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A NEW RECONSTRUCTION FINANCE CORPORATION OR NATIONAL DEVELOPMENT BANK: SOME BASIC ISSUES AND THREE PROPOSALS

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Introduction

At the end of the 93rd Congress and in the current 94th Congress, there have been a number of bills introduced which would create a Federal financing institution like the old Reconstruction Finance Corporation[1/] or a national development bank. These organizations would provide credit to private firms, local governments, and other groups through a variety of devices including direct loans, guaranteed loans, and stock purchases.

Support for an RFC-style organization has come from a number of different quarters. Senator Mansfield in September 1974 introduced legislation to create a new Reconstruction Finance Corporation. He felt it should be " ... the type of institution which ought to face up to the needs of distressed companies, rather than have those companies come before Congress for rescue on an ad hoc basis.[2/]" Carl Albert, Speaker of the House, in outlining Democratic alternatives to President Ford's fall 1974 economic proposals called for the establishment of a new Reconstruction Finance Corporation.[3/]

1/ For background on the RFC see CRS multilith "Emergency Federal Financial Assistance to Private Enterprise: A Selective Examination of Past Loan and Loan Guarantee Programs of the Federal Government," November 1974, 74-205 E.

2/ Congressional Record, (daily edition), September 24, 1974, p. S 17313.

3/ Mary Russell, "Albert Offers Economic Recovery Plan," Washington Post, November 11, 1974.

Felix Rohatyn, a partner in Lazard Freres and Company who has been heavily involved in the attempts by Lockheed to find a company to merge with in order to solve its financial problems, called for the revival of the Reconstruction Finance Corporation. The purpose of the revived corporation would be to act as a safety net for major corporations and banks which need a major infusion of capital in order to survive. 1/ Arthur Burns, Chairman of the Federal Reserve, said that while he hoped the country could get by without a Reconstruction Finance Corporation to bail out corporations, it is possible that such a rescue operation might be needed. 2/ It has been reported that President Ford and many of his advisors were interested in an RFC-type proposal until talked out of it at Vail, Colorado. 3/

The purpose of the RFC-style proposals is to provide credit through direct loans and guarantees to firms, local governments and others to fight the recession, overcome tight money problems, keep some firms from failing, help others expand, build public works, create jobs, and increase personal income.

1/ Felix G. Rohaytn, A New R. F. C. Is Proposed for Business, New York Times, December 1, 1974.

2/ Hobart Rowen, "Burns Said to Fear More Inflation if Dollar's Value Continues to Drop," Washington Post, March 6, 1975.

3/ "Ford's Falcon: Don Rumsfeld Takes Self-Assured Strides to White House Hub," Wall Street Journal, January 23, 1975.

As a general rule the proposals would set up a government-sponsored and owned corporation which would provide credit. The funds for this purpose would come from the sale of capital stock to the Treasury, and through the sale of obligations to both the Treasury and the public. These obligations would be backed by the full faith and credit of the United States. The corporation would not necessarily be a profit making enterprise.

These RFC-style proposals by their very existence raise questions about why such intervention by the Federal Government is needed in the nation's credit markets. It raises issues as to whether something is wrong with the way credit is currently allocated, and why current Federal credit programs, the Federal Reserve, and the private sector cannot meet the demand.

This report explores the larger issues raised by proposals for a new RFC or a national development bank, and discusses some of the bills that have been introduced in the 94th Congress dealing with the topic. These bills are not the only proposals which have been put forward. However, they do provide a range of suggested alternatives, and show various ways of dealing with the financing, organization, and programs of the proposed Federal credit institutions.

CHAPTER I - ISSUES

Proposals for the creation of a new Reconstruction Finance Corporation, a national development bank, or a similar Federal credit program to assist firms, local governments, and particular sectors of the economy are made in the belief that present credit institutions, both private and public, are not able to meet the needs of certain potential borrowers, and that this has detrimental economic and social effects. The proposals do not go into why current credit institutions are inadequate, but they do provide that, in most cases, funds must be unavailable from other sources. Applicants for assistance under these conditions in many cases, would be ones in which there is some question about their ability to repay on time the funds advanced. This could be because the applicant is engaged in a high risk venture, is in financial difficulties, is in an industry in a state of recession, is interested in a project with too low a rate of return, or is dependent on future Federal actions, either by the President or Congress, whose outcome is unsure. In short, these are potentially high risk loans.

Risk is the traditional means by which investors have made judgements on where to put their money. Generally, the higher the risk, the greater is the potential profit or loss to the investor. In the case of private lenders, higher risk means a higher rate of interest.

Applicants assisted under the RFC-style proposals would be those who could not pay the interest rate private lenders and investors would charge in light of the risk, and who were unable to qualify under already existing Federal credit programs. Risk under current Federal credit programs, as well as the proposed RFC-style proposals, is shifted in whole or in part to the Federal Government. Loan decisions are based on broad social, and political goals and priorities, rather than risk.

