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Part IV

EMERGING ROLE OF COMMERCIAL BANKS AS AGENCIES OF BUSINESS FINANCE

Chapter 8

EMERGING ROLE OF COMMERCIAL BANKS AS AGENCIES OF BUSINESS FINANCE

WHAT DO TWENTIETH CENTURY developments in the relations between business enterprises and commercial banks, as reviewed in the preceding chapters, imply for the functioning of commercial banks as business financing agencies? Do the developments reflect the operation of underlying forces tending to weaken the demand for the business financing services of banks? How may the future economic environment of business and banking shape business credit demands and the ability of banks to satisfy those demands? As a first step in answering these questions, the major developments in the relations between business enterprises and commercial banks may be summarized as follows:

1. Throughout the twentieth century, small and medium-sized businesses have been the major users of bank loan credit.

2. Up to 1920 business debt owed to banks increased as a fraction of the total funds used by business, but thereafter it fell in relative importance until 1935.

3. Between 1920 and 1935, and especially after 1929, the importance of current assets among total business assets decreased, thus weakening the demand for short-term loans.

4. The ratio of bank earnings on loans to business and holdings of corporate securities to total bank earnings remained relatively stable until 1929, after which it declined.

5. Bank holdings of corporate securities increased during the twenties and bank loans to business remained about constant, two changes that combined to produce a moderate lengthening of the average maturity of bank credit to business; during the thirties the growth of term lending produced a further lengthening of average maturity.

6. In the thirties business obtained its medium- and long-term

credit from banks and other financial institutions increasingly on a direct negotiation basis, thereby decreasing its use of investment banking and securities markets facilities and bringing these agencies and commercial banks into closer competition.

7. After 1930 the importance of commercial banks as suppliers of credit to business declined relative to that of life insurance companies, commercial finance companies, and government business loan agencies.

8. Commercial banks made certain significant adaptations in their business lending policies and practices after 1933. The most important were the extension of longer-term credits and of specially secured short- and medium-term loans to small and medium-sized concerns presenting higher-than-average risks.

9. During the thirties government began to play an increasingly important role in the business credit market through direct lending and through cooperative programs designed to accomplish the joint assumption, with private agencies, of credit risks. These developments were markedly accelerated during World War II.

10. Throughout the period studied bank credit of different kinds was highly substitutable; consequently, much credit not advanced directly to business enterprises flowed into the productive system in such a way as ultimately to affect the credit demands of business. Thus, during the twenties loans on securities provided, in part, funds to finance the operations of business concerns; the unprecedented growth of consumer instalment sales credit following World War I resulted in a partial replacement of accounts receivable by cash on the books of manufacturing and trading concerns; and vast sums borrowed by the federal government from commercial banks during World War II were used to provide plant facilities and working capital for businesses directly for war production, and indirectly for civilian production.

POSTWAR CREDIT DEMANDS

The amount of credit demanded by business from commercial banks and other financing agencies is at all times the resultant of a number of forces, not easily enumerated and even less easily weighed. Nevertheless, it is possible to point to the principal factors which determine aggregate credit demand, particularly if the distinction is made between those factors to which business credit demands are subject over the short run, and those that act upon business credit demands over the long run.

Short-Run Factors Affecting Business Credit Demands

No attempt is made here to present a quantitative estimate of the volume of commercial bank loans to business during the postwar transition. Any such estimate requires assumptions regarding business liquidity, the trend of prices, the amount of operating losses that businesses may sustain during this period, federal tax policies, and numerous other factors. Several equally plausible assumptions can be made about each factor, with enormous differences in the resulting estimate of commercial loan demand. However, it is possible to identify certain factors that can influence the business credit market in the transition period, and to classify these as contractive or expansive of business demands for credit.

1. *Contractive Factors* — Certain major factors, such as those indicated below, may operate to contract, or to prevent a material expansion of, the demands of business enterprises for bank credit during the postwar transition.[1]

(a) Large cash balances and holdings of federal securities. During the four years 1941–44 the annual gain in liquid assets of corporations averaged between $7 billion and $8 billion, and that of net working capital, between $4 billion and $5 billion.

(b) Government receivables. Under the Contract Settlement Act of 1944, payments on government receivables have been made promptly on the termination of war production contracts.

