Volume Title: Business Finance and Banking

Volume Author/Editor: Neil H. Jacoby and Raymond J. Saulnier

Volume Publisher: NBER

Volume ISBN: 0-870-14137-6

Volume URL: http://www.nber.org/books/jaco47-1

Publication Date: 1947

Chapter Title: Summary: Twentieth Century Developments in Bank Financing of Business

Chapter Author: Neil H. Jacoby , Raymond J. Saulnier

Chapter URL: http://www.nber.org/chapters/c4681

Chapter pages in book: (p. 1 - 20)

*Summary*

# TWENTIETH CENTURY DEVELOPMENTS IN BANK FINANCING OF BUSINESS

ABOUT ONE-HALF OF THE earning assets held by American banks at the beginning of the twentieth century may be classified as "business" loans; the remainder were principally loans made for agricultural purposes, loans secured by stocks and bonds and real estate, and securities. The bulk of the business loans were short-term credits extended to nonfinancial business — and mainly to manufacturing and trade concerns of small and medium size — for financing working capital needs. The network of banks was appropriately described as a "commercial" banking system, because short-term loans to nonfinancial business were the largest single class of bank earning assets, and banks were the principal agency engaged in making such loans.

Forty years later this relatively simple pattern of banking had altered in five important respects: "commercial" lending — or what in this study is called "business" lending — by banks had become subordinated to other bank financing activities, notably to the financing of the federal government; the types of loans made to nonfinancial business, and bank practices in extending such loans, had been greatly modified; banks were in more active competition with other types of financing institutions in lending to nonfinancial business; loans to financial enterprises, such as consumer and commercial finance companies, constituted a major element in bank loan portfolios; and the direct financing of consumers had become an important factor in banking.

Various interpretations have been placed on these broad changes in banking, not the least uncommon of which is that they indicate a long-run, and persisting, tendency for the business lending function of banks to decline. The present summary attempts to describe briefly the character of the changes in bank lending activities after 1900, and to show why these changes took place. Specifically, answers to the following questions are sought:

What basic underlying forces affected the business credit market after 1900 and, in particular, influenced the demands of non-financial business for bank credit?

What changes occurred after 1900 in the character of the business economy, and of business demands for funds, which influenced the demand for credit facilities?

How did the business financing needs met by the banks change after 1900?

What changes took place up to 1940 in the way commercial banks functioned as business lending agencies, and in the competitive framework within which these functions were performed?

What adaptations did banks make in lending policies and procedures to meet the changing demands of business for financing?

How did World War II affect business financing by banks?

And finally, against the background of this near half-century of development, what are the problems that banks face in adapting their lending practices to the changing credit needs of business?

## BASIC UNDERLYING FORCES AFFECTING BUSINESS DEMAND FOR BANK CREDIT

Developments in the business credit market between 1900 and 1940 reflected the action of numerous economic forces, some of them so deep-seated and so significant in their effect on business financing as to warrant special attention. These forces and their principal effects may be summarized briefly:

*First,* the general growth of the economy until 1929 and the interruption of growth in the thirties produced qualitative changes in the organization and practices of business, which affected the aggregate demand for business financing and which compelled financing agencies to make important adjustments in their business lending practices.

*Second,* after the beginning of the century, most sectors of the economy — particularly the extractive and manufacturing industries — tended to use higher proportions of fixed capital to direct labor. This development encouraged long-term, compared with short-term, financing and increased the risks of business lending, because of the greater potential and actual variability in the level of business activity.

*Third,* the tendency, especially marked during the twenties, for consumers to spend a greater proportion of their income on durable goods of high unit value caused an increase in the degree of instability inherent in the economic process and raised the proportion of consumer to producer credit in use in the business system. Among the results of this shift were the rise of the finance company, the partial substitution of credit extended to financial enterprises for credit extended to nonfinancial business, and significant changes in the institutional structure of the credit market.

*Fourth,* the persistent and, to a certain extent, increasing instability of business activity after 1900 was responsible for levels of risk higher than would otherwise have been the case. This fact affected both the magnitude and the character of business needs for funds.

*Fifth,* after 1930 the increased importance of government in the process of capital formation, and the financing of a sizable part of government expenditures by borrowing, resulted in an accumulation of government debt in the banking system and substantially altered the structure of assets held by banks. Furthermore, to the extent that the financing of government deficits increased the liquidity of business concerns, as during World War II, business demands for bank credit were weakened.

