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Federal Funds and Country Bank Reserve Management

Small Business Investment Companies: Promises and Perils

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. . . Participation in the federal funds market has enabled country banks to adjust their reserve positions easily while operating with lower excess reserves and correspondent balances.

Small Business Investment Companies: Promises and Perils

. . . Major changes in the S.B.I.C. Act could enable the program to attain its yet unrealized potential.

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Federal Funds and Country Bank Reserve Management

by Mark H. Willes

When a country bank decides to enter the federal funds market—and more of them are doing so every day[1]—this decision has significant implications for other bank operating policies. In the Third Federal Reserve District the typical country bank operating in the federal funds market holds significantly lower excess reserves and correspondent balances than banks not in the market. When it adjusts its reserve position, it generally relies more on federal funds than on borrowing from the Federal Reserve, the purchase or sale of securities, or changes in its correspondent balance.

EXCESS BALANCES

Table 1 shows the average amount of excess reserves held daily by a typical country bank in various size classes in the Third District over the 34 reserve periods between February, 1966 and May, 1967.[2] Excess reserves held by banks that participated in the federal funds market during the period were considerably lower than the excess reserves held by banks that did not participate. In fact, the differences are striking. Banks not in the market held excess reserves in amounts ranging from more than three to over six times as large, on the average, as those banks that did buy or sell federal funds one or more times during this period.

Table 1

AVERAGE EXCESS RESERVES HELD BY COUNTRY BANKS IN THE THIRD FEDERAL RESERVE DISTRICT, FEBRUARY 3, 1966 - MAY 24, 1967

Deposit size (Millions $)	Banks in federal funds market	Banks not in federal funds market
0 - 5	$13,000	$ 43,000
5 - 10	12,000	75,000
10 - 25	21,000	91,000
25 - 50	23,000	116,000
50 - 100	47,000	—*
over 100	59,000	—*

*All banks in the federal funds market.

Table 2 shows the same comparison for average correspondent balances held during the period. Again, the differences are impressive. Banks not in the federal funds market held correspondent balances in amounts ranging from over 60 per cent to as much as 258 per cent larger on average than participating banks. The differences in absolute dollar amounts are even more striking, ranging from an average of

[1] *See, for example, "Federal Funds During Tight Money,"* Business Review, *Federal Reserve Bank of Philadelphia, November, 1967.*

[2] *This period was selected for study because it spans the "crunch" of 1966. It therefore provides information on bank behavior during periods of tight money (summer, 1966) as well as periods of less reserve pressure (spring, 1966 and 1967). Also, because it is the same period covered in the study cited in the first footnote, it was possible readily to use some of the results of that study to aid in this analysis and to have the results of both studies comparable.*

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Table 2

AVERAGE CORRESPONDENT BALANCES HELD BY COUNTRY BANKS IN THE THIRD FEDERAL RESERVE DISTRICT, FEBRUARY 3, 1966 - MAY 24, 1967

Deposit size (Millions $)	Banks in federal funds market	Banks not in federal funds market
0 - 5	$ 102,000	$ 165,000
5 - 10	211,000	544,000
10 - 25	549,000	1,229,000
25 - 50	1,244,000	2,152,000
50 - 100	2,634,000	— *
over 100	7,453,000	— *

*All banks in the federal funds market.

$63,000 for the smallest banks to an average of over $900,000 for banks with deposits between $25 million and $50 million.

Since these results relate to small as well as large banks, they demonstrate clearly how the federal funds market has made it possible for banks of all sizes to reduce significantly the amount of funds they hold in nonearning form and for which they feel they receive inadequate compensating services.[3]

DEMAND FOR FUNDS

Although a few banks, mostly those which are accommodating banks, use the federal funds market as a "permanent" source of funds, most banks entering the market to purchase federal funds do so for relatively short periods of time to cover temporary reserve deficits. The customary alternatives for these banks are borrowing from the Federal Reserve, drawing down correspondent balances, and the sale of securities.

Federal funds and borrowing from the Fed

Member bank borrowing at the discount window has attracted more interest among economists and policymakers than any other form of reserve adjustment by banks. This is probably attributable in part to the fact that such borrowing has a direct effect on bank reserves and the potential supply of money and bank credit, and therefore is directly related to monetary policy.

One way of looking at member bank borrowing is to regard bankers as optimizing businessmen who try to obtain needed funds from the least-cost source. Included in the cost calculations are transaction costs, interest costs, and the disutility associated with any excessive or "inappropriate" borrowing from the point of view of the lender or the borrower.

