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## *Term Lending in Defense and War*

THE INITIATION OF THE DEFENSE program in 1940 and the beginning of active participation in war in late 1941 have set forces in motion that are certain to have important effects on the American banking system. The total impact of the vast defense and war program upon American commercial banking and upon methods of business financing is, of course, too broad a subject to come within the scope of the present investigation. In this chapter attention is directed only to the effect of the war on term lending to business concerns by private and public agencies.

Of necessity this chapter deals principally with developments that took place during the defense period. Much of the data necessary to describe the development of the program and its effect on banking has been curtailed since December 1941, although wherever possible statistical information has been brought up to date of writing. Also, the arrangements that will be called for to finance the greater needs of active war as contrasted to defense are only now being made and any description of these arrangements cannot, in the nature of things, be fully abreast of current happenings. Despite these limitations it is possible to indicate in general terms how the war effort is affecting term lending, for the changes produced began to show themselves during the defense period. Furthermore, it appears likely that the principal effect of active participation in war will be an intensification and acceleration of these tendencies.

### *Scope of War Financing*

The defense and later the war effort has involved a considerable amount of productive activity that could not be financed by the conventional advance of credit to private business enterprises. The scope of the financing must, therefore, be measured in part in terms of the direct financing activities of public agencies. One part of the program requires the construction of specialized munition plants and the creation of reserves of essential raw materials. Since this entails investments carrying very large uncertainties, special corporations have been created as subsidiaries of the Reconstruction Finance Corporation to make such investments. Rubber Reserve Company and Metals Reserve Company acquire stocks of rubber and critical metals, especially tin. Defense Plant Corporation constructs plants, purchases machinery and equipment, and leases these facilities to manufacturers holding defense contracts. Its interests are protected by rentals received from the lessee concerns or by contracts of reimbursement from the War or Navy Departments. Defense Supplies Corporation acquires and carries in stock essential materials, including aviation gasoline, nitrate of soda and wool. Defense Homes Corporation provides equity capital for housing projects located in defense production centers, in cases where private capital is not available.

The magnitude of the activities of these corporations is indicated by the fact that their total commitments (including actual advances of cash) amounted to $9,672 million by March 7, 1942, the commitments of Defense Plant Corporation alone being $4,798 million.[1]

Notwithstanding the important production activities carried on directly by public agencies, the military program has produced broad quantitative changes in business financing by private agencies. The magnitude of this program is indicated by the fact that between June 1940 and March 31, 1942 the Federal government had appropriated or authorized the expenditure of $137 billion (including the lend-lease program).[2] Total expenditures by the various departments of the Federal

[1] Report of the Secretary of Commerce, covering the defense and war activities of the Reconstruction Finance Corporation and its subsidiaries, March 21, 1942.

[2] *Victory*, Vol. 3, No. 15, p. 32.

government over this same period amounted to nearly $23 billion. These vast expenditures set in motion productive activities whose magnitude was limited principally by the availability of men and materials and the time required to construct facilities and equipment for the production of military goods. They generated great increases in employment, volume of production and demands by business concerns for credit to finance this production. Between mid-1940 and the end of 1941 total loans of member banks of the Federal Reserve System rose by $4 billion—about 30 percent.[3]

### *Definition of War Credit*

War credit is credit extended to business concerns for the purpose of financing the production or holding of military goods or the production of materials and equipment necessary for making such goods. Possession of a prime contract or a subcontract from the Federal government definitely marks a concern as a war producer. This definition is not entirely free from ambiguities, and the task of separating credit extended to finance war production from that granted to finance civilian production is sometimes a difficult one. Modern warfare is "total" in demanding enlistment of the totality of the nation's economic and financial resources and in requiring the subordination of civilian demands. What specific commodities have military value, and how can credit be traced and allocated to the production of such commodities? The great majority of articles produced in the economy may under some circumstances and in some ways contribute to the war effort, if only in support of civilian morale.