*Finally,* the persistent decline in interest rates after 1930 was a fundamental cause of many changes in the business credit market. One important result was that the widening margin between returns on loans and returns on investments encouraged banks to intensify their business lending activities. Bank lending policies and practices were changed, and new lending techniques were adopted. The different term structure of interest rates — with short-term rates below long-term rates — encouraged an extension of bank activities into the medium-term credit field.

## CHANGES IN THE CHARACTER OF THE ECONOMY INFLUENCING BUSINESS CREDIT DEMANDS

### *Relative Decline of Industries Most Heavily Dependent on Bank Credit*

In general, the changes in the industrial composition of the economy that took place between 1900 and 1940 were such as to weaken rather than to strengthen the demand for short-term bank credit. Industries most heavily dependent on bank credit — such as manufacturing and agriculture — tended to fall in relative importance, while industries less dependent on bank loan funds either held their own or gained, e.g., service trades and transportation and other public utilities. Furthermore, within the manufacturing group itself the industrial subgroups that showed the greatest increases in their relative contribution to total output were those typically placing least reliance on bank borrowings, while the industries that fell behind were those most dependent on banks. The enormous growth after 1930 in government's role in the economy of course involved no direct use of business credit.

### *Increase in Average Size of Business Enterprises*

The increasing average size of business enterprises, evident in every major industry except wholesaling after 1900, was an adverse factor in the use of bank credit, since the relative dependence on such credit was, in general, least among concerns of largest size, except in wholesaling. In the fields of manufacturing and retail trade, particularly, the very largest enterprises relied to only a minor extent on short-term financing. In wholesaling, the average size of concern probably did not change much between 1900 and 1920, but thereafter it declined. Since the dependence on bank credit by wholesale enterprises increases with size of concern, the tendency for their average size to fall after 1920 was a contractive factor in bank credit demand.

### *Shifting Relative Importance of Asset Items*

Changes in the asset structure of business concerns, and in the amounts of various kinds of assets used to conduct a given volume of sales activity, influenced the amount and character of business demands for bank funds. Not much is known about changes in asset structure during the years from 1900 to 1914, except for a combined sample of large manufacturing and trade concerns whose current assets in percent of total assets rose rather gradually. However, if this broad change in asset structure is representative of changes in other industrial areas, it reflects conditions favorable to the gradual increase in outstanding short-term bank credit during those years.

For manufacturing and trade concerns, World War I produced a sharp rise in the relative importance of current assets — a change that was reflected in the expansion of short-term debt relative to long-term debt from 1916 to 1920. The opposite condition prevailed in 1921–22, as the economy suffered a sharp postwar deflation, and as short-term debt was repaid or in some instances funded into long-term debt or equity.

Most of the changes in the asset structure of manufacturing and trade concerns from 1923 to 1928 weakened the demand for short-term funds and strengthened the demand for long-term financing. These changes were generally characteristic of large companies, which were accounting for a growing proportion of sales in this period, and not of small and medium-sized concerns. Fixed assets grew in relative importance; cash increased in proportion to total assets; and receivables and inventory became relatively less important elements among business assets. All these factors, while not characteristic of every line of manufacturing and trade, were sufficiently general among large concerns during this period to counteract in part the expansive influence of economic growth and business asset expansion on short-term bank credit demands, and to encourage long-term as against short-term financing.

After 1929, the general decline of prices and the contraction of business assets — notably current assets — were accompanied by a sharp deflation of short-term business debt. While this tendency was reversed after 1933, no appreciable recovery in the amount of bank credit used by business occurred until 1936. However, the bank credit that began to be used then in increasing amount was credit of medium term, extended primarily to large concerns; it differed from conventional short-term bank credit not only in respect to term but also in repayment provisions, which were commonly arranged on a regular amortization basis.

### *Increases in Business Cash Balances*

Not until the thirties did holdings of cash or its equivalent by large manufacturing and trade corporations assume amounts that could be considered excessive in relation to business needs for funds. Concurrently, the notes payable element among the liabilities of large concerns tended to decline in importance.