In the Third District, borrowing from the Federal Reserve usually can be accomplished by telephone, followed by a confirming promissory note and a few bookkeeping entries. Federal funds transactions with an accommodating correspondent bank usually can be carried out in a similar way. Although borrowing from the Federal Reserve must be supported by collateral, most federal funds transactions are unsecured. On the other hand, it may be possible to secure funds from the Federal Reserve later in the day than in the federal funds market. Consequently, transaction costs in the Third District, including a convenience factor, may in some cases favor federal funds, in others borrowing from the Federal Reserve. In general, however, the differences in most cases are minor and there is little reason to expect banks to exhibit a strong preference over time for one of these forms of reserve adjustment over the other on the basis of transaction costs.

Between February, 1966 and May, 1967,

[3] *Differences in average excess reserves and correspondent balances held by participating and non-participating banks may not be attributable solely to the activities of participating banks in the federal funds market. The effect of entry into this market may therefore be somewhat overstated. This error is likely to be small, however.*

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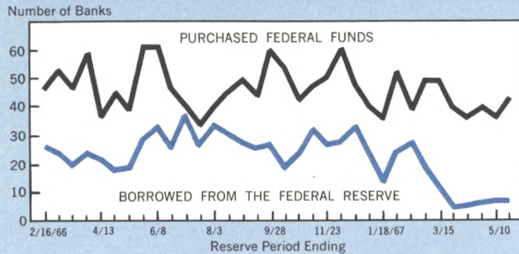
Chart 1

NUMBER OF THIRD DISTRICT COUNTRY BANKS WHICH PURCHASED FEDERAL FUNDS AND BORROWED FROM THE FEDERAL RESERVE, 2/3/66-5/24/67



however, country banks in the Third District consistently preferred buying federal funds to borrowing at the discount window. Chart 1 shows the number of those banks which were net purchasers of federal funds in each of the 34 reserve periods between February, 1966 and May, 1967. It also shows the number that borrowed from the Federal Reserve. The number of banks using the federal funds market was invariably higher than the number using the discount window, frequently being more than twice as high.

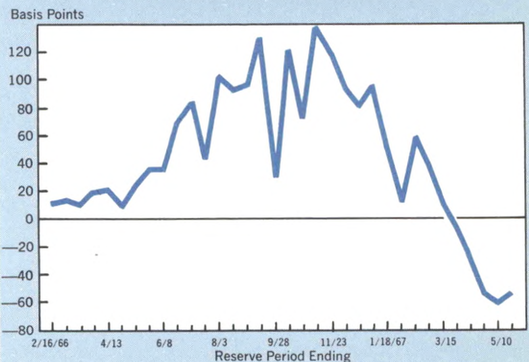
A similar impression is obtained by noting what individual banks did over the period as a whole. Of the 237 country banks that either purchased federal funds or borrowed from the Federal Reserve, 113 purchased federal funds exclusively and only 71 relied solely on the discount window. Of the remaining fifty-three that used both the federal funds market and the discount window sometime during this 16-month period, a majority used the federal funds market more than the discount window.

This preference for federal funds cannot be explained by differences in interest costs. Other things being equal, a federal funds rate higher than the discount rate should lead banks to prefer borrowing from the Federal Reserve. In fact, banks exhibited a strong preference for federal funds even though the federal funds rate was higher than the discount rate for all except the last four reserve periods (see Chart 2).

The reason most banks prefer federal funds to borrowing from the Federal Reserve is probably the high disutility they associate with the latter. A few banks still consider borrowing from the Federal Reserve a sign of weakness. To them it is a matter of pride that they never go to the discount window. More generally, the reluctance of banks to borrow has been encouraged over the years by Federal Reserve surveillance of member bank borrowing. Through official guidelines, informal discussions, and experience at the window, bankers have learned that such borrowing is a privilege not to be abused. This may not always be the case, but it was during the period under investigation. As a result, in order to avoid or reduce the chance of incurring the discipline of the discount window, many banks carry out some or all of their

Chart 2

FEDERAL FUNDS RATE MINUS THE DISCOUNT RATE, RESERVE PERIOD AVERAGES, 2/3/66-5/24/67



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short-run reserve borrowings in the federal funds market.

This does not mean that there are no reluctance-surveillance effects in the federal funds market. Some banks are reluctant to buy federal funds because they are unfamiliar with the market or feel that this form of borrowing is inappropriate. And the large accommodating banks often establish implicit or explicit limits on the amount they will sell to an individual bank, how frequently, and under what conditions. Nevertheless, the reluctance-surveillence effects associated with the purchase of federal funds are apparently much smaller generally than those associated with borrowing from the Federal Reserve, and a majority of banks in the Third District have gone to the federal funds market to limit their activity at the discount window.

