BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
Washington

Office of the Chairman

March 14, 1945.

Honorable O. Max Gardner,
Chairman, Advisory Board,
Office of War Mobilization
and Reconversion,
1261-B Lafayette Building,
Washington 25, D. C.

Dear Governor Gardner:

In your letter to me of March 5 you refer to the fact that Senate Bill 511 reintroduces the original Wagner-Spence Bill with certain amendments and suggest that I furnish you with a summary of my views in connection with this measure. I have testified before the Banking and Currency Committees of both Senate and House favoring enactment of this legislation because it rests on what I consider a very vital and fundamental principle; namely, that of encouraging the private enterprise system, of which private banking and credit institutions are an integral and indispensable part.

This measure would carry over into the reconversion period and, specifically, until the end of 1949, unless further extended by Congress, the guarantee principle of governmental aid which has worked out so successfully in FHA financing and in the so-called V and VT loaning operations for war production and transitional reconversion purposes. I have advocated the same principle in connection with agricultural loans. In fact, ever since I came to Washington more than a decade ago, I have invariably advocated the guarantee or insurance principle and opposed direct Government lending which, to my mind, can only be justified in periods of extreme economic emergency if, as should never be permitted, the private credit system has broken down.

The banks of this country are as much small business enterprise as any other components of the free enterprise system. Instead of setting up governmental lending agencies, financed out of taxes or deficits, to supplement or, as so often happens in fact, to compete with banks or other private lending institutions, it would be far better, if we mean to preserve this free enterprise system, to enable the banks and similar institutions to function effectively in meeting the various needs of business, industry, agriculture and individuals in the communities they serve.

Where oppressive and restrictive regulations beyond those required for public protection cripple private lending institutions, they should be liberalized and amended in the light of modern needs and conditions. Some progress has been made in that direction, notably in the revision of bank examination policy, which I had a hand in initiating in 1938. The revised procedure, now based upon appraisals of bank assets on

intrinsic worth rather than on fluctuating market values, has, I am glad to say, been adopted in principle by the three Federal bank supervisory authorities and those of practically all of the States, If it has not been carried out adequately in practice, it is largely because old habits die hard.

Similarly, the Banking Act of 1935 greatly liberalized the lending provisions of the Federal Reserve Banks that were so restrictive after the crash of 1929 that the System was incapable of rendering the very sort of aid to the private banks of the country that should have been provided.

Where governmental agencies actually compete with existing private credit institutions, they should, in my judgment, be abolished or narrowly restricted as standby mechanisms should emergency conditions develop. Thus you may recall, many of the smaller banks in the agricultural communities throughout the country complained bitterly and generally with justification that the Regional Agricultural Credit Corporations were soliciting agricultural loans both by direct methods and by advertising. Other governmental lending setups have erred in the same direction, and once established they usually seek to enlarge their operations and to justify their existence with increasing reliance upon the public purse, instead of diminishing or abolishing their operations once the emergencies for which they were theoretically created are past.

The RFC, which was set up belatedly to meet an extremely deflationary situation that private credit could not meet, should, in my opinion, be liquidated so far as its peacetime lending operations are concerned, when we no longer face the deflated condition for which it was created and private agencies are once more in a position to meet credit needs with the aid of the guarantee principle, if necessary. This does not mean, of course, any interference with the important major functions of the RFC in the wartime lending operations, whereby it and its subsidiaries like Defense Plant Corporation fill needs that private agencies are not in a position to meet, but merely that when the need for it no longer exists it should be liquidated like the HOLC.

S. 511 is merely a reapplication of the same basic approach with a view to meeting the credit needs of small business after the war. It would replace a direct lending provision in section 13b of the Federal Reserve Act, to which I have always been fundamentally opposed because this provision, while it did not create a new governmental setup financed out of public funds, authorized direct lending by the Federal Reserve Banks. In actual operation, every effort was made to have private lending institutions make or participate in these loans under 13b. The most striking current example of the opposite principle is the Smaller War Plants Corporation, for which Congress has authorized increasingly large amounts of capital that must, of course, be raised through the budget.

S. 511 repeals 13b. It authorizes the guarantee principle, as in FHA financing or more particularly in the V and VT loans. The loans would be made by private banks. To the extent that they make them without reliance upon the guarantee, so much the better. For borderline or more risky loans, a guarantee in part, that is, up to 90 per cent, would be available. But, as in the V and VT loans, the fee which the lending banks would pay for the guarantee would increase with the percentage of the loan guaranteed. Hence the inducement would exist for the banks to assume as much of the risk as they felt they safely could do. No appropriation would be required from Congress since the fund originally provided under section 13b, amounting to approximately 139 million dollars derived from the gold increment, would be made available. This would permit upwards of a half a billion to be loaned through this mechanism. It is my judgment that many of the estimates of the amount of credit that will be needed by small business after the war are grossly exaggerated and that this permissible total would adequately meet prospective needs. The loans, of course, would be made by local banks to local people whom they know and with whose character, capacity and reliability they would be familiar. Loans by governmental institutions unfamiliar with local conditions are a very different matter. It goes without saying that there can be no justification for giving easy governmental credit to competitors of existing and established small businesses who have relied upon private credit and who could not compete against what in effect would be governmentally subsidized newcomers in the field.

