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## *Chapter 4*

# CHANGES FROM 1900 TO 1940 IN THE INSTITUTIONS SUPPLYING BUSINESS CREDIT

AFTER THE EARLY TWENTIES the institutional organization of the business credit market underwent significant changes, and these changes were greatly accelerated during the thirties. First, new private lending agencies developed, and their activities and operations influenced established agencies of business financing. Second, relationships between established agencies were realigned and readjusted with functional differences tending to become increasingly blurred. Third, a number of public business financing agencies emerged to supplement the facilities offered by private financial enterprise.

## RISE OF NEW PRIVATE LENDING AGENCIES

### *Consumer Credit Agencies*

One of the major developments on the supply side of the business credit market was the growth of consumer credit agencies — personal finance and industrial banking companies, credit unions, and sales finance companies. This growth was especially rapid during the 1920's, paralleling the growth of the consumer durable goods industries.

The personal finance company, which is the oldest — at least in terms of its antecedents — of the consumer credit agencies, grew rapidly from not more than 500 offices with outstandings of less than $25 million in 1920 to 4,000 offices with outstandings of $577 million in 1940. The industrial banking company made its appearance in this country in 1910, and by 1940 had expanded to between 400 and 500 companies with outstandings estimated at $288 million. The first credit union was organized in 1909 and by 1940 there were nearly 9,000 in operation with outstanding loan balances

of $190 million. Most of the sales finance companies were organized after World War I, although some of the largest were started just before the war and even before 1900. By 1940 their number totaled over 1,000, and they held among their assets retail instalment paper of nearly $1.5 billion.[1]

Numerous factors lay behind the growth of consumer cash lending agencies, but two were fundamental. First, the urbanization and industrialization of the country made most individuals entirely dependent on a flow of *cash* income. Interruptions in this flow, or a sharp increase in consumer outlay, could quickly produce a need for borrowing whereas in a rural, agricultural society interruptions in income came mainly from crop failures, and even in those cases individuals would not be cut off entirely from a means of subsistence. Second, cash lending was encouraged by the wider use of goods and services of high unit value, many of which are considered as "essentials" to the American standard of living, and nearly all of which require the expenditure of amounts that are substantial in relation to current income.

Commercial banks in general were content until the early 1930's to serve as wholesalers of credit in this field rather than as retailers, for many reasons: newness of the credit area; inexperience in handling credits of the type involved; the necessity of conducting consumer instalment lending within a range of permissible charges designed primarily for business lending; doubt as to their ability to acquire locally a volume of business sufficient to carry overhead costs; unreadiness to conduct the promotional work essential to the acquisition of needed volume; the relative attractiveness of alternative uses of bank funds. The new agencies, in contrast, were favored by many conditions, not the least being the right to organize nationally and laws that exempted them from usury statutes and permitted higher rates on loans of small amount.

The primary reason for the growth of consumer instalment sales credit was that mass production, a necessary condition of low pro-

[1] More detailed historical discussions of these consumer credit agencies may be found in studies of the Financial Research Program of the National Bureau of Economic Research: *Personal Finance Companies and Their Credit Practices*, by Ralph A. Young and Associates (1940); *Sales Finance Companies and Their Credit Practices*, by Wilbur C. Plummer and Ralph A. Young (1940); *Industrial Banking Companies and Their Credit Practices*, by Raymond J. Saulnier (1940); and *The Business of Consumer Instalment Financing*, by Ralph A. Young (unpublished).

duction cost and low price, was contingent on mass consumption which, in turn, was impossible, or at least would not have occurred so soon, without liberal deferred payment terms. For various reasons, dealers and manufacturers failed to satisfy this credit demand directly: dealers were generally unable to assume the burden of carrying customer receivables, and manufacturers were unwilling to accept this burden because it was a function alien to their management capacities and because they had other financing burdens of considerable weight. In those cases where manufacturers undertook to carry the receivables of their dealer customers, they usually did so through separate corporations with specialized management and segregated capital.

In supplying consumer credit, assistance from some financial agency clearly was necessary. Among the established agencies the commercial bank was the most likely credit source, but until the early 1930's the part it played was primarily that of supplementing the equity capital of the new agencies with loan funds. It did not assume a direct financing role for several reasons: the business presented many new risk factors, not the least of which was the financing of dealers who carried relatively heavy inventories and whose financial position was relatively weak; the limitations on bank rates of charge to customers, imposed by law and convention, made it difficult to cover the costs of loan administration which were necessarily high because of the measures needed to limit risk, the small average size of individual credits, and the monthly payment features; operations were likely to be unprofitable unless individual banks could get a volume of business larger than seemed possible within the local markets to which they were limited by law; and, finally, other demands for bank funds were more attractive to the banks.

