Volume Title: Term Lending to Business

Volume Author/Editor: Neil H. Jacoby and Raymond J. Saulnier

Volume Publisher: NBER

Volume ISBN: 0-870-14129-5

Volume URL: http://www.nber.org/books/jaco42-1

Publication Date: 1942

Chapter Title: Characteristics of Term Loans

Chapter Author: Neil H. Jacoby, Raymond J. Saulnier

Chapter URL: http://www.nber.org/chapters/c5753

Chapter pages in book: (p. 47 - 72)

4

Characteristics of Term Loans

ATTENTION IS NOW FOCUSED directly upon term loans as business credit transactions, rather than upon the financial institutions and the busines concerns which comprise the demand and supply sides of the market. What are the maturities of loans at time of making, the nature of security taken by lenders, the uses of funds by borrowers, the types of repayment provisions? In approaching these questions it is well to bear in mind that the Reserve banks and the Reconstruction Finance Corporation have not been free, as have the private term lending institutions, to make loans of any kind. Their loans have had to conform to statutory prescriptions, the most important of which was that credit should not be available from private agencies.

Term Loans of Commercial Banks[1]

Term of Loan

It is significant that, of the loans held by commercial banks at the middle of 1941, about 30 percent of the number and 49 percent of the original amounts had terms *exceeding* five years at time of making. This indicates that the self-imposed rule of policy followed by a majority of commercial banks not to make term loans with maturities more than three, four, or five years distant has often been violated. Similar to the business loans of the RFC, however, a greater number and amount of bank term credits had terms of five years than of any other number of years, and there was also a concentration on three-year terms. Table 3 shows that ten years is a

[1] This section is based upon analysis of term loans held around June 30, 1941 by a National Bureau sample of 99 large commercial banks. See Appendix A for description of the data and of estimates made therefrom.

Table 3—NUMBER AND ORIGINAL AMOUNT OF TERM LOANS HELD BY 99 COMMERCIAL BANKS ABOUT JUNE 30, 1941, BY TERM AT TIME OF MAKING[a] (*dollar figures in thousands*)

Term at Time of Making	*Number of Loans*		*Original Amount of Loans*	
	Number	Percent	Amount	Percent
1 year	67	2.6	$17,839	1.1
2 years	268	10.3	60,435	3.6
3 years	403	15.5	157,508	9.4
4 years	188	7.2	104,525	6.2
5 years	868	33.3	489,690	29.2
6 years	196	7.5	180,651	10.7
7 years	159	6.1	170,620	10.2
8 years	115	4.4	101,838	6.1
9 years	32	1.2	35,351	2.1
10 years	261	10.0	330,613	19.6
Over 10 years	17	.7	9,879	.6
No information	33	1.2	20,303	1.2
TOTAL	2,607	100.0	$1,679,252	100.0

[a] National Bureau sample of 99 commercial banks. Excludes "revolving" term loans See Appendix A.

virtual maximum for bank term credit, with less than 1 percent of the number and amount of loans having terms exceeding this. The majority of longer term loans were for refunding purposes, and new money loans have tended to have shorter maturities.

Certain correlations have been observed between the term at time of making of loans analyzed and the industries of borrowers. The largest number of oil production loans had terms of three years, although the largest amount of credit extended to this industry had a ten-year term. Longer terms were of more than average significance in the retail trade, public utility, tobacco products, and lumber industries. Shorter than average terms were found in the construction industry. To some extent, terms have been shorter in those industries subject to a high degree of cyclical fluctuation in earning power than in industries not so subject, but there are numerous exceptions to this generalization.

There is also some evidence of positive correlation between the size of loans and their term to maturity. Within every category of loan size there was a larger number of loans representing a larger amount of credit with five-year terms than with terms of any other number of years, *excepting* loans under $10,000 and loans over $10 million. Among loans of less than $10,000, two- and three-year terms were comparatively important, and among loans over $10 million those with terms of ten years bulked largest in the aggregate. This phenomenon probably has two explanations: First, other things being equal, borrowers are able to repay smaller loans in a shorter period of time than they are able to repay larger loans; second, if other influences are held constant, banks make smaller loans to smaller businesses and seek to limit the inherently greater risks carried by these credits through a shortening of terms.

Security Taken

Table 4 shows that 56 percent of the number of bank term loans were secured, but secured loans represented only a third of the original amounts of credit extended. As would be expected, the typical secured loan was smaller than the average unsecured loan, because it was made to a smaller than average business and probably involved greater risk to the lender. Averages, of course, conceal a great deal of variation between individual concerns of all sizes. Although commercial bankers commonly hold that their real assurance of repayment lies in the agreement of the borrower to restrict his conduct in certain ways, in the majority of cases they have not relied solely upon the sanctions provided by loan agreements.

