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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Statement for the Press

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Statement of Chairman Eccles before the Senate Committee on Banking and Currency with reference to S. 2343.

In commenting on Senator Mead's bill (S. 2343) I thought that I could be of most service to the Committee if I began by briefly stating the problem which it is designed to meet. As I see it, there is a definite gap in our financial mechanism in respect to facilities it offers for meeting two classes of needs: (1) the short and intermediate credit needs of small businesses whose paper in present circumstances is at the borderline of bankable assets, and (2) long-time credit and capital needs of small and medium-sized existing or prospective enterprises.

In the first category belong chiefly enterprises which would be doing better if business activity were more fully restored, but which with business at its present level represent a degree of risk that banks quite rightly hesitate to undertake unassisted. They are not enterprises that have been mismanaged or ill-advised, but merely those whose business, either because it is new or because it is peculiarly affected by general business conditions or for some other similar reason, are not at this time able to secure credit from the banks. With the existing volume of unused funds, banks are eager to make all the loans they can, but their responsibilities to depositors make many of them hesitate about extending credit to concerns in this category. There no doubt exists a substantial number of cases of this kind.

The second kind of borrowers for whom additional facilities should be provided are those needing funds for periods extending for ten years or more. Ability of enterprises, and particularly of smaller ones, to obtain credit or equity or loan capital has greatly diminished in recent years. This has been due in part to the general trend toward bigger incorporated business units which has resulted in increasing opportunity for investors throughout the country to acquire equities in nationally known enterprises, which compete with local concerns for the local investors' money. It has been due also to the prohibition of security affiliates of banks, the increase in the cost of issuing securities, the prohibition of underwriting by banks, and the almost complete elimination of local underwriters of any kind. In the 1920's small and medium-sized concerns were able to raise long term capital locally, though at a pretty high cost, while now in many instances they are unable to raise it at all, except at costs that are entirely too high.

Banks meet a part of this need, but there are some demands of a character that banks do not feel justified in supplying, either because there is too much risk involved, or because the term is too long, or in case of bigger enterprises because in some areas there are no banks with sufficient resources to meet the requirements.

It seems to me that it is to fill this two-fold need for short and intermediate term credit for borderline enterprises and for long-time credit and capital for small and medium-sized concerns that additional facilities are required.

The Mead bill proposes to meet these needs by offering through the Reconstruction Finance Corporation insurance on certain terms for 90 per cent of any loan up to $1,000,000 made by an insured bank. I am in favor of accomplishing the purpose for which the bill is designed, but I have serious doubts whether the results of the measure would not be very disappointing. There are practical considerations which lead me to the belief that there would not be any substantial increase in bank loans as a result of the adoption of this legislation.

One weakness of the bill, in my opinion, is in the provisions regarding the distribution of losses, which differ from those contained in other insurance plans set up by Congress. Under the bill, insurance may be granted against a loss which an insured bank may sustain in excess of 10 per cent of the principal amount of the loan. Thus, for example, if a loss of $10,000 were suffered on an insured loan of $100,000, the insured bank would have to bear the entire loss and the Reconstruction Finance Corporation none. Since a bank would derive no benefit from the insurance until after it had suffered a loss equal to 10 per cent of the loan, I seriously question whether the bill in its present form would give any substantial inducement to banks to make loans which they would not make without the insurance, or which they could not make under the present plan of RFC commitments.

I have heard it suggested in connection with this bill that the banks would be eager to extend loans which could be insured under the bill because, inasmuch as their loss is limited to 10 per cent on any one loan and they may charge an interest rate of 4 per cent, the interest received on the loan by the end of two and one-half years will be 10 per cent of the amount of the loan and will thus have eliminated the possibility of any loss of principal. This reasoning ignores the fact that the interest derived by banks from their loans is the gross return and not the net return on the investment. The two are greatly different. The cost to a bank of making and servicing a loan is substantial and in the case of a loan on an installment basis it is increased. Even during the period of the 1920's the net returns to banks on their loans and investments were only around 1-1/2 per cent per annum and at present they are averaging less than 1 per cent. It is obvious, therefore, that a bank would have to receive interest on a loan for ten years or more before it could be sure that any loss on a loan insured under this bill would be eliminated, and then it would have earned nothing on its money.

In the second place, the rate of interest proposed in the bill for insured loans is set at 4 per cent per annum, less the insurance premium, which is lower than banks normally charge on loans of this character and even on better loans than contemplated by this bill. Banks would hesitate to charge their established customers a higher rate of interest than they charge on the special loans made under the proposed bill or to reduce the rate of interest which they customarily charge. Consequently, the banks would probably not be induced to make any considerable volume of insured loans on the basis provided in the bill.

