

LOANS TO INDUSTRY
BY THE
FEDERAL RESERVE SYSTEM

Issued by the
Industrial Advisory Committee
of the
Federal Reserve Bank of Dallas

February 28, 1935

Why Do Federal Reserve Banks Make Advances for Working Capital Purposes?

It is a matter of proper concern to bankers in general that many industrial and commercial enterprises have depleted their working capital during recent years, and in order to maintain pay rolls and procure materials for their operations are in need of such working capital for longer periods than commercial banks have felt warranted in granting, although the banks do have ample funds with which to meet the current short-term requirements of trade and industry. The situation imposes the duty of considering measures of accommodation, which at the same time would present opportunities for legitimate profit by banks willing to cooperate with new credit facilities provided for that purpose.

It was to meet this unusual need of commerce and industry for working capital that Congress, last June, amended the Federal Reserve Act so as to permit Federal Reserve banks to make a substantial volume of credit available through member banks and other financing institutions, or direct to borrowers.

Why Should Bankers Be Interested?

Commercial banks at the present time hold a large volume of deposits for which they cannot easily find profitable use. Obviously it is of the utmost importance to banks in general that employment be found for idle funds at rates which will yield a profitable return.

Under the terms of the amendment to the Federal Reserve Act banks may find employment for some of these funds by supplying the working capital which industry and commerce require without endangering either their solvency or their liquidity. The problem of finding funds for working capital for industry and commerce has thus been facilitated on a basis that is safe and profitable for the banks providing them.

What Are the Specific Advantages to Bankers?

A member bank may now make a loan for working capital purposes and, by paying a reasonable commit-

ment charge, procure from the Federal Reserve bank an agreement to take over the loan at any time within a specified period (which may be extended by mutual agreement) without recourse on the member bank for that portion not guaranteed by it, which may be as much as 80 per cent of the loan. The member bank is, therefore, put in the position of holding an earning asset with a reasonable return which has been made liquid to the extent stated by the obligation of the Federal Reserve bank to repurchase or rediscount it when requested to do so under the terms of the commitment, and which therefore is virtually underwritten by the Federal Reserve bank for the full amount less the member bank's participation, which shall be not less than 20 per cent.

The Terms of the Law

The pertinent parts of the law (Section 13b of the Federal Reserve Act) provide that:

Each Federal Reserve bank shall "have power to discount for, or purchase from, any bank, trust company, mortgage company, credit corporation for industry, or other financing institution operating in its district, obligations having maturities not exceeding five years, entered into for the purpose of obtaining working capital for any such established industrial or commercial business; to make loans or advances direct to any such financing institution on the security of such obligations; and to make commitments with regard to such discount or purchase of obligations or with respect to such loans or advances on the security thereof, including commitments made in advance of the actual undertaking of such obligations. Each such financing institution shall obligate itself to the satisfaction of the Federal Reserve bank for at least 20 per centum of any loss which may be sustained by such bank upon any of the obligations acquired from such financing institution,"

The law also permits Federal Reserve banks to make industrial advances in participation with financing institutions, provided such institutions obligate themselves for at least 20 per cent of any loss which may be sustained.

What Does the Banker Have to Do?

In concrete terms, what the foregoing provisions mean to member banks may be stated as follows:

First: A member bank may make a loan on a reason-

able and sound basis with a maturity not exceeding five years to an established industrial or commercial business for the purpose of supplying working capital.

Second: If the loan is acceptable to the Federal Reserve bank (which should be determined before the loan is made) the member bank may obtain from the Federal Reserve bank a commitment to take over the loan on stated terms at any time within the period of the commitment.

Third: The member bank pays the Federal Reserve bank for this commitment, the amount paid depending principally upon the length of time covered by the commitment.

Fourth: Under the terms of the commitment the Federal Reserve bank will take over the entire loan and relieve the member bank of obligation in connection therewith to the extent agreed to under the commitment. In other words, the member bank may sell or rediscount the loan without recourse to the extent of the Federal Reserve bank's participation, but it must continue under obligation for the remainder; or the member bank may retain in its portfolio its agreed portion of the participation and discount the remainder without liability.

What Conditions Does the Law Impose?

The loans are to have maturities not exceeding five years, and are to be made for the purpose of furnishing working capital to established industrial or commercial businesses.

In the regulations prepared by the Federal Reserve Board to implement the provisions of the amendment, no additional restrictions have been imposed. Attempts to supply technical definitions of such terms as "working capital" and "established commercial or industrial business" have been avoided. The law was passed as part of an effort to meet an emergency, and not to alter the basic principles upon which commercial banks and Federal Reserve banks are to operate. Accordingly the desire has been to interpret and administer it in the liberal spirit in which it was drawn and adopted, and not to rule out certain classes of loans in advance because they were essentially different from those that commercial banks have been accustomed to make.

Are Loans Large or Small?

There is no discrimination by the Federal Reserve banks against loans of small amount. On the contrary, the amendment was intended particularly for the benefit of small industries, and in line with that intention the Federal Reserve System has encouraged loans to small enterprise.