Unlike the RFC, commercial banks have usually taken pledges or assignments of *one type* of asset rather than of combinations of assets. Only a fourth of the number and a fifth of the amount of secured term loans were secured by a combination of the borrowing concern's assets. While ma-

Table 4—Number and Original Amount of Term Loans Held by 99 Commercial Banks About June 30, 1941, by Type of Security[a] (*dollar figures in thousands*)

Type of Security	*Number of Loans*		*Original Amount of Loans*	
	Number	Percent	Amount	Percent
	ALL LOANS			
Unsecured	1,140	43.7	$1,117,393	66.5
Secured	1,459	56.0	558,738	33.3
No information	8	.3	3,121	.2
Total	2,607	100.0	$1,679,252	100.0
	SECURED LOANS			
Real estate other than plant only	68	4.7	$10,315	1.8
Plant (including leaseholds) only	286	19.6	48,525	8.7
Machinery and equipment only	379	26.0	75,753	13.6
Assignment of government claims only	33	2.3	32,316	5.8
Receivables only	15	1.0	7,225	1.3
Inventories only	55	3.8	30,758	5.5
Stocks and bonds only	180	12.3	209,951	37.6
Life insurance only	44	3.0	7,890	1.4
Assignment of other claims only	51	3.5	14,246	2.5
Combinations of assets	348	23.8	121,759	21.8
Total	1,459	100.0	$558,738	100.0

[a] National Bureau sample of 99 commercial banks. Excludes "revolving" term loans. See Appendix A.

chinery and equipment was offered most frequently as collateral security for term credit, with plant and stocks and bonds running next in importance, stocks and bonds collateralized a larger *amount* of secured term credit than did any other type of asset. The comparative infrequency with which real estate was pledged suggests that commercial banks tend to place little reliance upon the liquidation values of special-purpose properties, and wish to avoid the restrictions (surrounding national banks especially) with regard to loans secured by real estate. Inventories or accounts receivable are infrequently used to collateralize medium-term credit. Such assets usually are pledged by business concerns to obtain short-term credit extended under special techniques.[2]

Another type of collateral security that may be taken by a term lender is the endorsement or guarantee of the debt by other entities than the borrowing concern, either officers, stockholders, parent companies or other persons. Evidently this has not been a device generally employed by commercial banks to increase the probability of payment of their term loans, for only about 18 percent of the number of loans, comprising a mere 6 percent of original amounts, were endorsed or guaranteed. The average size of endorsed loans was much smaller than that of nonendorsed loans. This doubtless reflects the efforts of banks to lessen the greater risks normally attached to smaller loans made to enterprises of less than average size.

Use of Funds by Borrowers

Almost 55 percent of the number of term loans made by banks were reported used solely to provide new money for expansion, although such loans comprised less than one-third of the original amounts of all loans held by banks at mid-1941. Although only 33 percent of the number of loans were expected to be used solely for retirement of obligations, these loans constituted 54 percent of all term credit. The amount of term loans used for refunding purposes is not surprising, in view of the comparatively large costs of financing through the securities markets as well as falling interest rates. On the average, refunding loans were more than twice as large as new money loans, more than a million dollars as compared with $402,000. About 12 percent of the number and amount of loans were used by borrowers *both* for new money and refunding purposes in undetermined proportions. Evidently term loans are generally contracted to finance special business programs, otherwise it would not have been possible for bankers

[2] See forthcoming publications, National Bureau of Economic Research (Financial Research Program), *Accounts Receivable Financing,* by Raymond J. Saulnier and Neil H. Jacoby and *Field Warehousing and Its Relation to Business Financing,* by Neil H. Jacoby and Raymond J. Saulnier.

to report an exclusive use for more than 87 percent of the loans.

With respect to the new money loans, the data in Table 5 indicate that about 30 percent of the number and nearly 50 percent of the amount were used solely to increase working capital of borrowers. Another 30 percent of the number of loans provided machinery and equipment. Loans to finance plant construction and to acquire various combinations of assets were comparatively less important. Of the loans used entirely for retirement, nearly 37 percent of the number and

Table 5—NUMBER AND ORIGINAL AMOUNT OF TERM LOANS HELD BY 99 COMMERCIAL BANKS ABOUT JUNE 30, 1941, BY USE OF FUNDS[a] (*dollar figures in thousands*)

Use of Funds	*Number of Loans*		*Original Amount of Loans*	
	Number	Percent	Amount	Percent
	ALL LOANS			
New money only	1,421	54.5	$531,467	31.6
Retirement only	861	33.0	908,463	54.1
Combinations of new money and retirement	288	11.1	206,475	12.3
No information	37	1.4	32,847	2.0
TOTAL	2,607	100.0	$1,679,252	100.0
	NEW MONEY LOANS			
Plant only	347	24.4	$79,347	14.9
Machinery and equipment only	430	30.3	95,879	18.0
Working capital only	402	28.3	262,024	49.3
Other single purposes only	23	1.6	14,773	2.8
Combinations of purposes	219	15.4	79,444	15.0
TOTAL	1,421	100.0	$531,467	100.0
	RETIREMENT LOANS			
Bonds only	316	36.7	$426,755	47.0
Bank debt only	163	18.9	132,645	14.6
Other debt only	194	22.5	161,224	17.7
Combinations of debt	89	10.4	100,747	11.1
Preferred stocks only	48	5.6	28,716	3.2
Other combinations	51	5.9	58,376	6.4
TOTAL	861	100.0	$908,463	100.0

[a] National Bureau sample of 99 commercial banks. Excludes "revolving" term loans. See Appendix A.

47 percent of the amount were devoted to the retirement of outstanding bonds. This striking fact illustrates the extent to which the bank term loan has encroached upon security marketing through the investment banking mechanism. Refunding of bank debt and other debt, taken together with bond refunding, accounted for nearly four-fifths of all refunding loans, the retirement of preferred stock or of a combination of obligations being of minor importance.

There have been rather sharp industrial variations in the uses of funds by borrowing concerns. The *number* of loans made solely to provide new money to the borrower was larger in all major industrial groups than the number of credits extended for refunding or for a complex of uses, except in finance where refunding loans were most frequent in number. The *amount* of credit advanced for retirement purposes exceeded the amount of credit for new money in all major industrial groups excepting wholesale trade, construction, and agriculture, forestry and fishing. Data on use of term loans by major and minor industrial groups are given in Table 6.

