BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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STATEMENT OF CHAIRMAN ECCLES
BEFORE
HOUSE BANKING AND CURRENCY COMMITTEE ON H.R. 3268

Mr. Chairman and Members of the Committee:

I am glad to have an opportunity to appear here this morning in order to urge the passage of H.R. 3268.

The bill has two sections. The first one repeals section 13b of the Federal Reserve Act and provides for the return to the Treasury of approximately 139 million dollars that was set aside from the gold increment to enable Federal Reserve Banks to make direct loans to industrial and commercial businesses. The second section of the bill substitutes for the direct lending authority a provision which would enable Federal Reserve Banks to guarantee in part loans by chartered banks particularly to small and medium-size businesses that need capital for periods up to ten years.

It is important to emphasize that the principal purpose of the bill is to make term loans especially to smaller businesses for the purpose of providing them with necessary capital that they could not otherwise obtain. It will fill a gap in private financing that now exists in enabling these enterprises to obtain essential financing. The costs of going to the capital markets for small business are prohibitive. Likewise, many banks properly feel that they cannot extend some term credits for from five to ten years without some protection as provided by this bill. It amounts to a form of spreading the risk by providing insurance for a fee. It is not the purpose of this bill, however, to provide guarantees for either short or long-term financing which banks can and should extend without assistance.

The basic need of the smaller, independently owned business enterprises is for long-term funds. Some businesses need funds for modernization of plant and equipment and additional facilities. The need also arises from the sharp increase in prices and greatly expanded volume of business resulting 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 a funding of their short-term obligations into a term loan.

Owners of small enterprises, as a rule, prefer to obtain funds on a loan rather than on an equity basis because they do not wish their stock ownership to be diluted or to run the risk of losing control of the business. Term loans amortized out of profits meet this need. This type of financing is particularly suitable for small businesses that need a substantial period of time to retire loans by gradual repayment from earnings.

There has been considerable objection to the bill from some of the larger banks on the ground that the smaller banks, in cases where the amount of the loan was beyond their legal limit, would resort to the guarantee even though the loan was of such quality that it could be made without the guarantee by giving participations to their correspondent banks or other banks in the community. In order to meet this objection, the Board recommends that the Committee adopt the suggestion of the Federal Advisory Council of the Federal Reserve System by inserting in the bill a provision that the guarantee shall only be available "when it appears to the satisfaction of such Federal Reserve bank that the business enterprise is unable to obtain requisite financial assistance on a reasonable basis from the usual sources." H.R. 3268 contains language of similar purport, but it would be preferable, I think, to substitute the wording favored by the Advisory Council and the Board.

The Board also favors the recommendation of the Federal Advisory Council that the bill be amended to provide that the guarantee be restricted to "chartered banking institutions" only. H.R. 3268 refers in one place to "chartered bank" and in another place to "financing institution."

It should be borne in mind that the Reserve System has had the authority under 13b for the past thirteen years to make direct loans or to make commitments to purchase loans made by private banks. On principle, we feel that the private banks should originate and make the loans based on their credit judgment, and that neither the Federal Reserve Banks nor any other governmental agency should extend such credits directly.

Section 13b, moreover, is not adapted to present day needs. It limits the extension of credit to loans for working capital only and provides that loans cannot be made for more than five years and can be made only to established businesses.

The proposed bill does not call for Government appropriations and, therefore, no drain on the Federal budget is involved. The Reserve Banks would use their surplus funds as a basis for the guarantees, and should losses be sustained they would first come out of the fund created by the guarantee fees charged. If this were not adequate, losses would be met out of the Reserve Banks' net earnings or surplus. I am sure that this responsibility placed on the officers and directors of the Reserve Banks, under regulations and supervision of the Board of Governors, will not encourage easy and unsound credits on the part of the private banks.

Under section 13b Federal Reserve Banks handled some 3500 applications for commitments and advances, aggregating about 560 million dollars. Similarly, under the V-loan program, 8771 authorizations for guarantees of war production loans, aggregating nearly 10.5 billion dollars, were handled. The interest and fees collected in connection with this total of about 11 billion dollars of operations were more than sufficient to cover expenses and losses and to show some profit. In other words, the record is not one of loose lending.

This bill, of course, does not place the Reserve Banks in competition with the private banking system. Credit judgment and responsibility would remain primarily with the lending bank. 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 could not guarantee any loan unless requested to do so by the local bank. If approved by the Reserve Bank the guarantee would be made promptly available without referring the matter to any agency in Washington. Each loan would have to be passed upon by the Federal Reserve Bank. There would be no blanket approval. The twelve Federal Reserve Banks and their twenty-four branches provide a regional organization through which local financing institutions in all parts of the country would have convenient access to a guaranteeing agency if 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 relationships with banking institutions. Its responsibilities for maintaining sound credit conditions, so far as its powers permit, make it the appropriate agency for this purpose.

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. This has been and would be the operating procedure.

It is evident, therefore, that the lending banks must carry some portion of the loans without guarantee and this will be a deterrent on their making undesirable and risky loans. The steeply graduated guarantee fees will induce banks to carry as much of the risks as possible and thus cause them to exercise careful judgment and prudence in passing upon credits.

Business and credit conditions at present and at some other times may not be such as to require extensive use of the guarantee authority. However, the Reserve Banks should have a stand-by service of this kind to render to business and industry when necessary. The amount of long-term funds that individual enterprises may need is often relatively small. Many loan demands do not exceed $10,000 and relatively few exceed $100,000. The bill is intended and designed primarily to help the smaller enterprises. The larger ones, as a rule, do not need this sort of assistance because they can go to the capital market and raise funds either by bonds or equity financing.

The guarantee service, as provided in this bill, would be available in the future, as it has in the past, without discrimination for all banks, whether members of the Federal Reserve System or not.

It would be ill-advised and shortsighted, in my opinion, for Congress to repeal section 13b in order that the 139 million dollars of Government funds thereunder may be returned to the Treasury and fail to provide this proposed alternative authority to the Federal Reserve Banks. The proposal is the result of long and extensive experience which the Federal Reserve System has had in connection with the loan guarantee principle. It is a tried and tested principle exemplified in Federal Housing Administration loans as well as in loans to veterans. This bill is a means of aiding the private banking system of this country to meet particularly the longer term financing needs of the smaller business institutions without assuming excessive risks.