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"WANTED: A NEW BANKING SYSTEM FOR SMALL BUSINESS"

ADDRESS

of

PETER R. NEHEMKIS, JR.

Special Counsel, Investment Banking Section,
Securities and Exchange Commission.

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WANTED: A NEW BANKING SYSTEM FOR SMALL BUSINESS

The small business enterprise is one of the Nation's most important employers, producers and customers.

We have in this country about 2,400,000 business units. Of this number more than 90 per cent are small -- that is to say, they have assets of less than $250,000. Big business constitutes only 1 per cent of the "business population." Almost half of the nation's gainfully employed have jobs in small business establishments. Despite the inroads of "bigness," we are still a nation of small enterprises.

But small business is important to the country for other reasons than that it constitutes the largest body of employers and producers.

Small business also performs a unique service for the American consumer: it is the small business man who is responsible for much of the versatility of product and service, which, despite standardization, is still highly valued by the consumer.

Nor can we afford to overlook the vital importance of small business to big business. It is frequently stated that the development of a new large business creates many new small businesses; it is less commonly recognized that without the existence of small enterprises it would be difficult for the large units to function. The large enterprise relies heavily upon smaller, independent units for the processing of a wide variety of machinery and products that are indispensable to its output and the distribution and sale of its product.

Perhaps the clearest example of the dependence of big business upon little business is the automobile industry. Without the small pattern and parts concerns the assembly lines of General Motors and Ford could not move; and without the network of dealers and distributors, the great automotive factories would be paralyzed.

But there is still a further aspect to the relationship between big and little business. It is from small business that large business grows: some of our largest and most important enterprises have emerged from "basement" or "backyard" origins. The classic example is, of course, The Ford Motor Co. which started operations with a cash capital of $28,000. It is sometimes useful to recall that Frank Woolworth started business with a stock of goods worth $200.

Nor should we overlook the highly significant fact that small business is the proving ground for large business. The radio was experimented with in homes and lofts long before it was put on the market by R.C.A. The plastic industry -- one of our fastest growing new industries -- had its origin in numerous small concerns which were later absorbed by the large units. I need scarcely remind this audience that the giant electrical industry was born only a few miles from Newark in the laboratories of Thomas A. Edison.

Moreover, because it is small, little business can adapt itself to changes in the business environment more quickly than can big business. You will all recall, in this connection, the huge expenditure which was required for the overhauling of plant and equipment to bring out the first model A Ford car. Now contrast this situation with that of two partners who own a small feather concern. They are being crowded by competitors. They decide to go into the manufacture of shuttlecocks used in the game of badminton. There are no boards of directors which have to be consulted; no battery of lawyers to advise on the effects of the proposed change; no special consultants to render reports upon the change in sales policy involved; no tax experts to report on how the change in business will affect federal, state and local taxes; and so on. Small enterprise may have less hull than the full rigged corporation, but, like the racing yacht, it carries a greater spread of sail, has a lighter draft, and can change its course more swiftly. The ability of small business to change its plant without undue disruption of operations helps to explain the amazing vitality of the small enterprise in the competitive struggle. Such factors, among others, contribute to the variety of product which enables the small concern to serve a shifting market and profit by changes in style and varieties of demand.

For these and other reasons, it is of the utmost importance that we should have in this country a continuous growth of new and healthy small businesses. Since 1927, in relation to population, the number of business units has been declining. In 1935, there was a thinner "business population" than at any time during this century. During these years, the heaviest mortality has unquestionably occurred among the smaller business units and especially among the individually owned concerns, which are by far the most numerous. It is gratifying to note, however, that the downward trend stopped in 1935 and that the "business population" has been increasing steadily.

II.

A major difficulty experienced by small business in recent years has been its inability to obtain adequate funds for its operations.

What kind of financial aid does small business require? What are the obstacles which stand in the way of its obtaining adequate financing?

By far, the most essential financial requirement of the small enterprise is for equity capital. But small business cannot obtain equity capital because it lacks direct contact with the sources of capital supply.

The major source of equity capital for small enterprise has always been the wealthy individual who was familiar with the business, its management, and the locality in which it operated.

Today, "angels" for small business are scarce. Your moneyed individual feels that the speculative profits are not worth the risk; he prefers to play safe and put his money in tax exempt government securities.

Where else can the small business man turn for equity capital? Certainly, not to the investment banker. The investment banker cannot afford to underwrite the securities of the small concern whose name is not known beyond its own community. And besides, the amount of capital involved is usually too small to yield a profit if, indeed, it can cover flotation costs at any reasonable rate of commission.