(c) Refunds of excess profits taxes,[2] carry-backs of net operating losses,[3] and, possibly, tax reductions. Refunds constitute a positive source of funds; other tax adjustments may release funds that would otherwise be paid out to government.

(d) The recapture by war contractors of amounts equal to the unamortized emergency plant facilities not needed for war contract work, or recomputation of depreciation over a longer time period.

(e) Price deflation. Price reductions associated with declining

[1] This analysis draws on the findings of an investigation by Wilson F. Payne, National Bureau of Economic Research, Financial Research Program.

[2] Revenue Act of 1942, Sec. 250. (Net postwar refunds for 1942 amounted to $545 million, and for 1943, to $902 million. See U. S. Treasury Department, Press Releases 44–54, December 31, 1944, and V–229, February 25, 1946.) Recoveries under Section 722 of the Act may also figure in claims.

[3] Revenue Act of 1939, Sec. 122.

business investment substantially reduce business loan demands. Even if accompanied by high productive activity, lower prices permit a given expansion in fixed and current assets to be financed with smaller dollar outlays.

2. *Expansive Factors* — Factors such as the following may tend to expand, or to prevent any contraction of, business demand for bank credit during the transition period.

(a) Outlays of cash in connection with expenditures for deferred maintenance, deferred replacement of equipment, the rebuilding of production and sales organizations, inventory increases, and credit extensions to customers. Some concerns may find these outlays negligible while others may find them so substantial as to give rise to an excess of cash outflow over cash inflow and a consequent reduction of liquidity. The liquid assets of concerns not affected by this excess of cash outflow will not generally be available to offset the cash deficits of other businesses.

(b) Outlays to finance an expansion of the physical volume of production beyond the prewar level. If a satisfactory level of employment is achieved during the replenishment process, the physical volume of production could be from 40 to 50 percent above that of 1940. Business concerns would then face the need of providing plant and working capital to sustain such a volume of civilian production. Under conditions of business expansion, a considerable amount of newly constructed plant and equipment would be called for, especially in such lines as soft goods manufacturing, trade, and service industries, the enlargement and improvement of whose facilities were checked during the war.

The growth in the working capital requirements of business may be crudely gauged by assuming that the current assets of business would expand proportionately to the increase in the volume of business transacted. If the physical volume of production should be 50 percent above that of 1940, the $55 billion of current assets possessed by all American corporations, excluding banks and insurance companies, at the end of 1939 would have to be larger by $27.5 billion (in 1940 prices) to provide the additional liquidity, inventories, and receivables that business would demand. The importance of funds for rebuilding nonwar inventories and customer credits is very great, but an estimate of the amount of funds needed for these purposes is difficult to make because of the possibility of changed trade credit terms, new methods of utilizing inventories, and other factors.

(c) Industrial readjustments caused by the war. The war hastened technological progress, raised somewhat the rate of obsolescence, and in some instances rendered whole productive arrangements out-of-date. In addition, shifts in population and in the regional distribution of industry may call for substantial new investment in the utilities, transportation, service, and construction industries.

(d) Credit to finance a revival of foreign commerce and foreign investment. Foreign demands may be present for all types of goods, especially raw materials and industrial equipment. Some part of these demands may be financed by long-term reconstruction loans by government agencies, but a margin — perhaps substantial in size — may be financed by private lending agencies on short term and long term.

(e) Outlays made by newly-established enterprises. Bank credit has probably always played a small part in the financing of strictly new, as distinguished from established, enterprises, but it may play a significant part during the transition period as a result of the government loan guarantees available to veterans under the Servicemen's Readjustment Act of 1944. Many new businesses, which would otherwise be started by demobilized servicemen with the exclusive aid of relatives and friends, may utilize bank credit as a result of such guarantees.

(f) Price inflation. Price inflation increases the value of current assets necessary for a given expansion in physical output, without improving the quality of those assets. It raises profit expectations, invites over-investment and speculation in inventory, and encourages short-term borrowing.

The possibility that the business economy might require additional accommodation from banks during the postwar transition, suggested by these considerations, has been borne out by the increase in commercial and industrial loans after mid-1945.

