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THE REAPPOINTMENT OF ALAN GREENSPAN,
OF NEW YORK, TO BE CHAIRMAN OF THE
BOARD OF GOVERNORS OF THE FEDERAL
RESERVE SYSTEM FOR A TERM OF 4 YEARS

WEDNESDAY, JANUARY 29, 1992

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10:05 a.m., in room SD-538 of Dirksen
Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of
the committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The committee will come to order.
Let me welcome all those in attendance this morning. We have
two items to attend to this morning.
One is that I want to report out the nomination favorably of
Albert Casey to be Chief Executive Officer of the Resolution Trust
Corporation. We’ll maintain a rolling quorum for that purpose and
I would ask that as members arrive, they record themselves on
that nomination.
I want to begin the period for voting now and will extend it until
the hearing concludes. If a quorum is established in that time, and
I expect it will be, we’ll announce the final vote before we adjourn
and the nomination will be reported to the full Senate later today.
Second, I want to take the occasion to welcome a new member to
the committee. Senator Arlen Specter of the State of Pennsylvania
is joining us this morning and we’re very pleased to have him as a
new member of the committee.
I think it’s appropriate to say that he follows in the very distin-
guished path of his former colleague, and our dear friend, Senator
John Heinz, who we lost in that tragic air accident. We keep John
Heinz’s picture up on the wall, Arlen, behind there, as I’m sure
you saw, as a continuing remembrance of him and tribute to the
outstanding job that he did on this committee.
Senator Chafee served in an intervening period in the seat that
you now hold and we’re sorry to lose Senator Chafee, but we’re
very pleased to have you and we welcome you as a member of this
committee.
Senator SPECTER. Well, thank you very much, Mr. Chairman, for
those very generous remarks.
I'm delighted to be on this very important committee and to carry forward the work that our late departed colleague, Senator Heinz, had been so active in.

This is a very important committee nationally, but especially important to the Commonwealth of Pennsylvania, dealing with the problems of housing and mass transit, to say nothing of the banking and Federal Reserve and FDIC and issues of overwhelming importance as we try to move through a very complicated time in our Nation's economy.

So I thank you for the introductory remarks and I look forward to very active participation.

The CHAIRMAN. We welcome you and we look forward to your contribution and active participation.

Senator Garn?

Senator GARN. Mr. Chairman, if I could just add my welcome to my distinguished colleague from Pennsylvania. I'm very pleased on this side of the aisle that we have such an articulate and intelligent colleague to join this panel.

Senator D'AMATO. Don't get carried away.

[Laughter.]

Senator SPECTER. I thank you, Senator Garn. I also thank Senator D'Amato.

Senator GARN. Well, with his remarks, we may try and find a replacement for him.

[Laughter.]

Senator D'AMATO. Believe me, there are a lot of people trying to do that.

[Laughter.]

The CHAIRMAN. This morning, the committee wants to welcome the Chairman of the Federal Reserve, Alan Greenspan, who is here for the purpose of his confirmation hearing for a second 4-year term as Chairman of the Federal Reserve Board, and his nomination to a new 14-year term as a member of that Board.

The job of Federal Reserve Chairman has often been called the second most important position in our Government. And there's good reason for that.

The Fed has responsibility for our Nation's monetary policy, giving it a key role in influencing economic fluctuations, the money supply, and the inflation rate.

It certainly has a great bearing on the degree to which we have economic growth in the economy.

The Fed is also one of our principal banking regulators, with specific responsibility for supervising State-chartered Federal Reserve member banks and all bank holding companies. And broader responsibility for ensuring orderly financial markets.

The Fed chairman also sits on the Oversight Board of the Resolution Trust Corporation, which supervises the disposition of failed thrifts.

This is a most important nomination, I think the most important nomination that comes before this committee, and very possibly before the entire Senate.

Now looking over the record of the last 4½ years, there is much to be concerned about, and we need to take a searching look at that record today.
This morning's GNP data, which shows the economy about flat in the last quarter of last year, are part of the continuing evidence of our current serious economic problems. The President, of course, focused much of his commentary last night on that same array of problems.

But poor economic performance is not just a recent or temporary development. Since Chairman Greenspan's initial appointment in the summer of 1987, the economy's annual average growth rate has been an anemic $1\frac{1}{2}$ percent. But even that rate reflects only growth in the labor force and increased rates of depreciation of capital goods.

Per capita national income, which better measures economic well-being, has shown no improvement at all during that time. And as a recent report by the Fed documents, incomes have been increasingly skewed toward the very wealthy, leaving average Americans and those at low-income levels worse off.

Pointing these facts out does not say that the blame for them and bad economic trends can be tracked to the Fed solely or without consideration of other major factors. But certainly it has a bearing, and a significant bearing and that needs to be examined today.

It is my own view that there still is clearly lacking an adequate national economic strategy to provide the growth we need to improve the economic well-being of our citizens and to enable our country to compete more effectively in the world economy.

Monetary policy is a vital element of economic strategy and must be carefully examined. Since August 1987, the principal measure of the money stock, M2, as it's called, has grown at only a 4 percent annual rate, which is half the rate of the preceding 4 years and less than the rate of price inflation.

M2 growth has been below the mid-point of the Fed's own target ranges in each of the last 5 years. In the last 2 years it was at or near the very bottom of its range, despite the recession. So something is clearly wrong here. When the Fed sets its own target range and finds that you've got a chronic situation where the performance is at the low end of that range, something is not working properly. I think we have to try to figure out what that is and respond to it. We need to discuss that and other suggestions about how we get our economy moving in a much more vigorous fashion.

In other areas there are also concerns. In recent years, we have witnessed a wave of bank and thrift failures unprecedented since the Great Depression. Although banks under the Fed's direct control have fared better than others, large holding companies under the Fed’s regulatory supervision have become increasingly weak, and the Fed’s lending practices to failing banks appears to have added to the ultimate cost of those banks that have failed.

Other important questions arise about the role of foreign ownership in our banking system. BCCI is one example. But the issue is broader than that and we'll get into that.

Now, just one or two other things here.

Last night, the President, in his remarks, made the following comment, and I'm quoting from page 4 of his speech. He is talking here about the problem of a lack of credit within the banking
system. And the direct quote that I want to cite into the record now is as follows. The President said:

The banking credit crunch must end. I won’t neglect my responsibility for sound regulations that serve the public good, but regulatory overkill must be stopped. And I have instructed our Government regulators to stop it.

I think in the course of your remarks this morning, I would ask you to tell us what that means. What specifically is being done? Has the regulatory process been out of bounds, as he implies here with respect to your part of the bank regulatory system, and what are these instructions that have been given to stop the practices that the President is objecting to? I’d like you to explain to us exactly how that’s being carried out so that we have a clear understanding of it.

There are other items. I know my colleagues have opening comments that they want to make. Let me yield to Senator Garn.

OPENING STATEMENT OF SENATOR JAKE GARN

Senator GARN. Thank you, Mr. Chairman. First of all, let me say on behalf of my colleagues on this side of the dias, that the President is coming up to meet with Republican Senators at 10:30. So if you see all or most of them leave, it’s nothing to do with you, Chairman Greenspan. It’s just that the most important person is more important than the second most important person, I guess.

However, I will ignore the first most important person and stay for the second most important person.

Chairman Greenspan, you have been waiting for this confirmation hearing since last July, when you were first nominated for a second term as Chairman of the Board of Governors of the Federal Reserve. I regret that the committee has made you wait so long for this confirmation hearing.

Many of us believe that the Federal Reserve should have eased monetary policy earlier last year. I believe the anemic economic growth we have recently been experiencing is largely attributable to inadequate growth in the monetary aggregates during 1991.

Recently, we have seen signs of a pick-up in monetary growth and I certainly hope that that growth continues. But if it doesn’t, I hope that the Fed is ready to act quickly to inject additional monetary stimulus into the economy.

As a member of Congress, however, I must confess to some embarrassment at criticizing the Fed and/or the administration’s economic policies of late, because Congress certainly shares at least as much blame as either of you for this economic difficulty.

The committees of Congress responsible for the financial services sector of our economy have a particularly poor record. I would modify that, however, to say that this committee acted on the President’s banking reform last year, by producing a broad comprehensive bill. This committee did recommend full funding for the RTC. But Congress as a whole failed to enact either. I think that that has added to the problem.

Last year, this committee rejected the renomination of an outstanding public servant, Comptroller of the Currency Bob Clark. What I said at the time and I now repeat is the voting down of his
nomination was an unsuccessful attempt to make Bob Clark the scapegoat for the problems in the commercial banking industry.

The result of that unfortunate political exercise has added, I believe, to bank examiners' fear for their careers and reputations if they don't put the fear of God into the on-the-line commercial bankers who dare to make new loans.

I would also comment about the President’s State of the Union delivered last night. The credit crunch has a lot to do with Congress because I can remember sitting here harassing every regulator that came before this committee for being too lax, and saying that we simply weren't tight enough. Now after they've tightened up, we are blasting them for being too tough.

Who can be surprised that our economy has been hobbled by inadequate credit? Congress deserves similar criticism for its failure last year to respond to the administration's constructive legislative package that would have strengthened the commercial banking industry. Again, I emphasize, this committee did not do that. We passed out of committee a very broad comprehensive bill that the House of Representatives was simply unwilling to deal with.

Last year, by imposing only new costs on banks to pay for the Bank Insurance Fund recapitalization, without helping the banks pay for those costs, Congress contributed to the further weakening of our banking system.

The budget released by the administration today projects an even more troubling consequence of the failure by Congress to act to strengthen the banking system. Unless Congress will act soon on the second half of the administration's proposal, the funding provided last year will not be enough.

And I would emphasize that in Mr. Casey's confirmation hearing last week, he testified that because Congress's unwillingness to enact the administration full amount requested, it cost the taxpayers $375 to $450 million since November 15.

Again, the Senate was willing to do that. The House was not.

The bottom line is this—if Congress continues to turn its back on financial restructuring, Congress will be guaranteeing an eventual need for a taxpayer bail-out of the Bank Insurance Fund, as well as the savings and loan insurance fund.

I certainly think the cycle has come full circle and it's time that Congress did something about the restructuring of our banking system.

This morning, I hope we can talk constructively about financial structure, as well as monetary policy. I hope my fellow Senators will use this hearing to give Chairman Greenspan a chance to fully explain all of his views, as I'm sure that we will.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Dixon?

OPENING STATEMENT OF SENATOR ALAN J. DIXON

Senator Dixon. Mr. Chairman, I'm pleased to be here this morning as the Senate Banking Committee considers the nomination of Alan Greenspan to another term as Chairman of the Board of Governors of the Federal Reserve System.
As you've pointed out, Mr. Chairman, many people believe that the chairmanship of the Fed is the second most powerful job in Washington.

I don’t know whether that’s true or not, but I do know the Federal Reserve exercises enormous power and influence over our economy. And it’s our economy that we need to be thinking about as we consider Chairman Greenspan’s renomination.

As my colleagues know very well, we are in a serious recession. People are hurting and every institution in Government must act to remedy that pain.

Monetary policy and the health of the banking system are two key factors in generating economic growth. But the banking system, while basically sound, is under serious stress and monetary policy as exercised by the Fed has not been able to get the economy moving again, at least not so far.

Chairman Greenspan told this committee when he was before us earlier this month that most of the Fed’s mail regarding the Fed’s efforts to bring down interest rates and expand the money supply has been critical.

I understand the fear of those living on fixed incomes who are seeing their interest income erode. But I also understand the fear of families that have seen their incomes stagnate or erode over the last several years and even longer. I understand that they are concerned about their future, about whether they can buy a home, about whether they can afford to educate their children, about whether they’ll be bankrupted by an unexpected illness.

And I understand that many Americans look at how our economy has been working in recent years and fear that their children will not have the opportunities they had and that their children will not live as well as they have lived.

I hope, Mr. Chairman, that you also understand those fears. When you’re confirmed, and I’m sure you will be, I hope you’ll be working with Congress and the President to get the economy moving again and to do everything you can at the Fed to help address the long-term problems we’re facing. I look forward to voting favorably on your confirmation. I thank the Chair.

The CHAIRMAN. Very good.

Senator D’Amato?

OPENING STATEMENT OF SENATOR ALFONSE M. D’AMATO

Senator D’AMATO. Thank you, Mr. Chairman.

Mr. Chairman, I find myself in an unusually difficult position because, personally, I have a great fondness and a good relationship with Mr. Greenspan, our Chairman, before he became Chairman, before I became a Senator, and all during that period of time.

I have to say, however, that the very thing I was concerned about, going back more than a year ago, close to 18 months ago was interest rates. I remember the hearing of January, when I said, and I’m paraphrasing:

What world do you live in? You’re worried about inflation. Businesses are closing. We’re in a recession. Cut the interest rates.

To simply say that we did too little too late is to underscore something that many, many, people have come forward to state.
Had the Federal Reserve made the kinds of cuts to finally get the discount rate down with greater dispatch, a great deal of the pain that many individuals have endured could have been minimized.

I'm not suggesting that this would have solved all of the economy's problems. There are other problems that could be corrected with better tax policy to stimulate spending and create investment incentives—particularly in the real estate sector. We need to revitalize this sector of our economy that has been so devastated and which accounts for such a significant portion of our gross national product.

The CBO 1992 budget report points out, and I quote:

The gradual pace of monetary easing may have eroded its stimulative effect.

I get no comfort by saying, I told you so. Had we had these lower rates 18 months ago, however, I think that it would have had a more substantial stimulative impact. Let's give credit where credit is due—there are some very beneficial things taking place.

The refinancing of home mortgages, for example, will reduce the interest expenditures of American families by about $40 billion a year. This is very positive.

I'm sorry the Fed had to wait so long to ease the discount rate. I think that it is a reflection of the Fed's failure to grasp the significance of what was actually taking place in the economy, and the depth of the recession.

I'm convinced that we now must look toward the future. I would like to hear from the Chairman, because we have discussed this issue both privately and at public forums, what Congress can do to deal with the absolute economic crisis as it relates to the real estate industry and the lack of credit for sound commercial projects.

This is not just a phenomenon indigenous to the Northeast region. Creditworthy applicants everywhere are suffering—people with unfinished projects can't get construction loans or permanent mortgages.

This restriction on credit is absolutely going to continue to exacerbate economic decline and the current recession. Banks will not loan to people undertaking beneficial often essential projects. I am not even talking about areas that have been overbuilt and that have too much commercial space.

I am referring to sound projects that are fully rented where people cannot get financing. This is the most frequent complaint I hear from individuals and firms in the real estate industry. It isn’t just the rich guy who suffers in this situation, it’s also the people who work in the industry—the carpenter, the electrician.

Congress and the regulators must address the problem of credit availability because even a discount rate of one percent will not have an appreciable impact unless that credit is going to be made available out there in the street.

While there has been some substantial improvements such as the refinancing of homes, we have still failed to address the problem of making credit available to see that good and creditworthy projects have adequate financing rather than banks calling in this type of loan.
Mr. Chairman, I ask that my prepared statement be included in the record as if read in its entirety, and I would hope that the Chairman would share with us later his thoughts on how we can address this critical problem of credit availability.

The CHAIRMAN. Without objection, it is so ordered.

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, I welcome Alan Greenspan, who is no stranger to this committee, for today's hearing on his reappointment.

The Fed has been promising us economic recovery for some time now. Indeed, I have railed at Chairman Greenspan for over a year to lower the discount rate of interest.

The Fed has taken Davey steps to cure the Goliath problems of the economy. Unlike Davey, however, the Fed did not kill Goliath even though the Fed had more than a slingshot at its disposal.

This is not just a case of bad aim. It is more of a case of no aim. The Fed should have been more decisive in lowering interest rates. As the CBO January 1992 Budget Report points out, "[t]he gradual pace of monetary easing may have eroded its stimulative effect."

Today, the discount rate is at 3.5 percent—the lowest it has been since November 1964, but banks are not making loans. Credit is finally cheap but it is unavailable even to creditworthy borrowers. As a result, lower interest rates came too late to provide any new credit to cure the economy's malaise.

You are probably expecting me to say that the Fed did "too little too late." This may be accurate, but I am not going to say it.

The growth in M2 continues to decline, down from 3.3 percent in 1990 to 2.4 percent in 1991. Credit is scarce and consumer confidence is low, primarily because there is so much uncertainty about the economy. Before a full economic recovery can happen, consumer confidence must be restored and credit must be made available.

The Fed, the OCC, the FDIC and the OTS issued a joint supervisory statement on November 7, 1991, in an attempt to ease the credit crunch. These guidelines are a step toward making credit more available in the area of commercial real estate loans.