Current Federal Credit Programs: Scope and Implications

Current Federal programs providing assistance to almost all sectors of the nation's economy are extensive. A new RFC-style credit institution would be an addition to these already existing programs. In order to understand the function and place a new RFC program could have, it is useful to have a grasp of the scope of current Federal credit programs. What follows is a brief description of these programs, their size, and scope, and their impact on the allocation of credit.

In fiscal year 1974 direct Federal and guaranteed loans outstanding totalled $286 billion. This breaks down into $133 billion in direct loans outstanding and $153 billion in guarantees. The estimates for fiscal years 1975 and 1976, contained in table 1, show a continuing increase in the total amount of loans and guarantees outstanding. Of the two forms of credit assistance, direct loans are estimated to increase in a greater amount and at a faster rate than guarantees.

Table 1

FEDERAL CREDIT PROGRAMS! TOTALS OF DIRECT AND GUARANTEED LOANS OUTSTANDING FISCAL YEARS 1974, 1975 AND 1976
(In millions of dollars)

	Direct Loans 4/			Guarantees 5/			Total		
	1974 actual	1975 estimate	1976 estimate	1974 actual	1975 estimate	1976 estimate	1974 actual	1975 estimate	1976 estimate
Wholly owned Government 1/ Enterprise (excluding off-budget agencies)	46,132	46,227	49,599	153,182	154,008	161,704	285,727	317,060	345,747
Off-budget agencies 2/	15,353	30,827	39,750						
Government Sponsored Corporations 3/	71,060	85,998	94,694	N.A.	N.A.	N.A.			
	132,545	163,052	184,043						

1/ This includes programs of Federal departments, like HEW, DOD, etc., and various agencies like the Veteran's Administration.

2/ This includes government agencies whose outlays are not included in the budget totals such as the Export-Import Bank, Federal Financing Bank and the Environmental Financing Authority.

3/ This includes privately owned government sponsored corporations such as the Federal Land Banks and the Federal National Mortgage Association.

4/ Data on direct loans comes from Special Analyses, Budget of the United States Government, Fiscal Year 1976, Tables E - 4 and E - 9, p. 87 and 93.

5/ Data on guaranteed loans comes from Special Analyses, Budget of the United States, Fiscal Year 1976, Table E - 7, p.91 .

N.A. - not applicable

Within the direct loan category, government-sponsored private corporations, such as the Federal Land Banks and the Federal National Mortgage Association provide a major share of net direct loans, accounting for 54 percent of the total in fiscal 1974, 53 percent in 1975, and 52 percent in 1976.

These government - sponsored corporations are of particular interest when considering a new RFC-style credit program, since they were created specifically with the objective of providing credit to particular sectors of the economy such as housing and agriculture.[1/] The outlays of these corporations basically are for net loans, and reflect primarily the difference between loan disbursements and loan repayments. The first government-sponsored corporations, like many RFC-type proposals, were financed through the issuance of capital stock to the Treasury, and by the sale of obligations on the financial markets. Over the years, the corporations financed in this manner bought back the stock, and have become privately owned, Government-sponsored corporations. As such, their activities are not reflected in the Budget of the United States and are not reviewed by the Office of Management and Budget.

1/ The seven government sponsored privately owned enterprises are the Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives, the Federal Home Loan Banks, Federal Home Loan Mortgage Corporation, and the Student Loan Marketing Association.

In fiscal years 1975 and 1976, Federal credit programs are expected to continue to provide a large volume of new loans and guarantees to certain sectors of the economy. Net Federal loans and guarantees provided during fiscal year 1974 were $26.6 billion, and are estimated at $31.3 billion in fiscal 1975 and $28.7 billion in fiscal 1976. More detail on net yearly figures is found in table 2.

This high volume of direct and guaranteed credit is part of a trend of increased Federal participation in domestic credit markets. For example, in fiscal 1965, total funds advanced in U.S. credit markets to nonfinancial sectors excluding equities, (i.e. stock), totalled $69.3 billion, of which $8.9 billion, were Federal loans and guarantees. Each year since then both the dollar volume of Federal participation and the total of all funds advanced has increased, reaching, in fiscal 1974, a Federal participation of $26.6 billion of the $177.2 billion advanced. Additional detail on Federal participation in domestic credit markets is found in table 3. This table shows that if only funds raised through marketable securities, such as bonds but not stocks, is considered, the rate of Federal involvement is even higher, though subject to ups and downs. It went from 2 percent in fiscal 1967, to 47 percent in fiscal 1973, and down to 26 percent in fiscal 1974. If will probably be high in fiscal years 1975 and 1976 when Federally-assisted market issues are estimated to reach $62 billion and $80 billion respectively.

Table 2

NET ANNUAL TOTAL GUARANTEES AND LOANS OF FEDERAL CREDIT PROGRAMS, FISCAL 1974, 1975 AND 1976
(in millions of dollars)

	Fiscal years		
	1974 actual	1975 estimate	1976 estimate
Guarantees 1/			
Total	$ 6,247 4/	$ 825 4/	$7,696 4/
Loans			
wholly owned Government enterprises (except off-budget agencies) 2/	1,929	614	3,372
Off-budget agencies 2/	2,155	14,955	8,925
Government Sponsored Corporations 3/	16,259	14,937	8,696
Total	20,343	30,506	20,993
Grand total	26,590	31,331	28,689

1/ Special Analysis, Budget of the United States, Fiscal Year 1976, table E-7, p. 91.