Other adjustment alternatives

In addition to purchasing federal funds or borrowing from the Federal Reserve, a bank in need of reserve funds can sell securities or reduce its correspondent balances. When country banks in the Third District buy federal funds, they generally cover a majority of their reserve needs (deficit) in that market.

For a given reserve period, a bank's reserve needs can be calculated after the event by adding together all of the funds it obtained from the purchase of federal funds, borrowing from the Federal Reserve, the sale of securities,[4] and the drawing down of correspondent balances and then subtracting any excess reserves. This was done for each country member bank in the Third District for each period in which it was a net purchaser of federal funds. Three of these reserve periods—those ending May 25 and September 28, 1966 and May 24, 1967—were then selected and simple correlation coefficients were calculated to see how closely a bank's reserve need was related to each of its components.

The correlation between the amount of federal funds purchased and the amount of the reserve need is quite high. Approximately 58 per cent of the variation in the reserve need was associated with the purchase of federal funds. Participating banks clearly relied heavily on federal funds to help cover their reserve needs. These banks also relied heavily on the sale of securities. Approximately 50 per cent of the variation in the reserve need was associated with changes in securities holdings.[5]

The correlation between the reserve need and the other components is low. Only 3 per cent of the variation in the reserve need was associated with borrowing from the Federal Reserve and only 2 per cent with changes in correspondent balances. This first result is consistent with the discussion earlier concerning banks preference for the use of federal funds over borrowing at the discount window. The low correlation between the reserve deficit and changes in correspondent balances suggests that banks which purchase federal funds do not use their correspondent balances much as a buffer to supply reserves.[6]

[4] *It could be argued that only changes in holdings of short-term securities should be included in the analysis. Because breakdowns in maturity are not reported at frequent intervals by country banks, holdings of total U.S. Government securities were used. These figures are provided twice each month by all country member banks. In the analysis that follows, securities holdings for a given reserve period were obtained by prorating these semimonthly figures among the relevant reserve periods.*

[5] *The variation in the reserve deficit accounted for by the purchase of federal funds and changes in securities holdings together is* not *108 per cent. These latter two variables themselves are slightly correlated (—.09) so that to a small extent they are both measuring the same thing. Taking account of this would reduce their combined effect to less than the maximum 100 per cent of the variation in the reserve deficit that needs to be explained.*

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SUPPLY OF FUNDS

Country banks often have excess reserves and are therefore in a position to enter the federal funds market on the supply side. Banks that do sell federal funds typically do so frequently. Of the 249 country banks in the Third District that sold federal funds between February, 1966 and May, 1967 almost 20 per cent did so in 31 or more of the 34 reserve periods, and over 60 per cent did so in more than half of the reserve periods.

When banks do sell federal funds, a majority of them channel most of their excess reserves into that market. If it is assumed that a bank can invest its excess reserves by selling federal funds, buying securities, or increasing its correspondent balances, then before making any of these adjustments it has total available excess reserves equal to the amount of funds invested in each of these alternatives plus any remaining excess reserves.

Simple correlation coefficients between available reserves and each of its components were calculated for the reserve periods ending May 25 and September 28, 1966 and May 24, 1967 for banks that were net sellers of federal funds in those periods. Over 70 per cent of the variation in available reserves was associated with the variation in federal funds sold. Changes in securities holdings ran a distant second, accounting for only 25 per cent of the variation in available reserves.[7] Changes in correspondent balances showed practically no relationship with the amount of available reserves, explaining less than 1 per cent of the variation of the latter. This again suggests that banks which use the federal funds market cease to use correspondent balances as buffers from which they make reserve adjustments. Apparently, they try to reduce them to minimum levels and hold them there.

IMPLICATIONS

When a bank decides to enter the federal funds market, this decision has significant implications for other bank operating policies. Once initiated into the federal funds market, most banks use it frequently, and for a large proportion of their reserve adjustments. Banks generally prefer to buy federal funds rather than borrow at the discount window, and sell or buy federal funds rather than buy or sell securities or make changes in their correspondent balances.

The fact that participating banks have been able to carry out such a large proportion of their reserve adjustments in the federal funds market is an indication of its importance. It has done more than provide individual banks a convenient way of making reserve adjustments. It has encouraged and allowed banks to change their money position targets and strategies with significant implications for individual banks and for the entire system. The federal funds market has enabled banks to squeeze down excess reserves and correspondent balances. This means higher earnings for many banks.[8]

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[6] *This does not imply that such balances are not extensively used for other purposes. They serve as compensation for services received from the correspondent bank, are the account through which checks may be cleared, and so on. In fact, the correspondent account is usually the conduit through which most country banks purchase and receive federal funds from their accommodating bank. What the above result means, then, is that while there may be a lot of activity in the correspondent account (large amounts of funds flowing through the conduit), its average level (the size of the conduit) does not change much from period to period in response to changes in the bank's need for additional reserves.*