Further to complicate the problem, most business concerns deal in several commodities possessing varying degrees of utility for military purposes. Credit advanced to such concerns cannot be earmarked as to use with exactitude. Loans made to government contractors or subcontractors engaged *exclusively* in producing military equipment, materials or supplies are clearly enough war loans. But how should one classify a

[3] *Federal Reserve Bulletin* (March 1942) p. 238.

loan to a manufacturer of steel grab buckets, who sells these articles to steel manufacturers using them in loading the iron ore necessary to produce the steel subsequently used in the products of the government contractors? And how should one determine what fraction of a loan to a manufacturer of lipstick cases also producing cartridge shells is war credit? No doubt rough estimates can be made in the majority of cases, but the inherent difficulties of these problems should be recognized in interpreting the data.[4]

### *Institutions Making Defense and War Loans to Business*

During the initial stages of the defense program, many businesses, especially the larger corporations that were at first relatively more important, financed their military orders with available working capital on hand. Other concerns took recourse upon the customary institutional sources of business credit, including banks, commercial finance companies, Federal Reserve banks, the Reconstruction Finance Corporation, public offerings of securities through investment bankers, or private placements of securities with life insurance companies or other institutional investors.

Government contractors have also had an additional source of funds for financing their contracts to completion, namely, advance payments on contracts made with the War or Navy Departments. Legislation passed during 1941 permitted these executive agencies to advance, from available appropriations,

[4] In reporting defense loans and commitments held on April 30, 1941, weekly reporting member banks of the Federal Reserve System were instructed as follows: "Include all commitments and loans made directly or indirectly for national defense purposes, whether or not secured by assigned government contracts, and whether made to prime contractors or to subcontractors. If the proceeds of a commitment or loan are to be used only in part for defense purposes, the reporting bank should if practicable, make an estimate of the amount so used and report only this amount. In the absence of information of the contrary, however, it may be assumed that if a borrower is engaged to a substantial extent directly or indirectly in providing facilities, supplies, or equipment for national defense, all new loans and commitments to such a borrower since the defense program was inaugurated oustanding on April 30, 1941, may be reported as being for the purpose of financing the defense program." See "Instructions for Preparation of Reports on Form F.R. 550," *Federal Reserve Bulletin* (September 1941) p. 873.

sums not exceeding 50 percent of the contract price of supplies or facilities, of which advance two-fifths may go to subcontractors participating in the completion of the contract. These advances may be authorized by Army or Navy officials without approval from Washington provided they do not exceed $100,000 on any one contract. Although data are not available to measure accurately the importance of this and other sources of defense credit, rough estimates of the roles played by the most important defense lending institutions—commercial banks and the Reconstruction Finance Corporation—may be made.

Commercial banks far surpass any other type of lending institution in the volume of such financing of business. It is likely that banks are making more than four-fifths of the number of all war loans and extending more than 90 percent of the amount of all credit advanced. About 5 percent of the number and amount of war loans are made by the RFC, and the balance by other institutions, such as factoring and commercial financing companies and Federal Reserve banks. These conclusions may be drawn from analysis of military contracts assigned by contractors to lending institutions during the period February 1941-January 1942, information on which is given in Table 15. It is assumed that the proportion of loans disbursed to amount of defense contracts assigned was the same for each type of lending institution.

The aggregate amount of defense loans held by commercial banks at the end of April 1941 fell just short of $1 billion.[5] If this estimate is correct, it appears that as a maximum such loans roughly constituted a third of the $2.75 billion increase in total loans of member banks between mid-1940 and mid-1941. The other two-thirds comprised credit granted to finance business expansion *resulting* from these defense activities. Moreover, the volume of defense lending by commercial banks

[5] This estimate is based on the fact that weekly reporting member banks of the Federal Reserve System, which account for about 49 percent of the amount of all loans and discounts in the American banking system, reported holding 3,630 defense loans totaling $460 million on April 30, 1941. (In addition, these banks had outstanding 2,254 commitments to make loans aggregating $633 million.) See *Federal Reserve Bulletin* (September 1941) pp. 866-74.

