

SMALL BUSINESS AND ITS CREDIT PROBLEM

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May I say at the outset that the opinions expressed below are my personal views, and in no sense represent an official viewpoint of the Board of Governors of the Federal Reserve System.

How small is small business? Nobody knows and nobody will ever know because, in this instance, size is purely relative. A large concern in Noroton, Connecticut, looks small in New York City.

We can make the picture somewhat clearer by having our definition of small business cover both small and medium-sized concerns. Even then the argument will be endless. So let us make an arbitrary ruling. It will not satisfy everybody but it will come closer to the facts. Let us say that, speaking broadly, a small or medium-sized concern is one which hires 500 or less employees or has total assets of less than \$1,000,000. If we use these guides -- and they seem to me to be fair -- we discover some interesting facts.

Before attempting to give any statistics, may I say that there are a number of ways by which to gauge the relative importance of small business in the national economy. If, for instance, you are a private individual and are thinking of purchasing a small concern, you naturally center your efforts upon finding out the asset value of the company, its earning power, the scope of its

market, either present or potential, and other facts of that nature. But if you are looking at this problem of small business from the standpoint of the public interest, then the information that you seek will be of an essentially different character. From the standpoint of the public interest -- that is, of the people as a whole -- there are three essential facts to know about small business. First, what proportion of those employed in industry are employed in small business? Second, what proportion of the national income is earned by small business and third, what percentage of the total number of corporations and unincorporated enterprises in this country have total assets of less than 1 million dollars?

According to a recent survey made by the Twentieth Century Fund -- an impartial agency devoted to the dissemination of factual information upon a variety of economic subjects -- we find, First, that - of those employed in 1929 (the latest date available) in all manufacturing industries, more than 62% were employed in plants hiring 500 workers or less.

We find, Second, that of the total national income, approximately 60 per cent is produced by small unincorporated enterprises and corporations with total assets of less than 1 million dollars.

We find, Third, that of all the corporations in this country, about 95% have total assets of less than 1 million dollars.

In giving these figures, I do not wish to mislead you by exaggerating the importance of small business. For instance, it is true that 95% of all corporations are small. But it is also true that these 95% own only 14% of the total corporate assets in the country whereas the remaining 5% of large corporations own 86% of these assets. But, when we are judging a problem of this character from the public interest standpoint, we must remember that assets, while most important, do not tell the whole story. The whole story must also include the number of employees dependent upon the successful functioning of small business and also the relative importance of small business in providing the nation with its yearly income.

From these two vital standpoints, our country has a stake in small business and a responsibility toward it which our Government should not shirk. While it may be true that a general recovery cannot be stimulated merely by stimulating small business, nevertheless it is likewise true that we shall never get a broad recovery of large and lasting proportions if we do not see to it that the credit flow to small business is continuous and of sufficiently generous proportions as to satisfy the legitimate needs of all classes of sound small business.

Also, it may be true that, as a result of the European war, all business will expand and that will have its temporary stimulating effect upon small business as well as large industry. Undoubtedly

something of this sort may take place. But we must also remember that war conditions will bring about innumerable dislocations, some of more or less violent nature. A small business that was recently regaining a good earning basis may, through no fault of its own, be thrown off balance or permanently crippled by the indirect but devastating effects of a European conflict.

Based upon a wide variety of information which includes Government and private surveys and reports, testimony of various individuals in Government hearings and many unsolicited letters from small businessmen, it is my opinion that there are two groups of business enterprises whose needs are not adequately met by existing financial machinery:

1. Those who need short and intermediate credit but whose credit standing at the present level of business activity does not make them acceptable risks for banks. These are not misconceived, or mismanaged, or insolvent businesses, but businesses whose prospects of success are dimmed by the current economic situation.

2. Small and medium-sized businesses which need loan or equity capital for an intermediate or long period. The growth of nation-wide business units, the discontinuance of bank affiliates and of underwriting by banks, the increased cost of security issues, and the disappearance of local underwriters have made it difficult for this type of business concern to find long-time credit except at prohibitive cost.

It has been said by many persons that Government should not enter further into the field of rendering financial assistance to business, because by so doing it will subsidize many mismanaged, unprofitably operated concerns. I would never advocate that the Government assist in making funds available to such enterprises. However, I do believe that there are many small concerns whose liquid resources have been severely strained by a series of depression losses. There are others who require funds to finance the purchase of new machinery and equipment, or to extend or improve plant operations, in order to enable them to carry on a more profitable operation.

In years past a substantial portion of outstanding commercial loans held by banks consisted of what would be termed today capital advances, but they were evidenced by short-term paper that was renewed from time to time as it matured. Today the demand is increasing for longer-term credit. These long-term loans are opening an avenue to banks for the expansion of their earning assets. While these loans lack liquidity and marketability, nevertheless many banks have made a number of such advances safely.

In making long or intermediate term loans, a bank not only has to consider the non-liquid and non-marketable character of such assets, but must consider the added risks involved, such as an adverse turn in the business cycle during their life, or management and technical changes that may occur. The volume of such loans any

one bank can make will depend upon the nature of its deposit liabilities; the volume of its holdings of other non-liquid and non-marketable assets, such as real estate loans; the quality of such loans available to it; and the ratio of its capital structure to its deposits. The risks involved are such that the Federal Reserve banks as banks of discount for their member banks would be performing the proper functions of a central banking system in assisting commercial banks to make this type of credit available.

