AID TO WAR CONTRACTORS

1 February 1950

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AID TO WAR CONTRACTORS

1 February 1950

GENERAL HOLMAN: Gentlemen, the subject of our lecture this morning is "Aid to War Contractors," and I can assure you that, in time of war, this is a much-discussed subject, particularly by the contractors and contracting officers. You can readily see why this is so. Because of the large volume and the time element, both large and small producers must be brought into the picture just as quickly as possible if they have any capacity for producing munitions. Many of these contractors will require funds to meet pay rolls, to get started, and these funds frequently take the form of government loans and advance payments. They may even need assistance in the form of tools, materials, and, in some cases, shop facilities.

Our speaker this morning is Major General Eugene M. Foster, the Army's Chief of Finance. You will be interested to know that General Foster was one of the original group that came into the Finance Department in 1920. I think there are only two or three of that group still remaining in the service. General Foster has had a long and distinguished career in fiscal fields both outside of Washington and here on the general staff and in the Finance Department. He is a graduate of both the Army War College and the Industrial College. He has always been very liberal, so far as the Industrial College is concerned, in helping us with our curriculum. He has given many lectures down here and has helped a great deal with seminars by always expressing the desire to appear personally whenever he was able to do so.

We are very appreciative, General, of your fine support throughout the years, and it is a great pleasure to welcome you here today.

GENERAL FOSTER: Gentlemen, it is a pleasure for me to return to the Industrial College of the Armed Forces and to commune with you over one of the subjects on which I know you have spent hours in research and in visualizing the conditions we may expect should we unfortunately be called upon to fight another war. I hope that I may be able to contribute in a small way at least to a partial solution to your problems.

The subject assigned me may be summarized under the title of "Aid to War Contractors" and is divided into two parts: first, financial assistance; and second, government-furnished facilities, equipment, and material. I shall address myself first to the subject of financial assistance because I believe that to be the more important of the two.

It is self-evident that, under the impact of a major war effort, placing as it does a great strain on our whole national economy, measures, sometimes drastic, must be put into effect to relieve this strain. One of the most important of these measures is the proper flow of credit.

Without the almighty dollar, the soldier's will to fight is dulled. Without the almighty dollar, the civilian in industry, regardless of his protestations of patriotism, lacks the incentive to labor. High wages and overtime pay inspired patriotism in many of the war workers in the last war, and the profit stimulus caused many industrialists to seek war contracts. I had better qualify that statement by saying that this did not apply to all men of industry, for, without the initiative, creative genius, innate ability, and drive of most of our men of industry, our allies or our military services could not have gained the splendid victory that was our.

I have been trying merely to highlight a self-evident fact; namely, that the need for dollars is so great and so important to all concerned in the war effort that it is not sufficient that the Secretary of the Treasury find ways and means to increase the Treasury balances to meet the war effort, but the channel must be clear and free to permit the flow of those dollars to the places where their fertilizing influnence will produce healthy crops of war materiel.

It might be well at this time to look at a few statistics developed from our experience in World War II. Appropriations, during the period 1 July 1941 to 31 August 1945, amounted to 225 billion dollars--and a billion dollars is quite a lot of money. Obligations of military funds for that period approximated 193 billion dollars. To bring it a little closer to our supply problems in the Army, actual expenditures against Army Service Forces appropriations for the period, omitting "Pay of the Army," showed an expenditure total of 92 billion dollars for procurement. Air Forces procurement expenditures totaled 23.7 billion dollars additional. In other words, industry had to find means of financing such a large program.

There is no problem for the military establishment to secure appropriations in an emergency. Congress was most generous in meeting our requests, and at no time did the Army or the Air Force curtail its activities because of lack of funds. I am sure the same can be said about Navy appropriations.

As has been stated, in a major war the whole national economy must be attuned to the war effort. Facilities now producing military materiel are limited, and the mere expansion of those facilities to their maximum capacity will not be sufficient for our needs. We must search out every plant that may be converted to war production, including individuals who have the know-how but with little or no existing facilities to produce munitions.

To do this, the military must not only be ready to advise industry of what we require of it but be able to suggest means and offer assistance to meet that requirement.

Many of you men here today are going to be called upon to perform services far beyond that normally expected of military men. You will be expected to advise a prospective contractor of some of the technical processes for producing a particular item of munitions. In addition, you must be able to advise on means by which his facilities may be increased and, most important, the sources from which the necessary capital for such purpose may be obtained.

In the last war the following means of credit were available to war contractors, and we can expect most of them to be available in another emergency:

1. A loan from a bank, secured by an assignment of claims under a government contract, or otherwise.

2. A loan from the Reconstruction Finance Corporation.

3. A loan from the Smaller War Plants Corporation.

4. A loan from a Federal Reserve bank under the provisions of section 13(b) of the Federal Reserve Act.

5. Advances from the War Department, Navy Department, or Maritime Commission if the business enterprise held a prime contract.