Long-Run Factors Affecting Business Credit Demands

The record of the twentieth century indicates that in the long run the amount of bank credit demanded by business is strongly affected by such broad factors as the following:

1. The rate of expansion of the total assets of business enterprises. A small increase in business assets can be financed largely by retained earnings; when asset expansion is substantial, business managements look to outside sources for funds, thus raising the potential demand for bank credit. Within a limited period of time, the movement of total business assets is closely associated with changes in gross national product. Over a longer period, a tendency for government to expand its relative share in national product means an absolute change in business assets smaller than would otherwise have occurred.

2. Self-financing among business concerns. The ability and willingness of a concern to finance the expansion of its assets through the retention of earnings clearly determines, given a rate of asset expansion, the concern's demand for external funds. While there is a widespread impression that business management relies increasingly on self-financing, there is no convincing evidence that this has been true for manufacturing and trade concerns. As pointed out previously,[4] the annual rate of total asset expansion varies considerably more than the rate of retained earnings, with the result that outside funds are needed mainly in years in which asset expansion rates are high or increasing rapidly. For years in which rates of asset expansion have been comparable, there has been no observable tendency for the proportion of funds provided from outside the business to diminish.[5]

3. The propensity of business management to rely on ownership rather than on credit funds. This propensity is revealed by the preponderance of equity funds in all samples of corporate balance sheets over the entire period studied, and is of great importance for commercial banks, because for reasons of prudence the law does not permit them to supply equity funds to business.

4. The propensity of business management of large corporations to use increasing amounts of long-term credit relative to short-term credit. This tendency was unquestionably strong after 1920, and especially after 1933; underlying it was a desire to avoid loss of

[4] See Chapter 3, pp. 92–96.

[5] If a larger fraction of the increments in business assets were to be financed with retained earnings, this would require (1) that the rate of asset expansion diminish, (2) that profit rates increase, (3) that smaller fractions of profits be disbursed in cash or property, or (4) that two or more of these factors operate simultaneously. In fact, between 1920 and 1940 profit rates showed a downward drift and there was little secular change in the fraction of net earnings distributed.

capital and control through default on short-term loans falling due in periods of sharp business contraction. The increasing prominence of fixed assets in the productive process, and the instability of business conditions, also have been factors emphasizing the use of long-term credit. Whether the use of such credit has been as characteristic of small and medium-sized concerns as it has been of large concerns is open to question, but even where it might have been preferred among businesses of small size its availability has heretofore been limited.

If, in the long run, the rate of expansion in the dollar value of business assets is high, and if prewar business financing practices persist, there will be a strong demand for bank credit, particularly medium- and long-term credit in the form of term loans and corporate debt securities. A considerable proportion of this credit will continue to carry appreciable risks.

FACTORS LIMITING COMMERCIAL BANK ADAPTATIONS

Certain features of American commercial banking and of the environment in which it operates have definitely impeded adaptations to long-run changes in the demands for funds by business concerns, and have restrained banks from taking risks in business financing. Unless these impediments can be removed or surmounted, further development of bank relationships with businesses may be handicapped. If banks are to perform a significant business financing function, their operations must be geared to the credit demands of the market, which the evidence of this study indicates have been increasingly for loans of medium and long term and for loans to small and medium-sized businesses often entailing high costs of loan administration and higher-than-average risk exposure.

Some of the limiting factors which will now be considered are related to the nature of the commercial banking system, and others to the scheme of public regulation that has grown up around it.

Business Fluctuations

Because of its long exposure to the hazards of general economic instability, bank lending is conducted on the assumption that a degree of instability will continue to characterize the economy. The disposition to assume ordinary risks of shifts in industrial demand and cost conditions would be greater if the risks of sharp cyclical fluctuations in the economy as a whole were reduced. The importance of this factor is clearly heightened by a tendency for the credit needs of business to involve loans of medium and long term to maturity.

Low Ratio of Capital to Total Liabilities

The fact that the commercial bank operates with a far smaller cushion of equity than do other types of business financing institutions accounts in part for the greater selectivity of risks by banks, and tends to limit banking operations to the more conventional lines. The ratio of capital to total liabilities for national banks fell from 34 percent in 1865, to 20 percent in 1900, 9 percent in 1940, and 6 percent in 1944. The six principal commercial finance companies, in contrast, at the end of 1941 had ratios varying from 15 percent to 22 percent, and these ratios tended to rise during the war years.

