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Statement of

William McChesney Martin, Jr.,

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Small Business  
of the  
Senate Banking and Currency Committee.

June 20, 1957

Mr. Chairman:

The Board of Governors concurs in the broad objective of Senate Bill 2160 now before your Committee, namely, to fill an apparent gap in existing credit facilities by providing for a new type of private investment institution to specialize in small business financing.

It seems likely that today the problem of small business financing is in the area of longer term credit and equity capital rather than in that of shorter term credit. This view takes into account the fact that business activities now require a higher investment in tools, machinery, and plant facilities than ever before in our history.

We also base our view in part on information concerning business and credit developments we receive from the twelve Federal Reserve Banks and their twenty-four branches. This information is derived not only from member banks but also from bankers and businessmen through their representation on the boards of directors of the Reserve Banks and branches and through many other established business and financial contacts. In this way it is possible for us at the Federal Reserve Board to obtain a fairly complete picture of the extent to which credit demands in various parts of the country are being met in total and by various categories of borrowers.

In making our appraisal of the credit situation, we combine these observations with careful analysis of a large volume of statistical information on loans by banks and other financial institutions.

From the available information, it is possible to draw certain broad inferences concerning the financing of small business.

We know, for example, that most loans made by commercial banks are to small businessmen. Further insight is obtained by studying the rates of interest charged by commercial banks on various sizes of business loans as reported to us in a quarterly interest rate survey. We are also now in the process of developing information from a recent loan survey on the location of business borrowers in relation to the institutions with which they bank. These and many other current efforts throw light on small business financing and its problems.

This kind of information broadly substantiates the thesis that the problem of small business financing is primarily one of long-term credit and equity capital, and that financing difficulties arise most frequently in the case of ventures where direct financing by commercial banks or other institutions which hold the liquid savings of the public is inadvisable.

There have been a number of attempts in recent years to cope experimentally with the needs of smaller firms for capital and longer term credit. I refer particularly to regional development corporations, organized under State charter with local financing, that have been established in the New England States and in some other areas.

These organizations have as their main objective the removal of impediments and imperfections in the market organization for supplying intermediate and longer term funds to small- and medium-size businesses, particularly those situated away from the main stream of supply. Assuming the potential borrower to be a reasonable credit

risk, sheer lack of knowledge on his part of alternative sources of financing may be the problem; or a lender may lack the skill necessary to arrange the appropriate financial accommodations for him; or insufficient lender competition or facilities in the field may cause the difficulty. By acting as intermediaries, sometimes advancing some funds along with those of participating lenders, at other times merely bringing borrower and lender together, these regional and local financing institutions perform a constructive function.

The efforts of these organizations should certainly be encouraged, and ways and means should be explored to further the participation of private commercial banks in their activities. Commercial banks, because of the demand nature of the bulk of their liabilities, must generally limit the extent to which they make loans outside the field of higher grade, shorter term obligations. They can facilitate the operations of development companies, however, by helping to minimize costs of investigating applicants and by extending loans to these companies in appropriate circumstances.

It strikes us as noteworthy that other private investment companies, organized under general incorporation acts of the various States to specialize in the equity as well as longer term debt financing of promising small business ventures, do not now exist in large numbers. In postwar years, only a few have been established. The privilege of Federal incorporation might offer some advantages and attract the formation of additional companies.

An explanation of the scarcity of private companies in this field may lie in two operating problems. One is the very high cost of original risk appraisal and subsequent supervision; the other relates to taxation. The bill under consideration recognizes the desirability of reducing the tax obstacle.

As to the role of the Federal Reserve with respect to the proposed new financing institutions designed to provide longer term debt or equity financing for small businesses, it would be appropriate, if the Congress sees fit, for the Board of Governors and the Reserve Banks to perform certain functions relating to the activities of such new facilities. These functions relate to chartering, examination, and fiscal agency duties. The performance of such duties is consistent and compatible with the similar functions now performed by the Federal Reserve.

However, the Board would favor neither the financing of such institutions by the Federal Reserve by purchase of stock or otherwise, nor the exercise by the System of any proprietary functions. For example, the Board should not have the responsibility to "promulgate standards to determine the eligibility of business enterprises for the purposes of this Act." Also, it should not be responsible for regulating the borrowing of the investment companies. Such activities should be specifically governed by the Act itself.

Our views on these matters are based on the fundamental objections discussed before this Subcommittee two years ago. Basically, our concern stems from the belief that it is good government as well as good central banking for the Federal Reserve to devote itself primarily

to the objectives set for it by the Congress, namely, guiding monetary and credit policy so as to exert its influence toward maintaining the value of the dollar and fostering orderly economic progress.

While we feel that it is undesirable for the Federal Reserve to provide the capital and participate in management functions in the proposed institutions, this should in no way be taken as minimizing our concern with the financing problems of small business. Despite the fact that available information on the subject is illuminating, some further investigation of the subject might be useful. The time required for such an investigation would preclude its use in the consideration of the pending proposed legislation, but it might provide valuable factual information for future reconsideration of the problem.

A fresh study of the small business financing problem might confirm the existence of gaps in the present financing facilities and techniques, and it might yield important by-products. The pointing out of potentially profitable lending opportunities could stimulate private enterprise to fill the indicated gaps.

Something like this happened as a result of the extensive research directed to consumer lending methods, practices, and experience carried on during the late twenties and the thirties. Dissemination of these research findings did much to spread knowledge of the opportunities of the instalment financing device through the financial community. This research also led to modifications of some State laws governing consumer lending. Wider knowledge of opportunities and broader legislative authority powerfully stimulated the increased provision of consumer credit facilities, which today make up such a large and important segment of our existing structure of private financing institutions.