6. A Regulation V-, VT, or T-loan from a bank or other financing institution guaranteed pursuant to the provisions of an Executive order and the regulations issued thereunder.

7. A direct loan from the War Department, Navy Department, or Maritime Commission.

8. A combination of two or more of the foregoing.

We will discuss them in the order just mentioned.

A Bank loan secured by an assignment of claims.—This law, passed in 1940, rescinded an act which had been effective for approximately 100 years. The purpose of the original act had been to prevent racketeering in government contracts by irresponsible bidders and to obviate the possibility of the Government being involved in law suits as to the proper payee under a contract.

By 1940, it was realized that the government contracting officers could exercise sufficient judgment over the reputability of a contractor to see that the interests of the Government were protected. However, this was only one of the arguments used for the voiding of this 100-year-old statute. The arguments for the 1940 statute were that it would encourage small and medium-sized contractors to seek government business and, by increasing the number of bidders, tend to expedite and reduce the cost of the defense program.

The provisions of the act permitted the assignment of any contract in excess of $1,000 to a bank, trust company, or other financing institution, including any Federal lending agency. It limited payments to one assignee only.

By expanding the credit facilities of contractors, the law contributed materially in increasing working capital, but it did not meet the full needs for such capital. It was available to prime contractors only. It is still in effect.

The next credit source was loans from the Reconstruction Finance Corporation. The RFC came into being by an act of Congress approved 22 January 1932. It was an attempt by the Administration to combat the developing depression by offering credit support to existing credit agencies, that is, bank, loan associations, mortgage companies, etc. The act was amended in June 1934 to authorize the RFC to extend loans directly to industrial concerns. This amendment put the Government in the direct lending business, that is, direct to the borrower. It was also the initial step in the government loan guarantee program, which technique was later to be used by the War Department in developing what I consider the most practical and successful means of meeting war contractors' working capital requirements--our guaranteed loan program.

In view of what has been stated, you may ask why the facilities of the RFC failed to meet fully the requirements of the war effort. You will find the answer in the fact that the law was administered by bankers, and their interpretation of its language limited loans to those of sound finance or, in other words, to good-risk loans. This subject will be dealt with further when we discuss the War Department loan program.

The next item, the Smaller War Plants Corporation, was authorized by the act of 11 June 1942 "to mobilize the productive facilities of small business in the interest of successful prosecution of the war, and for other purposes." During peace there has been a continuing demand that the military give a fair share of its business to small-sized firms. We will not go into a study of the need to ecnourage small business in order to prevent monopolies and possible threats to our free-enterprise system, for I am sure that subject has been amply covered by your studies here; but I do wish to highlight the fact that in an emergency we must explore and use every facility, large or small, in order to meet our war requirements. The Smaller War Plants Corporation was organized to assist in accomplishing this purpose. The credit-granting functions assigned to this new agency were very broad and included loans to acquire land, buildings, and equipment, to finance conversion to war production, to conduct war production, to reconvert to civilian production, and to carry on civilian production. It had a capital of 150 million dollars which it used to advantage, but its real contribution to the war effort was in encouraging small contractors to seek government business and in urging the military department to make use of such contractors.

By the act of 19 June 1934, the Federal Reserve Banks had been authorized to make loans to industry for working capital purposes, and when the need for such loans became apparent during the war, this authority was used to some extent. However, this procedure was of limited value for the same reason as applied to the RFC. It was operated by bankers, and safe-investment criteria were applied to any request for a loan.

The next item in our index of loan facilities is the advance payment program. Up to this time we have been discussing working capital credit secured from bank or government agencies other than those of the military establishment. Now we will go into such credit on the basis of appropriations available to the military. This technique of credit was through the means of advance payments made by the government contracting agency.

Prior to 1940, government departments were not authorized to make advance payments on government contracts. They were permitted to make partial payments on completed partial deliveries under a contract in accordance with contract provisions, but no advances on undelivered services or supplies were authorized.

The extent to which the advance payment program was used is evidenced by the fact that a sum of over 7 billion dollars was advanced to over 1,500 contractors. Yet, as we discuss this method of financing, we will find it did not meet our full requirements, mainly because its effectiveness was limited to the financing of the prime contractor.

Authority to make advance payments on contracts for war supplies not exceeding 30 percent of the contract price was given the departments in the act of 2 July 1940. This authority was superseded by title 2 of the First War Powers Act of 18 December 1941, under which Executive Order 9001, dated 27 December 1941, was issued. This order authorized the departments to make advances and progress and other payments under its contracts in any percentage of the contract price wherein, in their judgment, the prosecution of the war would be facilitated thereby. In the War Department, under this authority, chiefs of the technical services were authorized to approve the making of advance payments when the amount of the contract was less than 5 million dollars. Advance payments on contracts amounting to 5 million dollars or more and advance payments in excess of 50 percent of the amount of a contract required the approval of the Under Secretary of War. The Fiscal Director (Chief of Finance) was the agent of the Under Secretary of War in approving for him these advances. Under the Contract Settlement Act of 1944, authority was granted to increase the former limitations, if necessary, to carry a contract to completion or for interim financing. Increases of this nature could be made up to 90 percent of the total amount estimated to be payable under a contract, including termination charges, less any unliquidated balances of advance payments previously made.