I would be interested to hear from Chairman Greenspan whether the bank regulatory agencies have contemplated anything similar for other types of loans.

Finally, to give credit where credit is deserved (something banks should start doing)—lower interest rates have caused applications for refinancing to rise a dramatic 120 percent since October.

At a minimum, the refinancing surge has reduced the mortgage interest expense in some households. It is estimated that mortgage refinancing will save American families a total of $40 billion a year.

The CBO 1992 Report on the Budget states that there may be more room for the Fed to ease monetary policy further without any great risk of inflation. I will be interested to hear Chairman Greenspan's opinion on this.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Wirth?
OPENING STATEMENT OF SENATOR TIMOTHY E. WIRTH

Senator Wirth. Thank you, Mr. Chairman.

Chairman Greenspan, I want to start by thanking you for your service and for your willingness to take this task on again. I know it’s a very tedious and sometimes frustrating operation, but we really appreciate your help and your work.

Senator Domenici. Senator Wirth, would you yield for a request to the Chairman?

Senator Wirth. Absolutely.

Senator Domenici. Thank you very much.

Mr. Chairman, I know everyone has very difficult schedules. I don’t want to impose on you. But I very much want to inquire of the Chairman regarding some real estate and other issues.

Is it possible that you might accommodate, even if I’m very late coming back, to just leave it open for me to inquire?

The Chairman. Absolutely.

Senator Domenici. I appreciate that.

The Chairman. I’ll protect the Senator’s rights and we’ll always do that.

Senator Domenici. I thank you very much.

Senator Wirth. Mr. Chairman, I was just about to say, I know that some of our Republican colleagues have to go to meet with the President, I just had a couple of comments to make, but I know they have to leave. If you all want to jump right in at this point——

The Chairman. If we go in the order in which members have arrived.

Senator Bond, did you want to make a comment now?

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator Bond. Thank you. I certainly appreciate the courtesy of my friend from Colorado.

I do want to join in welcoming Chairman Greenspan before this committee for the long awaited reconfirmation hearing. I think it’s very timely that we have his views on economic policy in the wake of the State of the Union.

As our ranking member, Senator Garn, has pointed out, we have too much of a good thing today and several of us will be forced to be gone for a portion of this hearing.

Mr. Chairman, we would welcome your suggestions on how we can separate the wheat from the chaff and all of the different economic remedies which have been proposed.

I think we seem to hear bipartisan agreement that tax changes and policy changes are needed to spur long-term growth, investment, and international competitiveness, but we have a little problem that the labels seem to be applied to different remedies, depending upon the speaker.

For one example, we’ve heard much partisan rhetoric on the impact of a differential for capital gains. We would welcome your views in your high office as to what might be the basic economic impact if we did restore a differential for long-term capital gains.

I do want to commend you and the Federal Reserve for bringing interest rates down. I think all of us want to claim credit when in-
terest rates go down. None of us want to be around when interest rates go up.

We know that the Federal Reserve has the direct responsibility, but I think you would probably agree that Congress has a negative responsibility if we bust the budget. If the deficit goes up further, there’s no way that the Federal Reserve working on short-term rates can avoid long-term rates going up, which imposes an inflationary pressure.

One point I hope that you'll address, and I perhaps will have an opportunity to discuss it when we come back, is the seeming slow growth in the money supply.

A lot of concern has been expressed that the money supply has grown at the very low end of the target range, or perhaps even below. And there are some who think that this may have had a further impact on the credit tightening.

In any event, Congress is in bad need of constructive advice on how we can adopt fiscal policy that will complement the monetary policy toward making credit available and assuring long-term growth in the economy.

Mr. Chairman, I particularly appreciate your courtesy and that of Senator Wirth.

The CHAIRMAN. Very good. Senator Mack?

Senator MACK. I intend to stay, so if Senator Wirth wants to go ahead——

The CHAIRMAN. Very good.

Senator WIRTH. If I might, Mr. Chairman.

The CHAIRMAN. Senator Wirth?

Senator WIRTH. A very brief comment.

We’re having a major national debate about health care. And one of the pieces of that debate is how do we structure the system so that we do more to keep people well, the preventive side, rather than just focusing on helping people after they get sick. And I’m not sure that isn’t a useful metaphor as we look at the banking system.

I think all indications are that we’re going to continue to have some problems in various segments of the country, various regional areas such as we had some years ago in the Rocky Mountain region and the Southwest.

I wanted, when we get into questions, Chairman Greenspan, to have you focus a little bit on the preventive side. There are a number of ideas and proposals out there, and I think this is now a good time for us to sit back and look once again at what makes the most sense. The administration has proposed major structural changes, Glass-Steagall, providing new bank powers, as the best preventive medicine.

Others have suggested that the capital requirements that have been laid on the financial institutions have caused the contraction of credit and that maybe we should be looking at that. Some have suggested that there be something like the RFC, where the Government might help with those capital requirements.

A third set of proposals that has been made is various tax credits to banks related to the loans that they might make to job generating enterprises, small business in particular. Would that help
banks to meet their reserve requirements and encourage them to make loans?

Obviously, as well, there’s been reference to regulatory changes. When we get to this point, I’d very much appreciate your wisdom, what are the two or three or four things that you think would be most important for us to be thinking about and doing in this coming year if we are concerned about the preventive side of medicine for banks, rather than just waiting, as we have tended to do and I think that’s the nature of the way the Government operates to react to the problem.

Reaction has cost us billions of dollars in the savings and loan disaster and now we’re seeing a great deal of money going into the banks and the FDIC.

Maybe there are steps that we can take that would be more constructive and certainly save taxpayer dollars.

So that’s what my primary interest is and I really greatly appreciate the benefit of your wisdom and experience on that.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Wirth.

I might note, just in terms of the hearing today, back when your nomination was made, a little past mid-year of last year, for some reason the nomination was kind of in the mill at the White House for a while. It was finally made, and the papers came up here.

Senator Garn has pointed out a minute ago, as everyone in this room who follows the issues knows, we were involved in a very intense effort to try to get the comprehensive banking reform bill passed, which of course had in it some things that you felt very strongly about which you had come to speak for.

So in that period of time as we were working on that, the administration gave you a recess appointment which you now serve under, in which you are fully empowered to be able to operate in your capacity at the Fed.

Then, as we were coming down the home stretch in the closing days of the session of Congress, we scheduled this hearing. We had a date set, and we were programmed to do it. Then the banking bill unfortunately fell apart in the House of Representatives, and we were required to shift our schedule around. We had to cancel that hearing at the last minute, which I regretted, as I know you did as well.

So this is our first opportunity since that time to be able to have you here. We’ve looked forward to having you and are pleased you’re here today.

We’ve had two other Senators join us and I’m just going to ask them for any opening comments that they may have—

Senator Mack, Mr. Chairman?

The CHAIRMAN. I beg your pardon. Senator Mack, excuse me. We recognize you next.

OPENING STATEMENT OF SENATOR CONNIE MACK

Senator Mack. Thank you, Chairman Riegel.

Welcome, Mr. Greenspan. My focus today is really just a continuation of an expression of a problem that’s been developing in the State of Florida for 2 years now. It was 2 years ago in which I re-
member doing what all of us do when we go back home, listen to our constituents. Two years ago, I heard very, very clearly all around the State of Florida, but primarily as a result of examinations of the State's largest banks, that credit was not available, that credit was being turned off.

That's been running 2 years, to the point that in my last visit home, people were using words that I haven't heard in my 10 years in the Congress and my 16 years in business prior to that. They were talking about suicides.

Individuals who have worked their entire lives in developing projects and being involved in real estate, all of a sudden are finding that there just isn't credit available.

I guess I speak with a little bit more conviction about this particular problem because that 16 years prior to being involved in politics was in fact in the lending business. So I have some inclination, some idea of—I know some of these people. I know the projects that they're talking about. I can tell who's giving me the straight line and who's not.

And when I see in the State of Florida, certainly one of the fastest growing States in the Nation, and in particular areas which are the fastest growing in our State, with people moving in at rather rapid rates, with projects that in fact make sense, can't get credit, I wonder if it's that bad in my part of the country, how bad it must be in other parts of the country.

My concern in our discussions today, and I really just look forward to some dialog, is how do we address the question of providing credit primarily to the real estate market.

But I don't want to imply that there has not been an impact beyond that because there clearly has. Businesses of all types, lines of credit that have been established and have been on the books for 15 years, companies in better economic condition, better financial condition today than when they obtained the lines of credit originally, are now being told that those lines are no longer available.

And what concerns me is I see a downward spiral developing, and almost every action that we're doing creates an even further downward spiral. Things like the RTC dumping real estate onto the market at the worst time.

We told the RTC back in 1989, we wanted you to get this real estate and we wanted you to get rid of it. But that was 1989. This is 1992, and the markets are completely different. And to just dump real estate on the market, it seems to me that it just further depresses the market and continues the downward spiral. It undermines the capital structure of the financial institution. And the only way they know how to get their capital ratios back into place in these conditions is in fact to call loans or not make loans.

I would suggest that the good loans are the ones that are being called because they're the only ones that can pay them off.

And so my line of questioning will be really kind of like, what do we do to stop this? What do we do to get this thing turned around and going in the opposite direction?

So, again, I look forward to our discussions and I appreciate your being here this morning, Mr. Greenspan.

The CHAIRMAN. Thank you, Senator Mack.

Senator Sanford?
Senator Sanford. Thank you very much. I'll just put a prepared statement in the record and just make one comment now.

The Chairman. We'll make it a part of the record.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator Sanford. The biggest mark of the Great Depression was bank failures. That probably had a great deal to do with aggravating a slipping economy and possibly was the primary cause of the Depression, though that is a matter that might be debated.

In any event, almost the first thing done to stabilize the economy was to deal with the situation of bank failures. We did it in a way that demonstrated that it could be done. And indeed, a rarity—it could be done and make a profit for the Government in the process.

I'm very much concerned about what Senator Mack has just discussed. I've heard from literally hundreds of real estate people who are simply distraught that they're in a collapsing situation and see no way out and see very little that we are doing to help them.

I just talked to a furniture manufacturer who now is probably going to have to go out of business because he can't get a line of credit. He never had any problem with credit, never had any problem with not paying back, but he had that line of credit with the Bank of New England, reinforcing my proposition from the very beginning that that bank should never have been closed, but it should have been recapitalized under the concept of the old Reconstruction Finance Corporation procedures.

In fact, I put a piece of legislation in last spring to create a modern RFC that we called the Bank Emergency Investment Trust.

I want to mention that because while it's not precisely in your field, but it relates in another way to the banking regulation, I'm afraid that what we've just done with the Federal Deposit Insurance Corporation, the so-called improvement act that we've passed, that we probably have encouraged bank closings, the equivalent of bank failures.

The ripple effect—in fact, I called it a ripple effect until I realized it was coming from Boston to High Point, North Carolina. It's a wave effect of a bank failure.

I would hope that we could determine that the policy of this country should be that a bank will not be allowed to fail if there's any way to prevent that failure. And I think that in most cases, it can be prevented, not just to keep open a bad operation, but the very fact that we have that resource and potential gives us the tool to insist on mergers or to insist on management changes or to insist on anything we want to.

But so often, it's simply a bookkeeping matter of too little capital because of the dwindling value of the assets.

So, in any event, I want to put that into the equation, that part of our policy should be that the banks must not fail if there's any other alternative.
PREPARED STATEMENT OF SENATOR TERRY SANFORD

Mr. Chairman, I would like to commend you for holding this hearing this morning. I regard this nomination as one of the most important ones this committee is responsible for reviewing. Economic recovery is atop everyone’s agenda, however, all political posturing aside, solutions to our economic woes must address basic structural problems in our economy and result in long-term growth and productivity.

The members of the Federal Reserve Board play a key role in formulating economic policy by determining and implementing monetary policy. In short, the Federal Reserve’s influence over the lending and investing activities of depository institutions and their influence over the cost and availability of money and credit requires them to contribute substantially to the strength and vitality of the United States’ economy. It is imperative that the Chairman of this independent body demonstrates a solid commitment to lasting economic recovery.

There is no doubt that current economic troubles result from the build-up of debt. However, as the Federal Reserve reported earlier this week, savings due to lower interest rates for households is going toward debt reduction, not consumer spending. For the first time since the Depression, real spendable incomes have fallen in the majority of households. The recent dramatic reduction in the interest rate has not exactly brought about the expected results. The burden of past debts overwhelms profits, causing purchasing power to decline further.

I hope the Federal Reserve will listen to the recommendations of the many economists who have testified on Capitol Hill over the past month. I also urge the Federal Reserve to consider further cuts in the discount rate if appropriate, particularly since the inflationary fears expressed by the Fed in its slower than necessary reduction of the discount rate did not materialize, any further reduction of rates should be sooner rather than later.

In addition to executing monetary policy, the Federal Reserve Board functions as a regulator and ensures that commercial banks are responsive to the Nation’s financial needs and objectives. The projections for bank failures in 1992 are grim to say the least. The other regulators have been considering assistance programs to save troubled institutions that are financially viable. I am concerned that the recently passed Federal Deposit Insurance Corporation Improvement Act (FDICIA), will cause even more banks that are marginally capitalized, but financially viable to fail, thus costing the taxpayers more money, not to mention the disastrous effects a bank failure has on a community. An alternative to the costly practice of closing these banks could prevent foreclosures on loans made by such banks, the abrupt removal of the lines of credit to community businesses, and job losses. I will be interested to hear Mr. Greenspan’s comments on such a proposal.

Finally, in its role as a policy maker for bank regulation, I urge the Fed to look closely at the causes of the credit crunch. Complaints are rife of lenders refusing to renew good, well collateralized loans to creditworthy borrowers. This is one area where if the Fed does too little, too late, as some have suggested its interest rate
reductions were, there will be no opportunity to catch up. Businesses and borrowers unnecessarily put out of business cannot be easily revived. Economic value will decline and jobs will be lost, neither to be recovered.

Again, I commend the Chairman for holding this hearing in such a timely manner. I look forward to hearing Mr. Greenspan’s assessment of the economy and prospects for recovery.

Thank you, Mr. Chairman.
The CHAIRMAN. Thank you very much.
The Chairman of the Budget Committee, Senator Sasser?

OPENING STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Thank you, Mr. Chairman.

I want to welcome Dr. Greenspan before the committee this morning and say that his reappointment comes at a very critical time in the economic history of this country. Particularly if we look at the economic history of the country in the latter part of the 20th century.

I want to say at the outset, and Dr. Greenspan knows this, I have great respect for his professional expertise, particularly as an analyst of very complex economic data. I think perhaps he has no peer in that regard.

And I certainly appreciate Dr. Greenspan’s cooperation and the assistance that he has provided not only this committee, Mr. Chairman, but the Budget Committee which I’ve chaired over the last 4 years. He’s rightfully earned the respect of many members of both committees.

Now, having said that, we’ve got to face the fact that this Nation is in the grip of a very severe recession. It’s the longest recession that we’ve experienced since the 1930’s.

I think there’s something different about this recession than the other recessions that we’ve experienced since World War II. Perhaps we’re now evidencing some basic structural changes in this economy that we’ve not seen in previous recessions.

I was struck by a statement that Dr. Greenspan made before the House Banking Committee, a few weeks ago. And to paraphrase that statement, Dr. Greenspan said that he saw anxiety about the economic future of the country such as he had not seen in his lifetime.

Please forgive me for taking a little license with your statement, Mr. Chairman, but I’m speaking from memory and that is generally the thrust of your comments.

Perhaps that anxiety is based on substantial ground. Many economists believe that the actual unemployment rate is really in the double digits. And certainly the unemployment rate is in the double digits if you take into consideration those who want to work full-time but are obligated to work part-time because full-time jobs are not available.

There are more Americans on food stamps than at any time in our history, to my knowledge. I was astounded to learn that one in every ten Americans today, as this committee meets, Mr. Chairman, are on food stamps. And we’re seeing a new type of food stamp recipient—middle-class, white-collar individuals. Those who
previously had middle management jobs are now reduced to trying
to get by until they can find other work making ends meet means
supplementing their diet with food stamps.

Retail sales continue to fall. And just today, the new GDP figures
came out. We see that the economy is still dead in the water, the
last quarter just at 3/10ths of 1 percent increase.

I say all that to get around to saying this. The Federal Reserve
and monetary policy have played a role in this recession. I'll say
that quite frankly to you, Dr. Greenspan.

Throughout 1988 and the first half of 1989, the Federal Reserve
focused, it appears to me, almost exclusively on inflation and
pushed the Federal funds rate up to 10 percent.

Now this translated into interest rates that were much higher
than many thought justified and certainly much higher than I
thought necessary.