The effect of these twin tendencies on the demand for bank credit by large concerns was to increase the flexibility of their financing with bank funds; that is to say, where the ratio of bank debt to total assets was low, a relatively minor transformation of receivables and inventory into cash might have been sufficient to supply funds promptly to eliminate that debt from the balance sheet. When bank debt was eliminated, or nearly so, further inflows of cash were used to retire longer-term funds, to pay dividends in excess of earnings, or to build up "free" balances. Since there are limits during a period of business contraction to which it is possible and appropriate to follow the first two of these policies, the last took place on a considerable scale. Consequently, when sales growth set in again it was financed in large part by a transformation of cash back into receivables and inventory, even into plant, without recourse to external funds. Only when sales, and expectations of sales, were very high was an expansion of total assets needed, and consequently only then did a demand for outside funds arise. Since the amount of sales expansion that could be achieved without the use of outside funds increased with the amount of "free" cash holdings relative to total assets, the credit needs of large concerns, whose cash accumulations were most marked, were generally slow to increase.

Small and medium-sized companies up to 1940 were less successful than large concerns in accumulating cash; moreover, their ratios of payables to total assets showed no tendency to decline. Therefore, in years of reduced sales volume their cash holdings were decreased through operating losses, payment of unearned dividends, and retirement of current debt; and in years of expansion their use of short-term borrowed funds increased rather promptly. In other words, small and medium-sized enterprises had less flexibility than large concerns in financing asset accumulations with short-term credit.

### *Changing Relative Importance of Debt Items*

In the period 1900–1920, when bank loans to business were growing continuously, the proportion of debt to total business assets showed a corresponding tendency to rise. All types of borrowed funds increased, with notes payable expanding particularly during World War I and into 1920.

Beginning in 1920, however, all debt items declined as a percentage of total business assets. Among large manufacturing concerns the decrease was particularly marked for long-term debt and notes payable; the decline of trade credit was much less drastic. The liquidation of debt accelerated in the early thirties but exhausted itself by 1935; there was then some tendency for both short- and long-term debt funds in percent of total business assets to increase among all sizes of manufacturing and trade concerns.

*Asset Expansion and External Financing by Business*

In general it appears that business concerns did not retain sufficient earnings to finance rapid expansion of their assets, but that when asset expansion was at a low or moderate rate, retained earnings came near to satisfying the demands for funds. Sample data for manufacturing and trade concerns reveal that the annual financing needs of these enterprises increased sharply during World War I, rose persistently and at a relatively high rate during the twenties, and then contracted sharply in the early thirties. A rapid increase in 1934–37 was followed by a decline in 1938 and an enormous increase throughout the war period. This record of variability considerably exceeded that of the earnings retained by manufacturing and trade concerns, and suggests that the demand for external funds was more actively determined by the rate of growth of business assets than by the retention of earnings.

During 1934–37 the rapid growth of business assets created as great a demand for external funds, relatively speaking, as in any period of business expansion after 1914, indicating that the demand for outside funds continued to be substantial provided the expansion of business assets was at a high, and particularly at an accelerating, rate. However, the mere maintenance over a period of years of a given rate of expansion of business assets, even at a relatively high rate, seems to have been an insufficient basis for a vigorous demand for external funds. During such a period dependence on outside funds apparently was reduced because of the persistence of a high level of earnings, leading to a more rapid accumulation of retained earnings than to increased dividend disbursements, and because of a tendency for financing needs to be anticipated and provided for in the early stages of expansion.

## CHANGING CHARACTER OF BUSINESS FINANCING NEEDS

### *Shifts in Relative Importance of Industries Borrowing from Banks*

Information on the relative importance of different industrial groups as commercial bank borrowers is not available prior to 1920. In that year loans to manufacturing and trade enterprises comprised the largest percentage of total bank loans to business. Bank borrowings by public utilities and finance companies, in contrast, were of negligible importance in 1920. By 1940, however, the proportion of total loans extended to these businesses had risen sharply, while the percentage of loans to manufacturing and trade concerns had dropped considerably. Changes in borrowings of wholesale and retail trade cannot be measured separately, but indirect evidence clearly points to a substantial decline between 1920 and 1940 in the relative importance of loans to wholesalers.

### *Importance of Loans to Small and Medium-Sized Businesses*

Shifts after 1900 in the industrial character of the companies borrowing from banks make it difficult to reach conclusions as to changes in the average size of borrowing enterprises. For example, the rising importance of service concerns, which were typically small, tended to counteract the increasing importance among bank borrowers of public utility concerns (including railroads), where average asset size was high, and of a few very large finance companies. But whatever the size pattern of the business borrowing clientele in 1900, the "typical" short-term borrower around 1940 could be described as a small or medium-sized manufacturing or trading concern, of somewhat less than average profitability. Of the total amount of bank loan credit used by business around 1940, some 70–80 percent is estimated to have been used by companies with assets of less than $5 million.