Where advance payments were authorized, the amount of the authorization was based upon the use of the contractor's own working capital as much as possible. The advance payment agreement provided that all payments on cost-plus-a-fixed-fee contracts and at least 85 percent on fixed-price contracts be deposited into a special bank account with suitable negative covenants to protect the Government's interest. These authorizations were limited to 30-day requirements and withdrawals from special bank accounts were closely supervised.

The procedure for making advance payments was as follows: Requests for authorization to make advance payments in excess of the authority delegated to the technical services were in each case submitted through the head of the technical service concerned to the Fiscal Director (Chief of Finance) for approval or disapproval under the delegated authority of the Under Secretary of War. I will not attempt to give you the various items of information required to be furnished with such requests. They were 12 in number. Briefly, they included a showing of the need for the advance, a statement of the contractor's financial position, and such additional information as would permit of a proper evaluation of the need and the risk to the Government involved in the advance. Advances were authorized only upon the furnishing of adequate security by the contractor. The security was in the form of a lien in favor of the Government and paramount to all other liens, upon the supplies contracted for, upon the credit balances in any special accounts in which such payments may be deposited, and upon such of the material and other property acquired for performance of the contract as the head of the technical service and the contractor should agree to.

While this advance payment plan was not the full answer to the need for financing war contractors, it did serve a very useful purpose in aiding government contractors, as is evidenced by the fact that over 7 billion dollars in advances were made. But, in addition, it was a splendid financial venture by the military branches. Contractors receiving advances under this procedure were in most cases charged interest on the money so advanced by the Government. This interest was computed at the rate of 2.5 percent per annum on the unliquidated balance of advance payments outstanding from time to time. There were, however, exceptions to this interest charge which were (1) in connection with contracts which provided that the work there-under should be performed at cost without profit or fee to the contractor, (2) in connection with cost-plus-a-fixed-fee contracts on which the fee was disproportionately small compared to the amount of interest that would accrue on the advance payment, and (3) under certain conditions when specifically authorized by the Under Secretary of

War and a few other cases where circumstances warranted; but in the majority of cases the interest charge was made.

That it was a good business deal is evidenced by the fact that interest in a net balance of over 29 million dollars was earned by the Government to be deposited in the general fund of the Treasury. The term "net balance" means that, after deducting all possible losses (which totaled only 1.5 million dollars), we were able to accumulate this large net amount in interest.

There was one other type of payment that was used during the war that may be of interest here--the partial or progress payments. These involved payments to the contractor on property acquired or produced by him for the performance of his contract. They were limited to 75 percent of the cost to the contractor of the property upon which payment was made, and, in no event, was the total to exceed 80 percent of the total contract price of the supplies still to be delivered. Partial payments could be made up to 90 percent of the direct labor and material cost to the contractor on the property on which payment was made. These are provided for in the contract provisions and present no problem. Further, they differ from the advance payments inasmuch as there is no charge for advances so made.

The advance payment procedure might have answered most of our problems regarding the financing of war contractors had it not been for the fact that there was no provision whereby advances could be made to subcontractors. It was possible for the prime contractor to pass on to his subcontractor some of the advances he received, but this procedure was not generally used. Further, the bookkeeping and administrative detail involved in determining whether the contractor was using the funds advanced to him for purposes of his contract became increasingly difficult and burdensome as the number of outstanding contracts increased. With this difficulty and the fact that the needs of the subcontractors were not met, some other solution to the problem became necessary.

There is one item which I did not mention in my original listing of means of financing war contractors but which I feel should be mentioned at this time, and that is the prompt payment to contractors for work performed. I think the record of the Finance Department in maintaining continual surveillance over this operation, and the adoption by the department of every possible means of expediting payment, materially reduced the needs of contractors for working capital funds.

This brings us to the subject which we found to be the best practical solution in meeting the needs of war contractors for working capital. It was a Regulation V-, VT-, or T-loand from a bank or other financing institution guaranteed pursuant to the provisions of the Executive order and the regulation issued thereunder. In discussing the advance payment arrangements, I mentioned the fact that the War Department was going into the banking business; but it was not until we considered the guaranteed or

V-loan and later VT- and then T-loan plan that we really did become bankers. The department takes pride in the development of the guaranteed programs and feels they are an ideal means of financing war contractors. These programs were flexible--they met the requirements of subcontractors as well as those of prime contractors, they made use of commercial banking facilities, and were operated at a minimum cost to the Government.