2/ Ibid., Table E-4, p. 87.

3/ Ibid, Table E-9, p. 93.

4/ Many loan guarantees are converted to direct loans when acquired by government agencies. This occurs when a loan guaranteed by a government agency to a private lender is later purchased by a government agency. In this situation, the purchasing agency buys the debt obligation from the private holder of the debt. The borrower in turn now pays back the Federal agency. In this manner, the guarantee becomes a direct loan. The Federal National Mortgage Association, for example, acquired $3.7 billion of guarantees in fiscal 1974, they are estimated to acquire another $3.7 billion in 1975, and $2.4 billion in fiscal 1976, while the Federal Financing Bank is expected to acquire $10.6 billion of guaranteed obligations in fiscal 1975, and an estimated $5.8 billion in fiscal 1976.

TABLE 3

FEDERAL PARTICIPATION IN DOMESTIC CREDIT MARKETS (billions of dollars)

	Actual										Estimates	
	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976
Total funds advanced in U.S. credit markets to nonfinancial sectors [1] (excluding equities)	69.3	73.3	58.7	92.5	95.8	85.3	111.8	143.6	185.1	177.2	(5)	(5)
Advanced under Federal auspices	8.9	10.1	5.8	14.9	15.0	17.4	16.5	22.0	26.1	26.6	31.3	28.7
Federal participation rate (percent)	13	14	10	16	16	20	15	15	14	15		
Total funds raised in U.S. credit markets by nonfinancial sectors [1]	69.3	73.3	58.7	92.5	95.8	85.3	111.8	143.6	185.1	177.2	(5)	(5)
Raised under Federal auspices [2]	10.2	8.7	1.1	31.3	11.3	16.4	32.3	39.7	46.9	24.1	57.9	78.9
Federal participation rate (percent)	15	12	2	34	12	19	29	28	25	14		
Funds raised through marketable securities												
Market total (including CD's) [3]	25.6	29.0	27.7	52.2	36.5	52.2	72.7	79.4	86.9	95.7	(5)	(5)
Raised under Federal auspices [4]	6.1	6.5	.6	27.2	6.3	18.1	25.1	30.8	41.0	25.1	62.4	80.0
Federal participation rate (percent)	24	22	2	52	17	35	35	39	47	26		
Market total (excluding CD's) [3]	21.9	26.0	26.9	52.1	40.5	53.3	58.3	72.1	63.1	74.9	(5)	(5)
Raised under Federal auspices [4]	6.1	6.5	.6	27.2	6.3	18.1	25.1	30.8	41.0	25.1	62.4	80.0
Federal participation rate (percent)	28	25	2	52	16	34	43	43	65	34		

[1] Source: Federal Reserve Board Flow of Funds Statement (fiscal year data).
[2] Estimates from table E-10.
[3] Includes open market paper and bonds sold by financial intermediaries (compiled from FRB Flow of Funds data).
[4] Includes borrowing by sponsored enterprises and Federal Government plus all guaranteed loans in form of security market issues.
[5] Not estimated.
[6] CD's are negotiable commercial bank certificates of deposit of $100 thousand and over.

Source: Special Analyses, Budget of the United States Government, Fiscal Year 1976, Table E-1, p. 83.

The meaning of these statistics in relation to a new Federal credit program based on RFC experience is that the United States Government is already heavily involved in the provision and allocation of credit to the private sector through its several score loan and guarantee programs. The programs are engaged in the de facto allocation of credit. This allocation is done primarily through direct Federal borrowing on the nation's financial markets and by loan guarantees. In the case of direct borrowing, the Treasury, government agencies, and government-sponsored corporations borrow funds in the private market by selling their obligations, which in one way or another are backed by the U. S. Government. Because of this backing, these obligations carry a low degree of risk, and in most cases are highly liquid, meaning they can readily be resold if the need arises. As a result, issuers of such obligations pay a lower rate of interest than private borrowers. The funds raised are then lent to private borrowers who would otherwise not be able to obtain credit at as favorable a price or possibly not at all. In the case of a guarantee, the Federal Government in one way or another guarantees to a private lender that should there be a default by the borrower, the lender will be paid. Such a guarantee enables the borrower to obtain money at a lower rate of interest than would otherwise have been possible.

Many economic sectors eligible for proposed RFC-style assistance received some of the $26.6 billion in Federal credit assistance provided during fiscal 1974. In that year housing received Federal credit

assistance totalling $20.8 billion, or 78 percent of all Federal credit assistance advanced, while loans and guarantees directly related to business totalled $1.1 billion. More detail on these figures, as well as estimates for fiscal years 1975 and 1976 is contained in table 4. These estimates show that housing is still expected to receive a major share of credit assistance, totalling 60 percent in fiscal 1975, and 57 percent in fiscal 1976.