Repayment Provisions

To an important degree commercial bank term loans are repaid in equal or approximately equal instalments. Nearly 72 percent of the number and 56 percent of the original amounts of all loans held by banks at mid-1941 were so dischargeable. Even so, the schedule of equal instalments appears to have less vogue among the term credits of commercial banks than among loans of the Reserve banks and the RFC. About 7 percent of the number and over 11 percent of the amount of bank loans were repayable in one lump sum at maturity, and another 17 percent of the number and 29 percent of the original amounts had a "balloon" final payment. Loans with balloon payments were larger on the average than those repayable in one lump sum; and loans with either of these types of repayment provisions were larger than those repayable in equal instalments. Term loans with balloon payments closely resemble corporate bond issues with sinking funds usually

Table 6—NUMBER AND ORIGINAL AMOUNT OF TERM LOANS HELD BY 99 COMMERCIAL BANKS ABOUT JUNE 30, 1941, BY INDUSTRY AND USE OF FUNDS[a] (*dollar figures in millions*)

Industry	*New Money Only*		*Retirement Only*		*Combinations of Purposes*[b]		*All Loans*	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount
Oil production	*146*	*$86.3*	*42*	*$101.4*	*38*	*$62.7*	*226*	*$250.4*
Other mining and extraction	*34*	*15.6*	*33*	*77.0*	*14*	*14.1*	*81*	*106.7*
Construction	*12*	*3.1*	*4*	*.1*	*2*	*.5*	*18*	*3.7*
Wholesale trade	*95*	*6.7*	*29*	*3.9*	*19*	*2.5*	*143*	*13.1*
Retail trade	*111*	*20.9*	*56*	*34.5*	*23*	*11.9*	*190*	*67.3*
Finance	*94*	*63.1*	*149*	*188.7*	*15*	*13.6*	*258*	*265.4*
Pub. util., transp. and communication	*328*	*127.4*	*176*	*219.0*	*35*	*36.8*	*539*	*383.2*
Service	*108*	*15.8*	*55*	*36.3*	*23*	*13.0*	*186*	*65.1*
Agriculture, forestry and fishing	*26*	*.6*	*3*	*.2*	*3*	*1.2*	*32*	*2.0*
Government	*2*	*1.1*	*3*	*9.1*	..	..	*5*	*10.2*
Manufacturing	*465*	*190.9*	*311*	*238.3*	*153*	*83.0*	*929*	*512.2*
Food and products	77	26.2	33	12.7	21	7.8	131	46.7
Tobacco products	5	5.3	10	32.1	..	..	15	37.4
Textile mill products	22	2.5	12	9.5	9	6.3	43	18.3
Wearing apparel	10	2.5	4	3.2	2	.8	16	6.5
Lumber and timber	3	.7	12	6.9	7	1.1	22	8.7
Furniture and fin. lumber	9	2.6	6	.7	5	.5	20	3.8
Paper and pulp	40	14.9	33	41.6	11	10.5	84	67.0
Printing and publishing	38	12.5	34	12.1	12	3.2	84	27.8
Chemicals	25	20.1	15	10.1	5	.7	45	30.9
Petroleum and coal prod.	5	1.0	4	2.1	..	..	9	3.1
Rubber and products	6	1.5	13	13.9	1	.2	20	15.6
Leather and products	4	1.1	5	1.8	..	..	9	2.9
Stone, clay, glass	11	5.4	17	5.8	5	1.2	33	12.4
Iron and steel mills	35	19.1	40	39.5	19	13.0	94	71.6
Transportation equipment	39	34.0	4	.5	3	1.8	46	36.3
Non-ferrous metals	10	1.5	6	6.2	6	2.2	22	9.9
Electrical machinery	18	3.3	6	2.2	4	1.4	28	6.9
Other machinery	43	10.5	19	8.6	15	5.5	77	24.6
Autos and auto. equip.	18	4.1	9	2.8	7	5.5	34	12.4
Miscellaneous and not allocable	47	22.1	29	26.0	21	21.3	97	69.4
TOTAL	1,421	$531.5	861	$908.5	325	$239.3	2,607	$1,679.3

[a] National Bureau sample of loans made by 99 commercial banks. Excludes "revolving" term loans. See Appendix A.
[b] Includes loans for which no information was given.

designed to extinguish not more than two-thirds of outstanding debt before maturity, leaving the final payment as a sort of balloon. Hence it is probable that a business concern for which the making of a term loan was an alternative to a public offering of securities adapted this common feature of public corporate bond issues to its term loans. The additional risk to the lender of balloon or lump sum repayments as against amortization through equal instalments should not be overlooked. The insignificant fraction of bank term loans that is indicated by Table 7 to be repayable in accordance with net or gross income of the borrower was smaller than for Reserve bank or RFC loans. This may be interpreted as an indication that commercial banks dealt with a group of enterprises whose abilities to make repayment were so much more favorable that it was not necessary to gear the discharge of debt so carefully to the business fortunes of the debtor. However, repayment in accordance with net or gross income is likely to be more important than is indicated by the data, because such a method is often subsidiary or alternative to other methods specified in loan agreements.

