enterprises to meet substantial lump sum tax payments. A thorough approach to the problem of facilitating small business financing should provide for review and revision of the tax structure as well as broadening of loan and equity financing opportunities.
 - 2. High cost of small business financing. Even if there were a broad investment market for the debt and equity securities of small business concerns, which there is not, the high cost of preparing and publicly marketing such issues would seldom, if ever, justify this type of financing. Similarly, in the case of loans to small business, the cost of investigating credit applications, and of servicing small loans are so high in relation to the income received as to discourage large institutional investors from this type of lending. Some of the life insurance companies, such as Metropolitan, as well as some of the larger banks, are now experimenting with programs to reach the area of potential credit need.

3. Changes in investment preferences of individuals. There have been indications in recent years of a trend away from investment in equity securities to life insurance, Government security and other liquid assets holdings on the part of individuals. Such a trend complicates the problem of small business financing, since life insurance companies do not purchase or hold equity shares in any substantial amount and are not prepared, because of the cost aspect, to lend directly to small business on any extended scale.

II. Types of Small Business Financial Assistance Now Under Consideration

- A. Insured bank loans. Short and intermediate term loans of small amount which would be granted on fairly liberal terms and conditions by local banks and insured by some private or quasi-public institution. Such an insured loan program would provide for small business needs in cases where (1) local banks consider themselves "loaned up" on certain types of industrial and commercial credit (2) borrowers are good character risks but have inadequate collateral or lack proven earnings records.
- B. Larger loans, requiring participation of other banks. Many small banks are unable to provide their customers with credit in amounts or with maturities suitable for their needs. In such cases provision should be made for participation of other banks in the loan, with the originating bank handling the credit investigation and servicing the loan.
- C. Purchases of debentures and equity shares. In a number of instances small and medium-sized business require long term financing with repayment and interest dependent on earnings, or equity capital. Commercial banks are not in a position to advance long term credits or to make equity capital investments, but by reason of their close association with business concerns in their community, are well qualified to conduct credit investigations and to service investments, provided that funds can be obtained from some outside source.

III. Institutional Framework Required for Small Business Financing

- A. Role of the commercial bank. Most small and medium-sized business concerns maintain close and continuous contact, both as depositors and as borrowers, with commercial banks in their own or neighboring communities. As a result of this close association, the local banker relies as much upon his own knowledge of his customers' character and business abilities as upon the analysis of financial statements and earnings prospects in appraising the applicant's credit-worthiness. With the banker and borrower located in the same community, servicing and supervision of loans is a relatively simple matter. Moreover, the local banker has long been accustomed to appraising the prospects of sound local business concerns which require additional long-term credit or equity capital. These contribute investment opportunities

which the local bank cannot take advantage of, but can evaluate on the basis of its detailed knowledge of local conditions, the business, and its management. Such low cost credit administration and financial analysis cannot be duplicated by any organization whose regional coverage is less thorough than that of the commercial banking system. Any proposed new facilities or institution for facilitating small and medium-sized business financing should provide for maximum utilization of commercial bank experience and facilities, and for the greatest possible participation by commercial banks in the extension of credit.

B. Need for new institution. In order that small and medium-sized business may obtain the long term borrowed and equity capital which it needs and which commercial banks are unable, and individual investors unwilling, to provide, some intermediary institution should be created especially for this purpose.

C. Criteria for new institution

1. Ultimately, such institutions should be privately owned and managed, but in order to encourage their formation and provide initial capital, some public or quasi-public organization may have to assume responsibility at the beginning.
2. Their lending and investment activities should be conducted in close cooperation with commercial banks and provide for actual participation by commercial banks wherever possible.
3. In order to meet their current operating expenses, establish appropriate reserves and provide their stockholders with a reasonable return, such institutions would probably have to conduct certain loan insurance and lending operations in addition to investment functions.
4. The number of such institutions, or branches of one institution, should be large enough to provide adequate geographic coverage and some measure of competition among themselves, and the amount of their initial capital should be adequate to permit effective operation.

IV. Outline of O'Mahoney Bill (S.2975), Providing for the Establishment of Corporations to Facilitate the Financing of Small and Medium-Sized Business Concerns.

NOTE.--The following outline is restricted to points of major importance and covers (A) form and organization of the proposed corporations, (B) sources of their capital, (C) insurance, lending and investment authority, (D) tax status of proposed corporations, and (E) miscellaneous matters. In addition to stating

provisions of the present bill, the outline includes alternative provisions contemplated by its drafters, as well as comments on other provisions which are still being studied with a view to possible modification.⁷

A. Form and organization of proposed corporations.

1. Number, and procedure for organizing, corporations.
 - a. Present provisions - bill provides for a maximum of 36 corporations, equal to the number of Federal Reserve banks and branches. Five or more individual subscribers to shares could enter into articles of association and request a charter which would be issued by the Board of Governors of the Federal Reserve System with advice of the Secretary of Commerce.
 - b. Contemplated provisions - a limited number of corporations (between 12 and 36) would be specified by statute. Rather than permit any group of 5 individuals to apply for a charter, the revised bill would provide that Federal Reserve banks take the initiative in establishing such corporations.
2. Succession and corporate powers - such corporations would have succession for 30 years, unless sooner terminated by action of stockholders, Congress, or in violation of law. They would enjoy the usual corporate powers and would report annually to the Board of Governors.
3. Directors
 - a. Present provision - each corporation would have 9 directors, 3 to be appointed from the public by the Federal Reserve bank in whose district the Corporation's head office is located, and 6 to be elected by stockholders.
 - b. Contemplated provision - each corporation would have 9 directors, all of whom would be elected by the stockholders. (In the event that a Federal Reserve bank were to provide the major part of the initial capital of a corporation, most, if not all, of the directors would be elected by the Federal Reserve bank, but as stock was acquired by private individuals and institutions, control would pass from Federal Reserve to private hands).

