

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

To Board of Governors

From Eleanor J. Stockwell

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REC'D IN RECORDS SECTION
Date June 30 1970
Subject: Some Considerations With Respect
To Direct Lending Under Paragraph 3.

This is a preliminary review of some general and specific questions that might need to be faced in developing a program for direct loans, under paragraph 3 of Section 13, to businesses unable to obtain the bank credit they needed to tide them over a real but temporary threat of bankruptcy.

The staff assumes that, if paragraph 3 were to be used for this purpose, general guidelines would be provided in order to permit Reserve Bank officers to make as many of the loan decisions as possible and to assure reasonable uniformity throughout the System. The provisions of the guidelines would depend importantly on how broadly the Board wished the paragraph 3 authority to be applied.

First, how much risk would we be prepared to accept? The paragraph apparently precludes loans of obvious low quality but appears at the same time to permit some flexibility of interpretation. Under a narrow interpretation,^a Reserve Bank might be requested to approve only loans it felt to be of such high quality that there was practically no question that the loan would be repaid on schedule; however, disapproval of loans that appeared to be of somewhat lower quality might jeopardize the solvency of other businesses. A more liberal interpretation might give less weight to assured high quality where appropriate in the national interest; it should be recognized that, under

such an interpretation, Reserve Banks might make some loans to giant companies on which the borrower would default.

Second, given the emergency nature of the financing need, how much time and effort would a Reserve Bank be expected to devote to obtaining evidence that the business "is unable to secure adequate credit accommodations from other banking institutions"? And how is "adequate" to be interpreted? Would there be circumstances under which a paragraph 3 loan could be extended to an applicant who had refused a loan offered by a bank because the terms and conditions specified were unacceptable?

Third, what constitutes "unusual and exigent circumstances"? Must there be some potential injury to the general economy or at least to other businesses, if a particular firm should fail? In a sense, this is the converse of asking whether, despite its strong economic and administrative justification, it is politically feasible for size of business to be a criterion.

Fourth, should industry be a criterion? Selectivity on this basis might be a problem, since one provision of paragraph 3 seems to restrict the kinds of businesses to which loans may be extended to those that hold, or generate from their operations, paper that is eligible for discount. Most, but not all, industries typically have accounts receivable evidencing sale of goods and, within certain limits, these constitute eligible paper.

Fifth, what types of credit difficulties should be relieved by Reserve Bank loans if commercial bank loans are not available? Currently the major difficulties appear to center on commercial paper issuers. But equally serious problems might be faced by a corporation that was temporarily unable, because the underwriter thought market congestion too great, to float a planned security issue that was to have provided desperately needed funds, and the company was unable to obtain a bank loan to bridge the gap in timing. Similarly, inability to renew maturing bank or finance company loans, where renewal had been expected in the normal course, could easily produce corporate insolvency.

In addition to general questions such as these, there are others specifically related to the particular circumstances that resulted in denial of credit to a necessitous borrower. Three possible situations have been suggested; there might also be others, but these three illustrate some of the problems.

First,--the most likely and most difficult to handle--there might be a situation in which banks are not particularly strapped for funds but have become, to our way of thinking, unduly conservative in their lending policy. The conservatism may result from a pessimistic view with respect to general economic prospects or to prospects for particular borrowers. Or it may reflect more a reappraisal of the current scene. Hard evidence that some well-known companies are close to insolvency, and rumors that others are in an equally weakened

condition, may have persuaded banks that their credit analysis in the recent past has not been sufficiently rigorous, that the present creditworthiness of even their presumably "best" customers needs to be reviewed, and that improvement in the overall quality of their loan portfolio requires the imposition of very strict lending standards on new credits. Whatever the reason, the result is the same: borrowers that were formerly creditworthy are no longer considered to be so; bank lines that are not legally binding may not be honored; and a company that must have a short-term loan to survive and, in our view, would be able to repay such a loan, will fail--possibly taking others down with it.

The biggest question about our stepping in to this kind of situation probably arises because, in making a paragraph 3 loan to a necessitous borrower that a commercial bank did not consider creditworthy, the Reserve Bank would be substituting its judgment of creditworthiness for the bank's and would run a grave risk of making a very bad loan. It may be that the commercial bank's standards are tougher than we think is justified. But it may also be that the bank knows more than we do about a particular borrower. The borrower may have paper that is eligible for discount; the company's most recent financial statement may indicate that this firm has suffered no greater deterioration in profits or erosion in liquidity than other firms in its industry or than the company itself has weathered on earlier

occasions. But financial statements are not always completely candid documents and, even when they are, a firm's financial position can change rapidly.

If the Reserve Bank had access to all pertinent information about the borrower, a decision could then be made as to how much risk it was both legal and appropriate, in an economic sense, for the Reserve Bank to assume; but private lenders cannot be expected unfailingly to reveal unfavorable facts to which they are privy.

The Reserve Bank, of course, could not make the paragraph 3 loan unless the borrower's notes were either endorsed or otherwise secured to the Reserve Bank's satisfaction, and it has been suggested that Reserve Banks would probably be willing to take the commercial bank's endorsement as evidence that the loan did not involve undue risk. However, it has also been suggested that there would be very few cases where a bank was able but unwilling to make a loan and was nevertheless willing to endorse the borrower's notes. Thus, there may be some hesitancy to use paragraph 3 loans to make any sizeable contribution to the relief of this first situation.

A second possible situation is one in which the stance of monetary policy does not provide member banks with enough funds to accommodate all creditworthy applicants, and certain applicants that we would like to see accommodated are instead denied credit. In this kind of situation, we would have, not a different assessment than the

bank of the borrower's creditworthiness, but a different set of priorities. There are of course any number of reasons why a bank prefers one credit-worthy borrower over another; local needs or past relationships may take precedence over the national interest.

A paragraph 3 loan would be feasible in this situation, since the bank considers the borrower to be creditworthy, is unable--given its own priorities--rather than unwilling to make the loan, and presumably would be willing to endorse the borrower's notes. Some way would need to be found to assure that the bank's priorities were not influenced by the availability of Federal Reserve assistance; it would be an abuse of the paragraph 3 backstop if banks channeled all their own available funds into the highest quality non-emergency loans and then sent borrowers in need of emergency financing to the Reserve Bank.

However, the staff is of the opinion that this second kind of loan situation may not need to go the paragraph 3 route--that the simplest, most appropriate way to handle it would be through the discount window.

A third kind of situation is one in which a bank wants to make a loan to a particular borrower but is unable to because it is already at its lending limit for that borrower, and there is not time to negotiate new lines with other banks. If the loan were one that

we would like to have made, a paragraph 3 loan would seem appropriate, though a problem might arise if the borrower did not have paper that was eligible for discount.

These reflections relate to the use of paragraph 3 on a more or less formal basis to provide funds for some substantial number of businesses. If the paragraph were used on an ad hoc basis to cope with, hopefully isolated, cases as they develop, answers to some of the questions raised could be deferred, and might emerge gradually over time. However, the cases that are now surfacing are of the touchiest type--that is, they require that we weigh the importance of the national interest against the banking community's judgment as to the soundness of the credits.