THE RECONSTRUCTION FINANCE CORPORATION: SOME HISTORICAL PERSPECTIVE

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Preface

The current interest in providing federal government credit assistance to local governments and other borrowers has evoked comparisons with an earlier federal credit program, the Reconstruction Finance Corporation (RFC). Under the circumstances, it may be useful to review the history of that federal agency, and especially the circumstances which lead to its abolishment. As it turns out, the actual experiences of the RFC were not as uniformly favorable as seems to be the recollection that now prevails.

This study by James McGowen, a graduate student in the Washington University Department of Economics, demonstrates that using the federal government's credit power is a mixed blessing. The history of the RFC suggests that four problems may arise in such undertakings:

1. The criteria for granting federal credit assistance are likely to be vague and open to subjective interpretation.
2. The government subsidies often encourage and perpetuate misallocation of resources.
3. Government programs tend to develop a life of their own and to persist long after the problems for which they were created have been resolved.
4. Federal credit programs put the government in the position of holding assets of questionable quality or limited use, making it difficult to recover the original value of loans in the case of default.

It would seem that extensive and long-term federal credit subsidies to local governments would have additional shortcomings. It is hard to see any effective mechanism whereby the federal government could foreclose on New York City should it default. Thus, there might be little incentive for local governments to face their basic financial problems in an environment in which they can readily turn to the national treasury for aid.

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The Reconstruction Finance Corporation (RFC) was established by the U.S. Congress in the last year of the administration of Herbert Hoover. President Hoover originally envisioned the RFC as a temporary federal credit agency. Indeed, he stipulated that the corporation "...should be placed in liquidation at the end of two years." However, owing to the continuing economic problems of the thirties, the advent of World War II in the early forties, and considerable bureaucratic inertia in later years, the RFC remained in operation for more than two decades. Moreover, when the RFC was finally liquidated in late 1953, its form and functions had altered considerably from the agency created in 1932. It is instructive to study the evolution of the RFC over the years. The history of the agency illustrates both the types of problems which lead to a federal credit program and the types of problems which the program itself creates.

History of the RFC

The original purpose of the RFC was to promote the recovery of the nation's financial system and railroads. The Reconstruction Finance Corporation Act of 1932 originally granted the RFC lending powers which extended only to railroads, banks, insurance agencies and mortgage companies; the corporation had no authority to lend to commercial and industrial firms. By 1934, however, the Congress came to believe that the problems of the industrial sector also required the resources of the new federal corporation. Hence, in June 1934 Congress gave the RFC authority to make loans for industrial purposes. Congress originally placed strict limitations upon the volume of loans and the type of collateral security acceptable for industrial loans, and stipulated that the maximum maturity of
the loans would be five years.

These restrictions limited the volume of industrial loans made by the RFC in 1934 to a level below Congressional expectations. Congress responded in January 1935 by passing a law which eased collateral requirements, lengthened the maximum maturity of loans to ten years, expanded the list of industries eligible for RFC loans, and extended the life of the corporation for two more years. 

Continuing economic problems led to a further expansion of the RFC's powers during the late 1930's. In 1938, Congress enacted a law which gave the RFC the authority to purchase the securities and obligations of any business enterprise. The 1938 act also replaced the 10 years limitation on loan maturities with a provision which allowed the RFC to set maturity dates by administrative decision. Thus, by the end of the thirties, the RFC -- which according to President Hoover's initial intention was to be liquidated in 1934 -- was not only still very much alive, but was considerably more powerful than Hoover had intended it to be when he recommended its creation.

The performance of the RFC during the early years of its existence generally received high marks. An evaluation by economist Addison Parris was extremely laudatory:

"...the RFC must receive a large part of the credit for saving our banking system from ruin, and many insurance companies as well. Some of our largest corporations were kept afloat by the RFC during the 1930's, and the over-all image of the RFC was extremely favorable then. It was highly regarded by most businessmen, only the crustiest of conservatives opposing it..." 

