FEDERAL RESERVE BANK OF DALLAS

September 12, 1924.

FINANCING MANUFACTURING ENTERPRISES

To the Member Bank Addressed:

Although the Eleventh Federal Reserve District is essentially an agricultural section, the rapid growth of manufacturing in this section during recent years furnishes convincing evidence that the Southwest has reached that stage in its development where agricultural production is to be definitely supplemented by industrial enterprise as an important factor in the production of wealth. For this reason it is manifest that the financing of manufacturing enterprises must be reckoned with by the banks of this district as a permanent and increasingly important phase of credit extension.

The Federal Reserve Bank of Dallas is not concerned with the manner in which its member banks finance any particular industry, except in the sense that it feels a genuine interest in their welfare and that of the communities which they serve. Having no supervisory powers or duties with respect to the operating policies of its member banks, it does not presume to suggest to them what loans they should grant nor what loans they should deny. Nor does it offer them general advice on credit problems based upon any pretentions to superiority of judgment or wisdom. It does believe, however, that there are times when it can, with entire propriety and a reasonable likelihood of rendering a useful service, point out to its member banks certain courses of action by which they may not only increase the benefits they derive from the rediscount facility of the Federal Reserve System, but also measurably reduce the volume of their avoidable losses. With these objects in view, it is believed that a discussion of industrial credits will prove opportune and helpful.

A study of examination reports and other statistical records indicates that many of our member banks are sometimes hampered, a certain extent by being unable to utilize, for rediscount purposes, a large part of their bills receivable representing advances to manufacturing concerns, due to the fact that the paper either fails to comply with certain principles of eligibility or is not altogether presentable from a credit standpoint, although it may be regarded by the member bank as a profitable and collectible type of paper. This, at times, works an undue hardship upon the bank when occasion arises for obtaining seasonal accommodations from the Federal Reserve Bank, since the member bank's loans to manufacturing concerns are often the principal cause for rediscounting but are often carried in such form or condition that the paper evidencing such loans cannot be utilized directly in rediscount transactions. Thus it becomes necessary for the bank to rediscount an undue proportion of its liquid agricultural or commercial paper in order to take care of the credit needs of the manufacturer.

As a rule the ineligibility of a manufacturer's paper for rediscount is found to be due either to the operation of the legal loan limit or to the capital nature of his line of credit. The subject of "excess loans" has been discussed in a previous letter to our member banks. Our views on "capital loans" have also been fully explained in our circular of February 26, 1924, on "The Use of Credit in 1924". The present discussion, therefore, will be confined to the more important factors that often militate against the acceptability (from a credit standpoint) of certain types of industrial paper.

Assuming that the line of credit does not exceed the legal loan limit, and that it represents a bona fide credit transaction as distinguished from borrowed capital, the next fundamental question that arises is: "Is the firm doing a legitimate and profitable business, free from the taint of speculation? Is its business conducted upon such a basis that its ability to liquidate its short-term obligations is not exposed to other than the normal hazards of its own particular line of business?" Despite the fact that these questions are extremely elementary and involve the first principles of credit extension, there is abundant evidence that these requisites are often disregarded and large lines of credit are extended to a manufacturing concern with little or no inquiry into its method of doing business, such as its policy in dealing with violent competition for the purchase of raw materials or the sale of products. This is particularly true when its line of credit is supported by the individual endorsements or guarantees of its directors.