For release on delivery

Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking and Currency

House of Representatives

July 20, 1971
Developments over the past year or so have underscored the need for standby authority for Government guarantees of loans to business firms in emergencies where the alternative could be severe damage to the national economy. We hope that such guarantees will be needed only rarely, if at all. But in the light of recent experience, the prudent course is to put in place loan guarantee machinery, to provide better protection against the risk that a temporary liquidity problem of one business enterprise may grow into a major national problem.

One example of how this could happen came in mid-1970. The insolvency of the Penn Central Transportation Company, a prominent borrower in the commercial paper market, was followed by a sharp contraction of credit in that market. Since commercial paper is unsecured, investors backed away from other issuers about which there was any question. Concern spread through other credit markets, fed by fears that some firms with maturing commercial paper might be unable to obtain refinancing from alternative sources, and would thus be forced into bankruptcy. With investors generally becoming more cautious, companies with credit ratings less than Aaa experienced increasing 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 that member banks could pay on certificates of deposit of $100,000 or over. 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.

Congress is now considering this issue in connection with the pressing financial difficulties of another business enterprise, the Lockheed Aircraft Corporation. 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 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 guaranteed 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.

These principles are embodied in a bill, H. R. 8962, submitted to the Congress by the Board and introduced by Chairman Patman by request. The bill approved by the Senate Committee on Banking, Housing and Urban Affairs follows the same general pattern, except for the makeup of the Emergency Loan Guarantee Board. Both the Senate bill and H. R. 8962 provide for a three-man Board, with the Secretary of the Treasury as Chairman and the Chairman of the Federal Reserve Board as a member. They differ, however, as to the third member.

Under H. R. 8962, the other member would be the Secretary of Commerce, but under the Senate bill he would be the President of the Federal Reserve Bank of the District in which the prospective borrower is located. In the unlikely event that two or more applications were pending at one time involving borrowers in different Federal Reserve Districts, the makeup of the Board would be uncertain.

Perhaps arrangements could be worked out to divide the Board's responsibilities so that each of its actions would be related to a particular application, with one of the three members changing according to the borrower's location. But such arrangements would
need to achieve a consistent policy in passing on guarantee applications. The Board of Governors strongly prefers the provisions of H. R. 8962 in this respect.

I can well understand that Members of Congress may be concerned about possible abuse of the guarantee authority, and insist therefore on safeguards to ensure careful evaluation of proposed guarantees. Both H. R. 8962 and the Senate bill include such safeguards. Under either bill we can anticipate very limited use of guarantees. Both bills avoid the creation of a new bureaucracy which might develop an interest in drumming up business. Both bills provide for advance notice to Congress before a guarantee may be issued, to assure an opportunity for Congressional review. Both bills assure that the new Board will have the benefit of the independent judgment of the Chairman of the Federal Reserve Board.

Both bills also recognize the key role of the Secretary of the Treasury by designating him as chairman of the new Board. If Congress objects to having two Cabinet officers serving as members of the Board, perhaps the Chairman of the Securities Exchange Commission, an independent agency, should be considered as an alternative to the Secretary of Commerce. But the Senate bill would allot two votes on the new Board to officials of the Federal Reserve
System who are to serve in an individual capacity, while providing only one vote to the Administration official who serves as chairman. Thus it would create confusion as to whether the Administration or the Federal Reserve System should be held accountable for the new Board's actions. Both the Administration and the System would be given the appearance of responsibility without the authority to exercise it.

In other respects the bill reported to the Senate carries out the general recommendations of the Board of Governors. Whatever decision is reached about Lockheed, we hope that it will be possible for Congress to agree upon a longer-range solution along the lines of H. R. 8962, or the Senate bill with the amendment we suggest. Experience has demonstrated the need for this kind of protective umbrella for our economy.