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CHAPTER 7

Federal Lending and Loan Insurance Programs for Business and Financial Institutions

Development of the Programs

WHEREAS World War II was to bring federal credit programs to bear on a vast scale and in a wide range of industries, only limited segments of business received such aid in the earlier world war. The War Finance Corporation, established in 1918, helped finance certain essential war industries. The Director General of Railroads in 1919 and the Interstate Commerce Commission in 1920 were empowered to lend to railroads, which from 1918 through February 1920 were under federal operation. Specifically, financial assistance to the railroads consisted of operating loans made by the Director General out of a \$500 million revolving fund, notes taken in payment for capital improvements and purchases of rolling stock, and certain loans made on the cessation of federal control, from a \$300 million revolving fund set up under the Transportation Act of 1920 and administered by the Interstate Commerce Commission. New loans by the War Finance Corporation ceased after 1922, and new loans by the ICC, after 1924. There remained a program of loans for shipping.

Legislative action designed to promote United States shipping began with the Shipping Act of 1916 (34 Stat. 728), which created the U.S. Shipping Board. During World War I the board's efforts to increase the U.S. merchant fleet were carried out through a subsidiary, the Emergency Fleet Corporation, and after the war a revolving fund of \$125 million was established by the Merchant Marine Act of 1920 (41 Stat. 988) to finance ship construction in domestic yards. The Merchant Marine Act of 1928 (45 Stat. 689) reaffirmed the policy of financial aid to shipping concerns and supplemented it with a system of mail contract subsidies; but the Merchant Marine Act of 1936 (49 Stat. 1985; 46 U.S.C. 1111), which established the U.S. Maritime Commission as an independent agency in the Executive Branch, constituted a reorientation of policy. The commission sought to stimulate shipbuilding by a system of direct subsidies intended to

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make up the difference between domestic and foreign cost of ship operation, and by an indirect subsidy program under which the commission produced and sold merchant vessels to American ship-owners at prices below their actual cost in order to equalize the cost differential between domestic and foreign-built ships. The commission was also authorized to insure mortgages on all types of vessels owned by United States citizens and to make direct loans to shipping interests. Under Reorganization Plan 21 of 1950, the U.S. Maritime Commission was reorganized as the Maritime Administration and transferred to the Department of Commerce.

Meanwhile the depression of the early thirties had brought federal credit activity into other areas of business, with the establishment of the Reconstruction Finance Corporation in 1932—like all the foregoing organizations, a direct agency of the federal government. At first the authority conferred by the RFC Act (47 Stat. 5; 15 U.S.C. 601 *et seq.*) was of limited scope, directed mainly at the assistance of financial institutions (including banks and insurance companies) and of railroads. It was thought that aid to these strategic enterprises, many of which were under severe pressure at the time, would forestall the spread of unemployment. However, as financial and industrial difficulties became more insistent the need for a full-scale business lending program gathered force. A policy of aid granted at key points—at the top, as it were, of the economic pyramid—was replaced by a policy of supplying credit to business concerns generally. In 1934 the RFC was authorized to make loans directly to business where funds were not available from private lenders, and the Federal Reserve Banks were empowered, under Section 13b of the Federal Reserve Act, to undertake a similar program of direct lending.¹ The various extensions and revisions of RFC's lending authority and the precise nature of the financial assistance extended are described at some length in Appendix B. In compact form the variety of RFC's credit activities—through which from 1934 till its dissolution in 1953 the corporation disbursed \$15 billion in direct business lending alone, apart from its loan

¹ Section 13b of the Federal Reserve Act and Section 5d of the Reconstruction Finance Act were both added to the original statutes by acts of June 19, 1934 (44 Stat. 1105, Ch. 653, and 48 Stat. 1108-1109, respectively).

It is interesting to note that in the hearings that prefaced the adoption of Section 13b the Federal Reserve authorities sponsored a more novel arrangement which would have provided for the extension of business credits by federally sponsored "industrial banks."

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guaranteeing functions—has been shown in the listing in Chapter 1.

In the field of business lending, the year 1934 was notable also for the establishment of the Export-Import Bank of Washington. The bank was set up under Section 2 of Title I of the National Industrial Recovery Act (48 Stat. 195) with the specific purpose of helping finance trade between the United States and Soviet Russia. The bank did no business, however, on the ground that it could not do so as long as the settlement of debts and claims between the United States and the Soviet Union was still pending, and another institution, the Export-Import Bank of Washington, D.C., was also created in 1934. The initial purpose of this second bank was to promote trade between the United States and Cuba, but its functions were later extended to all countries except the Soviet Union. With the breakdown of debt settlement negotiations between the United States and Russia in 1935, the second bank was discontinued and all operations were concentrated in the Export-Import Bank of Washington. Over the years the Export-Import Bank has functioned primarily to finance exports of agricultural and industrial equipment, notably heavy machinery. Volumewise, among public institutions lending to business in the period under review it was second only to RFC, with loans financing trade with American firms totaling \$4.6 billion from 1934 through 1953. Its original common stock of \$1 million was subscribed by the Treasury, and preferred stock in much larger amount was taken up by the Reconstruction Finance Corporation. The Export-Import Bank Act of 1945 increased the bank's capitalization to \$1 billion wholly subscribed by the Treasury. Not only by the source of its funds but also in management the bank is directly attached to the federal government, its original board of trustees and currently its president being appointed directly by the President.

The prospect of very large amounts of war production work on a basis that presented difficult credit problems led to an important innovation in finance early in World War II. This was Regulation V of the Board of Governors of the Federal Reserve System under which the War and Navy Departments and the U.S. Maritime Commission guaranteed loans to war contractors by any lending agency, including the Federal Reserve Banks and the RFC. The regulation was issued April 6, 1942 under Executive Order 9112, dated March 26, 1942, and the program which it authorized was carried out by the Federal Reserve Banks as agents for the contracting services. The loans made under this original regulation were known as V

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loans; subsequently (September 1, 1943) the regulation was amended to permit the guarantee of loans made partially to replenish working capital upon the termination of war contracts, the so-called VT loan; and finally (September 1944) it was revised to permit the guarantee of loans exclusively to liquidate working capital tied up in terminated government contracts, the so-called T loans (authorized by the Contract Settlement Act of 1944).² Also under the revised authority of 1944, loans for production purposes or for a combination of production and termination financing purposes were made available, known as 1944-V loans.

This program carried into a new field, and extended to a very large volume of financing operations, the procedures of loan insurance first developed for real estate mortgages. Its effect, of course, was to meet enormous financing needs without recourse to direct government financing, though the inapplicability of the program to the financing of plant and equipment forced the government to enter that field through other and more direct measures, such as the construction and leasing of facilities by the Defense Plants Corporation and the direct extension of credits by the RFC and the Smaller War Plants Corporation.

In 1944 the Veterans' Administration was empowered to guarantee small term loans to veterans for establishing or expanding a business, and in December 1945 a reserve account form of loan insurance was added to the program.

The Defense Production Act of 1950 (64 Stat. 932) placed renewed emphasis on lending and loan guaranteeing activities related to the government's procurement and stock-piling operations for national defense. Both the RFC and the Export-Import Bank were directed by Executive Order 10281 of August 27, 1951 to make loans and to participate with other lenders in making loans to private business enterprises for plant expansion, technological development, and production of essential materials (including metals and minerals) upon certification of essentiality by the Defense Production Administration—currently the Office of Defense Mobilization—or any other designated federal agency, as provided by Sections 302 and 304 of the Defense Production Act of 1950. Guarantees by government pro-

² A summary of the programs is given in "Financing War Production and Contract Terminations under Regulation V," in the *Federal Reserve Bulletin*, March 1946, pp. 240-248, and in the technical paper "A Statistical Study of Regulation V Loans," by Susan S. Burr and Elizabeth B. Sette (Board of Governors of the Federal Reserve System, 1950).

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curement agencies of such loans made by public or private financing institutions were also authorized, by Section 301 of the act, using the facilities of the Federal Reserve Banks and under the conditions and terms established by Regulation V of World War II.

The legislation terminating the lending powers of the RFC (Public Law 163, 83rd Cong., July 30, 1953) also provided for the creation of the Small Business Administration to make loans—including immediate and deferred participation loans—to small business firms, and to make disaster loans.

Federal financial aid to business firms, in contrast with that to farmers and homeowners, has been extended almost entirely through direct rather than federally sponsored agencies. The Federal Reserve Banks are the only quasi-public agency involved; and although their services as agents for various federal agencies in the Regulation V and Defense Production Act programs were administratively important, loans to business from their own funds have been of comparatively small volume. Chart 11 makes that plain, and shows how the credit of the federal agencies lending to business was concentrated in a relatively few years: 1919–1921, 1932–1935, 1942–1947, and 1952–1953. Chart 12 shows the shifting importance of the major agencies, with RFC supplying in 1932–1935 and during World War II nearly two-thirds of the total disbursed, whereas in 1946 and 1947, and again in 1952–1953, the Export-Import Bank accounted for upwards of three-fourths of the total.

The course of federal credit activities directed to the financial sector of the economy (apart from Federal Reserve Bank credit to member banks of the Federal Reserve System)³ has been uneven, as Chart 13 shows. The first noteworthy phase was short-lived, being restricted to the early 1930's. In this period RFC loans were made on a large scale mainly to banks and insurance companies, primarily to alleviate distress caused by depression conditions. Almost concurrently, the RFC carried out a substantial program of stock purchases in banks and insurance companies, and lesser programs of the same type were directed to the financial assistance of savings and loan associations by the United States Treasury and, after 1934,

³ Advances to, and rediscounts for, member banks are not regarded as coming within the scope of the present study because, as was pointed out in Chapter 1, in connection with them the primary purpose of the Federal Reserve Banks is to influence general credit conditions through changes in member bank reserve balances and not to provide a financing service in a sense comparable to what is aimed at by the various agencies whose activities are included in our study.

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by the Home Owners' Loan Corporation (the two combined accounting for about one-seventh of the associations' total capital investment in 1932-1935).

In the second phase the principal activity consisted of lending by the federally sponsored Federal Home Loan Banks to their member institutions, mainly savings and loan associations. Quite in contrast to the programs of the early thirties, which had as their object the support of faltering financial institutions, Home Loan Bank loans to member institutions in recent years have served mainly to enable prospering savings and loan associations to increase their lending activity during a period of general economic expansion. Since 1950, federal assistance to financial institutions has consisted exclusively of these loans by the Federal Home Loan Banks, now almost altogether owned by their member associations.

Home Loan Bank lending ultimately affects the housing sector of the economy and will be discussed in the next chapter. With no other public or quasi-public agency currently extending credit to financial institutions (apart from the excluded Federal Reserve operations), the two following sections—on credit services and on lending experience—will be limited to federal financial activities in the field of business.

Services and Credit Terms

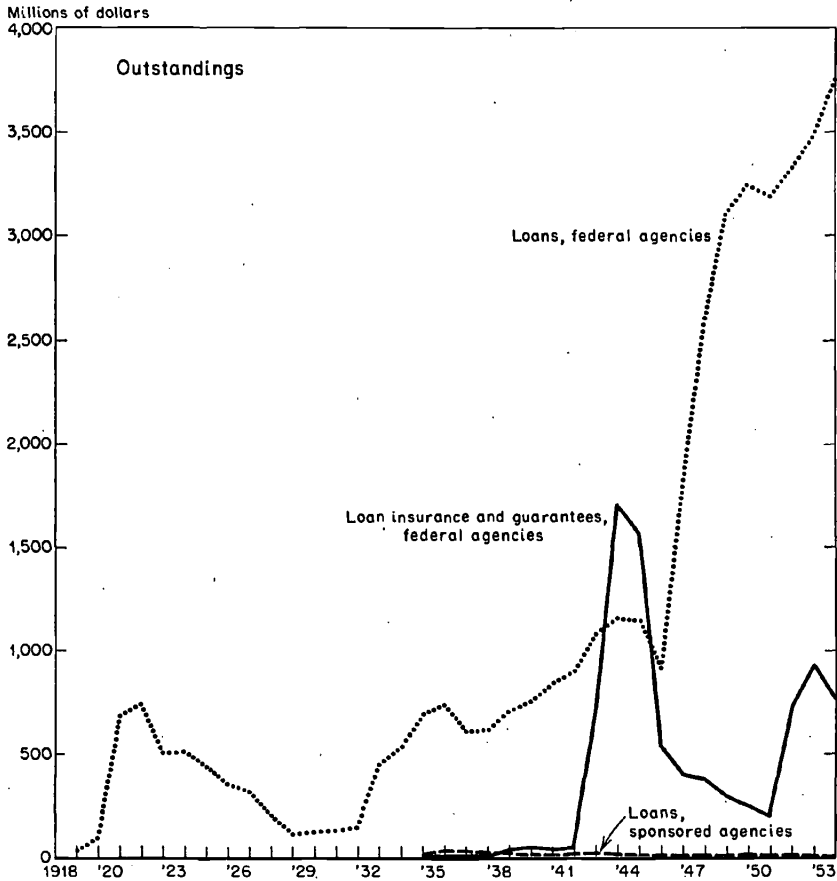
American business enterprises have traditionally made use of a number of different credit services, for each of which there has existed one or more supplying institutions and a more or less well-developed market. Among these services have been long-term loans, usually secured by mortgage or pledge of real estate or securities by the borrower; medium-term loans, running from one to ten years to maturity, and either secured or unsecured; short-term loans of less than one year's duration, usually unsecured and used principally for the conduct of current operations; trade or mercantile credit, obtained from suppliers and repayable within short periods of time. In addition, American businesses have used a limited amount of credit insurance, supplied by specialized underwriters and, in a somewhat different form, by factoring and commercial financing houses that purchase business accounts receivable without recourse.⁴

⁴ For a description of these business credit services and markets as of around 1946, see *Business Finance and Banking* by Neil H. Jacoby and Raymond J. Saulnier (National Bureau of Economic Research, Financial Research Program, 1947).

