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Statement of

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before the

Subcommittee on Small Business

of the Senate Committee on Banking and Currency

April 21, 1958

Early last fall, the Federal Reserve System initiated a comprehensive study of small business financing. This has long been a subject of public discussion and Congressional attention. One prominent feature of the discussion has been a questioning of the adequacy of facilities to serve the financing needs of small business.

Today we are reporting to you what the completed parts of the inquiry show with respect to this problem. One of the parts consists of background studies developed out of a re-examination of existing materials and data relating to small business finance. A second part comprises a set of special surveys of existing credit facilities and credit practices in serving small business financing needs. Both university and independent scholars as well as System specialists participated in the preparation of the background studies of Part I, but the special surveys in Part II were conducted and analyzed by Federal Reserve System staff exclusively.

The plan for the entire investigation contemplates a third avenue of inquiry, namely, a direct survey of the financial structure and experience of smaller businesses, developed through a national sampling approach. This part of the program is still in the category of work in progress. Because of the complexity of the task, extensive preparatory work is now under way; it will be another year before detailed plans can be executed and the results analyzed and made available. In our planning activity for this part of the study, we are receiving cooperative help from the technical staffs of the Bureau of the Census, the Federal Trade Commission, the Securities and Exchange Commission, and the Bureau of the Budget.

Major Findings of Study

In reviewing the findings of the study, it is essential to distinguish clearly among the various forms of business financing. These include short-term credit, intermediate-term credit, long-term credit, and equity or ownership capital.

Short-term credit. With respect to short-term credit, the evidence indicates that there is a large volume of such credit available to small businesses in a variety of forms from a number of sources. By order of importance according to volume of credit extended, the principal sources are: commercial banks; large manufacturing and wholesale suppliers; and finance companies and factors.

In late 1957, all commercial banks had about 1-3/4 million business loans outstanding aggregating over $40 billion. There was almost one loan outstanding to every two business enterprises in existence at the time. To be sure, some companies had several notes outstanding to different banks, and some had more than one note outstanding at the same bank. About two-thirds of the number and amount of bank loans to business had maturities of under one year, that is, were short-term loans, and about half of these short-term loans in number, and a fifth in amount, were loans to small business. The amount of such loans to small business approximated $5 billion.

Credit made available to businesses by manufacturing and wholesale suppliers is in the form of trade receivables. In late 1957, the total of such receivables less the trade payables of all nonfinancial corporations probably approached $25 billion. This was approximately equal to the total volume of short-term business credit outstanding at all commercial banks at the time. Although trade credit is available to businesses of all sizes, large companies extend more of it to smaller enterprises than they receive from such enterprises.

Finance companies and factors had over $3 billion of short-term credit outstanding to small business in late 1957. Such lenders provide short-term credit to small businesses on the basis of their accounts receivable. They also provide warehouse and "on the premises" financing of inventories.

Intermediate-term credit. In recent years, commercial banks, as well as finance companies, have developed further a variety of lending techniques and arrangements to increase the volume of intermediate-term funds available to small businesses. These have included instalment financing of store fixtures, varied equipment, and industrial machinery.

A large volume of intermediate-term funds is currently being made available to small businesses by commercial banks and finance companies. Late in 1957, over a third of the bank loans outstanding to small business concerns, totaling some $2-1/2 billion, had original maturities of over a year. Moreover, such credit had increased about a third since late 1955 and more than threefold since late 1946. In addition, finance companies had outstanding about 3/4 of a billion dollars of intermediate-term, equipment financing to small business in late 1957.

Long-term credit. In the area of long-term financing, the aggregate volume of funds available to small businesses is much smaller. The availability of long-term credit is limited for the most part to real estate mortgage financing. Commercial banks and life insurance companies are the principal sources of such funds. The total of such credit extended by insurance companies to small businesses and outstanding late in 1957 is estimated at more than $250 million.

Equity capital. A large volume of outside equity capital comes to small businesses from local investor sources and from relatives, business associates, and close friends. An estimate made by one contributor to the System's study indicates that in the neighborhood of $6 billion of outside equity capital has been put into one million new business firms during postwar years. This figure is approximately equal to total outside equity funds obtained through stock issues by larger business corporations over the same period. This is exclusive of existing ownership which is constantly being transferred, often through the medium of newspaper advertising. Little is known about the magnitude of such transfers, but it must be large.

Outside or external equity capital from investors other than friends and relatives is most readily available to small concerns with unusual growth potential--especially those producing or distributing products or services that are based on advanced technological developments, or to mining or oil enterprises with a promise of a rapid recovery of investment as well as a high profit return.

A few investment companies exist which specialize in equity investment in unusually promising small businesses. Individual investors seeking to diversify their investment portfolios constitute the main source of such funds. Because of the expenses and risks involved in making small equity investment, the return expected by these investors is relatively high. In principal financial centers, there are specialists who function by finding small business investment opportunities and, for a fee, bringing them to the attention of investors interested in venture ownership of business.

For small businesses in more routine lines of activity, such as retail distribution and the service trades, outside equity capital for expansion is much less often sought and must less readily available. In this connection, it should be noted that small businesses seeking long-term funds are often much more interested in debt money than equity funds, since they wish to avoid the dilution of their ownership control that the equity funds might entail.

