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Chapter 2
COMMERCIAL BANKS AS SUPPLIERS OF CREDIT TO NONFINANCIAL BUSINESS: 1940

IT IS USEFUL TO THINK of the American business credit market as being composed of two divisions, one concerned with short-term credit running for one year or less, and the other with medium-term and long-term credit running more than one year to maturity. The principal forms of short-term credit appearing on business balance sheets are accounts payable and notes payable due in one year or less, while the major forms of medium-term and long-term credit are term loans due in more than one year, bonds, debentures, and mortgage loans. Each class of indebtedness represents obligations due to a variety of creditors. In 1940 commercial banks were an important source of medium- and long-term as well as of short-term business credit, although they were not the major source of either type of credit.

SHORT-TERM VERSUS MEDIUM-TERM AND LONG-TERM BUSINESS CREDIT

While the technical distinction between medium- and long-term and short-term credit is based upon the term to maturity of the loan, one year being the dividing line, the true economic distinction is grounded on the nature of the business transaction being financed. For example, businesses whose operations are subject to strong seasonal influences are ordinarily large users of short-term credit obtained to finance seasonal bulges in their operations. In practice, however, there is no sharp divergence in the uses to which either class of credit is put by business concerns. Loans that are technically of short term may be used to finance fixed assets or long-sustained operations, and medium- and long-term loans may be used in part to finance temporary transactions.

Both loan markets are characterized by competition among particular sets of credit agencies. The two markets differ in credit appraisal methods and standards. In lending on short term, credit institutions tend to place greater reliance on the balance sheet of the borrowing business in order to determine whether liquidation of current "trading" assets is likely to produce sufficient funds to pay off the debt. In lending on medium or long term, greater emphasis is given to the earning power of the concern over a period of years, and its ability to "throw off" cash to service the debt.

In 1939 the short-term debt (defined here as equivalent to the current liabilities) of all American nonfinancial corporations amounted to $23 billion on a nonconsolidated basis.[1] Their gross outstanding long-term debt, on the other hand, was $33 billion, or about 45 percent more than the short-term obligations. More than half of the short-term debt was owed by manufacturing and trading concerns; nearly nine-tenths of it by these corporations plus public utility companies (including railroads). As for long-term debt, more than 70 percent was owed by railroad and other public utility companies, whose assets consisted primarily of fixed property.

Data for 1937 indicate that the proportion of assets financed by short-term debt declined quite sharply as size of corporation increased up to businesses having total assets of $5 million. But this tendency for the importance of short-term debt to shrink with increasing size of business was not offset by an expansion of the ratio of long-term debt to total assets, except among large businesses with total assets of $5 million and more, and among public utility companies. As between profitable and unprofitable corporations, variation in the use of short-term debt was very striking, the ratio

[1] Short-term and long-term business credit outstanding at any time can be measured only imperfectly. First, credits written to run a year or less are renewed frequently, and may be regarded by both borrower and lender as long-term loans. This produces a bias toward understatement of real long-term credit in available financial statistics. Second, business concerns customarily include among their current liabilities those instalments of a long-term debt that fall due within the ensuing fiscal year. This introduces a bias in the opposite direction. Third, short-term debt at statement date may be less than the year's peak because of the tendency to repay loans at that time and to use a fiscal year ending in a period during which short-term credit needs are at a minimum. Finally, business balance sheets fail to classify either short- or long-term debts as between types of creditors, which precludes direct measurement of their relative importance. While "accounts payable" may be presumed to measure debt due to trade suppliers, "notes payable" cover debt due to commercial banks, commercial finance companies, affiliated companies, trade suppliers, stockholders, or other agencies.

of current liabilities to total assets for unprofitable businesses being 40 to 50 percent higher than for profitable concerns.

What general explanation can be offered for the particular maturity distributions of debt found among business enterprises? Why do business concerns not borrow entirely on short term or entirely on long term?

Part of the answer to this question is provided by a study of the kinds of assets employed by businesses and their variability in value through time. Long-term credit demands are related to the ownership of fixed property, and short-term credit requirements are related to the volume of current assets and transactions. If the technology of a business is such that the amount of its assets varies considerably within short periods — a probable situation where current assets form a large proportion of total assets — the use of short-term debt is likely to be relatively larger than where total assets are comparatively stable. But the correlation of large current debt with large current assets in various industries is so imperfect as to indicate that the term structure of business debt is far from being controlled by the term structure of assets. The considerations affecting the division of the debt of a particular concern between short- and long-term obligations are not easily fitted into a neat formula. They may be described, in general, as considerations of technology, alternative cost, urgency, and flexibility.

SOURCES OF SHORT-TERM CREDIT TO BUSINESS

Three categories of short-term business liabilities can be distinguished: *trade credit* obtained by a concern from other businesses that supply it with inventories or, less frequently, with machinery or equipment; *commercial credit* obtained from banks, finance companies, governmental loan agencies, or other financial institutions; *"other" current liabilities* represented by the accrued obligations of a concern to tax collectors, insurance companies, or other agencies, and notes due to owners, stockholders, or other nonprofessional lenders. The significance of this division lies in the difference in the terms upon which each type is available and in the circumstances of its use. Trade credit is associated directly with the purchase of merchandise or services; commercial credit involves the formation of a relationship with a lending institution in the financial

Table 3 — ESTIMATED PERCENTAGE DISTRIBUTION OF CURRENT LIABILITY ITEMS OF NONFINANCIAL BUSINESS CONCERNS, BY MAJOR INDUSTRIAL DIVISIONS, 1939[a]

Industrial Division	*Trade Debt*	*Bank Debt*	*Amounts Due Individuals*	*Chattel Mortgages*	*Miscellaneous Current Liabilities*	*Accrued Liabilities*	*Total Current Liabilities*
Manufacturing	42.9%	17.2%	13.6%	1.0%	5.6%	19.7%	100.0%
Wholesale trade	64.0	18.5	10.5	.4	2.9	3.7	100.0
Retail trade	40.8	17.5	11.2	18.9	5.8	5.8	100.0
Construction	57.5	16.3	11.3	.5	7.7	6.7	100.0
Service	31.5	17.7	10.5	19.4	7.3	13.6	100.0
COMBINED	44.0%	17.4%	12.5%	5.7%	5.6%	14.8%	100.0%

[a] Based on data in Carl Kaysen, *Industrial and Commercial Debt — A Balance Sheet Analysis, 1939* (National Bureau of Economic Research, Financial Research Program, ms. 1942) Table A-1, which was compiled from a sample of about 6,200 concerns.

market; "other" current liabilities involve loans from agencies likely to be influenced by special considerations in assuming a creditorship position, and accrued expenses, such as taxes or insurance, chargeable to past operations but not yet due.