It resulted in economic growth that was too slow. I think the
Federal Reserve has an obligation not only to worry about infla-
tion, but it has an obligation to send a signal that the Fed believes
in a growing, dynamic economy to those who hew the wood and
draw the water in this Nation.

One way of doing that is to keep interest rates as low as the cir-
cumstances will permit.

Mr. Chairman, to the credit of Dr. Greenspan, I think since the
recession began, he's pursued the right direction on interest rates.
They've come down significantly. But I would say that they've
come down so gradually, that until just recently, with some very
significant easing, the economy has not noticed these very gradual
reductions in rates.

There was never any strong signal early on from the Fed that it
was going to do all it could to keep the economy out of recession. I
think the small, repeated easing measures may have created the
expectation in the economy that, there are going to be other easing
measures in the near future. And possibly some individuals and
businesses delayed spending in hope of getting lower interest rates.

These are not just my views. Dr. Paul Samuelson, a Nobel Prize-
winning economist, who Dr. Greenspan knows well and has con-
sulted with, has said before our committee that the Fed's response
to the recession has been, and I quote, "too slow, too little, too
late."

Mr. Chairman, I say all this because the reappointment of Dr.
Alan Greenspan that's pending before this committee ought to be
viewed in terms of the economic recovery that we want for this
Nation.

I think we need to know why monetary policy has not worked
thus far. I think we need to know if it ever will work, in Dr. Green-
span's judgment, to bring us out of this recession.

And I think we ought to try to send a very clear signal, those of
us who believe in this view, and I believe in it very strongly, that
the Chairman of the Federal Reserve Board and the Federal Re-
serve have an obligation at all times to send a strong signal to the
business community, to labor, and to others who work in this econ-
omy that the Fed is prepared to take the lead and do what's neces-
sary to stimulate growth in the economy.
I thank you, Mr. Chairman, and again, I welcome Dr. Greenspan before the committee.

PREPARED STATEMENT OF SENATOR JIM SASSER

Thank you Mr. Chairman for calling this hearing on Dr. Alan Greenspan’s nomination for a second term as chairman of the Federal Reserve Board. Dr. Greenspan’s appointment is a critical one, at a critical time.

I say at the outset that I have enormous respect for Dr. Greenspan’s professional expertise and competence, particularly as an analyst of complex economic data. I appreciate the cooperation and assistance he has provided this committee, and the Budget Committee, over the past 4 years. He has earned our respect for guiding the FED through an extremely difficult period.

However, the Nation is in the grip of a tremendous recession—the longest since the 1930’s. Many economists believe the actual unemployment rate is in the double digits. An unprecedented number of Americans—one in ten—are on food stamps and retail sales are falling faster than a plummeting meteor.

And let’s face the facts: The Federal Reserve, and Monetary Policy, have played a role in this recession.

Throughout 1988, and the first half of 1989, the Federal Reserve kept inflation on the front burner, and pushed the Federal funds rate up to 10 percent. This translated into interest rates that were higher than many thought justified. Resulting in economic growth that was too slow.

To his credit, since the recession began, Dr. Greenspan has pursued the right direction on interest rates—they have been brought down significantly. But the pace of the reductions have been very, very gradual. Until just recently, the FED’s easing has been so incremental—it’s almost as if the economy hasn’t noticed.

Mr. Chairman, there certainly was never any strong signal, early on, from the Fed, that it was going to do all it could to keep the economy out of recession.

Indeed, according to a recent report by the Congressional Budget Office, “the gradual pace of monetary easing may have eroded its stimulative effect. The small, repeated easing measures may have created expectations of further moves, possibly causing some businesses and individuals to delay spending in hopes of getting lower interest rates later on—it [The Fed’s Policy] may have helped to delay the recovery.”

This criticism has been echoed by others, most notably Dr. Paul Samuelson, who said the Fed, in responding to this recession, has been “too slow, too little, and too late.”

The speed, responsiveness, and effectiveness of monetary policy has become a key issue. Many of us were concerned 2 year ago, when we embarked on the 1990 budget agreement, that the Fed might not be able to takeover and counteract a contraction in fiscal policy.

But Dr. Greenspan told me in writing, at the time, that “Monetary Policy—can be—implemented in a very short span of time, if need be—[and] has the ability to act quickly enough to support economic expansion.”
Now, however, some 2 weeks ago—in Dr. Greenspan's own words: "Trying to be as oblique as possible"—we learned that "we have fairly extended lags of very indeterminant duration for monetary policy."

Mr. Chairman, we are at a very vital juncture both in terms of Dr. Greenspan's reappointment and in terms of economic recovery. We need to know why monetary policy has not worked thus far, and when if ever it will work, to bring us out of this morass. Accordingly, I would hope that Dr. Greenspan is not oblique in his presentation today. Thank you.

The CHAIRMAN. Thank you, Senator Sasser.

Senator Kerry?

OPENING STATEMENT OF SENATOR JOHN F. KERRY

Senator KERRY. Thank you, Mr. Chairman.

Mr. Chairman, welcome. I appreciate the time you took to visit both yesterday and prior to that. Also, your courtesies in helping me to try to understand some of the complexities that my colleagues have referred to. And I'm not going to take very long here. I know that we want to get to the questioning.

But as I expressed to you yesterday, I have concerns about the degree to which our Fed policy has in fact contributed to the current predicament that we're in. I was just actually looking back at some earlier visits which you made to this committee 2 years ago in which I asked some very, I thought, pointed questions about the state of the New England economy and found that you did not share the view at that time about some of the difficulties that we were facing.

And particularly, perhaps felt trapped between the difficulties of being Chairman of the Fed and the way in which the media respond to almost any pronouncement you make and the possibilities of in fact making happen what you feared and therefore, not wanting to say some things publicly as a consequence so that they wouldn't happen, but in fact they did.

So we're all troubled because many of us are concerned that it's hard for us to separate between where you are trying to legitimately protect from bad consequences occurring as a result of what you do perceive and say publicly, and then the steps you take as a matter of policy to try to remedy them.

I think Senator Sasser has articulated for all of us the sense that perhaps those steps to remedy never were taken, and that we're feeling some of those consequences right now.

You and I discussed yesterday what's happening in New England. It is not a recession; it is a depression. And we are hurting more deeply than perhaps any other region in the country.

What concerns me greatly is that everything that is happening to us today was happening to us 2 years ago, was raised in this committee 2 years ago, has been offered prior to this to Bill Seidman when he was serving, and now to Mr. Taylor, and to you and to others, and you serve on the Board of the RTC and are probably the single most influential member of the Open Market Committee and you are certainly the foremost banker, if you will, in this country.
I have, like my colleagues, enormous respect for your abilities and for your expertise. And none of us are capable of calling all of these things correctly, and they are indeed extremely complex, and I acknowledge that.

But some simple things seem to be overlooked at this point in time, or somehow, the message is not reaching those that need to be reached.

In New England, we have what I would call a collateral crunch, not just a credit crunch. The principal problem that so many of our businesses face is that the collateral that they offered has been suddenly reduced in value.

And notwithstanding the reduction in value of that collateral, which usually was real estate, the Fed kept monetary policy, credit policy, that was more concerned, as Senator Sasser said, with inflation and therefore, kept deflating the value of that collateral.

As a consequence of the devaluation of the collateral, an instant crisis was precipitated almost by the stroke of a pen, not by any other events in the market place.

Companies that were able to meet their orders, to pay their payroll, to meet their interest payments, to continue to produce, were suddenly put on the liquidation block, and are being today.

I can tell you, Mr. Chairman, and I told you this yesterday, but I want it on the record here, I visited a couple of weeks ago with an over 100-year-old department store chain based in Massachusetts. Ten different outlets. Real estate assets valued in today's market at $24 million.

They can't get a $750,000 line of credit.

I have received calls from companies in southeastern Massachusetts, one particularly, that has gone from 30 to 300 employees in the last couple of years. It could put 50 more employees to work tomorrow. It has half a million dollars of backlogged orders.

But instead of filling those orders and calling in those employees, it may be liquidated within the next weeks because its collateral is low and the banks are calling them in and suggesting that they've got to pay up immediately because of the arbitrariness of the regulatory process.

Now the President last night in the State of the Union message, said, that's got to stop.

Mr. Chairman, I heard that 2 years ago. I heard that in his last State of the Union message. And I've heard it from Secretary Brady. I've heard it from Mr. Taylor and from others.

So the question that many of us are just frustratingly left asking is who's really going to make this happen? Is the country's most influential banker and one of our single most important voices on the economy going to weigh in on this and have the ability, though I know you're not directly in charge of that, but clearly, you have influence with respect to it and clearly, the tight credit. The cost of money has a great deal to do with that deflation.

If the Fed had the interest rates lower, if the Fed has more money that's available, then you can lend that money at less cost and those companies are in less predicament. And perhaps the bankers look at the balance sheet differently.

There is a clear link in terms of your policies to these things that are happening to us.
This pain has been greatly augmented by bureaucracy and by bad judgment. It is not just the market place that has created this. It is Government that has significantly contributed to this downturn.

I think people are just increasingly frustrated with all of that. So as we turn to you, our most important banker, in this reconfirmation process, and I am certainly disposed to reconfirm you, I guess we just want to know, is it really going to happen? What's going to happen? What role do you intend to play? And with what kind of candor can you address these current predicaments and help us to understand where we're going?

I might add, I saw a study recently that showed, that compared Japanese car making with American car making. And the single great cost differential that they pointed out that existed was the cost of capital, and that what has really disadvantaged us to a great degree has been this preoccupation with inflation at a time when many of us perceive that it's deflation that is our concern, not inflation, and we can in fact use a little bit of inflation, almost.

The Fed certainly could play a very significant role in restoring some of the value to the real estate and to the market place of this country.

So those are my concerns as we approach this. And I might add, I don't know how to—I know people who were worth a lot of money, as many of us do, just a year ago, 2 years ago. And they're worth nothing today. They don't even live in the home they lived in. You can't describe what is happening out there.

I sat with workers who have been looking for work for 2 years. Their home is on the chopping block. They can't pay their medical bills. They don't know where to turn. And they look to us, and we're left saying that we really have been part of the problem.

Mr. Chairman, it's a daunting task and we all have confidence in you, but we're looking for the real answers to this to understand what the response is going to be.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Kerry.

Chairman Greenspan, let me ask you to stand and raise your right hand.

Do you swear that the testimony you're about to give is the truth, the whole truth, and nothing but the truth, so help you God?

MR. GREENSPAN. I do.

The CHAIRMAN. Do you agree to appear and testify before any duly constituted committee of the Senate?

MR. GREENSPAN. I do.

The CHAIRMAN. Very good. Thank you.

We're very pleased to have you now. All of us have known you for a good number of years. In our own case, it probably goes back about 2 decades. It's with great personal respect that the committee and I welcome you here. I'd like your opening comments and then we'll go to the questions.
STATEMENT OF ALAN GREENSPAN, OF NEW YORK, TO BE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM FOR A TERM OF 4 YEARS

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

I wish to thank you, Mr. Chairman, Senator Garn, and members of the committee, for scheduling this hearing to consider my nomination to a second term as Chairman of the Federal Reserve Board and to a full 14-year term as a member of that Board. I am especially grateful to President Bush for the confidence he has in me to make these nominations.

I have testified before you frequently on the state of the economy and the conduct of monetary policy, including as recently as 2 weeks ago. I also have given you my views and those of the Federal Reserve Board on a wide variety of specific regulatory and supervisory matters pertaining to banks over the last several years. I would expect to be addressing your questions on these issues again here today.

In my brief opening statement, however, on the occasion of these hearings on my confirmation, I thought it might be appropriate to step back a little from the application of policy in specific circumstances and discuss some general principles that I believe should guide decisions on the monetary policy and banking structure of this country.

I see the fundamental task of monetary policy as fostering the financial conditions most conducive to the American economy performing at its fullest potential. As I have often noted, there is every reason to believe that the main contribution the central bank can make to the achievement of this national economic objective over long periods is to promote reasonable price stability. Removing uncertainty about future price levels and eliminating the costs and distortions inevitably involved in coping with inflation will encourage productive investment and saving to raise living standards. Monetary policy is uniquely qualified to address this issue: Inflation is ultimately determined by the provision of liquidity to the economy by the central bank; and except through its effect on inflation, monetary policy has little long-term influence on the growth of capital and the labor force or the increase in productivity, which together determine long-run economic growth.

But a central bank must also recognize that the "long run" is made up of a series of "short runs." Our policies do affect output and employment in the short- and intermediate-terms, and we must be mindful of these effects. The monetary authority can, and should, lean against prevailing trends not only when inflation threatens, but also when the forces of disinflation seem to be gathering excessive momentum. That is, in fact, what has concerned us in recent months, and we have been taking actions designed to assist in returning the economy to a solid growth path.

However, the Federal Reserve, or any other central bank, must also be conscious of the limits of its capabilities. We can try to provide a backdrop for stable, sustainable growth, but we cannot iron out every fluctuation, and attempts to do so could be counter-productive. What we have learned about monetary policy since the beginnings of the Federal Reserve System is that the longer-term
effect of a policy action may be quite different from its initial impact; what we don't know with precision is the size and timing of these effects, especially in the short-run. Uncertainty about the near term twists and turns of the economy, along with the awareness of the potential differences between long- and short-term effects suggest both flexibility in the conduct of monetary policy and close attention to the longer-term context in conducting day-to-day operations.

Monetary policy actions are transmitted to the economy through the financial system, and the influence of weakness in that system on how the economy responds has been all too evident in recent years. A structurally sound and vigorous financial system not only facilitates monetary policy implementation, but is itself no less important to support an economy operating at its highest potential. Such a system must effectively and efficiently gather savings and distribute them to where they will be of most value to society in promoting productive investment and supporting consumption.

Banks and other depositories have a key role to play in this system. They are the channels through which payments pass, they are the chief repositories of households' liquid assets, and they extend credit to many who have limited, if any, access to alternate sources of financing. Our Nation's banking system must be strong, not only in the sense of safe and sound, but also in the sense of being efficient and innovative in delivering vital services to the economy. That strength undoubtedly has eroded in recent years, in part through errors of judgment by depositories and their regulators, but also through the combined effects of a stiffer competitive environment and continued legal restraints on the ability of depositories to respond and adapt.

Against that background, I, and the Board of Governors, have brought three interrelated principles to bear on our approach to banking structure and regulation. First is the importance of a strong capital position. Capital brings market discipline to bear on institutions that otherwise might be tempted to take excessive risk by their access to the Federal safety net. And it insulates the taxpayers holding up that safety net from the losses associated with unwise risk taking, should that occur nonetheless.

Second is the need for more certain and prompt supervisory actions when capital and other key indicators of the financial health of an institution decline. This not only will protect the taxpayers, but it also gives depositories planning their financial structures more certainty about governmental reactions and induces them to take early action to strengthen those structures.

Congress and the regulators have gone a long way in acting on these first two principles. Unfortunately, progress on the third is more limited. That principle embraces the necessity for greater competitive scope for well capitalized banking organizations—across boundaries of geography and product line. Both sets of boundaries have been made increasingly arbitrary and artificial by innovation and internationalization of financial services.

An ability to delivery desirable services to the public is a prerequisite for generating the profits necessary to build capital and for keeping an innovative banking system capable of meeting the
changing needs for credit and deposit services of a dynamic economy.

The last 4 years have seen no paucity of challenges at the Federal Reserve. As much as we sometimes might wish otherwise, I suspect the years ahead will be no less challenging. While much remains to be done, important strides have been made—in private markets and in Government policies to restore the normal vigor of the American economy and our banking system. To that end, I believe the Banking Committees’ oversight and our continuing consultations have been a most helpful and constructive factor. Should the Senate choose to confirm me for a second term as Chairman of the Federal Reserve Board, I would look forward to working with this committee to assure the sound financial system and vital economy the American people rightfully expect.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Chairman Greenspan.

We’ve been joined by Senator Graham.

Senator Graham, did you have an opening comment that you wanted to make before we go to the questions?

OPENING COMMENTS OF SENATOR BOB GRAHAM

Senator GRAHAM. Mr. Chairman, I do not, other than to express my admiration for the Chairman for his contribution to correcting monetary policy at a time when that has been the principal and only rudder available for U.S. economic direction.

I have some questions which I would like to ask at the appropriate time.

The CHAIRMAN. Chairman Greenspan, there are a number of subjects to move through today. As you’ve heard earlier, the Republican members of the committee, those not present, are meeting with President Bush, who has come up to the Capitol today.

We will accommodate them when they return. We’ll take whatever time it needs. If at any time we’re interrupted by a vote or you need a break, you indicate. But we want to proceed on through and attempt to finish today, even if we have to go past the lunch hour.