It is possible that, even if the banks did avail themselves of the opportunity to insure business loans, there would be loans, some of which they would have made in any case even though there were no way to insure them.

It is also to be noted that the bill contains no limit on the aggregate amount of insurance, so that the Government, through the agency of the Reconstruction Finance Corporation, would be subjected to an unlimited contingent liability. This does not seem to me to be good public policy, particularly since this liability would be incurred without assurance that the fundamental purpose of the bill, to stimulate a substantial volume of loans to business, would be realized.

I also wish to suggest to the Committee that the provisions of section 5 of the bill, authorizing the rediscount and purchase and sale by Federal Reserve banks of insured loans, be eliminated, because in so far as they relate to member banks these provisions are not necessary, since Federal Reserve credit can now be obtained by member banks on any satisfactory asset, and in so far as they relate to nonmember banks, they are not desirable, because nonmember banks, not being subject to Federal Reserve rules or regulations, should not be given the same borrowing privileges as those extended to member banks. These banks should depend upon their city correspondents where they carry their balances. Furthermore, section 5 would give to this type of loan a discount privilege that is not enjoyed by obligations insured under the National Housing Act or by other sound assets.

Turning now to the fundamental problem of the inadequacy of our facilities for supplying certain kinds of capital and credit needs, I should like briefly to review the experience of the Federal Reserve banks under section 13(b), which was intended to meet these needs.

It will be recalled that the Federal Reserve banks were required in 1933 to subscribe for stock in the Federal Deposit Insurance Corporation in an amount equal to one-half of their surplus ($139,299,557). The Act of June 19, 1934, provided for loans to industry both by the Federal Reserve banks and by the Reconstruction Finance Corporation and the Secretary of the Treasury was authorized to pay to the Federal Reserve banks the amount of their Federal Deposit Insurance Corporation stock in order to assist them in making industrial loans. The Secretary entered into an agreement with the Federal Reserve banks providing for the payment to them of, roughly, one-half of the amount of the industrial loans which they made. Under the law, the Federal Reserve banks are required to pay to the Treasury annually 2 per cent, if earned, on the amount received from the Treasury.

Under this law, the Federal Reserve banks up to May 24, 1939, have executed commitments to financing institutions and direct to business enterprises amounting to $64,000,000 and have made advances of approximately $58,000,000, indicating that they have made a substantial volume of loans to business and industry. However, I believe that the authority which has been given to the Federal Reserve banks in this respect has not been sufficiently comprehensive. Many loans which might otherwise have been made have had to be declined because of restrictions in the law, such as the requirement that industrial loans be made only for "working capital" purposes and only to "established" businesses and for periods of not more than five years. I believe that the experience of the Reconstruction Finance Corporation in this respect has been similar, though the law under which the RFC makes these loans was materially liberalized last year. It is apparent, in any case, that the problem still exists and has not been adequately met.

Realizing this, some of us, as long as two years ago, began to study the situation, in an effort to develop a practical plan for stimulating business loans, without involving expenditures by the Government or in any way affecting the budget. Briefly stated the plan is as follows:

The creation of an Industrial Loan Corporation as an integral part of the Federal Reserve System, using the Federal Reserve banks and branches as its field agents. It is my belief that this would be a most efficient and economical method since the Federal Reserve banks have offices already established in 36 cities (12 Federal Reserve banks and 24 branches) widely distributed in the various trade areas throughout the country, and are well qualified for such service because of their knowledge of business and economic conditions in their respective districts and their close contacts with local banking institutions. With this organization already in existence it would be possible to commence actual operations with a minimum of delay, and these operations could be expanded or contracted from time to time in accordance with changes in conditions. The experience gained by the Board of Governors and the Federal Reserve banks and the personnel of the System in connection with industrial loan operations during the past five years would be of great aid to them in performing this service.

The Corporation, whose board of directors might be composed of the members of the Board of Governors of the Federal Reserve System, would be authorized to provide funds for commercial and industrial enterprises through the acquisition of the obligations of such enterprises or by the purchase of preferred stock or by making commitments to do so. The amount of funds that could be supplied to any one business enterprise would be limited to $1,000,000, these advances to be made on a sound but liberal basis for a long period. Advances could be made directly by the Corporation or in cooperation with insured banks.