Sales finance companies, in contrast, were free from all these limitations. At the beginning of their development the funds they used were somewhat more expensive than those acquired by banks through public deposit. Their activities, however, were less affected by legal restraints and limitations of corporate powers; their management was prepared to experiment with new credit extension techniques; their freedom to organize national "branch financing" systems gave them many competitive advantages; their use of a wide margin of equity capital and the fact that they were not subject

to bank examination were strongly conducive to risk-taking; and finally, while their operating costs were high, they were free from legal limits on customer charges and, in many cases, received substantial subsidies from manufacturers.

### *Commercial Finance Companies*[2]

Another important development in the business credit market was the rise of the commercial finance company, which in many respects merges into the sales finance company; in fact, the two agencies are frequently combined in one general "finance company." In this study a "commercial finance company" is defined as an agency without a bank charter which performs one or more of the following functions: advances funds to business concerns by discounting accounts receivable, usually without notice to the trade debtor; makes loans secured by chattel mortgages on machinery or liens on inventory; and finances deferred payment sales of commercial and industrial equipment.

The first type of lending, non-notification accounts receivable financing, originated even before automobile financing; a company was chartered for this purpose in Chicago in 1905. By 1940 commercial finance companies ranged all the way from small concerns specializing in either non-notification financing of accounts receivable or the instalment financing of income-producing equipment for small businesses, or in some combination of these two functions, to companies with nearly a billion dollars of assets, conducting a broadly diversified program of business and consumer financing.

Like consumer credit agencies, the development of commercial finance companies was encouraged by a combination of circumstances. The principal basis of the demand for their equipment financing services is found in the rapid progress of technology. Better and more economical equipment for commercial and industrial establishments was introduced, and competitive conditions compelled all concerns, even those with modest financial resources, to install it or lose their positions in the market. The acquisition of this equipment presented no special financial problem for most

[2] For more detailed discussion see Raymond J. Saulnier and Neil H. Jacoby, *Financing Equipment for Commercial and Industrial Enterprise* and *Accounts Receivable Financing* (both studies of National Bureau of Economic Research, Financial Research Program).

large concerns, but such purchases proved burdensome for many small and medium-sized companies, especially in the trade and service industries where the vast majority of concerns are relatively undercapitalized. For enterprises in this group the new equipment which was essential to efficient technical operation could be acquired only on a deferred payment basis, designed to enable the buyer to amortize the debt out of income earned as the equipment was used. In satisfying this demand for credit the commercial finance company, like the sales finance company, had certain definite advantages. Its legal position permitted it to operate as a national "branch financing" organization, which was particularly important in soliciting the instalment paper generated through the sales of a manufacturer producing for a national market, and it was free of limitations under which it would have operated had it been organized as a bank. In general, the commercial bank kept out of the field of equipment financing, except as a lender to the finance company; and manufacturers and dealers chose to discount their receivables with finance companies for much the same reasons as those cited in the discussion of consumer sales financing above.

A second focus of interest for the new private financing agencies was the purchase of open accounts receivable. Commercial finance companies began buying the open accounts of small and medium-sized concerns before World War I, but the principal development took place during the thirties. Perhaps the basic factors accounting for the increase in the thirties were that many small and medium-sized concerns suffered an erosion of working capital during those years, as a result of successive years of operating losses, and that new and growing concerns found it difficult to obtain adequate financing in view of the general uncertainty regarding economic conditions. For both types of concerns the techniques of receivables financing often offered the most favorable basis on which they could obtain needed funds; and they naturally would look for financing facilities to an agency prepared to take higher than average risks, and to make loans on the basis of specially designed security devices.

Several considerations favored commercial finance companies in the development of this credit area. In the first place, the new agencies had complete freedom to introduce the somewhat novel and highly specialized credit extension techniques essential to success in such lending operations. Second, the regional or national

coverage of the companies enabled them more easily to acquire the volume of business necessary to cover overhead expenses and to provide the needed diversification of risks. Third, state laws, such as those relating to the taking of assignments of accounts receivable on a non-notification basis, were much more favorable to the operations of commercial finance companies than to those of commercial banks. Fourth, finance companies were able to charge rates commensurate with the administrative costs and risk factors peculiar to this credit area, whereas if they had been organized as banks they would have been limited to much lower levels of customer charges. Finally, they were better placed to undertake high-risk financing because of their substantial equity positions, and their freedom from responsibility for depositors' funds and from the bank examination which performance of the deposit function entails.