Table 4

NET LOANS AND GUARANTEES TO HOUSING AND BUSINESS IN FISCAL 1974, 1975 AND 1976 BY AGENCY +
(in millions of dollars)

	1974 actual	1975 estimate	1976 estimate
Housing			
Housing and Urban Development Department			
loans 1/	-39	285	-113
guarantees 2/	2,776	3,476	7,254
Federal Home Loan Bank System			
loans 1/	-20	-2	
guarantees 3/	3/ 7,640	6,453	1,270
Federal National Mortgage Association	4,756	4,646	3,491
Veteran's Administration			
loans 1/	-54	-343	-139
guarantees 2/	5,727	4,179	4,555
Housing total	$ 20,786	18,694	16,318
Business			
Small Business Administration			
loans 1/	126	86	127
Guarantees 2/	914	728	1,040
Economic Development Administration: loans 1/	14	21	15
Emergency Loan Guarantee Board 2/	70	30	-30
Business total	1,124	865	1,152
Total of all Federal loans and guarantees 4/	26,600	31,300	28,700
Housing sector as a percentage	78	60	57
Business sector as a percentage	4	3	4

1/ Special Analyses, Budget of the United States Government, Fiscal Year 1976, Table E-4, p. 87.
2/ Ibid., Table E-7, p. 91.
3/ Ibid., Table E-9, p. 93.
4/ Ibid., Table E-1, p. 83.

* Less than half a million dollars

\+ Other sectors of the economy not included in this table are agriculture, education, health, international assistance, and transportation.

The Private Sector

The private sector, even with the large and growing Federal participation in credit markets, is the major source of funds for the nation's economy. Flow of funds data indicate that in calendar year 1974, $194 billion was advanced in the credit market by non-financial sectors.[1/] Of this total, $51.5 billion was advanced by the U. S. Government, government - sponsored corporations, and Federal agencies, $19.1 billion was advanced by foreign sources and U. S. monetary authorities, and $123.4 billion by the private sector. In proportional terms, 64 percent of the funds advanced came from private sources, 27 percent from the U. S. government, government-sponsored corporation and government agencies, and 9 percent from monetary authorities and foreign investors. In calendar year 1973, $200 billion was advanced in the credit markets, of which 74 percent was private, and in 1972, $165 billion was advanced; of which 85 percent was private.

Various sectors of the economy such as state and local governments, households and corporations obtain funds in the credit markets through a variety of credit instruments including, among others, mort-

1/ Federal Reserve Bulletin, February 1975, Direct and Indirect Sources of Funds to Credit Markets, p. A 59. The total is derived by adding line 1, total funds advanced in credit markets to nonfinancial sectors, with line 11, Agency borrowing not included in line 1. The total adds up to the total of line 2, total net advances by public agencies and foreign, and line 12, total net advances private domestic funds. This method is used to compute the other total amounts advanced in credit markets for other years when using this source

gages, consumer loans, commercial bank loans, commercial paper, stocks, and bonds. The ability of corporations and firms to obtain funds is based on their availability, the willingness of investors to invest, and the interest paid on the obligation.

The call for additional assistance through an RFC-style organization has been prompted by a reduced availability of credit at low cost for many firms through traditional credit sources. Three of the more important sources are equities, commercial bank loans, and bonds.

The total net value of corporate equities sold annually has been declining since 1971, when, according to Salomon Brothers, the total net issuance of corporation common and preferred stock reached $13.5 billion. The value sold in 1974 is estimated at $3.2 billion, and 1975 is projected at $3.8 billion.[1/] This poor reception of equities is due to the falling prices on the stock market, and thus does not offer many firms a viable way of raising funds.

Commercial bank loans have also been a source of funds for corporations and other business enterprises, but the volume of these loans declined in 1974, and is projected to decline in 1975.

1/ Salomon Brothers, "Supply and Demand for Credit in 1975," New York, 1975, Table IIIC, p. 15. This publication, using flow of funds data, provides a consolidated tabulation of stocks and bonds sold, as well as other financial data in an easy to read form, along with Salomon Brothers 1975 projections.

According to Salomon Brothers, commercial bank loans were $48.9 billion in 1974, down from $72.9 billion in 1973. They are projected to fall to $29.9 billion in 1975.[1/]

This drop in the funds advanced by commercial banks was caused by circumstances facing these institutions in 1974, which continue to influence them in 1975. These include the changing pattern of foreign exchange rates, difficulties in handling the inflow of petrodollars, higher than average losses, and a lack of confidence caused by a number of bank failures within the last year, including the Franklin National Bank, the Security National Bank and the Northern Ohio Bank.