The advent of World War II led to further growth of the RFC. The agency not only continued to make domestic loans, but extended credit to foreign
governments as well. It also engaged in "preemptive" buying from neutral nations to prevent Germany and her allies from obtaining necessary war materials. Perhaps the most important of the RFC wartime activities, however, concerned the production and stockpiling of scarce items which were crucial to the defense production effort. In this capacity, the RFC played a major role in the development and control of the new synthetic rubber industry and the only tin smelter in the United States.7/

Confidence in the RFC and in Jesse Jones, who headed the corporation from 1932-1945, remained high during World War II. The extent to which many members of Congress trusted the integrity and business sense of Jesse Jones was illustrated by Jones himself in the following anecdote:

"When the Amendment to the RFC Act granting us these unprecedented powers was being discussed in the Senate in June 1940, one of the Senators called attention to the fact that under the amendment "that fellow," meaning me, "could lend any amount of money for any length of time at any rate of interest to anyone he chose." To this objection Senator Carter Glass of Virginia, who was in charge of steering the amendment through the Senate, replied: "Yes, but he won't.8/

By the end of World War II the RFC had gained enormous power. Jones described the extent of the activities undertaken by the corporation during his thirteen year tenure in the following terms:

"In January 1932, the Reconstruction Finance Corporation was created to combat the ravishing elements of deflation and despair in our own country...Eight years later, with the coming of the war, the immense resources and well trained capacities of the RFC were turned to strengthening America's arsenal and military might.

In these two roles, as a corporate combatant, the RFC loaned and spent, invested and gave away a total of thirty-five billion dollars ($35,000,000,000) and authorized many billions more that were not finally used. It grew to be America's largest corporation and the world's biggest and most varied banking institution."9/
The attitudes of many business and political leaders toward the RFC began to change soon after World War II. Jones resigned in 1945, and no one of his calibre filled the void left by his departure. Furthermore, contrary to the predictions of many economists and politicians, the end of the war did not usher in a new depression. The end of the war thus signalled the end of the "crisis" atmosphere of 1932-1945 which legitimized the activities of the RFC.

The change in attitudes toward the RFC was reflected in legislation designed to curb some of the corporation's powers. In 1947 Congress repealed many of the RFC's war powers and provided it with a new charter.\textsuperscript{10} Legislation was enacted in 1948 which reinstated the ten year limitation on loan maturities, emphasized the need for sufficient collateral, and stipulated that the corporation could not compete with private sources of credit.\textsuperscript{11} However, the 1948 law also extended the life of the RFC by eight years, indicating that, although Congress had adopted a more restrictive philosophy concerning the agency's powers, support for the corporation itself remained strong in the late 1940's.

The recommendations of the Senate Committee on Banking and Currency concerning the 1948 legislation indicate that Congressional support for the RFC stemmed mainly from three considerations. First, many members of Congress felt that the RFC should be maintained in order to provide necessary services in the event of another national crisis:

"It is difficult, if not impossible, to identify the beginning of...an economic downturn...The severity which such cycles have achieved, the alleviation which can result from Government activity of the nature performed by the RFC, and the possibility that the severity of any such decline may be reduced through immediate aid by such an agency, make it advisable to continue the RFC as a stand-by agency against any such contingency."\textsuperscript{12}
A second consideration was that many Congressmen also felt the RFC could perform useful services in times unmarred by wars or depression. In particular, some members of Congress from the South and West, notably Senator J. William Fulbright of Arkansas, maintained that the RFC was needed as a source of credit in their geographic areas, where they believed private credit was less plentiful than in the East.  

Other supporters saw the RFC as an important source of credit for areas hit by natural disasters.  

A final consideration which encouraged Congressional support for the RFC was its apparent ability to perform with limited burden to the taxpayer. It was widely maintained that the corporation entailed little or no ultimate cost to the government. Thus, the Senate Committee on Banking and Currency concluded that "It is the opinion of this committee that RFC provides an inexpensive check against...national economic distress."  

Serious criticism of the RFC began to surface soon after the 1948 law was enacted. An audit of RFC activities for fiscal year 1949 indicated that the reported net revenues of the RFC resulted from heavy government subsidization. The audit pointed out that the corporation held $350 million in interest free funds from the U.S. Treasury, and borrowed other funds at extremely low rates. Had the corporation paid market rates of interest for the use of these funds, its reported profit for fiscal 1949 of $5.2 million would have been converted into a $2 million loss.  