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CHART 11

Federal Credit for Business, 1918-1953

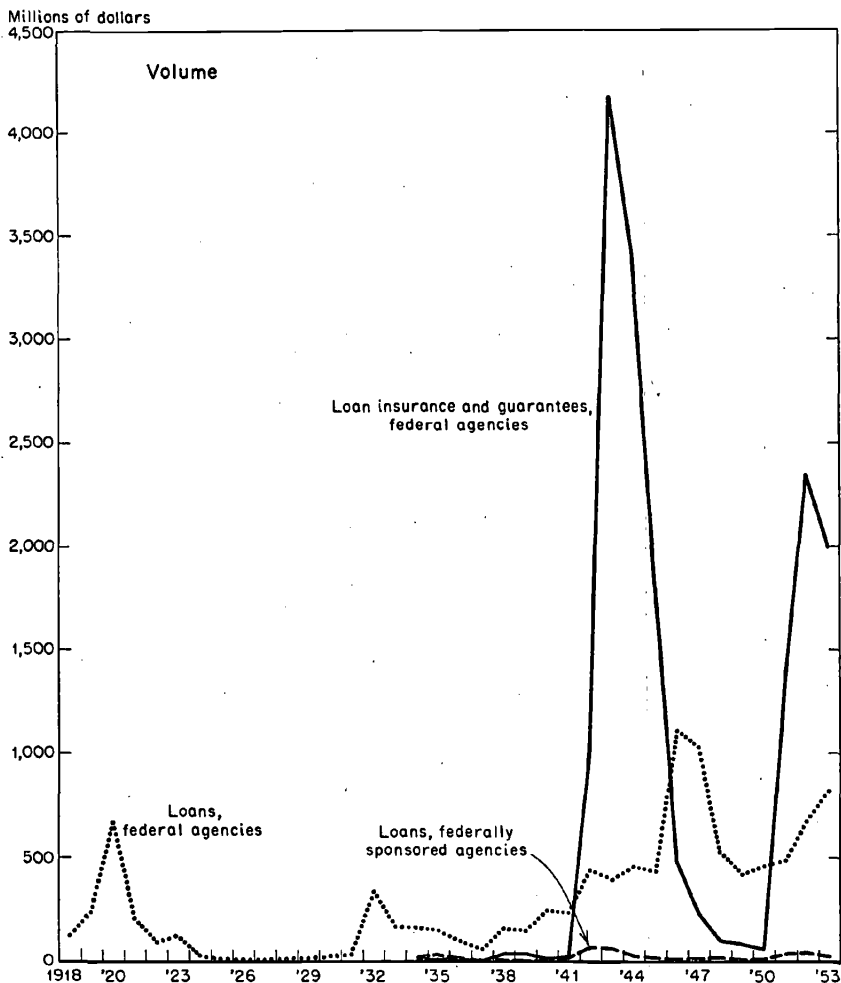


The task of comparing the credit services available through federal agencies with those customarily obtained from private financial institutions is considerably simplified by the fact that public agencies have confined their business credit activities preponderantly to lending on medium term and to the guaranty and insurance of such loans made by private financial institutions. In this connection it may be asked: What types of credit services have been provided and to what types of businesses? What unusual or unique economic functions have been served by federal credits to business? How have public and private agencies cooperated in business credit activities?

In dealing with these questions, attention will be focused upon the

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CHART 11 (concluded)



From Table A-5. For data on the components of the series, see Tables A-9, A-10, A-12 to A-14, A-16, A-18, A-21, A-27, A-30, A-32, and A-33.

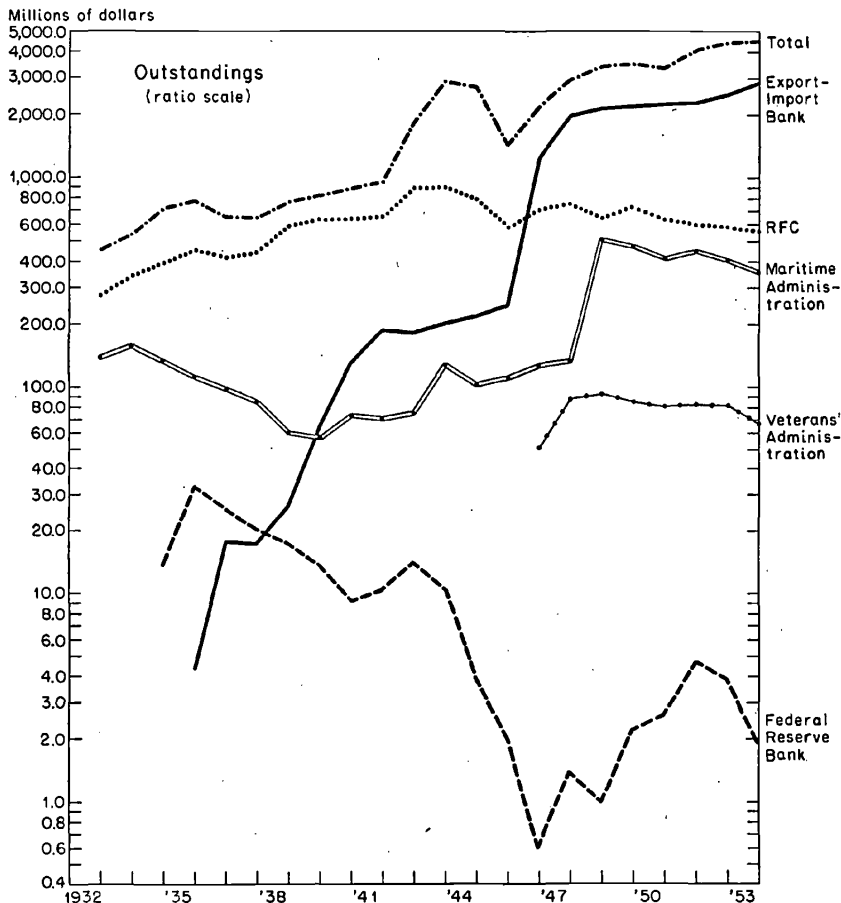
operations of the five major federal agencies and one federally sponsored agency having active business credit programs in the early 1950's; namely, the Reconstruction Finance Corporation,⁵ the Veterans' Administration, the Export-Import Bank, the Maritime Ad-

⁵ Public Law 163, 83rd Congress, enacted July 30, 1953, terminated all lending powers of the RFC under Section 4 of the RFC Act as amended, effective September 28, 1953. Executive Order 10489 transferred all powers, duties and functions of RFC under the Defense Production Act of 1950 to the Secretary of the Treasury, effective September 29, 1953.

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CHART 12

Business Loans, Loan Guarantees, and Loan Insurance by Principal Federal and Federally Sponsored Agencies, 1932-1953

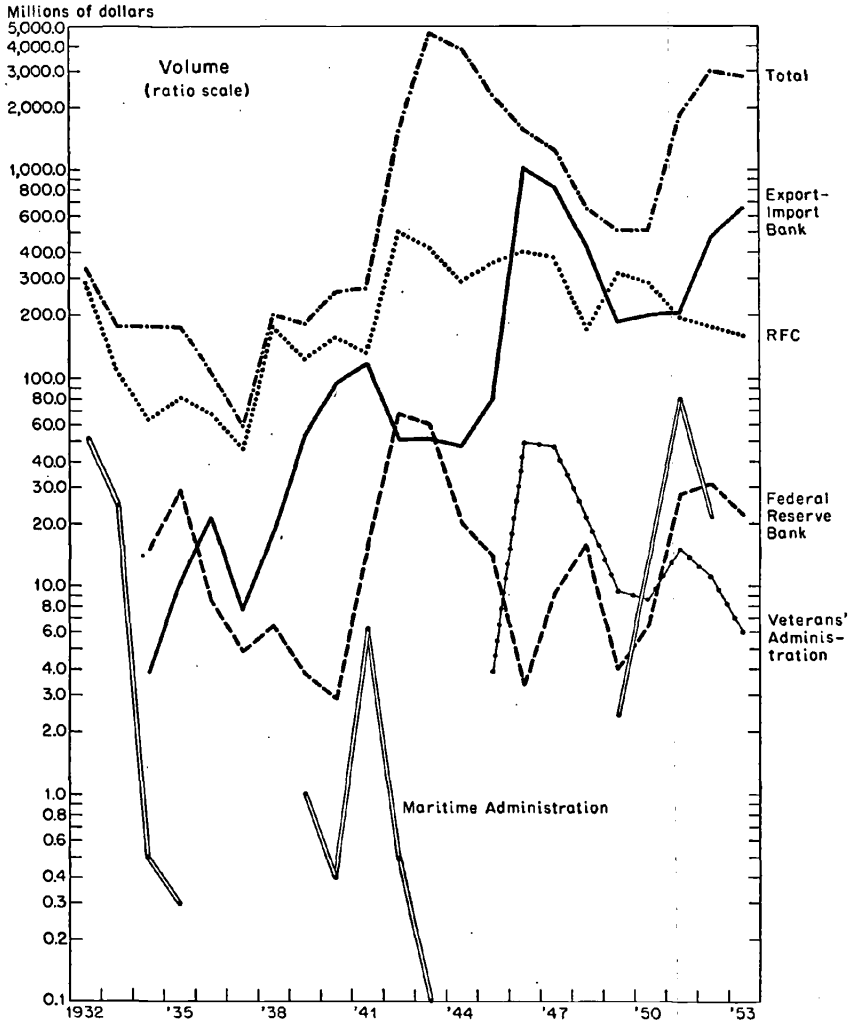


From Tables A-5, A-9, A-10, A-16, A-18, A-27, and A-30.

Total outstandings include, besides those of the federally sponsored Federal Reserve Banks and of the several direct federal agencies shown, those of the following direct agencies: the Director General of Railroads and the Interstate Commerce Commission in 1932-1953; the War Finance Corporation in 1932-1934; the Public Works Administration in 1934-1950; the Housing and Home Finance Agency in 1950-1953; the War and Navy Departments and U.S. Maritime Commission (including Regulation V and defense production guarantees) in 1942-1953; the Department of Commerce, the General Services Administration, and the Atomic Energy Commission (guarantees under the Defense Production Act of 1950) in 1951-1953. RFC totals include loans of the Smaller War Plants Corporation outstanding from 1942 on.

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CHART 12 (concluded)

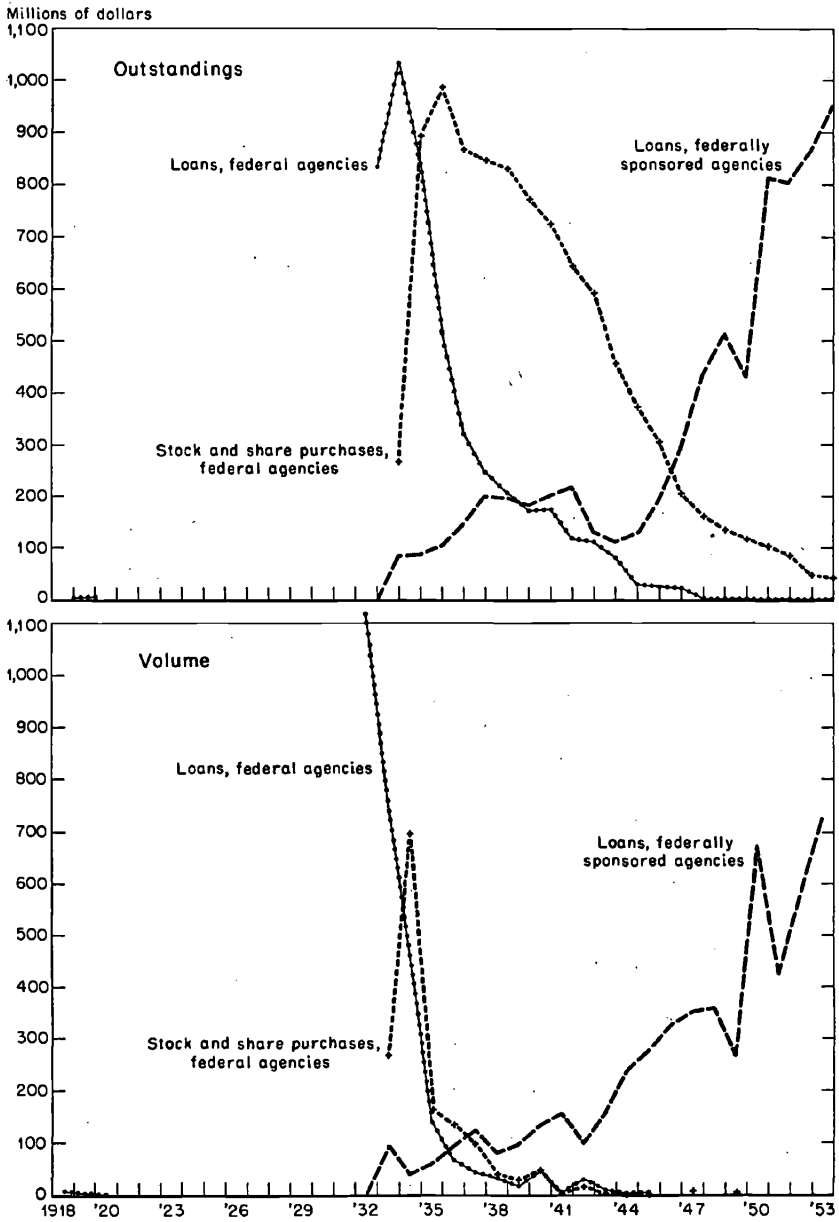


Total volume covers, besides the agencies shown: the PWA in 1933-1937; the HHFA in 1950-1953; the Department of Defense in 1942-1953; the War and Navy Departments and U.S. Maritime Commission in 1942-1946; and the Department of Commerce, the GSA, and the AEC in 1951-1953. RFC totals include loans of the Smaller War Plants Corporation for 1942 through 1946.

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CHART 13

Federal Credit for Financial Institutions, 1918-1953



From Table A-6. For data on the components of the series, see Tables A-9, A-11, A-12, A-17 and A-19.

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ministration, the Small Business Administration,⁶ and the Federal Reserve Banks.

These six agencies offered one or more of three types of credit services, mainly within the medium-term credit field: (1) direct loans, (2) guarantees of parts of loans made by private lending institutions, and (3) insurance against loss on loans made by private agencies. All except the VA have had power to lend money directly to businesses. All of them have also been empowered to offer loan guarantees by agreeing to take up a specified part (ranging up to 90 percent) of business loans made by banks or other private institutions upon default or upon demand by the private lenders concerned. In addition, the Veterans' Administration has insured certain private lenders against loss—up to the limits of a reserve fund built up in a fashion similar to FHA Title I loan insurance reserves—on small term loans made to eligible veterans for business purposes. The volume of these various activities, and the outstanding amounts of loans and loan insurance or guaranty extended under them, were shown in Charts 11 and 12.