[7] *The correlation between federal funds sold and changes in securities is only —.03, indicating their movements are essentially independent of each other.*

[8] *See "Federal Funds During Tight Money" for some figures showing the percentage of net operating income earned on the sale of federal funds by country banks in the Third District.*

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It also means higher costs and/or lower correspondent balances for those larger banks that hold the correspondent balances of country banks and must now either buy the "excess" correspondent balances as federal funds or see them transferred to another accommodating bank. While accommodating banks typically have higher costs and smaller amounts of correspondent balances from each bank, the total funds available to them is increased. They not only buy excess correspondent balances (some of which may be funds they already had), but they are also able to buy the excess reserves of their correspondent banks. The result is a more nearly complete utilization of bank funds,[9] and perhaps improved allocation of these funds as their transfer from one area to another is facilitated.

Perhaps the most significant consequence of bank participation in the federal funds market is the implication this has for monetary policy. Since banks in the federal funds market economize on reserves, as more and more banks continue to enter the federal funds market, the banking system is probably becoming increasingly sensitive to changes in monetary policy. With fewer excess reserves and "excess" correspondent balances to absorb changes in reserves, more banks, both small and large, are more directly and immediately affected by changes in the availability and of cost of reserves. Consequently, there is likely to be less delay in the response of the banking system to changes in monetary policy. Reserves supplied by the Federal Reserve are either used by the receiving banks or quickly transferred through the federal funds market to other banks that will. Conversely, if the Federal Reserve restricts the supply of reserves, banks must make a rapid adjustment because they do not have excess reserves to draw on. As a result, the actions of the Federal Reserve are transmitted more quickly through the banking system. The possibility of slippage, of lags in the adjustment process, is reduced, thereby increasing the ability of the monetary authorities to make timely changes in monetary policy.

[9] *This process is not yet complete. Every bank that could participate in the federal funds market does not yet do so, either because it chooses not to or because the market in its area is not yet sufficiently well developed to make it possible. If all banks did participate and as a result held excess reserves of $21,000 on the average as did the participating banks in this study, then on any given day all member banks would hold a total of about $128 million of excess reserves. Between May, 1967 and April, 1968, member banks held an average of $361 million. Consequently, it appears that continued expansion of the federal funds market could well result in a considerable further reduction of excess reserves.*

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Small Business Investment Companies: Promises and Perils

by Susan R. Robinson

Ten years ago, Congress passed the Small Business Investment Company Act. This Act established a new industry—one designed to fill a gap in the financial framework of the United States by providing venture capital to small businesses. The evolution of the S.B.I.C. industry during the past ten years has been erratic, and the future of the program is still in doubt. But even as the S.B.I.C. program floundered, the social desirability of more effective financing of small business ventures increased. Policymakers concerned with problems of urban economic and social development have begun to emphasize the role of private enterprise in providing jobs, incentives, and respect for large segments of the population. It is widely believed that economic vitality of small businesses plays a significant role in determining the economic viability of a region such as the Philadelphia area, as well as the whole country, by helping maintain competition, pioneering new products and processes, and providing an opportunity for the individual to be independent and creative.

Who gets S.B.I.C. help

Only small business concerns, as defined by the Small Business Administration, can receive funds from S.B.I.C.'s. They must have assets less than $5 million, net worth less than $2.5 million, and net average income after taxes of less than $250,000 in the preceding two years. Even if a firm does not meet these criteria, it still may be judged "small" relative to other firms in its industry. These limits are not confining, because a large percentage of all businesses, or over 5 million firms, are small by this definition.

Many small firms usually are able to obtain short- and intermediate-term loans from commercial banks and other sources, as well as various types of trade credit. But small business concerns frequently have difficulty raising adequate venture capital and obtaining long-term loans. Since small firms generate few funds

WHAT ARE S.B.I.C.'S?

A small business investment company is a private corporation with public backing, including loans from and supervision by the Small Business Administration, an agency of the Federal Government. It must have a minimum of $150,000 in capital and paid-in surplus in order to receive a license from the SBA, although the agency has discretion to require larger capitalization if it feels this is necessary for profitable operation. The S.B.I.C. can receive up to $10 million of fully subordinated 15-year loans at relatively low interest rates from the SBA. Congress has also given S.B.I.C.'s special tax advantages: long-term and short-term losses on its shares can be deducted from taxable income, while capital gains are taxed at the favorable capital gains rate.

In exchange for this, an S.B.I.C. is expected to provide equity capital, as well as loans, to new and small businesses.