Commercial bank lending practices are based on the assumption of certain preconceived "normal" conditions. A change in these conditions affects the ability of banks to provide credit. Among the factors considered normal is a favorable climate for the extension of loans. The banking system expects a favorable return on investments and the timely repayment of interest and principal. Banks are able to make the maximum contribution to the nation's welfare when there is a stable economic climate, full employment, stable prices and wages, and increasing industrial production. A corollary is that banks' customers are in sound financial condition with good earnings prospects. In addition, lending policies are affected by

1/ Salomon Brothers, op. cit., Table X, 1. 23.

the condition of banks themselves, and the limits of credit creation imposed by their internal condition. Even when banks make loans, their contribution to economic recovery is determined in part by the purposes for which the loans are used. Loans contribute to economic expansion when they are used for productive purposes, not speculative and inflationary ones.

At the present time these conditions are not being met. Unemployment is high, prices and wages are unstable, and the GNP has been declining. Many bank customers, including major corporations, are facing economic difficulties. Pan American World Airlines, Inc., Lockheed Aircraft Corporation, and W. T. Grant Company, are extreme examples, but they are symptomatic of problems elsewhere in firms both large and small. This is backed up by Dun and Bradstreet, Inc. statistics on bankruptcies which show a four year high reached in 1974, with debts of failing companies reaching $3 billion.

The concern about customers credit worthiness by banks is justified considering the bankruptcy data, and bank loan losses. In 1974, for example, 17 large bank holding companies, including Citicorp, Chase Manhattan, and Bank America, had net charge-offs to bad loans totalling $640.5 million. In 1973 the charge-offs of the same 17 were $394.8 million, indicating a 63 percent increase between 1973 and 1974 [1/]

1/ Stanley Strachan, "Banks Dig In For Shaky Loans, "New York Times, February 2, 1975.

Other estimates indicate that bad loan losses by banks totalled $2 billion in 1974, up from $1 billion in 1973.[1] The expectation is that in 1975 loan losses will be as high as in 1974, if not higher.

These loan losses reflect the poor financial condition of some corporations, and result from several trends affecting the financial structure of American corporations. One of these is the steady increase in corporate debt, and corporations increasing reliance on short-term loans and debt instruments to finance their operations. A clear description of this problem of corporate debt and its impact on the demand for funds in financial markets relating to 1974 taken from a Morgan Guarantee Survey follows:

1/ Edward Foldessy, "Widening Margin: Banks Try to Offset Loan Losses By Keeping Interest Charges High," Wall Street Journal, February 13, 1975.

Corporate debt, at $1.4 trillion at mid-year, was $40 billion larger than the nation's GNP at mid-year. Debt of corporations has been growing about as fast as debt of individuals. . . .

The rise in corporate debt increasingly has been showing up in short-term borrowings (bank and finance company loans, open market paper) as distinct from long-term debt (bonds). In the first three quarters, for example, short-term debt of corporations rose more than $34 billion, compared with a rise of $14 billion in long-term debt. Over all, about half of the total debt (excluding mortgage debt) of nonfinancial corporations outstanding at the end of September was short-term debt. In the mid-1960s, in contrast, only about 40% of corporate debt was short-term, and in the mid-1950s the share was only 35%. As corporations' debt-maturity structure has grown noticeably shorter, it has, of course, forced companies to make frequent borrowings and has subjected them more often to the vicissitudes of the money market.

Corporations, to be sure, are not unaware of this, and have apparently grown uncomfortable with the heavy weight of their short-term debt. Recently, spurred by gently declining bond rates and the apparent conviction that not much more early improvement in long-term interest rates is likely, corporations have sharply stepped up their bond flotations, many for the expressed purpose of funding bank borrowing and other short-term obligations. It is now estimated that the gross proceeds from bond issues will probably exceed $10 billion in the fourth quarter—in contrast to a quarterly average of about $7.5 billion in the first three quarters and only $5.5 billion per quarter in 1973.

Refinancing of past debt is, of course, much more costly (4% bonds of 25 years ago may now have to carry coupons of 9%). Simply looking at debt aggregates, thus, can understate the real and mounting debt burden. Increasingly, however, corporations have had no choice but to go into debt to finance plant expansion, to add to inventories, and to meet other business expenses. The reason: internally generated funds (principally profits and depreciation allowances) have proved to be inadequate. . . .

In the 1950s and early 1960s corporations generated internally $3 out of every $4. By the late 1960s the proportion raised externally began to rise sharply. This year, internally generated funds will pay for only about half of corporate spending.

One consequence of burgeoning corporate borrowing has been a steep rise in the ratio of debt to stockholders' equity in American manufacturing corporations. A decade ago, for instance, all manufacturing companies combined had only $20 worth of debt for each $100 of equity. By the end of 1973 the debt-equity ratio had doubled—to more than $40 of debt for each $100 of equity.

Conventional yardsticks indicate deterioration in recent years in over-all corporate debt quality. One possible indicator is the so-called corporate liquidity ratio—the ratio of nonfinancial corporations' cash, government securities, and other short-term assets to current liabilities. That ratio has declined steadily: in the early 1960s current assets amounted to 120% of current liabilities and by the end of the third quarter of this year this measure was down to 51%. As a consequence, corporations have a reduced ability to cope comfortably with debt repayment and to withstand temporary income interruptions. 1/

1/ The Morgan Guarantee Survey, "Debt--How Heavy a Burden?," November 1974, pp. 6-7.