The federal agencies have also acted as advisers and clearinghouses of financial information for businesses, especially small firms, and have provided stand-by sources of credit. For example, RFC received and disposed of nearly 336,000 different inquiries from businesses during a sixteen-month period ending October 31, 1947. Among them 68,000 pertained to business loans and 197,000 to miscellaneous matters, such as financial, management, engineering and accounting advice, and RFC policies.⁷ In many instances RFC referred inquiries to commercial banks or aided businessmen in framing their applications to commercial banks. In rendering such assistance and by serving as a *potential* source of credit the RFC, and other federal agencies that have performed similar functions,⁸ undoubtedly exerted an im-

⁶ The Small Business Administration began operations in October 1953 in accordance with the provisions of the Small Business Act of 1953 (Public Law 163). Therefore it seems appropriate to include it wherever possible in a discussion of credit terms and policies, at the same time noting that its lending program—in terms of loan disbursements—first became active in early 1954.

⁷ *Hearings* before a Subcommittee of the Committee on Banking and Currency, U.S. Senate, on S. Res. 132, "A Resolution for an Inquiry into the Operation of the Reconstruction Finance Corporation and Its Subsidiaries," Part 2, 80th Cong., 2nd sess., January 1948, Exhibit 37, pp. 455ff.

⁸ One of the responsibilities delegated to the newly formed Small Business Administration by the Congress was that of helping small business obtain competent management, technical, and production counsel and also a fair share of government procurement contracts. For a brief resume of progress under these

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portant indirect influence on the business credit market, wholly apart from the loan funds disbursed or the insurance or guaranty commitments made.

CHARACTERISTICS OF THE BUSINESSES SERVED

Indirect but significant evidence on the size of the businesses served by federal credit programs is at hand in comparative data of loan size. Excepting small business loans guaranteed or insured by the Veterans' Administration, the loans made or protected by public agencies have been predominantly of medium size. The average size of bank term loans to business during 1946 was about \$27,000.⁹ In contrast, loans disbursed by the RFC during 1934-1951 averaged \$72,300;¹⁰ Export-Import Bank loan authorizations over the same period averaged more than \$1 million;¹¹ the average amount of Federal Reserve Bank industrial loans approved through 1950 was \$176,000;¹² and loans by the Smaller War Plants Corporation (September 1942 through December 1945) averaged \$103,000.¹³ Bank loans made with immediate or deferred participation by RFC (that is, those authorized up to mid-1947) averaged \$138,700.¹⁴

The concentration of federal activities in the field of medium-sized loans is forcefully revealed in Table 44. Of commercial bank term loans to business firms in 1946, less than one-tenth were for individual amounts of \$25,000 to \$500,000. But considerably larger fractions of federal loans and guarantees were of that size—fractions ranging from one-third for direct business loans made by the RFC in 1934-1951 to more than three-fifths of all business loans approved by the Small Business Administration in the ten months to July 31, 1954.

programs through July 31, 1954 see the *Second Semi-Annual Report of the Small Business Administration*, of that date, pp. 53ff.

⁹ Duncan McC. Holthausen, "Term Lending to Business by Commercial Banks in 1946," *Federal Reserve Bulletin*, May 1947, Table 6, p. 505. During the year ended November 20, 1946, an estimated 119,900 loans totaling \$3,242 million were made.

¹⁰ From the National Bureau of Economic Research sample survey of direct loans made under RFC's regular lending authority (i.e., apart from wartime powers), reported in Appendix B (Table B-1).

¹¹ *Semiannual Reports* of the bank.

¹² *Federal Reserve Bulletin*, December 1951, p. 1541. Up to December 31, 1950, 3,698 applications had been approved for a total amount of \$651,889,000.

¹³ Douglas R. Fuller, *Government Financing of Private Enterprise*, Stanford University Press, 1948, Table 6, p. 151.

¹⁴ From Table B-36; based on the National Bureau of Economic Research compilation of all RFC participation loans except those made under blanket participation agreements or in the Small Loan Participation program.

TABLE 44

Size Distributions of RFC Business Loans, Small Business Administration Loans, Regulation V Loan Guarantees, and Commercial Bank Term Loans to Business

SIZE OF LOAN ^a	NUMBER OF LOANS				AMOUNT AUTHORIZED OR DISBURSED					
	Member Bank Loans	RFC Participations	RFC Direct Loans	Regulation V Loans	SBA Loans	Member Bank Loans	RFC Participations	RFC Direct Loans	Regulation V Loans	SBA Loans
Under \$5,000	65.3%	11.1%	28.3%	10.5%	2.5%	4.1%	0.3%	1.0%	0.1%	0.2%
\$5,000-9,999	13.9	13.5	14.5	8.6	8.6	3.2	0.8	1.3	0.1%	1.3
10,000-24,999	10.7	22.3	21.7	25.4	25.4	5.1	3.0	4.2	0.2	8.3
25,000-49,999	4.1	16.4	13.2	8.7	21.8	4.2	4.7	5.7	0.2	14.8
50,000-99,999	2.5	16.5	12.0	12.3	26.1	5.0	9.6	9.8	0.5	36.0
100,000-499,999	2.4	15.8	8.2	36.1	15.6b	16.3	26.7	19.0	5.0	39.4b
500,000-999,999	0.6	2.2	1.1	12.5	..	12.4	11.7	9.5	4.9	..
1 million and over	0.5	2.1	1.0	19.9	..	49.8	43.2	49.5	89.3	..
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

RFC direct loans refer to disbursements through December 1951 on loans authorized from 1934 through mid-1951, from Table B-2. RFC participations refer to authorizations from 1934 through mid-1947, from Table B-40. Bank term loans refer to transactions between November 1945 and November 1946 and cover amounts still outstanding at the latter time, from "Term Lending to Business by Commercial Banks in 1946," by Duncan McC. Holthausen, *Federal Reserve Bulletin*, May 1947, Table 6, p. 505. V-loan guarantees cover authorizations from 1942 through mid-1946 and refer to number of borrowers rather than of loans (with borrowers receiving a number of authorizations classified only once and then under the size class of their largest authorization), from *A Statistical*

Study of Regulation V Loans, by Susan S. Burr and Elizabeth B. Sette (Board of Governors of the Federal Reserve System, 1950), Table 11, p. 35. Small Business Administration loans cover direct business loans and participations approved from September 28, 1953 through July 31, 1954, from the *Second Semi-Annual Report of the Small Business Administration*, July 31, 1954, p. 45.

^a Distributions for RFC participation loans and for SBA loans are for the following class intervals: \$5,000 and under; \$5,001 to \$10,000; \$10,001 to \$25,000, etc., to over \$1 million. Size is based on amount authorized, except that bank loans are classified by size of outstanding balance.

^b Covers loans up to \$300,000.

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These figures are impressive despite the imperfect comparability of the different loan groups.¹⁵

Outside the medium loan size range, differences between the public credit institutions and the commercial banks were greater in the small than in the large size ranges. Ninety percent of commercial bank term loans were in amounts under \$25,000. The comparable figure for the Small Business Administration was only 37 percent; for RFC participations, 47 percent; for loans made solely by RFC, 65 percent. At the upper end of the size scale, the distribution by amount shows commercial banks and RFC each with about half their credit in loans of \$1 million and over. The V-loan guarantee program, geared to aid large key war industries, extended 90 percent of its credit in amounts of \$1 million or more; and virtually the entire portfolios of the Export-Import Bank and the Maritime Administration also consisted of very large loans.

It may be concluded, then, that with the single exception of the business loans guaranteed or insured by the Veterans' Administration—most of which were (for statutory reasons) concentrated within the \$1,000 to \$5,000 size bracket¹⁶—federal credit services have been directed to the middle ranges in the business-size spectrum. They have not been instrumentalities predominantly for the financing of small business. This conclusion is confirmed in the case of RFC by an analysis of the size of business firms receiving credit benefits, included in Appendix B. By and large, federal agencies have not found it feasible to make large numbers of small loans to small enterprises because of the high administrative costs per dollar of credit extended which such operations entail.¹⁷

Compared with the medium-term credits supplied by the commercial banking system, those provided by federal agencies have tended to be concentrated among manufacturing businesses. This has been true of all federal programs with the exception of the Veterans' Administration, which, being focused wholly on very small ventures, has been concentrated among retail trade and service

¹⁵ For instance, all the SBA loans and guarantees and many of the RFC direct loans were made during the inflationary period from 1947 on, whereas the bank loans, the RFC participations, and the V-loan guarantees stem partly or entirely from earlier periods. V-loan data refer to number of borrowers rather than of loans and are biased upward as to size.

¹⁶ See Appendix Table C-11 for a distribution of VA-guaranteed business loans made from May through October 1947 according to purchase price of assets acquired with the loan proceeds.

¹⁷ See the testimony of an RFC official, footnote 59, Appendix B.

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businesses where small size is characteristic.¹⁸ Table 45 presents comparisons of RFC participation loans, RFC direct loans, Federal Reserve Bank industrial loans, Small Business Administration loans, and commercial bank term loans according to the industry of the borrower involved. Manufacturing firms formed about 9 percent of the total number of operating businesses in the United States in 1949. Yet as much as 60 percent of all RFC participation loans, 48 percent of RFC direct loans, and 57 percent of Federal Reserve Bank loans and of Small Business Administration loans were made to manufacturing enterprises; and in line with the special purpose of the program, more than nine out of every ten V-loan guarantees authorized from April 1942 to June 1946 applied to a manufacturing credit.¹⁹ The majority of Export-Import Bank credits also went to finance capital goods exports by American manufacturing firms, even where the loan was made directly to a foreign government or corporation. On the other hand, only 14.6 percent of commercial bank term loans went to the manufacturing segment of business. Retail trade and service firms—which comprise 64 percent of all operating businesses in 1949—were numerically much more important users of commercial bank term credit and comparatively unimportant users of the credit services of federal agencies.

One reason is that the risks of term lending have been, on the average, greater with manufacturing than with trade, service, or financial firms because the commitment to fixed assets is relatively greater, the term to maturity of the required credit is longer, fluctuations of profits are wider, and the impacts of technological changes and economic fluctuations are more severe. A contributing factor was the very severe erosion of working capital suffered by many medium and small American manufacturing firms during the thirties. As a result, proportionately more manufacturing firms have been ultra-marginal to private lenders and have sought public credit.

GEOGRAPHICAL DISTRIBUTION OF CREDIT

Federal credit services appear to have exerted a pull on the regional distribution of economic resources generally toward the South Atlantic, Gulf, and Pacific Coastal regions, and away from the earlier-developed areas of the nation—New England, and the

¹⁸ See Appendix Table C-17 for a distribution of VA-guaranteed business loans made in 1949-1950 by industry of borrower.

¹⁹ Burr and Sette, *op.cit.*, Table 8, p. 28.

TABLE 45

Industry Distributions of RFC Business Loans, Federal Reserve Bank Industrial Loans,
and Small Business Administration Loans, with Those of Commercial
Bank Term Loans and of All Operating Businesses

INDUSTRY	NUMBER OF LOANS				AMOUNT AUTHORIZED OR DISBURSED					
	ALL U.S. BUSINESS FIRMS	Member Bank Loans	RFC Partici- pations	RFC Direct Loans	FRB Loans	SBA Loans	Member Bank Loans	RFC Partici- pations	RFC Loans	SBA Loans
Manufacturing and mining	8.9%	14.6%	60.4%	48.0%	57.0%	56.6%	52.0%	71.7%	76.2%	61.8%
Construction	8.4	5.3	6.9	6.3	3.0	5.0	1.4	7.0	3.0	5.2
Wholesale trade	5.1	6.8	4.9	4.6	11.0	21.0	4.9	6.5	1.4	14.5
Retail trade	42.7	37.3	13.3	15.5	21.0		9.0	2.4	2.8	
Transportation, com- munications, and public utilities ^b	4.8	11.7	6.1	8.3	1.0	10.2	21.1	3.4	8.1	14.4
Services	21.5	16.7	3.9	14.6	5.0	5.4	5.1	1.1	3.0	3.3
Finance, insurance, and real estate ^c	8.7	0.2	3.3	0.5	1.6	6.7	5.1	..
All other ^d	e	7.4	1.3	2.1	2.0	1.8	4.9	1.2	0.4	0.8
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

RFC direct loans refer to disbursements through December 1951 on loans authorized from 1934 through mid-1951, from Table B-7. RFC participations refer to authorizations from 1934 through mid-1947, from Table B-41. Bank loans refer to term loans outstanding November 20, 1946, from "Term Lending to Business by Commercial Banks in 1946," by Duncan McC. Holthausen, *Federal Reserve Bulletin*, May 1947, Table 2, p. 502. Federal Reserve Bank loans represent the number of applications from January 1, 1935 to May 1, 1940, from "Capital and Credit Requirements of Federal Reserve Industrial Loan Applicants," by Charles L. Merwin, Jr. and Charles H. Schmidt (National Bureau of Economic Research, Financial Research Program, mimeo, 1942), Table A-6, pp. A-7f. Small Business Administration loans, inclusive of immediate and deferred participations, are those approved from September 28, 1953

through July 31, 1954, from the *Second Semi-Annual Report of the Small Business Administration*, July 31, 1954, p. 47. Business firms are those in existence at the end of 1949, from *Survey of Current Business*, January 1952, p. 10.

^a Predominantly manufacturing enterprises.

^b Data for RFC direct loans exclude railroads.

^c Data for banks exclude real estate firms.

^d Includes forestry, fishing, and farming (mainly the latter two) for RFC and SBA; for banks, excludes farming but includes real estate and also a few cases unclassified by industry.

^e Not covered in the Department of Commerce estimates of the business population.