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internally, relative to their needs, outside financing is required for expansion purposes. However, they do not have access to the national capital markets and many individuals, commercial banks and other financial institutions are reluctant to invest in small businesses or to lend to them on a long-term basis. Small businesses generally are more risky than large ones—they have, for example, a worse record of loan defaults and discontinuances, lower credit ratings, less satisfactory financial ratios such as profit to net worth and working capital to assets. Management of small businesses is often less experienced than that of large firms, and inadequate attention is usually paid to management succession. Communication is also a problem for a small business—there is no easy way to seek out potential investors. This lack of venture capital and long-term loans is the financial gap that S.B.I.C.'s are designed to fill.

There is not, of course, a complete void. In Philadelphia, for example, there are a few organizations, both profit and non-profit, which provide venture capital for small businesses. They include the Southeastern Pennsylvania Economic Development Fund, Job Loan Corporation, Philadelphia Industrial Development Corporation and, at the state level, the Pennsylvania Industrial Development Authority. The impact of these organizations is just beginning to be felt, however, and there is much that a strong S.B.I.C. program can contribute.

Ideally, an S.B.I.C. seeks to buy shares in a fairly new firm which has growth potential. The firm is probably too risky to attract capital from banks, too small to go public, and too large to be financed by the owners' personal resources. In the ideal situation, the S.B.I.C. also provides advice and possibly loans if the need arises, and hopes to recover its investment when the firm eventually sells shares of stock to the public.

S.B.I.C.'s have been criticized for their investment policies. For example, some companies are reluctant to invest their funds in anything except highly marketable securities, and many confine themselves to established firms. There has been an emphasis on loans rather than on investment in stock, which means a heavy debt burden for small businesses. Philadelphia S.B.I.C.'s have an even greater percentage of gross loans and investments in the form of loans than the average for all S.B.I.C.'s in the United States—88 per cent in September, 1967, vs. about 52 per cent. There has also been a widespread emphasis on real-estate investment which is not encouraged by the Act. In short, many S.B.I.C.'s have not been doing what they were set up to do and there has been severe criticism of S.B.I.C.'s from both inside and outside the program.

How the S.B.I.C. program evolved

Because of risks in financing small business and because no one was certain how Government financing and supervision of S.B.I.C.'s would work out, there was no immediate stampede to set up S.B.I.C.'s after the Act was passed in 1958. In late 1959 and early 1960, however, the publicly owned stocks of several large S.B.I.C.'s began to perform very well. They became popular securities in a very speculative market, and were bid up to unreasonably high levels. This market behavior attracted attention of promoters and prompted the formation of many new S.B.I.C.'s. Unfortunately, when stock prices plummeted in 1962, S.B.I.C. issues fell sharply and the industry as a whole became less attractive to both investors and promoters. The flow of new capital into the program was reduced to a trickle.

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As memories of 1962 faded, the industry settled into a more normal period of growth, but by the mid-1960's it had become evident that the S.B.I.C. program still faced numerous perils. Many observers felt that the average S.B.I.C. was too small to be effective; as of September, 1967, capital plus paid-in surplus for the average S.B.I.C. was $750,600. Problems of size were of great concern in Philadelphia because capital plus paid-in surplus of the dozen area S.B.I.C.'s averaged about $500,000—only two-thirds of the national figure.

Moreover, there was a serious lack of experienced managers among S.B.I.C.'s, even though the high-risk nature of the business demanded talent and experience. Also, there were instances of fraud as unscrupulous persons were attracted by the prospect of generous amounts of low-interest Federal loans.

The SBA recognized that some companies were engaged in "illegal and unethical practices."[1] An investigation of all S.B.I.C's two years ago revealed that over 350 S.B.I.C.'s—about half of those licensed—had violated federal regulations. The abuses uncovered and the general failure of the S.B.I.C. program to fulfill its promises prompted Congress to amend the 1958 Act in an attempt to make the S.B.I.C. program more efficient and effective.

A new ball game

New amendments to the Small Business Investment Company Act which took effect in January, 1968, coupled with substantial strengthening of supervisory activities of the Small Business Administration during the past two years, have changed the rules of the game.

[1] *Small Business Administration,* 1966 Annual Report *(Washington, D.C.: U. S. Government Printing Office), p. 22.*

Because the SBA found larger companies were more successful, one of the most important new rules is designed to induce S.B.I.C.'s to increase their capitalization by liberalizing SBA loan policies—particularly for S.B.I.C.'s having capital and surplus in excess of $1 million. In the past, S.B.I.C.'s could receive loans from the SBA equal to their capital and paid-in surplus. Now they can receive $2 in loans for every $1 of capital and paid-in surplus up to $1 million, and $3 for every $1 in excess of $1 million. There is a limit of $10 million in SBA loans, so that a "fully loaned" S.B.I.C. with over $3.7 million in capital and paid-in surplus cannot qualify for additional SBA loans by increasing capital.