There has been a great deal of newspaper discussion and feeling among small business men that the Securities and Exchange Commission has been responsible for the inability of small businesses to obtain equity capital. In my oinion, this attitude is not based on fact.

The Commission has done everything within its power to reduce the costs of registration to the lowest level compatible with its duties under the Securities Act. It has provided for various exemptions from registration with respect to issues below $100,000. And for issues of intermediate size -- for which there is required the filing of a full registration statement -- special concessions have been provided. In order to reduce the cost of registration, the Commission has reduced the amount of information required from the small business concern.

Some of you may not be familiar with the fact that the Commission has established a special unit within its Registration Division for the purpose of aiding prospective registrants and advising them and their representatives on problems arising in connection with their registration statements. This unit has been utilized largely by small business men.

The high cost of flotation of small issues -- over and above the cost of registration -- has been of major concern to the Commission. Studies prepared by the Commission's staff show that, among registered issues with expected proceeds of less than $1,000,000, the cost of flotation amounts to about 20 per cent of the proceeds for common stock, about 16 per cent for preferred stocks, and about 7 per cent for bonds.

An important fact, which is often overlooked in discussions of this problem, is the heavy compensation absorbed by the underwriters and other distributors of securities. For stock issues of less than $1,000,000, between 80 and 90 per cent of the total flotation costs has consisted of compensation paid for underwriting and distribution. For bond issues of similar size, 70 per cent of the flotation costs has been absorbed in such compensation. Other expenses, also not attributable to registration under the Securities Act, constitute a considerable portion of the remaining costs. While it is difficult to estimate precisely the additional cost of selling small issues resulting from registration under the Securities Act, it appears that such extra cost is not in excess of about 1 per cent of the gross proceeds; in fact, there is reason to believe that it is nearer one-half of 1 per cent.

It is not the alleged cost and delay of registration which is responsible for the small volume of unseasoned equity issues. A more significant factor -- again frequently overlooked -- is the inability of the small issues to find purchasers.

An analysis of 700 small security registrations shows that, one year after the effective date of the registration, over one-third had not sold any of the securities registered. This means that over 200 such issues -- fully registered and ready for market -- could not find a single purchaser in the year following effective registration. This would appear to indicate that, in the words of Chairman Frank -- and I quote -- "the obstacles standing in the way of the successful flotation of issues of small and particularly unseasoned enterprises are to be found in places other than the requirements of the Securities Act."

In the final analysis, the small business enterprise has never utilized—and in all probability will never utilize—the machinery of investment banking or the security markets. Statistics of the Bureau of Internal Revenue show the average assets of the small corporation to be $47,000. Plainly, the corporation with total assets of less than $250,000 is not the kind of enterprise which can be financed profitably by the investment banker or whose securities are suitable for trading in the public markets.

To say that the registration requirements under the Securities Act are a deterrent to the flow of capital to small business is plainly without any foundation. Issues of less than $100,000 are exempt from registration. In my opinion, it is extremely doubtful whether many of the 253,000 business corporations with average assets of $47,000, or the more than 2,300,000 small business establishments in this country will ever have occasion to raise capital in such amounts as to require registration.

With the wealthy individual disinclined to place his funds in the small enterprise, and the capital markets largely closed to small business as a source of equity capital, what other avenues are open?

The commercial bank? The answer, as you are all aware, is "No."

Now the commercial banker has been subjected to a great deal of criticism for not aiding small business. In general, the attitude of small business toward the commercial bank is summed up in the remark of the business man who said: "If your business is in shape for a bank loan, it doesn't need one."

At the possible risk of incurring your displeasure, I want to take issue with some of the extreme criticism which is being directed against the commercial banker. In my opinion, such criticism is not only unjustified but is based on a failure to recognize the responsibility of the banker to his depositors, as well as the inherent limitation of commercial banking as a medium for supplying small business credits.

In the first place, not all small business enterprises have difficulty in obtaining bank credit.

The heart of the problem has always been (and continues to be) that sizeable group of small business men whose concerns are not so firmly established and whose personal resources are not so great as to be able to satisfy the credit standards of commercial banking. Those businesses which experience difficulty in obtaining bank credit generally fall into one of two groups: (1) that group of older enterprises whose liquid and capital assets have been dissipated through the depression years and whose credit facilities have been cut off through the shut down of more than 15,000 local banks; or (2) that group of younger enterprises, still in the early stages of development, which have not yet either accumulated sufficient liquid and fixed capital or have been unable to establish permanent credit relations.