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Middle Atlantic and East North Central states. The tendency of federal business credit to finance firms in areas which are newly industrialized and have gained relatively most rapidly in population and economic wealth during the past generation is evident not only in RFC lending²⁰ but also in Federal Reserve Bank industrial loans (though not among privately made small business loans guaranteed or insured by the Veterans' Administration). This may betoken a relatively greater lack of private credit facilities in the regions of most rapid growth; it may indicate the presence in these areas of relatively more firms in new industries or other high risk situations. At any rate, disproportionately large numbers of RFC and Federal Reserve Bank loans to business were made in the capital deficit areas of the nation, and disproportionately small numbers in the capital surplus areas such as the New England, the Middle Atlantic, and the East North Central regions.

TERMS TO MATURITY

Federal business credit agencies have functioned predominantly in the medium-term market. At the inception of their business lending operations during the early thirties, RFC and the Federal Reserve Banks made, or facilitated the making, of business loans with longer maturities than were then commonly available from commercial banks, life insurance companies, or other private lenders.²¹ After 1934 private lending agencies progressively entered the medium-term business credit market; federal agencies appear to have continued to operate in the more lengthy segment of the market, but this difference between public and private agencies is tending to lessen.

Business loans guaranteed by the Veterans' Administration brought the commercial banking system into a new type of credit operation, namely term lending to new and very small firms. Whereas probably more than three-quarters of the small business loans made by commercial banks are written to mature within a year, virtually no VA-guaranteed business loans have matured in less than ten months.²²

²⁰ See Appendix Table B-8, which compares the regional distribution of RFC direct business loans disbursed in 1934-1951 with that of all business loans held by commercial banks in 1941 and 1951 and of all operating businesses in 1948.

²¹ Cf. N. H. Jacoby and R. J. Saulnier, *Term Lending to Business* (National Bureau of Economic Research, Financial Research Program, 1942), pp. 24f.

²² See Appendix Table C-12 for a comparison of maturity of distributions for VA-guaranteed business loans and commercial bank term loans to small businesses. Appendix Table B-2 gives comparable data for RFC direct loans to business concerns.

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Loans guaranteed under Regulation V had original maturities running over one year in about two-fifths of the cases,²³ and the Export-Import Bank has been concerned primarily with the provision of medium-term credit, nearly 70 percent of the loans outstanding at the end of 1953 having original maturities of ten years or less.²⁴

CREDIT POLICIES

A basic policy of all federal agencies lending to business has been to provide credit only to firms unable to procure it from the usual sources on reasonable terms. The agencies interpreted this to mean an inability on the part of the prospective borrower to obtain funds at conventional rates from the commercial banks with which it ordinarily dealt, and they have faithfully sought to avoid making loans that such commercial banks would make.²⁵ This policy has defined in part the class of business borrowers with which federal agencies would deal—firms which were ultra-marginal credit risks or which lacked local banking connections.

Federal statutes have embodied other credit standards as well. The RFC statute required that loans should be “so secured or of such sound value as reasonably to assure repayment,” and in practice the agency required that adequate collateral security be supplied. RFC totally eschewed unsecured lending.²⁶

Industrial advances by the Federal Reserve Banks were also required to be “on a reasonable and sound basis,” and this was interpreted by most banks to mean full collateralization. On V loans, the commercial bank concerned ordinarily relied on the government contract as collateral. Export-Import Bank loans usually involved collateral or endorsement, and the Maritime Administration’s ship loans have been secured by first mortgages. By law, the Veterans’ Administration might guarantee or insure a small business loan to a veteran only if the experience and ability of the veteran were such that there was a “reasonable likelihood” that he would be successful,

²³ Burr and Sette, *op.cit.*, Table 18, p. 50.

²⁴ *Seventeenth Semiannual Report*, Export-Import Bank of Washington, July-December 1953, Appendix C.

²⁵ RFC and Federal Reserve Banks did not insist that credit be “unavailable” from other lenders than commercial banks, or from other commercial banks than those in the applicant’s community. Nor did they require the applicant to show an inability to obtain equity funds.

²⁶ See *Hearings* before a Subcommittee of the Committee on Banking and Currency, 81st Cong., 2nd sess., May 8 and 9, 1950, on *A Study of the Operations of the Reconstruction Finance Corporation* pursuant to S. Res. 219. *Analysis of Income and Costs*, statement of Harvey L. Gunderson.

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and only if the purchase price paid by the veteran for business property or for the cost of constructing such property did not exceed "the reasonable value thereof" as determined by a VA-designated appraiser.²⁷ The law also requires that realty loans be secured by a first mortgage, and that loans for machinery, equipment, working capital, good will, or intangibles be secured by personalty "to the extent legal and practicable." It is clear that Congress has intended that the normal banking measures be taken to assure repayment or recovery of funds disbursed.

The question naturally arises: If loans by federal agencies were supposed to be sufficiently secured to assure repayment, why were not the business enterprises using their services in a position to satisfy their requirements from private sources? Why did they come to federal agencies? One answer would seem to be that the adequacy of security is a matter open to a wide range of judgments; federal agencies were expected—and frequently were able—to take a more liberal view of the value of collateral than could private bankers.

Moreover, some firms which were unquestionably worthy of private credit lacked local banking facilities altogether, or lacked facilities that were adequate to their needs. A questionnaire mailed to more than 15,000 commercial banks by the Subcommittee of the Senate Committee on Banking and Currency investigating the RFC in 1947 brought forth these significant findings: Of the nearly 8,000 banks which responded, half reported that they had refused to make some business loans which appeared to be sound credit risks. Several reasons were given, of which the most frequent were: the loan exceeded the bank's legal limit; the requested maturity was too long; the bank lacked experience with the requested type of loan, or the applicant was launching a new enterprise.²⁸ Behind these reasons lay the restrictions on risk assumption imposed by banking laws and bank examining officers, and the need for liquidity imposed by the slender capital resources and the high ratio of demand deposits which characterize American banking. The inquiry indicated that ordinarily RFC did not make types of loans that banks were not making; rather, it took *higher risk* loans than many banks could,

²⁷ Veterans' Administration, *Lenders' Handbook*, December 1948, supplementary pp. 3.5f., citing 38 U.S.C. 694C.

²⁸ *Hearings* . . . on S. Res. 132, Part 1, 80th Cong., 1st. sess., December 1947, pp. 253ff.

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or would, make.²⁹ The same appears to have been true of the working capital loans made by Federal Reserve Banks, the exporter credits of the Export-Import Bank, and the ship purchase or construction loans of the Maritime Administration. In the case of the Veterans' Administration, the existence of loan guaranty or insurance, by reducing exposure to risk of loss, doubtless induced many banks to make loans they would not otherwise have made.

In his study of the operations of Export-Import Bank from 1934 through 1947, Marsh reached the conclusion that the bank had faithfully followed the statutory injunction "not to compete with private capital," and had financed export transactions for which private credit was not available, either because of the high trading risk or the high risk of inability to transfer funds from the foreign buyer's country.³⁰

Another business credit policy apparently followed by most federal agencies was not to lend money primarily for the purpose of enabling a firm to refund or repay other debts. Federal credit was supposed to fulfill the primary purpose of financing new activity, and not to bail out private credit institutions from loans of questionable collectibility.³¹ Nevertheless, a material fraction of the funds provided by federal business credit agencies was used to repay or retire existing debt, sometimes in order to relieve a borrower's property of prior liens so that the federal agency itself could obtain a first lien. Thus, the proceeds of about one-fifth of RFC's direct business loans, aggregating more than one-third of the funds disbursed, were so utilized.³² Comparison with an analysis of the use of the proceeds of commercial bank term loans to business firms

²⁹ This appears to have been the thought expressed by John D. Goodloe in testimony as chairman of RFC before the Special Subcommittee of the Senate Committee on Banking and Currency. He stated that apart from long-term credit to small firms "we know of no important general classification [of business] that is unable to obtain private credit. However, there will always be a lack of credit for concerns which fall within the lower level of desirability from the risk standpoint." Cf. *Hearings* just cited, p. 35.

³⁰ Donald B. Marsh, *The Export-Import Bank of Washington* (Department of Financial and Business Research, Chase National Bank of New York, mimeo., May 5, 1947), p. 43.

³¹ The official instructions of RFC to its loan agency managers stated: "Generally, a loan should not be made for the primary purpose of discharging an existing indebtedness, except for the purpose of paying income taxes on a compromise basis. There may be circumstances, however, under which a reasonable portion of a loan may be used for discharging an indebtedness, but no part should be used to pay off a bank or other financial institution in liquidation or to reduce existing indebtedness of slow or questionable nature."

³² See Appendix Table B-3.

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outstanding June 30, 1941 indicates that RFC credits and private term credit were used for about the same purposes.³³

Proportionately more of federal credit has performed the function of financing new ventures than of private credit. It is estimated that about one in seven of the direct business loans made by RFC went to enterprises that were yet to be established at time of loan authorization. Among these loans were such well-publicized venture financing operations as Kaiser Steel Company, Carthage Hydrocol Inc., and Lustron Corporation. RFC was also active in financing firms in relatively new industries—including motor courts, cold storage lockers, alfalfa dehydrators, and bottled gas—where private credit was difficult to obtain because of the novelty of the industry and the lack of data and experience for appraising risks. VA-guaranteed business loans were, of course, entirely for the purpose of enabling veterans to establish or expand their own businesses. Most veterans used the proceeds of loans to purchase going concerns or to expand established ventures; about 35 percent of the proceeds of loans closed between April 26 and October 25, 1947 were to start a business.³⁴

CREDIT STANDARDS

In applying the statutory credit policies, federal business credit agencies have examined many more applications for loans, loan insurance, or loan guaranty than they have approved. Over the period 1934 to mid-1951, RFC received about 88,000 applications for business loans (covering both direct loans and participation loans exclusive of blanket participation agreements), of which it approved about 47,000, or 53 percent. The percentage of approvals to applications received rose as high as 74 percent during the first war year, 1942, and fell as low as 41 percent during 1949, reflecting variations in economic conditions, in the percentage of applications withdrawn, and in RFC's policy regarding acceptance of applications, as well as variations in the rigor with which applications were scrutinized.³⁵ Up to May 31, 1940, Federal Reserve Banks had approved only 2,900 or 30 percent of the 9,590 applications for business loans received by them.³⁶

³³ Cf. N. H. Jacoby and R. J. Saulnier, *Term Lending to Business*, pp. 51f.

³⁴ See Appendix Table C-15.

³⁵ From material supplied by the RFC.

³⁶ Charles L. Merwin, Jr. and Charles H. Schmidt, *Capital and Credit Requirements of Federal Reserve Bank Industrial Loan Applicants* (National Bureau of Economic Research, Financial Research Program, mimeo., 1942), Tables A-2 and A-8, pp. A-3 and A-11.

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In examining the differences in financial characteristics between samples of approved and rejected loan applicants for Federal Reserve Bank loans, Merwin and Schmidt found that the approved applicants ran larger in asset size, were more heavily weighted by manufacturing concerns, were somewhat more profitable (or less unprofitable), and were somewhat less indebted than were the rejected applicants.³⁷ Trends in financial ratios were less favorable for the rejected than for the approved applicants. This appears to indicate that the primary reason for rejecting applications was failure of the applicant to meet minimal financial standards of the Federal Reserve Banks; not availability of private credit, or other reasons. Systematic information as to why RFC, VA, and other federal agencies declined applications for credit services is not available, but scattered evidence suggests that failure to meet the credit standards of the public agency was predominant. Data on a small sample of applications rejected by RFC, for example, reveal that "insufficient collateral," "earning ability not demonstrated," "excessive debt retirement," "inexperienced management," "insufficient equity investment," and "promotional venture" were the reasons most frequently assigned.³⁸

The financial trends and ratios of firms borrowing from RFC are known from a sample of the loans; and although comparable data for commercial bank term loans are lacking,³⁹ some inferences as to comparative credit standards may be drawn. Nearly half of the RFC loans were made to businesses whose current ratio (current assets/current liabilities) in the fiscal year preceding the date of loan application was less than the two-to-one standard generally regarded as minimal by commercial banks. Moreover, a fifth of the number and about one-third of the amount of RFC loans went to firms with a net-worth-to-debt ratio of *less* than one-to-one, whereas the average ratio for American business as a whole is about two-to-one.⁴⁰ Finally, about two-thirds of the number and amount of loans went to firms rated "good" or "fair" by Dun and Bradstreet, while

³⁷ *Ibid.*, p. 8.

³⁸ *Hearings* . . . on S. Res. 132, Part 2, 80th Cong., 2nd sess., January 1948, p. 459.

³⁹ The publications of Robert Morris Associates contain aggregates and averages of information about financial ratios and trends of samples of firms submitting their financial statements to commercial banks, but the statistics are not in a form which facilitates comparison with federal agency credit standards.

⁴⁰ Based on a distribution in which nearly 20 percent of the loans went to firms failing to report financial data of this type. Many of these doubtless had low net-worth-to-debt ratios. See Appendix Table B-10.

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relatively few loans were made to firms rated "high." The conclusion appears justified that the preponderance of borrowers from RFC were at, or under, the margin of creditworthiness, when judged by the ordinary standards of commercial banks.

COOPERATIVE CREDIT ARRANGEMENTS

Part of the effort of public agencies to avoid competition with private credit institutions and to accelerate the flow of credit to business firms has taken the form of cooperative credit relationships. RFC policy was consistently directed toward inducing commercial banks to make business loans by its readiness to enter into immediate or deferred participations. In immediate participations, RFC and a commercial bank each advanced a specified part of the funds under a single loan agreement initiated by either lender. In deferred participations, a bank advanced the total amount of a loan from its own funds, and the RFC agreed to "take up," i.e. to purchase, a specified percentage of the loan upon demand by the bank, in effect guaranteeing to the bank repayment of that portion of the loan. Federal Reserve Banks have entered into similar cooperative arrangements with commercial banks.

The Export-Import Bank and commercial banks have cooperated in several ways. Export-Import Bank has supplied "supplementary credits," in which both it and a commercial bank have lent money to the same exporter; it has at all times made its current portfolio of loans available for purchase by private investors; commercial banks have participated in numerous credits arranged by it; finally, "agency agreements" have been made with commercial banks engaged in financing exports, whereunder the Export-Import Bank has agreed to "take out" or reimburse the lending bank for a specified proportion of the credit on demand—essentially a deferred participation or loan guarantee. Commercial bank credits disbursed at Export-Import Bank risk under agency agreements represented about 19 percent of the total of EIB loans and guarantees made from February 12, 1934 to December 31, 1946.⁴¹

The V-loan program and the business credit activities of the Veterans' Administration were, of course, entirely cooperative in character. Material on the characteristics of business loans made with RFC participation, of those made cooperatively by Federal Reserve

⁴¹ Cf. Marsh, *op.cit.*, pp. 44-47.