An important new requirement for receiving "three-for-one" SBA loans is that the S.B.I.C. have 65 per cent of its investment portfolio in venture capital financing of small businesses. This requirement will, of course, keep an S.B.I.C. from accumulating funds without making any investments. In the past, many S.B.I.C.'s in the Philadelphia area have been extremely liquid—in fact, one publicly owned S.B.I.C. based in Philadelphia had every dollar of assets in cash or U.S. Government securities as of September 30, 1967.

Other major changes in the Act attempt to bring diversification of investments. One section states that an S.B.I.C. may not have more than one-third of its portfolio in firms of the same Major Group of the Standard Industrial Classification, such as building construction or food stores. Because these groups are fairly broad, some Philadelphia S.B.I.C.'s have complained that this rule could force them to give up profitable opportunities for investment. However, since some of the appeal of an S.B.I.C. to investors is its "miniconglomerate" character,

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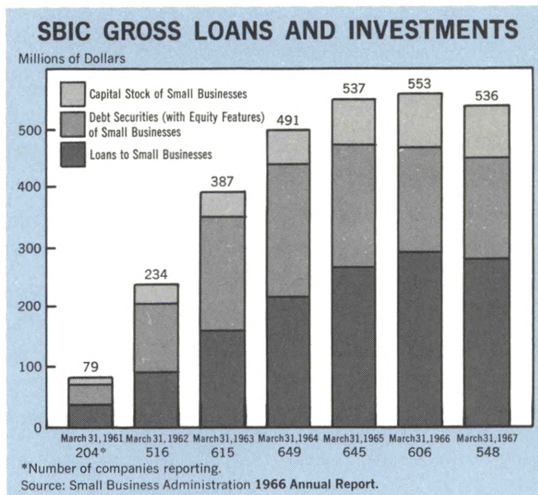
this rule is not necessarily detrimental.[2] Another new rule prevents an S.B.I.C. from investing more than 20 per cent of its capital and paid-in surplus in a single firm. This, too, will force diversification of the S.B.I.C.'s interests. Still another recent rule specifically forbids investment in unimproved real estate which is not in the process of development. This should help end real-estate speculation by S.B.I.C.'s and encourage them to channel more funds into small businesses.

Another important change may cause an increase in the amount of funds potentially available to S.B.I.C.'s: commercial banks may now invest up to 5 per cent of their capital and surplus in the stock of an S.B.I.C. rather than only 2 per cent under previous rules. But banks will no longer be allowed to control over 49 per cent of a single S.B.I.C. In the past, bank-affiliated S.B.I.C.'s have been among the most successful.[3] Hopefully, even though new S.B.I.C.'s cannot be wholly owned or controlled by banks, they will continue to have profitable relationships with commercial banks.

Impact of monetary conditions

Success of the S.B.I.C. program depends not only on regulatory changes but also on the general economic climate. For example, it is clear that periods of prosperity are good for small businesses and therefore S.B.I.C.'s. But a viable S.B.I.C. program may also help shape economic conditions. The continued flow of new capital from S.B.I.C.'s into the income stream through small businesses during recessions may help somewhat to spur economic recovery. Although



*Number of companies reporting.
Source: Small Business Administration **1966 Annual Report.**

the volume of such investment may be quite small in comparison with aggregate economic variables, at the margin it could be a positive force helping stimulate economic activity.

The possible effects of monetary policy on operations of S.B.I.C.'s are not yet clear. The original S.B.I.C. Act received a significant push towards passage when it appeared that small businesses felt disproportionately harsh effects from tight money in 1957. It was hoped that S.B.I.C.'s, because of their SBA financing, would help supply funds to small firms even when money was scarce. The success of this plan has not yet been demonstrated, mainly because we have not had adequate opportunities to observe S.B.I.C.'s during tight money. Although there have been three periods of monetary restraint (in 1959, 1966, and 1968) since the program began, marked changes in the S.B.I.C. program during each period have made it difficult to test for effects of tight money. During 1959 the program was just getting off the ground; in 1966 the SBA administrative "purge" was under way; and in 1968 the new amendments took effect. Nevertheless, data for 1966 as well as

[2] *Elizabeth M. Fowler, "Personal Finance: Investment Units,"* New York Times, *December 21, 1967, p. 55.*

[3] *S. J. Flink,* The Role of Commercial Banks in the S.B.I.C. Industry *(New York: American Bankers Association), 1965.*

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responses to a recent survey of Philadelphia S.B.I.C.'s can be used to get some idea of the effects of tight money on capital accumulation, loans, and investments of S.B.I.C.'s.