These financial problems of corporations help to explain the current reduction in the volume of commercial loans by commercial banks. If banks expect difficulties in collecting outstanding loans, they are going to be much less likely to provide significant new amounts of credit, no matter how much of an easy money policy is pursued by the Federal Reserve.

The more conservative bank lending policies of commercial banks, and their potentially adverse effects on economic recovery have been commented on by officials of the Office of the Comptroller, the Federal Reserve Board, and the Federal Deposit Insurance Corporation. James Smith, Comptroller of the Currency, in a talk before a meeting of the American Bankers Association, suggested that banks should not be too restrictive in their lending practices, and should be "important participants in causing an economic recovery to get under way."[1] John E. Sheehan, a governor of the Federal Reserve Board, at the same meeting felt banks could make more credit available to encourage economic expansion to credit worthy firms, and not use the financial condition of the bank as an excuse to deny this credit. Frank Wille, chairman of the Federal Deposit Insurance Corporation, before another American Bankers Association Conference, said:

1/ Edward Foldessy, "Banks Should Step Up lending to Spur Economy, 2 High-Level Regulators Urge," Wall Street Journal, March 5, 1975.

2/ Ibid.

> At a time when the economy is declining, the reluctance of the commercial banker to grant loans adds to the contractionary forces in the economy and will delay or retard our overall recovery from recession. Bankers can perform a needed public service now by resisting overly conservative inclinations and by moving aggressively to respond to the needs of credit-worthy borrowers. 1/

Bonds are another source corporations may use to finance their operations. The bond market in recent years has become an important and growing source of funds for industry. In 1974 net bond sales totalled $24.7 billion, almost double the $12.7 billion sold in 1973. It is estimated that in 1975 corporate bond sales may increase to $31.1 billion. 2/ This corporate reliance on the bond market is due to the fact that equity financing has declined and the volume of commercial bank loans is also declining.

The bond market, though, is not a source available to many less credit worthy firms. The heavy demand on the bond market is in large degree the result of borrowing by corporations with good ratings, and even these corporations can pay high interest rates. In February 1975, for example, an Aaa corporate bond yielded, on the average, a return of 8.62 percent, as Aa bond 8.81 percent, an A bond 9.47 percent, and a Bbb bond, 10.43 percent. This is a spread of 1.81

1/ FDIC News Release, "Financial Planning for Banks and Bank Holding Companies in a Changing Economy," Address by Frank Wille, February 20, 1975, PR 11-75 (2-20-75)

2/ Salomon Brothers, op. cit. p. 12.

percentage points between Aaa and Bbb. 1/ A year earlier, in February 1974, Aaa bonds had an average yield of 7.85 percent and Bbb 8.59 percent, a spread of .74 percentage points, and in February 1973, Aaa bonds had an average yield of 7.22 percent and Bbb, 7.97 percent, a difference of .55 percentage points. 2/

The high cost of funds on the bond market and the wide spread between high and low rated bonds discourages many less credit worthy firms from using this approach to obtain funds. In addition, many firms in financial difficulties, who would be recipients of RFC-style assistance, may have had their ratings downgraded to reflect their condition. This could substantially increase their borrowing costs on the bond market. In 1974 alone some fifty companies had their ratings downgraded. 3/

Even with these problems though, the level of corporate bond activity is expected to be high in 1975. A Bankers Trust projection for 1975 was that corporate demand would be heavy, but that investors would be looking for high quality issues of relatively short maturity. 4/ This analysis was in line with that of Salomon Brothers, which sees a high level of activity with increased investor concern over safety, coupled with interest in medium term bonds. 5/

1/ Moody's Bond Record, March 1975, p. 139.
2/ Ibid.
3/ Business Week, "The Crushing Burden of Corporate Debt," October 12, 1974, p. 54.
4/ Money Manager, "Corporate Bonds," February 18, 1975, p. 47.
5/ Salomon Brothers, *op. cit.*, p. 6.

The private credit markets, which have traditionally been the source of a large proportion of funds for corporate and other economic activity, have not been able to function at the level necessary to satisfy demand. This is due to lenders and investors becoming increasingly selective in advancing funds, combined with the shaky financial condition of some prospective borrowers. Those who favor expanded Federal credit assistance are concerned that the loans and investments which are made by the private sector will not be extended to those companies, industries, or sectors, which, while they cannot meet economic criteria for private sector financing, may be engaged in activities of high social priority. Proponents thus argue that an RFC might perform two roles to supplement the private market: 1) direct credit extensions or capital infusions when companies or other borrowers cannot obtain funds in the private markets, and 2) guarantees in instances where private market financing would be forthcoming with this additional security.