Short-Term Nature and Instability of Deposit Liabilities

The deposit liabilities of banks are short term and of unstable character, and they are to a considerable degree beyond the control of bank management. Banks, owing large sums to the public payable on demand or short notice, seek to acquire a set of assets that will enable them to meet their liabilities under all foreseeable conditions. The asset structure of commercial and industrial enterprises, in contrast, is broadly determined by their production technology; the major financial problem of these concerns is that of choosing an appropriate structure of liabilities.

At mid-1945 commercial banks had by far the largest volume of deposits in history. Barring a rapid reduction in outstanding federal debt, the total amount of deposits held by the banking system will probably not diminish. It might even increase as a result of a return to the banks of currency in circulation and bank purchases of federal securities from the public. Yet the amount and composition of deposits of many individual banks are likely to be highly unstable, because of population movements, basic regional shifts in the location of industry, and transfers of deposits between consumers and business enterprises. Under these conditions banks will continue to give attention to the maturities of their assets. Concern over the extended maturity of term loans certainly has been a factor limiting the willingness of commercial banks to undertake this type of lending.

It may be argued that commercial banks, in acquiring loans or investments, need not be concerned about the composition and stability of their deposit liabilities, because they can always have recourse to the Federal Reserve banks for funds in the event that deposits are withdrawn in unexpectedly large amounts. Term loans to business enterprises may, for example, be used by commercial banks as a basis for borrowing from a Federal Reserve bank. But American commercial banks are generally averse to borrowing at a central bank, because of cost, concern over their credit position, and tradition. For these reasons the accumulation of earning assets by banks has been, and will continue to be, influenced by the maturity and other features of their deposit liabilities.

Risk Quality of Bank Assets Other Than Business Loans

Ordinarily a bank is able to accept more risk and longer maturities on its business loans, the higher the quality and the shorter the maturities of its other loans. It is clear that for many years following World War II loans to government will be the principal earning asset of American banks. The preponderance of federal securities in bank portfolios raises the question of the extent to which banks are exposed to risk in carrying these assets. The Board of Governors of the Federal Reserve System implied that government securities may be regarded as "riskless" assets by bank managements, when it pointed out that the large growth in bank liabilities since 1941 was accompanied by a growth in assets involving "no risk of loss."[6] If commercial bank holdings of government securities continue to be free from risk, they must be immediately salable in unlimited quantities without loss. If the official policy of the federal fiscal and monetary agencies should be to give long-term unqualified support to the price of government securities, important implications for business lending operations would follow. Bankers would then consider themselves able to extend loans of longer maturities and to

[6] *Thirtieth Annual Report of the Board of Governors of the Federal Reserve System,* 1943, p. 30.

take greater business loan risks than would be true if they should face the possibility of market depreciation of their large holdings of government securities. Conversely, a definite withdrawal of support would, among other consequences, lead to a more cautious attitude toward business lending.

Regulation of Bank Investments

Both law and administrative regulation have restricted bank financing of business through the purchase of debt securities. The National Bank Act of 1863 was silent on the subject of bank investment, with two exceptions: it required that a national bank purchase government bonds as collateral for its circulating notes; and it limited the liabilities of a single obligor for money borrowed to a stated percent of the paid-in capital of the bank. Later, under an interpretation of the National Bank Act by the Comptroller of the Currency, national banks were permitted to purchase corporate and other bonds, and in 1927 they were given specific statutory authorization to make such investments. As a result of the Banking Acts of 1933 and 1935 banks were required to abstain from underwriting security issues through affiliated companies, from wholesaling securities, and from holding the obligations of any one obligor in amounts exceeding 10 percent of their capital and surplus account.