### *Growing Importance of Medium-Term and "Direct" Lending*

Bank lending in the field of medium-term credit under a specialized instrument — the term loan agreement — increased markedly between 1933 and 1940. As a result, loans of short maturity declined in importance among the business loan assets of banks: thus, bank loans with maturities of less than 90 days accounted for 57 percent of all loans and discounts in 1913 and about 30 percent in 1940. In medium-term lending, banks served size groups of borrowers ranging from very small to very large; but the bulk of credit of this type which they extended was to businesses that lay between the very large concerns financed by life insurance companies and the medium-sized and small concerns served by public lending agencies. Because medium-term loans had been made by banks for only a short period prior to World War II, generalizations regarding change are precarious, but at the outbreak of the war bank term loans apparently were being used to an increasing extent by companies of smaller size and by a wider range of industries than in the middle thirties.

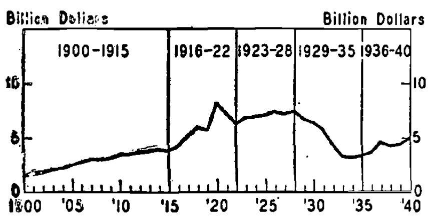
Changes in the role played by banks in the long-term credit market, through their purchases of corporate debt securities, may be indicated, roughly, by broad shifts in the character of the bond market. Between 1900 and 1939 the pre-eminence of the railroad in the market for long-term credit (represented by bonds with original maturity of over 15 years) was successfully challenged by public utilities; and in the medium-term credit market (represented by bonds of maturity of 15 years and less), by manufacturing companies. Average size of long-term credits, like credits in the medium-term market, increased, and original maturities of outstanding bonds had a somewhat lower average term in 1939 than in 1900.

Another important change in the medium- and long-term business credit market was in the relative importance of "direct" as against "indirect" borrowing, that is, in the advance of funds on the basis of direct negotiation between borrower and lender as against the acquisition of funds through the public sale of evidences of debt. In so far as the functioning of commercial banks is concerned, there was little if any change in the relative importance of the two means of raising funds up to 1922; during the remainder of the twenties, however, indirect financing, through bank purchases of publicly offered corporate securities, gained considerably in relative importance. This tendency was reversed in the thirties as the private placement of corporate securities and the acquisition of medium-term funds through term loans tended to grow in importance. Of the gross proceeds of bond issues in 1942–43, 42 percent was provided by private placements, in contrast to 29 percent in 1934–35; and bank term loans in 1940 amounted to one-half of bank holdings of corporate securities, whereas in the middle thirties the proportion was negligible.

## CHANGING POSITION OF COMMERCIAL BANKS IN THE BUSINESS CREDIT MARKET

Although a basic continuity is apparent in the development of relations between banks and business enterprises between 1900 and 1940, it is strikingly evident that the banking changes which took place can be described most effectively if the entire interval is divided into a series of relatively brief periods. Thus, functional shifts and adaptations can be discussed by periods in which substantially different forces and conditions were influencing the business credit market. The dividing years may be determined, roughly, by changes in the business loan outstandings of national banks, as indicated in the accompanying chart; they are not necessarily the same as those years which divide periods of change in other aspects of the economy.

Business Loans of National Banks, 1900–1940




*1900–1915: A Period of Sustained Banking Growth*

Since the present study is limited to banking changes in the twentieth century, the first period of banking development is dated arbitrarily from 1900. In this period which extends through 1915, business loans of national banks grew fairly regularly at an average annual rate of about $150 million. Gently rising prices and a growing volume of business assets were associated with the gradual expansion in business financing by banks, whether measured by the increase of bank portfolios of business loans and discounts, or by the increase in such portfolios plus bank holdings of private corporate securities. Compared with the periods that followed, this was an era of relatively long and stable growth, marked by no apparent change of basic importance in the general functional pattern of banking or in the way the specific function of financing business was performed.