Section 10b of the Federal Reserve Act now authorizes a Federal Reserve bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System to make an advance to a member bank on its promissory note with a maturity up to four months, when secured "to the satisfaction of such Federal Reserve bank". This makes eligible as security at Federal Reserve banks long and intermediate term loans made to business. This provision in the Federal Reserve Act, although providing aid from the Federal Reserve System to member banks in making such loans, does not offer as effective cooperation as is provided for under the limited provisions of Section 13b of the Federal Reserve Act. This Section authorizes the Federal Reserve banks under certain circumstances and conditions to make loans to business enterprises. However, the statutory limitations of Section 13b, which provide that loans can be made only to established commercial and industrial enterprises for working capital purposes and that maximum maturities

cannot exceed five years, do not permit the Federal Reserve banks to operate satisfactorily in meeting the present situation.

In spite of the restricted nature of the present Section 13b of the Federal Reserve Act, it may be interesting to note what the Federal Reserve banks have accomplished in making direct advances, advances in cooperation with banks, and commitments to banks covering advances made by such banks, to business enterprises since June 1934.

The Federal Reserve banks have received over 9,300 applications, amounting to \$400,000,000. Of these, 2,750 were approved, amounting to \$184,000,000. Approximately 1,200, amounting to \$60,000,000 were declined, because the funds were not to be used for working capital purposes as required by law, or because the applicants were not established industrial or commercial enterprises. Of this grand total of \$184,000,000, advances and commitments direct to borrowers amounted to only \$38,000,000, whereas the total commitments to and advances through financing institutions amounted to \$73,000,000.

To the end of 1938 net earnings on industrial advances, before making provision for losses, amounted to \$2,800,000. Determined losses charged off aggregated \$160,000, and reserves set aside to take care of estimated losses amounted to \$1,865,000. This left net earnings of about \$770,000 for the period June 19, 1934 to December 31, 1938. At the present time the Federal Reserve banks have

outstanding \$15,000,000 in advances and \$11,000,000 in commitments. Of the advances outstanding about \$2,500,000 are past due three months or more. The Reserve banks have acquired about \$1,300,000 of miscellaneous assets in connection with the liquidation of defaulted obligations. What the final losses will be is impossible to state at this time, but present indications are that they will not be unduly large.

From the record cited above, you can see that the Federal Reserve System has materially aided banks in meeting the long-term working capital needs of business. However, it is undoubtedly true that the restrictions placed upon the Reserve banks, to which I have referred, have prevented the granting of many loans that could have otherwise been made. For this reason, it is my belief that a plan for the creation of an Industrial Loan Corporation as an integral part of the Federal Reserve System, using the Federal Reserve banks and branches as its field force, would be of great assistance to both banks and business enterprises, both in the field of long-term financing and in those other situations mentioned previously. This is the plan originally suggested by Chairman Eccles before a Congressional committee last Spring.

The Federal Reserve banks have offices already established in 36 cities (12 Federal Reserve banks and 24 branches). These offices are widely distributed in the various trade areas throughout the country, and are well qualified for such service, because of their

knowledge of business and economic conditions in their respective districts and their close contacts with local banking institutions. With this organization already in existence, it would be possible to commence operations with a minimum of delay and expense. Also operations could be expanded or contracted from time to time in accordance with changing conditions. The experience gained by the Board of Governors and the Federal Reserve banks in connection with industrial loan operations during the past five years would be of great aid to them in performing this service.

Briefly, the plan is this: Funds in the Treasury now set aside or used for industrial loans under the provisions of Section 13b - about \$139,000,000 - would be turned over to an Industrial Loan Corporation. This would involve no additional borrowing or increase in the public debt. The Board of Governors would be the Board of Directors of this Corporation, and the 12 Federal Reserve banks with their 24 branches would be the field agents to pass on applications. In this way, prompt and economical action would be assured by utilizing existing machinery and experienced personnel.

The corporation would make loans or commitments or acquire preferred stock, but not more than \$1,000,000 to any one borrower. Intermediate or long-term loans could be made by private lenders and insured banks protected by commitments of the corporation.

The corporation would have \$100,000,000 of capital and \$39,000,000 of surplus. It would have power to issue \$500,000,000 of Government-guaranteed debentures. Upon liquidation, all remaining assets would go to the United States Government. One important feature of the plan would be to set aside, out of its surplus \$25,000,000 for an insurance fund for small loans not exceeding \$25,000. The Industrial Loan Corporation would guarantee 10 per cent of any lender's aggregate insured loans, so that the loss on any loan even up to 100 per cent would be absorbed by the corporation, so long as aggregate losses did not exceed one-tenth of the lender's insured loans. The principle behind this plan is the same as that in Title I of F. H. A. The Corporation's possible losses on insured loans would be limited to the \$25,000,000 set aside as an insurance fund. It has been estimated that the aggregate cost to the borrower, including insurance and service charges would not exceed 6 per cent.

In making this proposal, my only object is to offer what seems to me to be a practical plan for meeting the problem as it exists today. This plan does not provide for the creation of a new Government credit granting agency, but broadens the powers of the Federal Reserve System in order to enable it to be of more effective assistance to banks and business.

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 situation squarely and without reliance on an entirely new setup of elaborate and perhaps unwieldy machinery, but with the assistance of a flexible, permanent Federal agency such as the Federal Reserve System. Then, if it should develop after the passage of such simplified legislation that the need is not as serious 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 would take care of this increase in demand regardless of volume.

This plan seems to me to offer the most effective solution to the difficulties in which a large and important sector of our industrial economy finds itself bogged down. The discouraging condition of small business is not primarily a result of its own inefficiency. It exists because of powerful economic disturbances over which it has no control and against which it cannot individually wage a successful fight without some reasonable amount of cooperation from a permanent public-interest agency.