Equally effective in limiting bank participation in business financing through the purchase of debt securities were the regulations of the Comptroller of the Currency in regard to the valuation of investments by bank examiners. Up to 1936 for national banks, and to 1938 for state banks, security holdings were valued by examiners at market prices, and deficiencies of market price under cost were viewed as "estimated losses," which were required to be written off the books of the bank. In 1938 a joint agreement of federal and state bank supervisory agencies modified this practice by providing that "investment grade" securities be valued at cost, and other securities not in default be valued at average market prices during the preceding eighteen months. "Investment grade" securities are defined by three classifications: those placed in the four highest groups by recognized rating services; bonds rated below these four groups but viewed by the examiner as of investment quality; and unrated securities of equivalent grade. Unrated bonds on which inadequate bank credit information prevents determination of quality are not, in general, adjudged of investment grade — a procedure that places a premium on bank investment in better-known and well-rated securities of large concerns. While banks are not prohibited from buying the unrated securities of small or less well-known businesses, they are required to maintain credit files containing adequate information for the appraisal of such bonds as to investment quality. The maintenance of such files necessarily involves considerable cost and inconvenience.

Examination of Bank Loan Portfolios

Public supervisory authorities and bank officers agree that examination of bank loan portfolios has affected the readiness of commercial banks to make innovations in their business lending policies, particularly as regards term lending, or to engage in special types of business lending involving higher-than-average risks.

Traditionally, the practice of bank examiners was to place, or "classify," loans subject to criticism in "slow," "doubtful," or "estimated loss" classes. Up to 1934 it was not unusual for a bank examiner to classify all loans maturing in more than one year as "slow." At a joint examiners' conference called by the Secretary of the Treasury in that year it was agreed that the term "slow" would not be applied to loans which were reasonably certain of ultimate repayment "by reason of the sound net worth of the maker and/or endorser, even though their assets or a large part thereof may not be of a liquid nature under present conditions . . ."[7] It was further agreed that collateral loans would not be classified as "slow" as long as the collateral had "sound intrinsic value" even though it was not salable at the time. In 1938 a further step was taken to remove any unfavorable stigma from intermediate- and long-term loans. The bank supervisory agencies agreed to place all uncriticized loans in Class I, and to classify all criticized loans in classes designated II, III, and IV, dropping altogether the categories "slow," "doubtful," and "loss," the first category being dropped because of its "improper emphasis on maturity."[8] The new procedure placed major emphasis on the earning capacity of the borrower and endorser, and less emphasis upon the immediate value of the borrower's liquid assets or collateral. Despite these changes, it was stated as

[7] *Annual Report of the Federal Deposit Insurance Corporation*, 1938, p. 62.
[8] *Ibid.*, p. 63.

late as April 1941 that confusion still existed as to the new examination procedure and that some examiners "still criticize capital loans and, to a lesser degree, real estate and other long-term loans."[9]

Usury Laws

Last of the significant factors that have limited the functional flexibility of commercial banks is the fact that maximum interest rates exist with respect to lending activity. These limitations are imposed by the usury laws, and they also grow out of the reluctance of banks to lend money — even where law would permit — at rates in excess of "standard" or "conventional" bank rates. While some banks charge service fees or employ other measures to raise the gross income return, especially on small loans and on those which, due to higher-than-average risk exposure, involve special costs of administration, other banks, uncertain of their legal position, have held back from accepting loans in which the circumstances called for higher gross charges than were consistent with legal maximum rate regulation.

A maximum charge, whether fixed by law or convention, clearly acts as a restraint on lending under conditions of relatively high risk or high cost of loan administration. Such maxima unquestionably have retarded the readiness of banks to undertake certain of the newer forms of collateralized business lending or to make small term loans.

ADJUSTMENTS IN BANK LENDING POLICIES AND PRACTICES

Commercial banks have made several adjustments to the changing structure of the business credit market and to the changing needs of businesses for credit. One adjustment has been "constructive lending" — that is, extending the application of credit survey techniques to small and medium-sized business concerns, actively seeking out promising managements, and taking a positive attitude toward the formulation of financing programs designed to meet specialized needs. Other adjustments involve the more extensive use of corre-

[9] *The Answers of the American Bankers Association,* in Reply to a Questionnaire of the United States Senate Committee on Banking and Currency (New York, April 1941) p. 42.

spondent relationships in assuming business credit risks, and cooperative action with public lending and loan-guaranteeing agencies.

Constructive Lending

The increasing complexity of business operations poses serious problems for the small and medium-sized concerns that comprise the bulk of the market for bank business credit. In such businesses the principals are often specialists in but one field of management, such as engineering, marketing, or production, and they may not be well qualified to formulate policies and supervise practices in other fields. The small size of such concerns makes it difficult for them to possess all types of managerial talent, and therefore the services they require of financial institutions include business counsel as well as credit.