PREPONDERANCE OF TRADE CREDIT

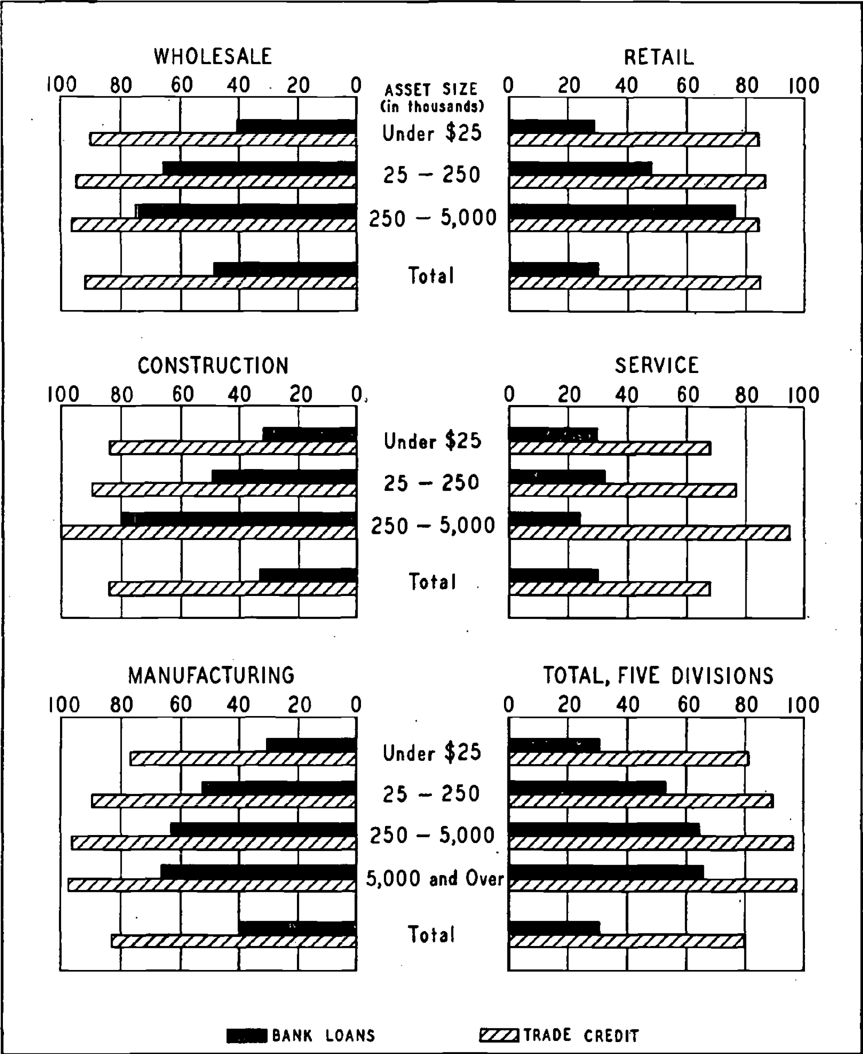
Quantitatively trade credit is the most important type of short-term business credit in every major industrial division of the non-financial economy (Table 3). In 1939 trade debt was about two and one-half times as large as bank debt for manufacturing, trade, construction, and service industries combined.[2]

Furthermore, because of its role in current transactions, trade credit is found in the balance sheets of businesses with far greater frequency than is bank credit (Chart 6). Irrespective of size, degree of profitability, or kind of industry, an overwhelming majority of businesses showed accounts payable on their balance sheets at the end of 1939: in wholesaling, 92 percent; in manufacturing, 83 percent; in retail trade, 85 percent; in construction, 84 percent; and in the service industries, 68 percent. The frequency of use of trade credit rose steadily with size of concern in all major industrial groups, probably because big businesses purchased on credit from a larger number of suppliers than did small concerns and were more likely to be using *some* trade credit at any given time.

While perhaps 80 percent, or 2.7 million, of the 3.4 million non-financial businesses at the outbreak of World War II had outstanding trade debt, only about 35 percent, or not more than 1.2 million, of them had outstanding debt to financial institutions — mainly to commercial banks. Because, as indicated above, the ratio of trade debt to bank debt was approximately two and one-half times in manufacturing, trade, construction, and service industries combined,

[2] Debt to business suppliers outweighed bank debt by 3.6 to 1 in construction; in wholesaling the ratio was 3.4, in retailing 2.8, in manufacturing 2.5, in service 1.7, and for all five divisions combined it was 2.6. See Carl Kaysen, *Industrial and Commercial Debt — A Balance Sheet Analysis* (National Bureau of Economic Research, Financial Research Program, ms. 1942) p. 30. For public utilities and extractive industries the data suggest that trade credit was more than double the amount of outstanding bank credit. See Sidney S. Alexander, *Changes in the Financial Structure of American Business Enterprise, 1900–1940* (National Bureau of Economic Research, Financial Research Program, ms. 1943) Table 9, p. V-8. Unfortunately, Alexander's data compare accounts payable with notes payable, and a substantial fraction of the latter evidences debts owed to agencies other than banks.

Chart 6 — FREQUENCY OF SHORT-TERM DEBT AMONG NONFINANCIAL BUSINESS CONCERNS OF DIFFERENT ASSET SIZES, 1939
(*in percent of all concerns in each size class*)



Only one-third to one-half as many nonfinancial businesses used bank credit as used trade credit. The relative frequency of use of both forms of credit was especially high in manufacturing, wholesaling, and construction. In the five major industrial divisions combined, frequency of use rose with asset size of business.

it appears that for the average business utilizing both types of short-term funds the average amount of trade credit was in excess of the amount of its bank loans. For the major industrial divisions, there was substantial correlation between the frequency of use of trade credit and of bank credit. This correlation suggests that bank borrowing was used by business management in most cases to supplement other sources of short-term credit, and not to substitute for that obtained from business suppliers.

What is the explanation of the fact that about two and one-half times as many businesses used trade credit as used bank credit, and in amounts about two and one-half times as large? The answer is not simple. A substantial part of outstanding trade credit was "float," representing sums due to trade suppliers which were in process of payment at the time balance sheets were drawn. A considerable amount of trade debt was also incurred more or less "automatically" by business managements as a matter of purchasing convenience, and in the case of unprofitable concerns as a matter of necessity. Apart from these factors, the relative uses of trade credit and bank credit appear to have been related to the size, industry, and technology of business concerns. Thus large concerns (i.e., chain stores and mail-order houses) purchasing from small suppliers tended to have low levels of accounts payable, as did concerns purchasing standardized commodities in well-organized markets (i.e., millers, meat packers, and tobacco manufacturers). Nevertheless, taking the economy as a whole, industries that used relatively large amounts of trade credit also used relatively large amounts of short-term bank credit, indicating the existence, commented upon above, of a complementary rather than a competitive relationship between the two sources of credit.

BUSINESSES USING SHORT-TERM BANK CREDIT

A telescopic view of the short-term business borrowing clientele of commercial banks around 1940 would result in the "typical" borrower being described roughly in these terms: It was a small or medium-sized manufacturing or trading concern, of somewhat less than average profitability, which tended to borrow repeatedly in a succession of years.

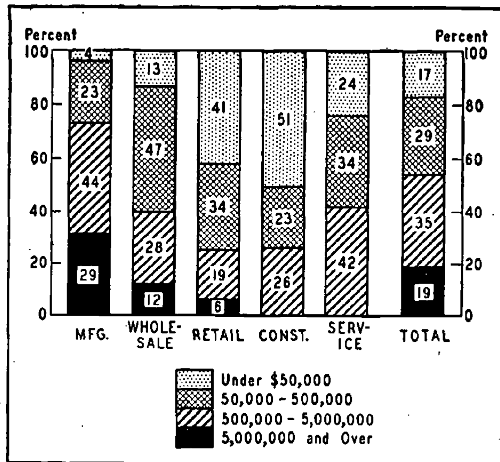
While there is no direct information on the industrial distribu-

tion of short-term bank credit around 1940, collateral information from several sources leads to the conclusion that manufacturing and trading enterprises were the two most important categories of business borrowers from commercial banks. Together they accounted for more than half of all outstanding "commercial and industrial" loans. Miscellaneous finance companies — mainly personal loan and sales finance organizations — accounted for another sixth to a quarter of these loans; public utility concerns for an additional 15–20 percent; and the balance were scattered among service, construction, and miscellaneous industries.

Small and medium-sized enterprises accounted for the preponderance of outstanding short-term bank loans in all industrial divisions, except public utilities and miscellaneous finance where large-scale enterprise tended to predominate. A sample of business concerns in five industrial divisions indicates that in 1939 no less than 71 percent of the amount of all bank loans to manufacturing concerns was owed by concerns with total assets under $5 million (Chart 7). The analogous figure was 88 percent in wholesaling, 94 percent in retailing, and about 100 percent in construction and service, with an over-all figure for the five divisions combined of 81 percent.