The authority for the guaranteed loan program was based on Executive Order 9112, dated 26 March 1942. This order was issued at the solicitation of the War and Navy Departments and the Maritime Commission, by virtue of the authority vested in the President by the various provisions of the First War Powers Act approved 18 December 1941, on the basis that such action would facilitate the prosecution of the war. The first "whereas" of the order reads as follows:

> "Whereas in order that contracts of the War Department, the Navy Department, and the United States Maritime Commission (hereinafter referred to as Maritime Commission) which are now outstanding or may hereafter be entered into for war production, including the obtaining or conversion of facilities, may be promptly and effectively performed, it is essential that additional facilities be provided through governmental agencies to supply necessary funds to contractors, subcontractors and others engaged in such war production pursuant to such contracts;..."

The other further authorized the use of funds appropriated by Congress for the purpose of guaranteeing loans, and authorized the use of the facilities of the Federal Reserve banks and the Board of Governors of the Federal Reserve System.

It recognized the need of small business for assistance by the following "whereas":

> "Whereas the guaranteeing or making of such loans, discounts, advances and commitments will greatly facilitate the participation of small business enterprises in war production;..."

The Office of the Fiscal Director of the War Department (Chief of Finance) was given the authority by the Secretary of War to administer the program in his name. The success of the program is a tribute to our national military policy wherein a small Regular Army is expanded to an army of millions of men through the inclusion therein of men of every walk of life and who are trained in every technique of business. Bankers who volunteered for service with the Army brought with them the latest commercial banking methods and procedures, and the small group of Regular officers blended with these business technicians to guide their commercial training and abilities into military accomplishments.

The organization consisted of a special division in the Office of the Fiscal Director (now Chief of Finance) handling advance payments and guaranteed loans, with military representatives located in the various Federal Reserve districts as liaison officers to assist contractors in securing the necessary war loans. These liaison officers were located in the Federal Reserve banks. They were people who were familiar with banking procedures and with making loans. They were the operating people in the field. They did a fine job. There were not so many of them, but they were in each district, maybe one or two in each district.

The Federal Reserve banks made available to these liaison officers office space and facilities, andany expense involved was reimbursed to the Federal Reserve banks from earnings accumulated from the loans. The operations were along this line: A contractor would be contacted by a representative of the technical service as to his ability to produce munitions. After it was determined that he had a potential for production either in facilities or know-how, the financial problems were reviewed. He had the opportunity to go to his own bank and borrow up to the limit that the bank would allow. If this was not sufficient, the representative of the technical service and the contractor would contact the Army fiscal liaison officer asking aid in financing the contractor's need. After an investigation of the contractor's financial condition to determine that he was a reasonable risk, giving consideration to the emergency requirements for war production, the bank would be advised that guarantees would be granted under the provisions of Executive Order 9112, and a guarantee agreement would be drawn up to cover the transaction. After approval of the agreement, the contractor would be granted his loan by the bank, and the loan would be administered by the bank and supervised by the Federal Reserve bank acting as fiscal agent for the United States. The extent of our guaranteed loan program covered borrowings in excess of 8 billion dollars.

You will remember, in the beginning of this talk, I mentioned the fact that the ample appropriations available to the War Department made it possible for us to finance war contractors without specific appropriations for that purpose from Congress. Initially, when the program was begun, the Federal Reserve banks and some contractors were afraid that if appropriated funds were to be used, there was a danger, if the war ceased suddenly, that the appropriations might all be used up in procurement, and there would not be sufficient balances to meet guarantees. The delay incident to obtaining new appropriations would be fatal to reconversion. To satisfy this demand, there was set up on the books of the Finance Department a reserve under each appropriation covering procurement. It was decided that, initially, this reserve would be approximately 20 percent of our total guaranteed loans. However, as the program progressed and was accepted with confidence by the banking fraternity, the department felt it unnecessary to maintain full 20-percent reserves. It was felt that, in view of the possible cancellation of contracts that would come with the close of war, sufficient funds would be changed to an unobligated status to meet any requirements under the guarantees, and thereafter the reserves were not adjusted as the program advanced. The program, however, was so successful that any losses could have been paid from guarantee fees and the use of appropriated money rendered unnecessary.

A description of the various types of loans may be of interest.

V-loan.--A production loan based on a certain percentage of amounts due on uncanceled contracts. Originally, going concerns not needing working capital were not eligible for a V-loan, since, originally, such loans were confined to present needs or immediate anticipated needs for war production.

VT-loan.--A production loan based on borrower's investment in uncanceled and canceled contracts. Protection against termination exists in allowing borrower to include in the loan formula his investment in receivables and inventory and also payments made or to be made to subcontractors under canceled contracts.

T-loan.--A termination loan based on borrower's estimate of termination claims. Of 560 such T-loans guaranteed by the War Department, only one offers possibility of loss due to the company's overstatement of its claims. However, it should be borne in mind that, when this basis of borrowing was incorporated in the Contract Settlement Act of 1944, the prime objective was to provide interim financing with a minimum of delay and red tape. The T-loan program successfully served its purpose.