B. Sources of capital of proposed corporations

1. Equity capital

- a. Present provisions - bill provides that shares of these corporations would be eligible for purchase by: member banks, up to 1 per cent of their capital and surplus; Federal Reserve banks, up to 1 per cent of capital and surplus of member banks within their respective districts; nonmember banks, other financial institutions, corporations and individuals subject to approval of Board, the amount held by any one stockholder not to exceed 10 per cent of a corporation's outstanding shares. Minimum paid-in capital and surplus of each corporation to be one million dollars.
- b. Comment - it is not yet certain what modification of the equity capital provisions will be made in the revised bill. Both the minimum paid-in capital requirement and the maximum permissive subscription by Federal Reserve banks are probably too small to permit effective operation. One per cent of member bank capital accounts amount to little more than 90 million dollars. In the Philadelphia District, a capital of 1 million would not enable one of these proposed corporations to take over present Federal Reserve bank 13b loans and commitments. In order to cover just its normal operating expenses during the first years of operation a corporation would have to have more than 1 million dollars invested. A revised bill may establish a higher percentage of member bank paid-in capital and surplus and/or provide that some portion of current Reserve Bank earnings be invested in these corporations; with initiative for organization of these corporations transferred from individuals to Reserve Banks, minimum capital requirements could be established by Board regulation.

- 2. Debt capital - each corporation would, subject to conditions and limitations prescribed by the Board, be authorized to issue bonds, debentures and promissory notes not to exceed the amount of its paid-in capital and surplus. Member banks would be permitted to purchase and hold such bonds, debentures or notes in amounts not to exceed 10 per cent of their capital and surplus.

C. Insurance, lending and investment authority

- 1. Insurance
 - a. Present provisions - corporations authorized to insure banks against loss on small business loans or obligations, such insurance not to exceed 10 per cent of total loans or obligations of an insured bank, or 95 per cent of aggregate loans to, or obligations of, any one business concern. Such insurance is further restricted to:

(1) Not more than \$10,000 of loans or obligations of any one enterprise,

(2) Loans with a maturity of 5 years or less.

No audits or appraisals would be required on insured loans or obligations but banks would certify as to borrower's good personal and business reputation notwithstanding a lack of commercial assets, collateral or security.

b. Comment - it is not clear whether the 10 per cent limitation applies to outstanding loans or to total loans made from the inception of the program, whether or not they were still outstanding. The former would seem to be preferable with some arrangement being made for greater insurance coverage at the beginning. It would be desirable, if it is possible to do so, to work out some safeguard so that small businesses that are getting adequate private financing now would not be forced to pay an insurance fee, and presumably a higher over-all cost for money, under the new program.

2. Lending

a. Present provision - corporations authorized to make loans to or purchase obligations of small business, with or without security and with maximum maturity of 12 years, provided that applications for financial assistance of this kind be initiated through member banks or other banks or financial institutions cooperating with the corporation.

b. Comment - to insure the cooperation of banks and other existing private financial institutions with the program, it might be desirable to restrict the new corporations to the making of direct loans that cannot be obtained at reasonable cost from existing private financial institutions rather than authorizing, as the bill does, that applications be "initiated through" existing private financing institutions.

3. Investment

a. Present provisions - corporations may purchase common or preferred stocks or income bonds of small business concerns, provided the total of such investment does not exceed 20 per cent of the combined capital, surplus and outstanding indebtedness of these corporations. May also invest up to 5 per cent of capital and surplus in the capital shares of local industrial development corporations.

b. Comment - if the primary purpose of these corporations is to provide equity capital, the 20 per cent limit may be too restrictive.

4. Limitation on large loans

a. Present provision - the aggregate amount of financing in sums of \$250,000 or more to single enterprises shall not exceed 25 per cent of a corporation's combined capital, surplus and outstanding indebtedness.

b. Comment - some restriction on the proportion of individual loans in excess of a certain amount may be needed, partly for political reasons, to assure direction of lending and investment activities to small business, but the present provisions may not be suitable.

D. Tax status of proposed corporations

1. Present provision - would exempt these corporations from all forms of taxation, except real property taxes, for a period of 15 years.

2. Comment - in lieu of such a blanket tax exemption for a 15 year period, it might be preferable to grant these corporations the same exemption regarding income taxation that is available to investment companies.

E. Miscellaneous - Business Lending Activities of the RFC and the Federal Reserve

1. Present provision - none.

2. Comment - if the proposed bill passes, there seems no reason why the business lending activities of the RFC and the Federal Reserve System should be retained. It might be desirable, however, for the RFC or its equivalent, to retain certain powers to provide extraordinary financial assistance such as was suggested by Chairman McCabe in his Nov. 1949 statement before the Congressional Subcommittee on Monetary, Credit and Fiscal Policies. Examples might be financing of railroads, air carriers, large public projects, or disaster relief. Such financing, either because of the size of the loan or type of operation involved, would not be suitable for existing private financial institutions or the new corporations.