Analysis of the "notes payable" in 1937 of all nonfinancial business corporations generally

Chart 7 — PERCENTAGE DISTRIBUTION OF SHORT-TERM BANK DEBT OF NONFINANCIAL BUSINESS AMONG CONCERNS OF DIFFERENT ASSET SIZES, 1939



For each of the five major industrial divisions considered here, except construction, businesses with assets of $50,000 to $5,000,000 accounted for the bulk of the short-term bank debt. In construction, the largest percentage of short-term bank debt was used by concerns with assets of less than $50,000.

confirms the view that "big business" was a minor element in the short-term credit clientele of banks, small and medium-sized corporations with assets under $5 million accounting for 61 percent of all notes payable, although only 30 percent of corporate assets and 53 percent of corporate sales were attributable to this group. A survey of commercial and industrial loans made by Federal Reserve member banks during one month of 1942 shows that 71 percent of the amount of such loans went to small and medium-sized businesses.

Unprofitable businesses showed relatively larger amounts of bank credit on their balance sheets than did profitable concerns, both because losses reduced equity and automatically increased the relative importance of bank debt, and because lack of profits reduced the ability to pay off outstanding bank debt. Nearly 60 percent of all nonfinancial corporations reported no taxable net income during 1937. These concerns accounted for but 22 percent of the gross income of all corporations in that year, but they owed 43 percent of the amount of notes payable.[3] The percentages of notes payable to total assets at the end of 1937, for income and deficit corporations of different sizes, reveal a markedly greater indebtedness for small than for large corporations, as well as heavier indebtedness for the unprofitable businesses of each size-group (Table 4).

Roughly two-thirds of the business concerns receiving credit from a bank at a given time might have been expected to be in its debt during the following year according to 1939 data for a sample of companies. This may be inferred from the fact that 64 percent of the sample indebted to banks were either "steady" or "seasonal" borrowers, while only 36 percent were "occasional" borrowers.[4] Among manufacturing, wholesaling, and retailing concerns the proportion of "steady" bank borrowers rose with size of concern. The turnover of businesses pledging their accounts receivable, equipment, or inventories as collateral security for bank

[3] In *Statistics of Income for 1937*, Part 2, it is reported that 192,028 corporations, or 40 percent of the total active corporations, filed returns showing net income in 1937, while 285,810 corporations, or 60 percent, filed returns showing no net income. The income corporations had total gross income of $109 billion or 77 percent of all corporate gross income, while the no-income corporations had $33 billion of gross income or 23 percent of the total.

[4] It would be valuable to know to what extent turnover in the borrowing clientele of commercial banks results from (1) business birth or discontinuance and (2) improvement or deterioration in the financial status of continuing enterprises. Both factors play a part, but the importance of each cannot be measured from existing data.

Table 4—NOTES PAYABLE IN PERCENT OF TOTAL ASSETS FOR NONFINANCIAL BUSINESS CORPORATIONS (INCOME AND DEFICIT), BY ASSET SIZE OF CORPORATION, 1937[a]
(*dollar figures in thousands*)

Asset Size of Corporation	*Income Corporations*	*Deficit Corporations*
Under $50	9.2%	15.8%
50–100	9.7	13.8
100–250	8.8	12.4
250–500	7.9	10.3
500–1,000	6.9	9.8
1,000–5,000	5.9	7.6
5,000 and over	2.0	3.1
TOTAL	3.3%	5.8%

[a] Based on U. S. Treasury Department, *Statistics of Income for 1937*, Part 2. Industrial divisions covered are manufacturing, wholesale and retail trade, construction, service, mining, and public utilities including railroads. Data as of December 31.

loans was more rapid than that of concerns borrowing in the traditional way on their unsecured notes. This may have been due in part to the attitude of commercial bankers that the former methods of financing constituted interim arrangements, and that within a limited period of time the borrower should improve his financial affairs to a point where funds could be advanced on some other basis or else he should get out of debt to the bank altogether.[5]

CHARACTERISTICS OF SHORT-TERM BANK LOANS TO BUSINESS

At the outbreak of World War II the majority of commercial bank loans to business took the form of straight promissory notes payable on demand or running for six months or less to a definite maturity date. The survey of commercial and industrial loans made by Federal Reserve member banks, which covered the month from April

[5] Raymond J. Saulnier and Neil H. Jacoby, *Accounts Receivable Financing* (National Bureau of Economic Research, Financial Research Program, 1943) p. 99.

Notwithstanding many exceptional cases, the *average* field warehouse receipt financing arrangement endured for about three years, and the typical accounts receivable financing arrangement lasted for under four years. See Neil H. Jacoby and Raymond J. Saulnier, *Financing Inventory on Field Warehouse Receipts* (National Bureau of Economic Research, Financial Research Program, 1944) p. 60, and *Accounts Receivable Financing*, p. 66.

16 to May 15, 1942, indicates that the 90-day note was the principal basis of short-term debt to banks. The average maturity of loans is, of course, a misleading measure of the average length of time any individual business is continuously in debt to a bank, because many bank loans are renewed successively, the borrower paying off part or all of an old note with the proceeds of a new one. Inasmuch as 41 percent of the total loan volume of the one month surveyed was accounted for by renewals of old loans, it would appear that the majority of loans were renewed in whole or in part at their average maturity of 90 days.

Apart from advances against demand or short-term notes, banks and commercial finance companies also entered into credit relationships with business which were short term in form but long term in actual duration, because of a "revolving credit" feature. The principal illustrations are loans secured by business accounts receivable, loans secured by warehouse receipts arising from the deposit of merchandise in a field warehouse on the premises of the borrowing business, and the financing of commercial and industrial equipment on instalment terms. These newer "short-term" business credit forms, which are described in Chapter 5, more directly recognize the actual duration of business credit requirements than does the traditional short-term commercial loan.

In both number and amount, the majority of short-term bank loans to business in 1939 were not collaterally secured by liens on business assets. They involved "open" credits, based on the financial worth and reputation of the borrowing enterprise or its principals and carrying only their promises to make repayment. Only 20 percent of all enterprises in five industrial divisions that borrowed from commercial banks in that year provided collateral security. Service industries most frequently provided liens on assets (in 43 percent of the cases), probably because many businesses such as garages and repair shops purchased equipment on conditional sales contracts or under chattel mortgages. Retail concerns furnished liens on assets in 26 percent of the cases, construction in 20 percent, manufacturing in 20 percent, and wholesale trade in 11 percent. Probably less than 20 percent of the $6,671 million of "commercial and industrial" loans held by operating insured commercial banks in the United States at the end of 1940 were collaterally secured.[6]

[6] Commercial and industrial loans on this date probably included about $2,162 million of term loans, which were not short-term credits, and about one-third of

While the newer forms of short-term business credit extended by banks involve collateral security, they constitute a minor part of total bank credit. The preponderance of business loans of commercial finance companies, it should be observed, are collaterally secured business loans.

Only a minor proportion of unsecured bank loans to business concerns in 1939 carried the endorsement of others than the borrower, thus providing the lending institutions with additional security. About 25 percent of the unsecured loans to manufacturing concerns were endorsed, 31 percent in wholesale trade, 26 percent in retail trade and in construction, and 7 percent in service industries. Among small corporations especially, principal stockholders or officers were often required to endorse the notes given by their companies. To the extent that this occurred, the limited liability otherwise enjoyed by owners of corporations partly disappeared.

INTEREST CHARGED ON SHORT-TERM BANK LOANS

The effective annual interest rates — including any special service fees — charged for business credits around 1940 were determined by the size of the loan, the amount of risk of non-repayment attached to the loan, and the character of the financing plan. From the point of view of the lending institution, the major element in the charge was not "pure" interest, or the return on "riskless" loan assets with short maturities, for which the yield (e.g., on high-grade commercial paper) was under 1 percent at that time; it was the expense of loan administration and the premium for risk of nonrepayment. In making a loan of any amount, a bank incurs certain "fixed" costs in investigating the applicant and appraising his financial worth and prospects. When these expenses are spread over a small loan, the charge per dollar is necessarily higher than when they are spread over a large loan. Moreover, the risks of lending to small ventures are typically greater, because the average profit rate is lower and less stable than for large businesses.

According to the Federal Reserve member bank survey made in 1942, interest rates charged on business loans averaged 3.4 percent.