Direct loans.--While authority to make direct loans was included in Executive Order 9112, this method of financing was kept to a minimum. Only four direct loans for production purposes, in the amount of 11 million 850 thousand dollars, were made by the Army. Four more direct loans, in the amount of 56 million dollars, were made under Joint Termination Regulations to provide funds to prime contractors to settle subcontractors' termination claims. In those cases where the banks for some special reason did not want to participate, the contractor asked for a direct loan, and the department granted it.

I might say that, in this loan program, the Army, Navy, and Maritime Commission worked very closely together. If a contractor wanted money to finance his Army war production contract and he had another contract with the Maritime Commission or Navy, the service having the largest contract would handle the financing for the other interested services, and the losses, if any, would be shared proportionately by the services. One service would carry the guarantee and arrange to take care of the contractor's needs.

Under the guaranteed loan agreements, the bank could at any time request the War Department to purchase the guaranteed portion of the loan. This was a sound protection to the banks. However, the War Department was called upon to purchase approximately only 20 million dollars of the guaranteed portion of loans. Of that amount, we have recouped 16 million dollars. These were different from and in addition to the direct loans previously mentioned.

The thing we must realize about this loan business is that the amount loaned was in line with the amount of business which the Government gave a contractor. So we did have good security. When we made a guarantee, we knew that the man had enough government contract business to cover any amount which he would get under the loan. It was only in case the war ended suddenly that we would be in danger. It is evident from the success of the program that our guarantees were not excessive.

To emphasize the point that the guaranteed loan program was a broad, all-inclusive one to meet war suppliers' financial needs, it may be well to cite a few specific cases of loans to show you that we played no favorites regarding size. I mention a case of a loan of $4,000 on a revolving credit guaranteed 90 percent. (This revolving credit may be explained as follows: Where we have a loan of $4,000, the contractor could draw out $3,000 and later pay back some and continue to borrow, just so the amount did not exceed at any time the total of $4,000 in his revolving credit. Our guarantee would be on 90 percent of the loan, the bank having a 10-percent share. The bank was doing a patriotic job as well as good business. This item was a termination loan supported by a claim of the contractor for approximately $4,000. He had a number of other unterminated purchase orders aggregating about $14,000. The application for the loan was made 14 September 1945, and the guarantee agreement was consummated on 24 September 1945. The loan was paid off when the termination claim was settled.

We now skip to one of the largest credits ever extended, to the knowledge of the banking fraternity. It was a V-loan with a maximum credit on a revolving basis of 1 billion dollars. It was to one of the Nation's largest industrial organizations. About 200 banks participated in the credit. Our guarantee percentage ranged between 50 and 90 percent, depending on the outstanding balance. The highest amount drawn down at any one time was 100 million dollars. The application for the guarantee was made 10 October 1942 and was approved 31 October 1942. Of course, this is the official record. I assure you, however, that extensive negotiations were carried on before formal documents were drawn up. This loan was paid in full.

Undoubtedly, you gentlemen would like to hear more about how we made a profit out of this banking enterprise. Banks, in making loans to contractors under this program charged not to exceed 5-percent interest on loans made. The War Department required of the banks a fee for guaranteeing the loan; that is, a percentage of the interest earned by the banks. This percentage was based on the percentage of the guarantee and varied from about 10 to 50 percent of the interest rate. This little operation netted, after deduction for all losses and expenses incurred by the Federal Reserve banks in administering the loans, about 18 million dollars, which will be eventually deposited to the general fund of the treasury.

Until now we have been talking about working capital needs of war contractors. The subject of fixed capital will now be discussed. Under this heading, I think it may be well to discuss first facilities. In this field, the Reconstruction Finance Corporation had full sway. The Army did not have sufficient appropriations to finance the construction of War Department facilities. It did have funds, under the appropriation "Expediting Production," which were used to supplement the funds of the RFC in this program. Under this arrangement, an agreement was entered into between the military establishment and the Defense Plant Corporation of the RFC whereby the financing of facilities construction was undertaken by the RFC. This contract provided that the Army advance to the RFC 40 percent of the estimated cost of a facility and the RFC provide the balance. The RFC was reimbursed for its investment from rentals charged to contractors for the facilities constructed. The contract provided that when the rentals equaled the amount invested by the RFC, the plant would become the property of the military department.

The war ended when much of this financing had not been completed; that is, the rentals paid to the RFC were not sufficient to reimburse it for the amount advanced by it. However, the bookkeeping was very much involved, and, it was impossible to determine the rentals and reimbursements on any plant. The following solution was finally developed: The RFC would permit the War Department and the Navy Department to take over any plant that they felt they needed for their needs or to be held in stand-by status. Plants that we did not require were turned over to the RFC for disposal, the proceeds going to the RFC account. I Have never seen a financial statement of this account, but it was agreed it was useless to continue research in this matter in view of the fact that it was government funds that were involved, and any returns which the War Department may have gotten could not be used for current operations. The Congress later approved this action.