A task force of the prestigious Commission on Organization of the Executive Branch of the Government (the Hoover Commission) issued a highly critical report on the RFC in early 1949. Indeed, the report recommended liquidation of the corporation. The task force based its recommendations
on arguments diametrically opposed to those advanced in the 1948 report of the Senate Committee on Banking and Currency which had recommended the extension of the RFC's activities. In particular, the task force maintained that:

"It is not the public interest for the Government to keep an emergency institution alive during non-emergency periods, in the hope that its existence may mitigate the effects of a future crisis, the date, the nature, the duration, the scope, and the magnitude of which are all unpredictable." 17/

The task force also argued that in many cases assistance extended by the RFC to business enterprises in the form of loans might have a negative value from the national point of view, because "it encourages the continuance of ventures which should be permitted to discontinue, and...prevents their owners from going on to occupations for which they may be better suited." 18/

Despite the criticisms of the Hoover Commission task force and the restrictions incorporated in the 1948 law, the RFC continued to be a powerful agency. A study by the National Bureau of Economic Research indicates the RFC actually expanded its direct business loans substantially in the late 1940's and early 1950's. In fact, in terms of dollar value, almost half of all loans extended by the RFC under its direct business loan program (which began in 1934) were issued between June 1948 and June 1951. 19/ The findings of the NBER study are summarized in Table 1.

The criteria used by the RFC to approve loans in the late 1940's were extremely vague. The practical guide of profitability was not applicable to RFC loans since the corporation was prohibited from competing with private sources of credit by the 1948 law. Hence, a large portion of the loan applications to the RFC were the type which were considered to be poor risks by private credit institutions.
Table 1

Estimated Number and Amount of RFC Direct Business Loans Disbursed 1934-1951, by Periods of the Business Lending Program

<table>
<thead>
<tr>
<th>PERIOD OF LOAN AUTHORIZATION</th>
<th>NUMBER</th>
<th>AMOUNT (THOUSANDS)</th>
<th>PERCENTAGE DISTRIBUTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 1934 to January 1935</td>
<td>389</td>
<td>$20,947</td>
<td>2.4%</td>
</tr>
<tr>
<td>February 1935 to April 1938</td>
<td>1,118</td>
<td>87,609</td>
<td>7.0</td>
</tr>
<tr>
<td>May 1938 to May 1940</td>
<td>2,140</td>
<td>106,277</td>
<td>13.3</td>
</tr>
<tr>
<td>June 1940 to February 1945</td>
<td>600</td>
<td>67,279</td>
<td>3.7</td>
</tr>
<tr>
<td>March 1945 to January 1947</td>
<td>2,792</td>
<td>191,752</td>
<td>17.4</td>
</tr>
<tr>
<td>February 1947 to May 1948</td>
<td>2,397</td>
<td>120,256</td>
<td>14.9</td>
</tr>
<tr>
<td>June 1948 to June 1951</td>
<td>6,607</td>
<td>565,520</td>
<td>41.2</td>
</tr>
<tr>
<td>TOTAL</td>
<td>16,043</td>
<td>$1,159,640</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Source: National Bureau of Economic Research survey of RFC direct business loans. The sample includes 2,851 loans and covers disbursements through December 1951 on loans authorized through June 30, 1951, exclusive of participation loans and national defense loans.
One criterion for loan approval set by Congress was that RFC loans should only be made for purposes which would serve the public interest.\(^{20}\) The RFC, however, apparently ignored this criterion. The test of public interest would have called for a decrease in the volume of loans during the period of inflationary pressure after 1948, instead of the substantial increase in loans which actually occurred.\(^{21}\) Moreover, individual loans were made to gambling casinos, bars, snake farms, and manufacturers of alcoholic beverages (see Table 2).\(^{22}\)

Rumors began to circulate in 1949 that the real criterion for RFC loan approval was friendship with certain influential people in Washington. When these reports persisted, the Senate Committee on Banking and Currency decided to investigate RFC lending practices. The committee placed Senator Fulbright in charge of the investigation.

The Fulbright subcommittee began its examination of the RFC in February 1950. The examination lasted more than a year and included the testimony of scores of witnesses.

The investigation disclosed numerous examples of favoritism and corruption in RFC activities. Moreover, the corruption was not confined to a few officials in the RFC, nor to the corporation's lower levels. Donald Dawson, who was a trusted advisor to President Truman, was directly implicated as were members of the Washington law firm of Goodwin, Rosenbaum, Meacham and Bailen. Walter L. Dunham and William E. Willet, two of the RFC's five directors, were also found to be connected with influence peddling activities. For example, in the case of a loan to Central Iron and Steel Company, the Fulbright subcommittee had the following comments:
Table 2