### *Effects of the Rise of New Private Lending Agencies on the Business Credit Market*

The relation between consumer credit agencies and the business credit market is indirect, yet the growth of these agencies had important effects on that market and especially on the position within it of the commercial bank. First, through these agencies credit was extended in increasing amounts into the consumption process, thereby enabling producers and distributors to sell for cash. As a result sellers did not need to carry a large amount of consumer receivables, a condition that is closely related to the demand for short-term business credit, since a low ratio of receivables to sales is usually associated with a low ratio of notes payable to sales and to total assets.[8]

Second, the way in which consumer credit agencies financed themselves influenced the business credit market. In 1940 sales finance companies used equity funds to finance about 25 percent of their total assets, and short-term borrowings were used to finance between 60 and 70 percent. For personal finance companies equity funds

[8] For example, the automobile industry has one of the lowest ratios of receivables to sales, and its ratio of notes payable to sales is among the lowest of all industrial divisions. See Walter A. Chudson, *The Pattern of Corporate Financial Structure: A Cross-Section View of Manufacturing, Mining, Trade, and Construction, 1937* (National Bureau of Economic Research, Financial Research Program, 1945) Chart 4, p. 42 and Chart 5, p. 51.

provided about 60 percent of the financing needs, and notes payable supplied the remainder, except for national companies which used some long-term debt in 1940. In general, the use of equity funds in consumer instalment financing would be expected to have a restrictive effect on the total demand for bank credit, whereas the use of bank borrowings would alter the industrial composition of such demand. That institutional developments after the early 1920's produced this latter effect is revealed by the changes in the relative importance, as users of bank credit, of intermediary finance agencies and manufacturing companies, referred to in Chapter 3.

Direct participation by commercial banks in the field of consumer instalment financing exerted a contractive influence on business demand for bank credit. The extension of credit into the economic system through such a channel may restrict to some degree the demands for business credit arising from other segments of the economy, subject, of course, to the qualification that any given extension of funds, if it is expansive in regard to total economic activity, need not on balance contract the demand for funds by other lines.

Until the early 1930's the finance companies in both the consumer instalment credit and the business financing markets conducted their business with little direct bank competition. Indeed, the finance company worked side-by-side with the commercial bank, each doing a type of business for which it was especially designed and qualified. The newer concerns became specialized "retailers" of credit, depending on the banks and on their own equity resources for the funds which they needed, while the commercial banks acted as "wholesalers."

This situation changed markedly during the early 1930's. By that time business loans of commercial banks had decreased sharply; bank earnings had declined, partly because of changes in the character of bank assets and partly because of declining yields on high-grade loans and investments. The interest of the banks in new types of lending was stimulated by the fact that banks had had an opportunity to observe the successful operation of finance companies; also, successful and profitable experience with Federal Housing Administration insured loans had made a significant impression on bankers' views as to the soundness of the instalment payment method. As the techniques appropriate to the new types of lending

became more widely known, better tested, and more or less conventionalized, many of the barriers that had once kept the banks from direct participation were removed. By 1940 they had acquired a fairly substantial interest in the instalment financing of income-producing equipment and in lending on the security of assigned accounts receivable; in fact, in 1940 the banks surpassed the commercial finance companies in the volume of business done in these fields.

### *Tendencies in Inter-Agency Competition*

A statement of institutional developments on the supply side of the business credit market would be incomplete if note were not taken of the fact that the newer business lending agencies showed an increasing tendency to extend credit in areas customarily served exclusively by commercial banks, just as commercial banks tended, much more extensively it should be observed, to do a "finance company" type of business. As a result, functional distinctions became blurred and in some instances almost completely disappeared. This tendency toward mutual penetration of market areas was most pronounced in the relationships between commercial banks, industrial banking companies, and commercial finance companies; it was present, but less markedly so, in the relations between personal finance companies and commercial banks.

Commercial banks and commercial finance companies came closer together, in part because the commercial finance companies broadened their functional basis to include such activities as term loans, made on a pattern similar to that followed by commercial banks, and in part because of the widening of commercial bank activities. The institutional adjustments involved an extension into areas of larger-size loans and higher quality credits by the finance companies and industrial banking companies, and greater activity in the field of smaller business loans and higher risks on the part of commercial banks. This process of institutional adjustment also affected the personal finance and sales finance companies, the former through a tendency to increase the portion of loans made to small proprietors, the latter through a tendency to undertake commercial finance company functions. Each type of agency had, of course, a market in which competition from other agencies was relatively insignificant, but increasingly these areas tended to narrow while the areas of inter-agency competition tended to widen.

## RELATIONSHIPS BETWEEN OLDER PRIVATE BUSINESS FINANCING AGENCIES AND COMMERCIAL BANKS

While certain adaptations in bank lending policies can be traced to the rise of new private agencies in the fields of consumer and business financing, others grew out of changes in banks' relations with established business financing institutions — such as life insurance companies, investment banks, and factoring companies.