Last February, the Fed’s monetary policy report noted about the FOMC, as it’s called, and I’m going to quote:

Committee members stressed that M2 expansion, noticeably above the lower end of the range, likely would be needed to foster a satisfactory performance of the economy in 1991.

And it looks as if they were right when one examines what has happened. M2 growth stayed right at the bottom of the range, while the economy went into a very severe recession.

I think the question that I have, and you’ve heard it repeated here today by a number of members in different ways, why is it that the Fed has seemed to be unable to get the M2 number up higher, even higher within your own range? And why has it proven to be impossible to get a faster money supply growth?

I’m convinced that’s really hurt us. I don’t say that that’s been the intention of policy, but that’s the way policy has taken place here. I think we need to understand what happened and what can be done to fix it.
Mr. Greenspan. That's a major issue, Mr. Chairman.

First, let me say that M2, which we have focused on and still believe to be the crucial money supply aggregate, has behaved in ways which really have confounded history.

If we were to look at the relationship, for example, between interest rates and money supply in the context of the way the system functions, say, prior to the last year, year and a half, money supply now would be running at the upper end, perhaps even touching the outer edges of the ranges.

What has occurred is a very significant and major downward shift in the relationships between interest rates and money supply growth.

I might add, parenthetically, that M1 and the monetary base have been growing very rapidly, but that has not spilled over into M2.

In addition, we are not getting the relationship between the economy and money supply that has historically been the case.

In fact, if you take a close look at the relationship between interest rates, on the one hand, and income velocity on the other, a relationship which has tended to be remarkably tight and reflecting a much more sophisticated analytical relationship, what we have found is that income velocity—that is, the ratio of gross domestic product to M2—has been rising slightly over the last year when, by all history, the sharp decline in interest rates that had occurred would have implied a significant decline in velocity.

Or put in another context, we are getting far more in the way of GNP or gross domestic product per dollar of M2 than history would have suggested.

So we have got two major problems with respect to the M2 aggregate.

On the one hand, we're having difficulty keeping it up at levels which we would like, although I must say in recent weeks it's shown a good deal more buoyancy.

But it is certainly true over the last year, it has been running much beneath where we would like and it kept falling relative to our expectations based on past history throughout the year.

Fortunately, this did not bring with it the type of contraction in economic activity which historically would have been suggested merely looking at the levels of M2 which actually prevailed.

We have seen, for example, a significant contraction in the savings and loan industry as we've taken a big chunk of that industry out and liquidated it, and a major part of the decline in M2 as a measured variable reflects a very dramatic decline in small time deposits, especially in the thrifts.

Fortunately, we have had a dramatic expansion of securitization of home mortgages and as a consequence of that, the contraction of the thrifts as an institution has not, so far as we can judge, materially affected permanent home mortgages.

The issue of construction loans is a different issue, which I presume I will address at a later time.

But what this is saying to us, in effect, is that we have had a major structural change without affecting the levels of economic activity, even though a big chunk of the M2 was in effect dissipated.
Similarly, we are also seeing evidence of a very large change in recent months of individuals moving from M2-type deposits into mutual funds, which are not included in the M2 aggregate, but do provide the form and type of liquidity which M2 usually measures.

Having said all of that, I myself and my colleagues are still concerned that the money supply has been dragging and has been a factor which has been suppressing the normal levels of nominal GNP.

It turns out that the numbers are not very large, but any suppression, in our judgment, is unacceptable.

The major reasons why we moved interest rates lower at many times when in fact the economy was rising through a goodly part of the third and fourth quarters, is that money supply was behaving, in our judgment, at too slow a pace. And we continue to hold that view.

My impression is that the most recent data are suggestive of an easing in that process and some expectation that the money supply is moving back to more normal relationships. But it's much too soon to know that.

And so, finally, Mr. Chairman, I would say to you that it is a major issue with us. We are doing as much as we can to understand what the changes in the process are. And rather than abandon M2 and saying its behavior is irrelevant, on the contrary, we say it's something that has to be explained and indeed, we have other evidence which suggests to us that it does remain an important element in monetary policy guidance.

The CHAIRMAN. I'm going to try to stay within the time limits today as best we can and still allow people to finish a point that they're making. And I'm going to try to do that now with myself and do it the same way with everybody else because I don't want to lose the points that you've just made. The concern that I have is this. You've acknowledged to us that your targeting on M2 has fallen way short of what you would like to have seen.

Mr. GREENSPAN. That's correct.

The CHAIRMAN. And I take what you're saying is you think that things are working in some new and unusual way, and in fact has hurt the kind of recovery that we might have gotten.

Mr. GREENSPAN. In part.

The CHAIRMAN. Well, let's say it's in part. I know there are other factors here as well.

Here's what I'm concerned about. It's so late in the game now, with just the damage that's been done, the kind of downward spiral problem that Senator Mack has referred to, we've got 16 million people in the country right now that want to work and are not able to find full-time work, and it's a very, very serious problem.

It seems to me that we have to be certain that we're getting M2 up to a level that really provides the money supply that the economy needs.

In other words, I don't think we can afford to continue to fall short. I think we have to be certain that what you're doing is adequate to really lift that to a sufficient level.

And I want to know whether you can tell us today with confidence and with a very high degree of judgmental certainty on your part that what we are now doing in terms of the new monetary
policy efforts that you're undertaking has solved this problem, and that we are now going to see M2 growth sufficient to really lift this economy and keep it moving up.

Mr. GREENSPAN. Let me just say, first, Mr. Chairman, remember that M2 is really a proxy for something else. It's the proxy for adequate liquidity in the system.

There are occasions when M2 has failed to be an appropriate proxy for the total of liquidity in the system which has been occurring. And rather than be directly concerned in all cases, irrespective of what happens, to focus on a specific level of M2—what we ought to do is to focus on the requirements of adequate liquidity in the system.

And to the extent that M2 is used to make certain we get the position where it, in effect, is registering the correct

The CHAIRMAN. Well, that's the question. Are we getting it? Can you tell us today as you sit here, after a series of policy steps that really didn't get that job done, recognizing the proxy point you make, are we getting it now?

Can we be confident that we've taken the policy steps, and they're now in place, to give us the lift that we need in this area?

Mr. GREENSPAN. What we are seeing, Mr. Chairman, is that the liquidity is beginning to build. We're seeing it in large part coming from other than money supply areas.

For example, there has been, as you well know, record issuances of both equity and debt in the financial markets which is improving and has been a major factor in liquifying the strained balance sheets that I discussed before this committee a couple of weeks ago.

This is a very potent force and an important one.

There are also indications of a general stirring that is going on in the markets which are suggestive that the balance sheets are improving.

At this particular moment, my own impression is that M2 will shortly begin to reflect those forces. If it does not, obviously, we have to look very closely to make certain that what we are looking at is a statistical aberration, a failure of a proxy to adequately measure what it's really supposed to be measuring, or whether the fundamental liquidity aspects of this economy are falling short.

The CHAIRMAN. Senator Garn?

Senator GARN. Thank you, Mr. Chairman.

Chairman Greenspan, I want to go back to what I along with some other members talked about in opening statements, the so-called credit crunch.

As I'm sure you're aware, one of the aspects that I feel very strongly about which is not discussed very often as a part of that problem is lender liability. I feel very badly that in the comprehensive banking bill we passed last year, many parts were eliminated in conference. Part of that was my section on lender liability.

I still feel that this is a very significant part of the credit crunch. A lot of the evidence is anecdotal, but it comes from all over the country. We've had many banks who issue small business loans testify before the committee saying that they simply were being very, very cautious and not making a lot of the loans that they used to because of the possibility of being held liable for pollution clean-up that they had nothing to do with.
My bill went through several different modifications making it very clear that if a financial institution RTC, FDIC, or Government agencies held property, and they had anything to do with the management and in any way contributed to that pollution, they ought to be held liable for the clean up.

Just because you simply held a mortgage on this particular business, building, whatever, you are not liable for the clean up. The environmentalists have fought the bill as somehow anti-environment. It has nothing to do with pollution. Beyond a credit issue, it is a matter of fairness that someone who had nothing to do with causing pollution should not be required to pay for the clean-up.

Governor Kelly testified last fall that environmental liability is a significant contributing factor to the present credit crunch. Bill Seidman testified last fall that if there was one thing that we could do before the end of the session that would be helpful to him at the FDIC, it would be to pass lender liability.

So with all of that background, I simply would like your opinion of the impact of this liability problem and pollution control on the credit crunch. Also, do you feel it is important to clarify those court decisions and pass legislation that would ensure that innocent lenders are not held liable? Finally, what impact would lender liability have on the credit crunch if we were able to pass it?

Mr. Greenspan. Senator, in the surveys that we have taken through our various Federal Reserve banks, we have clearly concluded that it is a problem and that it is a factor in the restraint of credit.

To that extent, it is an element in the credit crunch and it is a factor which is causing problems which are quite significant for a number of lenders.

I would be hopeful that this issue can be resolved as expeditiously as one can do it through the legislative process.

Senator Garn. Well, I appreciate that. I certainly intend to continue the push for it because all of the other solutions we have talked about, there are other factors. I do think this is a more significant one than a lot of people think.

I think everybody believes that there has been an overreaction on the part of the regulators and examiners. I can certainly understand why.

As I also mentioned, the regulators took a beating from Congress a few years ago for being too lax. If I had been a regulator and constantly was berated at witness tables and other forums I would tighten up as well.

I do think there has been overreaction, as the President mentioned last night. I would like your opinion, do you agree that there has been an overreaction, and if so, what steps are you taking at the Fed to try and alleviate that part of the problem?

Mr. Greenspan. Senator, there has been an overreaction. I think it's important. If I may take a minute to go back and review a little history to understand why that is, so that we'll have some basis of preventing this type of what I would call a regulatory cycle reemerging in the future.

It's fairly clear, as I've indicated to this committee previously, that with the enactment of some of the incentives for commercial real estate in the 1981 Tax Act, we oversolved a problem which we
had earlier; that is, depreciation—the tax codes on depreciation prior to that Act, especially for commercial construction, were really much too restrictive and noneconomic.

But instead of changing it to economic, we overdid it and went the other direction. We created incentives which, in conjunction with a tight market, induced a veritable explosion in commercial construction and, most specifically, commercial construction values.

Appraisals went up very sharply and what we were observing was presumed collateral values which would support very substantial amounts of commercial mortgages through banks.

As it's turned out, that bubble broke. The valuations which reached their peak in 1985 nationally, and at a later time in the east, brought down collateral values very substantially, and created a whole attitude toward real estate which we're living with today.

But in that process, as commercial bankers moved to create. A major increase in the proportion of their assets which are commercial mortgages, and the values kept escalating, supervisors, and examiners, looking at these appraisals, certified actions as being appropriate, those actions.

That has turned around 180 degrees for just the reasons you imply. I don't find it at all surprising that we've had a regulatory reversal. Human nature, being what it is, any of us in that particular position would have done precisely what the examiners and supervisors have done.

What we have to implement, as policy, are means of supervision which prevent that type of cyclical behavior from occurring.

We obviously cannot change human nature, but we certainly can change the procedures that we are involved with.

So I would look at the particular period not as one that leads us to forbearance for forbearance's sake—would be a terrible mistake. We should look at the current period as a means by which we can look at policy over a full cyclical horizon and be able to put in place policies which would prevent this very unfortunate supervisory cycle which I believe we have gone through.

I must say to you, Senator, that my colleagues in this area don't all agree with me on this question. This is a view that I have. Some of them have different views. Some of them think I'm mistaken on this.

But what we are all in agreement on is that we have to get a long-term, rational policy of supervision which doesn't create ups and downs solely as a result of supervisory reactions to volatile changes in appraisals.

Senator Garn. My time is up. I agree with you because I sat through the years when we were constantly hearing forbearance. We certainly don't want to go back to that time because that was a major cause of the S&L crisis. Everybody was pleading in those hearings saying, “don't close my institution.” “Let them grow out of it.” And “Keep them open.”

In return, now you get the overreaction of what is now too tight. I think that overreaction exists and it must be modified. But you used the key word. If we push from these political pulpits to go back toward forbearance, we will buy another financial disaster.

We must try and smooth out those ups and downs. Congress must encourage a much more balanced policy. Ease up. I'd like to
get the word forbearance out of our vocabularies because of the disastrous consequences of forbearance in the 1980's.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Wirth?

Senator WIRTH. Thank you, Mr. Chairman.

Mr. Greenspan, I'd like to go, if I might, to the question that I suggested in my opening comments about the health care metaphor.

There has been a good deal of discussion over the last 3 years about bank powers, as some have suggested, the solution to the problems that our financial institutions have.

I think it has been demonstrated, one, that that issue is enormously difficult for us to resolve, no matter where you come down on it, because of all of the veto power conflicting interests and views that surround this issue. And second, some disagree pretty strongly that new powers in fact would have a major impact, at least in the immediate future.

The question then becomes, are there steps that we ought to be considering relating to these very special institutions, our banks and other financial institutions, are there steps that we might take that will help in the short term.

I mentioned capital requirements earlier. Senator Mack built upon that and knows much more about this than I do, the notion that such tight capital requirements are putting pressures on banks to call long-time performing loans.

Are there steps that we might take there? Are there steps that we might take in the upcoming tax legislation?

Some have suggested the potential of tax credits to banks. If they are making loans of a particular nature, tax credits could help support capital.

I would like to know what would you do? If you were sitting where we are, looking at the economic recovery package that's coming up, what would you suggest that we ought to be doing from the perspective of the Banking Committee for both the short-term and the long-term?

Mr. GREENSPAN. Well, with respect to the Banking Committee or banks?

Senator WIRTH. Banks in general. What might we initiate, obviously? It would go to many committees of jurisdiction. But banks as a general proposition.

Mr. GREENSPAN. Senator, looking at the major problems that we have seen in banking over the years, as we've observed, their franchise began to erode for competitive reasons with respect to other financial institutions. It's become increasingly clear that giving them powers which enables them to compete, but also to increase the average capital position, is a necessity and is clearly the long-term required solution to the difficulties which confront banks.

The Basle capital requirements were, as you may recall, the result of conversations initiated 4 or 5 years ago, and were meant, and continue to apply to longer term needs of the world banking community, especially those in the United States.

I would be very chary about trying to change those mid-stream. First of all, it would be almost impossible to get international
agreements. I do think that we can look at certain areas of the way in which we control capital.

We have, for example, been looking at the so-called leverage ratio, which is a secondary capital ratio imposed because the basic agreement at this stage does not have interest rate risk embodied in it.

There are discussions which have been proceeding in which we're trying to examine whether we have the most sensible set of capital standards.

I would be——

Senator WIRTH. Excuse me. Those are discussions between you and the Department of the Treasury or——

Mr. GREENSPAN. Yes. These are amongst the various supervisory and regulatory authorities.

I would be very careful about changing long-term capital requirements at this specific stage; that is, bringing them down for cyclical reasons, because I'm not sure that we can effectively do that. And I must say, Senator, I'm not convinced that the problems that we have with respect to what we call the credit crunch lie to a very large extent, or even a material extent, in those capital requirements.

I do think that the fear of losing capital is a very crucial aspect of this whole phenomenon. But it is largely the consequence of fears of bankers that their nonperforming loans will turn bad, be written off, cut into their capital, and require that they squeeze down the total institution.

So I would be far more inclined at this stage to look at alternate means of resolving these issues, and I would be very hesitant at this stage, unless it is effectively demonstrated, and I doubt that is the case at this stage, that these are a major impediment to the functioning of these particular institutions.

Senator WIRTH. What are the alternate means that you were just referring to?

Mr. GREENSPAN. I would say at this particular point, what we are finding is that, while the credit crunch has not eased, it hasn't gotten worse. But we are now for the first time beginning to see some evidence that nonperforming loans are beginning to flatten and turn down.

This is a necessary condition for the ending of the credit crunch because unless and until bankers feel comfortable that the quality of their assets are such that expanding loans will not impair the franchise value of their bank, until that occurs, we are going to continue to get an extraordinarily distorted extension of credit that we have called a credit crunch, but has broader implications with respect to the way the financial system functions.

At this stage, we are getting increasing capital into these institutions. Rather than lower the requirement, it's far more important that we just increase the amount of capital to assuage the concerns that some banks obviously do have.

And we have seen a very dramatic increase in capital, and anything that this committee can do to enhance the capability of institutions to attract capital would be helpful.

As I and my colleagues have testified before this committee on numerous occasions, it is our belief that the best way of doing that
is to try to improve the powers of these institutions in a manner which would enhance their attractiveness to the financial market, and increase their earnings, and because earnings are increasing and the outlook for earnings improves, that capital will automatically flow from the market place into these institutions in a manner which would be more than adequate to finance them.