The association of management counsel with credit advances was particularly noteworthy in the operations of commercial finance companies during the thirties. Some finance companies had separate counseling organizations, and for the services of these organizations they charged fees in addition to loan charges. The ability to render counseling service, especially to small concerns with inadequate managerial staffs and relatively weak financial standing, made it possible to make loans that were not otherwise feasible and to protect the interest of the financial agency in such loans. Among commercial banks it has long been customary to give informal counsel to business customers, and recently some banks have organized departments for this purpose.

Part of the task of meeting more adequately the financial needs of small and medium-sized concerns is the formulation and introduction of lending programs specially designed to meet these business needs without sacrifice of reasonable margins of safety, and the administration of such programs within manageable ranges of operating costs. Surveys of business credit demand are often undertaken in connection with these programs, since their success may hinge on the acquisition of a volume of lending of a given type sufficient to support the administrative outlays associated with specialized financing procedures. Such analyses of the market for bank credit, to determine the amount and character of the financing services demanded by business, and constant alertness to the needs of individual customers will continue to be essentials of constructive lending operations.

Correspondent Relationships

Correspondent relationships, which have always facilitated cooperative action among banks, have recently been adapted to serve more effectively the business financing activities of commercial banks. The adaptations have taken several forms, one of which is the wider use of participatory arrangements to provide financing facilities for large enterprises in industry and trade. Arrangements of this type may be carried on within a given network of correspondent relationships, or they may involve the joint participation of several correspondent systems. It is customary in such participations for the lead to be taken by the larger institutions.

Of special interest to this study are participations in which the loan originates in a small institution and, because of its size, complexity, or other factors, is turned over in part to a neighboring institution or to one in a larger money market. In certain cases the cooperating bank may, by virtue of its experience and specialized personnel, play an important part in formulating the loan agreement. Participatory arrangements of this type make it possible for a unit banking system to operate, where such operation is essential, with the conveniences and capacities of a regional or national financing system.

A second important adaptation of correspondent banking relationships relates to the provision of financing facilities for small and medium-sized concerns requiring specialized types of credit because of the relatively high risks involved. In such instances correspondent relationships are useful in making available to associated banks, especially those of small size, the skills and techniques developed in the specialized departments of other banks, and in sharing with correspondent institutions the experience of specialized lending operations. While these participations often consist primarily of sharing information on procedures, practices, and experience, they are sometimes extended to the cooperative assumption of risks on loans which, for various reasons, an individual bank wishes to share with other lenders.

A third general line along which correspondent banking relationships are being developed is that in which a given bank makes arrangements with a manufacturer of consumer durable goods, or of commercial and industrial equipment, for the financing of sales, usually on instalment terms, within a given region through a system of specially selected associated banks. This is again a means of giving to a system of independent banks the advantages of a regional or national organization.

Finally, special mention should be made of the regional credit pools organized under the sponsorship of the Small Business Credit Commission of the American Bankers Association. The plan involves the establishment of a pool of credit to which banks in a region can subscribe. The pool will take all or part of any loan which a local bank considers itself unable to make, either because of the size of the loan or because some feature, such as the term to maturity, involves risks that the individual institution prefers not to assume alone. By early 1946 forty-eight regional bank credit groups had been formed with about $670 million pledged to aid in financing medium and small businesses.

Government Business Lending and Loan Guaranteeing Agencies

The development described above as "constructive lending" involves independent action by individual banks in adapting their lending policies and practices to changing credit demand conditions. In contrast, the development of new ways in which correspondent bank relations can be made to serve more effectively in the conduct of business and consumer financing requires the joint or collective action, within the framework of independent banking, of a group of banks. Adjustments have also taken place at a third level, involving the cooperative action of public and private agencies.

It has been pointed out previously[10] that, where existing banking facilities are unable to meet particular credit demands, a public agency may function as a direct lender, carrying the full amount of the loan involved. Public agencies also participate in loans of commercial banks, or make commitments to take up all or part of a loan made by an individual institution, if the latter institution decides at some point that it wishes to dispose of the loan. Public agen-

[10] Chapter 4, pp. 121 ff., and Chapter 7, pp. 187 ff.

cies guarantee loans made by banks. Finally, public agencies help to introduce new lending methods and facilitate the wider application of techniques of lending specially designed for small and medium-sized enterprises presenting relatively high risks.