Table 7—Number and Original Amount of Term Loans Held by 99 Commercial Banks About June 30, 1941, by Type of Repayment Schedule[a] *(dollar figures in thousands)*

Type of Repayment Schedule	*Number of Loans*		*Original Amount of Loans*	
	Number	Percent	Amount	Percent
One sum at maturity	180	6.9	$191,242	11.4
Equal, or approximately equal, instalments	1,866	71.6	945,845	56.3
Larger final payment	449	17.2	481,177	28.7
In accordance with net or gross income	8	.3	5,205	.3
Other methods	72	2.8	40,209	2.4
No information	32	1.2	15,574	.9
Total	2,607	100.0	$1,679,252	100.0

[a] National Bureau sample of 99 commercial banks. Excludes "revolving" term loans. See Appendix A.

Medium-Term Securities Privately Purchased by Life Insurance Companies

Term of Loan

It has already been observed that the corporate bonds and notes purchased privately from issuers by life insurance companies are for the most part long-term credits, outside the area marked out for study. On a definition of medium-term credit as running for 15 years or less, approximately 75 percent of the amount of all private placements would be excluded.[3] If medium-term credit is limited to that with terms of 10 years or less, then 88 percent of the amounts of all private placements purchased by insurance companies are excluded. No matter how the medium-term business credit market is defined, insurance company loans are of much greater average term than those of commercial banks or public agencies. With respect to length of credit, they have stood on the one extremity of the market, just as the Reserve banks have occupied the other end, with commercial banks and the RFC in an intermediate position. Table 8 indicates that less than 16 percent of the number and 15 percent of the amount of all privately purchased issues having terms of 15 years or under matured five years or less after date of issuance. Well over half the amount of credit carried a term of more than ten years. A tendency exists to concentrate maturities on five, ten and fifteen-year periods after issuance. Insurance companies have occasionally split loans running over ten years with commercial banks, taking that part repayable after ten years and leaving to banks the shorter maturities of the loan. This type of financial cooperation does not appear to have developed far. Only 46 loans (originally amounting to $65.6 million), out of the 2,764 term loans held by 99 large commercial banks at the middle of 1941, had been split with insurance companies alone or with other banks *and* insurance companies.

[3] See Appendix B for method of estimation.

Table 8—PRIVATELY PURCHASED SECURITIES OF MEDIUM TERM, HELD BY 5 LIFE INSURANCE COMPANIES AT DECEMBER 31, 1940, BY TERM AT TIME OF ACQUISITION AND BY TYPE OF SECURITY[a] (*dollar figures in thousands*)

	Number of Issues		*Amount of Issues*	
	Number	Percent	Amount	Percent
	TERM AT TIME OF ACQUISITION			
Less than 5 years	23	10.6	$74,288	9.0
5 years	11	5.1	45,447	5.5
6–9 years inclusive	44	20.3	143,210	17.4
10 years	42	19.4	150,104	18.2
11–14 years inclusive	32	14.7	116,918	14.2
15 years	65	29.9	294,142	35.7
TOTAL	217	100.0	$824,109	100.0
	TYPE OF SECURITY			
Unsecured	*131*	*60.4*	*$547,928*	*66.5*
Secured	*86*	*39.6*	*276,181*	*33.5*
Lien on real estate[b]	60	27.6	166,975	20.3
Lien on equipment[c]	23	10.6	80,296	9.7
Other liens[d]	3	1.4	28,910	3.5
TOTAL	217	100.0	$824,109	100.0

[a] National Bureau sample of holdings of 5 life insurance companies. See Appendix B. Term at time of acquisition is regarded as identical with term at time of issuance.
[b] Includes first mortgages or first liens, or both, on real estate. Also includes first mortgage and collateral trust notes, and second mortgages.
[c] Includes first mortgages or first liens on equipment, and equipment trust certificates.
[d] Includes combinations of security, preferred ship mortgages, and collateral trust notes.

Security Taken

Concerns that have placed their securities privately with life insurance companies have nearly all been prime credit risks—corporations of regional or national scope. It is a normal consequence that over 60 percent of the issues, comprising about two-thirds of the original amounts of credit, have been unsecured. Among secured loans, Table 8 shows that first liens or mortgages on real estate have been the most important type of security, with liens on equipment next in frequency of use. In instances where security has been taken from public utility and manufacturing concerns, it has been most frequent to take first mortgages on fixed assets, or to collateralize the loan with stocks and bonds, or both. Credits advanced to railroad companies have been secured in the main by liens on equipment, often established through the creation of equipment trusts, although the chattel mortgage is growing in importance as a security device.

Use of Funds by Borrowers

While there are no quantitative data available to measure the way in which concerns privately disposing of issues to insurance companies have utilized the loan proceeds, it is likely that the pattern of use is similar to that of bank term loans. That is, the bulk of credit has gone to retire or refund outstanding obligations. Yet it is clear that some part of private placements has provided money for business expansion. Railroad equipment trust issues are definitely within this category.

Repayment Provisions

Only about one-quarter of the number and amount of medium-term securities privately acquired by life insurance companies have carried serial maturities, and thus have been similar to term loans of commercial banks and public agencies with respect to repayment provisions. Table 9 indicates that the majority of these medium-term issues are legally repayable in lump sums at maturity, although sinking funds have occasionally been provided for in purchase agreements. By and large, securities privately placed appear to have carried repayment arrangements substantially similar to those of publicly marketed securities. Such arrangements have differed from those associated with commercial bank term loans in that a much smaller proportion of private placement credits have provided for regular schedules of payments, completely amortizing debts at their maturity dates. Other factors being the same, the risks of nonrepayment of privately placed issues have therefore been greater.