### *1916–1922: Rapid Expansion and Contraction of Bank Loans to Business*

The second period is that of World War I and its immediate aftermath of accelerated price inflation and subsequent deflation. From 1916 to 1920 the commercial banking system grew rapidly, as war production programs, inventory accumulation, and rising prices increased business demands for bank credit. During these years business loans of national banks rose on the average by $870 million annually. Although price declines began in 1920 the deflation of bank credit was not pronounced until 1921–22. These were years of sharp contraction in business assets, yet the business loan increases of the earlier years were not entirely lost. As far as the business lending activity of commercial banks is concerned, the noteworthy effect of the economic expansion of World War I was a volume of business loans outstanding in 1922 nearly double that of 1915. However, total bank assets had increased about proportionately and the period ended with little over-all change in the relative importance of the business financing function of banks.

### *1923–1928: Period of Change in the Character of Bank Financing of Business*

An appraisal of the years 1923–28 depends on whether only the growth of bank lending (still primarily short-term in character) is considered, or whether changes in bank holdings of corporate securities as well as changes in bank loans to business are taken into account. From the former viewpoint the third period contrasts sharply with the second; between 1923 and 1928 national bank loans to business increased at an average annual rate of only $180 million, which was about one-half the 1916-22 average annual increase. However, from the latter viewpoint, where business loans are combined with bank holdings of corporate securities, the rate of growth of bank holdings of business obligations was very nearly the same in the years 1923–28 as in the earlier period. Concurrently the amount of loans made on real estate and on the security of stock exchange collateral increased substantially. While the proportion of these loans which can be properly termed business loans cannot be determined, it is clear that some were made explicitly as such and that a good part of all credit thus extended had the effect of lessening business demand for bank credit of conventional form. There was a distinct shift away from the conventional short-term, commercial type of lending and toward other, less direct, ways of financing business. In view of these facts the years 1923–28 are better characterized as ones in which significant changes occurred in the ways in which commercial banks performed their business financing functions than as years in which the conventional short-term financing of business tended to decline.

### *1929–1935 and 1936–1940: Periods of Contraction and Revival in Bank Lending to Business*

In sharp contrast to earlier periods, when changes in the industrial structure of the economy, in the asset structure of business, and in the financial policies of business management were the primary factors affecting the business credit market, the demand for bank credit by business in the years 1929–35 was dominated by contraction of business assets, price declines, and general financial deflation. These circumstances were crucial in their effect on the business financing function of commercial banks. While a moderate increase in the business loan outstandings of banks began in 1936, as business activity revived and the rate of business asset expansion increased, the amount of bank credit in use by business in most years in the period 1929–40 bore a definitely lower proportion to the total value of goods and services produced in the economy than in previous periods. Furthermore, drastic shifts occurred in the relative importance of the business financing function of commercial banks and in the banks' competitive position.

As regards the former, the combined total of bank loans to business and bank holdings of business securities fell from 43 percent of total bank earning assets in 1930 to 30 percent in 1940. During the period 1929–35 the change in relative importance resulted from a shrinkage in the business loan assets of banks which was more rapid than that experienced by total earning assets; in the years 1936–40 the decline was due to a slower increase of business loans than of bank earning assets as a whole.

As regards changes in the competitive framework within which commercial banks functioned as business lending agencies, a useful measure is the proportion of total business and consumer instalment credit extended by commercial banks compared with that extended by other agencies. For this comparison business and consumer instalment credit are combined because of the substitutability of the latter for the former, and the close competitive relationships between agencies functioning in these fields. While the total amount of business plus consumer instalment credit in use in the business system in 1940 differed little from that in use in 1930, the relative importance of the various agencies serving this joint market was very much altered between those two years. First, that part of the combined market served by commercial banks fell from 73 percent to 45 percent. Second, the segment served by insurance companies rose from 18 percent to 37 percent. Third, consumer instalment credit, which comprised but 9 percent of the total business plus consumer credit in 1930, accounted for 20 percent in 1940. The commercial banks' share of the consumer instalment credit market rose from 4 percent in 1930 to 27 percent in 1940. Finally, in comparison with the shifts in the importance of the major agencies serving the combined business and consumer credit market, the growth in the importance of commercial finance companies and of public lending agencies was of minor importance. The development of these agencies doubtless affected certain segments of the combined market with considerable force, but it did not substantially change the relative positions of major agencies.

Shifts in the positions of various agencies in the combined business and consumer credit market are, of course, the net result of numerous forces and conditions, but they clearly reflect two major developments of this period: first, the rise of consumption credit relative to production credit, and, second, the growth of medium- and long-term business credit, compared with the conventional short-term type.