*Table 15*—Percentage Distribution of the Total Number and Amount of Defense Contracts Assigned to Different Types of Lending Institutions, February 27, 1941 to January 29, 1942[a]

| *Cumulative to* | *Commercial Banks* | | *Federal Reserve Banks* | | *Reconstruction Finance Corp.* | | *Other Lending Institutions* | | *All Contracts Assigned* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Number | Amount | Number | Amount | Number | Amount | Number | Amount | Number | Amount |
| February 27, 1941 | 84.2 | 95.7 | .. | .. | 6.4 | 3.4 | 9.4 | .9 | 100.0 | 100.0 |
| May 1, 1941 | 85.2 | 94.5 | .. | .. | 5.6 | 3.9 | 9.2 | 1.6 | 100.0 | 100.0 |
| May 29, 1941 | 85.9 | 95.4 | .. | .. | 5.1 | 3.3 | 9.0 | 1.3 | 100.0 | 100.0 |
| June 26, 1941 | 86.1 | 94.2 | .. | .. | 4.7 | 4.3 | 9.2 | 1.5 | 100.0 | 100.0 |
| July 31, 1941 | 84.6 | 93.6 | 1.9 | .5 | 4.2 | 4.1 | 9.3 | 1.8 | 100.0 | 100.0 |
| August 28, 1941 | 84.4 | 91.8 | 1.7 | .5 | 4.9 | 5.9 | 9.0 | 1.8 | 100.0 | 100.0 |
| September 25, 1941 | 84.4 | 91.7 | 1.7 | .5 | 5.1 | 5.9 | 8.8 | 1.9 | 100.0 | 100.0 |
| October 30, 1941 | 84.0 | 91.9 | 1.6 | .5 | 5.0 | 5.7 | 9.4 | 1.9 | 100.0 | 100.0 |
| December 26, 1941 | 84.3 | 91.6 | 1.5 | .5 | 4.4 | 5.5 | 9.8 | 2.4 | 100.0 | 100.0 |
| January 29, 1942 | 84.3 | 91.6 | 1.4 | .5 | 4.4 | 5.2 | 9.9 | 2.7 | 100.0 | 100.0 |

[a] Based upon tabulations furnished by the Board of Governors of the Federal Reserve System.

grew very rapidly during 1941 and 1942, as the war production program expanded to encompass a larger number of business enterprises. During this twelve-month period the number of war loans increased by more than six times and the amount of such loans more than quadrupled, to judge from the volume of contracts assigned to lending institutions by government contractors.[6]

Up to March 7, 1942 the RFC had authorized 675 direct loans to some 480 different business enterprises engaged in war production, under both its regular business loan powers and the special defense lending powers acquired by it on June 25, 1941. Under both laws nearly $665 million of defense and war credit had been authorized by that date. In addition to its direct loans to business concerns the RFC has cooperated with banks in their war loan programs by taking participations in credits extended to concerns engaged in war production. Up to March 7, 1942, the Corporation had authorizations of such participations in the amount of $23 million on loans aggregating $37 million. While this amounts to a very large volume of direct loans and participations, the major contribution of the RFC to the volume of defense and war lending has been its loans to, and purchases of capital stock of, its subsidary defense corporations, which, as indicated above, amounted to nearly $10 billion by March 7, 1942.

### *Term Lending of Commercial Banks in Defense and War*

The proportion of all war loans that are made on a term loan basis, that is, the proportion having a term of over one year, is not significantly different from the proportion of term

[6] See Table C-4. It is assumed that loans not accompanied by assignments of claims grew at a rate equal to those so accompanied, and that the proportion of loans granted to amount of assigned contracts remained constant throughout the period. Another evidence of growth in bank lending for defense is that 369 banks located in 142 cities reported to the American Bankers Association that they held 6,219 defense loans amounting to more than 517 million at the end of June 1941. In short, a group of banks roughly comparable in number and size to the weekly reporting member banks held defense loans 71 percent larger in number and 13 percent larger in amount than the weekly reporting banks had had oustanding only three months earlier.

loans to total business credits extended before the defense period. To the extent that defense and war have affected term lending it has been by changing the characteristics of term loans made rather than by increasing the relative importance of term loans. Thus, about 7 percent of the number and 21 percent of the amount of the defense loans made by medium-sized and large commercial banks are term loans, running a year or more to maturity; term loans held by large commercial banks at the end of 1940 were estimated to constitute 22 percent of all loans and discounts held by them.[7] Like traditional business loans, many loans were written to run less than one year but were expected by both banker and borrower to be renewed at maturity and to extend more than one year. Data on all defense loans held by weekly reporting member banks of the Federal Reserve System at the end of April 1941, showing their distribution by term at time of making, are given in Table 16.

