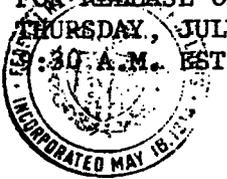


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Statement by

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Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Capital, Investment and Business Opportunities

of the

Committee on Small Business

of the

House of Representatives

Washington, D.C.

Thursday, July 20, 1978

I appreciate the opportunity to appear before this Subcommittee today to present the views of the Board of Governors of the Federal Reserve System on H.R. 12666, a bill to amend the Small Business Investment Act of 1958.

The Board of Governors generally favors the enactment of legislation that encourages financial assistance to small businesses. The original version of the Small Business Investment Act contained a provision that allowed banks to invest an amount equal to 1 per cent of their capital and surplus in the stock of small business investment companies. Since then, we have seen the amount increase to 2 per cent in 1961 and 5 per cent in 1967. Although bank and bank holding company investment in small business investment companies represents a departure from the traditional separation of banking and commerce, and such investments often involve a fair amount of risk, the Board has supported this type of investment because of the desire to encourage bank assistance to small businesses.

Today, small business investment companies have, in the aggregate, total resources of approximately \$1.1 billion, of which bank-controlled companies hold \$282 million and companies in which banks have a minority interest have an additional \$60 million. While \$637 million of the \$1.1 billion total is derived from Small Business Ad-

ministration funds, approximately one-third of all private investment in small business investment companies, or \$160 million, has been provided by banking organizations.

Banks, of course, are in the business of making loans rather than investments, and banks provide a substantial volume of funds to small businesses in the form of loans. Bank loans to small businesses that were guaranteed by the SBA totaled \$2.7 billion in 1977. Loans made with SBA participation or guarantee, moreover, represent a very small proportion of the total lending by banks to small businesses. In fact, according to estimates from the Federal Reserve Survey of the Terms of Bank Lending, more than half of the dollar amount, and 99 per cent of the number, of all commercial and industrial loans made by commercial banks represent loans of less than \$500,000, which is the maximum size of SBA loans to business. This survey covers business loan activity during one week of each quarter and, based on the most recent such survey, commercial banks are estimated to have made--in that one week--231,000 loans of less than \$500,000 for a total amount of \$5.3 billion.

It is our understanding that this bill is intended to remove legal impediments which may prevent banks, savings and loan associations, pension funds and insurance companies from making investments in small businesses. It is also our understanding that, with respect to financial institutions, the bill's provision permitting an investment of up to

5 per cent of an investor's net worth directly in small business concerns is intended to strike a balance between the funding needs of small businesses and the necessity of maintaining the soundness of financial institutions. As I noted previously, however, banks and bank holding companies are now allowed to invest up to 5 per cent of their capital and surplus in small businesses through the medium of small business investment companies. While the statute conferring this authority refers only to banks, it also extends to bank holding companies, because under the Bank Holding Company Act, legislation that enlarges the investment authority of national banks automatically enlarges the powers of bank holding companies to the same extent. Of course, bank holding companies, with regulatory approval, can invest in any company that engages in activities that are closely related to banking, and they may purchase up to 5 per cent of the shares of any company regardless of its activities. This bill would not curtail that authority.

One result of the enactment of this bill would be that the total authorized equity exposure in small businesses would double. Banks might invest up to 5 per cent of their capital and surplus in small business investment companies and, additionally, up to 5 per cent of their net worth directly in small business concerns. The Board believes that bank support of this country's small businesses is a particularly important goal, and it is willing to support a modest increase in the pool of bank funds legally available for equity investment,

particularly since our experience has been that supervisory problems associated with existing small business investment company activity by banks have been rare. Therefore, the Board would favor allowing banks to make direct small business investments that, when aggregated with their indirect investments under present law, would not exceed 10 per cent of capital and surplus. This would afford banks a considerable degree of flexibility in fashioning their small business investment programs, and would increase the aggregate amount that might be invested. However, in order to facilitate the use of this new authority by banks, the Board believes that it is important that the tax advantages applicable to investment in small business investment companies should also be available for direct investment in small business concerns.