## ADAPTATIONS IN BANK LENDING PRACTICES

Primarily as a result of developments affecting business demands for credit, significant adaptations were made in the business lending policies and practices of commercial banks. During the years 1923–28 the adaptations were mostly in the direction of increased holdings of private corporate securities, larger holdings of loans secured by real estate, and increased extensions of stock exchange collateral loans. In 1929–35 adjustments were limited by the over-all contraction of credit demand, but during those years forces and conditions developed which provided strong stimuli for change. By 1936, and in certain cases by 1934, significant adaptations were being made which in a few years substantially altered the functional character of the commercial banking system as a business financing agency. The salient changes may be summarized briefly.

(1) Banks greatly increased their participation in the consumer instalment credit market. Since this market grew more than the commercial banks' participation in it, the banks were able to hold larger consumer debt outstandings without reducing their loans to finance companies. However, since the acquisition of consumer receivables by business financing agencies placed nonfinancial business concerns in possession of cash, bank participation in this market, whether direct or indirect, was in varying degrees substitutive for direct business lending.

(2) Banks were able to serve more effectively as suppliers of credit to large concerns by extending serial repayment loans of longer average term, a development caused primarily by changes in the asset structure of nonfinancial businesses and in their business financing policies.

(3) Banks showed increasing responsiveness to the credit needs of small and medium-sized businesses, which provided the bulk of demand for their credit at all times. Because enterprises of these sizes fared badly during the thirties, the extension of credit to them called increasingly for methods designed to provide greater security for the lending agency and to minimize risks of default and loss. The adjustments which commercial banks made to meet these credit needs more effectively were marked by a willingness to write loans on terms more attractive to such borrowers (for example, term loans with instalment amortization and revolving credits supplying a reasonable guarantee of working capital facilities over periods longer than customary), and by the use of a wider range of security devices (such as the assignment of receivables, liens on income-producing equipment, the trust receipt, and the field warehouse receipt).

## EFFECTS OF WORLD WAR II ON BUSINESS FINANCING BY BANKS

During World War II business demand for bank credit was subject to two opposing forces: the stimulative effects of the war production program and the contractive effects of controls and limitations over civilian production not essential to the prosecution of the war. More specifically, expansive factors were the immense war expenditures of the federal government, which rose from an annual rate of $6 billion in the fiscal year 1941 to $90 billion during the fiscal year 1945, and the vast increase in gross national product, from $97 billion in 1940 to about $200 billion in 1944–45. Associated with these forces was the greater volume of output and of inventories, even though expansion of both these elements was limited by contraction in certain lines of civilian goods. Contractive factors were a net decline in the number of operating business concerns, higher ratios of sales to inventory and to receivables, a decline in the production of consumer durable goods between December 1941 and December 1942, and liquidation of consumer credit outstandings, which greatly affected the borrowings of finance companies.

In general, wartime developments in the financial structure of business were such as to forestall any substantial rise in the demand for commercial bank credit. While net fixed assets appear to have declined after 1941, because of rapid depreciation accruals, there was a great expansion in the total plant operated by business, reflecting an increase in gross private plant and in government-owned plant used by business. Between the end of 1939 and mid-1945, an expansion in current assets, owing in large measure to the postponement of replacement and maintenance expenditures and to the retention of earnings, outstripped a rise in current liabilities to the point where net working capital increased about $23 billion.

The principal effects of these developments on the business lending activities of commercial banks can be seen in the movement of business loan outstandings and in the composition of the business loans held by the banking system. Commercial and industrial loans in December 1941 rose to a peak about 45 percent above the amount of such loans at the end of 1939, then declined sharply through mid-1943, and subsequently advanced again so that at the end of June 1945 they were about 18 percent above the level at the close of 1939. Factors associated with war production programs or with wartime economic controls which served to keep the volume of outstanding business loans only moderately above their 1939 level were advances and prepayments to war contractors, a decline in finance company borrowings which was caused by a reduction in consumer instalment indebtedness, profitability of small and medium-sized concerns which made it possible for them to finance a large part of their asset expansion through the retention of earnings, reduction of financing needs for agricultural crop movements, which reflected transportation shortages, and a reduction in borrowings by trade concerns following the liquidation of trade receivables.