Table 9—PRIVATELY PURCHASED SECURITIES OF MEDIUM TERM, HELD BY 5 LIFE INSURANCE COMPANIES AT DECEMBER 31, 1940, BY METHOD OF REPAYMENT AND YEAR OF MATURITY[a] (*dollar figures in thousands*)

Method of Repayment and Year of Maturity	*Number of Issues*		*Amount Outstanding*	
	Number	Percent	Amount	Percent
Serial maturities	*58*	*26.7*	*$174,674*	*23.0*
Single maturity	*159*	73.3	*586,333*	77.0
Prior to 1945	29	13.4	105,628	13.9
1945 to 1950	55	25.3	189,642	24.9
1950 to 1955	60	27.7	217,327	28.5
During 1955	15	6.9	73,736	9.7
TOTAL	217	100.0	$761,007	100.0

[a] National Bureau sample of holdings of 5 life insurance companies. See Appendix B.

Business Loans of the Reconstruction Finance Corporation[4]

Term of Loan

The RFC has been bound by no statutory limitation on term of business loans. The Corporation has announced that the repayment program is to be set up in such a way as not to restrict the development of business or impair the working capital of the borrower during the life of the loan. The most definite specification regarding term has been:[5]

> For established industries whose need is principally for shorter term credit, loans usually should be repaid within five years or less. When loans are primarily to finance capital expenditures, a longer repayment program may be considered.

In view of the fact that about 13 percent of the number and half the amount of loans approved have had terms exceeding five years, it seems reasonable to infer that a substantial frac-

[4] This section is based mainly upon a study by the authors of review committee reports in the files of the RFC pertaining to a random sample of 40 loans approved and 40 loan applications rejected.

[5] Reconstruction Finance Corporation, *Circular No. 13,* revised, "Information Regarding Loans to Business Enterprises" (Washington, 1938).

Table 10—NUMBER AND AMOUNT OF SAMPLES OF RFC BUSINESS LOANS REQUESTED AND APPROVED, BY TERM OF LOAN TO MATURITY (*dollar figures in thousands*)

Term of Loan to Maturity	LOANS REQUESTED[a]				LOANS APPROVED[b]			
	Number		*Amount*		*Number*		*Amount*	
	Number	Percent	Amount	Percent	Number	Percent	Amount	Percent
Less than 1 year	1	1.0	$2	.0	2	3.7	$27	.3
1 year	1	1.0	1	.0	2	3.7	151	1.5
2 years	4	3.9	19	.2	4	7.4	9	.1
3 years	8	7.8	1,478	12.8	11	20.4	2,188	21.1
4 years	2	1.9	92	.8	7	12.9	314	3.0
5 years	51	49.5	4,543	39.4	21	38.9	2,376	22.9
6–7 years	7	6.8	1,867	16.2	3	5.6	224	2.2
8–9 years	6	5.8	111	1.0	2	3.7	315	3.0
10 years	20	19.4	1,970	17.1	2	3.7	4,775	45.9
Over 10 years	3	2.9	1,446	12.5	..	..	..	..
TOTAL	103	100.0	$11,529	100.0	54	100.0	$10,379	100.0

[a] National Bureau sample of 103 applications for loans.
[b] National Bureau sample of 54 approved loan applications.

tion of RFC credit has been intended to finance capital expenditures or to refund outstanding debt. The figures contained in Table 10 reflect a concentration upon three and five years in term of loans approved. Even more significant is the fact that term of loans requested by applicants considerably exceeded the length of term granted. No less than 35 percent of a number of applicants, collectively applying for nearly half of all requested RFC credit, wanted terms of more than five years. This may be interpreted as evidence that the fundamental need of many applicants was for equity capital or longer term credit than the RFC felt able to extend. Any analysis of RFC loans by term at time of making must be recognized as of limited significance, because of the almost continuous modification of loan agreements by the Corporation in order to cure defaults, to postpone foreclosure proceedings, or to meet changed circumstances of the borrower. This flexibility of term loans has been noted previously. Although the Corporation generally pared down requested terms in approving loans, RFC credit has been of longer term than that of the Reserve banks.

Security Taken

A significant difference between commercial bank and RFC term loans is that practically all RFC business loans have been secured. It was considered necessary to obtain first liens on real estate and equipment, and other creditors were asked to subrogate their claims through "stand-by" agreements. The pledge of inventories through a field warehousing arrangement was frequently required. Assignments of accounts receivable were often taken. The cash surrender value of life insurance policies on the lives of partners, principal officers or stockholders was frequently required to be pledged, or in cases where no policies were in existence, the principals of the borrower were sometimes required to procure them. Personal endorsements of the loan by principal officers or stockholders with "outside" financial strength were often obtained. In many instances several, and in some cases all, of these types of security were taken on individual loans. Since the RFC Act did not require security but stated that business loans should be "of such sound value, or so secured, as reasonably to assure retirement or repayment," it is plain that the Corporation dealt with borrowers whose financial statements did not warrant unsecured credit, that is, with the "marginal" borrowers whose credit needs the RFC loan program was designed to fulfill.

Use of Funds by Borrowers

The RFC has been restricted by the legal requirement that loans shall be made for the purpose of "maintaining or promoting the economic stability of the country or encouraging the employment of labor." The Corporation announced that it would make loans for the hiring of labor, the purchase of materials and machinery, the financing of industrial constructtion, the establishment of new business enterprises or the expansion of existing concerns. Its intention has not been to lend money primarily to enable a borrower to pay existing indebtedness, although a portion of the proceeds of a loan may be so utilized.[6] Although no analysis of loans by borrowers' intended use of funds is available, review of a sample of cases indicates that, while the bulk of funds provided borrowers with new money, rather substantial fractions—in some instances more than 50 percent—of individual loans have been used to discharge previous debts. But such uses would be quite consistent with law, if it could be shown that withholding of RFC credit would have resulted in a discontinuance of operations by the unfortunate applicant. It is a naive but frequent error to argue that refunding loans never affect employment or business activity.