The arrangement whereby the RFC was to finance facilities was a great advantage to the War Department in that the financing and rental arrangements were all the responsibility of RFC. Despite the Complications in accounting which developed, I consider that the arrangement for having RFC handle the finances of facilites was a successful one.

The material aid in the way of equipment, machine tools, etc., furnished government contractors was accomplished under the following procedures: The demand for industrial tools soon created a deficit in the amount to meet requirements. Some tools were purchased by the War Department and later loaned to contractors. The demand soon became so great that the War Department asked the Reconstruction Finance Corporation to finance a pool for tools. All orders for tools would go through that agency and it would loan them out to the government contractors. At the end of the war, the tools had to be accounted for or the Reconstruction Finance Corporation reimbursed therefor. At the end of the war, many of these tools were declared surplus and were sold. However, later, by act of Congress, the remaining tools were turned over to the War Department for a wartime reserve. Many of these tools are now in storage in stand-by plants where they will be available for use in an emergency. Many of the tools will be sold to the manufacturers. Others will be covered by contractual provisions according to the type of contract made with the contractor for the work done or the facility furnished. Most of the tools have already been assigned and some are now on lease.

The materials that were furnished contractors involved those items in short supply over which the Government desired to maintain a strict control. The materials were bought in large quantities and issued to government contractors on the basis of their government contract requirements. This raises the question as to why all these materials and equipment were not sold outright to the contractor, thus obviating the necessity for accounting therefor. The answer is that the items were those in short supply over which a strict control had to be maintained. Once they were sold, the Government lost control over them. But there was another side to the question; that is, most of these contracts involving government-furnished material were cost-plus contracts, and the Government would have reimbursed the contractors for their expenditures for such material and equipment and would have again come into possession of the items, or at least required an accounting therefor.

There was some difficulty after the war in adjusting many of the accounts involving government-furnished material. This difficulty was mainly chargeable to the inexperience of the property officers assigned to account for the property issued to the contractor, or to the action of the contracting officer in permitting deviation from normal accounting requirements. Present studies provide that, in the future, this property will be kept on both a mony and an item accountability account so that, in liquidating a contract, the contractor will be required to account for so many dollars' worth of property issued to him.

The complex subject assigned me would permit of a discussion far in excess of the time that you men could listen to me talk and still keep awake. Therefore, I will summarize my conclusions, as follows:

1. Experience has shown that, in war, Congress will make available the necessary funds to meet our mission.

2. The guaranteed loan program developed during the late war is a sound method of providing working capital for all types of war contractors. The advance payment program may be used to advantage in

assisting prime contractors.

3. Any program for working capital credit to war contractors must be based on the need for the production rather than its safety as an investment. It must, therefore, be in the hands of military men.

4. The use of commercial banking facilities for funds for financing war contractors is the most efficient and economical way to accomplish our purpose.

5. Any assistance to contractors must be based on the need of that contractor to produce war materiel, and the financial safety of such program must be secondary. The furnishing of government material to war contractors is an essential means of controlling items in short supply necessary to the war effort. The use of the Reconstruction Finance Corporation as a subsidiary financing agent for providing facilities for war contractors is advisable.

COLONEL McCULLOCH: Gentlemen, before we start the question period, I would like to jog your memory on one point, if you will permit. Throughout the Procurement Course, in consideration of purchase assignment, we have heard a number of expressions of views with respect to who should do the job, and we have consistently heard the theory that any policy or any organization that is developed must be responsive to the requirements of command, at least on the side of the military.

Now we have gone over to the financial side--and, certainly, the control of funds is the control of power. We have heard from a private banker this year that this authority should be delegated primarily to private bankers. We have heard that it is a normal responsibility of the Federal Reserve bank to meet requirements for guaranteeing loans and advancing funds. Then we have General Foster's expression of opinion this morning. So there seems to be some difference of opinion as to how this thing should be done in the next war.

We are ready for questions.

QUESTION: General Foster, in the last war, some completely new facilities were built on the property of existing companies. I can see that those companies had a favorable bargaining position in such cases, but we were left in the position after the war in which the only thing we could do with such buildings was to tear them down or sell them at bargain rates. I know of at least one such case. Is there any way we can prevent that situation in advance and not be caught with a big investment on which we cannot even bargain?

GENERAL FOSTER: I know what you have in mind. I can think of one case where part of a building had to be torn down in order to allow a man to get through to another building that had been built and which he had bought from us. But those are matters which should be taken care of in the contract arrangement ahead of time. What probably happened was that the contracting officer did not foresee that difficulty at the time and did not provide for it.

I have no solution to the problem. The contracting officer must work out those details with the contractor when the original contract is drawn up. Generally under our contracts, the contractor had a priority in buying the plant when the war ended. But I agree with you that there were many cases where we had a plant on our hands that no one else could use very well, and the plant was sold at a sacrifice. There were cases like that, and there will be such cases again.