How Are the Loans Classed by the Supervisory Authorities?

As the loans may have long maturities many banks have been reluctant to take them because of possible criticisms by bank examiners and supervisory authorities. In that connection it may be stated that the Comptroller of the Currency and the Federal Reserve Board

have issued instructions to their examiners that industrial loans which have long maturities, but which are covered by commitments from the Federal Reserve banks, are not to be classified as "slow." Instructions have also been given to examiners not to include advances covered by commitments in the class of loans subject to criticism, and not to classify as subject to criticism the portion of such advances not covered by commitments, except with respect to apparent losses.

Under a recent ruling by the Comptroller of the Currency national banks are authorized to make industrial advances exceeding the 10 per cent limitation imposed by Section 5200 of the Revised Statutes on loans to one person, provided the Federal Reserve bank has granted a commitment to take over from it at least as much of such loan as is in excess of the 10 per cent limitation. This enables national banks in many instances to take care of their customers' needs for working capital more effectively than would otherwise be possible.

Who Passes on These Loans?

The special nature of the industrial advances is indicated by the fact that the law established an Industrial Advisory Committee in each Federal Reserve district for the purpose of aiding the Federal Reserve banks in carrying out the industrial loans provisions. Each member of these committees is a person actively engaged in some industrial pursuit. Each application for an industrial loan or commitment is passed on first by the Industrial Advisory Committee and is then transmitted with the Committee's recommendation to the Federal Reserve bank for final action.

What Security Is Demanded?

Obviously there must be a sound basis for the loans. There must be grounds for a reasonable expectation that the enterprise will succeed if it gets the credit for which it applies.

Loans made thus far differ widely as to security accepted. Any security with intrinsic value will be considered—mortgages against land, buildings and machinery, or lawful pledge of raw material and other personal property.

Direct Loans to Industry

Besides authorizing the Federal Reserve banks to make commitments to take over industrial loans and advances and to participate in loans with financing institutions, the law also authorizes the Federal Reserve banks to make loans direct to industry. On this point the law reads as follows:

"In exceptional circumstances, when it appears to the satisfaction of a Federal Reserve bank that an established industrial or commercial business located in its district is unable to obtain requisite financial assistance on a reasonable basis from the usual sources, the Federal Reserve bank, pursuant to authority granted by the Federal Reserve Board, may make loans to, or purchase obligations of, such business, or may make commitments with respect thereto, on a reasonable and sound basis, for the purpose of providing it with working capital, but no obligation shall be acquired or commitment made hereunder with a maturity exceeding five years."

Most of the working capital loans thus far made by the Federal Reserve banks have been direct to borrowers. Any established industrial or commercial business in need of additional working capital which it cannot obtain from the usual sources and to which a loan can be made on a sound and reasonable basis, is eligible for a direct loan from the Federal Reserve bank. The terms governing direct loans to industry are similar to those governing advances through financing institutions.

Are the Federal Reserve Banks in Competition with Member Banks?

The provision that loans may be made direct to industry does not put the Federal Reserve banks in competition with member banks, as it authorizes such loans to be made "in exceptional circumstances" only, and when the borrower "is unable to obtain requisite financial assistance on a reasonable basis from the usual sources." It was apparently the intent of Congress that no business in need of working capital and warranted in getting it should be left without other recourse if unable to obtain the needed funds from the usual sources.

What About Non-Member Banks and Other Financing Institutions?

Although the procedure for procuring commitments on

industrial loans is described herein from the point of view of member banks primarily, under the terms of the law the same facilities and procedure are available to non-member banks and other financing institutions.

How Much Money Is Available?

The total amount of industrial loans and commitments of the twelve Federal Reserve banks outstanding at any one time is limited by law to approximately \$280,000,000. The maximum available for that purpose in this district is approximately \$8,000,000.

What Is the First Step?

The first step for the member bank or other financing institution which desires to make industrial loans and to procure commitments thereon, is to make inquiry of the Federal Reserve bank. Inquiry may be made either as to the procedure in general or with respect to a specific loan.

The purpose of the industrial loan amendment is to assist enterprise and encourage employment and the Federal Reserve banks are anxious to carry out the spirit and purpose of Section 13b. Therefore, there should be no reluctance on the part of any member bank or other financing institution to make inquiry with respect to the policy and procedure of making these loans, or to discuss any suggested or contemplated loan.

INDUSTRIAL ADVISORY COMMITTEE
FOR THE
ELEVENTH FEDERAL RESERVE DISTRICT

Clarence Ousley, <i>Chairman</i>	President, Globe Laboratories, Fort Worth, Texas.
T. M. Cullum.....	President, Cullum and Boren Company, Dallas, Texas.
Lewis R. Ferguson.....	Vice-President and General Manager, Lone Star Cement Co., Dallas, Texas.
Will B. Marsh.....	President, Chronister Lumber Co., Dallas and Forest, Texas.
Charles R. Moore.....	President, Austin Bridge Company, Dallas, Texas.

All inquiries relative to loans to industry should be addressed to the Federal Reserve Bank of Dallas, under whose authority this circular is issued.