Out of its capital funds, which would be procured in the manner hereafter explained, the Corporation would be authorized to set aside up to $25,000,000 as an insurance fund for the purpose of granting insurance covering loans to small business enterprises. The insurance provided would differ from that proposed in the bill and would be similar to that under Title I of the National Housing Act. The insurance fund of $25,000,000 would be a revolving fund which would make possible outstanding loans of $250,000,000. This would be sufficient to meet the needs for a considerable period and would involve a fixed amount of contingent liability with no possibility of losses exceeding the $25,000,000 to be furnished by the Corporation. The insurance premium, in my judgment, should not exceed 1/2 of 1 per cent per annum on the face amount of any loan covered by the insurance and the maximum rate of interest on any such loan should not exceed 5 per cent on the outstanding balance. An insured loan would not exceed $25,000 in amount and should be amoritzed so as to be paid off within ten years.

In proposing this insurance plan my object is to meet in a liberal and practical way the needs of small business enterprises. This proposal, with its limitation of $25,000 on insured loans, in no way competes with or duplicates the proposal in the bill under consideration which provides for insurance of loans up to $1,000,000. Under this proposal the Corporation would set up an insurance reserve amounting to 10 per cent of the total insured loans, adding to this reserve the insurance premiums, and would meet out of this total reserve all losses incurred by any one lender provided they did not exceed 10 per cent of his entire insured loans. In other words, even a 100 per cent loss on a given loan would be covered by the insurance so long as the aggregate losses incurred by a lender were no larger than one-tenth of the total of his insured loans. This is unlike the insurance plan set up under the Mead bill under which the lender would stand all of a 10 per cent loss on each individual loan before the insurance would become applicable to the remaining 90 per cent.

As already indicated, the proposal would involve no additional appropriation of public funds and no increase in the budget. The capital of the proposed corporation would be derived from the return to the Federal Reserve banks by the Secretary of the Treasury of the amount subscribed by these banks in 1933 to the stock of the Federal Deposit Insurance Corporation.

The Secretary would use for the purpose that part of the increment resulting from the reduction in the weight of the gold dollar, which has been employed or is now set aside for participation in industrial advances.

The Treasury has already paid to the Federal Reserve banks under the authority in existing law about $27,500,000, and the plan would contemplate that the remainder of the amount of $139,299,557 which the Secretary now has authority to pay (or approximately $112,000,000) would be paid over to the Federal Reserve banks and by them to the Corporation. Of this amount $100,000,000 would be the capital of the Corporation, with $25,000,000 set aside for the insurance fund, and the remainder would be its paid-in surplus. The existing provisions of section 13(b) of the Federal Reserve Act authorizing industrial loans by the Federal Reserve banks would be repealed, and outstanding loans and commitments of the Federal Reserve banks under that section would be transferred to the Corporation at their book value as a part of its capital assets.

In order to obtain additional funds if needed, the Corporation would be authorized to issue debentures equal to five times its capital. While it is proposed that these debentures be guaranteed by the United States, the contingent liability which would be assumed by the Government by reason of such guarantee would be definitely limited to $500,000,000, with a cushion of $100,000,000, which is already in existence and may be expected fully to cover all the losses that can be reasonably expected to occur. It is also proposed that the debentures would have the usual tax exemption possessed by obligations of similar Government corporations, unless a policy should be established to the contrary.

It would be contemplated that so far as possible the Corporation would utilize officers and employees of the Board of Governors of the Federal Reserve System and of the Federal Reserve banks, but it would also have authority to employ additional employees if this should prove to be necessary.

Net earnings of the Corporation would be retained in surplus after making necessary provisions for such losses as the Corporation would have to risk if it is successful in accomplishing its purposes.

Upon liquidation of the Corporation, all of its capital and surplus would become the property of the United States.

The above is a brief statement of the proposal, but I would be very glad to give any further details or assistance in connection with the matter if desired by the Committee. It is my view that this proposal would go far in meeting the problem of providing additional facilities for obtaining credit and capital for such business concerns as have a legitimate need that is not supplied by existing facilities.

In making this proposal my only object is to offer what seems to me to be a practical plan for meeting the problem, to the solution of which the Mead bill is addressed. I suggest that the plan, if it is favorably received by the Committee, be incorporated into that bill. I have no interest in asking for more power in this field for the Federal Reserve System, but have suggested that its facilities be used simply because this seemed to me to be a most efficient and economical way to achieve the desired result. If the substance of the plan appeals to the

Committee but if it should wish to entrust its execution to another agency, I shall be satisfied.

If after consideration Congress should feel that it does not desire to enact a proposal of this kind, it would be my recommendation that section 13(b) of the Federal Reserve Act be repealed, because it does not operate satisfactorily in meeting the situation, and that provision be made for the orderly liquidation of outstanding loans and commitments and for the return to the Treasury of the amounts which it has paid to the Federal Reserve banks after deduction of their actual operating losses.

Finally, I feel that I should add that I do not believe that this or any other similar plan, however desirable as an improvement in the existing mechanism for facilitating the flow of funds for small business, will in itself bring about a substantial business improvement.