### *Life Insurance Companies*

Until the early 1930's there was little direct competition between commercial banks and life insurance companies in the field of business lending. Such competitive connections as did exist were limited to life insurance company holdings of corporate bonds and to their relatively insignificant holdings of mortgage loans secured by industrial properties. In 1933, however, and more definitely in 1934, the two agencies tended to come closer together in those functional aspects most closely related to business financing.

This tendency was due to several developments. First, the growing participation of commercial banks in the term loan market increased considerably the average maturity of business loan assets of banks and brought them closer in character to the medium-term, if not to the long-term, investments of insurance companies.[4]

Second, direct financing of businesses by insurance companies was increased through their purchases of privately placed debt securities, especially those of medium term, and by an expanding program of direct loans to industry secured by mortgages on plant and equipment. In many cases there is actually little difference in economic character and effect between the private purchase by an insurance company of an issue of medium-term securities to be amortized on an instalment payment or serial basis, and the extension of business credit by a commercial bank under a term loan agreement. The similarity between industrial mortgage financing by insurance companies and term lending by commercial banks also is great. In this type of financing the insurance company takes a

[4] For a discussion of the development of term lending by commercial banks see Chapter 5, pp. 139–42.

mortgage on the industrial plant as security, but the credit is weighed with less regard to real property values than to the insurance company's estimate of the ability of the borrower to repay the loan in instalments out of the proceeds of business operations. The basis of the loan is exactly the same as that underlying the term loan, with the exception that the industrial mortgage may have a somewhat longer maturity.

Industrial mortgage financing by insurance companies was only beginning in 1940–41; at that time one large life insurance company and two others of smaller size were actively interested in developing such loans and had organized special departments for this purpose. Although the volume of credit extended was not large, it attracted considerable attention since it indicated a trend in insurance company loan policy which might be continued. In any event the practice supplements insurance company acquisitions of private placements of medium-term securities as a development in loan policy which brings the insurance company into closer functional relationship with the commercial bank.

These adaptations in life insurance company investment policies reflected, basically, a vast increase in the resources for which the companies had to find investment, as a greater portion of the savings of the community was channeled into use through the medium of these institutions. Another influence was the tendency, which began in 1934, for a larger proportion of corporate debt issues to be placed privately with institutional investors.

A third influential factor is that commercial banks tended to make increasing amounts of loans on the security of life insurance policies, much along the lines of the "policy loans" that had been made for years by life insurance companies themselves. The relative importance of policy loans and premium notes among life insurance company assets, as well as their absolute amount, declined regularly after 1933; this development can be attributed in part to the increased activity of commercial banks, but more to improved economic conditions, which tended to lessen the demand for loans of this kind, and to the increasing availability, at declining costs, of credit for personal needs through a widening range of consumer credit agencies. In 1933 policy loans and premium notes, amounting to nearly $3.5 billion, comprised 17.8 percent of the total assets of 49 legal reserve companies holding over 90 percent of the assets of

all companies. At the end of 1940 these life insurance companies held approximately $2.8 billion, or approximately 10 percent of their total admitted assets, in policy loans and premium notes. No estimates have been made of the volume of life insurance policy loans held by commercial banks although it is reasonably certain that they amounted to a negligible sum before 1935. However, as a rough estimate, the liberal assumption that policy loans held by banks at the end of 1940 equaled 10 percent of their personal loans outstanding at that time would place commercial bank holdings at but 2 percent of those of insurance companies.[5] Therefore it is impossible to conclude that commercial banks played a significant investment role in this field; their competitive influence was felt primarily through their offering loans at rates below the 6 percent rate customarily charged by insurance companies, and through their satisfying in part, by their personal loan services, the type of credit demand met by the policy loan. More extensive direct participation by banks in the policy loan field was restricted by a number of conditions, including the relatively high administrative costs of lending on this basis.

Along with these evidences of competitive relationships, commercial banks and insurance companies showed tendencies to engage more extensively in cooperative financing arrangements. Such arrangements may provide, for example, that out of a given issue of securities a bank or group of banks will take those that have the short- and medium-term maturities, and one or more insurance companies will take the longer-term portion. Because of the short-term nature of bank deposit liabilities and the long-term and more stable liabilities of the insurance companies, this cooperative sharing of credit extensions is mutually advantageous.

### *Factoring Companies*[6]

For many years factoring companies played a unique role in the financial system of this country. By the mid-1930's, however, the

[5] Total personal loan outstandings of commercial banks at the end of 1940 amounted to $586 million (*Federal Reserve Bulletin*, June 1944, p. 606).

