BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

April 25, 1947.

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

My dear Mr. Chairman:

When Chairman Eccles appeared before your Committee on April 17, 1947, during hearings on the bill S. 408 relating to guarantees of business loans by the Federal Reserve Banks, there was read into the record a letter addressed to you by Mr. John D. Goodloe, Chairman of the Reconstruction Finance Corporation, dated April 15, 1947, in which the enactment of that bill was opposed on various grounds. Chairman Eccles requested an opportunity to amplify what he said orally by submitting a letter to be incorporated in the hearings, and on behalf of the Committee you accorded him this privilege. This letter is in accordance with that understanding.

Mr. Goodloe suggests that guarantees of business loans by the Federal Reserve Banks on the basis provided in the bill would involve the application of unsound banking practices; and he refers to the fact that the ratio of capital and surplus of the Reserve Banks to their liabilities at the present time amounts to only about one per cent. This statement, however, ignores the fact that the Federal Reserve Banks are central banking institutions and not commercial banks and that the relationship of their capital and surplus to their liabilities does not have the same significance as do similar ratios at private banks. Over 90 per cent of the assets held by the Federal Reserve Banks against their liabilities consists of gold certificates and obligations of the United States Government. Most of the rest of their assets are in the form of items in process of collection, cash, and loans to member banks secured by Government obligations. The deposit liabilities of the Reserve Banks consist principally of the reserves of their member banks which under the law must be maintained with the Reserve Banks and are not available for customary withdrawal. The principal remaining liabilities of the Reserve Banks are represented by Federal Reserve notes which constitute obligations of the United States and are wholly secured by gold certificates and Government obligations. Thus, the capital and surplus of the Federal Reserve Banks are entirely adequate when measured by their risk assets.

Even if the guarantee authority were used by the Reserve Banks to the full extent permitted by the bill, it would not affect the discharge by the Reserve Banks of their broader responsibilities in the monetary and credit field. There is nothing in the bill which would tend to bring about or contribute to a national financial crisis. Rather than contributing to an economic collapse, the authority provided in the bill would make it possible for small business concerns to obtain credit which would not otherwise be available to them.

On the second page of Mr. Goodloe's letter it is stated that the surplus funds of the Federal Reserve Banks which would be used for the purposes of this bill are funds in which the United States has a direct interest. These surplus funds are the accumulated excess earnings of the Federal Reserve Banks resulting from their operations, and the United States has the residual interest in such of these funds as remain after meeting the obligations of the Reserve Banks in case they are dissolved or go into liquidation. Obviously, therefore, the use of these funds by the Federal Reserve Banks as going concerns is quite different from the use of public funds derived from appropriations by Congress.

Mr. Goodloe's letter raises a further question as to whether the funds available under this bill would be adequate. It is the Board's belief that the maximum amount authorized by the bill would be sufficient to enable the Reserve Banks to provide guarantees with respect to all the risk credit that will be needed within the near future. The bill is intended to provide the Federal Reserve Banks with a stand-by authority to be used whenever the need may arise. If it should become apparent at any time in the future that the funds available are not sufficient to meet the need then existing, the permission of Congress for additional authority could, of course, be requested. In this connection, Mr. Goodloe cites the fact that the Reconstruction Finance Corporation, during 1946, made loans aggregating approximately $445,000,000 to business enterprises which could not secure credit through the usual banking channels. It is understood that the bulk of these loans was made under the Corporation's blanket participation agreement. In the Board's opinion, however, it is questionable whether there is any need for the guaranteeing of business loans in such large volume during periods of prosperity such as existed in 1946 or whether it is desirable that so much credit be created at a time of great inflationary activity. It is also open to question whether many of the loans made under the Corporation's blanket participation agreement would not have been made even if no guarantee had been available. The plan was unnecessary and has now been discontinued.

The suggestion is made in Mr. Goodloe's letter that the bill does not contain provisions which would adequately protect the Federal

Reserve Banks against loss. This suggestion overlooks several important considerations. It is contemplated that under the bill regulations would be prescribed by the Board of Governors which would contain provisions with respect to the soundness of loans guaranteed and the extent of the risk to be assumed. Such regulations, coupled with the fact that the Federal Reserve Banks would utilize their own funds in making guarantees, would provide adequate protection against loss. Moreover, loans guaranteed under the bill would originate with local banks who would be fully acquainted with the character, financial ability, and solvency of their customers; and they would not be willing to make loans with or without a guarantee unless they had reason to expect their repayment.

Under the bill, lending banks obtaining guarantees would pay guarantee fees which would be steeply graduated according to the percentage of the loan carried by the lending bank. Consequently, banks would wish to carry as much of the loan as possible and would exercise careful judgment and prudence in passing upon credits.

Guarantee fees received under the bill would constitute a fund out of which any losses could be absorbed. Federal Reserve Banks would, of course, be expected to incur some losses if they are to guarantee any large volume of loans, since the purpose of the legislation is to guarantee loans the quality of which is such that the banks would not make them without a partial guarantee. The fund accumulated from guarantee fees, however, should be adequate to cover such losses, and even if experience under the bill should be more unfavorable than now anticipated, it is believed that losses which could not be taken care of out of current earnings of the Federal Reserve Banks would not amount to more than a relatively small portion of their surplus.

Finally, Mr. Goodloe's letter quotes an excerpt from the report of the House Banking and Currency Committee on the bill which became the Federal Reserve Act as indicating that the entry of the Federal Reserve Banks into the field of direct risk lending would represent a departure from the traditional concept of their purposes and functions. It is believed, however, that there is nothing in the original or amended Federal Reserve Act which is inconsistent with guarantees of business loans by the Federal Reserve Banks. Guarantees of such loans would be entirely in harmony with the authority conferred upon the Reserve Banks by the original Act to provide indirect assistance to business enterprises by the discount of commercial paper held by their member banks; the only difference is that in the one case a member bank bears only a part of the risk, while in the other case it is required to assume all of the risk.

In this connection, your attention is called to the fact that the report of the House Committee on the original Federal Reserve Act,

referred to by Mr. Goodloe, expressly stated that one of the fundamental elements of that legislation was the "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 report of the Senate Banking and Currency Committee on the original Federal Reserve Act similarly stated that one of the chief purposes of that Act 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."

The authority which would be conferred upon the Reserve Banks by this bill is in keeping with powers customarily exercised by central banking institutions and in the Board's opinion is entirely in harmony with the basic concept of the functions of the Federal Reserve Banks.

Sincerely yours,

(Signed) Ernest G. Draper

Ernest G. Draper,
Chairman Pro Tem.