Conclusion

The call for a new RFC-style credit organization is based on the belief that both Federal credit assistance and private lenders and investors are not reaching certain potential borrowers. Sponsors of the proposals believe that a new Federal credit program, in addition to the many which already exist, would help those borrowers currently unable to obtain funds. At the present time the private sector is unable

to provide a "sufficient" level of credit because of problems in the equity and bond markets, and more restrictive commercial bank lending policies. The demand for funds by private firms has not declined, even though there is a recession. This heavy demand for credit by business is not in line with past experience. During the 1957-1958 and 1960-1961 recessions there was a significant decline in corporate demand, and only small increases duriing the 1953-1954 and 1969-1970 recessions.[1]

The RFC concept proposals raise a number of questions. Since no new credit is created directly, but the existing pool simply reallocated, would a new Federal program freeze out certain borrowers who now obtain credit on the private market? Would this result lead to demands for additional programs for those frozen out? Further, is another Federal credit program needed, when there are already a host of such programs helping many sectors of the economy. If the Small Business Administration, the Federal Loan Guarantee Board, the Economic Development Administration, the Farmers Home Administration and the variety of housing credit programs have not been able to provide the necessary credit through the billions they have allocated why is a new program, which will work along with these currently operating programs, do any better?

1/ Money Manager, "Unparalleled Financial Roadblocks to a Quick Recovery," November 25, 1974, p. 3.

Perhaps part of the current problem in credit availability is that there is a lack of coordination among present Federal programs, and an unwarranted belief that credit alone is sufficient to revive certain sectors of the economy. In fiscal 1974, $26.6 billion was provided in Federally assisted credit. It is estimated that the figure will be $31.3 billion in fiscal 1975, and $28.7 billion in fiscal 1976. This is without any new RFC style program. Each credit program operates basically on its own, pursuing its own particular goals. There is no comprehensive policy on how credit assistance is going to be used. Perhaps in order to be more effective some Federal decisions have to be made on national credit priorities. If there is only so much federally subsidized credit available in a year, which sectors are going to come first? It is housing, energy, electric utilities, the environment? What occurs at the present time is that no targets are set. Specific credit programs are enacted in the belief that they will help solve the particular problem they are addressed to.

Credit assistance alone, as an examination of some of the Federal government's current efforts shows, is not always sufficient. Billions of dollars have been allocated to housing, yet the industry is hard hit by the recession. The Lockheed Corporation was provided with a $250 million loan guarantee, yet it is still in severe financial difficulties. Millions have been provided to the Northeastern railroads, and they are still in desperate financial shape. In many

of these cases credit alone may not be sufficient to overcome the problem. It may also require some kind of Federal commitment to the industry or economic sector justified on more than narrow economic grounds. Housing and railroads have many social, political and macroeconomic impacts which may justify assistance. Aiding Lockheed and other financially troubled corporations in many cases may not work if success is judged by profit and loss, since they are in severe financial difficulties. Assistance to these firms may be justified though, depending on the social, political, and macroeconomics returns they give.

An RFC-style organization could be used to promote these broader goals when this is not being done by other Federal credit programs. The RFC could also help to relieve the pressure on Congress to assist firms on a company by company basis, and might provide the framework for a more orderly allocation of credit by the Federal government. Some opponents take issue with these purposes as ill advised functions of government; others find the purposes worthy but the RFC-style organization less well suited to them than other alternatives.

CHAPTER II - LEGISLATIVE, PROPOSALS

This section looks at three bills introduced in the first session of the 94th Congress which would create an RFC-style organization or a national development bank. It briafly outlines the purpose, organization, eligibility requirements, assistance offered, and funding provisions of each bill. The proposals reviewed are H.R. 803, the Reconstruction Finance Corporation Act of 1974; S. 21, the National Development Act of 1975; and S. 321, the Economic Revival and Development Act of 1975.

H.R. 803 - The Reconstruction Finance Corporation Act of 1975

Purpose: The bill would establish the Reconstruction Finance Corporation (RFC) which would assist businesses unable to otherwise obtain financing.

Organization: The RFC would be a government-sponsored and owned corporation. It would be run be a six member board of directors consisting of the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve, and four others appointed by the President. No limit is set on the life of the corporation.

Eligibility: Eligible recipients for assistance would include any individual, corporation, company, firm, partnership, society or other entity engaged in the manufacture of goods or provisions of services,

as well as an enumerated list of financial institutions. In order to receive assistance applicants must have not been able to obtain assistance from other sources. Priority is given to applicants engaged in providing products or services in which shortages are perceived to exist, or who are engaged in activities deemed in the public interest.

Assistance: The corporation could provide direct loans or loan guarantees, or it could purchase the stock, capital notes, or debentures of enterprises which could be used for: 1) the expansion of a facility or the purchase of supplies and materials; 2) working capital; 3) payments of debts and obligations. The maximum guaranteed loans outstanding could be $2 billion and could extend for a maximum of ten years. Loans could be for a maximum of 12 years, and would bear a rate of interest the same as the current average yield on all outstanding obligations of the United States. The maximum amount of a loan could be up to 5 percent of the RFC's outstanding capital stock and bonds.

Funding: The RFC would be financed by the sale of up to $2 billion worth of capital stock, which would be purchased by the Treasury, and RFC bonds, notes, and other obligations sold to the Treasury and the general public. The amount of RFC obligations outstanding could total three times the subscribed capital stock. These obligations of the corporation could be for a maximum of 12 years;

they would be guaranteed by the United States Government, and would be exempt from State and local taxation.

