



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

Z-2018 (On office
copies only)

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

March 21, 1947

Dear Sir:

As you know, the Board has recommended to the Banking and Currency Committees of Congress the enactment of a bill to repeal section 13b of the Federal Reserve Act and to amend section 13 of the Act so as to authorize the Reserve Banks without the use of Government appropriations to guarantee business loans on a more effective basis than is permissible under existing law. The bill recommended by the Board was introduced in the Senate on January 27, 1947, and is now pending in the Senate Banking and Currency Committee.

While this bill (S.408) has been endorsed informally by some members of Congress and others, it is meeting with some opposition particularly among the larger banks. It has been more than a month since the bill was introduced and no action has been taken on it. Favorable action by the Committee and by Congress on the authority to guarantee loans will, of course, depend largely upon the extent to which widespread support develops, and we are informed that Congress has not as yet received evidence of active and effective support of this kind.

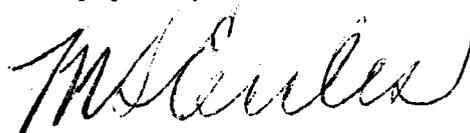
It is important to bear in mind that the bill consists of two sections, the first section repealing the present authority of the Federal Reserve Banks to make industrial loans contained in section 13b and providing for the return of the funds received from the Treasury under this section, and the second section amending section 13 so as to confer upon the Reserve Banks a more effective authority to make guarantees of loans to business enterprises. Since the President's Budget Message for 1948 contained a recommendation for the return to the Treasury by the Federal Reserve Banks of funds received under section 13b, it seems a foregone conclusion that legislation to this end will be adopted. If the proposed amendment to section 13 providing authority for Federal Reserve Banks to make guarantees does not receive adequate support, the probabilities are that Congress will enact only the first section of the pending bill. In that event the Federal Reserve Banks would no longer have any authority to make or guarantee loans to business.

There is enclosed a memorandum explaining the bill and the manner in which the authority would operate. It will be appreciated if you will discuss the matter with your directors at their next meeting in the light of this memorandum and will bring it also to the attention of the board of directors of each of your branches, if any. You may also wish to use the memorandum in discussing the subject with the local press if you deem it appropriate. It would be helpful to explain the proposal to business and financial leaders and others in your district in such manner as you may consider advisable, in order to acquaint them with the merits and objectives of the bill. It is important that they understand that, unless sufficient support develops for the authority to make guarantees, Congress may decide to pass the bill in a form which would leave the Reserve Banks without any authority in this field.

However, I am convinced that we can expect Congress to pass legislation in some form to aid in the financing of business enterprises, particularly small business, and that, if responsibility is not given to the Federal Reserve System to reinforce the lending activities of the established banking system, authority will be given to some agency of the Government which will involve the use of Government funds. As more fully pointed out in the enclosed memorandum, the Federal Reserve System is especially qualified to administer this function both by reason of its organization and experience and because its primary responsibility is in the field of credit.

In my opinion, the situation with respect to the bill is such that affirmative action is required, and whatever is to be done must be done promptly.

Sincerely yours,



M. S. Eccles,
Chairman.

Enclosure

TO THE PRESIDENTS OF ALL FEDERAL RESERVE BANKS

FEDERAL RESERVE ASSISTANCE IN FINANCING SMALL BUSINESS

The Board of Governors of the Federal Reserve System has recommended to the Chairmen of the Senate and House Banking and Currency Committees a bill which would provide assistance in financing small business through established banking channels. It was introduced in the Senate on January 27, 1947, and is now before the Senate Committee.

The Proposed Legislation

The bill (S. 408) would repeal section 13b of the Federal Reserve Act, adopted in 1934, which authorizes Federal Reserve Banks to make industrial loans. Certain provisions of this section have proved so restrictive as seriously to impair the ability of the Federal Reserve Banks to assist in the financing of business.

In lieu of section 13b, the new bill would add a paragraph to section 13 of the Federal Reserve Act authorizing Federal Reserve Banks to guarantee loans made by financing institutions to business enterprises on a much more effective basis than that permitted by present law. While the Federal Reserve Banks would no longer have authority to make direct loans to business, they would be authorized to guarantee business loans subject to regulations prescribed by the Board of Governors and to the following qualifications:

- (1) No loan guaranteed could have a maturity of more than 10 years.
- (2) A Federal Reserve Bank could guarantee up to, but not more than, 90 per cent of any loan.
- (3) The aggregate amount of all guarantees could not exceed the combined surplus of the 12 Federal Reserve Banks.
- (4) In order to insure the availability of guarantees for loans to smaller businesses, the aggregate amount of all guarantees which are individually in excess of \$100,000 could not exceed 50 per cent of the combined surplus of the Reserve Banks.
- (5) The Reserve Banks would utilize their own funds to carry out guarantees made under the bill.