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which were collaterally secured. See Neil H. Jacoby and Raymond J. Saulnier, *Term Lending to Business* (National Bureau of Economic Research, Financial Research Program, 1942) pp. 30, 49, and 50.

But the rate ranged from 5.5 percent on loans to the smallest class of borrowing businesses to 1.8 percent on loans made to the largest class of concerns. Industrial variations in loan rates, which roughly measure differences in the risk of investment in various fields, were also quite marked. Finally, collateral loans carried substantially higher charges than did unsecured loans, because the charge had to cover the additional expense of appraising and handling the collateral security.

Charges by commercial banks on accounts receivable loans ran between 6 and 9 percent per annum during 1941. Commercial finance companies, which generally assumed somewhat larger credit risks and incurred greater administrative expenses in lending against accounts receivable, charged rates running between 9 and 20 percent. Loans secured by field-warehouse receipts, which were made by both banks and commercial finance companies, involved credit costs ranging from 4 to 10 percent. In financing business equipment on instalment terms, lending institutions appear to have charged between 5 and 7 percent.

NATIONAL CHARACTER OF SHORT-TERM CREDIT MARKET

The degree of uniformity in the characteristics of short-term business credit in different parts of the United States in 1940 reflected a credit market more national in character than is often assumed. At the outbreak of World War II, a business concern of given size and industry would probably have used credit of about the same maturity, employed it for about the same purposes, paid about the same charge for it, and provided the same type of collateral security, whether the concern was located in Boston, Chicago, or Seattle. The policies of business managements in the use of short-term credit did not vary significantly over the nation.[7] Those regional differences in loan characteristics that did exist were attributable in large part to differences in the size and industrial affiliations of businesses in different regions. For example, geographical variations in the use of the newer collateralized business loans clearly

[7] It has been found that in 1939 "The pattern of credit use . . . appears to have little connection . . . with . . . geographic location and population size of location centre." See Carl Kaysen, *op. cit.*, p. 39.

reflected differences in the economic resources of the several regions. Lending on field warehouse receipts was used with more than average frequency in the Pacific area, where it is particularly adapted to the canning and lumbering industries. Accounts receivable financing flourished in the Atlantic states, where the textile industries are important. For even the cost of bank credit, the evidence indicates that a considerable fraction of the wide spread of *average* interest rates charged business concerns in different regions can be resolved into regional variations in the average size or industrial affiliation of borrowers.[8] Regional differences in interest rates — particularly those charged by very small banks to very small businesses — also reflect other factors, such as differences among regions in the costs of money to the banks.

SOURCES OF MEDIUM-TERM AND LONG-TERM CREDIT TO BUSINESS

Medium-term and long-term business credit running more than one year to maturity has taken two broad forms in the United States: *direct* loans obtained by personal negotiation with lenders and including such types as term loans, private placements of bonds, notes or debentures, and mortgage loans; *open market* loans obtained through public offerings of debt securities, in which the services of investment underwriters and dealers are ordinarily utilized as intermediaries between borrowing concerns and their creditors — the ultimate security holders. In 1940 commercial banks engaged in both direct lending on medium term and the purchase in the open market of medium- and long-term corporate securities for investment account. As grantors of medium- and long-term business credit, banks competed with a set of lending agencies different from those they faced in the short-term credit market, and, to a considerable extent, they served larger businesses.

In obtaining medium- and long-term credit, the business community made use of direct loans with much greater frequency than open market loans. Of the 650 thousand concerns estimated to have outstanding medium- and long-term debt in 1940, only about 3.2 thousand, or ½ of 1 percent, had publicly distributed debt secu-

[8] See *Federal Reserve Bulletin*, November 1942, p. 1089.

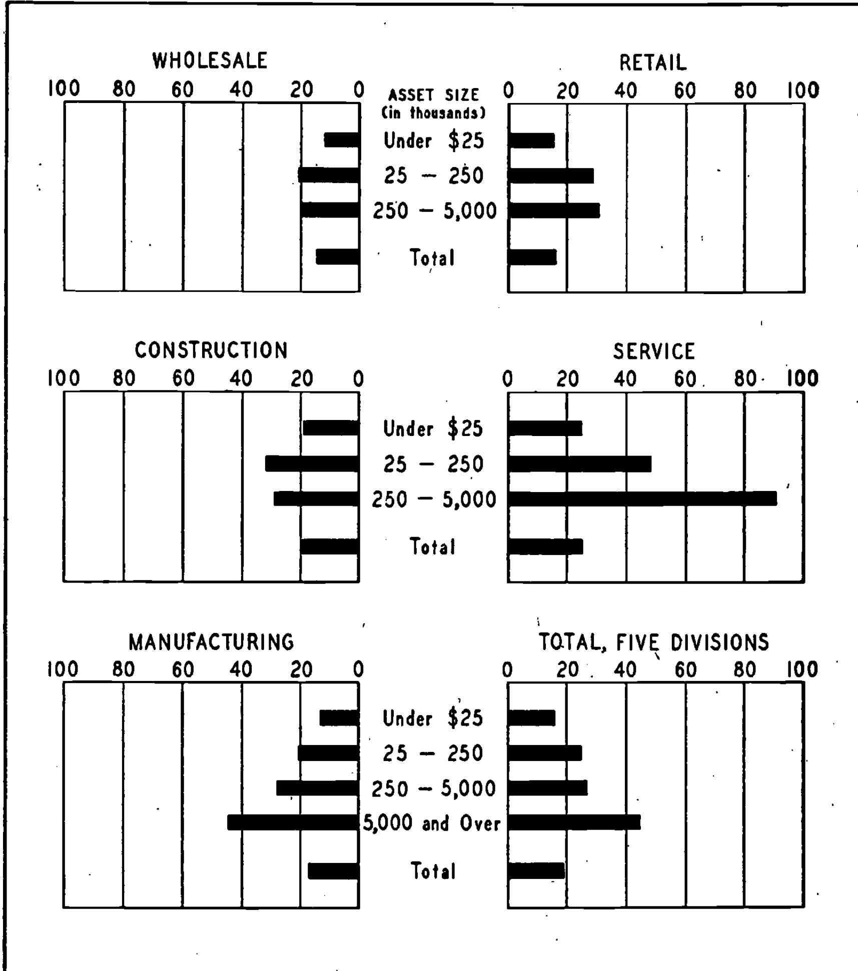
rities outstanding. The remaining 99.5 percent had negotiated their loans directly with a financial institution, an affiliated business concern, or an individual. Only a minor fraction of the number of such direct loans could be traced to a particular type of creditor. It is known that up to the end of 1940 the government loan agencies, comprising the Reconstruction Finance Corporation and the Federal Reserve banks, had granted term loans to about 11 thousand enterprises. In addition, commercial banks and the largest life insurance companies had lent directly to about 3.8 thousand businesses. Apparently hundreds of thousands of small and medium-sized concerns had obtained medium- and long-term credit from individual capitalists, local insurance companies, savings banks, savings and loan associations, investment companies, trust funds, nonprofit organizations, or other business enterprises.

The amount of the gross long-term debt of all corporations at the end of 1940 was about $52 billion. Approximately $8.3 billion represented debts owed to other corporations, indicating the great extent to which businesses were financing each other through long-term loans. As for the balance of these obligations, life insurance companies were the most important holders, their portfolios of long-term debt securities amounting to approximately $10 billion. Commercial banks ranked next, with holdings of about $5.1 billion made up of $2.2 billion of term loans, $2.4 billion of marketable securities of business corporations, and about $500 million of mortgage loans to industry. Mutual savings banks held about $1 billion of corporate bonds and notes, and the Reconstruction Finance Corporation had outstanding loans to nonfinancial businesses amounting to $599 million. After deduction of these known repositories of long-term corporate debt from the total, $27 billion remained to be accounted for. Presumably, this balance represented the outstanding long-term business credits extended by other sources, as mentioned above.