Repayment Provisions

Like the credits of the Federal Reserve banks, nearly all of the RFC business loans have been repayable in a number of instalments, not always equal in amount. A majority of the loans were intended to be discharged in monthly, rather than in quarterly, semi-annual or annual instalments. This probably reflects the close control that the lender to financially straitened concerns necessarily must exercise, also the desire of lenders in a new and untried field to take precautions to protect their position. A significant feature of the plans of repayment was that many called for fixed dollar amounts or certain amounts per unit of product sold, whichever was greater. These schedules represented efforts to scale the discharge of indebtedness roughly in accordance with the ability of the debtors. Some loan agreements contained the so-called "fifty percent clause," which requires the debtor to pay stated instalments or 50 percent of earnings before depreciation and Federal income taxes, whichever is greater.

[6] Reconstruction Finance Corporation, *Circular No. 13,* revised.

Industrial Loans of the Federal Reserve Banks[7]

Term of Loan

By law the term of Reserve bank loans to business enterprises has been limited to five years. That this limitation on maximum term of loans has narrowed the market for Reserve bank business credit is evidenced by the fact that loans comprising half of the amount of commercial bank and RFC term credit have maturities exceeding this length. Such evidence as is available indicates that the bulk of Reserve bank loans, in number and amount, have matured at two to five years. A few credits have been extended for periods of six or nine months, and thus do not fall within the category of term loans. But the large number of renewals of loans that were not discharged in accordance with existing schedules limits the significance of any tabulation of loans according to term. Indeed, a basic characteristic of all term lending is the need for rescheduling the payments of loans in the light of debtors' changing circumstances. The longer life of term credits necessitates estimation of borrowers' needs for funds and of their ability to repay loans, and such estimates are perforce revised through time. During 1941 the repayment provisions of many term loans made to prime business concerns required relaxation as a result of the strain put on their working capital by the high productive activity of the period.

Security Taken

The Federal Reserve Act provided that industrial advances should be made upon "a reasonable and sound basis," leaving the banks free to determine whether or not to take collateral security on their industrial loans. The fact that few loans have been unsecured indicates that the character of borrowers from Reserve banks has been different from that of term

[7] This section draws upon a study of the National Bureau of Economic Research (Financial Research Program), *Capital and Credit Requirements of Federal Reserve Bank Industrial Loan Applicants,* by Charles L. Merwin and Charles H. Schmidt (ms. 1941). It is partially based upon a review by the authors of a sample of credit files pertaining to Section 13b loans made by the Federal Reserve Banks of New York and Philadelphia.

Table 11—Number and Amount of Industrial Advances of Federal Reserve Banks to May 31, 1935, by Principal Type of Security[a] (*dollar figures in thousands*)

Principal Type of Security	Number of Loans: Number	Number of Loans: Percent	Amount of Loans: Amount	Amount of Loans: Percent
Secured	*124*	*74.7*	*$9,458*	*82.8*
First mortgages on real estate	33	19.9	6,401	56.0
Chattel mortgages on machinery and equipment	27	16.3	1,179	10.3
Second mortgages on real estate	17	10.2	640	5.6
Accounts receivable and contracts	30	18.1	835	7.3
Life insurance	8	4.8	143	1.3
Unlisted stocks	4	2.4	113	1.0
Listed stocks	3	1.8	79	.7
Capital stock of borrower	2	1.2	68	.6
Unsecured	*42*	*25.3*	*1,966*	*17.2*
Total	166	100.0	$11,424	100.0

[a] Taken from James C. Dolley, The Industrial Advance Program of the Federal Reserve System," *Quarterly Journal of Economics*, Vol. L (February 1936). Data secured by the author through questionnaires to the several Federal Reserve banks.

loan debtors of commercial banks, as was in fact required by law. Only two of the 200 loans approved by the Philadelphia bank were unsecured, and these ran for terms of 18 months or less.[8] A tabulation of industrial advances up to May 31, 1935, appearing in Table 11 and covering a substantial fraction of all Federal Reserve business credit, indicates that only a quarter of the number and 17 percent of the amount of such credits were unsecured. Most loans have been secured by first mortgages on fixed assets, chattel mortgages on equipment, or assignment of accounts receivable; the right was generally reserved by the lending bank to require additional security at its option.

The character or circumstances of concerns receiving Reserve bank credit made it necessary to acquire protection against the possibility that the borrower might be unable to make repayment. Reserve bank loans could only be made if

[8] Glenn K. Morris, *The Loans to Industry Program of the Federal Reserve Bank of Philadelphia* (unpublished thesis, June 1940).

credit was unavailable from private sources. While some firms were good credit risks, their commercial banking connections had been severed as a result of the banking crisis of 1933, and many others could not get bank credit because of deterioration in financial position after 1929. In a number of cases, the Reserve banks have approved loans of a specified amount, some part of which was disbursed upon the deposit of real estate mortgages or other security, and the remainder when and as accounts receivable were assigned by the borrower in the ratio of 1½ to 1. The taking of assignments of accounts receivable, in addition to liens on other assets, appears to have been used with considerable frequency as a security device. Borrowers were nearly always in dire want of working capital and receivables provided the best security for the bank, as well as a good method of gearing the amount of the loan to the working capital needs of the debtor.