Senator WIRTH. Mr. Chairman, thank you very much.

The CHAIRMAN. Thank you.

Senator Specter?

OPENING STATEMENT OF SENATOR ARLEN SPECTER

Senator SPECTER. Thank you, Mr. Chairman.

Chairman Greenspan, you and I have discussed an issue which I would like to pursue with you this morning, and that is an idea which Senator Domenici and I proposed on stimulating consumer purchasing power by use of IRA's and 401(k) programs, with an opportunity for people who have those interests to be able to withdraw a certain amount, which we established at $10,000 a year for middle-income Americans, without any penalty and without tax in the first year, with taxes to be paid in the 4 succeeding years.

President Bush, last night, in his State of the Union address, picked up that idea. I would like to explore it with you today in terms of your evaluation as to what that might add to consumer purchasing power.

There is obviously a trade-off if we use savings. But savings are really for a rainy day and we have in effect a cloudburst today with the economic problems which we face.

We find ourselves in a straightjacket of a sort, with the budget agreement because we cannot reduce taxes. We cannot increase spending without finding some set-offs. But we have the available funds, some $800 billion.

This idea which Senator Domenici and I have proposed is a take-off on the Super IRA proposal which has 74 cosponsors, where the idea has been advanced to use IRA's in the future and allow those funds to be utilized for capital investments like college tuition or medical expenses or first time homebuyers.

Our proposal would utilize the existing IRA's to try to stimulate consumer purchasing power pretty much on a concept that we need some revitalization of confidence.

Paraphrasing what Franklin Delano Roosevelt said, all we have to fear is fear itself, if we can get the process going, people would be inclined to spend some of their money if they thought that they were not going to be alone.

And I know from your prior testimony, you have noted that the statistics are not as bleak now as they have been at some times in the past, in 1982, for example, except for the factor of confidence.

You and I had discussed this, as I noted, before, yesterday, in addition, when we had a brief conversation. I would be interested in your assessment as to how much money might be spent and what effect it might have on consumer purchasing power.

Mr. GREENSPAN. Senator, as we discussed yesterday, it's not an easy calculation to make largely because what we are in effect trying to make a judgment of is how many individuals would take
advantage of the tax changes that are implicit in that activity, such that they would decide to forgo long-term or retirement savings to make purchases in the short-run. It is fairly clear that some would. What we are not clear on, and hopefully, we can get a better judgment of, is what type of impact that would have.

As I indicated to you yesterday, I suggested that since we are unclear as to how much of an effect that might have, it would be really important, to avoid significant fiscal hemorrhage, that these types of activities have upper limits on them so that they would be contained both with respect to levels and time, so that they achieve the type of specific purpose which I presume is the basis of your particular recommendation.

Senator Specter. If I might just interrupt you there.

So you would think that, if it is to be done, there ought to be an upper limit, say establish some dollar figure, and when that much has been taken down by holders of IRA’s or 401(k)’s, that that would be the end of it, until we had a chance to re-evaluate the economic impact and see if there was too much stimulus to consumer purchasing power.

Mr. Greenspan. As I indicated to this committee a couple of weeks ago, Senator, I have not yet come to the point where significant fiscal initiatives for short-term means are desirable.

My main concern with respect to that issue is not so much that moderate types of activities will create distortions in the system. I’m worried about if they begin to mushroom and you begin to overload the system.

So my concern really rests with the fact that whatever is done, if it is done, be limited because if it turns out that, in an endeavor to impact some short-term fiscal stimulus to the system, we do so, but create some longer-term problems with respect to fiscal affairs, we will be most concerned about the outcome.

So what I’m saying is I hope that, in evaluating this, that you endeavor to keep it to the specific rifle focus, so to speak, that you’re endeavoring to engage in.

Senator Specter. When we talked yesterday, you said you would give some thought, some idea as to what kind of consumer purchasing power might be generated, and perhaps also to what you would establish at this point as an outer limit to see what the status of the economy was after X-dollars had been spent.

I realize that these are very complex, judgmental calls and as I said to you yesterday, we really need the help of the experts, realizing how difficult it is.

Could you give us some guidance along those lines?

Mr. Greenspan. Yes. We will look at it and try to give you our best shot at what type of impact is likely to occur under various assumptions relevant to what you are suggesting.

Senator Specter. Well, the red light has gone on in my first round. I will not exceed my time, but just to focus the questions which we’d like your written responses to, would be what impact you think would be present on stimulating consumer purchasing power and what upper limit ought to be restricted without unduly fueling those fires.

Thank you very much, Mr. Chairman.

Thank you, Chairman Riegle.
Mr. GREENSPAN. Following our discussion, I directed the Board's research staff to do an analysis of your proposal for allowing penalty-free withdrawals from IRA and 401(k) plans for certain purposes and to estimate the effect of the proposal on consumer purchasing. I am enclosing that analysis for your review.

It should be noted that because of the multiplicity of factors involved, the analysis is difficult, and it must be recognized that it is not possible to reach a high degree of confidence with respect to the conclusions.

This memorandum analyzes Senator Specter's proposal regarding penalty-free withdrawals from retirement account, focusing especially on the issue of how great an impact the action would have on household spending. Section I describes in greater detail the provisions of the proposal; Section II discusses some analytical considerations bearing on the spending issue; Section III presents some relevant estimates derived from the national Survey of Consumer Finance; Section IV offers some conjectures on the likely spending effects.

I. The Proposal

The proposed legislation would allow certain taxpayers to make penalty-free withdrawals from retirement-type accounts, provided the withdrawals are applied toward one or more qualified purchases. Specifically:

- The proposal would allow withdrawals from IRA's, Keoghs, and 401(k)'s.
- Eligibility would be restricted to those earning less than $100,000 (if married and filing jointly), $50,000 (if married and filing separately), or $75,000 (all others).
- According to the legislation in its current form, qualified expenditures would include the purchase or improvement of real property, and the purchase of durable goods. In his floor speech and in other communications, Senator Specter has also mentioned medical expenses and college tuition.
- Each taxpayer would be allowed to withdraw no more than $10,000.
- Withdrawals would have to be made on or before December 31, 1992; associated expenditures would have to be made either (a) within 6 months of the withdrawal, or (b) by the time the taxpayer files his/her return for the relevant tax year (in most cases, no later than April 15, 1993). The more restrictive of (a) or (b) would be the binding rule.
- Regular tax liability on the withdrawn funds would still be owed; however, the liability could be spread over a period of 4 years following the withdrawal.
- In his floor speech and written communications, Senator Specter also mentions the possibility of allowing those who take advantage of his proposal to replenish the funds in their IRA or 401(k) over the 5 years following the withdrawal. The existing legislation does not contain this provision.

II. Analytical Considerations

Several analytical points are worth making about the likely impact of the proposal on household spending:

- It is useful to think of qualifying households as falling in one of three categories: not liquidity-constrained, extremely liquidity-constrained, and somewhat liquidity-constrained.
- Households that are not liquidity-constrained will probably not be interested in tapping their retirement savings, because doing so would remove those savings from their current tax-sheltered status.
- Households that are extremely pressed for funds will be tapping their funds in any event, and would choose to pay the 10 percent penalty in the absence of Senator Specter's proposal. The extra spending generated by the Senator's proposal via these households would be only $1,000—smaller by an order of magnitude than the overall amount of $10,000.
- Therefore, the proposal likely would have its greatest impact on the spending of the intermediate group: those households that are somewhat liquidity-constrained, but not too much so. These households will be induced to make a withdrawal that they otherwise would not have made.
- About two-thirds of 401(k)'s have borrowing provisions. Therefore, owners of these accounts have access to the wealth they hold in 401(k)'s even in the ab-
sence of Senator Specter's proposal. Evidence suggests that many households take advantage of these loan provisions. For example, one recent survey found that 9 percent of account-holders initiated a new loan during 1990, while 21 percent had a loan outstanding at the end of 1990.1 Roughly 90 percent of such plans allow general-purpose loans (and therefore cover a wider range of expenditures than would Senator Specter's plan).

- The tax amortization feature probably will make relatively little difference to the proposal's influence on spending: Standard theories of consumer behavior predict that taxpayers who know that a liability is outstanding will be inclined to set aside most, if not all, of the tax liability upon receipt of the withdrawal. This prediction is supported by available evidence concerning the relationship between ordinary income tax refunds and consumer spending.

III. Empirical Evidence

The following estimates from the 1989 Survey of Consumer Finance shed further light on the likely impact of the proposal on household spending:

- According to the SCF, qualified accounts (including IRA's, 401(k)'s, Keoghs, thrift, and saving plans) amounted to $1.239 trillion in 1989.4
- Of this amount, $893 billion was held by families headed by someone aged less than 59 years old. Older people already can withdraw funds from retirement accounts without penalty.
- Next, $736 billion was held by families meeting both the income constraints specified under the Specter proposal and the above-mentioned age cutoff.
- Ownership of that $736 billion was highly concentrated, however. If we count only the first $10,000 in retirement funds per family, then the qualified pool of funds shrinks to only $136 billion.
- Median liquid assets held by all families meeting the proposed age and income criteria were $1,950.5 Among families reporting ownership of some retirement funds, median liquid asset holdings were $6,180. Among families holding at least $5,000 in retirement funds, median liquid asset holdings were $6,180. Among families holding at least $5,000 in retirement funds, median liquid asset holdings were $9,800. This result conforms with the common finding that those who save via IRA's and Keoghs also tend to save by other means. Families that are holding substantial amounts outside their retirement accounts will be less interested in tapping their retirement funds if given the opportunity to do so penalty-free.
- Transaction costs could be sufficiently great to persuade some families who otherwise would take advantage of Senator Specter's proposal not to liquidate their IRA's or 401(k)'s. These costs would include, for example, early withdrawal penalties.

IV. Spending Effects

A fundamental fact should be kept in mind while assessing the likely influence of the proposed program on household spending: The proposal would do nothing to raise the wealth of households, other than of those who anticipated incurring a withdrawal penalty. Therefore, the proposal would influence household spending mainly by relaxing liquidity constraints currently binding on some households. The above data from the SCF suggest that this impact probably would not be very great, given that a considerable portion of the available retirement-related wealth is owned by families holding substantial amounts of other liquid assets.

3 Low-income taxpayers will experience some benefit from being allowed to smooth some of the liability into lower tax brackets. However, evidence from the Survey of Consumer Finance suggests that eligible families would have higher-than-normal incomes, and so would not benefit from this aspect of the proposal to any great degree.
4 Respondents to the 1989 SCF reported total holdings in IRA's and Keoghs of $598 billion. For comparison, the Employee Benefit Research Institute puts the total for IRA's and Keoghs in 1989 at $494 billion. SCF respondents reported an additional $225 billion in 401(k)'s, quite close to the estimate of $277 billion based on data from the Department of Labor's Form 5500. Finally, SCF respondents reported $346 billion in thrift or saving plans, or other defined-contribution plans with borrowing provisions.
5 Liquid assets were defined as the sum of checking accounts, money market accounts, CD's, other bank accounts, mutual fund holdings, saving bonds, other Government and private bonds, direct stock holdings, and accounts held at brokers.
Some withdrawals undoubtedly would occur if the proposal were to be adopted, but the incremental effect of the proposal on expenditure will be less than the total amount withdrawn for two reasons: First, some withdrawals would have been taken, even in the absence of the program, by families extremely pressed for liquidity. Second, some withdrawals from 401(k)'s will represent, in effect, a substitution of outright withdrawal for borrowing that would have taken place in the absence of the program.

There is no way of predicting with any confidence the amount of additional expenditure that would be forthcoming in response to implementation of the proposal. It seems reasonable to guess, on the basis of the evidence presented here, that the increment to spending would amount to less than 1 percent of personal consumption expenditure (or $40 billion)—and it quite possibly would be substantially less. If the permissible penalty-free withdrawal were to be raised to $20,000, it would raise the amount released on the estimates above from $136 billion to $206 billion. However, while the spending effect probably would be greater, it would likely be only modestly so, because the additional balances affected would, on average, be held by individuals who are less liquidity-constrained.

The CHAIRMAN. Thank you.

Senator Sasser?

Senator SASSER. Thank you, Mr. Chairman.

Dr. Greenspan, I want to go back to a question that I really didn't get to ask in its entirety the last time you were here. It's an important question.

One of the implicit understandings underlying the 1990 budget agreement was that the Congress, and the administration, to some extent, would be transferring to the Fed the obligation of keeping the economy rolling along and not going into recession.

Indeed, it was partly at the urging of the Fed that we arrived at a budget agreement to reduce spending and raise revenues by roughly $500 billion over 5 years.

And as an inducement to do that, there was an implicit understanding that we would see rates coming down, or at least that the Fed would be mindful of the economy. In essence, the Congress and the administration were getting in the backseat of the car and putting you and your colleagues at the steering wheel, to some extent, Dr. Greenspan.

At the time I was concerned about the effect that a contraction in fiscal policy would have on the economy to the extent that this budget agreement was a significant $500 billion reduction.

I asked you in July of 1990, if monetary policy could act quickly to counter the fiscal contraction that was coming.

I thought that the Fed ought to be easing in advance of the budget agreement, due to what I perceived to be a lag effect in monetary policy.

This economy is sort of like the Queen Elizabeth II. You turn the wheel and the ship starts responding sometime later, very slowly.

You responded, at the time, that the Fed would wait until after the budget agreement was finalized to ease rates and you did assure me, and I quote, "that monetary policy changes can be suggested, debated, decided, and implemented in a very short span of time."

And continuing from your letter, "If need be, monetary policy has the ability to act quickly enough to support economic expansion."

Now, you did wait until after the budget agreement to ease. As a matter of fact, the Fed did not seriously begin to reduce rates until December of 1990, after the recession was already 6 months old.
The steps that were taken initially were very gradual, as I said earlier, and very incremental.

Monetary policy was supposed to be our safety valve, but we fell off into a recession, anyway. Thus far, monetary policy does not seem to have worked and Congress sits here with its hands tied with regard to fiscal stimulus by the 1990 budget agreement.

I want to ask you, Dr. Greenspan, why the Fed didn’t act quickly when we were on the cusp of the recession, to push rates down and prevent a further economic downturn.

I want to go further and ask you, do you believe that monetary policy is capable of pulling us out of the recession now? Should we rely only on monetary policy? And if so, when is it going to get us out of this economic quagmire? That’s a three-pronged question.

Mr. Greenspan. Senator, first let me start by saying that we started easing basically in the spring of 1989, as we began to see the consequences of the balance sheet problems which were beginning to emerge and the weakness that was occurring in the underlying system.

We moved the Federal funds rate, as you in fact indicated another time, down from approximately 10 percent to under 8 percent in the fall of 1990.

And in that sense, we had been basically trying to anticipate a change in the levels of economic activity in advance.

It was not clear to what extent the recession would take hold and whether or not the level of easing that had already taken place was adequate or not adequate.

One of the basic problems that we had was a recognition of the fact through all of this period and subsequently, that a crucial element in addressing what we variously called either the balance sheet problem or a specific form of the balance sheet problem, the credit crunch. What that particular process needed to address it was lower long-term interest rates.

And our major concern was to be certain that as we moved short-term rates lower, we could move, induce, drive, whatever the appropriate term is, long-term rates to move with the short-term rates because, basically, the Federal Reserve cannot control directly long-term rates.

The evidence that we had coming out of the latter part of the 1980’s was that the market’s basic evaluation of inflation, rightly or wrongly, was that it was going to remain at a fairly significant level. And what that did was to keep long-term interest rates up higher than would otherwise be the case by a significant amount.

Without going into the analytics of that at this time, what became clear to us in our evaluation of the long-term market was that the decline that was occurring in long-term rates, modest as it was, was wholly a reflection of the fact that the inflation expectations that were falling and reflecting the long-term rate were those only of the next 3-to-5 years.

The market’s implicit long-term inflation expectation 10, 15 years out remained stubbornly high. And our concern was that unless we could break the back of that expectation, our ability to bring long-term rates down enough to make a significant difference would be limited.
And indeed, as I mentioned here a couple of weeks ago, it really was not until the fall of 1991, that the first major signs were there that the long-term inflation expectations embodied in the market place were beginning to ease enough so that we could look to a major decline in long-term rates if we eased.

That’s the reason why we accelerated our monetary easing in that period, because it became clear that we now had the capability of really bringing long-term rates down.

And that has had the effect, as I’m sure you’re aware, in fact, as you have mentioned, of significantly increasing the refinancing of mortgages and homes. It’s created a record level of issuance of corporate debt for purposes of liquification of corporate balance sheets, and has indirectly created a major increase in equity issuance as well.