H.R. 12666 would also make another significant alteration in the authority of banks and bank holding companies to invest in small businesses. Currently, the 5 per cent of capital and surplus that banking organizations are allowed to invest in small businesses may be so invested only indirectly through the medium of small business investment companies, and a small business investment company as a rule may invest no more than 20 per cent of its capital and surplus in any one small business concern. Thus, the present law has the advantage of insuring some diversification of the total amount of equity capital committed to small business concerns by banks. Allowing direct investments in small business concerns, however, as is proposed by H.R. 12666, would permit banking organizations to invest an additional 5 per cent

of their net worth altogether in a single small business concern, and this amount could conceivably be augmented by indirect investments by a bank in the same concern through a small business investment company. Although the business judgment of bankers and the bill's requirement that an investor not acquire control of a small business concern would reduce the likelihood that a bank or bank holding company would place the entire 5 per cent amount in one small business, the Board believes that in view of the uncertainty associated with investment in small business concerns, the amount that may be invested in any one such company need not be increased five-fold. Instead, the Board recommends that the aggregate investment, direct and indirect, in any one small business concern should not exceed 2 per cent of the bank's capital and surplus, or \$50,000, whichever is greater. Such limitations would be similar to the diversification requirements now applicable to small business investment companies.

The proposed bill would also affect the trust activities of banks by modifying the standard of prudence to which trust fund managers are held. Although this modification will cover only 5 per cent of available trust assets in a particular trust, we are concerned that as written, this legislation would supersede common law and statutory law prohibitions against self-dealing, conflicts of interest and similar potential abuses by trust fund managers. While the Board is not certain that creation of a new fiduciary standard is the preferable method of encouraging additional investment in small businesses, we believe that if this method is adopted, additional language should be added to prevent such potential abuses.

The Board believes that several other provisions of the bill also should be modified to avoid certain problems, and I will briefly enumerate them. First, the Board would not consider it appropriate, and does not expect that it is the bill's intention, to permit a bank to become the general partner of a small business concern. Second, the Board considers it particularly important that banks not acquire control of small businesses in which they invest. For that reason, the bill's provision regarding control of a small business concern should be clarified by providing a standard for determining the existence of control. The Bank Holding Company Act control standards might appropriately be used as a model for such a clarification. Moreover, although present regulations of the SBA may already preclude investment in financial institutions, such as savings and loan associations, the Board wishes to make it clear that it does not believe banks or bank holding companies should be permitted to invest in financial institutions on the basis of this bill. Third, in order to avoid conflict among regulatory agencies, we believe that responsibility for regulation of bank investment in small business concerns should be vested in the relevant bank regulatory agency rather than in the Small Business Administration. Fourth, the present use of "capital and surplus" as a base for computing permissible investment in small business investment companies should be carried over in this bill.

Finally, the Board has a strong concern that the preemption of all Federal and State law by this bill may have unforeseen consequences. If Congress enlarges bank investment authority the Board believes it

would be more appropriate to do so by specific authorization as Congress did in connection with small business investment companies rather than using the phrase currently in the bill, "Notwithstanding any provision of State or Federal law." For example, the authority of State member banks of the Federal Reserve System to purchase shares of small business investment companies is subject to concurrent State authorization and restrictions in the field. H.R. 12666 departs from this principle, however, since its provisions will specifically supersede any conflicting provisions of State or Federal law. The Board believes that, unless Congress finds an overriding national need for different treatment, it would be appropriate to respect the traditional prerogatives of the States to determine and limit the powers of banks chartered by them.

In conclusion, the Board believes that while the goals of H.R. 12666 are desirable, certain modifications of the bill are in order, principally to protect the safety and soundness of the banking system, to encourage bank equity investment in small businesses, to integrate better the bill's provisions with those of existing law regarding small business investment companies, and to reflect traditional State prerogatives with respect to State banks under the dual banking system. If the Subcommittee would find it useful, I will be glad to direct the Board's staff to draft for the Subcommittee's consideration technical amendments regarding any of the points I have raised.

This concludes my ~~presented~~ comments. I hope these comments have been helpful and I ~~will be~~ pleased to try to answer whatever questions you may have. Thank you