*Table 16*—NUMBER AND AMOUNT OF DEFENSE LOANS HELD BY WEEKLY REPORTING MEMBER BANKS AT APRIL 30, 1941, BY TERM AT TIME OF MAKING[a] *(dollar figures in thousands)*

| *Term at Time of Making* | *Number of Loans* | | *Amount of Loans* | |
|---|---|---|---|---|
| | Number | Percent | Amount | Percent |
| Non-instalment loans | | | | |
| Less than 1 year | 2,976 | 82.0 | $324,236 | 70.5 |
| 1–2 years | 42 | 1.2 | 13,301 | 2.9 |
| 2–3 years | 17 | .5 | 1.603 | .3 |
| 3–5 years | 41 | 1.1 | 24,088 | 5.2 |
| 5 years and over | 9 | .2 | 3,328 | .7 |
| Instalment loans | | | | |
| Less than 1 year | 168 | 4.6 | 20,258 | 4.4 |
| 1 year and over | 160 | 4.4 | 53,585 | 11.6 |
| Miscellaneous loans | 217 | 6.0 | 19,713 | 4.3 |
| ALL LOANS | 3,630 | 100.0 | $460,112 | 100.0 |
| Total—less than 1 year | 3.144 | 86.6 | 344,494 | 74.9 |
| Total—1 year and over | 269 | 7.4 | 95,905 | 20.8 |

[a] Based upon tabulations furnished by the Board of Governors of the Federal Reserve System.

[7] See Appendix A.

One significant result of defense financing is a gradual extension of term credits of smaller size, presumably to business concerns of smaller proportions. The average amount of term loans made for military purposes, and held by weekly reporting member banks of the Federal Reserve System at the end of April 1941, was $357,000. This amount is only 54 percent of the average size of all term loans held by comparable banks at the middle of 1941. A reasonable interpretation is that ever-smaller concerns are receiving Federal contracts or subcontracts to produce goods of military value. These enterprises need credits running for more than a year in order to acquire the plant, machinery and equipment, and working capital necessary to finance their contracts to completion.

A second important effect of the military program upon bank term lending has been a definite change in the pattern of use of term credit obtained by borrowing concerns. Whereas only a third of the amount of all bank term loans held at mid-1941 provided new money to borrowers (the remaining two-thirds being for retirement of outstanding debt or preferred stocks), term loans made for defense purposes were all new money loans. Thirty-seven percent of the amount of term loans for military production held by weekly reporting banks on April 30, 1941 provided funds for new plant facilities, 43 percent provided working capital for expanded production, and the balance was used for a combination of these purposes.[8]

A third repercussion of war financing upon term lending by commercial banks has been an increasing emphasis upon the term loan agreement and a decreasing emphasis upon collateral security. War term loans of banks are secured by assignment of government claims less frequently than other term loans are collaterally secured. As much as 72 percent of the number and 70 percent of the amount of war term loans were not accompanied by assignment of government claims. As this is the type of security most likely to be used in connection with a term loan, it appears improbable that loans not secured by government claims were secured by other

[8] See Table C-6.

assets. The implication is that, in the majority of instances, the borrower's credit standing was considered so satisfactory that the taking of collateral security appeared unnecessary.

No important change has occurred with respect to repayment provisions. Term loans for defense purposes display little difference in this regard from other term loans. Fifty-six percent of the amount and 60 percent of the number of such term loans were repayable in instalments. The fact that an even larger fraction of these term loans is not amortized in instalments is probably to be explained by the use of loan proceeds. The defense and war loans finance the execution of specific government contracts and the borrower's ability to repay is created at time of delivery of completed goods to the government.

