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Summary of Findings

A "TERM LOAN" IS A LOAN to a business enterprise that is repayable, according to agreement between borrower and lender, after the lapse of more than one year. Such loans fall within the "medium-term" credit market, which is defined for purposes of this study to include credits that run for more than one but not more than fifteen years. Since 1933 four types of financial institutions have directly extended medium-term credit, so-defined, to American business enterprises on a broad scale—commercial banks, life insurance companies, the Reconstruction Finance Corporation and Federal Reserve banks. Findings of broad significance arising from a study of the present-day market for medium-term business credit are:

1. Term loans by banks and private purchases of medium-term bonds or notes by insurance companies have experienced enormous growth and have tended to displace short-term loans and public issues of securities through investment bankers as methods of business financing. At the end of 1940 term loans comprised nearly a third of the commercial and industrial loans and about 12 percent of all loans held by commercial banks.

2. Private financial institutions are dominant in this field of credit, the operations of the public agencies being minor in scope and non-competitive in nature.

3. Term loans have been a method of financing comparatively large businesses. The public agencies' borrowers were much smaller than those of banks or insurance companies, but even so, more than half the number of loans granted by public agencies were made to concerns with total assets of over \$100,000.

4. Term lending institutions have devised new standards and procedures for appraising credits, in order to determine whether a borrower can amortize a loan out of available incoming cash.

Causes of Growth

Term lending experienced remarkable growth after 1933 as a result of an expansion in business demand for medium-term loans relative to the demand for short- or long-dated credit or equity capital, and because of the increased ability and willingness of financial institutions to supply such credit. It was given impetus by business demands for funds to modernize or re-equip plants and to effect savings through the refunding of outstanding debts at lower interest rates. The supply of medium-term credit expanded in consequence of a number of developments: growing excess reserves in banks, lower yields from high-grade bond investments, broader access to Federal Reserve credit facilities, deposit insurance, the example of long-term amortized mortgage loan insurance offered by FHA, revised practices of bank examination, changes in the public regulation of bank investments, the Securities Act of 1933, and the lending operations of public agencies.

Structure of the Market

The annual volume of term loans made by commercial banks has risen steadily in recent years: \$217 million in 1938, \$827 million in 1939, and \$1,352 million in 1940. Estimates of the medium-term business credit of all institutions outstanding at year-end indicate a similar growth: \$1,081 million in 1937, \$1,547 million in 1938, \$2,271 million in 1939, and \$3,199 million in 1940. At the end of 1940 commercial banks held an estimated \$2,162 million of term loans, life insurance companies held about \$900 million of medium-term bonds and notes privately acquired from issuers, the Reconstruction Finance Corporation had outstanding business loans of \$121 million, and the Federal Reserve banks held outstandings of somewhat less than \$16 million.

Twenty-six large life insurance companies and possibly as many as 2,900 commercial banks located throughout the United States held some medium-term loans at the end of 1940, term lending being concentrated among banks with deposits of \$10 million or more located in the larger centers of population. These private institutions had made term loans to about 3,800 business enterprises up to the end of 1940, while the public institutions had granted term credit to approximately 11,000 concerns. In total, it is possible that about 10 percent of the more than 130,000 businesses in the United States with total assets of \$100,000 or more have obtained medium-term credit.

Marked differences are found between the private and public lending agencies both in size of borrowers and in average amount of term loan. Insurance companies acquired medium-term bonds only from the larger companies, those with total assets of \$1 million or more; only 4 percent of the amount of commercial bank credit went to borrowers whose total assets were less than \$1 million; on the other hand, 19 percent of the amount of RFC loans and 27 percent of the amount of Reserve bank loans were made to borrowers whose total assets were less than \$1 million. The average term loan of insurance companies was \$3.8 million and of commercial banks \$664,000, in sharp contrast to the average loan authorization of \$56,000 for the RFC and \$73,000 for Reserve banks.

There are also significant differences in the industries of concerns whose credit needs were met by different term lending institutions. Manufacturing concerns accounted for a larger percentage of the credit extended by each type of agency than did any other major industrial class. But public utilities, mining and extraction (including oil production) and financing concerns combined received nearly 60 percent of commercial bank term credit and over 45 percent of insurance company credit. Loans to manufacturing, wholesaling, retailing and construction concerns were relatively more important in the portfolios of the public than of the private agencies.

There is a high degree of cooperation among term lending institutions, nearly 68 percent of the amount of bank term loans and about 55 percent of insurance company and Reserve bank term credit being split with several institutions. Less than 16 percent of RFC business credit was participated in by other lenders. Cooperation in term lending performs an economic function parallel to that of the underwriting syndicate in investment banking.

Term Loan Characteristics

Loans made by each type of lending institution have their own characteristics, but loans of the private agencies resemble each other more closely than they resemble loans of either public agency.

Term

Although more loans of commercial banks have terms of five than any other number of years, about 30 percent of the number and 49 percent of the amount of these loans have terms exceeding five years. Few loans have terms of more than ten years. Maturities of RFC loans are generally similar to those of commercial banks, while Reserve bank loans, legally limited to five years, for the most part run less than three years. Insurance companies advance longer credits than other institutions, only 15 percent of the amount having terms of five years or less, and over half the amount maturing after ten years.

Use of Funds by Borrowers

A third of the amount of bank term loans provides borrowers solely with new money, principally for working capital or machinery and equipment. About 54 percent is used exclusively for refunding purposes, chiefly to retire bonds. Medium-term credit of insurance companies appears to have a similar pattern of use. Reserve bank advances are limited by statute to working capital purposes, but RFC loans have enabled

borrowers to finance capital expenditures or refund outstanding debt as well as to increase working capital.