So, in that sense, monetary policy is clearly working to try to break the back of this credit crunch balance sheet constriction of the economy.

Is it enough? I think so. Do I know that for sure? The answer is no, I do not.

Senator Sasser. Can you assure us today that monetary policy will bring us out of this recession?

Mr. Greenspan. My best judgment at this stage is that it will.

Senator Sasser. Well, when, Dr. Greenspan?

Mr. Greenspan. I would say that if it is not doing so within the next several months, then the statement I’m making requires revision.

[Laughter.]

But let me be much more specific and tell you what we know and what we don’t know.

Senator this is a situation—that is, the balance sheet strain situation—is unique to the second part of the 20th century. We have not seen anything like this before.

We have not seen real estate values fall precipitously. We have not seen collateral values create the type of problem that has been so much of a concern to us.

What we do see at this particular stage is a stirring in the markets. We are seeing, for example, some evidence that homebuilding is finally beginning to move, and that’s a crucial aspect of the situation. We are beginning to see some very subtle signs that the erosion in the economy is beginning to stabilize.

If that process continues, then the economy will be picking up on its own independently of whatever fiscal policy moves the Congress chooses to make.

My only concern about fiscal policy moves is that it is very easy to overdo them. And we have sufficient experience of overloading the system, which suggests to me that we have to be quite careful.

My best judgment at this stage, fully recognizing that we are dealing with a very shallow data base, and a very extraordinary set of circumstances which we have not seen before, is that this economy can move out of this extraordinary lethargy with monetary policy alone.

I say that knowing that I don’t know that for certain, but it is my best judgment at this stage.
And as I said to this committee when I was here the last time, I'm not yet ready to argue in favor of a significant fiscal package. That might occur. In other words, it is conceivable that there are other forces here which we are not aware of at this point which would suggest that we do that.

I have not seen them as yet.

Senator Sasser. Well, my time has expired. Thank you, Mr. Chairman.

The Chairman. In yielding to Senator Mack I think some would argue that the President in part last night did put forward a fiscal package.

Mr. Greenspan. I would say that the President did, and I would say that it is not a major one and, like many of the packages which individual Members of the Congress and specifically this committee have brought forward, they are not the types of packages which in and of themselves would, in my judgment, create long-term problems.

My estimate is I don't think they are necessary at this point, but I understand that it's very easy to have differences of opinion and a desire to create an insurance which I have full sympathy with knowing the state of our knowledge.

My concern is not any of the individual packages that I have heard because none of them, or I should say none of which I am aware, have the capacity to overload the system in the long run.

My major concern is that in the process of endeavoring to reach an agreed package within the Congress that the type of negotiations that could occur could create a much larger and potentially fiscally disruptive package of an order of magnitude that no individual member or sponsor would himself particularly wish as the final conclusion.

The difference really is whether or not whatever is done is restrained to a short-term package without long-term implications, or whether in the bargaining process that might emerge we create a package which is far too large for the type of problem which it needs to address.

The Chairman. Senator Mack.

Senator Mack. Thank you, Senator Riegle.

Mr. Chairman, I want to pursue the comments in my opening statements having to do with real estate, and I'm drawing from the things you said here this morning that you do believe that real estate values or the decline in real estate values is a major factor in this recessionary period that we're experiencing.

Mr. Greenspan. Most certainly. The decline in real estate values has had a very extraordinary effect on commercial lenders, mainly banks, but also insurance companies and others, and it has been the major factor which has created the credit crunch.

Senator Mack. All right. Again, I just want to mention a couple of figures for the record. We did talk about them yesterday, but FDIC sources for Florida insured commercial banks. For example, one of them that really stands out is the unused commitments on commercial real estate and construction loans. Those total loans declined from September 1990 of $4.4 billion to September 1991 to $2.25 billion, about a 50 percent decline. Now to me that's an indicator of future activities. It might be short-term future activities,
but clearly future activities with respect to construction and development.

Mr. Chairman, you mentioned liquidity and increased capital and with low-interest rates, but yet the banks are not lending. They are not lending money in the real estate market, and it seems to me that without some—if we cannot find some way to increase lending in real estate, I don’t know what can occur that can stop the decline in values of real estate.

I guess what I’m saying to you is you have kind of implied that if we would just hold tight that with the increased liquidity and increased capital in our lending institutions that they will eventually lend again in real estate. I am not comfortable with that response at all.

Mr. Greenspan. Let me suggest, Senator, that there has obviously got to be more to the response that I have just given you with respect to that particular problem. What we are dealing with at this particular point is a general attitude on the part of a number of banks that they over lent in a lot of different areas, mainly real estate, and are under extraordinary pressure at this stage with respect to the safety and soundness of their institution, or at least as they perceive it, and are particularly concerned about getting non-performing loans down and the safety of their capital position assured.

Fortunately, we seem to be getting, as I indicated earlier, some indication that overall nonperforming loans are flattening out and in many areas declining. It is not an overly impressive trend yet, but it’s really the very first sign that we’ve had that something of this nature is occurring.

If we get increasing earnings in the banks, which is beginning to occur, and that’s the reason why the stock prices for bank holding companies have done so well of late and why individual banks have been able to sell new equity in the market with some degree of success in recent months.

Basically we are looking at a situation where appraisal values, at least until recently for which we have data, are still falling. It is unclear whether those appraisal values are truly reflecting the actual values of properties in an open market sense or whether we have been engaging in accounting procedures with respect to appraisals which focus on liquidating values of property for collateral.

Senator Mack. Let me just hope in here for a second. It seems to me that what is happening in the area of appraisals is the reverse of what occurred as you talked about it a little bit earlier in the beginning of the cycle if you will, the 1981 through 1985 and beyond period in which people were appraising on their expectations of a marketing continuing to increase, whereas today the appraisals are being made on the basis of a market that they see continuing to decline.

Again, just because the time is somewhat short, I understand what you’re saying, but I just say to you that the folks that I’m talking to in Florida, we’re going to see many good businesses go under as a result of the failure to be able to obtain credit.

Mr. Greenspan. I agree with you, Senator, and that’s what concerns us the most. What I’m trying to suggest is what we as regulators have got to do, and we have come part way, but not as far as I
would like to see us get, what is needed is to find a mechanism which accelerates this process by which what we are getting is a willingness to lend, because of a perception on the part of the bank that their capital position is now secure and eventually a sense that unless they start to lend, they will begin to lose their competitive position vis-a-vis other banks.

And I would say to you that we have been only partially successful to date, but it is an ongoing concern on the part of regulators, and unless and until this issue can be put behind us, an intensive effort has to be maintained to find solutions to what is the unique event in the post-World War II period.

I have not run into anything close to this, and I'm sure you, Senator, as a banker have observed very much the same phenomenon. This is a very different type of problem than we have seen in banking since the 1930's.

Senator MACK. Just a final comment. In my 26 years, 16 in business and 10 in the Congress now I have never seen anything like this, and I do think that we need to come up with some creative approach frankly to address the question. I don't see anything out there that I have heard that indicates that something is going to stop this continual decline in the value of real estate.

My concern is if we don't it could further undermine the value or the capital structure of other financial institutions which brings more real estate into the hands of the FDIC and the RTC who then turns around and dumps it on the market and further drives down the values of real estate.

So I look forward to working with you to see if we can come up with some kind of approach. Again, I know projects, and I know what the values are and I have seen recent appraisers. Bankers are just saying if it has the term real estate in it, we're not lending. We don't care if there is a cash flow and we don't care whether there is a real estate collateral value to protect it, they are not lending, and that's killing our economy.

Mr. GREENSPAN. Senator, that's precisely the problem. It's the word "real estate" if we could change would be helpful. The reason we moved as we did to change the HLT definitions where we could, because it was an idea, a concept originated by the regulators, is precisely for this reason.

The difficulty that we have got in dealing with real estate is it's a generic concept and security analysts and analysts of all types look at the issue of real estate as something which is negative, and what we have got to do is to change the structure of the way this issue is being approached.

I will say just at the end of this short conversation that fortunately there appears to be improvement in the banking system. Earnings are improving, capital is improving, and while that is not a sufficient condition to end this particular problem, it is clearly a necessary condition. So it's not as though we are back to square one. We are not. But we still have a good way to go as far as I'm concerned.

Senator MACK. Thank you, Mr. Chairman.

The CHAIRMAN. We need to continue that. I appreciate that line of questioning. I think it's very important.

Senator Graham.
Senator Graham. Thank you, Mr. Chairman, and I would like to continue that and return to the earlier discussion on capital standards.

One of the criticisms that has been made of the capital standards is that they are not discrete in terms of types of real estate. For instance, housing, residential housing is treated as it would be commercial, and that’s particularly true as it relates to the construction finance.

What I’m hearing is that a major impediment to the residential housing industry has been the inability of builders to get access to construction finance, and that in part is because of the unfavorable capital standard which is set for all construction finance whether it’s of a commercial property or of a housing property.

(A) Is that factually accurate as you understand the capital standards and, (B) If it is accurate, do you believe that is a legitimate reason why banks have been reticent to make residential construction finance and; (C) What would you do about it?

Mr. Greenspan. Well, Senator, the standards stipulate that residential mortgages are weighted at half the commercial rate or the construction loan rate on the grounds that——

Senator Graham. No, I’m speaking about construction and not the in-loan mortgage.

Mr. Greenspan. Yes, OK. Construction loans at this stage are weighted the same as commercial mortgages, and the reason they are is the fact that they are perceived to be a standard loan with risk involved.

Senator Graham. Are construction financed loans for residential rated at the same level as construction finance for commercial?

Mr. Greenspan. Commercial. In other words, it is only the permanent mortgage that is weighted at a half.

Senator Graham. Is the empirical data over time that construction financing for residential had the same degree of risk for the lender as construction finance for commercial?

Mr. Greenspan. My recollection is that if you took a look at the basic loss record, one to four family mortgages over a long period of time, the loss rate is very low.

Senator Graham. Now, again, I’m focusing on the construction.

Mr. Greenspan. But the construction loans in the most recent period have apparently created lots of problems for a lot of depository institutions.

Senator Graham. And that’s for residential as discrete from commercial construction?

Mr. Greenspan. That’s correct. But as you may be aware, Senator, there has been discussion about segregating parts of residential mortgages, or I should say there is a case which the builders have been pushing and we have been looking at in which they argue that if a particular project or a particular loan is basically pre-sold, in other words, if a house is pre-sold and the long-term mortgage is available, that the risk of take-out is really de minimis and that therefore the construction loan on that particular type of project should be counted at the 50 percent risk weighted basis like the other loans.

That is an issue which we are examining at this stage, but in answer to your general question, construction loans, whether for
residential or non-residential, are unweighted, meaning a hundred percent of risk.

Senator GRAHAM. I would like to have some analytical work done on that distinction between residential construction and other forms of construction finance to see if there is a justification for the similar treatment that is now being accorded.

Mr. GREENSPAN. When I used to look at these data, my recollection is that we do not request on our forms to separate residential from non-residential construction loans so that the data are not directly available, but I suspect we ought to be able to get at least some judgments in calling around and trying to get a sample which might be useful for your purposes.

Senator GRAHAM. My anecdotal information and my own intuition would be that there would be a difference, and it would be a difference in the direction that the residential construction has been less of a vulnerable pattern.

Mr. GREENSPAN. I would suspect that you're correct on that, Senator, but let's see if we can find some direct evidence which demonstrates whether that is in fact the case.

[Chairman Greenspan subsequently submitted the following information for the record:]

Consistent with the Basle Accord, the standard risk weight for claims on private sector obligors under the U.S. risk-based capital guidelines is 100 percent. The 100 percent risk category encompasses a broad spectrum of credit risk ranging from AAA-rated corporate commercial paper to loans for speculative real estate development. Residential construction loans generally are considered to be less risky than commercial real estate development loans. While there are no firm data, anecdotal evidence from around the country provides support for that statement. At the same time, residential construction loans are considerably more risky than many other types of loans in the 100 percent category. I would note, for example, that speculative residential construction loans played an important contributing role in the failure of a number of savings and loan associations and banks in the southwest and northeast.

The one exception in the Basle Accord to assigning a 100 percent risk weight to claims on private sector borrowers is for permanent loans secured by mortgages on residential property. These loans may be assigned a 50 percent risk weight. The Basle Accord, however, specifically excludes assigning loans to companies engaged in specifically excludes assigning loans to companies engaged in speculative real estate development to the 50 percent risk category.

However, where a developer has obtained a construction loan to build a 1- to 4-family residence that has been presold and that meets reasonable prudential criteria, we believe a case can be made that such loans are not speculative in nature and can be treated the same as permanent loans on 1- to 4-family properties for capital adequacy purposes. Reasonable prudential criteria would include, for example, a substantial earnest money deposit from the buyer and a firm commitment for permanent mortgage financing. In such circumstances, the risk of the builder failing to complete construction of the residence and, thus, failing to close on the sale and repay the construction loan has been greatly reduced. Accordingly, Federal banking regulators currently are considering extending the preferential 50 percent risk weight to presold residential construction loans that meet prudential criteria of this type.

Senator GRAHAM. Mr. Chairman, in the limited time that I have I'm going to shift to an entirely different subject matter.

One of the provisions in the banking bill that passed last November had to do with the international banks and provided a greater responsibility to the Federal Reserve System for the oversight of those banks, banks of a foreign origin doing business in the United States.
One of the peculiarities of my State which has caused concern is that many of those foreign banks are from relatively small countries and therefore themselves are small financial institutions and that they might be disadvantaged by a regulatory scheme that required excessive by their standards amounts of scale of operation in order to do business in the United States.

The legislation which passed had some provisions that were intended to discourage that negative view of the smaller foreign banks. I wonder if you have any comments as to where the Federal Reserve Board is in terms of implementing those foreign banks standards and specifically how they might affect smaller banks from smaller countries?

Mr. Greenspan. Well, Senator, as you know, we did have conversations and correspondence on this question. So we're fully aware of your interests and concerns.

I assume that the regulatory provisions to implement the legislation that has just been passed are in process at this stage, but I don't know specifically how far along that is.

[Chairman Greenspan confers with his staff.]

General Counsel says it's probably going to be available in about 60 days.

Senator Graham. Thank you, Mr. Chairman. I would like to continue to monitor that as it goes through the regulatory process.

Mr. Greenspan. We shall do so.

The Chairman. Senator Bond.

Senator Bond. Thank you, Mr. Chairman.

Chairman Greenspan, to go back to the points I raised in my initial comments, it would be very helpful for you to give us some guidance. All of us are facing a smorgasbord of remedies, and there are some sound economic ideas, there are some different policy prescriptions, there are some mechanisms that would probably make Rube Goldberg look unimaginative and there are perhaps a few that are just plain wrong.

For guidance as we approach the economic stimulus package would you set out the two or three worst ideas, the things that we must not do first.

Mr. Greenspan. I appreciate the question, Senator.

We are in a very difficult period at this stage. It is true that our economic statistics indicate that we're not declining, we're flat, but it is a flatness which seems to have no bounce at this stage, and as I've said here on previous occasions and at other committees, there is a general view of the longer-term outlook in this country amongst many segments of our population which is, in my judgment, very discouraging, and I am quite concerned that there is this fear about the longer term which must be addressed.

Therefore, I'm very much concerned that if we engage in too large a fiscal package, assuming a fiscal package comes down the pike, we could actually undercut the longer term and create much more difficult problems for the budget, and in fact create in many respects the type of long-term economic climate that a lot of our citizens are fearful of.

So I would say, first, it is terribly important that whatever is done that we do not change the long-term, or do not increase the
long-term structural budget deficit. Actions to reduce it are crucial if we are to increase savings in this society and investment.

I would list that as the critical criterion, because if you give a number of different criteria, none of them will be adhered to. So I would basically say it is very important that not only do we protect the long-term budget deficit from increasing in rhetoric, but we do so in a manner which is implementable and the markets can perceive it as implementable, because if they begin to fear that we are going to create a major new inflationary surge over the very long term, they may be wrong, but what they will succeed in doing is moving long-term interest rates up and that will be clearly counterproductive to our short-term desire to get the economy moving.

Senator Bond. When you say a large fiscal package then, you are clearly saying a large increase in the deficit. If there were a major revisions within the tax structure, for example, that did not increase the deficit, would that alone be a problem? Would that cause uncertainty, or is just the deficit?

Mr. Greenspan. No, I would think that anything which was constructed in a manner which not only stipulated that the budget agreement, so to speak, or the ranges of longer-term deficits were kept in place, but that actions were taken to make sure that was in fact to be done.