In summary, it is accurate to say that defense and war financing of business, while not altering any of the fundamental characteristics of term loans described earlier in this study, is serving to accelerate and emphasize the use of certain of their distinguishing features. It appears to have accelerated tendencies that were evident in the pre-defense period, namely a tendency toward the making of smaller loans, a shift toward new money uses and away from refinancing and a decreasing emphasis on the use of the different forms of security. Furthermore, it seems probable that these tendencies may be intensified during the war period.

### *War Term Lending of Public Agencies*

Although the RFC has since 1934 possessed power to make loans to business concerns, and in fact authorized many defense loans under its original powers, on June 25, 1940 it was granted even broader authority.[9] By Act of Congress, the RFC was permitted to make loans to (or with the approval of the President to purchase the capital stock of) any business corporation for the purposes of "(a) producing, acquiring and carrying strategic and critical materials, as defined by the President, or (b) for plant construction, expansion and equip-

[9] Public, No. 664, 76th Congress.

ment, and working capital to be used by the corporation in the manufacture of equipment and supplies necessary to the national defense, on such terms and conditions and with such maturities as the Corporation may determine."[10] Obviously this Act greatly expanded the powers of the RFC to make loans to concerns engaged in military production.

There were no requirements in the 1940 law that borrowers be solvent, that loans be of such sound value or so secured as to assure repayment, or that credit be unavailable at prevailing rates for the class of loan applied for—restrictions all contained in the original 1934 business loan legislation. The existence of a national emergency presumably was deemed sufficient cause for relaxing credit standards applicable to concerns producing or holding materials vital to national welfare. Inferentially, the philosophy was that the RFC should assume greater risks in granting credit to that peripheral group of concerns unable to obtain credit either from private agencies or from the RFC under its regular business loan powers, in order to assure an expeditious mobilization of military production.

Although data are not available on the term to maturity of defense loans made by the RFC, certain inferences with respect to the term of these loans may be made from an analysis of the use of the funds by borrowing concerns. About a third of the amount of RFC defense credit was designated as being used for working capital only, about a quarter for acquisition of plant facilities only, and the remainder for repayment of debts or combinations of purposes. To an overwhelming ex-

[10] As the law did not specify how the RFC should determine that credit would be used by an applicant "in the manufacture of equipment and supplies necessary to the national defense," it is uncertain whether this phrase required an applicant to hold a prime contract, to be a defense subcontractor, or to be a producer of machinery and equipment necessary to the operations of either or both prime contractors or subcontractors. The Corporation has announced that it is impracticable to specify in advance the particular terms and conditions upon which defense loans will be authorized, the Directors making the final determination in each case of the extent to which the credit will aid the national defense program. Reconstruction Finance Corporation, *Circular No. 23*, "Information Concerning Loans and Purchases to Aid in the National Defense Program" (July 1940) p. 2.

tent, the indicated purpose for which RFC defense credits have been granted to borrowers is the provision of new money (Table 17). It seems reasonable to infer that credit utilized for acquisition of plant, machinery and equipment is repayable, at least in part, after the lapse of one year.

The RFC has made a large number of small loans, presumably to small enterprises, and thus has served a group of borrowers similar in size to those receiving normal business credit from it. Up to mid-September 1941, loans of less than $50,000 accounted for about two-thirds of the number of defense loans authorized but only for 1.3 percent of the amount. On the other end of the scale, ten loan authorizations each for $10 million or more accounted for nearly two-thirds of the amount of RFC defense credit granted to business. These RFC loans have gone to a large number of very small concerns and to a few very large concerns. Many of the small borrowers have operated air training schools and services, and have sought credit wherewith to purchase small training planes. Because of their extremely small size and lack of appreciable equity funds in the business, they have not been first-class credit risks. Five of the ten very large authorizations were made to aircraft manufacturers for plant expansion or working capital to complete government contracts. Data are given in Table 17.