BUSINESSES USING MEDIUM-TERM AND LONG-TERM CREDIT

The 650 thousand American business enterprises that owed medium- and long-term debt at the beginning of World War II may be compared with the more than 2.7 million concerns that were in-

Chart 8 — Frequency of Long-Term Debt Among Nonfinancial Business Concerns of Different Asset Sizes, 1939
(*in percent of all concerns in each size class*)



Among the industrial divisions considered here, long-term debt was found most frequently in the service industries and least in wholesaling. In all divisions except wholesaling and construction, the frequency of use of long-term debt rose with size of business.

debted on short-term account. Among large corporations, only 44 percent had long-term debt in 1937. Such debt was least frequent among the extractive industries (26 percent of the concerns), higher in manufacturing (41 percent), still higher in trade (52 percent), and well-nigh universal among public utility corporations, 99 percent of which had such obligations. These figures generally bear out the theory that long-term debt, which imposes an annual fixed charge on earnings, is incurred most often by concerns having the greatest stability in earning power.

Among corporations of different sizes in the five major industrial divisions studied, less than one-fifth of those with total assets under $25 thousand showed long-term debt on their balance sheets in 1939 (Chart 8). But as asset-size of business increased the percentage of businesses having such debt rose, and 80 percent of the industrial giants with assets of $500 million or more were so indebted.[9] The marked rise in the use of long-term debt with size of enterprise probably reflected the increasing availability of such credit as the average profit rate rose and as annual earning power became more stable. It may also have resulted from a financial policy of business management not to commit the earnings of future years until there was a high probability that the commitment could be met without difficulty.

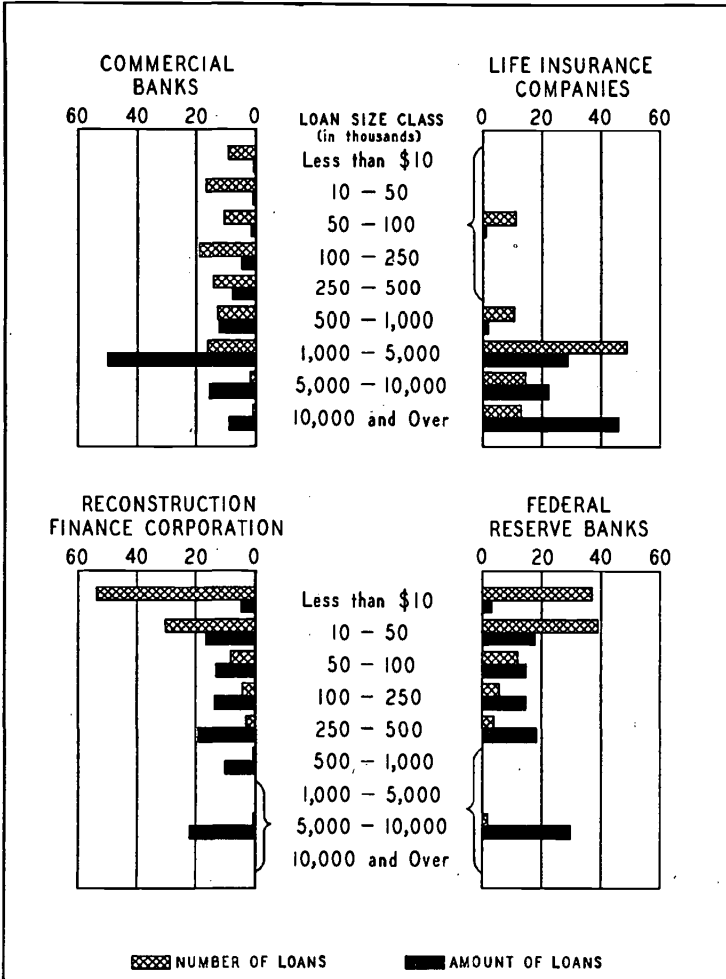
The businesses to which banks and life insurance companies granted the bulk of their medium- and long-term credit differed considerably from those served by the Reconstruction Finance Corporation and the Federal Reserve banks. As shown by Chart 9, these public lending agencies on the whole did not compete extensively with the private institutions in regard to the size of medium-term business loans made; and this absence of extensive competition with respect to size of loan reflects a similar condition with respect to size of business served.[10]

For all types of lending institutions, manufacturing businesses were the most important class of recipients of term loans (Chart

[9] The low frequency of long-term debt among small manufacturing corporations was confirmed by C. L. Merwin, who found that only 26 percent of a sample of 1,300 such concerns with total assets under $250 thousand had outstanding bonds or mortgages in 1936. Temporary National Economic Committee, *Financial Characteristics of Small Manufacturing Corporations* (Monog. 15, Washington, 1941) pp. 110–12.

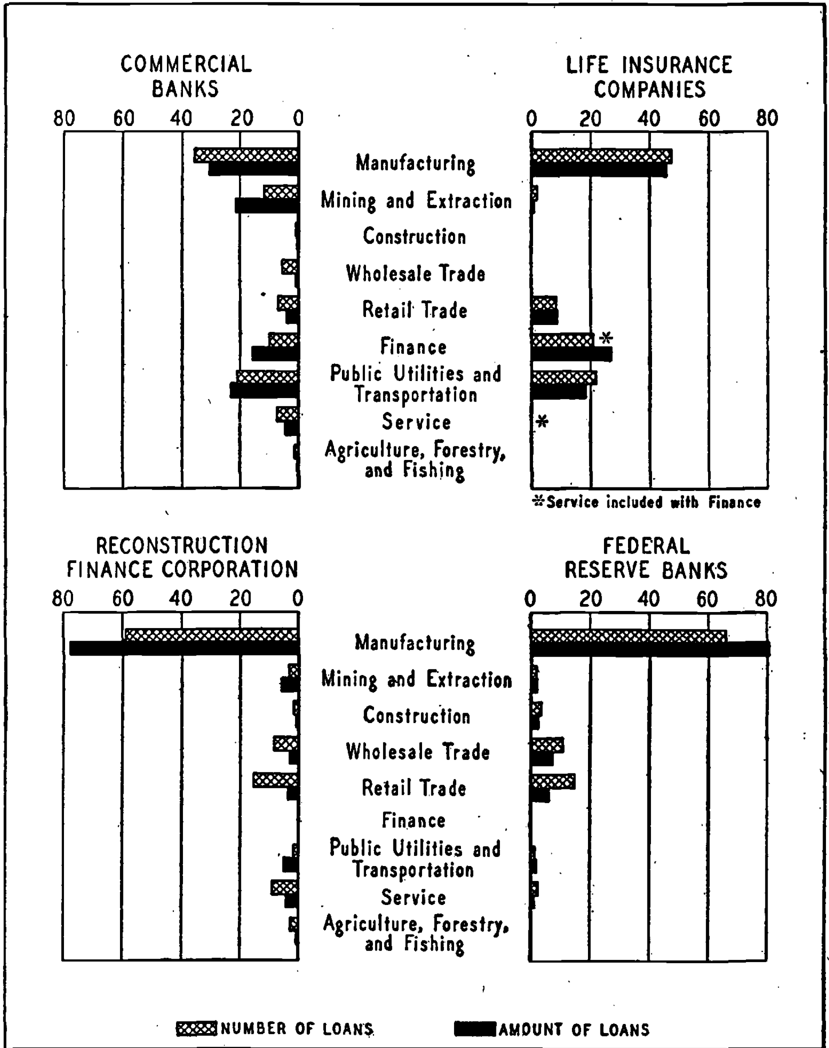
[10] See *Term Lending to Business*, *op. cit.*, p. 36.

Chart 9 — PERCENTAGE DISTRIBUTION BY SIZE OF LOAN OF NUMBER AND ORIGINAL AMOUNT OF MEDIUM-TERM LOANS HELD BY LENDING INSTITUTIONS AROUND 1940



The largest number of loans made by public loan agencies were in amounts less than $500,000; loans of life insurance companies were primarily in excess of this amount. Commercial bank loans were more diversified.