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Banks, and of those guaranteed under Regulation V and under the VA program, follows.

Of the 47,000 business loans separately authorized by RFC under its regular and wartime powers from 1934 to mid-1951, some 15,100, or nearly one-third, involved cooperation with commercial banks. Another 11,100 participation loans were authorized under Blanket Participation Agreements arranged during the reconversion years 1945 and 1946. Our information on loan and borrower characteristics concerns mainly the ordinary (rather than the BPA) participations.

A study of the approximately 6,000 ordinary participation loans authorized during the thirteen years from 1934 through mid-1947 (a period for which information on the participating banks was readily available)—involving gross loan amounts of about \$828 million for 2,018 different commercial banks—revealed these salient facts:⁴²

1. The great majority of participations carried a deferred rather than an immediate commitment.

2. More participation loans involved an RFC risk of 75 percent of the total loan than any other percentage. The volume of participation lending would probably have been much less if RFC had not been the major partner in carrying the risks.

3. Participation loans were preponderantly of medium and large size; they averaged larger than loans made by RFC on its own account, and much larger than the term loans made by banks without participation. Clearly, they were not a device for financing small business.

4. The industrial and regional distributions of participation loans resembled those of direct RFC loans.

5. The banks which utilized participation facilities tended to be well-established institutions of medium and large size, with national charters or Federal Reserve membership, located in medium and large-sized cities. About one-eighth of the banks in the nation were involved. Participation was demonstrably not a measure utilized principally by small banks in small communities to aid in the meeting of local credit demands.

6. There was a considerable measure of concentration in the use of participation facilities: a third of the number and half of the

⁴² See Appendix B for supporting tabular material and a more detailed treatment of the findings.

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amount of loans authorized from 1934 through mid-1947 involved RFC participations with only 99 banks. On the other hand, more than half the banks that participated with RFC did so on only one occasion.

7. Because a quarter of the number of all participation loans were in amounts which exceeded the legal loan limit of the creditor bank, one may infer that an important motivation for banks in seeking RFC guarantees was the opportunity, when most of the risk on a business loan could be shifted to a public agency by paying a relatively small fee, to make larger loans than the regulatory laws or prudent bank management policies of asset diversification would otherwise permit.

The most important post-World War II venture of public agencies into the guaranteeing or insuring of business loans for commercial banks was the blanket participation (BPA) program, begun by RFC in March 1945 in an effort to provide ample reconversion credit and to forestall anticipated mass unemployment. A commercial bank that negotiated a blanket agreement with RFC was, in effect, automatically assured of a deferred participation by RFC of up to 75 percent of the amount of any business loan conforming to the statutory restrictions on RFC loans. Under blanket guarantees the volume of RFC participations greatly expanded. For the first time, federal guaranty reached banks in small communities,⁴³ and embraced loans of smaller average amount than had been made under ordinary participation arrangements, although they were not by any means small loans.⁴⁴ BPA demonstrated the potentialities of a streamlined governmental underwriting of business credit risks, and suggested some of the dangers as well, coming under criticism as an untimely stimulus to credit and an encouragement to loose lending practices. The program was withdrawn in January 1947.

With respect to a considerable proportion of regular participation loans, it appears that RFC functioned as a risk-distributing agency for banks of medium size. In an economy increasingly characterized by large enterprises with large credit requirements, and where the dominant pattern of banking is one of small-scale institutions with limited capital resources, it was perhaps natural that RFC participation should take on that emphasis. Partly to meet the problem of limiting the exposure to risk of loss for an individual

⁴³ See Appendix Table B-49.

⁴⁴ See Appendix Table B-48.

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bank in meeting the credit demands of its area, commercial banks have developed an intricate set of correspondent relationships. Commercial bankers have contended that the correspondent banking system is an instrumentality capable of solving the problem of diversification of risks, and that a public credit agency for the purpose is unnecessary.

The preceding description of RFC participation credits and of the banks involved appears to apply in its major outlines to the participation loans made by Federal Reserve Banks. More than half of the number and two-thirds of the amount of Federal Reserve Bank loans and guarantee commitments to business represented loans made cooperatively with commercial banks and other financial institutions. In the majority of the loans, the commercial bank assumed between 20 and 50 percent of the liability for loss. Cooperative loans averaged larger in amount than the loans made by the Federal Reserve Banks alone. Each of the twelve Federal Reserve Banks was delegated authority to pass upon the creditworthiness of applicants and to work out the terms of its loans, subject only to broad regulations laid down by the Board of Governors of the Federal Reserve System. Hence there were material variations between Federal Reserve districts in the use of cooperative arrangements. On the whole, experience with cooperative loans proved somewhat better than with loans made solely by the Reserve Banks—a conclusion which might have been expected.

Measured by the volume of funds involved, the most extensive federal program of business loan guaranty was the V-loan program of World War II.⁴⁵ The armed services were authorized to guarantee loans made by private financial institutions to meet the working capital needs of businesses engaged in war production either as contractors or subcontractors; and the Board of Governors of the Federal Reserve System established a procedure under Regulation V by which the twelve Federal Reserve Banks administered the guarantees, as agents for the War and Navy Departments and the U.S. Maritime Commission. The purpose was to assure an adequate flow of credit to finance war production. Extensions of the regulation to apply to working capital needs as contracts terminated have already been described. Regulation V originally established a maximum interest rate of 5 percent on the loans to be guaranteed, which was reduced in September 1944 to 4½ percent. It provided for a maxi-

⁴⁵ Cf. *Federal Reserve Bulletin*, March 1946, pp. 240-248; also Burr and Sette, *op.cit.*, pp. 7ff.

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mum guarantee of 90 percent, except in unusual cases, and the lending institution was charged a fee graduated upward as the guaranteed portion of the loan increased.

Authorizations under Regulation V from April 1942 to June 1946 totaled about \$10.5 billion.⁴⁶ Most were revolving credits, so that although some authorizations were never disbursed but functioned as standby credits, others were used many times over, and the total of disbursements reached \$12 billion. Some part of the credit undoubtedly would have been advanced without federal guarantee, because commercial banks shifted a material part of their lending for war purposes from an unguaranteed to a guaranteed basis after Regulation V was promulgated.⁴⁷ Even when guaranteed credit was at its peak, it represented only about two-thirds of all bank credit for war purposes, the banks having carried the risk of the other one-third themselves.

The concentration of V-loan guarantees with large banks was quite pronounced: only 10 percent of all commercial banks took part, and nearly all of them were of medium or large size.⁴⁸ In fact, 98 percent of all banks with deposits of \$50 million or over, and 78 percent of those with deposits of \$10 to \$50 million had loans guaranteed under Regulation V, as against only 1 percent of the banks with deposits of under \$1 million and 6 percent of those with deposits of from \$1 to \$2 million. The V-loan guarantee program bypassed the small bank, just as it bypassed small businesses.

Both in statutory conception and in actual operation, the business loan guaranty program of the Veterans' Administration has had a markedly different character from other federal programs of loan guaranty or insurance. The salient distinctions may be summarized as follows:

1. Unlike other federal business loan guaranteeing agencies, VA lacked the power to lend directly to business.

2. VA enforced no requirement that the borrower show unavailability of nonguaranteed credit from private sources, whereas other public agencies made the granting of credit or credit guaranty contingent upon a showing that the prospective borrowing business had been unable to obtain credit on reasonable terms from private sources.

3. Other federal business credit programs have been restricted to

⁴⁶ Burr and Sette, *op.cit.*, Table 2, p. 14.

⁴⁷ *Ibid.*, p. 19.

⁴⁸ *Ibid.*, Table 20, p. 52.

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established or solvent firms, to firms engaged in exporting or some specified type of economic activity, or—as in the case of Federal Reserve Bank industrial loans—to the financing of working capital needs; but VA loans have been unrestricted in all these respects.

4. VA was forbidden by law to charge for its guaranty service on business credits, and the loans it could guarantee were held to a maximum interest rate (5.7 percent per annum for insured non-real-estate loans) that is low in relation to the high risks and administrative costs involved. Other federal business credit agencies have had broad administrative powers to determine charges for credit services (though in practice they have tended to standardize rates without distinction among borrowers and to vary rates rather infrequently through time).

5. VA guarantees have been limited to very small amounts—50 percent of the amount of a loan but not more than \$2,000 in the case of loans not secured by real estate, or \$4,000 in the case of real-estate-secured loans—whereas other public agencies have usually been permitted to make, guarantee, or insure loans of any amount.

6. The VA program has been more decentralized than that of any other public agency. More than seventy regional offices were operated at one time, each with power to approve loans finally for guaranty or insurance.

VA-guaranteed business loans have been preponderantly amortized term loans to very small firms. They averaged under \$3,000 in amount, with an average VA liability of approximately \$800.⁴⁹ They had a modal term to maturity of two and one-half to three years, and were amortized in equal monthly installments.⁵⁰ Nearly three-quarters of the loans closed during June and July 1947 were secured by liens on personal property employed in the business.⁵¹

Measured against private credit to businesses of fairly small size, VA guarantees appear quantitatively unimportant. From 1945 to December 1954, 217,764 loans, in an aggregate original amount of \$588 million, had been disbursed; and about 57,000 loans, with balances estimated between \$100 million and \$150 million, were outstanding.⁵² The number of “small business” loans held by Federal

⁴⁹ *Loan Guaranty*, Veterans' Administration, December 1954, p. 57.

⁵⁰ From Appendix Table C-12, which gives the maturity distribution of loans made between May and August 1947, and Table C-14, which gives the repayment schedule for loans closed in June and July 1947.

⁵¹ See Appendix Table C-13.

⁵² Compiled from data in *Loan Guaranty*, Veterans' Administration, December 1954, p. 57.

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Reserve member banks in November 1946 is estimated at 514,000, and the amount outstanding, at \$2.9 billion.⁵³ Yet VA guarantees might bulk large if they could be compared solely with private credit to similar borrowers: that is, new and extremely small firms. Their importance lies in the introduction of term lending into that market, and in inducing commercial banks to undertake and gain experience with such loans.

PRICING OF CREDIT SERVICES

The pricing policies of federal business credit agencies contrast with those of private-lending institutions in certain distinctive characteristics. There has been evident, in the first place, a strong tendency to standardize the interest rate or commitment fee charged within each broad class of loans rather than to discriminate between borrowers and loans according to size, credit risk, and costs of loan administration. Secondly, there has been a tendency toward inflexibility of charges through time, instead of sensitive and frequent adjustment to changing supply-demand conditions in the money markets. Thirdly, the pricing policy has tended to consider only partial costs, with interest rates and commitment fees in many instances insufficient to defray the full cost of supplying the credit services if the cost of capital funds employed is included. Fourthly, in loan guaranty and insurance programs congressional as well as administrative actions have operated in the direction of reducing charges for business credit by private lending institutions, frequently below current market rates.

RFC, whose statute did not prescribe its customer charges, set a standard 5 percent rate on direct loans or immediate participations in 1935. This was reduced to 4 percent on April 1, 1939 and restored to the 5 percent rate on November 10, 1950, apparently in response to criticism that full costs were not being met. RFC's loan guarantee fees were originally graduated from 1/2 percent to about 2 percent, depending on duration; were shifted upward, then downward, and on November 10, 1950 were raised to a flat 2 percent.

Each Federal Reserve Bank has fixed its own rate for industrial loans and commitments, subject to approval by the Board of Gov-

⁵³ "Member Bank Loans to Small Business," by Charles H. Schmidt, *Federal Reserve Bulletin*, August 1947, p. 963. In the survey, the definition of small business covers manufacturing and mining firms with total assets of less than \$750,000, wholesale trade concerns with assets under \$250,000, and all other firms with assets under \$50,000.

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ernors of the Federal Reserve System. At the beginning, five of the banks announced a standard loan rate of 6 percent, one bank announced a standard rate of $5\frac{1}{2}$ percent, and the remaining banks published rates varying from 4 to 6 or 5 to 6 percent.⁵⁴ Later the different banks tended to abandon the standard rate and to move toward a range of rates, until at the end of 1954 the published range of rates on loans was $2\frac{1}{2}$ to 5 percent and $3\frac{1}{2}$ to 5 percent for all banks excepting St. Louis, for which it was 3 to 5 percent and Atlanta and Kansas City, where it was $2\frac{3}{4}$ to 5 percent. The range of rates on loan guarantees at the end of 1954 was $\frac{1}{2}$ to $1\frac{1}{4}$ percent or $\frac{1}{2}$ to $1\frac{3}{8}$ percent per annum of the amount of the Reserve Bank's commitment.⁵⁵ Despite these changes in pricing policy, recent charges only partially reflect the variation of individual loan risks and costs. As with RFC, changes in Federal Reserve Bank rates through time have been comparatively infrequent.

Congress fixed a maximum annual interest rate of 4 percent on business loans eligible for guarantee by the Veterans' Administration,⁵⁶ and a maximum rate of 5.7 percent on insured loans not secured by real estate—rates demonstrably below the competitive rate for loans of similar risk and administrative cost. It did not authorize the VA to make any charge whatever for business loan guaranty or insurance, so that these services represent an outright subsidy to the veteran borrower.

For Regulation V loans the Board of Governors of the Federal Reserve System limited the interest rate that could be charged by the lender to 5 percent and established a definite scale of charges to be made by Federal Reserve Banks for entering into contracts of loan guarantee.⁵⁷ The scale was altered twice. After September 11, 1944, the Reserve Banks were required to charge a fee of 10 percent of the total interest collected on a loan, when the percentage of the loan guaranteed was 60 percent or less. As the percentage of the

⁵⁴ *Banking and Monetary Statistics*, Board of Governors of the Federal Reserve System, 1948, Table 118, p. 446.

⁵⁵ *Federal Reserve Bulletin*, January 1955, p. 27.