Collateral Security

Only a third of the amount of bank and insurance company loans are collaterally secured, stocks and bonds or machinery and equipment in the case of bank loans and real estate in the case of insurance companies being taken most frequently on secured loans. In contrast, practically all RFC loans and 83 percent of the amount of Reserve bank credits are secured, usually by a combination of the borrowers' assets. Such security has been considered necessary by the public agencies to protect their interests in granting credit to concerns presumably unable to obtain financing from other sources.

Repayment Provisions

About 72 percent of the number and 57 percent of the amount of bank term loans, and about 25 percent of the amount of insurance company medium-term credits, are repayable in equal instalments. Nearly all the remaining loans mature in single amounts or have relatively large final payments ("balloon" notes). In contrast, practically all RFC and Reserve bank loans are repayable in equal monthly, quarterly, semi-annual or annual instalments, because of the necessity of gearing repayment closely to the abilities of financially-straitened borrowers to "throw off" cash. In many instances, instalment payments are a certain percentage of sales or net income before depreciation.

*Changes in Bank Term Loan
Characteristics and Lending Practices*

No marked change has occurred since 1934 in term, size of borrowers or size of loans made by banks. Such changes in industry of borrower as have occurred have been dictated mainly by conditions of demand for credit, durable goods industries becoming more important borrowers during cyclical

upswings. However, banks are tending to dispense with collateral security, to insist upon amortization of loans in equal instalments, to split loans among several lenders, and to increase the proportion of credit devoted to business expansion.

Term Lending Operations of Banks

Few banks have set up separate organizations to handle term loans, but they have frequently employed personnel trained in long-term investment credits and have assigned the task of credit analysis to analytical units connected with bond or trust departments.

Term loans are generally accompanied by agreements, "tailor-made" to fit the circumstances of each borrower, containing restrictions on the borrower's indebtedness, requiring maintenance of certain minimum financial conditions, subjecting management personnel and capital expenditures to control of the lender, requiring the keeping of accurate books and records, providing for acceleration of the debt under certain circumstances, and specifying any collateral security that may be required.

Credit standards applied by banks relate mainly to the earning power of a business, whereas those of the RFC and Reserve banks necessarily lay relatively greater stress upon collateral security. In determining whether applicants meet their credit standards, all agencies conduct thorough investigations and prepare analyses both of financial statements over the past seven or more years and of the efficiency of the applicant's production facilities and marketing methods in relation to those of other concerns in the industry.

Term loans at the end of 1940 formed 22 percent of all loans held by 50 large commercial banks, and 30 percent or more of all loans held by five of the largest banks. They comprised well over half of the commercial and industrial loans held by these 50 institutions. The industrial character of its territory and the attitudes and training of its personnel are crucial factors in determining the amount of term loans a bank

can develop. Given these factors, bankers consider the stability of their deposits, the ratio of capital to deposits, and the quality and maturities of other assets, in determining what proportion of total assets should take the form of term loans. Few, if any, banks have set up special term loan reserves against which losses may be charged, although the occurrence of loss is a recognized contingency. Banks infrequently lend individual borrowers up to the legal limit, preferring to split very large loans with other institutions.

Interest Rates and Costs in Term Lending

Interest rates charged by private institutions for medium-term credit have been much lower and more variable than those of the public institutions. The average bank rate varied between 2 and 3 percent during 1940 and stood at 2.16 percent at the end of 1941. Yet a larger *number* of loans carried 5 to 6 percent rates than any other rate, the higher rates on these small loans reflecting the larger costs of loan administration per dollar of funds advanced. To limit these costs, many banks will not make term loans of less than \$50,000 or \$100,000. For the most part, medium-term issues privately purchased by insurance companies have yielded 2 to 3 percent. In contrast, rates of all Federal Reserve banks have varied within a range of 3½ to 6 percent, while the standard rate of the RFC has been 5 percent, a few loans carrying 4 or 6 percent.

Compared with the loan rates of the private institutions, these rates have not as fully reflected differences in the risks and maturities of loans and the costs of administering them. That they have been low, relative to the risks assumed and the costs of loan administration, is indicated by the possibility of ultimate loss on RFC business loans as a whole, and the failure of Reserve banks to realize any considerable net income from industrial advances. The profitability of term lending to banks or insurance companies cannot be accurately determined from the data on hand.

Term Lending in Defense and War

The rapidly expanding war production program has been paralleled by a sharp increase in war lending activities. By the end of 1941 the total loans of Federal Reserve member banks had risen by 30 percent over mid-1940; between February 1941 and January 1942 the number of loans made to finance war production, and secured by assignments of government contracts, increased by about six times. Commercial banks have made about 90 percent of these contract assignment loans, the RFC about 5 percent and other agencies the remainder. That part of the war program that has required the construction of specialized plants and the creation of reserves of essential raw materials has been financed to a large extent by the RFC through its subsidiary corporations. Up to March 1942, these corporations had made commitments, including actual advances of cash, totaling nearly \$10 billion.

Necessarily, many loans made to finance war contracts have been term loans. The war program has not, however, altered the proportion of term loans to all business loans made; this proportion remains, as in pre-war conditions, at about 21 percent. However, marked changes have occurred in certain of the characteristics of term loans. Up to mid-1941 all war term loans were new money loans. A further notable change has been the extension of term credits of smaller size, presumably to smaller business concerns. Finally, such term lending places less emphasis on collateral security and more emphasis on the term loan agreement as a means of stipulating risk-limiting conditions.