Selected Business Loans Made By the RFC

<table>
<thead>
<tr>
<th>Loan Details</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Distillers of America, Inc.; United Distillers of America, Ltd., NY;</td>
<td>$331,500.00</td>
</tr>
<tr>
<td>unpaid loan balance, June 30, 1950</td>
<td></td>
</tr>
<tr>
<td>James Distillery, Inc., Baltimore, MD; unpaid loan balance, June 30, 1950</td>
<td>$315,000.00</td>
</tr>
<tr>
<td>Harvard Brewing Co., Lowell, MA; undispersed authorized balance, June 30,</td>
<td>$300,000.00</td>
</tr>
<tr>
<td>1950</td>
<td></td>
</tr>
<tr>
<td>Bluebeards Castle Hotel Corp., St. Thomas, VI; undispersed loan balance,</td>
<td>$250,000.00</td>
</tr>
<tr>
<td>June 30, 1950</td>
<td></td>
</tr>
<tr>
<td>Morello Winery, Kerman, CA; undispersed loan balance, June 30, 1950</td>
<td>$200,000.00</td>
</tr>
<tr>
<td>Coast Drive-In Theatres, CA</td>
<td>$164,669.22</td>
</tr>
<tr>
<td>Shore Club Lodge, Inc., Boise, ID; unpaid loan balance, June 30, 1950</td>
<td>$164,500.00</td>
</tr>
<tr>
<td>Saratoga Hotel Co., Saratoga, WY; undispersed loan balance, June 30, 1950</td>
<td>$125,000.00</td>
</tr>
<tr>
<td>Coast View Winery, Inc. Fresno, CA; participating unpaid loan balance, June</td>
<td>$117,750.00</td>
</tr>
<tr>
<td>30, 1950</td>
<td></td>
</tr>
<tr>
<td>Gold Front Bar, Gold Front Theatre, Gold Front Recreation, Cheboygan, MI;</td>
<td>$85,000.00</td>
</tr>
<tr>
<td>undispersed authorized balance, June 30, 1950</td>
<td></td>
</tr>
<tr>
<td>The Wooden Shoe Brewing Co., Minster, OH; unpaid loan balance (participating)</td>
<td>$65,040.00</td>
</tr>
<tr>
<td>June 30, 1950</td>
<td></td>
</tr>
<tr>
<td>Plymouth Rock Bar, Detroit, MI; authorized</td>
<td>$39,500.00</td>
</tr>
<tr>
<td>Sandpiper Inn, Fort Walton, FL; January 26, 1950</td>
<td>$32,000.00</td>
</tr>
<tr>
<td>Cactus Courts, Carlsbad, NM</td>
<td>$11,446.00</td>
</tr>
</tbody>
</table>

"The subcommittee has made a study of the circumstances surrounding the loans which RFC made to Central Iron & Steel Corp. As such, it is a member of a group of companies which are clients of the Rosenbaum firm.

Another subsidiary of Barium Steel Corp. had sought financial assistance from RFC some years before. It was turned down because of severe defects in its financial policies and in the financial policies of the parent's principal officials, who made a practice of "milking" the subsidiaries. The same people and the same policies were found to be dominant in Central Iron & Steel Co. Primarily for this reason, its initial application was scheduled for "automatic decline," a process which would have ended in rejection of the application unless the RFC Board interfered by a freak action.

Notwithstanding his knowledge of the earlier unsuccessful applications, Willett brought about a substitution of examiners on this case in time to avoid "automatic decline." The first Central Iron & Steel loan was granted on June 3, 1949, and the second was granted on September 16, 1949, the total at that point being $6,300,000. The loans were granted over the objection of all examiners and reviewers with the single exception of the substitute examiner, Hubert B. Steele.

One month after the second loan was authorized, Steele left the RFC and obtained employment at $15,000 a year with Goodwin, Rosenbaum, Meacham & Bailen and Joseph E. Casey, jointly. He received a payment of $5,000 on the day he reported for duty. Rosenbaum explains that the $5,000 payment was for 4 month's salary in advance."23/

Other blatant examples of corrupt practices included the RFC loans to the Lustron Corporation and the Kaiser-Frazer Corporation. In the Lustron case, Carl Strandlund, the president and principal owner of Lustron, charged that RFC director Dunham repeatedly tried to transfer control of the corporation to some of his friends and associates. Strandlund further testified that when Dunham failed in his attempts, he turned his attention to the deliberate destruction of the Lustron Corporation.24/

In the Kaiser-Frazer case, evidence indicated that Edgar Kaiser of the Kaiser-Frazer Corporation had been approached by influence peddlers on
several occasions, including Joseph H. Rosenbaum of the Goodwin, Rosenbaum, Meacham and Bailen law firm, who claimed to have influence over the decisions of Willet and Dunham.\textsuperscript{25/}