Use of Funds by Borrowers

Under the statute, Reserve banks could lend funds only to provide borrowers with "working capital." Although the Board of Governors of the Federal Reserve System has never defined this phrase by regulation, preferring to leave its interpretation to the individual Reserve banks, the conception is fairly clear. This restriction to loans for working capital has probably served to reduce the potential amount of credit that could be extended by the Reserve banks even more than their restriction to loans with maximum terms of five years. Less than 16 percent of the original amounts of all term loans held by commercial banks at mid-1941 were intended to be used by borrowers exclusively to augment working capital. One method whereby Reserve banks have controlled the disposition of loan proceeds has been to write into loan agreements the requirement that the increase in borrower's net current assets *after* disbursement of the loan, but excluding the loan from current liabilities, must be kept at least equal to the amount of the loan.[9] Such a financial stricture precludes

[9] Glenn K. Morris, *op. cit.*

use of the proceeds for refunding, plant expansion or improvement, although money borrowed for working capital may release other dollars for other purposes, and close control by the banks over use of funds is not always feasible.

Repayment Provisions

Almost without exception, the Reserve bank term loans have been repayable in annual, semi-annual, quarterly, or monthly instalments of equal or approximately equal amounts. Among a sample of loans examined, there were no cases of payments in a single sum at maturity or balloon notes representing comparatively large final payments. Although instalment payments have constituted the normal method of discharge of debt, the schedules of these payments have often been changed prior to the maturity of loans in cases where the borrower was unable to part with cash at the rate or in the manner contemplated in the original loan agreement. The major conversions have been from annual or semi-annual payments to quarterly or monthly payments. In some instances, debtors have been required to pay specific amounts or a certain number of dollars or cents per unit of product sold, whichever was greater.

Changes in Term Loan Characteristics and Lending Practices Since 1934[10]

Term loans of commercial banks offer the best opportunity for discovering changes in loan characteristics and lending practices that have occurred since 1934. Information concerning medium-term securities acquired privately by life insurance companies and Reserve bank and RFC business loans is inadequate for such analysis. Even a study of commercial bank term credit is subject to the limitation that detailed information is available only on loans *held* at recent dates rather than upon all loans *made* since 1934. To the extent that there is a high degree of correlation between other characteris-

[10] This section is based upon an analysis of term loans held at mid-1941 by a National Bureau sample of 99 large commercial banks. For description of this sample see Appendix A.

tics of loans and the period and method of their repayment, any analysis of the characteristics of loans held at a given date but made during different years will be misleading. However, careful cross-checking to determine whether such correlations exist, and the establishment of appropriate limitations on periods of comparison, can eliminate significant errors arising from this cause.

Shifts in Term of Loans

The view has been frequently expressed by bankers that term loans are tending to have longer maturities. Although this hypothesis could be tested adequately only by examining the distribution, according to term at time of making, of all term loans made by commercial banks during recent years, analysis of term loans held at mid-1941 does not support the thesis that terms have tended to lengthen. Considering only loans made since 1936 and having four or more years to run at time of making, it has been true in every year except 1938 that five years is the most characteristic. During 1938 there was a marked shift to longer terms, nearly 38 percent of the loans made in that year having ten-year maturities, after which year there was a shift back to the five-year term. The total amount of credit having *more* than five-year terms fell from nearly 70 percent in 1938 to 56 percent in 1939 and to 42 percent in 1940; during the first half of 1941 there was a rise to 53 percent. Thus, there is no evidence available of a marked change in the term of loans.

Shifts in Size of Loans

There is some evidence that up to 1940 commercial banks tended to make term loans of larger size, if the average amounts of term loans made during different years and held at mid-1941 may be taken as a criterion. The explanation may lie in the business expansion which followed 1938. The average original amounts of loans rose from $247,000 for loans made during 1936, to $341,000 for loans made during 1937, to $651,000 during 1938, and to $773,000 during 1939.

Thereafter, the average feel to $748,000 during 1940, and to $636,000 for loans made during the first half of 1941. It appears likely that after 1939 banks extended term credits to somewhat smaller firms. But conclusions from these data must be tentative, since there is some tendency for loans of smaller amount to be paid off more rapidly than larger loans. The existence of such a tendency would make information on the sizes of loans held at any given date unreliable for our purposes.

Shifts in Size of Borrowers

Apparently no pronounced shift occurred during the period 1934-41 in the size of concerns securing term credit from commercial banks, although over this period there was a slight tendency toward borrowing by larger firms. During 1936 and 1937 the modal borrower had total assets between $100,000 and $1 million, while during 1938 he had assets of $1-5 million. In 1939 the size of the typical borrower fell to the level of 1936 and 1937, but during 1940 he had assets of $10-50 million. There was a drop to the $1-5 million class during the first half of 1941. With respect to the aggregate *amounts* of loans made: During 1937, borrowers with total assets of $50-100 million received the largest amount of credit going to any one size class, while in each year since 1937 the largest amount of term credit has been granted to firms with total assets of $100 million or more.

Shifts in Use of Funds by Borrowers

Since 1936 there has been a slight relative increase in the importance of term borrowing to obtain new money, and a slight relative decline in the use of funds for retirement of debt and capital liabilities. These tendencies have not been pronounced, and they were affected by the short business cycle of 1936-39. Both in number and aggregate amount, term loans for new money in 1938 and 1939 fell in relative importance. New money loans expanded comparatively during 1940 and the first half of 1941, probably in reflection of growth in national productive activity. During the first six months of 1941 new money loans constituted two-thirds of the number and 42 percent of the amount of term credit extended—the highest proportions of the period under review. These changes appear to mirror variations in the character of demand for business financing, rather than alterations in the willingness of the banking system to supply funds for different purposes.