The Wagner-Spence Bill, if enacted, would serve an all important need in the reconversion period by bridging the gap between termination (VT) loans and those needed especially by smaller business enterprise to acquire plant, machinery, inventory, etc., that otherwise would be taken over and disposed of by the appropriate surplus disposal agencies. As you know, the V loan program enabled the Reserve Banks to act as guarantors for the Army, Navy and Maritime Commission in war production loans made by private banks to war contractors and subcontractors. Similarly, the so-called VT program was developed to finance contract cancellation pending settlement by the Government. When settlement is made, the money has to be applied to the VT loan, and the Army, Navy and Maritime Commission have no further authority whereby loans that will then be needed to finance purchase of surplus property could be guaranteed. The Wagner-Spence Bill would supply this deficiency, and would greatly facilitate and simplify disposal of surplus property. War contractors and subcontractors desiring to acquire government-owned plant, machinery, inventory, etc., would be enabled to finance such purchases through the same channels using the same guarantee mechanism with which they are familiar, and the Government's interest would be safeguarded as it has been in the V and VT loans. Contractors in possession of surplus property would be able to negotiate for purchase at the time of contract settlement, thus avoiding delay, expense and other complications that would arise if the property had to be removed and disposed of elsewhere.

That, in substance, is about all there is to the matter. It is by no means complex, nor does it introduce anything novel. This basic principle, as exemplified in the FHA mortgages or in the V loan program, has been

generally approved, certainly it has not been subject to criticism, by the public or the Congress as direct Government lending so often is. It will become increasingly subject to criticism, I venture to say, after the war when the Congress will be under pressures to scrutinize more closely the costs of Government and the taxes necessary to meet them.

The Wagner-Spence Bill as first introduced contained no limitation on the percentage of the loan that could be guaranteed, or on the life of the authority, or on the amount of guarantees that might be outstanding. The bill in its present form differs from the original one in that limitations were introduced at my request to meet criticisms. It was intended, however, to provide by regulation that not over 90 per cent of a loan would be guaranteed, since if a bank is not willing to assume 10 per cent of the risk, the loan doubtless should not be made at all. It would be my idea to have liberal provisions by regulation so that loans would be for as long as possibly ten years and be on an amortized basis.

I feel very strongly that the bill would be valuable in getting private credit flowing without expanding public credit or without competitive governmental lending. It will enable the banker to make loans too risky for him to make otherwise. It will put him in a position where he has some chance of competing with direct governmental lending operations, if they should not be discouraged or prevented by Congress.

While it is somewhat a repetition, I am citing below a summary of arguments for the bill that I embodied in my testimony and in a letter to Chairman Murray of the Senate Special Committee to Study Problems of American Small Business:

> "The bill would encourage a greater flow of funds from the private banking and credit system into those marginal credit risks which banks would not assume without a guarantee.
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> "All loans would originate with banks or other private financing institutions. Amounts, terms, collateral and other details of proposed loans would be worked out between the borrower and the financing institution to which he applies. Thus the operation of the plan would be decentralized throughout the United States.
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> "Credit extensions in the marginal area of risk would be encouraged by guarantees up to 90 per cent of those loans on which banks may desire guarantees. The lender would share in the risk to the extent of 10 per cent or more, which would be a sufficient exposure to prevent lending institutions from involving the guarantee fund in careless or excessive credit hazards.
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> "No new appropriation would be required. An appropriation made by Congress in 1934, amounting to $139,000,000, would be adequate to guarantee a total of more than $500,000,000 of loans outstanding at any one time.

"The benefits of the guarantee would go primarily to the smaller units of business and industry. For the small businesses that are regarded by bankers as marginal or debatable credit risks, the guarantee would be the decisive factor in establishing their credit. Term lending, in which the risk factor is generally higher, would be especially encouraged.

"The plan would be administered by experienced personnel in the Federal Reserve Banks who are administering the V-loan and T-loan programs, a similar credit mechanism. Financing institutions are already familiar with services of the Federal Reserve Banks in this field. Thus no new personnel, controls over banking, or untried activities or principles, are involved.

"Finally, no competition between direct Government lending and the private credit system would be involved. On the contrary, the guarantee plan would encourage the existing private system to extend credit which otherwise might be furnished by the Government or not at all. The trend toward multiplication of Government credit agencies, if continued, may threaten the destruction of the private banking system."

The foregoing summarizes in general my view so far as the credit problem affecting small business is concerned. The question of providing equity capital presents a different problem that I think can be most effectively met by special benefits extended through the tax structure.

I am having this letter mimeographed and am enclosing copies for your convenience since you indicated that you might wish to send them to members of the Advisory Board.

I shall be happy to furnish any further information that you may desire at any time.

Sincerely yours,

(Signed) M. S. Eccles.

M. S. Eccles,
Chairman.