RECONSTRUCTION FINANCE CORPORATION
WASHINGTON

April 15, 1947

Honorable Charles W. Tobey
Chairman
Committee on Banking and Currency
Senate Office Building
Washington, D. C.

My dear Senator Tobey:

This is in response to your request of February 19, 1947, for a report on the bill, S. 408.

This bill would (1) repeal Section 13b of the Federal Reserve Act, (2) require a return to the Treasury of the aggregate amount which the Secretary of the Treasury has heretofore paid into the Federal Reserve Banks under the provisions of Section 13b, and (3) authorize the Federal Reserve Banks to guarantee any financing institution against losses up to 90% on loans, with maturities of not more than ten years, made to business enterprises. The guaranties and commitments outstanding at any one time would not exceed the combined surplus of the Federal Reserve Banks.

Whether Federal Reserve Banks should guarantee risk loans made by member banks we believe is dependent on the answers to the following:

1. Is the proposal in keeping with the original concept of the purposes of the Federal Reserve Act?
2. Is the proposal in keeping with fundamentally sound banking practices and principles?
3. Would the adoption of the proposal result in supplying the risk credit needed by business?

It is the purpose of this report to present certain considerations which are involved in these questions, the answers to which may have farreaching effects on our banking structure and the total economy of the country.

At the present time the banks of the country are as strong as they have ever been in history and they must be maintained on the soundest basis which can be devised. The commitment by Federal Reserve Banks, whose capital and surplus in relation to their liabilities at the present time amount to only about 1%, to guarantee loans on the basis provided in the bill raises, we believe, a serious question as to the effect the assumption of such risks will have on our present banking structure. Obviously, during periods of high productivity, the assumption of such risks would not in and of itself be immediately dangerous, but in a period of national financial crisis might well contribute to another economic collapse.

Proponents of the bill state that the Federal Reserve Banks would utilize their own funds and that no use of Treasury funds or any appropriation by the Congress would be required. While technically this view can be supported, nevertheless in the event of losses it would be necessary, obviously, to draw on reserves. The second paragraph of Section 7 of the Federal Reserve Act, as amended, provides as follows:

> "The net earnings derived by the United States from Federal reserve banks shall, in the discretion of the Secretary, be used to supplement the gold reserve held against outstanding United States notes, or shall be applied to the reduction of the outstanding bonded indebtedness of the United States under regulations to be prescribed by the Secretary of the Treasury. Should a Federal reserve bank be dissolved or go into liquidation, any surplus remaining, after the payment of all debts, dividend requirements as hereinbefore provided, and the par value of the stock, shall be paid to and become the property of the United States and shall be similarly applied."

This provision would seem to raise serious doubt that the surplus funds in question belong to the Federal reserve banks. While it is true these funds do not constitute Treasury funds and are not appropriated, they nevertheless appear to be funds in which the United States has a direct interest.

In view of Federal Reserve's experience to date under Section 13b, it is not unreasonable toquestion, in the event restrictions in existing power are removed, whether loans would be made in sufficient number to meet the credit requirements of borrowers unable to obtain credit through normal banking channels. Under the present Section 13b, the reserve banks may lend money to provide funds for working capital, such loans to have maturities of five years or less. While admittedly the restrictions referred to are important, nevertheless the power granted by that Section has been exercised only to a moderate degree. In fact, as of December 31, 1946, only a little more than one-half million dollars was outstanding under that Section, involving only two Federal reserve banks. In view of this experience to date under Section 13b, your Committee, in passing on the merits of S. 408, may wish to explore the extent to which the authority contained in that bill is likely to be exercised.

Assuming, however, that the authority would be exercised to the limit, the amount made available under S. 408 would be inadequate. During the year 1946 alone, which was one of high production and prosperity, the Reconstruction Finance Corporation made loans aggregating approximately $445,000,000 to business enterprises which could not secure credit from usual banking channels. On the other hand, if we could assume that authority were to be exercised to the limit, the business risks which would be assumed by the Federal reserve banks are far greater than those ever assumed by the RFC. Business enterprise loans may be made by the RFC only to solvent businesses and must be so secured as reasonably to assure repayment. S. 408 makes no provision whatever for security and contains no requirement as to solvency. The losses which might result are difficult to anticipate. Certainly, however, the minimum of losses which may reasonably be expected under S. 408 would be greater than the percentage sustained to date under Section 13b, which requires loans to be made "on a reasonable and sound basis".

Finally, the entry of the Federal reserve banks into this field of direct risk lending represents a departure from the traditional concept of their purposes and functions, which, as stated in the report on H. R. 7837, later enacted into the Federal Reserve Act, are:

> "1. Establishment of a more nearly uniform rate of discount throughout the United States, and thereby the furnishing of a certain kind of preventive against overexpansion of credit which should be similar in all parts of the country.
>
> 2. General economy of reserves in order that such reserves might be held ready for use in protecting the banks of any section of the country and for enabling them to go on meeting their obligations instead of suspending payments, as so often in the past.
>
> 3. Furnishing of an elastic currency by the abolition of the existing bond-secured note issue in whole or in part and the substitution of a freely issued and adequately protected system of bank notes which should be available to all institutions which had the proper class of paper for presentation.
>
> 4. Management and commercial use of the funds of the Government which are now isolated in the Treasury and subtreasuries in large amounts.
>
> 5. General supervision of the banking business and furnishing of stringent and careful oversight.
>
> 6. Creation of market for commercial paper.
>
> Other objects are sought, incidentally, in these plans, but they are not as basic as the chief purposes thus enumerated." (Page 11, House Report No. 69, 63rd Congress, First Session.)

The Bureau of the Budget advises that they have no objection to the submission of this report.

Sincerely yours,
(Signed) John D. Goodloe.
Chairman.