Chart 10 — PERCENTAGE DISTRIBUTION BY MAJOR INDUSTRIAL DIVISIONS OF NUMBER AND ORIGINAL AMOUNT OF MEDIUM-TERM LOANS HELD BY LENDING INSTITUTIONS AROUND 1940



For all lending institutions, manufacturing accounted for more borrowers and more credit than did any other industrial group. The industrial diversification of the commercial bank market was greater than that of any other type of institution.

Table 5—Estimated Percentage Distribution of Original Amounts of Bank-Eligible Corporate Bonds Outstanding, 1939, and of Medium-Term Loans Held by Commercial Banks, 1941, by Major Industrial Divisions[a]

Industrial Division	*Bank-Eligible Corporate Bonds Outstanding January 1, 1939*	*Term Loans Held July 1, 1941*
Manufacturing	11.6%	30.6%
Mining and extraction[b]	1.0	21.4
Construction	[c]	.2
Wholesale trade	1.4 (Wholesale and retail trade combined)	.8
Retail trade		4.0
Railroads	33.3	22.7 (Railroads and other public utilities combined)
Other public utilities	44.0	
Service	.4	4.5
Finance	8.3[d]	15.8
Total	100.0%	100.0%

[a] For sources see Appendix, p. 230.
[b] Includes agriculture, forestry, and fishing.
[c] Less than .05 percent.
[d] Estimated on the basis of data from National Bureau of Economic Research, Financial Research Program, *Moody's Manual of Investments*, and other sources.

10); these enterprises together with finance companies took more than half of the term loans of the banks and insurance companies. Railroad and other public utility corporations negotiated only 23 percent of the amount of term loans of commercial banks, but they issued more than 75 percent of bank-eligible corporate bonds outstanding (Table 5).[11]

[11] While there is little direct information regarding the character of corporations whose issues were held by banks for investment account, such data are available for all bond issues *outstanding* on January 1, 1939 which were eligible for purchase by commercial banks under the regulations of the federal supervisory agencies. "Eligible" bonds are those placed within the first four rating groups by a recognized rating service. (See *Annual Report of the Federal Deposit Insurance Corporation*, 1938, p. 64.) Bonds rated below these four groups, but viewed by examiners as of investment quality, and unrated bonds of equivalent grade are appraised for examination purposes in the same manner as are those in the four highest rating groups; these data, however, could not be included in the tabulations presented here. A fair assumption is that the bulk of the corporate bond *holdings* of banks consisted of the eligible high-rated securities.

Of the $29 billion of railroad, industrial, and public utility bonds outstanding on January 1, 1939, 57 percent met the requirements of the federal supervisory agencies for purchase by commercial banks. (Data from records of Corporate Bond Project, National Bureau of Economic Research, Financial Research Program.)

CHARACTERISTICS OF MEDIUM-TERM AND LONG-TERM LOANS TO BUSINESS

Significant differences existed before World War II between the medium- and long-term loans of banks and of other credit institutions. There were also differences between the direct and the open market business loans of commercial banks with respect to the term of the debt to its maturity, the type of security taken by the lender to assure repayment, the use of the funds by the borrower, the provisions for repayment, and the interest charged the borrower.

Maturity

The original term to maturity of corporate bonds eligible for purchase by commercial banks around 1940 was considerably longer than that of term loans made directly to business. Practically all the amounts of corporate bonds were due after five years, whereas approximately half of all term loan credit matured within five years (Table 6). The majority of direct business loans of the RFC also matured within five or ten years, while the maximum term of

Table 6—Estimated Percentage Distribution of Original Amounts of Bank-Eligible Corporate Bonds Outstanding, 1939, and of Medium-Term Loans Held by Commercial Banks, 1941, by Original Term to Maturity[a]

Original Term to Maturity[b]	*Bank-Eligible Corporate Bonds Outstanding January 1, 1939*	*Term Loans Held July 1, 1941*
1 year	c	1.1%
1–3	.1%	13.0
3–5	.3	35.4
5–10	5.9	48.7
10–15	13.6	.6
15–20	6.2	...
20–30	36.3	...
30–50	29.7	...
Over 50	7.9	...
No information	...	1.2
Total	100.0%	100.0%

[a] For sources see Appendix, p. 230.
[b] Each interval is exclusive of lower limit and inclusive of upper.
[c] Less than .05 percent.

Table 7—ESTIMATED PERCENTAGE DISTRIBUTION OF ORIGINAL AMOUNTS OF BANK-ELIGIBLE CORPORATE BONDS OUTSTANDING, 1939, AND OF MEDIUM-TERM LOANS HELD BY COMMERCIAL BANKS, 1941, BY TYPE OF COLLATERAL SECURITY[a]

Type of Security	*Bank-Eligible Corporate Bonds Outstanding January 1, 1939*	*Term Loans Held July 1, 1941*
All Bonds or Loans		
Unsecured	17.6%	66.5%
Secured	82.4	33.3
No information	...	.2
TOTAL	100.0	100.0
Secured Bonds or Loans		
Real estate mortgages only	54.4	10.5
Stocks and bonds only	3.1	37.6
Other types of assets only	...	30.1
Combinations of assets	42.5	21.8
TOTAL	100.0%	100.0%

[a] For sources see Appendix, p. 230.

loans by the Federal Reserve banks was limited by law to five years. Lending institutions sought to compensate for the lack of marketability of the direct loans by requiring, in most cases, instalment repayments under a prearranged schedule and by imposing shorter final maturities.

Collateral

Only about one-third of the amount of bank term loans to business around 1940 was collaterally secured by liens on assets, while more than four-fifths of the open market issues outstanding were so secured (Table 7). As would be expected, the typical secured loan was smaller and carried a somewhat greater risk of nonrepayment than did the typical unsecured loan, thus indicating a tendency for lenders to substitute collateral security for financial strength or early maturity as a risk-limiting device.[12] With respect to those credits that were secured, real estate only or a combination of assets

[12] It is also significant that among medium-term issues a far higher proportion of low-rated than of eligible corporate bonds was secured, and that among all issues the frequency with which security was taken increased measurably with term to maturity.

was used more frequently as security under corporate bond indentures, whereas single types of assets other than real estate were more frequently pledged to secure term loans. Like bank term loans, one-third of the amount of medium-term securities privately purchased by life insurance companies was collaterally secured, reflecting their prime quality as credit risks. In marked contrast, 83 percent of the business credit granted by the Federal Reserve banks and virtually all that of the RFC was secured. The public agencies, dealing with borrowers unable to obtain accommodation through private channels, were compelled to take every precaution to assure repayment. A feature of the RFC loans was that combinations of assets were placed under lien in many instances.

Use of Funds

The majority of bank-eligible corporate issues around 1940 were for both retirement and new money purposes, whereas bank term loans were generally used exclusively for either one or the other purpose (Table 8). Thus term loans served simpler functions in the borrowing businesses, because they were of shorter term to maturity and of smaller average amount. RFC loans were restricted by statute to "maintaining or promoting the economic stability of the country or encouraging the employment of labor," and the Corporation announced that it would *not* lend money primarily to enable a borrower to repay existing debts. Federal Reserve bank loans were limited by law to the provision of "working capital," which precluded use of the proceeds for refunding, plant expansion, or improvement.

