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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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I appreciate your invitation to present the views of the Board of Governors on legislation to authorize government guarantees of loans to business in emergencies.

The need for prudent provisions to deal with credit needs in emergency conditions has been newly underscored by developments over the past year or so. Last spring, within a few months after I assumed my present duties, financial markets suffered an erosion of confidence severe enough to cause widespread concern that the country might face a liquidity crisis--a situation in which even creditworthy firms might be unable to borrow the funds they needed to carry on their business.

The sharpest contraction of credit came in the commercial paper market, following the insolvency of the Penn Central Transportation Company, a prominent borrower in that market. Since commercial paper is wholly unsecured, investors backed away from issuers about which there was any question. Concern spread throughout the credit markets, fed by fears that some borrowers might be unable to obtain sufficient credit from alternative sources to refinance maturing commercial paper and thus be forced into bankruptcy. With investors generally becoming more cautious, companies with credit ratings less than Aaa experienced increased

difficulty in borrowing through the bond market, as was evidenced by the sharp widening of spreads in the structure of corporate bond yields. In short, there appeared to be a risk of bankruptcies spreading to firms that in other circumstances would be regarded as perfectly sound.

Confronted with an incipient crisis, the Federal Reserve System acted promptly to assure the availability of loanable funds to meet the credit needs of firms that were being squeezed by the contraction of the commercial paper market. First, the System made it clear to member banks that the discount window would be available to assist them in meeting such needs. Second, the Board suspended ceilings on the rates of interest member banks could pay on certificates of deposit of $100,000 or more. In this way banks were placed in a much better position to attract funds to lend to their hard-pressed customers.

These two actions helped to restore confidence, and fear of a liquidity crisis abated. We can all take comfort from the fact that the money and credit markets met the tests of mid-1970 successfully. Looking ahead, however, we need better assurance that temporary liquidity problems of major corporations will not be allowed to damage the national economy.

Traditionally, this country has relied on private financial markets to determine whether credit should be granted or denied. I firmly believe that this is a sound principle, and I am concerned, as I know you are, about how we can preserve this principle and at the same time provide standby authority under which the Government might backstop the private financial markets in emergencies. In authorizing Federal credit assistance, the Congress has understandably concentrated largely on helping homebuyers, small businesses, farmers, and others who will, in ordinary circumstances, need such assistance far more than big businesses do.

In extraordinary circumstances, however, even a large, well-established, and creditworthy enterprise may experience difficulty in obtaining needed credit, and failure to provide that credit could be extremely costly to the general public--in terms of jobs destroyed, income lost, financial markets disrupted, or even essential goods not produced. We should be able to find a way to deal with this problem without injuring the free enterprise system.

In testifying today, it is certainly no part of my purpose to suggest that Congress delay its decision about Lockheed. My

aim is rather to recommend that your Committee, with Lockheed fresh in mind, address itself to the question of devising more general standards and procedures to govern credit guarantees in possible future emergencies.

The Board believes there are several guiding principles that should be followed in designing such assistance. First, assistance should be offered only to protect the economy against serious injury. I have mentioned the mid-1970 experience as just one example of conditions under which such a need could arise. Whatever the particular circumstances, assistance should be reserved for those rare instances where it is needed to enable a sound enterprise to continue to furnish goods or services to the public, and where failure to meet that need could have serious consequences for the nation's output, employment, and finances.

Second, since the assistance is designed to protect the public interest, it follows that it should not be used simply to protect large firms from failure, or to bail out bad management, or to shield creditors or shareholders from the consequences of unwise investments. Guarantees should be a last resort, issued only when there is reasonable assurance of repayment of the

guarar teed loan and when there is no other way to avoid serious injury to the economy. Since any such guarantee would be subject to conditions assuring a preferential status for the government relative to other creditors or shareholders in the event of insolvency, and since guarantees would be available only in emergencies, the existence of the authority should not in any real sense erode the disciplines of the private enterprise system. Rather, it should be regarded as a kind of insurance policy to protect the general public against a highly specialized risk.

Third, assistance should be provided through Federal guarantees of private loans rather than through outright advances of public funds. Aside from its obvious budget savings, this approach would have the advantage of assuring that experienced private lending officers will administer the loans in accordance with Federal guidelines and supervision.