The pending bill would repeal the appropriation of about \$139,000,000 available under existing law for industrial loan operations of the Reserve Banks, and Government appropriations would no longer be used for this purpose.

Operating Procedure

The bill does not place the Reserve Banks in competition with the private banking system. Loans guaranteed would originate with local banks dealing with local people whom they know and with whose character, capability and capacity they would be familiar. A Federal Reserve Bank would not guarantee any loan unless requested by the local bank; but if such a guarantee is desired it would be promptly available, when approved by the Reserve Bank, without referring the matter to any agency in Washington. The twelve Federal Reserve Banks and their twenty-four branches provide a regional organization through which local financing institutions in all areas of the country would have convenient access to a guaranteeing agency.

As in the case of war production loans under the V-loan program, a maximum interest rate would be set for guaranteed loans. The present maximum rate under section 13b is 5 per cent and it is contemplated that the initial maximum rate under the new legislation would be the same. Within this limit, which may be subject to change with changing conditions, interest rates would be determined by the borrower and the bank.

Guarantee fees charged would be specified percentages of the interest rate, graduated according to the percentage of the loan guaranteed. The method would be similar to that used in the V-loan program, when guarantee fees ranged from 10 to 30 per cent of the interest rate, according to the percentage of the guarantee.

Need for the Legislation

A basic need of small, independently owned business enterprises is long-term funds. Some businesses need funds for modernization of equipment and some need special labor-saving facilities in addition to other requirements. The need also arises from the great increase in prices and greatly expanded volume of business which have come about in recent years and which have resulted in a much larger volume of accounts receivable and of inventories. Because of these various factors many enterprises whose financing needs have ordinarily been met through current borrowings now need financing on a longer-term basis.

Owners of small enterprises characteristically prefer to obtain their funds on a loan rather than an equity basis, because they do not wish to permit a dilution of their own interests or to run the risk of losing control of their businesses. For this purpose term loans, amortized out of profits, are essential and desirable. This type of financing is particularly suitable for small businesses, which need a substantial period of time to retire loans by gradual repayment from earnings.

Although large corporations secure a substantial amount of funds through term loans, the greater part of their need for long-term funds is met through security issues, a source not available to small concerns. The amount of long-term funds that the individual enterprise needs is relatively small. Many of these loan demands do not exceed \$10,000 and relatively few exceed \$100,000.

It is recognized that business and credit conditions at present and at other times may not be such as to require extensive use of the guarantee authority which this bill provides. However, the Reserve Banks should have a stand-by authority of this kind in order that partial guarantees may be promptly available whenever needed. The Federal Reserve System, which is a permanent organization created by Congress and responsible to Congress, is especially qualified to provide this service because of its close contacts and daily business relationships with banking institutions. Moreover its responsibilities for maintaining sound credit conditions make it the appropriate agency for this purpose.

Guarantees Are a Tested Method

The system of providing financial assistance through partial guarantees of loans no longer involves untried principles and procedures. For many years the Federal Reserve System has had experience in making and guaranteeing business loans under section 13b of the Federal Reserve Act. Although the authority of the Federal Reserve Banks under that section was restricted, they approved 3,542 applications for commitments and advances amounting to \$566,000,000, and their personnel gained a fund of knowledge and training in this type of financing. Interest and fees collected exceeded expenses and losses.

During the war the Federal Reserve System acquired valuable experience in the administration of the V-loan program for guaranteeing war production loans. Under that program they processed 8,771 guarantees, aggregating nearly 10-1/2 billion dollars. The guarantee fees collected far exceeded expenses and losses sustained and the operation resulted in a very substantial profit for the Government. The pending bill follows the guarantee principle which was applied under that program, and financing institutions are already familiar with the services of the Reserve Banks in that field.

The President has recommended that funds heretofore received by the Federal Reserve Banks for their industrial loan operations be returned to the Treasury. Consequently, it seems probable that the first section of the pending bill, which would carry out the President's recommendation, will be enacted. That section, however, would also repeal the existing industrial loan authority of the Reserve Banks. Accordingly, unless there is sufficient support for the second section of the bill

which would provide the authority of the Federal Reserve Banks to guarantee business loans, Congress may decide to adopt only the first section of the bill, thus leaving the Federal Reserve Banks without any authority in this field.

Over the period since 1934, and especially during the war, the numerous small businesses throughout the country have become more vocal concerning their financing needs. The commercial banking system and related financial institutions are in a strategic position to meet these needs by supporting the pending bill.