While there are in these two groups a considerable number of business men who may have a legitimate complaint against the commercial bank, by far the greater number cannot obtain bank credit on the basis of the existing credit standards and lending techniques of the commercial banks. To constitute a good credit risk, an enterprise should be profitable. But if the enterprise is expanding rapidly, the probabilities are that it will be short of capital and the equity will be thin. The likelihood is also present that the tangible assets will be special purpose plant and equipment of negligible value on an auction basis.

The position taken by the commercial banker that the funds at his disposal belong not to him but to his depositors and therefore can be loaned only to individuals and enterprises whose assets and future prospects make repayment certain, is fundamental to sound banking practice. Faced with this responsibility, the commercial banker is compelled to find that the assets or business prospects of a considerable proportion of the smaller enterprises in his community are such as not to warrant bank credit.

Furthermore, in discussing this problem, we should be perfectly candid and recognize that under our system of banking, the commercial bank cannot be expected to supply the need for equity capital. In making long- or even intermediate-term loans, a bank must consider not only the non-liquid and unmarketable character of the assets which it will have to hold, but also the additional element of risk which will be involved, such as an adverse turn in the business cycle; or a change in the management; or a new development in technology which may even wipe out the borrower's business.

Moreover, the extension of small business credits requires special skill and facilities which are largely lacking in the existing commercial banking system. The growth in the average size of commercial banks, the spread of branch banking, and the closing down of thousands of small unit banks, has resulted in a situation in which bank officers no longer have the same intimate knowledge of local management and enterprises, which their predecessors possessed. The earlier generation of bankers were largely business men: they either owned or managed the local banks. Through their own personal business experience, they were intimately acquainted with business needs and business management. Today, by and large, this group of bank officials has been supplanted by a personnel which has risen from the ranks: they are primarily *bankers* rather than *businessmen*. This newer type of bank manager is disposed to pay greater attention to the static elements of assets and liquidity than to the dynamics of growth and expansion. As a result of this gradual shift in banking personnel, the commercial banks have largely lost their intimate contact with the business activity of the community. And most of them have not yet substituted for this loss of personal contact the kind of machinery which can achieve the results which were obtained earlier.

Prior to the recent banking crisis, when the local banks were usually owned and managed by the community's substantial citizens, it was not uncommon for the bank to have among its own stockholders the responsible backers of those local enterprises which enjoyed bank credit. Hence, to a considerable extent the ultimate cushion of risk for the bank as well as the enterprise, rested upon the same individuals. Today, this picture has changed. During the banking crisis, this cushion of risk became impaired. Local bank stockholders and directors were compelled to draw heavily upon their own resources to make good assessments on their stock and to protect the solvency of their banks. Frequently, they had to make good on the double liability which was attached to their stock. To no small extent, the banking crisis served to undermine the financial standing of those individuals upon whose credit loans had formerly been made. Local business enterprises which had formerly constituted good risks were, therefore, seriously affected. And those enterprises which had never enjoyed satisfactory banking relations now found that it was even more difficult to establish them.

While many local banks have returned to their traditional lending practices, or have endeavored to meet the problem through the establishment of personal loan departments, and the Government through the Federal Reserve Banks and the Reconstruction Finance Corporation, has also attempted to alleviate the situation, the void has not been filled completely.

The successful financing of small business requires that loans be made to a large variety of unrelated enterprises and that there be many different loans in each classification. In the absence of such diversification, solvency is placed at the mercy of business uncertainties in a restricted field. Most commercial banks, as presently operated, lack the special skill and facilities for the supervision required in the handling of a large variety of small business credits.

Although this sector of small business is not being favored by the commercial bank, it does obtain credit. Today, the banker for small business is the accounts finance company, the personal loan company, the factor, the trade creditor, and other private lenders.

These intermediary lenders have largely supplanted the commercial bank in the financing of small business. The commercial banks, on the whole, do not appear to be concerned with the competition of these "retailers" of credit. By financing the accounts finance company, the factor, the personal loan company, and the trade creditor, the commercial bank engages in profitable operations without directly assuming the risk, expense and responsibility of handling an enormous number of unrelated and widely scattered transactions.