Concerns performing air training and transport service and manufacturers of miscellaneous Army equipment and supplies have provided the largest *number* of RFC defense borrowers. Manufacturers of aircraft and parts, and of critical metals and other materials, have accounted for almost two-thirds of the total amount of defense credit extended. Contractors engaged in construction work or in shipbuilding have not resorted to the RFC for funds on as large a scale as have producers of Army equipment and supplies.[11]

[11] Analysis of the amount of all defense contracts awarded from June 13, 1940 through August 30, 1941 indicates that 17.2 percent were for construction, 28.0 percent for ships, 27.4 percent for airplanes and parts, and 27.4 percent for ordnance and supplies. See National Industrial Conference Board, *Addenda to the Conference Board Economic Record* (September 1941).

*Table 17*—Number and Amount of Defense Loans Authorized by the Reconstruction Finance Corporation to September 13, 1941, by Use of Funds, by Size of Loan and by Type of Product or Service of Borrower[a] *(dollar figures in thousands)*

| | *Number of Loans* | | *Amount of Loans* | |
|---|---|---|---|---|
| | Number | Percent | Amount | Percent |
| USE OF FUNDS | | | | |
| New money only | *377* | *90.2* | *$211.355* | *79.5* |
| Working capital only | 126 | 30.1 | 88,187 | 33.*1* |
| Acquisition of machinery or equipment only | 135 | 32.4 | 2,077 | .8 |
| Acquisition of plant facilities only | 39 | 9.3 | 66,984 | 25.2 |
| Combination of purposes | 77 | 18.4 | 54,107 | 20.4 |
| Repayment of debt only | *8* | *1.9* | *40,048* | *15.1* |
| Combination of new money and repayment | *33* | *7.9* | *14,232* | *5.4* |
| Total | 418 | 100.0 | $265,635 | 100.0 |
| SIZE OF LOANS | | | | |
| Under $5 | 20 | 4.8 | $78 | b |
| 5–10 | 125 | 29.9 | 873 | .3 |
| 10–50 | 122 | 29.2 | 2,765 | 1.0 |
| 50–100 | 30 | 7.2 | 2,000 | .8 |
| 100–500 | 79 | 18.9 | 15,418 | 5.8 |
| 500–1,000 | 10 | 2.4 | 7,308 | 2.8 |
| 1,000–10,000 | 22 | 5.2 | 60,973 | 23.0 |
| 10,000 and over | 10 | 2.4 | 176,220 | 66.3 |
| Total | 418 | 100.0 | $265.635 | 100.0 |
| TYPE OF PRODUCT OR SERVICE OF BORROWER | | | | |
| Air training service | 171 | 40.9 | $6,070 | 2.3 |
| Aircraft and parts | 41 | 9.8 | 96,991 | 36.5 |
| Naval construction, repairs and parts | 28 | 6.7 | 10,788 | 4.1 |
| Army equipment and supplies (except guns and ammunition) | 94 | 22.5 | 22,571 | 8.5 |
| Guns, ammunition and components | 36 | 8.6 | 7.799 | 2.9 |
| Defense housing and public utilities | 10 | 2.4 | 10,288 | 3.9 |
| Critical metals and materials | 21 | 5.0 | 69,746 | 26.2 |
| Other, and no information | 17 | 4.1 | 41,382 | 15.6 |
| Total | 418 | 100.0 | $265,635 | 100.0 |

[a] Based upon releases by the Federal Loan Agency of Letters of Jesse Jones ro Congress, dated May 9 and September 16, 1941. Includes authorizations under both Section 5d of the RFC Act and Act of June 25, 1941. Cancellations or recissions of authorizations no deducted.

[b] Less than .05 percent.

Federal Reserve banks have participated in the war financing program in two ways. First, as will be shown below, they act as liaison agencies of the War and Navy Departments and the Maritime Commission in extending guarantees to lenders against loss on loans made to concerns to finance the completion of war orders.[12] Second, through industrial advances made under section 13b of the Federal Reserve Act the banks have extended credit directly to contractors. This aspect of war financing (while still relatively small as contrasted to other sources of credit for war contractors) has tended to increase. While the total amount of industrial advances increased only slightly from the beginning of 1941 to March 1942, commitments and participations outstanding more than doubled.