[6] For a discussion of the history of factoring companies and their 1940 status, see *Accounts Receivable Financing*, *op. cit.*, pp. 18–20, 39–47. See also Chapter 5, pp. 142–44, below.

uniqueness of their position tended to be lost, although it had by no means disappeared. This came about for two reasons: other agencies offered services similar to those customarily associated with the factoring business, and the factors themselves made certain adjustments which brought them to a closer functional similarity with the commercial banks and the commercial finance companies.

While evidences of changing relationships among financing agencies in this area are numerous, a few developments are outstanding. First, after limiting their activities to the textile industry for nearly a hundred years, factoring companies in the 1930's began to finance other industries; some companies went into non-textile fields to purchase open accounts with full, or with only partial, assumption of risk. Second, some commercial finance companies, which were originated to finance open accounts receivable on a non-notification basis and without assumption of risk, began to offer a factoring service quite like that of the "old-line" factor, most frequently for clients outside the textile industry. Third, after 1935 or thereabouts commercial banks developed non-notification financing of accounts receivable on an increasing scale and, to a lesser extent, a few banks undertook regular factoring functions for textile and other mills. In summary, the tendency was for all three types of agencies — factors, commercial finance companies, and commercial banks — to become more alike functionally, although each agency still retained a functional position which was in most respects unique.

## EMERGENCE OF PUBLIC BUSINESS FINANCING AGENCIES

Before World War II various government agencies had come to play important roles in the business credit area. For the most part these agencies came into existence in the early thirties when the protracted depression affected both business needs for funds and the abilities of established private agencies to meet those needs.

The activities of public business financing agencies were of two general types: (1) direct lending, in which the public agency extended credit to a business concern, and (2) loan guaranteeing and financing undertaken cooperatively with private agencies.

*Reconstruction Finance Corporation*

The Reconstruction Finance Corporation was established by Act of Congress in 1932, to check the deflationary tendencies then current in the economy; it was empowered to make loans or advances to "any bank, savings bank, trust company, building and loan association, insurance company, mortgage loan company, credit union, Federal land bank, joint-stock land bank, Federal intermediate credit bank, agricultural credit corporation, or live-stock credit corporation . . ."[7] In the same year the Emergency Relief and Construction Act extended these powers to include the right to make loans for the promotion of public housing and slum clearance, for low-income housing activities, and for the financing of certain types of public works.[8] The direct business lending activities of the agency did not begin until 1934 when the agency was empowered to make loans directly to industry, or in cooperation with banks or other lending institutions, whenever it appeared that the employment of labor would thereby be maintained or increased; loans were to be adequately secured, they were to be made only to "established" businesses and solvent borrowers, and were not to exceed $300 million in aggregate, or $500 thousand in individual, amount.[9]

The business lending powers were granted for a number of reasons. First, it was believed that the RFC could fill gaps in local financial facilities caused by bank failures and by the generally tightened conditions of the business credit market; in fact, the legislation restricted RFC activities to making loans only ". . . when credit, at prevailing bank rates for the character of loans applied for, is not otherwise available . . ."[10] Second, it was thought that direct loans by the RFC might be required where operating losses had so depleted the working capital of business concerns that they were unacceptable credit risks for private financing agencies.

The business lending activities of the RFC increased fairly

[7] Reconstruction Finance Corporation Act, *Federal Reserve Bulletin*, February 1932, p. 95.

[8] Emergency Relief and Construction Act of 1932, *Federal Reserve Bulletin*, August 1932, pp. 520–27.

[9] An Act relating to direct loans for industrial purposes by Federal Reserve banks and for other purposes, *Federal Reserve Bulletin*, July 1934, p. 432.

[10] The Reconstruction Finance Corporation Act as amended, Section 5 (d) (United States Congress Supp. VII, Title 15, Ch. 14).

steadily; outstandings of direct loans to commercial and industrial enterprises rose from approximately $6.2 million at the end of 1934 to $112 million at the end of 1940 (exclusive of loans to aid in national defense). Since RFC loans to business were made predominantly on a term basis, their relative importance can be judged best by comparing them with the term loans of commercial banks; at the end of 1940 RFC industrial loan outstandings equaled nearly 6 percent of commercial bank term loans.

The second of the business lending activities of the RFC, namely, making commitments to take up loans made by private lending agencies when and if the latter wished to turn over all or part of the loan, and taking participations in loans made in part by private agencies, also grew in the period 1934–40. As of the end of 1940 the RFC had participations in outstanding loans amounting to nearly $6.3 million and outstanding agreements to purchase participations of nearly $3 million. It will be noted that this activity was complementary rather than competitive as regards the interests of private agencies in the business credit market.