This is one thing I want to emphasize. I think I have mentioned it before. War is waste. With all our planning and everything we may do, we are going to have cases where the Government gets the worst of it. On the other hand, if the Government gets the best of it during the days of the war, we can take the losses afterward. We must do what we can to protect ourselves against such losses, but we are going to have them in every war. We are going to have cases where the Government sustains a loss because of some failure in the beginning. But when we are trying to get production for the war effort, our thoughts are of the fellow at the front, not the dollars back home, and we are going to do many things that are not good business. Time is our most valuable asset. We must use every available source to reach maximum production. The contractor has the upper hand. He may say, "Do you want me or not." You want everybody, and, therefore, you must take some even at a bad bargain.

QUESTION: General, there has been much discussion, from several points of view, about relocation and dispersion of industry. My question deals with a possible peacetime solution to that problem. Is it legally within RFC's authority, for instance, to restrict the lending of money to a contractor who will build a plant where we want him to put it and thereby start dispersion in that way? Can that be done legally now, or is a new law required?

GENERAL FOSTER: I would have to refer to the RFC law to see what the authority is for peacetime operations, but in war RFC puts the plants where we tell it to put them. The RFC has definite authority to say what it is going to loan money on, and it can say, "IF you don't put the plant where we want it, then we won't loan you the money." Some of its actions have already indicated it has that authority. The RFC is not required to make a loan which, in its judgment, is not in the interest of the United States.

COLONEL McCULLOCH: As a matter of fact, General Foster, does the RFC, as a matter of standard operating procedure, refer requests for loans to the military for an expression of opinion prior to granting them?

GENERAL FOSTER: When the loan does deal with some item of national defense, it would do that very thing.

QUESTION: Before the war, I was one of those moss-backed bankers you mentioned. However, Colonel McCulloch has given an excellent course in war finance, which has straightened us out.

My question is on the guaranteed loans. It seems to me you are, in effect, creating a government-guaranteed bond, so that it is pretty fancy paper. Why don't you use that method entirely rather than the advance payment method, because, in the advance payment method, you are actually getting into the banker's business?

GENERAL FOSTER: Of course, I am favorable to the guaranteed loan. This is very definite. But we started out with the advance payment. The guaranteed loan program was a later development. We are using the advance payment today in a very few cases. It is used in cases where contractors are not anxious for the contract and we use the advance payment as an incentive.

When we started to make contracts after the war for fertilizer for shipment to Germany, contractors were not interested; they had plenty of business. One firm said, "We are not interested in it as a business deal, we don't want to put our money into it. But if you give us an advance payment, we will accept the contract as a service." That Company went into the business on the basis of advance payment.

We are not in the guaranteed loan program now.

QUESTION: Can you now, or is the law out?

GENERAL FOSTER: I don't know. I know we have gone out of business as a definite policy. I think we used the War Powers Act to get the Executive order out, and I think that has lapsed. I would have to check on it. I think you might check on it down here.

General Royall, when he was Secretary of the Army, said, "I want you to get out of the banking business as soon as you can. Let the bankers handle it." So we got out of the guaranteed loan program in a hurry. We still have a few collections to make.

QUESTION: General, when, in time of war, the Government is guaranteeing the amount of a loan that a bank won't give without the guarantee, what incentive is there to the banker to give any loan without a government guarantee?

GENERAL FOSTER: He gets more interest. He gets 5-percent interest if he does it without a guarantee, while he gets only 2- or 2.5-percent interest if he does it the other way. There is a very definite incentive.

Besides, bankers are patriotic. They do not all require the dollar to be patriotic. There were many instances where people contributed to the war effort and got nothing out of it themselves. The bankers are an example. Many of the things were carried on even if they did not make a profit, so long as they did not lose money.

But there is still the profit incentive, and I have talked with a number of bankers all of whom consider it a fine program.

QUESTION: Most of the restrictions on financial procedures grow out of the fear of fraud or actual instances of fraud, I believe. We released those restrictions during the war. Would you care to discuss the actual experience in fraud growing out of that release?

GENERAL FOSTER: I will say that the amount of fraud that has come to light is very small, although we have had outstanding cases. The Garsson case was one that got a lot of publicity. I remember one firm we were dealing with on a guaranteed loan, up to six months ago. That firm tried every way it could to keep from paying the loan. It made all sorts of promises.

I do not think that the number of fraud cases, in which the Government was actually imposed on, was very great or very serious. And even if we had had all the restrictions, we still would have had fraud in an effort as big as our war effort. We still will have people who will find ways to chisel.

QUESTION: General, most of us are rathernaive about finance. I feel I am terribly so. But I can follow your theory of public financing. The banker gets 5 percent on a loan made in connection with a government contract. In the negotiation of the contract, one of the things considered in the price the Government will pay is the fact that the company is paying 5 percent on the money he has to borrow to produce the equipment needed. This is our normal method of doing business when war comes along, as you say. But sometimes the banker is not willing to take the whole risk, so the Government gets in the business.