Repayment Provisions

In regard to method of repayment, no less than 88 percent of the amount of bank-eligible corporate bonds was repayable in one lump sum at maturity, whereas about 85 percent of all term loan debt was repayable in instalments, for the most part equal in amount but in many instances with a final "balloon" note larger than its predecessors. Serial bonds were relatively unimportant in open market corporation financing, except in the financing of railroad equipment. But approximately 17.5 percent of corporate bond issues required annual purchases of outstanding debt through sinking funds, thus reducing debt in the hands of the public periodically in

Table 8—Estimated Percentage Distribution of Original Amounts of Bank-Eligible Corporate Bonds Outstanding, 1939, and of Medium-Term Loans Held by Commercial Banks, 1941, by Use of Funds[a]

Use of Funds	*Bank-Eligible Corporate Bonds Outstanding January 1, 1939*	*Term Loans Held July 1, 1941*
All Bonds or Loans		
New money only	14.8%	31.6%
Retirement only	32.6	54.1
Combination of purposes	41.8	12.3
No information	10.8	2.0
Total	100.0	100.0
New Money Bonds or Loans		
For plant or equipment only	84.2	32.9
For working capital only	7.8	49.3
For both or other purposes	8.0	17.8
Total	100.0	100.0
Retirement Bonds or Loans		
To retire bonds only	95.8	47.0
To retire other debt only or combinations of debt	...	43.4
To retire preferred stock only	4.2	3.2
Other combinations	...	6.4
Total	100.0%	100.0%

[a] For sources see Appendix, p. 230.

much the same manner as do serial maturities. In the case of term loans, the amount of gross and net income is the primary consideration in forming term loan repayment schedules, but the amount to be repaid serially is not usually made conditional on the realized gross or net income of the borrower, because this practice would thrust a considerable amount of business risk upon the bank.[18] Medium-term securities privately acquired by life insurance companies tended to resemble open market bonds in their repayment provisions, about three-quarters of their amount being repayable in a lump sum and one-quarter carrying serial maturities. On the other hand, almost all the RFC and Federal Reserve bank loans to busi-

[18] The payment of interest upon income bonds is, of course, made conditional upon the existence of net income.

ness were repayable in instalments, which were generally due monthly or quarterly rather than annually. These requirements undoubtedly reflected the close control that the lender to financially-straitened businesses finds it necessary to exercise in order to protect his position.

Interest Rates

Nearly all term loan credit and long-term credit acquired under bank-eligible corporate issues around 1940 cost the borrowers between 2 and 5 percent (Table 9). However, while 38 percent of term loans were made at rates below 3 percent, all eligible corporate bonds maturing in more than 15 years were issued at rates of 3 percent and over. Term loans, because of their smaller average size, might be expected to carry a rate above that on corporate issues; on the other hand, corporate issues, having an average term to maturity longer than that for direct loans, might be expected to carry the higher rate. These two factors tended to, but did not completely, offset one another, which accounts for the differential in average interest rates.

The average charge by banks for medium-term and long-term credit extended to business enterprises, it is significant to note, was about equal to their average charge for short-term credit, the higher quality and larger size of the long-term loans offsetting the shorter life of the short-term loans. Likewise, among public lending agencies rates tended to be about the same, regardless of final maturity; for both RFC and Federal Reserve bank loans to business, rates varied from 3½ to 6 percent, depending mainly upon size, industrial character, and credit standing of the borrower.

COMPETITIVE FORCES WITHIN THE MEDIUM-TERM AND LONG-TERM BUSINESS CREDIT MARKET

In direct lending on medium and long term during the years prior to World War II, life insurance companies, commercial banks, and government loan agencies — the three principal types of institutional suppliers of these types of credit to business — served different size groups of business. Life insurance companies provided both medium-term and long-term loans primarily to large concerns; banks provided credits of intermediate length to size groups of bor-

Table 9—ESTIMATED PERCENTAGE DISTRIBUTION OF MEDIUM-TERM LOANS MADE BY COMMERCIAL BANKS, MARCH 16–31, 1939, MEDIUM-TERM ISSUES PRIVATELY PURCHASED BY LIFE INSURANCE COMPANIES, 1938, AND ORIGINAL AMOUNTS OF BANK-ELIGIBLE CORPORATE BONDS ISSUED IN 1938, BY EFFECTIVE RATE OF INTEREST

Effective Rate of Interest	*Term Loans Made by Commercial Banks March 16–31, 1939*[a]	*Issues Maturing in Less Than 15 Years Privately Purchased by Insurance Companies During 1938*[b]	*Bank-Eligible Corporate Bonds Maturing in Less Than 15 Years Issued in 1938*[c]	*Bank-Eligible Corporate Bonds Maturing in More Than 15 Years Issued in 1938*[c]
1–2%	1.0%	...	.1%	...
2–3	37.1	31.3%	19.3	...
3–4	45.5	55.6	57.2	85.4%
4–5	15.2	13.1	20.6	14.5
5–6	.5	...	2.7	.1
6–7	.6	...	.1	...
7 and over	.1	...	...	...
TOTAL	100.0%	100.0%	100.0%	100.0%

[a] From Neil H. Jacoby and Raymond J. Saulnier, *Term Lending to Business* (National Bureau of Economic Research, Financial Research Program, 1942) p. 103.

[b] *Ibid.*, p. 106.

[c] From compilations of the National Bureau of Economic Research, Financial Research Program, Corporate Bond Project, supplemented by material from Baltimore and Ohio Railroad, *Analysis of Sales of Railroad Securities Under Authorization of Interstate Commerce Commission from May 1920 to December 31, 1938* (Baltimore, 1939). Only publicly placed obligations are included. Data are based on single-maturity, fixed-income bonds plus equipment trust certificates and other serial bonds. "Bank-eligible" bonds are those placed within the first four rating groups by a recognized rating service.

rowers ranging from very small to very large, but the bulk of this credit went to concerns of medium size; the government loan agencies served medium-sized and small businesses.

In medium- and long-term lending, the intensity of inter-agency competition was great in the making of large loans to the larger businesses possessing impeccable credit ratings. Banks and insurance companies competed actively for such business, which drove down the loan rate. In the making of medium-term loans to small businesses, inter-agency competition was less intensive, because the private lending institutions often considered the risks and costs of lending to this clientele too high relative to the rates which they could (or would) charge. Medium-term credit, in practice, was available to many small businesses only at, or with the participation of, the Reconstruction Finance Corporation or the Federal Reserve banks. To the extent that public regulation of banks and life insurance companies discouraged the assumption of credit risks, such regulation served, of course, to intensify competition for the large, prime loans and to reduce it for small loans.

A number of factors account for the substantial fraction of long-term credit to business procured directly from a lending institution in 1940 rather than indirectly through a public offering of bonds or notes — even by large concerns able to use either method. In the first place the costs of making a public offering were numerous and onerous. They included expenses imposed upon issuers by the Securities Act of 1933, underwriters' commissions, costs of advertising, the printing of registration statements and prospectuses, the engraving of certificates or bonds, transfer taxes, and costs of listing the new securities on exchanges and of maintaining transfer facilities. But the greater speed and flexibility of direct financing versus open market financing may have weighed as heavily as cost considerations. Compared with public issues, direct loans had the advantage of rapid negotiation and expeditious modification to meet changed circumstances. Direct loans also offered the advantages of requiring no special public disclosures of corporate affairs, and of freeing directors of the borrowing corporation from the civil liabilities they would carry if a public offering were made.

But the public offerings possessed special advantages of other kinds. They could broadly establish the credit of the borrowing concern, enabling it to obtain lower interest rates in future financing. Wide distribution of the debt of the borrowing business could

enable the concern occasionally to repurchase and retire debt on advantageous terms. The choice between open market and direct borrowing appeared to be based upon a weighing of alternative costs and advantages in the light of the borrowing business' circumstances.