The depths of disrepute into which the RFC fell during the Fulbright investigations is illustrated by the fact that the two men most intimately associated with the development of the RFC both called for its liquidation during the hearings. Herbert C. Hoover, who, as president called for creation of the RFC and signed the initial RFC legislation testified before the committee that "To go directly to the point...I believe that the RFC should be liquidated."\textsuperscript{26/} Hoover went on to discuss in detail the reasons for his opinion. His statement included the following observation:

"When the RFC was established there were seven Directors who could probably have earned an aggregate of $1 million a year who served for usual government salaries. When we get outside of an emergency we can no longer call on men of that quality to leave their occupations. We must employ men who are willing to work for modest salaries. Then we expect them to have all of the judgment and all of the experience of these men of the first order..."\textsuperscript{27/}

Jesse Jones, who dominated the RFC in its earlier years, did not testify before the Fulbright subcommittee. He did, however, write a letter to Senator Harry Byrd of Virginia, who had introduced a bill which called for the liquidation of the RFC. In his letter to Byrd, Jones said, "I have your letter and your bill, of which I approve. I am, of course, shocked by the exposures Senator Fulbright's committee has brought out, and doubt if he has done more than scratch the surface."\textsuperscript{28/}

The findings of the Fulbright subcommittee gave momentum to the movement to liquidate the RFC. Yet, the attempts to end the agency did not succeed without a struggle. Senator Fulbright himself continued to support
the RFC, despite the disclosures of his subcommittee. He believed that the problems of the corporation stemmed from poor organization which encouraged corruption.29/

Senator Fulbright's position met with strong opposition from two members of his subcommittee, Senators Homer W. Capehart and John W. Bricker, who issued a minority report which stated:

"The risks inherent in the making of direct Government loans cannot be eliminated either by reorganization or by congressional prohibitions...Regardless of the calibre of RFC personnel, the form of organization, or the loan procedures adopted, political influence and favoritism will continue as long as direct government lending to individuals or enterprises is authorized by the Congress. This is so because the objective tests of financial merit are secondary in RFC loans, and almost all applications to the Corporation involve loans which private lending institutions have found to be economically unsound. In granting certain loans and denying others, the RFC must therefore necessarily use arbitrary and subjective standards."30/

Debate over the fate of the RFC continued for two years after the disclosures of the Fulbright subcommittee. The liquidation of the agency finally occurred in 1953, following a change of Presidential administration.31/

Some Conclusions

This brief history of the Reconstruction Finance Corporation shows that the agency achieved some useful purposes during the early years of its existence. However, the major growth in its lending occurred after the original justification (the depression of the 1930's) had passed. The abuses which led to the agency's termination occurred during this latter period, especially the late 1940's and the early 1950's.
On the basis of this survey, it appears that several fundamental problems are likely to be associated with the operation of a governmental credit agency such as the RFC:

1. The criteria for granting loans by the federal government are likely to be vague and open to subjective interpretation.
2. Government subsidization of private activity often encourages and perpetuates a misallocation of resources.
3. Agencies of the federal government tend to develop a life of their own and to persist long after the problems for which they were created have been solved.
4. Federal credit programs put the government in the position of holding assets of questionable quality or limited use. This makes it difficult to recover the original value of loans in the case of default. It also complicates the process of liquidating the agency.
Footnotes

1/ U.S. Congress, State of the Union message by President Herbert C. Hoover, 72nd Congress, 1st sess., December 7, 1931, Congressional Record, LXXV, p. 25.


3/ Public Law 417, 73rd Congress, June 19, 1934.

4/ Public Law 1, 74th Congress, January 31, 1935.

5/ Public Law 479, 75th Congress, April 13, 1938.


8/ Ibid., p. 9.

9/ Ibid., p. 3.

10/ Public Law 132, 80th Congress, June 30, 1947.


14/ S. Rept. 974, op. cit., p. 7.

15/ Ibid., p. 6.


Footnotes (continued)


20/ See, for example, S. Rept. 974, op. cit., p. 11.

21/ Saulnier, Halcrow, and Jacoby, op. cit., p. 433.


24/ Ibid., p. 10.

25/ Ibid., p. 11.


27/ Ibid., p. 124.

28/ Letter cited by Senator Harry F. Byrd in testimony in Hearings on S. 514 et. al. op. cit., p. 133.

29/ See, for example, the comments of Senator Fulbright and Senator Paul H. Douglas of Illinois in U.S. Congress, Senate, 82nd Congress, 1st sess. April 12, 1951, Congressional Record, XCVII, pp. 3742-3746.