Prior to World War II these several devices were used by the Reconstruction Finance Corporation, the Federal Reserve banks, and the Export-Import Bank of Washington; during the war they were extended to the Smaller War Plants Corporation and, in the case of the loan guarantee, to all the government procurement agencies. Under the Servicemen's Readjustment Act of 1944 government loan guarantees of potentially vast funds are available, while the International Bank for Reconstruction and Development extends the principle of government guarantee to foreign investment. On August 24, 1944 Chairman Eccles of the Board of Governors of the Federal Reserve System proposed legislation to extend the V loan principle to postwar business loans of all kinds; this would be accomplished by authorizing a member bank to apply to the Federal Reserve bank of its district for a guarantee up to 90 percent of the amount of any loan made to a business concern for any purpose.

The development of government lending and loan-guaranteeing operations is readily explained by the economic instability and uncertainty that characterized the period of the thirties, and by the special credit problems involved in business financing during World War II. While these techniques undoubtedly aided banks to adjust themselves to new conditions in the business credit market, they raise questions concerning the future position of banking. This is particularly true of the use of loan guarantees. Clearly, if loan guarantees are developed to the point where government carries the risk of virtually all business credit, then the commercial bank is left only with the clerical task of loan administration. Business would depend for the conduct of its operations upon the availability of what would, to all intents and purposes, be public credit. Unlike the other adaptations considered above, public loan guarantees in the long run entail a constriction of the independent business financing function of the banks.[11]

[11] The problems inherent in this development have been stated in the *Annual Report of the Federal Deposit Insurance Corporation*, 1943, p. 13: "Assumption by the Government of the risks inherent in credit extension by privately owned financial institutions

FUTURE RELATIONSHIPS BETWEEN BUSINESS ENTERPRISES AND COMMERCIAL BANKS

The primary purpose of this study has been to trace and explain the development since 1900 of the relationships that exist between commercial banks and business enterprises. The study was originally suggested by a basic question confronting the commercial banking system: Are the business financing functions of commercial banks undergoing gradual decline?

The evidence clearly shows that while the manner in which commercial banks perform business financing functions has changed considerably in the last 25 years, and while the bank credit used by business during the thirties was far less, absolutely and relatively, than the credit used during the twenties and earlier, there is no reason to believe that in the calculable future the business financing functions of banks will be of less importance than at present. On the contrary, the evidence shows that the adaptations made by banks in their business financing practices enabled them, during the revival years of the thirties, to play a more important role in the business credit market than they did during the early thirties. Whatever may have happened in the second half of the thirties in the proportion of business loan assets to other assets of banks, it is clear that there was a revival in the absolute amount of bank credit used by business.

That revival can be attributed in part to changed conditions in the total demand for funds by business enterprise, traceable ultimately to a higher rate of business asset expansion. But it was brought about also by adaptations which commercial banks began to make in their business lending policies and practices. A willingness to risk funds on long term reestablished their position in the financing of large concerns. The development of lending techniques more appropriate to the needs of the small and medium-sized business concerns, which have traditionally constituted the bulk of the banks' market for business credit, brought banks into broader contact with this part of the business community. The revival of busi-

to private business enterprise would reduce the chances of continuation of banking and business under private ownership and control. In order to avoid excessive loss the guarantor, an agency of the Federal Government, would have to set standards and review each individual loan transaction. In effect, the guarantor would determine who could and who could not have credit, as well as the channels through which such credit would be obtained."

ness lending by commercial banks was facilitated by certain changes in public laws and regulations affecting these institutions; among these were the liberalization of rediscount facilities, the revision of bank examination procedures, and the action of public agencies engaged in direct business lending and in loan insurance.

The business financing function of commercial banks might well decline if banks should confine their operating practices and policies to those characteristic of the first three decades of the century. Recent developments strongly suggest, however, that if the business economy continues to experience growth, if banks make the adaptations which are within their power, and if the environment of public law and regulation within which banks operate is conducive to risk taking, there will be no decline in the demand for their business financing services.