⁵⁶ Congress amended the law effective August 10, 1948, to permit the Administrator, with the concurrence of the Secretary of the Treasury, to approve of rates up to $4\frac{1}{2}$ percent. Effective May 5, 1953 the Veterans' Administration, with the approval of the Secretary of the Treasury, authorized an increase in the maximum interest rate to $4\frac{1}{2}$ percent per annum.

⁵⁷ Burr and Sette, *op.cit.*, pp. 45f. The Reserve Board also limited the commitment fees that banks were permitted to charge business firms on the undisbursed portions of loans authorized by them.

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loan covered by the guarantee rose, the fee ranged upward to a maximum of 50 percent of the interest charge when the fraction of the loan guaranteed was over 95 percent. The scale was applicable to all loans, irrespective of size, credit risk, or administrative costs.

Congress has fixed the maximum rate chargeable on ship construction loans by the Maritime Administration at $3\frac{1}{2}$ percent if the ship is to be used in foreign trade, and at $5\frac{1}{4}$ percent if in domestic trade. For its insurance of ship mortgage loans made by private lenders the agency has fixed a premium of between $\frac{1}{2}$ percent and 1 percent per annum of the insured amount of the loan.

Among the federal sources of business credit only the Export-Import Bank appears to have adopted a flexible interest rate policy. This was a matter of administrative decision; Congress left the bank's management free to establish its own scale of charges. Most loans to foreign governments have carried rates ranging from $2\frac{1}{2}$ to $3\frac{1}{2}$ percent per annum; loans to foreign or domestic business enterprises have been made at rates in the range of 4 to 5 percent; special exporter-importer credits have been extended at 6 percent.⁵⁸

The implications of the standard loan rate policy followed by federal business credit agencies have received much attention from congressional committees and others. RFC's policy was examined intensively by a Senate subcommittee in 1947 at which time officers of the corporation testified that distinctions in rates as between sizes, maturities, and risk qualities were impractical.⁵⁹ The committee's report suggested that the managers of local RFC loan agencies, consulting their advisory committees of bankers and businessmen, should be free to set loan rates in the light of local conditions and without required adherence to a national standard rate.

The RFC standard loan rate policy was again examined in 1950 by a subcommittee of the Senate Committee on Banking and Currency which demonstrated the inverse relationship between lending costs and size of loan, which meant that at the standard rate, then 4 percent, the income from a relatively few large loans made up the losses on many smaller loans.⁶⁰ The corporation's loan rate policy was at variance, of course, with the customary practices of commercial banks, as is shown by comparison of average bank rates on

⁵⁸ *Twelfth Semiannual Report to Congress*, Export-Import Bank of Washington, January-June 1951, Appendix C, pp. 32-54.

⁵⁹ *Hearings* . . . on S. Res. 132, Part 1, 80th Cong., 1st sess., December 1947, p. 65.

⁶⁰ *Analysis of Income and Costs* (cited in footnote 26), p. 71.

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business loans of different sizes with the RFC rate as of November 1946.⁶¹

Another implication of the comparatively inflexible interest rate policy of federal lending agencies is that public credit tended to become relatively more attractive during periods of economic expansion, when interest rates would tend to be rising. The opposite would be the case during periods of credit contraction. Thus the federal policy had a tendency of producing a perverse cyclical effect. Effective coordination of federal lending operations with over-all fiscal and monetary policies for economic stability would seem to imply a more flexible loan rate policy than that typically followed by federal agencies.

Credit Experience

With the exception of the Export-Import Bank, the default experience and loss experience of federal lending and loan guaranteeing programs for business have been unfavorable in comparison with those of private business credit institutions. However, this result was to be expected in view of the relatively high-risk financing in which federal agencies have engaged, and does not necessarily reflect adversely on the management of the programs. Certain of the activities for which Congress made the public agencies responsible were destined from the beginning to result in appreciable losses, a fact that should be kept in mind in appraising the credit experience of the public agencies.

It is important also to recognize the character of the economic environment in which the programs functioned and its relation to their default and loss experience. Economic expansion over most of the thirties and forties made many credits good which under depressed or even stable economic conditions would have resulted in losses. The experience records available to us fall within an unusually favorable period, from the mid-thirties to the early fifties. It would be an egregious error to regard that experience as characteristic of federal business credit agencies in all time and under all conditions.

DEFAULT RATIOS

Evidence on the extent of delinquency among active loans in the portfolios of federal agencies supplying credit service to business refers mainly to loans made after World War II. At the end of 1951

⁶¹ See Appendix Table B-51.

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about 87 percent of the number and 90 percent of the amount of the Reconstruction Finance Corporation's active business loans (about four-fifths of which dated from 1948 or later) were "in good standing"; the remainder were delinquent in some respect.⁶² This record cannot be compared directly with the experience of commercial banks with term loans, but it is known that during 1951 less than 1 percent of the bank loans of all types appraised by bank examiners were classified as "substandard" in quality.⁶³ It would seem to follow that the RFC loans were of distinctly lower quality than those held by commercial banks.

Estimated default ratios (ratios of the number and amount of loans delinquent to the number and amount of active loans) for the RFC direct business loan portfolio at the end of 1951, by size of loan, term to maturity, size of borrower, industry of borrower, region of borrower, year borrowing firm was established, and principal use of proceeds are shown in Appendix Tables B-12 to B-14. Loan size appears to have had little relation to default experience, but it is interesting to observe that defaults were less frequent among the loans with longer maturities than among those made for shorter periods, possibly because the former were more conveniently related to the capacity of the borrowing firm to make repayments. By and large, the differences in delinquency ratios among various categories of loans were not marked. Higher than average default ratios were found for (1) loans with maturities of less than five years; (2) loans used principally to increase working capital or to retire debt; (3) loans to firms in the transportation, communications, and public utilities group; (4) to firms in the South Atlantic, East South Central, and Mountain regions; and (5) to firms with declining sales or profit trends. Loans to businesses in most asset-size classes under the \$250,000 level had less than average delinquency, and the ratio for businesses just forming at time of loan or too young to show three-year financial trends was about average. The absence, in general, of marked differences in delinquency ratios is an interesting phenomenon, suggesting that RFC's credit standards were consistently applied to all groups of loans.

⁶² Based on the National Bureau of Economic Research sample survey of RFC direct business loans exclusive of participations and national defense loans. For details, see Appendix Tables B-11 through B-16 and accompanying text.

⁶³ *Annual Report of the Federal Deposit Insurance Corporation*, December 31, 1951, Table 108, p. 154.

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For business loans guaranteed by the Veterans' Administration, default ratios over the period 1946-1954 ranged from 1.4 percent in the first year to 9 percent in 1954:

<i>End of Year</i>	<i>No. of VA-Protected Business Loans Outstanding</i>	<i>Default Ratio^a</i>
1946	41,875	1.4%
1947	68,972	4.5
1948	68,422	5.8
1949	68,446	6.0
1950	62,658	5.0
1951	94,236	4.1
1952	110,766	4.5
1953	80,102	7.5
1954	56,615	9.0

^a Loans in default at year end plus cases for which claim payments were pending, as percentage of all active loans. From Appendix Table C-8.

In connection with the rise in the ratios from 1951 to 1954, the increase and then decrease in number of outstandings, exerting a downward and then heightening effect on the default ratio, should be borne in mind. We lack corresponding measures to make a comparison with non-VA-guaranteed commercial bank loans to businesses of comparably small size.

FREQUENCY OF LOSS

The frequency and the severity of loss are more important, of course, than the incidence of default in the description of loan experience. It is of interest to examine, first, the proportions of all loans extinguished which resulted in some loss to the agency and, secondly, to consider the ratio of the amount of realized net loss to the amount disbursed on extinguished loans.

It is estimated that RFC, from 1934 to the end of 1951, extinguished 9.3 percent of its business loans with some loss.⁶⁴ Loss frequency was distinctly high with loans to firms in the transportation, communications, and public utilities group (a result in which loans during 1945 and 1946 to small trucking enterprises played a large part); with loans in the Mountain and East South Central regions

⁶⁴ The figure refers to direct loans made under regular lending powers (i.e. national defense loans and loans made in participation with private lenders are excluded).

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and in the territorial possessions; with loans used principally to purchase land or buildings or to purchase equipment; and with loans to firms just organizing at time of application and those too young to show three-year trends in financial condition.⁶⁵

Among the VA-guaranteed small loans made after 1944 to veterans establishing or expanding a business, 7.5 percent of those extinguished by the end of 1954 were loss loans—that is, terminated with payment by VA of a claim by the private lending institution that made the loan.⁶⁶ The ratio had trended downward from about 15 percent in the early years.⁶⁷

Information is available on Federal Reserve Bank loss experience with business loans up to December 31, 1940, by which time the great majority of the loans had been made. Funds had been disbursed on 2,027 loans, of which 1,132 were participations with commercial banks and other private financial institutions and 895 were made independently by the Federal Reserve Banks. In the first group losses were charged off, or provided for, on 4 percent of the total number; in the second group, on 6 percent. Federal Reserve Bank experience was thus more favorable than RFC's with respect to the relative frequency of loss; but undoubtedly (although documentation is lacking) both were unfavorable in comparison to commercial bank term lending.

It was to be expected that losses on loans guaranteed under Regulation V would be relatively small, because the government was the principal customer of the borrowing enterprises as well as the guarantor of their loans. Yet a number of "distress cases" arose, mainly as a result of problems such as poor management or high costs, and in a few cases because of unexpected contract cancellations. Some of the distress loans were liquidated through the joint efforts of the originating commercial bank and the Federal Reserve Bank of its district; yet 157 loans, totaling \$66 million, were purchased by the Federal Reserve Banks as agents for the procurement agencies in fulfillment of their guarantees.⁶⁸ The loss loans numbered about 1.8 percent of all loans extinguished, and were of smaller average size than other V loans. Among industry groups of loans, those to manufacturers of aircraft and aircraft parts had a relatively poor record.

⁶⁵ See Appendix Tables B-24 through B-29.

⁶⁶ Up to December 25, 1954, 149,021 loans had been paid in full and 12,128 loans terminated by payment of a claim, for a total of 161,149 loans extinguished. See *Loan Guaranty*, Veterans' Administration, December 1954, p. 57.

⁶⁷ See Appendix Tables C-7 and C-9.

⁶⁸ Burr and Sette, *op.cit.*, p. 57.

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No losses had been realized up to the end of 1951 on the comparatively few ship purchase and construction loans held by the Maritime Administration, although several loans were delinquent at that date. Willingness, under the broad purpose of advancing the merchant marine, to extend or renew loans not in current status may partly explain the favorable record, but data on that aspect are lacking.

EXTENT OF LOSS ON EXTINGUISHED LOANS

We turn to records of the amount of realized losses on extinguished loans. It is estimated that up to the end of 1951 the Reconstruction Finance Corporation's loss ratio slightly exceeded 2 percent, which is to say that the corporation lost two cents on every dollar of funds disbursed on all business loans extinguished by that date.⁶⁹ Comparable figures for commercial bank term loans are unavailable, but insured banks reported losses, charge-offs, and transfers to reserve accounts in 1951 amounting to less than one-half of 1 percent of loans and discounts of all types that were outstanding at the end of that year; which, since the weighted average maturity of the loans was probably under two years, implies a maximum loss of less than 1 percent of the amount extinguished during the year.⁷⁰

RFC losses from the amount advanced on loans extinguished before 1952 appear to have been heaviest on loans to very small firms (with total assets under \$25,000); to businesses just organizing at time of loan; to manufacturing firms in the petroleum, coal, chemicals, rubber group; and to firms in the Mountain region and the territorial possessions.⁷¹

The full amount of the losses realized on the small business loans guaranteed by the Veterans' Administration is not accurately known, because VA collects no data on the aggregate amount of repayments made by debtors nor on the lender's total loss, but accounts only for that part of the loss which was compensated by governmental guaranty or insurance. Up to December 25, 1954, VA had

⁶⁹ From the National Bureau of Economic Research sample survey of RFC direct business loans made under regular lending powers (i.e. excluding participation loans and national defense loans); see Appendix B, page B-97.

The Controller of RFC in 1950 estimated a higher loss ratio, about three cents on each dollar of investment, probably referring to loans inclusive of those made under wartime powers. See *Analysis of Income and Costs* (cited in footnote 26 above), pp. 86 and 92.

⁷⁰ *Annual Report of the Federal Deposit Insurance Corporation, 1951*, pp. 154 and 162.

⁷¹ See Appendix Tables B-33 to B-35.

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paid lenders' claims in the amount of \$9,653,000, equal to 2.7 percent of the total original amount of loans that had been repaid in full or 1.6 percent of the total principal amount of all the loans guaranteed or insured to that date.⁷² For RFC, estimated losses through 1951 in ratio to the amount of all business loans made were 1.3 percent,⁷³ a figure difficult to compare with the 1.6 percent for VA because the latter covers only the compensated portion of the total loss on the loans, because more of the credit extended under VA guarantee than of that advanced by RFC up to the given dates was still of unknown outcome, and for other reasons.

Like the RFC and VA business loan programs, that of the Federal Reserve Banks also produced losses of larger amount than are ordinarily encountered in private banking activities. According to an unpublished study by the Board of Governors of the Federal Reserve System, estimated net losses were approximately \$1.9 million through 1951. Thus realized losses approximated 0.6 percent of the amount loaned through 1951 and as much as 3 percent of the amount loaned during 1934-1940, when loans were most numerous and were more in the nature of a credit aid to businesses generally than were the fewer, large loans made during and after the war. The FRB loss ratio on loans made through 1951 is below that for RFC (0.6 as against 1.3 percent); the fact that participation loans (with a comparatively good record as among the FRB loans) are covered in the ratio for the Reserve Banks but not for RFC may partly explain the difference. Extensive losses on certain large loans are the chief factor in the loss ratio for the FRB program. The record apparently varied considerably among the different reserve districts; losses on loans appear to have been comparatively heavy in those—such as New York, San Francisco, and Richmond—where the business lending programs were most active.⁷⁴ It should be reiterated that the inflationary boom of the forties affected the outcome of loans made then, and for earlier loss loans brought substantial recoveries, so that in more normal conditions the record would have been less favorable. At the end of 1940 the amount of money set aside by the Reserve

⁷² *Loan Guaranty*, Veterans' Administration, December 1954, p. 57.

⁷³ Appendix Table B-33.