The small business financing study is exploring in detail two sources of equity capital to small businesses, namely, internal financing--that is, retained earnings and depreciation allowances--and funds made available by relatives, business associates, and close friends. Unquestionably, these sources of funds are very important. More information on these sources will be obtained from Part III of the study.

The question of a gap in facilities. These general findings from the study confirm the impression that we conveyed to this Committee in our testimony last June, namely, that there is a gap in the existing structure of financing institutions which lies in the longer term debt and equity capital areas. Although there is clearly an institutional gap, there is still the question as to whether there is an economic gap, that is, whether there is a gap that can be filled on a self-sustaining basis. In other words, can long-term financing be made available on terms that will provide lenders and investors with returns commensurate with the higher risks and other costs involved, as well as enabling small business to avoid an undue burden of fixed charges and inflexible financial structures?

Doubt in this respect arises particularly in the case of long-term debt. Since the profit and loss hazards of small business operations run high, ten-year debt of such enterprises is long term. Also, long-term debt of small businesses is both high in cost to their owners and high in risk and other costs to suppliers of such funds. Accordingly, the financing gap narrows down to one of equity financing or equity-type financing such as has been developed by larger corporations in recent years through the bond instrument convertible into stock.

In specifying a gap in the financing facilities available to small business in these terms, it needs to be remembered that the bulk of the small business population is engaged in routine or repetitive activities that primarily provide a means of support to the owner and perhaps a few other individuals and grow only slowly over the years. These small businesses frequently have enough permanent or long-term investment and are not in the market for more, since the use of more long-term funds would only reduce the rates of return to present owners.

There are some small business enterprises, however, which offer a promising growth potential. They have identifiable financing needs that are not being met.

Main Principles for a Government Program

Although some elements of the Federal Reserve study of small business financing remain to be completed, enough information has been amassed to suggest that there is room for a Government program to foster the flow of private investment funds to small business. A number of proposals are pending before the Congress to achieve this end. In previous testimony and in communications to the Committee, we have commented on various of these proposals. Perhaps the greatest help that we can be at this stage towards the formulation of constructive legislation is to express our views on the main principles that should be considered in its drafting.

Study of the record indicates that an appropriate Governmental program for furthering the investment finance of small business should avoid the pitfalls of (1) building into the private economy undesirable Government subsidy, (2) putting a burden on Government of choosing among applicants for investment financing, and (3) maintaining in the economy uneconomic business units. In our judgment, the most efficient program of Governmental aid for small business will be one that makes maximum use of market incentives and standards in attracting private venture capital to the small business area. The market place is the most efficient allocator of economic resources.

It will be no easy task to design such a program. Our study does not point to any one best approach but rather suggests that emphasis should be put on flexibility, broad private cooperation and participation, and protection of the public interest.

Long-term investment in small business would be a new frontier for Governmental assistance. There is much to be learned about the problems of administering such a program. Accordingly, any new effort should be approached experimentally and on a small scale, with a simple organizational structure that is sufficiently flexible to adapt to the varied situations that will be encountered. The most fruitful contribution to small business finance that can be made would be to stimulate private innovation in filling this gap.

The requirement of flexibility also calls for freedom from arbitrary restrictions that would handicap a program. For example, the development of an economically sound and efficient program would be hampered by restrictions which would (1) limit eligibility for assistance to applicants for funds already turned down by other financing sources, (2) impose unnecessary restrictions on the forms or maturities in which funds are to be made available, (3) fix arbitrary ceilings on interest rates or rates of return, or (4) limit the geographical mobility of funds. Some such restrictions would have to be imposed if the financing were made available predominantly out of public funds. They are not appropriate when, through the use of private funds, main reliance is put on the discipline of the market.

Private financial participation necessarily implies private administration at local levels at which specific loan decisions are made. Private citizens with an intimate knowledge of small business conditions and problems are in the best position to judge creditworthiness of applicants for investment funds, as well as to offer valuable advice in tailoring financing to the particular needs of the applicant.

The ability of local groups to mobilize private capital would be enhanced if they were permitted, in fact encouraged, to seek creditworthy businesses aggressively and without restriction. If they were limited to investment only in enterprises not able to obtain financing elsewhere, or required to bear heavy expenses of investigating and appraising financing situations only to have to surrender the more promising ones to other investors, they could not be expected to operate at a sufficiently profitable level to continue attracting private capital. Neither are they likely to attract private funds unless they are free to earn economic rates of return and to realize gains on successful investments.

Incentives in the form of special tax treatment may be needed to stimulate the flow of capital to small business. Such tax incentives, of course, should not provide a haven for activities other than the supplying of investment funds to smaller business.

To the extent that Government funds are used to supplement private capital, the public's interest must be adequately protected. It would be appropriate for general investment policies to be established by the Federal agency administering the program, and for application of these policies by local instrumentalities to be subject to regular review and examination. The responsible Federal agency should account completely and separately for all Government funds used, so that the public could be fully informed of all economic costs involved.

Whatever Government contribution is provided should serve to stimulate, rather than dominate financing of the program. If the program is based on economically sound principles, private capital will be forthcoming. Therefore, the Federal Government's financial contribution could appropriately be limited to a portion rather than a multiple of the private capital willing to invest in small business.

Small business is a vital sector of a free, competitive enterprise economy, and the existence of a gap in financing facilities which serve it may be inhibiting to the prosperity and growth of the nation. Therefore, the Board believes that Government should foster an experiment in developing new private facilities to meet the investment financing needs of smaller businesses.