Senator Bond. One or two of our colleagues, and I don't see any of them here to speak for themselves, so I would ask the question maybe on their behalf. One or two of our colleagues have said that maybe this is the time for us to consider moving toward a consumption tax to some degree as a means of improving our international competitiveness in exports, imports and also to lessen the disincentive for saving and investment. Would such a proposal have a positive or negative impact on long-term growth in job creation?

Mr. Greenspan. In strictly economic terms if one looks at a shift from income taxes to consumption taxes, one must assume that the savings rate for the Nation as a whole rises and that you create the type of investment that one would presume occurs as a consequence of that.

The concern that a lot of people have, however, is that if you move in this direction, you create the dynamics which could very readily create much higher value added or business transfer taxes and not really address the budget deficit.

In principle I like the idea of moving to consumption taxes, but as a practical matter I'm not certain that there is any easy way to do so in the particular context that now exists within this country and the different interest groups that would be affected one way or the other. So I'm not inclined to push in that direction because I don't think it will get very far.

Senator Bond. Well, my next question obviously is now that we've gotten rid of the less desirable options, from a fiscal policy standpoint what economically would be the most sensible changes we could conceivably make to encourage savings and long-term investment for growth and job creation?

Mr. Greenspan. Senator, as I have said before this committee on numerous occasions, the best way to get national savings increased
is to reduce the drain of budget deficits against gross private savings.

I have also indicated that while the evidence on IRA's, for example, is mixed with respect to whether they engender savings or not, that the goal of increasing national savings is so important to this country that one could almost argue that even if it's unclear, one should take the risk that the IRA's will work because at worse they can't do very much harm.

But when you get beyond that, it is very difficult to find a series of tax proposals which will enhance private savings, especially in the household sector, in any appreciable manner relative to the effect that a significant reduction in the budget deficit would do.

Senator Bond. Capital gains?

Mr. Greenspan. I wouldn't look at capital gains as a savings issue as much as I would as an investment incentives. So I would not put that in as a particular tax which I would look to as a major creator of savings directly.

Senator Bond. Mr. Chairman, I thank you and thank the members of the committee.

The Chairman. That's a pretty important answer.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR PAUL S. SARBAanes

Senator Sarbanes. Thank you very much, Mr. Chairman, and, Chairman Greenspan, welcome.

Senator Sarbanes. I sat down to breakfast this morning and promptly proceeded to get indigestion reading an article on the front page of the Business Section of the Baltimore Sun, "Confidence Slips Another Notch," and I don't know whether you can see this chart from there, but this is consumer confidence.

Mr. Greenspan. That's the Conference Board survey which was released yesterday.

Senator Sarbanes. That's the Conference Board survey and it shows another further drop. I mean it has really dropped, precipitously over the last few months, and in fact the Conference Board said that it was now down to its lowest level since the 1981-82 recession.

Mr. Greenspan. As I recall it was since 1980.

Senator Sarbanes. In October the index took an especially steep dive falling to 60.1 from 72.9 the month before. It slid further to 52.7 in November before stabilizing in December, and now it has gone down again to 50.4, and they do a survey of 5,000 households. They found only 6.4 percent of all respondents in January consider business conditions good, while 51 percent said they were bad. Both figures show more pessimism than in the preceding month.

Moreover, the survey showed that an increasingly large number of households are experiencing hardship. Close to one out of four report that someone in the household was unemployed over the past 12 months. Of those who are back on the job, nearly half are making less money. So if they've been unemployed, even if they managed to get back on the job, just under half are making less money than they were making before.
Now in this article it said the report from the Conference Board was considered especially significant by economists because it showed that Americans aren't responding to some of the lowest borrowing costs in nearly two decades. That means they aren't taking out loans for new homes, cars and appliances in sufficient numbers to stimulate the economy out of the recession.

On the contrary, economists said, the Conference Board survey shows that many consumers are holding back saving their money in case they need it for essentials.

I think individuals are focusing more on the further deterioration of the job market and their own family's financial situation, said Gary Ciminero, Chief Economist at Fleet-Norstar Financial Group in Providence, the biggest bank in economically battered New England. Job prospects and job concerns continue to mount. That's what driving things he said. It should be patently obvious that interest rate cuts haven't worked.

The article then goes on and says Federal Reserve Board Chairman, Alan Greenspan, who orchestrated dramatic reductions in interest rates last year to encourage more borrowing, has said those moves should be sufficient to get the economy growing again.

And let me just interject, I understand you're reasserting that position this morning in response to the questioning that has been put to you.

The article then goes on and says by some reckonings the economy is in the 18th month of recession, which would be the longest slump since the Great Depression.

Then, quote, and I'm now quoting from the article, this is not my statement, “For heavens sake, this report today should have told Alan Greenspan you haven't done enough.”

Let me repeat that. “For heavens sake, this report today should have told Alan Greenspan you haven't done enough,” said Morey Harris, Chief Economist at Paine, Weber Group, a large Wall Street brokerage.

What do you say to those comments?

Mr. GREENSPAN. First, let me say that the evidence of borrowing is beginning to emerge in the important residential construction area. We are beginning, as I'm sure you've seen, to get reports at this moment, to a large extent anecdotal, but increasingly in a statistical sense that residential housing is beginning to come back and that sales are beginning to pick up in the month of January.

I will go further with respect to the specific issue relevant to actions taken by the Federal Reserve to repeat what I said here 2 weeks ago. If the Federal Open Market Committee concludes that more is required, we will be there.

Senator SARBANES. What is the down side of doing more? If we've got this consumer confidence problem, we've got a sluggish economy and the employment rate last month was the highest it has been during the recession of 7.1 and capacity utilization is down, what is the down side of easing monetary policy further?

You've actually not eased it significantly. In fact, you're just about paralleling now the easing that was done in previous recessions at a time when fiscal policy was also being used as a tool to stimulate the economy rather than being, as it were, frozen as in this instance, and when we didn't have the credit crunch problem that a number of my colleagues have referred to in the course of
their questioning, both of which it would seem to me would add additional arguments for further easing of monetary policy.

Mr. GREENSPAN. I would agree that the evaluation of relative degrees of ease during recessions does require, as you point out, taking into account the fact that fiscal policy has been unable to implement its usual role, and that is an issue which we reflect upon.

On the other side of it to be considered as well is that even though confidence has eroded quite considerably and you don't need these surveys to know that that is in fact the case—you just speak to people—the economy is up from its lows and is more than half way back from where it started down. So that in that sense it is not the same type of environment. We are in fact, and have been, easing in an economy which has come up off the floor, and in that respect it is not that we are looking at a continuous erosion in activity.

But to respond to your question, which is a very important one, our major concern since we view this problem as a balance sheet problem is to get long-term interest rates down. It will not serve our purposes very much if we bring short-term rates down and long-term rates don't move with it.

Senator SARBANES. Well now let me just ask you on that very point. In this morning's budget the administration makes the assumption that the interest rate on 90-day Treasury bills will fall from 5.4 percent in 1991 to 4.1 percent in 1992, and then raise to just over 5 percent through 1997. For 10-year Treasury notes the administration assumes the interest rate will fall from 7.9 percent in 1991 to 7 percent in 1992, and then gradually decline to 6.6 percent by 1997.

I have three very quick questions to put to you.

First, did the administration consult with you before it developed its interest rate assumptions?

Mr. GREENSPAN. They did not.

Senator SARBANES. Are these assumptions realistic?

Mr. GREENSPAN. I don't know. This is the first time I've heard them, or I might say the first time I heard of some of the numbers was this morning when I saw it on the tape.

Senator SARBANES. Therefore, I gather the answer to the last question is also negative, and that is did the administration get a commitment from you to conduct monetary policy to achieve these interest rates?

Mr. GREENSPAN. NO.

Senator SARBANES. So the administration has in effect developed these interest rate assumptions sort of out of the air, or at least they have not been developed with any consultation with the Federal Reserve which helps to make the interest rates; is that right?

Mr. GREENSPAN. That's conventional procedure. I don't think that I recall an administration consulting with the Fed on these budget forecast numbers. Implicit in their numbers, incidentally, is a rise in the Treasury bill rate because it currently is at 3.8 percent.

Senator SARBANES. Do you think it's realistic that these rates are going to come down the way they've projected them?

Mr. GREENSPAN. The long-term rates?
Senator SARBANES. Yes, and the short-term rates.

Mr. GREENSPAN. Well, the short-term rates are rising in their forecast and not declining. I mean currently we're at 3.8 percent. Did you say they are at 4.2 percent?

Senator SARBANES. This is for the year. This is not at a particular point in the year.

Mr. GREENSPAN. I can't comment on the specific forecast, but there is an inflation premium which is still in long-term interest rates which I think over the long run will gradually dissipate, and I see no reason why long-term rates should not over the longer run move lower if inflation expectations continue to be subdued as they clearly are in the current period.

Senator SARBANES. Well, Mr. Chairman, my time is up.

The CHAIRMAN. Chairman, I want to just clarify one thing and then I want to go to Senator Domenici, and that last night the President in his remarks said the following. He said, "Finally working with the Federal Reserve we will continue to support monetary policy that keeps both interest rates and inflation down."

Now, of course, working with the Federal Reserve can mean a lot of different things, but I take it from your testimony just now that that should not be read to mean a consultative relationship in terms of really forecasting these interest rates and trying to arrive at a monetary policy blend with non-monetary policy that would produce the numbers in the budget. I take it should not be read to mean working with the Federal Reserve would carry that message with it; is that correct?

Mr. GREENSPAN. That is correct. We do obviously consult with them and try to coordinate as best we can because this is one Government and these policies are of necessity interrelated with one another. So we do exchange views on a fairly continuous basis and, in my view, quite satisfactorily.

We do not engage, however, in creating common specific interest rate goals to be implemented by some joint effort. That is not what that means nor, in my judgment, should it mean. I don't think that would be an appropriate role for the central bank.

The CHAIRMAN. Senator Domenici.

Senator DOMENICI. Thank you very much, Mr. Chairman.

Chairman Greenspan, let me clarify a statement you made in response to Senator Bond's inquiry regarding the capital gains, the difference in the treatment of capital gains from ordinary income treatment. You indicated that you would not put capital gains under the heading or rubric of increasing savings. But might I ask doesn't it quite appropriately fit in the category of stimulating investments?

Mr. GREENSPAN. In fact, I thought that's what I said. I said it creates incentives to invest and, as I've argued before this committee on numerous occasions, it's an important element in any tax program, and I've even gone further in repeating a position I've held for a number of years that I would much prefer to see the capital gains tax at zero because it's not the type of revenue raiser which is appropriate for an economy which needs growth.

Senator DOMENICI. Well, I would put it this way. There are a lot of Senators and other people in the country talking about catching up with Japan, and it appears to me that when we talk that way
we do not refer to catching up with Japan in terms of increasing investments because as a matter of fact there is a lot of catching up to do there in that they have a capital gains differential of significant proportions and other incentives to investment in savings. Is that not correct?

Mr. Greenspan. I believe so, but I'm looking at it strictly in terms of what our economy needs. I would not necessarily allude to what others are doing because each economy in respect to incentives and its tax structure is quite different, and it's important to look at our particular structure not necessarily in the context of how it looks relative to other countries.

Senator Domenici. I understand that, and I agree wholeheartedly. However, I don't think it's just an accident that most of the competing economies do treat capital investment significantly different than we do in terms of the gains upon disposition or sale which, as I say, could be an accident, but it seems to me to be rather significant in that it's everywhere.

Mr. Greenspan. That is correct.

Senator Domenici. Let me ask with reference to monetary policy and reducing interest rates and the efforts you have made thus far. I gather what you have said here today is if it appears that more is necessary, obviously the Federal Reserve is concerned about the lack of responsiveness in the American economy in terms of growth; is that correct?

Mr. Greenspan. That is correct. Senator.

Senator Domenici. And that is the most significant negative quality in the American economy today, and you're not concerned about inflation and other things as much as you are with the failure of this economy to catch hold and grow; is that correct?

Mr. Greenspan. No, I don't think it is correct. Unless we are concerned about inflation, we are not concerned about long-term growth, and I would argue, as I indeed indicated in my opening remarks, that if we wish to have a functioning economy which grows at its maximum long-term potential, one of the necessary conditions to achieve that is a non-inflationary economy. What inflationary economies basically do is create an inordinate amount of volatility in the system and over the long run it inhibits real growth. So I would not separate the issue of inflation as a long-term concern and long-term growth.

Senator Domenici. Let me move to another point. The American people seem to be saying in most of the major poles of late when they are asked what they are most concerned about, they seem to be saying that you're saying that the long-term growth of the American economy is a very high concern, and they are suggesting that one of the principal concerns that they have is the rather large American deficit.

Now since the American people feel that way, and I believe they are smarter than we give them credit for, are you also saying here today that you do not favor significant new spending programs at this point in time because they are probably going to affect the long-term health of the American economy?

Mr. Greenspan. I would be cautious about spending programs because it will make the reduction in the long-term structural deficit exceptionally difficult, and since I view that as a major issue to
create savings in this economy which leads to investment, I would be very reserved about major new expenditure programs.

Senator DOMENICI. Well, I believe that most of the criticism about the President's proposals has been summarized in a statement of no new ideas. It seems to me that most of those new ideas are new spending programs of one sort or another which are absent from the President's proposals with reference to the overall budget.

And because I believe that, I wanted to ask you, probably within the next 48 hours somewhere in the House, probably in the Ways and Means Committee, a chart will go up for all the world to see and the major networks will be there, and it's going to be a measuring of the President's tax proposals according to the progressivity formulas that have been invented over there in the House by this professional staff.

Now that bothers me very much because obviously there is a difference between progressivity as they define it and a stimulus for this economy which may come from the tax side. And might I ask, could you suggest to us what kind of index we might generate and, believe me, since they generate one, we ought to generate one here in the next 48 hours. Don't you think we ought to invent one, or could we invent one and put it to the test and call it job creating index? Would the Federal Reserve have any opinion on the job creating qualities of the tax proposals that are before us and others that the other side might have?

Mr. GREENSPAN. Well, I would certainly say that we couldn't do anything in 48 hours because we have just seen these proposals in the last 12 to 15 hours.

The crucial question here is not the immediate incidence of taxation, which is the procedure that is employed here, but some endeavor to try to find what is the change in after tax earnings of various different groups within our society, and that to me is a much better measure of the degree of progressivity. If in fact implicit in any particular program is an ability to enhance the level of economic activity, it may well turn out that a program which in the first iteration looks to be progressive may turn out to be the reverse and vice versa.

Senator DOMENICI. I thank you for that answer, and I frankly believe you should not be so cautious about preparing an index because nobody other than five or six people can understand theirs, and maybe we can use five or six that would understand ours and it ought to therefore be just as good.

However, let me move on to real estate. The President has hit the nail on the head. Hardly any other national perspective is being given to the policies involved in real estate free fall in values and what we ought to do to prop it up.

I urge that you and the Federal Reserve monitor carefully what is happening to real estate values in the United States and that you do everything within your regulatory power without additional ones to see that the lending institutions are taking the right course of action in their lending practices regarding such things as mark to market and those concepts that are out there that make it more difficult to justify either new loans or the continuation of old ones in the commercial market.
I think it's devastating to find that there is no increase and in fact a loss in the total lending for commercial purposes and on commercial real estate by our major banks in the United States. That has got to turn around, and if there are regulatory impediments you should try to cure them, and I urge where we need to change things that you suggest to us what we change them, because most Americans don't understand that real estate is a huge part of the American economy. From houses and homes all the way to office buildings and everything in between is a very large part of the transactional activities in this country, and we've got to stop that fall some way.

I think the President's suggestions are good, and I don't have time to ask you if you do, but I will submit a question to you on that score in writing and ask for other suggestions along those lines.

Thank you very much.

Mr. Greenspan. Let me just say very quickly, Senator, that we spend an inordinate amount of time trying to understanding what is going on in real estate values throughout the Nation. It's not an easy job, but we've put a great deal of thought into that issue and follow it very closely.

Senator Domenici. Thank you very much.

The Chairman. Senator Shelby.

OPENING REMARKS OF SENATOR RICHARD C. SHELBY

Senator Shelby. Thank you, Mr. Chairman.

Mr. Chairman, I was not here for all of Chairman Greenspan's testimony. I was in the Energy Committee, and I have a prepared statement that I would like to be made part of the record first.

The Chairman. Without objection, it's so ordered.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Mr. Chairman, I first want to commend you for scheduling this morning's hearing. I believe that the state of the Nation's economy demands a strong hand at the helm. The chairman of the Federal Reserve should not be subject to the political vagaries of the confirmation process. I hope that after this hearing, we will then have a swift markup and floor vote.

Chairman Greenspan, you steer the Nation's economic ship through turbulent waters right now. The economy has floundered in a recession for several quarters. Unemployment is up, bankruptcies are up, housing starts are down to the lowest level since World War II.