⁷⁴ From an unpublished study, "13b Loan Program of the Federal Reserve System, 1934-40," by Caroline H. Cagle, Division of Research and Statistics, Board of Governors of the Federal Reserve System; also "The Industrial Loans of the Federal Reserve Bank of New York," by Robert V. Rosa: unpublished address to the Sixth Annual Convention of the National Conference of Commercial Receivables Companies, October 17, 1950.

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Banks as provision against business lending losses, together with amounts already charged off, approximated 5 percent of the credit advanced up to that date.

The loss ratios on loans guaranteed under Regulation V have been almost infinitesimal, owing to the unusual circumstances under which the guarantees were extended. By the end of 1949 the uncollected balance of loans purchased from commercial banks by the federal procurement agencies pursuant to their guarantees had been reduced to about \$6 million. Guarantee agreements covering an additional \$800,000 of loan balances were still outstanding on that date. It has been estimated that losses on the entire program will be about 0.06 percent of aggregate loan authorizations, and about 0.4 percent of the peak amount of guaranteed V-loan credit outstanding (\$1.8 billion at the end of July 1944).⁷⁵

Up to June 30, 1954 the Export-Import Bank reported losses of \$496,068, representing less than 0.1 percent of cumulative gross income, and 0.01 percent of the total amount disbursed under all authorizations, since the establishment of the bank in 1934.⁷⁶

REVENUES, COSTS, AND OPERATING RESULTS

A general picture of the operating results of federal business credit programs is difficult to form because information on the largest of them—that of the Reconstruction Finance Corporation—is deficient. The statements published by the agency itself relate to its combined programs for housing, railroads, and other segments of the economy as well as business, and the underlying accounts do not permit precise calculations for the business program alone. Moreover, they require adjustment to reflect operating results from the standpoint of the public: that is, to include the cost of interest-free capital supplied by the Treasury, and earned surplus not returned to the Treasury. Published statements show a net income of about \$100 million from all RFC lending programs during the five years 1946–1950; estimates on a full-cost basis put the five-year profit for the combined programs at only about \$21 million.⁷⁷ Estimates developed in congressional hearings in 1950, covering the business program alone for twenty-one months in fiscal 1949 and 1950, indicate a net

⁷⁵ Burr and Sette, *op.cit.*, p. 57.

⁷⁶ *Eighteenth Semiannual Report to Congress*, Export-Import Bank of Washington, January–June 1954, pp. 3 and 4.

⁷⁷ See page B-166.

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deficit of \$13.6 million after provision for losses and as adjusted to reflect the cost of all funds employed.⁷⁸

For the similar but smaller program of the Federal Reserve Banks during the period when it reached the widest variety of businesses an unprofitable record is also indicated if allowance is made for realized and anticipated losses on loans and for interest on funds employed. From 1934 up to the end of 1940 the combined operating accounts of all twelve Reserve Banks for the industrial loan program could be summarized as follows:⁷⁹ The preceding figures suggest that up

(1) Gross earnings (interest, fees, etc.)		\$7,411,733
(2) <i>Deduct:</i> Administrative expenses	\$3,976,848	
Interest on funds supplied by U.S. Treasury (1¾ percent × \$27.5 million × 5 years)	2,406,250	
Total expense		6,383,098
(3) Net income before losses		1,028,635
(4) Losses charged off		430,293
(5) Balance		598,342
(6) Estimated losses at December 31, 1940		2,447,459
(7) Estimated net deficit		(\$1,849,117)

to the end of 1940, Federal Reserve Bank charges would have had to be about 25 percent higher to have enabled the banks as a group to break even on the industrial loan program. By the end of 1951, recoveries on losses previously written off and withdrawals from allowances for estimated losses in consequence of the inflationary boom during and after World War II had eliminated the net deficit. The figures appearing above, however, appear to represent the normal results of the program in a stable economic environment.

This picture of the operating results of the Section 13b loan program in all Federal Reserve Banks finds confirmation in Rosa's analysis of the New York Federal Reserve Bank's experience. Rosa found that aggregate gross earnings were roughly double out-of-pocket administrative expenses, and that the balance of net income was just equal to realized losses. Provision for interest on funds employed, anticipated future losses, and overhead expense absorbed by

⁷⁸ See Appendix Table B-52.

⁷⁹ From an unpublished study by the Board of Governors of the Federal Reserve System.

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the New York Federal Reserve Bank created a considerable deficit in the operation.⁸⁰

Most successful of the federal agencies supplying business credit, from the point of view of operating net income, has been the Export-Import Bank. This institution has been required only since 1945 to pay interest on its Treasury borrowings. Yet its gross income from operations has been so large from the beginning that, if the bank had paid interest or dividends into the Treasury on all funds advanced to it since its establishment at a rate representing the interest cost of those funds to the Treasury, its earned surplus at the end of 1951 would still have amounted to \$165.7 million as compared to the reported figure of \$262 million as of that date.⁸¹ From February 2, 1934 to June 30, 1954 operating results were as follows:⁸²

(1) Gross income (interest, fees)		\$563,191,520
(2) Expenses:		
(a) Administrative expense	\$ 9,439,670	
(b) Interest paid U.S. Treasury	116,841,621 ^a	
(c) Dividends paid U.S. Treasury	105,905,178	
Total		222,746,799
(3) Losses		496,068
(4) Net retained earnings		\$330,508,983

^a Represents interest paid on new borrowings from 1945 on.

The sources of the Export-Import Bank's profitability, in comparison with other public suppliers of credit to business, have been a very large average loan size and an exceedingly low administrative outlay arising from a compact, centralized operation. The remarkable record of profitability may also be attributed to the fact that the bank has been the sole and official foreign lending agency of the United States government; as such, it has been in a position to minimize risks and losses in ways not open to other federal credit agencies or to private institutions.

Operating results of the war loan guaranty program under Regulation V are not known precisely, because the expenditures of the Federal Reserve Board (as agent) and of the military procurement agencies (as loan guarantors) that were allocable to the administra-

⁸⁰ Rosa, *op.cit.*, pp. 10f.

⁸¹ *Thirteenth Semiannual Report to Congress*, Export-Import Bank of Washington, July-December 1951, p. 21.

⁸² *Eighteenth Semiannual Report to Congress*, Export-Import Bank of Washington, January-June 1954, p. 4.

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tion of the program are not available. Other gross revenue and expense items up to the end of 1949 were as follows:⁸³ Prima facie, it

(1) Gross income (guaranty and commitment fees and interest)		\$35.0 million
(2) Expenses deductible:		
(a) Reimbursable expense of Reserve Banks	\$3.6 million	
(b) Estimated losses	6.3	
(c) Paid to banks by guarantors	1.7	
Total		11.6
(3) Balance before FRB and military agency expenses:		\$23.4 million

would appear that the V-loan program was at least self-supporting and possibly profitable to the government.

The guaranty and insurance of small business loans by the VA was frankly intended to be a subsidy to veterans who desired to enter business and showed reasonable likelihood of success; no charge was made for those services. Yet it is of interest to know the costs of the credit services, and what charge would have had to be made for them if they were priced at full cost. Although the Veterans' Administration has published no official statement of the costs of administering the loan guaranty and insurance programs, data made available by it make possible a rough estimate of its expenditures from the beginning of the program in 1944 up to the end of 1952. For the business loan program alone, the expenditures may be estimated as follows:⁸⁴

(1) Gratuities of 4 percent paid veterans		\$ 5,848,000
(2) Net cost of claims paid by the government		8,496,000
(3) Direct salary and other costs of loan origination		3,336,000 ⁸⁴
(4) Direct salary and other costs of loan servicing and liquidation		5,679,000 ⁸⁴
(5) Office and other overhead expenses		1,803,000 ⁸⁴
Total expenses		\$25,162,000

Up to the end of 1952, 198,134 individual business loans had been closed and disbursed in a total principal amount of \$532,-

⁸³ Burr and Sette, *op.cit.*, pp. 57f.

⁸⁴ Through 1952, total direct administrative costs charged to the loan guaranty program (including home, farm and business loans) was \$70,374,244 and general administrative expenses including office and other overhead costs were estimated at 20 percent of total direct costs. About 75 percent of total costs charged to the loan guaranty program are assumed to have been expended in loan origination, and 25 percent in loan servicing and liquidation. Loan origination expenses are assumed to be allocable among the home, farm, and business loan programs in proportion to number of loans disbursed, and loan servicing and liquidation expenses in proportion to number of claims filed after default.

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769,000, or an average amount per loan of \$2,689.⁸⁵ Total expenses formed 4.72 percent of the aggregate principal amount of funds loaned, and 15.1 percent of the guaranty or insurance of all loans. The cost of guaranty or insurance has averaged about \$127 per loan. In summary, it appears that the VA would have had to charge "premiums" of about 5 percent of the total principal amount of business loans disbursed, or of about 15 percent of the guaranteed portion of such loans, in order to break even on the operation.

Impact on Business Enterprises and Business Financing Institutions

RELATIVE MAGNITUDE OF PUBLIC AND PRIVATE CREDIT AIDS TO BUSINESS

In comparison to the total amount of credit utilized by business, that supplied by public lending institutions has been small. Table 46 records year-end outstandings of business loans and loan guarantees by federal and federally sponsored agencies from 1918 through 1953, shows the percentage ratio of federal credit to the total debt owed by business corporations, and measures similarly the outstandings of the principal private lending institutions: for life insurance companies, their investments in stocks and bonds (mainly bonds) of business and industrial corporations; for commercial banks, their loans to, and investments in bond and security offerings of, commercial enterprises.⁸⁶ Through 1941 the ratio of federal business credit to total corporate debt never rose much above 1 percent. At its highest, in 1943 and 1949, it was only 3 percent. Life insurance companies and commercial banks were each supplying about eight eight times as much business credit as federal agencies at the end of 1953. There is to be observed, however, a mild secular uptrend in the relative importance of federal credit in the total debt of American business.

⁸⁵ *Finance, Guaranty of Loans, Veterans' Administration*, December 1952, p. 71.

⁸⁶ The data are not strictly comparable because of different definitions of business by the several types of lender and because total debt refers only to the net corporate long- and short-term debt exclusive of that owed by unincorporated businesses. Despite these deficiencies the comparisons are believed to be meaningful.

Inclusion of loan guarantees in the amount of federal credit causes some overlapping (from 1934 on) with the bank figures. Loan guarantees were important during World War II, and in 1943 and 1944 even exceeded federal loans. From 1946 through 1953 they comprised less than 20 percent of federal credit, or less. For series measuring federal credit both inclusive and exclusive of guarantees against a differently constructed debt total, see Table 7 in Chapter 2.

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Only an incomplete picture of the relative importance of public and private credit to financial institutions can be given. Loans made directly by commercial banks to other banking institutions are reported regularly, but there are many other types of financial assistance furnished by one private agency to another on which information is lacking—for example, purchases of stock or shares.

Federal lending to financial institutions before 1932 was negligible; but in that year over \$1 billion was advanced. By 1940, the debt of financial institutions to public agencies had been reduced to \$373 million, yet was nearly five times as large as the combined total (\$77 million) of loans to commercial banks and mutual savings banks held by other banks and of the amount owed by savings and loan associations apart from their indebtedness to the Federal Home Loan Banks (Table 3, Chapter 2). For financial institutions, therefore, loans of government agencies were for a time very much more important than their borrowing from private sources. By 1950, the indebtedness of private lending institutions to public agencies had all been retired (except for some \$800 million of outstanding loans by the Home Loan Bank to savings and loan associations—ultimately, a credit aid to the housing sector, since the associations lend almost exclusively on mortgage security). Public holdings of stocks and shares of financial institutions were considerable in the late thirties and early forties (Chart 13, above). Their relative importance can be judged only for savings and loan associations. Government-supplied capital in 1940 was about 5.1 percent of the amount of the private savings capital then in use by the associations; in 1951, government contributions to capital had been entirely repaid.⁸⁷ As of the end of 1953, government capital (in the form of RFC investment in capital stock, notes, and debentures) had also been largely retired from banks, trust companies, and insurance companies.

It may be concluded that on an aggregate basis, federal credit to business has not been large enough to exert important over-all effects on employment and production, on the formation of new enterprises, on the size of the business population, or on the average asset-and-liability structure of American enterprises; and effect of governmental influence on the stability of the supply of business credit has been

⁸⁷ See Appendix Tables A-11 and A-19 for data on outstanding amounts of federally held savings and loan association shares. For data on outstanding amounts of private savings capital, see *Trends in the Savings and Loan Field*, 1951, p. 4.