Audit: The RFC could obtain information on the condition of applicants for, and recipients of, assistance from among others the Treasury, the Comptroller of the Currency, the Internal Revenue Service, as well as all other Federal departments, agencies, commissions and boards. In addition, firms would have to give the corporation the right to audit them as a condition for receiving assistance.

S. 321 - The Economic Revival and Development Act of 1975

Purpose: The purpose of the bill is to provide assistance to firms in times of recession, which is not defined, whose failure would increase unemployment and dislocation, as well as to provide assistance to firms unable to obtain financing when they serve a public purpose. The ultimate aim is to unlock the potential of the nation's economy, expand economic opportunity, stimulate development, reduce unemployment, and promote economic stability.

Organization: The bill would create the Restoration Finance Corporation, which would be a government sponsored and owned corporation. Its life would extend until January 1, 1980. It would be run by a seven member board consisting of the Secreatry of the Treasury, the Secretary of Commerce, the chairman of the Federal Reserve Board, and four others appointed by the President.

Eligibility: Business concerns are defined as any person eligible for assistance. Those uneligible for assistance are: 1) persons receiving assistance under the Regional Rail Reorganization Act of 1973; 2) monopolistic of ologopolistic firms other than electricity or energy producers; 3) persons able to obtain financing elsewhere, and 4) firms which do a large amount of business with the Federal government. The bill requires that at least 25 percent of the lending assistance go to the agricultural, housing, and small business sectors of the economy.

Assistance: The Restoration Finance Corporation would provide loans and loan guarantees to firms for: 1) plant expansion and the purchase of equipment and materials; 2) working capital; 3) payment of debts; 4) economic development activities and 5) other undefined purposes. Loans to corporations with assets over $50 million would be evaluated by a special panel. Interest on loans would take into account the current average yield on outstanding marketable obligations of the U. S. of comparable maturity issued in the preceeding year. Guarantees made by the corporation would in most cases be for 50 percent of the loan, going up to 80 percent in exceptional cases. Interest rates on the guarantees would be at currently prevailing rate for similar private obligations.

The corporation could charge up to 1/2 percent for the investigation of applicants, and a premium charge up to 1 percent for the

guarantee. The limit of assistance to a firm would be 1 percent of the outstanding stock and obligations of the Restoration Finance Corporation.

Funding: The corporation could issue up to $3 billion in capital stock, which the Secretary of the Treasury is authorized to purchase. The corporation could issue notes, debentures, bonds and other obligations with a value up to ten times the paid in capital stock. The corporation's obligations would be guaranteed by the United States.

The receipts and disbursements of the corporation, other than its administrative expenses, would not be included in the budget totals of the U.S. and would not be included in the public debt limit.

Audit: The Reconstruction Finance Corporation, GAO, or another representative of the corporation would have the right to audit firms receiving assistance. The Senate and House committees having jurisdiction would exercise continuing oversight.

S. 21 - National Development Act of 1975

Purpose: The legislation would establish the National Development Bank to provide loans to build public facilities, provide loans to business and industry, and fund low and moderate income housing projects.

Organization: The National Development Bank would be an instrumentality of the United States with the general corporate powers of a corporation organized under the laws of the District of Columbia. There would be fourteen members on the board of directors including the Secretaries of the Treasury, Housing and Urban Development, Agriculture, and Labor, as well as ten others appointed by the President. No limit is set on the life of the bank.

Eligibility: There are no clear eligibility standards which restrict the types of firms or individuals who may apply.

Assistance: Loans, loan guarantees or the purchase of the obligations of a firm could be used for the establishment of new firms or the expansion of old ones in defined depressed urban areas. Recipients must agree to fill a certain number of jobs with under or unemployed inidviduals and to provide job training.

Loans, loan guarantees and the purchase of obligations would be provided for capital expenditures for public works and community facility projects.

Loans and loan guarantees would be provided for low and moderate income housing projects participating in insured and guaranteed low and moderate income housing loan programs of the Department of Housing and Urban Development, the Veterans Administration, and the Farmers Home Administration.

Interest rates on loans are the interest on marketable U. S. bonds maturing in 6-12 years, exclusive of those at less than six percent, plus one-half percent. Guarantees may be made for 100 percent of the loan at a rate not more than one and one-half percent above the Federal Reserve Rediscount Rate.

Technical assistance would also be provided, under the legislation

[illegible] could issue capital stock worth up to $5 billion, which would be subscribed to by the Federal Financing Bank, located in the Treasury Department. The bank could also issue notes, debentures, bonds and other evidence of indebedness equal to twenty times the paid in capital stock of the bank. The obligations of the bank would be guaranteed by the United States. In the case of default by the bank on its obligations, these obligations would be purchased by the Federal Financing Bank. The bill specifically states that the obligations of the bank would not be tax exempt.

Audit: The GAO is empowered to audit the financial transactions of the bank.

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