Shifts in Iudustry of Borrowers

Changes in the industrial character of concerns negotiating term loans appear to have been dictated mainly by the business cycle. For example, the iron and steel industry suddenly rose to a position of relative importance during 1937, in which year it accounted for 15 percent of the number and 29 percent of the aggregate amount of term credit extended. Not until 1941 was this industry again an important term borrower. The public utility industry, while comparatively a large term borrower during every year since 1934, rose in relative importance during 1938 (a year of cyclical depression) and subsequently declined. There is evidence that oil production loans did not develop in volume until after 1938, perhaps in response to increasing restrictions on oil output imposed by state conservation authorities. Concerns in the transportation equipment industry first loomed into a position of importance during 1941, probably in consequence of national defense activities. In summary, alterations in the demand for medium-term credit appear to have dominated the industrial nature of borrowers, rather than changes in bank lending policy.

Shifts in Security Taken

To judge from their practices during different years in making the term loans held at mid-1941, commercial banks have definitely been disposed to dispense with collateral security. Although the number and aggregate amount of secured term loans made during 1936 and 1937 greatly exceeded the unsecured loans, during succeeding years the aggregate amounts of new unsecured loans exceeded the amounts of new secured loans, greater numbers of loans continuing, however, to carry security. During the first six months of 1941, both the number and amount of uncollateralized credits surpassed secured credits, over 72 percent of all loans being unsecured. This phenomenon is probably to be explained by the growing familiarity of bankers with term lending techniques, combined with an intensification of competition among lenders. Broader reliance is being placed upon the restrictive clauses contained in term loan agreements, while less stress is being laid upon the pledge of specific assets by borrowers.

Shifts in the Taking of Commitments

There has been no significant change in the frequency with which commitments have been made by the public or private agencies to assume the risks of commercial bank term loans. With the exception of loans made during 1938, in every year since 1936 the number of term loans with respect to which commitments were made did not exceed 7 percent and the amounts of such loans did not exceed 4 percent of all term credit. During 1938 there was a marked increase in the relative number and amount of loans for which commitments were made by other lenders, nearly 15 percent of the number and 5 percent of the amount of all loans made in that year carrying commitments. This may be interpreted to reflect the sharp depression of 1938, during which the credit-granting activities of the public term lending agencies increased and lenders' appraisal of uncertainties were made with less optimism, leading to a greater desire to distribute risks.

Shifts in Methods of Repayment

Ever since 1936 there has been a slightly increasing disposition on the part of commercial banks to make term loans repayable in equal or approximately equal instalments, or repayable in accordance with the gross or net income of the borrower. But this tendency has not been strong, since the single payment loan and the balloon note have almost maintained their relative positions. Balloon notes reached their position of highest relative importance during 1939, nearly one-fifth of the number and one-third of the amount of term credit extended in that year having a larger payment due at maturity than at any preceding date.

Shifts in the Splitting of Loans

Analysis of term loans held in bank portfolios at mid-1941 yields some evidence of an increase since 1935 in the frequency with which the cooperation of other lenders is sought in extending credit. It is likely that this fact is explained by the tendency, noted previously, for the average size of term loans to increase. Relatively the largest number and amount of all split term loans were made during 1939, the year in which the average size of loans was largest; nearly half the number and three-quarters of the amount of term credit extended in that year were divided between the originating banks and other institutions.

Summary of Changes

As far as can be determined from analysis of loans held at a given date, the nature of bank term loans does not appear to have altered markedly during the five preceding years. Term of loans, size of loans, and size and industry of borrowers have not undergone any marked change. Nonetheless, developments have occurred to emphasize the distinctive features of business term loans. The tendencies to dispense with collateral security, to insist upon amortization of debt in equal instalments, and to split loans among several lenders have become more pronounced. Furthermore, the comparative increase in the proportion of term credit devoted to business expansion augurs better for a sustained volume of term lending than would be the case if an increasing fraction of borrowed funds were devoted to retirement of debt or preferred stock. Term borrowing for the latter purpose is motivated principally by continued reduction in the structure of interest rates, that is, upon a condition that is quite unlikely to persist indefinitely.

Toward the end of 1940 the willingness of commercial bankers to make new term loans appears to have abated somewhat, if the volume of term loans made during the first half of 1941 in comparison with those made during the comparable part of 1940 is indicative. The probable causes were the rather rapid decline in interest rates of term loans, the likelihood that some banks may have built up portfolios of term loans to a point beyond which they did not wish to go, and a belief that the risks carried by medium-term credit had risen in consequence of the growing uncertainties of international affairs. The fall in term loan interest rates was apparently due to the intense efforts exerted by commercial banks during immediately preceding years to employ idle cash, and to sharpening competition of insurance companies and other financing institutions in making the larger and longer-dated loans. Added to all of these causes is the necessary decline in the demand for term loans to refinance outstanding obligations at lower interest rates, as corporations have gradually exhausted the possibilities of effecting savings in fixed charges by such action.

It is not amiss to observe finally that the enormous expansion in the volume of medium-term credit up to the end of 1940 (of which commercial bank term loans are the largest part) has come to penetrate nearly every section of the business credit market, in terms of industry, size of borrowers and uses of funds.