### *Credit Standards and Procedures in Defense and War Financing*

In financing business enterprises producing war materials and supplies, bankers have not been confronted with credit problems *essentially* different from those of normal times, but they have had to make certain adaptations in their credit standards and procedures. The need for bringing the entire productive capacity of the nation rapidly into utilization has entailed: first, extension of additional amounts of credit to borrowers with long-established credit relationships; second, opening of new lines of credit to concerns (many of them small and financially weak) with which lending institutions had not previously had credit relations. To enable lenders to meet these new credit demands and yet protect themselves against loss, certain new devices for facilitating the flow of funds have been evolved.

One important facilitating device is the Assignment of Claims Act of 1940, which permits all claims against the Federal government for payments of $1000 or more to be assigned to "a bank, trust company, or other financing institu-

[12] Guarantees are provided for in Executive Order No. 9112 issued on March 26, 1942 (*Federal Reserve Bulletin*, April 1942, pp. 299-301) and are extended under Regulation V of the Board of Governors of the Federal Reserve System (*Federal Reserve Bulletin*, May 1942, pp. 424-27).

tion, including any Federal lending agency."[13] Claims may be assigned under contracts either for supplies or for plant facilities. When a claim is assigned, written notice together with a copy of the assignment must be filed by the assignee with the General Accounting Office, with the contracting officer of the Federal government or the head of his department, with the company supplying the contractor's surety bond, and with the Federal disbursing officer, if any, designated in the contract to make payment. Further to protect lenders, the Act permits the War or Navy Departments to write contracts with suppliers under which payments are not subject to reduction or set-off of tax or other debts due the Federal government by the assignor.

Another device which facilitates the flow of credit into war production is the Emergency Plant Facilities Contract. Many manufacturers have hesitated to expand their plants in the belief that this expansion might be worth little or nothing at the end of the emergency. The Emergency Plant Facilities Contract provides that a manufacturer can erect a plant certified as necessary for national defense and be reimbursed the entire cost by the Federal government in 60 equal monthly instalments following completion of the facilities. At the termination of this period, title passes to the government, unless the contractor desires to retain the plant. In the latter case, he contractor may purchase the plant at cost less the depreciation specified in the contract or at a lower negotiated price. The contract thus provides a favorable distribution of risk between contractor and government, in leaving to the contractor the normal risks of production, but in requiring the government to carry the risk of obsolescence and excessive plant capacity at the end of the emergency. By assignment of payments due from the government under such contracts, contractors can secure funds from banks to finance plant construction.

A third facilitating device for encouraging private financing

[13] Public, No. 811, 76th Congress. Approved October 9, 1940.

of plant expansion is a ruling of the Treasury Department that when a concern expands a plant, certified as necessary for national defense, it may amortize the total cost over a period of 60 months, deducting this amortization from its income for tax purposes.[14] Such amortization may be allowed whether the plant expansion is privately financed or financed under an Emergency Plant Facilities Contract. This ruling has stimulated expansion of plants in which business concerns have definitely intended to retain an interest after the emergency.

Further steps taken to expedite the completion of financing arrangements for concerns—particularly smaller concerns—having war production contracts have recently been announced by the Federal government. On February 19, 1942 the RFC authorized its thirty loan agencies to approve, on their own responsibility, loans not in excess of $100,000 without referring them to Washington. Further to facilitate production, the War Production Board established a Bureau of Finance in its Division of Industry Operations to furnish advice and assistance on financing arrangements to holders of contracts and to concerns desirous of obtaining contracts. Arrangements are sought for loans from commercial banks and, where such are not possible, for loans from the RFC, a Federal Reserve bank or some other public financing agency.

Finally, a recent Executive Order has authorized the War Department, Navy Department and Maritime Commission to enter into contracts with financial institutions, both public and private, guaranteeing, in whole or in part, loans made by these institutions to finance war contractors and subcontractors. The War and Navy Departments and the Maritime Commission are empowered to extend this guarantee where they believe the work being done is essential to the prosecution of the war. Furthermore, the War and Navy Departments and the Maritime Commission are authorized in this Executive Order to make loans directly to war contractors or to partici-

[14] T. D. 5016 relating to Second Revenue Act of 1940, Sections 23, 24.

pate with any public or private lending agency in the making of such loans.[15]