The development of this cooperative lending, which was designed to support and supplement private institutions in the credit market, is of interest for two reasons. First, it tended to maintain rather than change the institutional structure of the market and, second, it exerted a direct influence on the operating policies of private agencies. The latter resulted from the fact that commitments were made or participations taken by the RFC or other public lending agencies only when the private lending agency associated with the transaction extended the credit on terms that conformed to standards laid down by the public body. These standards usually pertained to rates of interest, maturity, and repayment terms.

### *Federal Reserve Banks*

The original purpose of the Federal Reserve banks, namely, that they should serve as "bankers' banks" and that it was not their function to make direct loans to industry, commerce, and agriculture, was sustained without exception until 1934, when the Federal Reserve Act was amended to initiate a program of direct lending to commercial and industrial enterprises. The reasons for the initiation of the program were the same as those that led to the expansion of

RFC powers; indeed, both agencies were granted additional powers in the same Act of Congress. The amendment to the Act empowered the Federal Reserve banks "In exceptional circumstances, when it appears to the satisfaction of a Federal Reserve bank that an established industrial or commercial business located in its district is unable to obtain requisite financial assistance on a reasonable basis from the usual sources . . . [to] . . . make loans to, or purchase obligations of, such business, or [to] make commitments with respect thereto, on a reasonable and sound basis, for the purpose of providing it with working capital, but [that] no obligation shall be acquired or commitment made . . . with a maturity exceeding five years."[11] The limitations to working capital loans and to loans of maturities not over five years, it will be noted, were restrictions on the lending powers of the Federal Reserve banks which were not imposed on the RFC. The reserve banks were also empowered to make credit available indirectly through banks and other financial institutions by discounting for, or purchasing from, those agencies obligations originating in the extension of credit to businesses and made on the same terms that were applicable to direct loans. These "take-out" arrangements could be entered into provided the private financing agency obligated itself to absorb at least 20 percent of the loss that might arise from such loans. The reserve banks were also empowered to participate in loans where the private financing agency was taking 20 percent or more of a credit extended and assuming an obligation for loss on a proportionate basis.

The industrial advance program, however, never assumed very large proportions, even when compared with the relatively modest program of the RFC. Its high point was reached at the end of 1935 when industrial loan outstandings of the Federal Reserve banks amounted to $32.5 million; by the close of 1940 they had fallen to $9.2 million. A similarly minor role was played by the Federal Reserve banks in their loan participation and commitment program; at the end of 1940 they had $5.2 million of commitments and $6.4 million of participations outstanding. Thus, more than in the case of the RFC, a major effect of the Federal Reserve bank program on the business credit market was exerted through supplementary or cooperative credit activities. Like the RFC activity, this program

[11] An Act relating to direct loans for industrial purposes by the Federal Reserve banks, and for other purposes, *Federal Reserve Bulletin*, July 1934, pp. 430–34.

expedited certain adaptations in the lending policies of private financial agencies.

*United States Maritime Commission*

After 1936, when the United States Maritime Commission was formed and took over about $100 million of ship construction loans and ship sales notes from the United States Shipping Board Fleet Corporation, public lending activity in this field declined sharply. At the end of 1940 ship construction loans of the Commission amounted to $36 million, nearly all of which had been made by the Shipping Board.

The Maritime Commission made little use of its power to extend insurance on ship mortgage loans made by private financial agencies, where the ship financed and the terms of the loan met certain standards laid down in the enabling legislation. On October 1, 1940 there were only four approved applications outstanding, amounting to $1.3 million, on which the Commission had either extended insurance or had committed itself to do so.

*Export-Import Bank of Washington*

The Export-Import Bank of Washington was created in 1934 by Executive Order, and was continued until January 22, 1947 by an Act approved January 31, 1935, subsequently amended.[12] After a series of increases the lending authority of the Bank was set, as of September 26, 1940, at $700 million.

The usual function of the Bank, which was organized with the single original objective of facilitating trade between the United States and Soviet Russia, was to finance export trade in agricultural and industrial products. In this connection it made direct loans to exporters, and it financed exports indirectly through loans to foreign governments and to their central banks. Also, it purchased and sold participations with private banks. The Bank's powers were extended in 1940 to cover loans to governments, central banks, or acceptable banking institutions and, where guaranteed by the same, to

[12] The Export-Import Bank of Washington was made a continuing independent agency of the government by the Export-Import Bank Act of 1945. Since the present discussion is concerned only with developments through 1940, the expansion of lending authority under the 1945 Act is not discussed here. The text of the Act and a general policy statement of the Bank may be found in the *Federal Reserve Bulletin*, August 1945, pp. 767–69 and October 1945, pp. 1000–1005.

any political subdivision, agency, or national, where the purpose was to assist "in the development of the resources, the stabilization of the economies, and the orderly marketing of the products of the countries of the Western Hemisphere."