S.B.I.C.'s attempting to raise capital during a period of tight money would experience considerable difficulty because lenders and investors generally would not place most S.B.I.C.'s near the top of the list of possible recipients of funds when money becomes scarce. The feeling is that most S.B.I.C.'s are too small and that their investments in small business are especially subject to shrinkage because of small business failures during tight money. However, our survey revealed that most established S.B.I.C.'s tend to raise capital infrequently and are very flexible in their plans—that is, attempts to raise capital can be speeded up or postponed in order to avoid tight money periods. But a prolonged period of monetary stringency could keep new S.B.I.C.'s from being formed; could curtail capital raising by larger S.B.I.C.'s; and could decrease the effectiveness of the SBA's drive to increase capitalization of each S.B.I.C. to at least $1 million.

S.B.I.C.'s also might not be able to increase or maintain their profit margins during tight money. Since all their loans and most of their investments are made for at least five years and since they are not highly marketable, S.B.I.C.'s could only shift funds into higher-yielding loans or investments as existing commitments matured.

But tight money could also help S.B.I.C.'s by creating better business for them. For example, the hypothetical X Company approaches a major bank for a loan during a period of tight money. Although the bank considers X an excellent candidate for a loan, all its funds available at the time are being used to accommodate larger and older clients. The bank refers X to the A.B.S.B.I.C., which is happy and also able to lend to X. Some Philadelphia S.B.I.C.'s reported securing better-quality clients as a result of tight money.

Because S.B.I.C.'s receive a large part of their investable funds from the Government, they should be more insulated from both decreasing availability of money and rising interest rates than most other financial institutions. Of course, they would have difficulty raising capital, but for every $1 they could raise, the S.B.I.C.'s would receive $2 or even $3 in SBA loans. So, on the basis of limited observation, it seems that tight money brings curses as well as blessings for S.B.I.C.'s. Just what the net effect of restrictive monetary policy is can be determined more precisely only after we have additional observations of tight money coinciding with stability in the S.B.I.C. program.

Prospects for the future

Will S.B.I.C.'s become a viable, dynamic force in the financial arena or will they fail to grow and mature? Certainly, the S.B.I.C. program has had a rough infancy and childhood. But the purges and legislative changes of the past two years have excised many marginal S.B.I.C.'s from the program. Observers of the industry feel that several new developments of the past two years are likely to determine whether S.B.I.C.'s will fulfill the original aims of the Act or whether some alternative means of financing small business must be found.

There are already some encouraging signs that performance of the industry as a whole is improving. Between 1962 and 1967, S.B.I.C. assets grew 38 per cent, and gross loans and investments jumped 130 per cent, as shown in the chart. In the year ended March 31, 1966, the industry showed an over-all profit for the

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first time. And profits have continued to grow—from $10.7 million at that time to $17 million for the year ended September 30, 1967. Reflecting growth in profits, the value of the price index of publicly owned S.B.I.C. stocks, published by Stanley M. Rubel, has been climbing. It doubled in 1967, reaching a post-1961 high. At the end of June, 1968, it was 18.9 as opposed to a low of 6.9 in December, 1966. Some firms have watched their shares double since 1966, but prices in general have not approached inflated levels of 1961. Philadelphia S.B.I.C.'s also made a profit last year on average. Of the 12 Philadelphia S.B.I.C.'s reporting for both 1966 and 1967, eight showed a profit, and average rate of return on assets was 2.25 per cent. Of course, encouraging stock price and profit performance do not necessarily mean S.B.I.C.'s are fulfilling their promises, but they are an indication that S.B.I.C.'s are growing more viable.

So, perhaps at least some of the perils which faced the S.B.I.C. program are being overcome, and perhaps the promises of the program will be realized in increasing measure. Philadelphia needs viable, active, aggressive S.B.I.C.'s to help fund small businesses with potential and add to the economic vitality of the area.