Under this program the Federal Reserve banks act as liaison agencies between the Federal departments, financial agencies and war contractors. Wherever possible the Federal Reserve banks attempt to arrange the credit extension without guarantee, through private agencies, through the RFC, or through their own facilities as provided for under Section 13b of the Federal Reserve Act. If this is not feasible the banks arrange a guarantee of all or part of the loan by the Federal department concerned. As a last resort, the public agency may extend funds directly, making the entire loan or taking a participation therein. Regulation V, which governs operations under this plan, provides that rates of interest, maximum or otherwise, are to be specified from time to time by the Board of Governors of the Federal Reserve System after consultation with the Federal departments and the Reserve banks and that the maturity of the loans made or guaranteed in whole or in part under this plan shall not exceed five years.

The availability of loan guarantees has had a profound effect on the credit appraisal problem faced by lending institutions in making war contract loans. This protection has greatly reduced the major source of risk in war lending, namely that the contractor will fail satisfactorily to produce the materials contracted for according to all the specifications of the contract, along with the other risks attendant upon such loans. These loan guarantees do not, however, dispose entirely of the problem of credit appraisal in the making of war loans. Lending agencies are encouraged to take only partial guarantees. For this reason they necessarily examine loan applications with care though it is the objective of the guarantee to reduce to a minimum the limitations that peacetime credit rules and standards set on production. Further, it is stated in Regulation V that the objective of the plan is to obtain "maximum war production expeditiously" but that the Federal Reserve banks

[15] Executive Order No. 9112 issued March 26, 1942.

"will make reasonable efforts to afford the War Department, Navy Department and the Maritime Commission the best available protection against possible financial loss consistent with this objective."

Before the availability of loans and guarantees from the War and Navy Departments and the Maritime Commission, the focus of the credit analysis was the likelihood that the borrower could actually produce and deliver the commodities called for by the contract. Under present arrangements, even though a guarantee may be given against nonperformance on the part of the contractor, there remains the necessity of sifting out those contractors eligible to receive this degree of protection. It is obviously necessary to make careful judgments where only partial guarantees are taken. Also, an assessment of the competence of the contractor in estimating and controlling costs remains vital in credit analysis of defense and war loans, for it determines how much credit is required in order to complete the contract. The lending and guaranteeing agencies must be satisfied that the contractor has adequate plant capacity and can obtain the necessary raw materials, skilled labor and transportation facilities. Finally, quite aside from questions of creditworthiness there is the further point that the urgency of our need for war materials is such that the technical efficiency of the contractor must be judged carefully by the agency extending a guarantee against default through nonperformance.

The credit standards applied to defense loans made under the regular business loan powers of the RFC were such that, as a group, these loans were expected to "stand on their own feet" and pay out without loss to the Corporation. Loans made under the Act of June 25, 1940 represented credits extended for the most part at the request of the Army or the Navy Department, and granted to concerns producing urgently needed military supplies. As a class, these latter loans have carried larger risks to the lender. For a time many of the borrowers were subcontractors who, unlike direct contractors with the Federal government, were then unable to obtain an advance from the government to aid in financing their production and sorely lacked working capital. The major risk assumed by the RFC in granting credit to these concerns has been that the borrowers may have inadequately estimated the costs. This contingency has been especially likely in defense and war production, much of which involves products that are experimental or new to the manufacturing concern. The problems presented to the RFC by these loans have been reduced greatly by the facilitating legislation reviewed above.

All these aspects of credit analysis necessarily become more difficult as the war effort widens and intensifies. As more concerns are drawn into war production it is inevitable that smaller concerns and, further, less efficient producers must be utilized. Both of these tendencies, and in particular the latter, increase the risks attendant upon war term lending. While the burden of carrying the risks may be shifted in whole or in part by a guarantee, this does not, of course, reduce the losses that will eventually be sustained. This necessity of extending term credit to relatively high-risk concerns is likely to have a significant effect on the future of term lending. The experience thus gained by lending agencies should raise their ability to lend funds to relatively small concerns within manageable limits of risk. The resulting accumulation of experience and development of skill cannot fail to have a lasting effect on business lending policy and practice.