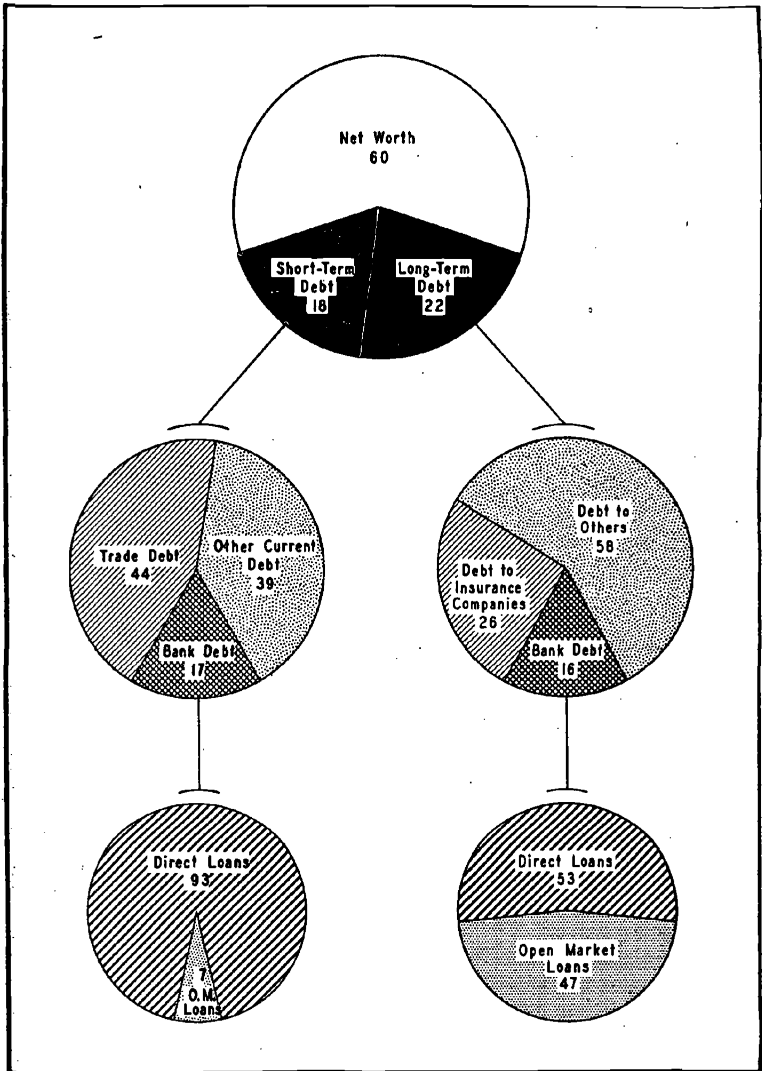
STAKE OF COMMERCIAL BANKS IN FINANCING OPERATIONS OF NONFINANCIAL BUSINESS

A surprisingly small percentage of the total earning assets of the commercial banking system at the end of 1940 represented outstanding credit to nonfinancial business enterprises. The amount of such credit is estimated at about $10.3 billion, or less than 25 percent of the total earning assets of $42.6 billion held at that time by all operating insured banks. Loans to nonfinancial business were only half as important as federal, state, and local government securities, and about equal in importance to the aggregate amount of credits extended to security dealers, agriculture, consumers, and nonprofit institutions. Thus, well before the necessities of war had inflated federal borrowings from the banks, government as a banking customer was twice as important as business, excluding agriculture and security dealers. Wartime federal financing only accentuated this condition.[14]

About $7.7 billion or three-fourths of all bank credit to nonfinancial business took the technical form of "loans and discounts," and the balance of $2.6 billion was investment in "securities." This distinction does not break down nonfinancial business credit into short-term and long-term advances, nor into credit extended through the open market and that granted directly. The data in Chart 11 are classified along these lines and reveal the astonishing fact that nearly half of all bank credit to nonfinancial business was long-term in character, maturing more than a year after being contracted. This measures the extent to which banks had departed by 1940 from the short-term self-liquidating business advance sanc-

[14] The large role which direct consumer financing had come to play in banking operations by the end of 1940 was also of great significance. Consumer credit, comprising instalment loans and home mortgage loans, amounted to about $4.4 billion, or nearly one-half of outstanding business credit. Consumer instalment loans as of the end of 1940 are estimated by the National Bureau of Economic Research, Financial Research Program, as approximately $1.5 billion. The *Annual Report of the Federal Deposit Insurance Corporation*, 1940, p. 145, records loans secured by residential property amounting to $2.9 billion.

Chart 11 — COMPOSITION OF THE DEBT OF NONFINANCIAL BUSINESS CONCERNS AROUND 1940
(*in percent*)



Of the total short-term debt owed by nonfinancial business, bank loans comprised only about one in every six dollars, and nearly all such bank credit was acquired directly. Of the long-term debt, one dollar in six was also owed to banks, but nearly half consisted of securities purchased in the open market.

tioned by the classical theory of banking. Of equal interest was the great difference between the relative importance of open market and direct loans. Nearly 93 percent of short-term bank credit to nonfinancial business was extended directly to the borrower, while only 53 percent of long-term credit was so transmitted.[15] The minor importance in the United States of open market dealings in the short-term debts of nonfinancial business concerns contrasts strongly with market conditions for trade bills and acceptances in British finance. Likewise, the extent to which American banks purchased directly the long-term obligations of business enterprises is notable in comparison with British practices.

From the point of view of the gross revenue it produced, credit extended to nonfinancial business was a more important aspect of commercial banking than the relation of such loans to total "earning assets" suggests. Available data do not reveal the amount of banks' gross earnings from loans to nonfinancial business. They show only gross earnings from loans of all kinds and from investments in securities of all kinds, thus mingling business concerns with other borrowers. From these data it is known that for banks, on the average, the gross revenue collected from each dollar of loans in 1940 was about twice that collected from each dollar of investments, the figures being respectively 4.18 percent and 2.07 percent.[16] Since a preponderance of credit to nonfinancial business takes

[15] It should be noted that Chart 11 pertains to *all* business enterprises, while certain other charts — for example Charts 3 and 4 presenting data by industrial divisions — pertain only to *corporate* business enterprises, since data for all business enterprises are not available by industries. Inasmuch as corporate business comprises about 88 percent of all business assets, no great distortion is produced when the corporate sphere alone is examined.

[16] This conclusion may be drawn from data in Table 119, p. 144, and Table 139, p. 190, of *Annual Report of the Federal Deposit Insurance Corporation*, 1940 (dollar figures in thousands):

	Loans and Discounts	*Investments in Securities*	*Totals*
Held December 31, 1940			
Amount	$18,397,775	$24,163,328	$42,561,103
Percent	43.2	56.8	100.0
Gross earnings during 1940			
Amount	$768,770	$499,650	$1,268,420
Percent	60.6	39.4	100.0
Earnings per dollar, 1940	4.18%	2.07%	2.98%

Because commitment fees and standby commissions on business loans apparently are not included in "interest and discount on loans," the preceding figures understate to a minor degree the true difference between the gross revenue from loans and that from investments.

the form of loans and a preponderance of other credit takes the form of securities, the former as a whole produced a higher rate of gross income per dollar than did the latter as a whole. When allowance is made for the somewhat higher effective yield of corporate bonds than of government security holdings, it may be concluded that roughly one-third of the gross earnings of banks from all credit operations accrued from business credit.[17] Nothing can be said with certainty concerning the net profitability to banks of any type of lending operation in 1940, because banking costs are not commonly broken down between loans and investments of different kinds.

The extent of the financing of nonfinancial business enterprises in 1940 was not, of course, the same for all commercial banks. The stakes of individual banks differed according to the size of the banks, the size of the centers in which they were located, the economic character of the territories, and banks' operating policies. Broadly speaking, business loans formed relatively high percentages of the total assets of medium-sized banks with total deposits between $500 thousand and $10 million. In many instances these banks were located in cities where diversified industrial activity made the demand for business credit most active. Agricultural credits comprised a large percentage of the total loan portfolios of small banks, since these banks usually served agricultural areas or were located in small population centers where local demands for business credit were not extensive. Mortgage loans secured by residential and other property formed a substantial proportion of the loan portfolios of banks with assets of over $10 million, except those in central money markets. Nevertheless, divergencies among banks in the importance of business financing activities were not strikingly large prior to World War II.

[17] In making this estimate, gross earnings from commissions, fees, collection, exchange, and service charges, and other current operating earnings have been *excluded*, although some part of these earnings of banks is certainly attributable to their loan and investment activities. If income from trust, collection, exchange, and other services is included, total gross current operating earnings of all insured operating commercial banks during 1940 amounted to $1,631,074,000. (See *Annual Report of the Federal Deposit Insurance Corporation*, 1940, Table 139, p. 190.) Of this total, business credit may be roughly estimated to have produced $374,809,000, or 23 percent.