From its organization in 1934 through 1940 the Bank, including the Second Export-Import Bank which was organized in 1934 and liquidated in 1936, made loan commitments of about $655 million of which $150 million were canceled. Disbursements amounted to $210 million. Repayments brought the sum outstanding on December 31, 1940 to $131 million, of which $83 million were the Bank's own loans and discounts, and $48 million were acceptances of other banks underwritten by the Export-Import Bank.

## RELATIONS BETWEEN PUBLIC AND PRIVATE BUSINESS LENDING AGENCIES

As indicated in the foregoing sections, by the end of 1940 public and private business financing agencies had relationships in the business credit market which were complementary and cooperative as well as possibly competitive. Consequently, the effects of public lending agencies on the business credit market, and on private agencies serving that market, were of different kinds. Quantitative expression can be given to these effects in some instances, but certain of them, such as changes induced in the business lending policies of private institutions, can be described only qualitatively.

At the end of 1940 loans to business by public agencies probably amounted to less than $200 million. This includes all direct loans to industry and commerce made by the Reconstruction Finance Corporation and the Federal Reserve banks and one-half of the loans and discounts of the Maritime Commission and the Export-Import Bank; the latter rough adjustment has been made since most all of the Maritime Commission's loans were carried over from an earlier experiment and because the Export-Import loans were partly to public bodies. The portion of the business credit market served by public agencies at that time can be estimated as about 3 percent of the "commercial and industrial loans" of all commercial banks. But since most public agency loans to business were of intermediate term, a comparison with commercial bank term loans may be relevant: the outstanding loans of public agencies equaled nearly 10 percent of the term loans of commercial banks at the end of 1940.

A sharper comparison can be drawn, however. There is no question that the average size of public agency business borrowers was smaller than that of borrowers from private agencies; but the credit standing of the former can only be inferred from certain characteristics of the loans made by public agencies, which are suggestive of relatively high risks — such as greater dependence on security devices, loss experience, and the like — and the statutory mandate under which the financing activities were conducted. An indication of loss experience is that the RFC stated in 1940 that it anticipated a loss of 10 percent on its then outstanding loan volume, while the Federal Reserve banks expected that the interest income from their industrial advances would be sufficient only to cover their administrative costs. In so far as loans of this type would not be made by commercial banks, it may be concluded that the public agencies operated until 1940 in a segment of the business credit market where they were least likely to compete with commercial banks. In some respects the competitive effect was probably felt more directly by commercial finance companies, since their activities were more nearly confined to that section of the business credit market which was also served by public agencies.

These are over-all measures of loan quality, however, and within the totals there doubtless was a margin that was a proper sphere of activity for private agencies. In any case, public agencies served that segment of the business credit market which was made up of small and medium-sized concerns — the segment that produced the majority of bank borrowing customers and in which banks made the bulk of their loans. These facts, and also the fact that commercial banks by 1940 were making an increasing proportion of their term loans to medium-sized concerns, suggest that the degree of competition between the two sets of agencies was increasing.

On the other hand, the entry of public agencies into the business credit market had certain expansive effects on loan volume and certain modernizing effects on bank lending policies and practices. These were produced in two ways: first, through the activity of public agencies in taking participations in loans made by private agencies, as remarked on above. The amounts of these participations and commitments to take participations were not great; the RFC and the Federal Reserve banks had but $20.9 million outstanding at the end of 1940. However, the net effect of these supporting activities was somewhat greater than indicated by their outstandings,

since the private credit supported was a multiple of the amount of such participations and commitments outstanding, determined by the percentage of the latter to the total credit extended jointly.

Second, the interest of commercial banks in newer types of business lending techniques, for use especially among concerns that are small and relatively unattractive as credit risks, may be attributed in part to experimentation with them by public lending agencies. In this credit area the public agencies had to experiment not only with the term loan technique but also with new types of security devices, such as the trust receipt and the assignment of accounts receivable, etc. In this sense they facilitated adaptations of certain credit extension methods useful to private agencies. To select an example from another credit area, it has been found that the interest of commercial banks in consumer instalment credit — and doubtless also in the instalment financing of business purchases of machinery and equipment — was stimulated by their successful and profitable experience with home modernization loans insured by the Federal Housing Administration, and by their observation of the activities of the Electric Home and Farm Authority.

It is impossible to weigh the effects of these two sets of influences, one of which was in a sense competitive and the other genuinely complementary, but it is clear that there were two aspects to the problem of relationships between public and private business financial agencies as of 1940, and that competitive relations comprised but a part of the picture.

