Draper, E.G.
6/2/39

STATEMENT OF HONORABLE ERNEST G. DRAPER

RE: S. 2343

In testifying on this subject, I wish to make it clear that what I shall say represents only my own personal views and not necessarily the views of the Board of Governors of the Federal Reserve System.

This subject of loans to small business has been such a controversial one that there is danger either of (1) no satisfactory legislation being enacted or (2) such elaborate machinery being set up as to cause the Government an inordinate amount of expense in order to relieve a situation that might have been cured by simpler and more economical means.

Since June 1934 the Reconstruction Finance Corporation and the Federal Reserve banks have had authority to make loans to business and industry subject to certain limitations; and the authority of the Reconstruction Finance Corporation in this respect was broadened by the Act of April 13, 1938. Under the present law, the authority of the Reconstruction Finance Corporation to make such loans will expire on June 30, 1941; but there is no such time limitation on the authority of the Federal Reserve banks to make loans to business and industry. However, the Federal Reserve banks are authorized to make such loans only with maturities of not exceeding five years and only in order to provide "working capital" to businesses that are "established". It is obvious that these restrictions prevent the granting of credit in many legitimate cases where it might be helpful to small business and to the community at large.

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Many persons with knowledge of the general problem genuinely feel that the existing avenues for credit to small industry are insufficient. They insist that there is a legitimate need for credit on the part of small but sound concerns and that this need is not at present being met by any agency, either public or private.

The results of certain surveys which have been made on this subject purport to show that there is no need for additional credit facilities for small businesses. I do not doubt that such surveys have been made in the utmost good faith; but the results are not convincing to me, because the conclusions are based very largely upon the fact that only a small percentage of persons to whom questionnaires were sent replied to them. There are many reasons other than the lack of need for additional facilities which may account for the failure of many businesses to reply to such questionnaires.

Why not get to the bottom of this problem, once and for all, by devising legislation which is simple in character, inexpensive in operation and cooperative in its approach? In this way we could meet the present difficulty squarely and without reliance upon an entirely new set-up of elaborate and perhaps unwieldly machinery. Then, if it should develop after the passage of such simplified legislation that the need is not as great as anticipated, no great harm would be done and no great expense incurred. If, however, the need should prove to be greater than anticipated, the flexible machinery of this new plan could easily take care of any increase in demand, regardless of its volume.

There is much to be said in favor of the approach to this problem proposed in the Mead bill, since it avoids the creation of an additional system of banks, which would be expensive and slow to get into operation, and seeks instead to encourage the use of part of the enormous amount of credit now lying idle in the banks by providing insurance through the Reconstruction Finance Corporation, which is already in existence and has accumulated much experience in this field.

I believe, however, that the bill would be improved and liberalized in some respects. I have in mind insurance covering

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Finance Corporation would share any loss that might occur on some pro rata basis to be specified in the law.

I also hope that your Committee will consider the advisability of adding to this bill a separate title providing for the utilization of the existing machinery of the Federal Reserve System in extending additional credit facilities to small businesses on a much more liberal and flexible basis than the Federal Reserve banks are now permitted to extend under the limitations prescribed in section 13b of the Federal Reserve Act. Such a plan deserves careful consideration, because the existence of the 12 Federal Reserve banks and 24 branches located strategically throughout the United States and already staffed with trained and experienced personnel offers an excellent opportunity to decentralize the actual administration of this business and have it handled locally by persons familiar with the problems and already in close touch with the banks of the regions in which the applications arise.

At the same time the assets and liabilities resulting from such operations could be segregated in a separate corporation organized as an integral part of the Federal Reserve System, utilizing the existing personnel and other facilities of the Federal Reserve banks and acting under the general direction of the Board of Governors, which could be charged with the duty of seeing that the corporation functions in such a manner as to meet whatever legitimate need there is for additional credit facilities for small businesses, either directly or through

cooperation with existing banks and other financing institutions.

I wish to make it clear that this is proposed as an addition to the Mead Bill and not as a substitute for it. The provision of such additional facilities on a regional basis could not in any way impair the effectiveness of the facilities provided for in the Mead Bill but would supplement those facilities in a manner which might prove to be very helpful.

SUGGESTIONS FOR IMPROVEMENT OF
MEAD BILL, S. 2343

(Presented by Hon. Ernest G. Draper)

The provisions in the bill regarding the distribution of losses (p. 2, line 8) differ from those which are contained in other insurance plans set up by Congress. The bill, as now drafted, provides that the Reconstruction Finance Corporation may insure against the whole or any part of a loss which an insured bank may sustain in excess of 10 per cent of the principal amount of the loan. Thus, for example, if a loss of $10,000 were suffered on an insured loan of $100,000, the insured bank would have to bear the entire loss and the Reconstruction Finance Corporation none. Since a bank would derive no benefit from the insurance until after it had suffered a loss equal to 10 per cent of the loan, a question arises whether the bill in its present form would give sufficient encouragement to banks to make such loans on a more liberal basis than they would without such insurance. It is believed that the benefits afforded by the bill might be more generally utilized if this provision were changed so that the insured bank and the Reconstruction Finance Corporation would share in such loss as might occur on some pro rata basis to be specified in the law.

It is also believed that more loans would be made and increased benefits derived from the legislation if more flexibility were provided in the bill with respect to rates of interest and the insurance premiums. The restrictions in the present draft in these respects may result in limiting the usefulness of the additional facilities provided by the bill.

The fifth limitation in section 3(b) of the bill (page 3, line 22) would forbid the making of such loans to a borrower of which an officer, director or security holder owning more than 10 per cent of any class of the borrower's stock is, or has been within the preceding 12 months, a director of the bank making such loan. It is doubtful whether this restriction would serve any useful purpose and it may prevent the making of sound and desirable loans. It is believed, therefore, that the bill should be liberalized by eliminating this restriction.

The bill would be improved if the provisions of section 5 regarding the rediscount and purchase and sale by Federal Reserve banks of obligations evidencing loans insured under the bill were changed to a provision authorizing the Federal Reserve banks, subject to regulations prescribed by the Board of Governors of the

Federal Reserve System, to make advances to member and nonmember banks for periods not exceeding six months at a time on their promissory notes secured by such obligations, at rates to be established from time to time by the Federal Reserve banks subject to the review and determination of the Board of Governors. From the standpoint of practical operation, experience has shown that it is more convenient and less expensive both to the Federal Reserve banks and to the member banks for the Federal Reserve banks to make advances to member banks on their promissory notes secured by the pledge of assets than it is to rediscount such assets. Rediscounts, furthermore, are ordinarily held until maturity so that the discounting bank has to pay the discount rate from the date of discount until maturity, whereas advances can be made for limited periods and renewed from time to time as the circumstances require, so that the borrowing bank pays interest only for the period during which it needs the credit.

If it is deemed advisable to provide a market in which such obligations can be sold, it is suggested that consideration be given to provision for the organization of a corporation to purchase such obligations and to issue and sell debentures against them, in a manner similar to that in which the RFC Mortgage Company now operates in the field of insured mortgages.

It is not clear that the insurance provided in the bill would inure to the benefit of an institution which rediscounts or makes an advance against such a loan, since section 4(b) provides that the insurance shall inure only to the benefit of any "assignee" or any "purchaser". To eliminate any doubt on this point, it is suggested that the remainder of the sentence following the words "the benefit of" on page 5, line 10, be changed to read "any person to whom such a loan shall have been assigned or pledged, or by whom such a loan shall have been purchased or rediscounted."