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TABLE 46

Outstanding Amounts of Federal Loans and Loan Guarantees to Business, of Life Insurance Company Business Investments, of Commercial Bank Business Loans and Securities, and Net Corporate Debt, 1918-1953
(*dollar figures in millions*)

END OF YEAR	NET CORPORATE DEBT ^a	OUTSTANDING BUSINESS LOANS OR INVESTMENTS				AS PERCENTAGES OF NET CORPORATE DEBT				
		Federal Agencies ^b		Commercial Banks		Federal Agencies		Life Insurance Companies		Commercial Banks
		\$	%	\$	%	%	%	%	%	
1918	\$47,000	\$ 30	\$2,039	\$13,900	0.1%	4.3%	29.6%			
1919	53,300	94	2,044	16,400	0.2	3.8	30.8			
1920	57,700	680	2,024	18,500	1.2	3.5	32.1			
1921	57,000	740	2,030	17,400	1.3	3.6	30.5			
1922	58,600	506	2,189	17,700	0.9	3.7	30.2			
1923	62,600	508	2,408	18,900	0.8	3.8	30.2			
1924	67,200	442	2,747	19,800	0.7	4.1	29.5			
1925	72,700	353	3,103	20,900	0.5	4.3	28.7			
1926	76,200	321	3,565	21,600	0.4	4.7	28.3			
1927	81,200	204	4,043	22,100	0.3	5.0	27.2			
1928	86,100	118	4,642	21,800	0.1	5.4	25.3			
1929	88,900	120	4,995	20,700	0.1	5.6	23.3			
1930	89,300	125	5,448	19,500	0.1	6.1	21.8			
1931	83,500	140	5,663	16,300	0.2	6.8	19.5			
1932	80,000	450	5,580	12,000	0.6	7.0	15.0			
1933	76,900	533	5,388	9,800	0.7	7.0	12.7			
1934	75,500	704	5,510	9,800	0.9	7.3	13.0			
1935	74,800	773	5,897	10,600	1.0	7.9	14.2			
1936	76,100	646	6,593	12,000	0.8	8.7	15.8			
1937	75,800	642	7,111	12,200	0.8	9.4	16.1			
1938	73,300	762	7,895	10,800	1.0	10.8	14.7			
1939	73,500	815	8,538	10,300	1.1	11.6	14.0			

(continued on next page)

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TABLE 46 (continued)
(dollar figures in millions)

END OF YEAR	NET CORPORATE DEBT		OUTSTANDING BUSINESS LOANS OR INVESTMENTS AS PERCENTAGES OF NET CORPORATE DEBT			
	Federal Agencies ^a	Life Insurance Companies ^b	Federal Agencies	Commercial Banks	Life Insurance Companies	Commercial Banks
1940	\$ 75,600	\$ 886	\$ 9,250	\$11,100	1.2%	14.7%
1941	83,400	950	10,174	13,200	1.1	15.8
1942	91,600	1,823	10,315	11,800	2.0	12.9
1943	95,500	2,885	10,494	11,900	3.0	12.5
1944	94,100	2,711	10,715	12,900	2.9	13.7
1945	85,300	1,456	11,059	15,800	1.7	18.5
1946	93,500	2,191	13,024	19,100	2.3	20.4
1947	108,900	2,964	16,144	22,400	2.7	20.6
1948	117,800	3,402	20,322	23,500	2.9	19.9
1949	118,000	3,490	23,179	22,200	3.0	18.8
1950	142,100	3,393	25,403	27,700	2.4	19.5
1951	163,600	4,061	28,204	31,300	2.5	19.1
1952	171,700	4,410	31,646	28,500	2.6	16.6
1953	179,400	4,522	34,570	33,100	2.5	18.5

^a Net corporate debt (both long- and short-term) as defined by the Department of Commerce, from *Survey of Current Business*, September 1953, Table 1, p. 14, and October 1954, Table 1, p. 14.

^b Refers to direct loans and loan guarantees and insurance by federal agencies and direct loans to business by the Federal Reserve Banks. Data are from Appendix Table A-5.

^c Represents investment of all United States life insurance companies in business and industrial bonds and stocks, from *Life Insurance Fact Book 1954* (Institute of Life Insurance), p. 67.

^d Data for 1918-1941 were estimated by inflating National Bureau of Economic Research estimates of national bank business loan and security holdings by annual ratios of total assets of national banks to total assets of commercial banks in continental United States

and converting midyear figures (1918-1938) to end-of-year figures by linear interpolation. Data for 1942-1953 were compiled from *Annual Reports of the Comptroller of the Currency, Federal Reserve Bulletins*, and *Trends in the Savings and Loan Field, 1953* (Home Loan Bank Board), p. 5, and reflect the following types of loans or securities held by commercial banks in continental United States: commercial and industrial loans (including open market paper), adjusted to exclude loans to savings and loan associations by deduction of "other borrowed money" reported in *Trends*; loans to brokers and dealers in securities; and all bonds, notes, debentures, and securities other than those of the United States government and of state and political subdivisions, with Federal Reserve Bank stock eliminated by deduction of FRB paid-in capital reported in *Federal Reserve Bulletins*.

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through aid to lending institutions rather than to businesses directly. Federal lending programs in the business field appear, however, to have had a selective effect on the allocation of economic resources through aid to particular types of business firms.

SELECTIVE EFFECTS OF FEDERAL CREDIT AIDS ON THE BUSINESS POPULATION

In the first place, federal agencies provided a very significant measure of assistance to firms in certain industries: notably, railroad transportation, ocean shipping, and foreign trade. Railroad loan programs have been conducted by several federal agencies since 1918; the merchant shipping industry has likewise received a considerable fraction of its credit from federal agencies; and foreign trading enterprises, and domestic manufacturing enterprises heavily dependent upon foreign markets, have been aided importantly by the Export-Import Bank. There is no means, however, of measuring precisely the effects of federal credit even in these areas where it has been of relatively great importance.

Second, federal loans and loan guarantees have provided significant assistance to new firms and new industries, helping them through periods of trial to the point where some have been able to obtain funds from private financial institutions. The Reconstruction Finance Corporation made many loans to firms in relatively unfamiliar lines, unable to obtain private credit for lack of data on which the private creditors could gauge the risks involved. This appears to have been true of RFC loans to motels, fresh-frozen food canning and packing firms, petro-chemical firms, and food locker enterprises. It was also true of Veterans' Administration guarantees and insurance of very small term loans to enable veterans to initiate or to purchase small enterprises.

Newly established and very small firms have been assisted not only through VA protection of privately made loans but also through financing by the RFC, Federal Reserve Banks, and the Smaller War Plants Corporation. Credit from private financial institutions has rarely been a factor in the financing of new, small ventures, because the risks have been considered too high to lie within the commercial banking range. Public agencies, however, have made a considerable number of such small business loans, have invited and occasionally received private institutional participation, and have to some extent loosened up the credit market for the new, small enterprise. They

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have shown that the risks of such lending may be kept within tolerable limits by taking appropriate collateral security. Undoubtedly, many bankers who gained familiarity with lending operations of that type through participation in a defense loan guaranteed by a federal agency have been led to continue them without federal cooperation.

Third, federal agencies have carried on a certain amount of marginal financing for firms which were financially weak but which appeared to have reasonable prospects of success and for profitable firms whose rapid market growth had outstripped their financial resources. Marginal financing was provided especially by the loans of Federal Reserve Banks to mercantile and manufacturing ventures and by the loans of the RFC. A large part of the guarantees of war production loans by the War and Navy Departments and the U.S. Maritime Commission were also of that character.

To summarize: although federal credit aids to business probably have not exerted a powerful influence on the aggregate of resources employed in business, they have significantly influenced the movement of resources into (or their retention in) a few established industries considered essential to national security, into certain comparatively new industries, and into firms whose financial conditions were marginal as regards the availability of credit from private financial institutions. Whether these resource-allocational effects have been socially beneficial on balance, and whether more efficient methods of achieving them might have been devised, are issues beyond the purview of this study.

EFFECTS ON BUSINESS FINANCING INSTITUTIONS AND PRACTICES

The most significant effects of federal credit programs on the business sector of the economy appear to have been the institutional changes brought about in the markets, credit practices, and economic roles played by private business financing agencies. Furthermore, over a sufficiently long period of time, such institutional effects ultimately may produce material changes in the utilization of resources. We shall consider, in turn, the following institutional effects: first, the effects of federal aid to financial institutions on their risk-taking ability; second, the effects of federal business credit services on the size of the credit markets confronting private institutions; third, competitive relationships between federal agencies and private institutions in extending credit to business; fourth, effects of federal

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lending and loan guaranteeing operations on the term to maturity, collateral security requirements, and other terms of business credit.

1. Federal credit and capital to support commercial banks and life insurance companies maintained the solvency, enhanced the risk-taking ability, and strengthened private financial institutions during periods of severe economic strain. The most extensive and dramatic use of federal financial aid for these purposes was in the RFC bank loan and capital programs of 1932-1934. RFC loans to banks were of two types: "confidence" loans made to active banks for the purpose of enabling them to keep open, and liquidation loans to closed banks to facilitate an early discharge of their depositor claims. The first type of loan predominated up to March 1933, when the national "bank holiday" occurred; thereafter the second type of loan was most frequent. Between February 1932 and March 31, 1933, RFC authorized 10,178 loans to 6,100 banks and trust companies under which \$1 billion was disbursed. The RFC also invested nearly \$1.2 billion in preferred stock, capital notes, and debentures of 6,104 banks.⁸⁸

2. Federal credit programs undoubtedly exerted a net expansive influence on the markets for private financing institutions, thereby increasing their earning power, equity investment, and financial strength. Federal credit maintained and supported private credit institutions by means of direct loans and by relieving them of assets believed to be illiquid or undesirable. By injecting credit into the economy at numerous points, federal agencies also raised the level of production and the demand for private credit. It is important to observe in this connection that federal credit aids to agriculture and to housing, as well as directly to business, have indirectly created new demands for loans by business firms from private financial institutions. Thus, federal financing of farmers enlarged the credit demands of food processors; and federal credit for home construction created needs for private bank loans among building contractors and building material and equipment manufacturers.

3. Although it is certain that federal credit activities have brought about a net expansion in the market for private business financing,

⁸⁸ Jesse H. Jones with Edward Angly, *Fifty Billion Dollars: My Thirteen Years with the RFC (1932-1945)*, Macmillan, 1951, pp. 25 and 614f. See Chapters I-V for an absorbing account of the circumstances under which these programs were executed. For an appraisal of the economic effects of the programs, see *The Reconstruction Finance Corporation, 1932-1941*, by James B. Eckert (unpublished dissertation, Cornell University, 1947), Chapter V.

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they have also operated in certain respects to compete with, and to restrict the markets of, banks and other private lending agencies. The ways in which that influence took place are not immediately apparent, however, and require an understanding of the nature of competition in the rendering of credit services.

Competition in extending credit consists in offering loans at lower interest rates, in offering more favorable repayment or collateralization terms and conditions, in offering longer maturities on loans, or in providing borrowers with such ancillary services as accounting and financial advice, or general management counsel. The analysis of competition in credit markets is further complicated by the fact that borrowers differ with respect to the probability that they will repay their debts, and because of differences in size, financial strength, and probable future earning power. Even if the effective interest rates charged, the terms and conditions of loans, and the ancillary services offered by public and private lending institutions were identical, the two might still compete with each other in assuming risks of different magnitudes. Credit is a highly differentiated commodity, and borrowers are not influenced to select one rather than another lender merely by comparing nominal rates of interest.

With these considerations in mind, it becomes apparent how federal agencies may compete with private lenders, even though public agencies are debarred by statute from making loans to businesses to whom private credit is available. For example, RFC could make a business loan which, because of small amount, high risk, or large costs of loan administration, a commercial bank could not afford to make at less than 7 percent annual interest. RFC adopted a more or less standard rate: during most of its period of activity, 4 percent. By lending at this relatively low rate, RFC in effect underpriced the credit by charging less than its full cost. It would not necessarily eliminate RFC competition with a commercial bank for RFC to offer a participation in the loan to the bank, because a share in the loan might still not be profitable to the bank at the low interest rate fixed by RFC.

Neither do statutory measures for eliminating competition do away with the encroachment on private credit markets which occurs if federal agencies offer loans on more favorable terms (longer maturities, less burdensome collateral requirements, more lenient treatment of defaults, etc.) to relatively high-cost or high-risk borrowers at the same interest rates as are charged to low-cost or low-

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risk borrowers. The strong and pervasive tendency in public credit operations toward standard interest rates and terms of loans has been observed. Standard terms tend to make federal agencies the most attractive sources of credit to borrowers to whom private institutions can advance funds only at comparatively high interest rates and on closely restricted terms. It is in the high-risk segment of the credit market that the operations of federal agencies have cut most deeply into the potential loan markets of banks and other private lenders. To minimize this kind of competition between private and public credit agencies would require: first, changes in public policy permitting and encouraging banks to take longer risks and to charge commensurately higher interest rates;⁸⁹ second, policies of public credit agencies that gear their charges for loans to individual borrowers more closely to the actual risks and costs of loan administration, and abandonment of a standard loan rate; third, a policy of public credit agencies to offer commitments to purchase participations in the loans of private agencies for a fee measuring as accurately as possible the costs and risks involved, and to sell to private institutions their interests in loans originated by them.⁹⁰

4. Another institutional effect of federal business credit programs has been an extension of the use of the amortized term loan, running for periods exceeding one year and repayable in periodic installments. It is notable that all of the federal agencies loaning money to business have extended term loans almost exclusively. The amortized term loan has been a development of the past twenty years. It has to a considerable extent replaced the traditional short-term, single payment, promissory note that was often paid up annually and renewed by the business borrower. A number of factors account for the development of term lending by commercial banks during the middle thirties; but the credit activities of the RFC and the Federal Reserve Banks in making term loans beginning in 1934 helped set the stage for an expansion of private financing of this type. Public

⁸⁹ Usury laws, strong banking conventions against high loan rates, and public supervision of banking which has discouraged risk assumption by banks, have all operated to cause banks to abdicate their position in the high-risk loan market. The problem is not strictly one of competition by the federal credit agencies; it is, rather, that public policy proscribes banking service in a particular segment of the business credit market, a segment where federal agencies then step in to meet the demand.

⁹⁰ See "Government Loan Agencies and Commercial Banking," by Neil H. Jacoby, *American Economic Review*, Vol. XXXII, No. 1, March 1942, pp. 258f. for a more complete discussion of these measures.

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agencies facilitated the extension of bank term credits by offering to, and taking from, commercial banks substantial participations in term loans. The familiarity with medium-term loans gained by commercial bankers from observations of, or participation in, term credits of the public agencies was to a large extent responsible for private term lending.

A similar process may be observed in connection with the term credits granted by the Export-Import Bank after 1933 to finance the movement of American machinery and equipment into the hands of foreign enterprises and governments. Here again, medium- or long-term export credits have rarely been available from American commercial banks; yet a number of years are required before the earning power of exported equipment can produce the means of repaying its purchase price. Such long-term export credits were first provided by the Export-Import Bank.

The Veterans' Administration, through its guaranty or insurance of small-term loans made by commercial banks or other lending institutions to veterans to purchase or establish businesses, also pioneered in sponsoring the application of the amortized term loan principle to new and very small enterprises. As a result of a strong desire to assist returning veterans, and of the risk sharing undertaken by the VA, commercial banks were induced to enter a new field of lending. Many bankers gradually learned how to make these small business term loans safely and profitably.

Federal agencies have performed in the field of business credit an economic function similar to that discharged by them in the field of housing credit. They have tended to lengthen the maturities of loans and to broaden the use of the amortized loan. In this respect, they fostered an adjustment in the nature of business credit responsive to the increasing use of durable producers goods by business enterprise in the American economy. The term lending principle has brought commercial banks new problems of portfolio management and of liquidity maintenance; but undoubtedly it has helped business enterprises by relating repayments to earning power.