## CHANGED POSITION OF COMMERCIAL BANKS

Before a measurement of changes in the relative position of the commercial bank as a business financing agency is attempted, the changes that took place between 1930 and 1940 in the total outstanding debt, public and private (of which business debt is an element), will be traced. Shifts in the relative positions of various credit institutions did not manifest themselves prominently until after 1930, although the total amount of bank credit used by business began to fall in 1929.

The outstanding fact is that total debt at the end of 1940 ($166.5 billion) differed little from that at the close of 1930 ($174 billion). However, significant changes occurred in the composition of total

debt and in the relative importance of various institutions as creditors. The most important was the relative increase in the public debt element, which rose from 17.3 percent of total debt in 1930 to 31.8 percent in 1940. This change can be attributed almost wholly to the federal debt, since state and local debt was only slightly higher in 1940 than in 1930.

Within the area of private debt, the segment consisting of business obligations retained its relative position;[13] but at least one element, consumer debt, must have risen in relative importance since the absolute amount increased from $6.3 billion in 1930 to $8.8 billion in 1940.[14] Long-term debt rose from 64.7 percent of total private debt in 1930 to 68.1 percent in 1940, a change which is in keeping with the basic trends in corporate financial structure and policies discussed in earlier chapters.

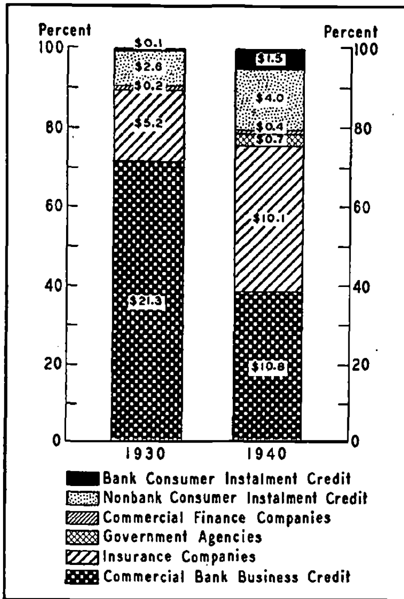
Clearly, in terms of its absolute magnitude the credit area within which commercial banks function as business lending agencies was smaller in 1940 than in 1930; their area of credit activities was wider, however, in the sense that at the end of the decade they offered a greater variety of lending services. Did changes also occur in the comparative positions of the commercial bank and other business financing agencies? In order to answer this question it is useful to combine, as in Chart 24, credit extensions of the principal business financing agencies with consumer instalment credit, since changes in the relative positions of these elements are referred to most often in discussions of the changing position of the commercial bank.

The most important change was the rise in the relative position of the insurance company as a holder of business debt. This increase, however, is not to be interpreted exclusively as a displacement of commercial bank credit, although this was true in some degree. Over the period the commercial bank holdings of corporate securities fell by $4.0 billion, while insurance company holdings rose by $4.9 billion; therefore the increase in the holdings of insurance

[13] Data on the elements of business debt have been estimated by the Financial Research Program of the National Bureau of Economic Research; the method of estimation differs from that followed by the Department of Commerce in its estimates of total private debt, but this fact is thought not to affect the findings as to relative changes in components of total debt.

[14] It should be noted that these figures are totals of instalment credit, single payment loans, charge account, and service credit outstanding, whereas the consumer credit data presented in Chart 24 are for instalment credit only.

*Chart 24* — Business Credit and Consumer Instalment Credit Extended by Principal Financing Agencies, 1930 and 1940
(*dollar figures in billions*)




Major credit market changes between 1930 and 1940 were the increased relative importance of insurance companies in the extension of credit to business, and the rise in consumer instalment credit relative to business credit. While business credit extensions by government agencies and commercial finance companies increased, they remained minor elements in 1940.

companies must have come in part from holdings of the public and from new offerings.

Another important change was the rise in the ratio of consumption to production credit, a change which has been characterized above as at least partly substitutive in nature. Although commercial bank participation in the consumption credit area expanded between 1930 and 1940, the increase did not offset the decline in the banks' position within the production credit area; indeed, banks would have lost ground both absolutely and as compared with insurance companies even if they had acquired the entire net change in consumer instalment debt.

It is sometimes argued that the increase in credits extended to business by nonbank lending agencies and by public bodies contributed, through a substitutive process, to the decline of the commercial loan. While some such displacement may have taken place, it was of modest proportions. Changes in the relative importance of commercial finance companies, factors, and government lending agencies, however significant their developments may have been in certain sub-areas of the credit market, or in the organization and techniques of the business credit market, were negligible when compared with the rising importance of the insurance company and the shift from production to consumption financing.