Fourth, to assure thorough and well-balanced consideration of the need for assistance, responsibility for passing on guarantees should be vested in top Federal officials concerned with overall economic and financial policy. We suggest that this function be vested in a board chaired by the Secretary of the Treasury, with the Secretary of Commerce and the Chairman of the Federal Reserve

Board as members. No permanent staff would be required, since guarantees would be issued only under exceptional circumstances, and staff could be assigned as needed from the governmental units represented on the board. Thus no bureaucracy would be created with an interest in expanding the "program." There would be no "program"--only standby authority, ready for use in the event of need.

Fifth, Congress should be informed in advance of any proposed guarantee, so that it will have an opportunity to review the proposal to the fullest extent consistent with the need for prompt action. A possible model for such a procedure may be found in the Defense Production Act as amended last year. As you will recall, that Act now prohibits guarantees of V-loans in amounts over $20 million without approval of Congress. It also precludes the use of guarantees of loans under that amount to prevent insolvency except under certain conditions, including a certification by the President, transmitted to the Congress at least ten days in advance. While a $20 million limit would be impractical for purposes of emergency assistance, the certification procedure seems well suited for this purpose. Following that model, a guarantee would be authorized only if the President

certifies that it is needed to avoid serious and adverse effects on the economy and a copy of that certification, with a detailed justification, is sent to the Congress and the two Banking Committees at least ten days in advance.

These principles are embodied in a bill, S. 2016, submitted by the Board and introduced by your Chairman and Senator Tower. Guarantees outstanding under S. 2016 would be limited to a total of $2 billion. In addition to the conditions I have already mentioned, guarantees could be issued only if the borrower furnished assurances that the loan is not otherwise available on reasonable terms and conditions, if the lender certified that he would not make the loan without the guarantee, and if the loan could not be guaranteed under the Defense Production Act. The bill also provides that fees shall be charged for guarantees and deposited in a fund from which payments required as a consequence of any guarantee are to be made. In the event that amounts in the fund proved insufficient to make such payments, the Secretary of the Treasury would be authorized to obtain the needed funds through public debt transactions.

Since the Federal Reserve System acts as a lender of last resort to financial institutions, principally its member banks,

we are sometimes asked whether we could or should perform the same role for nonfinancial enterprises. This question merits at least a brief comment.

The Federal Reserve Act now includes a provision (paragraph 3 of section 13) that empowers the Board of Governors, in "unusual and exigent circumstances" and by an affirmative vote of at least five members of the Board, to authorize the Federal Reserve Banks to make certain types of direct loans to individuals, partnerships or corporations.

The purpose of this provision of law, which was enacted in 1932, was to permit Federal Reserve Banks to make short-term loans to enterprises that are creditworthy but are unable to secure adequate credit accommodations because of unfavorable conditions within the financial system. The only loans made under this provision were granted between 1932 and 1936, totaling 123 in number and about $1.5 million in amount.

Paper discounted by Federal Reserve Banks under that paragraph must be of the "kinds and maturities made eligible for discount for member banks under other provisions" of the Federal Reserve Act. This means, among other things, that the paper may not have a maturity of more than 90 days at the time of

discount. The paragraph further provides that the paper shall be "indorsed or otherwise secured to the satisfaction of the Federal Reserve Bank," which the Board has construed to mean that a Reserve Bank should ascertain to its satisfaction that the indorsement or the security offered is adequate to protect the Reserve Bank against loss.

In light of these restrictions in the law and the background as to the intent of the law, the Board concluded last year that it would not be appropriate to invoke this authority to authorize extension of Federal Reserve credit to Penn Central. Speaking more broadly, since legislation is needed in any event to assure that adequate authority is available to cope with possible future emergencies, the Board believes that guarantee authority such as provided in S. 2016 would be preferable to direct provision of Federal Reserve credit. We make this recommendation not only because we believe assistance should take the form of a guarantee rather than direct lending, but also because we believe that the Congress, the President, and key Administration officials should participate in any decision to extend such assistance.

These are the considerations that lead the Board to recommend enactment of S. 2016. Whatever your decision

may be as to the need for immediate action in the case of Lockheed, the Board hopes that you will give the most serious consideration to a longer-range solution such as S. 2016. Experience has convinced the Board that legislation of this type is needed as a protective umbrella for our sensitive economic society.

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