

4/16/47

1. Proposal consistent with Federal Reserve Act.
2. Federal Reserve Surplus Adequate in relation to Liabilities
3. Gov't Funds Not Used
4. Sufficiency of credit under this Proposal.
5. Volume of B6 operations.
6. RFC loans. (Volume - \$445 million in 1946)
7. Adequate Security under S. 408.

MEMORANDUM REGARDING RFC LETTER

Proposal Consistent with Original Act. - The proposal contained in S. 408 is in no sense out of harmony with the original concept of the Federal Reserve Act. There is nothing in the original or amended Act which is inconsistent with guarantees of business loans. The guarantee of business loans provided by this bill harmonizes completely with the discount by Federal Reserve Banks of commercial paper held by member banks as authorized by the original Act. The only difference between the two is that in one case the member bank bears only a part of the risk and in the other case must assume all the risk.

The reference to the House Committee Report on the original Federal Reserve Act overlooks the fact that the Committee Report clearly indicated that one of the fundamental purposes of the original Act was to assist in providing financial assistance to business and commerce. On page 16 of this Report, it was stated that any effective legislation on banking would have to include certain fundamental elements and the first of these was:

"Creation of a joint mechanism for the extension of credit to banks which possess sound assets and which desire to liquidate them for the purpose of meeting legitimate commercial, agricultural, and industrial demands on the part of their clientele."

Furthermore, the Senate Committee Report on the original Act (p. 7) stated that one of the chief purposes of the bill was to "make available effective commercial credit for individuals engaged in manufacturing, in commerce, in finance, and in business to the extent of their just deserts."

Federal Reserve Surplus Adequate in Relation to Liabilities. -

The reference to the relationship of the capital and surplus of the Federal Reserve Banks to their liabilities ignores completely the fact that the Federal Reserve Banks are central banking institutions and not commercial banking institutions. This ratio has no significance with respect to Federal Reserve Banks, since over 90 per cent of their assets consists of gold certificates and obligations of the United States Government. Furthermore, the deposits of the Federal Reserve Banks comprise principally the reserves of the member banks, which are required by law to be maintained in the Federal Reserve Banks and are not available for customary withdrawal. The other principal liability of the Reserve Banks is for Federal Reserve notes, which are entirely covered by gold certificates and obligations of the United States Government. In addition the notes themselves are obligations of the United States. The surplus of the Federal Reserve Banks is adequate when measured by their risk assets. There is nothing in this loan program which would tend to bring about or contribute to a national financial crisis or economic collapse, but, on the contrary, the use of this authority might help to prevent such an occurrence.

Government Funds Not Used. - The RFC states that funds to be used by the Federal Reserve Banks for making business guarantees are funds in which the United States has a direct interest because of the provisions in section 7 of the Federal Reserve Act requiring net earnings derived by the United States from the Reserve Banks to be used

to supplement the gold reserve against United States notes or applied in reduction of the debt. This requirement of section 7 related to the franchise tax, which was repealed in 1933.

It is true that the United States has a residual interest in Federal Reserve Bank surplus in the event of future dissolution of the Banks, but the United States has no present interest in such surplus. Of course, under present plans, 90 per cent of the Federal Reserve Bank earnings may be paid to the United States in the form of interest on outstanding Federal Reserve notes and if so the Government will be interested in any losses that the Federal Reserve Banks might incur. This is far different, however, from using appropriated funds.

Sufficiency of Credit under This Proposal. - With respect to whether sufficient credit would be forthcoming if the proposed amendment were enacted, it can be pointed out that any sound loan which a banking institution might bring to a Federal Reserve Bank would in any proper case be guaranteed. That is not the case, however, under existing law because of the limitations contained in the statute. The adoption of the present proposal would, it is believed, supply all the risk credit that may be needed within the next year or two for this purpose. If it should then be apparent that the authority should be enlarged, the permission of the Congress for additional authority can be requested.

Volume of 13b Operations. - Under the law as it now exists, the Federal Reserve Banks have approved approximately 3,500 applications

aggregating \$570,000,000 for advances and commitments. Figures compiled at the end of 1937 indicated that over 88 per cent of the loans did not exceed \$100,000 in amount and that such loans constituted over 36 per cent of the total dollar amount. Earnings in the form of interest and commitment fees on these loans and commitments aggregated \$9,561,000, as compared with expenses and losses of \$6,856,000. To the end of 1946, therefore, Federal Reserve Banks had a net profit from this operation of approximately \$2,705,000. At the present time, loans outstanding aggregate \$1,058,000, and commitments outstanding \$7,150,000.

RFC Loans. - With respect to the approximately \$445,000,000 of loans to business enterprises by the RFC during 1946, it may be pointed out that this amount represents largely loans under the Corporation's blanket participation program. It has been repeatedly stated that many of these loans would have been made through the usual banking channels even without RFC assistance. As a matter of fact, it is questionable whether there is a need for making any large volume of such loans during periods of prosperity such as existed in 1946. The blanket participation program was discontinued by the RFC in January of this year following widespread criticism of the program.

The RFC statute requires that loans be made only to enterprises which, in the opinion of the board of directors, are solvent and that they be, in the board's opinion, of such sound value or so secured as reasonably to assure repayment. It is difficult to see

how under the blanket participation program the RFC could carry out these statutory responsibilities, when the question as to whether the obligation should be assumed was decided by the financing institution in the field and was not considered in advance by the board of the RFC.

Adequate Security under S. 408. - The suggestion that S. 408 makes no provision whatever for security and contains no requirements as to solvency overlooks the fact that regulations will be prescribed by the Board of Governors which will contain adequate provisions as to the soundness of the loans or extent of the risk to be assumed. Within these regulations, the fact that the Federal Reserve Banks must utilize their own funds in making guarantees will provide adequate protection against loss. Even under section 13b there is no requirement that commitments to take over loans from financing institutions be on a sound or reasonable basis.

4/16/47