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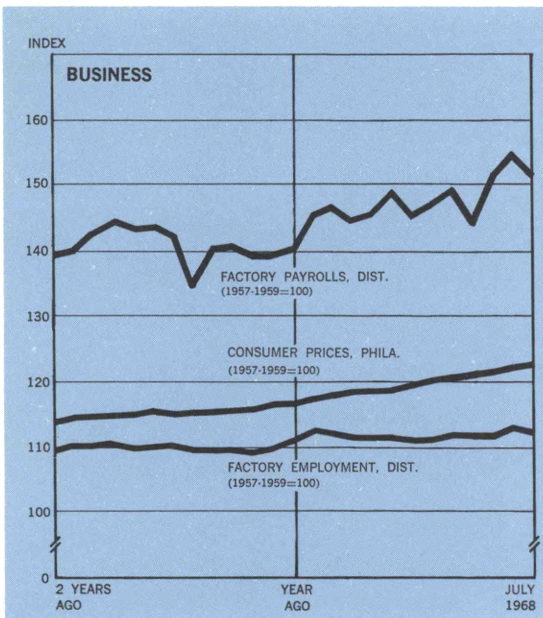
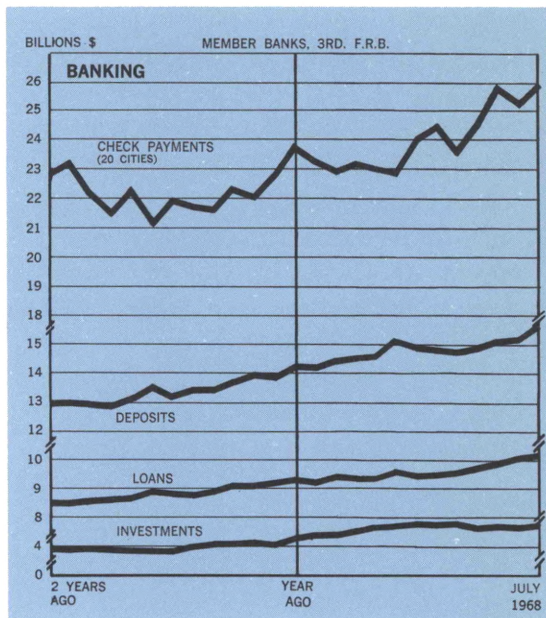
FOR THE RECORD . . .





SUMMARY	Third Federal Reserve District			United States		
	Per cent change			Per cent change		
	July 1968 from		7 mos. 1968 from	July 1968 from		7 mos. from 1968
	mo. ago	year ago	year ago	mo. ago	year ago	year ago
MANUFACTURING						
Production	....	....	....	− 6	+ 6	+ 4
Electric power consumed	+ 1	+13	+10	....	....	....
Man-hours, total*	− 2	+ 2	+ 1	....	....	....
Employment, total	− 1	+ 1	+ 2	....	....	....
Wage income*	− 2	+ 8	+ 7	....	....	....
CONSTRUCTION**	−21	+ 1	+20	+ 7	+18	+13
COAL PRODUCTION	− 3	+14	0	−11	+ 5	+ 1
BANKING						
(All member banks)						
Deposits	+ 3	+10	+10	+ 2	+ 9	+ 9
Loans	+ 2	+10	+ 9	+ 1	+10	+ 8
Investments	+ 1	+12	+16	+ 2	+ 9	+13
U.S. Govt. securities	− 1	+ 3	+ 9	+ 4	+ 5	+ 7
Other	+ 2	+20	+24	+ 1	+12	+18
Check payments***	+ 2†	+ 9†	+11†	+ 3	+22	+17
PRICES						
Wholesale	....	....	....	0	+ 2	+ 2
Consumer	0‡	5‡	+ 5‡	0	+ 4	+ 4

*Production worker only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSA's
‡Philadelphia

LOCAL CHANGES Standard Metropolitan Statistical Areas*	Manufacturing				Banking			
	Employ-ment		Payrolls		Check Payments**		Total Deposits**	
	Per cent change July 1968 from		Per cent change July 1968 from		Per cent change July 1968 from		Per cent change July 1968 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Wilmington	+ 3	+ 5	− 2	+12	− 4	0	− 3	+ 7
Atlantic City	....	....	....	....	+ 2	+12	+ 9	+ 8
Trenton	0	− 2	− 2	+ 6	+23	+ 9	+ 6	+10
Altoona	− 2	+ 3	− 3	+12	+ 1	+10	+ 4	+14
Harrisburg	0	+ 2	0	+ 7	+ 1	+ 9	+ 3	+18
Johnstown	0	+ 4	+ 2	+15	+ 3	+12	+ 2	+ 9
Lancaster	0	0	− 2	+ 4	+ 4	+16	+ 1	+ 8
Lehigh Valley	0	+ 2	+ 1	+ 9	+ 4	+14	+ 2	+12
Philadelphia	− 1	0	− 1	+ 7	+ 2	+10	+ 3	+11
Reading	− 4	+ 1	− 7	+ 6	+ 5	+31	+ 1	−25
Scranton	− 1	− 1	− 1	+ 6	+ 3	+ 4	+ 1	+10
Wilkes-Barre	− 3	+ 2	− 3	+ 8	+ 5	+13	+ 1	+13
York	0	+ 3	− 2	+10	+ 5	+ 8	+ 2	+ 7

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.

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