The phenomenal growth of these intermediary financing institutions shows that credit can be extended successfully to small business *if an appropriate credit machinery is utilized.* Such a machinery has been developed by these intermediate lenders. They, rather than the commercial bank, have developed "mortality tables" expressly designed for the financing of small business. The successful experience of these financing agencies is due largely to their having employed such techniques and methods as (a) pooling of risks; (b) routine procedures for appraisal, accounting, and servicing; and (c) establishment of schedules of charges appropriate to each class of risk as well as individual risks.

These "retailers" of credit, through their ability to organize the multiplicity of small transactions into aggregates, and to graduate financing charges and terms in accordance with the special requirements of each individual industry and client, are able not only to attract equity capital but also to tap the credit of banks and the capital markets -- sources of capital supply to which small business individually has no access.

While small business is obtaining its credit to an increasing extent from these intermediary bankers, the cost of such credit is considerably in excess of the cost of bank credit. The small enterprise which utilizes this medium of credit is, therefore, placed at a disadvantage in relation to those of its competitors who are able to obtain bank credit or utilize the capital markets. Moreover, since this field of credit extension is largely unregulated, practices vary widely and abuses are prevalent.

III.

The techniques developed by these "retailers" of credit offers a solution to the problem of financing small business.

I think the time has come when small business should have available to it a banking system designed to serve its special needs as effectively as the existing financial institutions serve the requirements of big business.

Various proposals in this direction have been advanced by members of Congress. Certain of the measures which have been proposed for the provision of more adequate long-term and intermediate credits for small business recognize that the commercial banks cannot undertake this type of financing without additional mechanisms for the distribution of risk, for guidance to banks unfamiliar with the handling of small business credits, and for extensions of credits which local banks are unable to provide.

Senator James Mead has proposed legislation for the creation of an Industrial Loan Corporation which would utilize the existing machinery of the Federal Reserve System.

The proposed corporation would utilize the 12 Federal Reserve banks and their 24 branches. It would finance small and intermediate businesses through the acquisition of the obligations of such enterprises, or the purchase of preferred stocks, notes, *et cetera*. The corporation would also make loans or make loans in cooperation with local banks or guarantee loans made by the banks directly. The basic principle underlying this proposal is that of Title I of the Federal Housing Act, which covers loans made by banks for modernization of residential dwellings. This proposal utilizes the existing banking system but endeavors to overcome some of its deficiencies in the handling of small business credits.

To overcome the deficiencies of the commercial bank and to fill up the void in capital and credit facilities for small business, Mr. Justice Douglas, when he was Chairman of the Securities and Exchange Commission, proposed the establishment of a capital credit banking system.

Last week, Chairman Frank addressed the Kiwanis Club of Cleveland on this very subject. He there proposed that there be established a system of regional finance companies. In each of the Federal Reserve Districts, there would be set up a financial institution, the common stock of which would be owned by private persons in the district. The government would invest in their preferred stocks, but such preferred stock would have little, if any, voting power. These institutions would purchase the common stocks of local enterprise. The institutions would not make loans -- they would supply equity capital. In short, the institution proposed by Chairman Frank "would be a sort of speculative finance company or investment trust."

It is believed by those who have given serious consideration to this problem that the special and varied financial services required by small business and its need for long-term capital, particularly equity capital, can be met only by the creation of a new financial machinery organized on a regional and functional basis.

Capital credit banks, under this machinery, would purchase equities in small business enterprises and would extend credits at costs sharply below present levels. Such a system of banks would be able to harness to it the trade and business experience of those members of the community who are familiar with the enterprises in their localities. A movement in this direction would go far in restoring the personal banking which was characteristic of earlier times. Credit extensions would again be based on the dynamic factor of growth and expansion as it was in the past.

However, it cannot be emphasized too strongly that merely to reduce the cost of credit or to make the supply of capital more abundant, will not solve all of the small business man's problems.

Obtaining credit and capital facilities are a necessary first step: in addition, small business also requires that its functions and activities be improved. It must be enabled to possess, in its field, the operating and developmental efficiencies which large business enjoys through expert accounting, managerial, operating and capital techniques. Small business should have available to it a systematic informational and research service comparable to that furnished to the farmer by the Department of Agriculture or which big business enjoys through its own research facilities and the Department of Commerce.

Just as the credit and marketing problems of the farmer have been dealt with successfully through the establishment of a system of land banks, intermediate credit banks, commodity credit agencies, so, too, the capital and credit problems of small business can be solved successfully if they are broken down into manageable elements and special solutions provided for their distinctive requirements.

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