More striking than the changes in the amount of business loan outstandings during the war period was the change in the composition of the business loans held by banks. There was an enormous flow of bank funds into war and out of nonwar uses, a rise in the proportion of bank credit used by large concerns, which were most active as producers of war goods, and sharp increases in bank credit in districts, such as Chicago and San Francisco, where war production activities grew most rapidly.

The other feature of wartime developments in banking that is worthy of special attention is the greater role played by government loan guarantees. When the special risks of the wartime financing process appeared to slow the development of the war production program, they were virtually eliminated by the guaranteed war loan programs; on June 30, 1945 about 18 percent of the commercial and industrial loans of all insured commercial banks were held under at least partial government guarantee. In general, World War II produced an extension of the principle of loan guarantees and caused considerable government activity in the area of business financing through advances and prepayments on war contracts.

## EMERGING ROLE OF COMMERCIAL BANKS

Postwar credit demands over the long run will be affected by the same broad factors that have determined the magnitude of business demands for credit in the past. These are the rate of business asset expansion, the extent to which asset expansion is accomplished through the retention of business earnings, and the decisions of management as to the form in which externally acquired funds are to be taken — whether in equity or in debt, and if the latter whether on a long-, medium-, or short-term basis. However, it is useful to distinguish between those specific factors to which business credit demands are subject over the long run and those of a short-run nature. Over the short run, as the economy accomplishes postwar transition, business credit demands are subject to both contractive and expansive forces. Among the contractive forces are the high wartime liquidity achieved by business; the payments due by government on terminated war contracts; tax refunds and claims and possible tax reductions; and funds recoverable on unamortized emergency plant facilities. Expansive forces include needed reconversion expenditures; expenditures for the expansion, relocation, and improvement of productive facilities; the uneven capacity of business concerns to finance activities from the liquidation of assets and current earnings; credit demands of new businesses; and price increases. The probable strength of these two sets of factors is extremely difficult to judge but, on balance, the factors of expansion seem likely to predominate.

As the long-term factors indicated above make themselves felt in the business credit market, the general environmental conditions within which business financing is conducted will be changed, and the position of commercial banks as business financing agencies will depend in considerable part on their ability to adapt themselves to the changing conditions. While adaptations can be expected, certain factors tend to limit the flexibility of banks in making adjustments to new conditions, notably the persisting environment of economic instability in which all business financing agencies must operate, lower ratios of bank capital to deposit liabilities, the short-term nature of bank deposit liabilities, the risk quality of bank assets other than business loans, regulations affecting bank investment in business securities, examination procedures of bank supervisory agencies, and the operation of legal and conventional conditions affecting maximum loan charges.

Despite these limitations, commercial banks have made significant and effective adaptations in their business lending policies and practices — adaptations which have been facilitated in some instances by the action of public agencies. Prominent among these are the formulation of specialized loan programs designed to meet the needs of business concerns in all size classes, and a more specific adaptation of the system of correspondent banking relationships to the problems of business financing.

While the manner in which commercial banks function as business financing agencies has undergone significant changes since 1900, there is no evidence of a persisting tendency for the business lending function of commercial banks to decline. On the contrary, this function of the commercial banking system has been expanding since the mid-thirties. Further recovery and expansion will depend upon the rate of growth of the assets of the business enterprise system, the making of effective adaptations to changing conditions in the field of business financing, and the existence of public laws and regulations conducive to risk-taking.

# THE PLAN OF THE BOOK

PART I OF THIS STUDY PRESENTS a detailed analysis of the business credit market around 1940 and of the position in that market of the various agencies that serve the credit needs of business. The decision to begin the study with this analysis was made mainly because an understanding of the structure of the business credit market in a selected recent year facilitates the analysis of changes in the relationship between business financing agencies and nonfinancial business since 1900. The magnitude and significance of these changes are more readily understood when related to conditions in a base period. The year 1940 was chosen for this comparison because of the availability of necessary data and because conditions had not at that time been much distorted by World War II.

Part II describes the major changes that occurred in the business credit market over the years 1900–1940. Particular attention is given to developments that affected the credit demands of nonfinancial business, to changes in the relationships among various business lending agencies, and to shifts in lending policies and practices.

In Part III, the analysis of relationships between financial institutions and business enterprises is extended through the years 1940–45 in order to show how these relationships were affected by the war production program and war financing methods.

Finally, Part IV is concerned with the emerging role of commercial banks as business financing agencies, viewed against the background of changing relationships between business finance and banking since 1900.