Now, I negotiate a deal with a fellow for a purely government contract, as you mentioned. He says, "I am not interested in the business, but if you will give me the money to make it, I will make it." You turn around and charge him 2.5 percent interest on the money you loan to make something for you. Why not just let him have the money without any interest and negotiate a lower price?

GENERAL FOSTER: As I said, we had many cases of advance payment where we did not charge interest. They were cases where there was no profit to the contractor, such as in the case that I mentioned.

QUESTION: Let the contractor have his legitimate profit when you negotiate the contract in the first place, but eliminate the interest rate.

GENERAL FOSTER: Those are the items that are taken into consideration when a contract is made. There is authority in the advance payment regulations to make an advance without charging any money for it.

QUESTION: General, I wounder if the 1940 authority to assign contracts still exists?

GENERAL FOSTER: Yes, sir, it still exists. It was a very fine departure from the old restrictive things prior to the war. Prior to the war, if a contractor assigned his contract, he lost control. We could not pay the assignee or even the contractor. He had to go to court. That is how strict it was.

QUESTION: General, in the early stages of the last war a lot of time was lost because all these questions concerning what could be done with the contracts and how you could finance had to be settled in the Secretary of War's office. I believe that under the present regulations questions of that magnitude still have to be settled in his office. In the event of another war, what do you think will happen in order to avoid the confusion that took place in the last war?

GENERAL FOSTER: Let me bring it a little closer home. In 1934, when I was in the Industrial College, I worked on the Industrial Mobilization Plan. We were very proud of it. We thought it was a wonderful plan. When the war came, it was not used, in spite of the fact that it was a fine thing.

No matter how many plans we work out, we will still have that chaos that comes with war. We must take advantage of our experience in the last war, add that to our previous experience, and maybe come out with the nearest approach to perfection that we can get. But it will not be perfection.

I lived through the First World War. We had thousands of claims that had to be settled afterward because the Comptroller General said the contracts were not signed by a proper contracting officer. No one thought that technicality would be used, but it was, and you are going to have it in any war you have.

The Army Under Secretary--now the Assistant Secretary is handling it--is the man charged with the industrial policy for the Army, and he will have to get into the picture. But I do not think there will be so many big problems reaching him as formerly. There will be enough echelons below him to take care of a lot of them.

QUESTION: Do you think an agency similar to the Army Service Forces would have to be established in order to decentralize these decisions?

GENERAL FOSTER: You are getting onto another subject. I was with the Army Service Forces--I was their budget man--and I could go on quite a bit about the Army Service Forces. But I am not going to do it because I would get shot around here if I took over somebody else's problem.

COLONEL McCULLOCH: That is a smart answer, General.

General Foster, would you take one minute to tell us one more thing, please. As I understand it, following the war, Mr. Royall was so exercised about a lack of records on government material furnished to contractors that he found it necessary to set up a board to reconstruct those records. What were the difficulties that occasioned that, and what is going to be done about it the next time?

GENERAL FOSTER: I am glad you asked me that because I had it in mind. I knew it was a question that would come up. I was surprised it did not come up before this.

Again I go back to the chaos of war. I will say this: The regulation on accounting for government-furnished material was not defective. The human element was the failure there. We are making some changes in the regulation, but still we will have the human failure. We placed in the contractor's plant a contracting officer who was responsible for getting production. We also placed there as his assistant a property officer. That property officer was "John Doe," who, a few weeks before, had been walking the streets. We put him in and said, "You are property officer here." We gave him a "get rich quick" supply stock record experience and said, "All right, there you are. You do it."

So he goes to the plant, and material is shipped in to him in large quantities. He picks it up on his stock record card and starts off with a very fine record. But the contracting officer is under pressure from Washington to get production. He finds that this little property officer here is taking too much time of the contractor's people in keeping records on this item or that item or this type of control and says, " Cut it out. We cannot wait for that paper work."

The result was that, at the end of the war, when we started to clean up the debris from our contracts, we found that many contractors were not able to account for all property we had given them. As I say, it was the failure on the part of our property officers to keep a proper record and the contracting officer's feeling, "We must expedite everything," that made it necessary to have a board of officers after the war to settle accounts.

That was not a tremendous job. It took some time because the board went into each case. The largest account on which we got a settlement from the contractor was about $300,000. These cases arose not because the contractor tried to defraud us or anything like that; it was a failure of the record. We could not audit the account to find out what the settlement should be. So the board members listened to the contractor's plea, then they took what they could from the record, and said, "It looks like you owe us about this amount." Then they agreed on the amount, and it was settled. Most of the cases involved small amounts, and they were merely an effort to clean up the debris of the war so that somebody would not say years later, "Here is a fellow who got away with murder."

That board may have a few cases outstanding now, but practically all of them have been cleaned up.

COLONEL McCULLOCH: Sir, on behalf of the student body and the staff and faculty, I express our appreciation not only for this talk but for your continuing interest in the College. Thank you, sir.

(4 Apr. 1950--650)S.