Interest rates have plunged but there is still a credit crunch. Lenders are hesitant to lend, even to the best borrowers. Consumers are not buying, out of fear of what tomorrow will bring. Businesses are laying off thousands of employees at a time, in a vicious downward cycle, that seems to escalate.

We cannot lay the blame for this at your feet. We have asked you from your first day to do the job with one hand tied behind your back; the budget deficit leaves the Federal Reserve with less room to maneuver. The commercial real estate market was overbuilt. Not surprisingly, asset values dropped. The decline in values
was precipitated by vast Government holdings of real estate acquired from failed savings and loans.

Worse than all of this bad news, is what you and I discussed a couple of days ago: the long range expectations of this generation. For the first time ever in our Nation’s history, this generation is fearful over what the future holds. Rather than hoping to surpass their parent’s standard of living, today’s generation is hoping merely to obtain it.

I believe that the present recession represents a fork in the road. We can go for a short-term boost to the economy and hope to coast out of this recession. Or we can put together a package of long-term growth incentives that will enhance this Nation’s competitiveness and fuel the country’s growth for years to come.

For the health of the country and for the future of today’s generation, I believe that we must emphasize long range growth. I hope that today in your testimony you will share with us your view on the merits of some of the ideas out there, such as investment tax credits, capital gains relief, and expanded IRA’s.

Last night, in his State of the Union Address, the President listed a number of items he would like to see passed by Congress by March 20. Presumably, he is looking for a turn around in the economy by November. If we were to pass his initiatives, many of which are already supported by many of us here on the hill, would the economy respond that quickly? Or are we already working our way out of the recession, without these incentives?

Are there any proposals out there, that if we passed them, we would do more harm than good?

You have done a good job for this country so far and I trust that you will continue to do so in the future. Thank you, Mr. Chairman.

Chairman Greenspan, I had a nice conversation with you a couple of days ago about a lot of things that you’ve rehashed here today, and I appreciate that.

I asked you then, and it has been alluded to today about monetary policy, the easing of interest rates. I commend the Fed for what you’ve done there. I hope you will do more. I mentioned this the other day and you did not rule that out. You indicated to me and you indicated a few minutes ago that it will depend on what happens in the economy, so to speak, and what the numbers show.

I don’t believe you can just jump start the economy strictly by monetary policy, but I believe that will be a significant factor. What bothers me is that any stimulus could have counter results, and as an economist and Chairman of the Federal Reserve you’ve indicated that to me.

What I’m concerned with, and we had the President’s State of the Union last night and his opening proposals. They’ve been hashed here today, and a lot of those I personally like. They will overall do some good for the long run and hopefully not a lot of damage to the deficit, but this could just be the opening bid in the Congress. It’s a political year and, as Senator Domenici had mentioned, we don’t know what is going to come out of my side of the aisle or the other side of the aisle or a combination of everything.

That has got to concern you as Chairman of the Federal Reserve and your Board of Governors. Will it be some legislation that will really do some damage to the economy as the economy begins to
pick up, as we hope it will. Is that a real concern of yours, Mr. Chairman?

Mr. Greenspan. Yes. As I said earlier while you were in your other committee, Senator, in looking across the spectrum at the various individual short-term fiscal initiatives which members of this committee, and others, those in the House and the administration, none of them that I'm aware of strike me as potentially creating major difficulties in the longer term.

In that respect the bond market's reaction to the President's program, which was quite positive in both Tokyo and London right after he spoke, is an indication of that.

But the concern that I have is that in the process of trying to implement any of these programs into a general agreement which can pass both Houses and be accepted by the President, that instead of averaging programs, we add them up, and that would concern me because that would create a longer term problem for the economy which would immediately be perceived in the markets which would move long-term interest rates back up and create a short-term problem for us that I doubt very much that we need.

Senator Shelby. Is it basically a fundamental given among economists that the worst and most dangerous thing for any economy is debt and deficit? High deficits will breed, among other things, inflation, the psychology of inflation and retard long-term growth?

Mr. Greenspan. Senator, there are differences. There are a number of very reputable economists who think that the deficit either does not matter or it hasn't the types of effects that the majority of economists believe that deficits do.

Senator Shelby. What is your opinion?

Mr. Greenspan. My opinion is that they matter and they matter a great deal, and my major concern is——

Senator Shelby. And why? Explain that.

Mr. Greenspan. Essentially it's largely that they subtract from private savings and as a consequence delimit the amount of financing available for domestic private investment, and that in turn is a crucial issue with respect to American standards of living, the growth of the economy and the general lifestyles that we would like to achieve.

Senator Shelby. And the fear that the American people have as I go around, and not just in my State of Alabama, but there is a great fear among the American people, and a lot of economists say this, that our children will not have the standard of living that we have and will not have the opportunities that we have. You've heard that and you've seen numbers on it.

Mr. Greenspan. Senator, that view, which I find very disturbing, is one of the elements in the lack of confidence which Senator Sarbanes has so correctly identified.

Senator Shelby. Chairman Greenspan, just briefly could you compare the 1982 recession to where we are in 1992 as to the severity and the problem in structure and debt and everything that goes with it. Let's go back 10 years. In 1982 we were in a recession, and we're in one in 1992.

Mr. Greenspan. The 1982 recession, if one believes the data are accurately reflecting various changes in what is going on in the
The economy, was much more severe than we have been going through to date. The unemployment rate, the layoff rate and all of the various labor force indications, the levels of economic activity and operating rates all suggest that. That’s the reason why I’m so concerned about the climate of confidence in this country.

If it were worse, one could say it was the result of the short-term business cycle, that therefore when the economy came out of a recession, as it always does, that we would be restored to some sense of normality. But rather than give one a sense of unconcern when you look at some of these data and their relative degree of relationship to the 1982 or 1975 recessions, it actually creates more of a concern on my part because it’s telling me that something much more profound is going on which we don’t at this stage yet fully understand.

Senator Shelby. Briefly you’ve alluded to the fact here and you’ve told me personally that there are some numbers, and of course they are not crystallized maybe yet, indicating that the economy is beginning to turn around. Do you look for a turn-up in the economy in the second quarter, some signs of something positive and not just a little bubble?

Mr. Greenspan. Yes, I do. My best judgment as to the forces that are now beginning to emerge suggest that. But I do wish to hasten to add that we are in an environment which is quite different from historical business cycles, at least of recent history. We have to be cautious about coming to definitive conclusions without the firm evidence emerging, and as far as I’m concerned, I would expect the economy to quicken its pace, but I’m spending a great deal of time watching rather than forecasting.

Senator Shelby. There have been a lot of false signals in the past.

Mr. Greenspan. Exactly.

Senator Shelby. Mr. Chairman, my time is up.

The Chairman. Thank you.

Senator Kerry

Senator Kerry. Thank you, Mr. Chairman.

Chairman Greenspan, you talked about the problem of inflation and your reaction to it, and a number of Senators have asked you about that. Would you rather have inflation or deflation?

Mr. Greenspan. I would prefer neither. They are both destructive.

Senator Kerry. Well, isn’t it true that historically in the United States the greatest periods of real growth in America have always come with 5 or 6 percent inflation and that every time we’ve had zero inflation we’ve had periods of stagnation?

Mr. Greenspan. I’m not sure which is cause and which is effect because of the difficulties that one has in evaluating this process.

It used to be that the conventional wisdom amongst macroeconomists was that the ideal state was a modest degree of inflation as creating maximum economic growth. That view has been largely discarded in the last decade or so pretty much around the world, and what evidence we have is suggestive of the fact that the lower the rate of inflation, or more exactly the lower the rate of expected inflation, the lower is the risk premiums embodied in the cost of
capital, and the crucial issue relevant to economic growth is low capital costs.

What evidence that we have suggests that inflationary environments do not lead to cost of capital that is sustainable over the long run, and often what you get is a combination of both expansion and inflation in which it's the expansion which is causing the inflation, but it doesn't go on very long. It's a cycle, and unless and until we can observe growth which is sustainable, it is very difficult to argue that inflation helps rather than hinders.

Senator KERRY. Do you agree that we have a collateral crunch right now?

Mr. GREENSPAN. Oh, I do indeed, yes.

Senator KERRY. Let me before I ask you the open ended question, let me share with you an article that I found particularly interesting. It's an October 15, 1991 article in the Wall Street Journal written by Mr. John Rutledge, who is Chairman of Rutledge and Company, a merchant bank in Claremont, California.

He said the following:

The Fed Reserve has been busy since December cranking the Federal funds down a quarter point at a time searching for the level of interest rates that will breathe life back into the dead economy. It might just as well save its breath. The issue for policymakers is not how to make people willing to spend money. It is restoring their confidence so they will stop trying to unload the stockpile of houses, cars and other fixed assets that they already own. There is no level of interest rates that will make the public content to hold the existing stock.

He then says:

It's the availability of money for business, not its cost, that is at issue. The United States does not need lower interest rates. It needs Roto-Rooter for the banking system. As long as bank regulators pay more attention to credit risk than interest rate risk, however, bankers will keep socking their money away in Treasuries and businesses will go hungry for working capital.

That is precisely what is happening in New England, and I think that's exactly what the Senator from Florida referred to.

Now he states:

The Fed should work with the RTC to estimate the size of this aggregate supply bulge from the resale markets and to target a money growth rate sufficient to sterilize the effects of the RTC sales on net worth.

In retrospect this is precisely what Paul Volker did with the Fed in 1983 when growth in M2 jumped to 11.8 percent. It happened again in 1986 with a 9.5 percent M2 growth under somewhat milder deflationaly circumstances.

Mr. Rutledge ends his article by saying:

An explicit announcement by the Government that it will use monetary policy to stabilize the price of real assets would restore the public's confidence in their homes and in their futures and would provide a firm foundation for long-term growth.

Could you comment on that.

Mr. GREENSPAN. Well, that's a very long issue to comment on, but let me make a few basic comments.

You have to distinguish between asset values and commodity values. I have no doubt that were we to inflate the currency by a massive program of expansion that we could turn all sorts of values up. You could very easily inflate residential and commercial real estate, but the question that is far more important is what happens to the rest of the economy in the process.

And I would suggest to you that that would seem to work only for a very short period of time and create a massive structural
problem in the financial system with values going all over the place, mainly adversely.

Senator Kerry. May I interrupt you there politely and just ask you to follow up on that—isn’t that exactly what happened in 1986 with the change in passive loss and its sudden imposition so that the collateral went down, and now you’re seeing this massive uncomfortable adjustment in the marketplace as a result of that?

Mr. Greenspan. No, but the declines in values that occurred at that time were really very small relative to what we’re seeing today. First of all, residential property values did not go down. They were still going up during that period.

The decline that occurred in the overall commercial real estate value in that period was largely in the Southwest. Actual commercial real estate values were rising in the East and continued to rise until 1988. So the situation was far different then from what we’re confronted with today. That’s not to say that I don’t think we ought to be looking at this thing for further actions that can be taken to resolve it.

In response to Senator Mack’s question, I think that we’re not there. We’ve made some progress. We understand a lot of the processes that are going on, and frankly the banking system is improving and we’re a lot closer to the resolution of this issue, but I don’t think we’re there yet. We’ve got a way to go.

Senator Kerry. What steps would you now recommend?

Mr. Greenspan. I would not wish to recommend anything at this stage unless and until the regulators, my colleagues in this particular area were all in agreement on a specific project, because I don’t think it’s productive to raise issues until we have resolved them.

We are all aware of this particular issue, and we are quite concerned about the decline in real estate values. As far as I’m concerned unless and until we turn that around, we are going to have very serious continuing problems. Even though improvements are occurring in a number of financial institutions, I just don’t see how we can get commercial banks, insurance companies and the like back to full viable operation assisting the economy until this real estate issue is resolved.

If somebody could find a way to wave a wand which would resolve some particular problem in this economy without any other adverse consequences, it’s exactly that that I would choose. If we could find a way to turn real estate values up without secondary negative effects, that would be the most important thing that we can do as a regulatory initiative.

Senator Kerry. I take it, and my light is on—

The Chairman. Go ahead and finish.

Senator Kerry.—but I take it that the President’s suggestion of restoring passive loss is not meant to apply, and you would not want it to apply to new construction—

Mr. Greenspan. That is correct.

Senator Kerry.—but that would only go as to existing structures, and that would restore value.

Mr. Greenspan. Well, I haven’t looked at the detail of the President’s proposal.

Senator Kerry. There wasn’t any that we saw.
Mr. GREENSPAN. I don't know whether or not it's for existing structures only. Is it?

Senator KERRY. I don't know. That's what I'm asking, but it seems absurd to me to return to where we were obviously creating an economic benefit to put up something that nobody is going to use.

Mr. GREENSPAN. The majority of the projects I would assume under the President's proposal would be existing structures.

As I've said here, and 2 weeks ago, I discussed precisely this question of passive losses and changing the tax law limiting, however, the capability of taking such losses to existing properties on the ground that the last thing we need is more newly constructed empty space.

Senator KERRY. And I cut you off before you were able to end the Government making this announcement about monetary policy in order to restore value.

Mr. GREENSPAN. I'm not disposed to make specific announcements about anything that would be contemplated unless and until we get to a point where those types of things would be done.

I will say to you that I know John Rutledge quite well, and I have great respect for his insights. I happen not to agree with his particular proposals that he is suggesting there because he's leaving out a large number of secondary consequences which I don't think would be tolerable.

Senator KERRY. Thank you, Mr. Chairman.

The CHAIRMAN. Chairman Greenspan, we're going to continue on here. Would you want a brief break? We're going to stop at about 1:45.

Mr. GREENSPAN. No, that's all right.

The CHAIRMAN. All right. Then we'll either come back this afternoon if there are questions left, or perhaps tomorrow. I would like to do it today if that's workable for you.

I want to take you quickly through some things that we've touched on today.

When you were here 2 weeks ago you indicated at that time that the Fed had taken the policy actions in lowering rates that you thought would get the job done, and that as you saw it at that point, and you've confirmed today as I've heard you, you feel professionally that your policy for the moment at least is where you want it to be and you think it will work.

You're not certain about that, but you think it will work. You're seeing at least the beginnings of some positive signs, but importantly you said also 2 weeks ago that you have further room that you can go if you decide later that you need to do that. Is that a fair summary?

Mr. GREENSPAN. That is correct, Mr. Chairman.

The CHAIRMAN. OK. Now I've also heard you say today that you're not convinced looking at the economy that we need a fiscal stimulus package added to the mixture right now, that in effect you think monetary policy easing that you've done is enough, in your professional judgment, and will probably work, and you're not prepared at this time to say that a fiscal package is needed from a policy point of view.
You said the President, or whoever is putting one forward, could do it as an insurance policy, but from your point of view, monetary policy now, having been eased as much as it has, will be sufficient without a fiscal stimulus package added on the margin. Is that correct?

Mr. Greenspan. It should be sufficient.

The Chairman. It should be. It's your professional judgment as you sit here today that you think in fact it is and will be. You're not recommending either further monetary policy easing now or a fiscal stimulus package.

Mr. Greenspan. That is correct, Mr. Chairman.

The Chairman. All right.

Senator Sarbanes. Is that no fiscal stimulus package or nothing beyond the limited restrained package that you indicated you thought would not create long-term problems?

Mr. Greenspan. It's a marginal call, Senator. My major concern about a limited package is that it will not remain limited. If it were limited, then I really have no strong objections to it.

The Chairman. But significantly what he has said here today, and what the record will reflect, and he has just in a sense confirmed, is he thinks that the monetary policy actions already taken in and of themselves, in his judgment, will be sufficient to bring the economy out of this.

Senator Sarbanes. As I understand it, it's your view that nothing further should be done. I mean that's basically your view right now?

Mr. Greenspan. Yes, that's correct, Senator. If I had my choice, knowing all the uncertainties, of which there are innumerable ones, but one has got to make a decision, the decision I would make at this stage is for the moment to do nothing.

The Chairman. Now having established that clearly, let me just say to you with all due respect——

Mr. Greenspan. May I just amend that slightly because this issue came up 2 weeks ago.

The Chairman. Yes.

Mr. Greenspan. I would go, as I indicated back then, to the passive loss question and the capital gains question, which I did raise 2 weeks ago when this issue came up. I have not changed my view in the last 2 weeks, let's put it that way.

The Chairman. Well, in that area it seemed to me that you were making the point that you were talking in terms of general economic policy in theory. That was not in the context of what it takes to pull the economy out of the recession and get back on a growth track, which is really the thrust of my question to you now.

Mr. Greenspan. That's correct, yes.

The Chairman. All right. Now I must tell you for what it's worth, and we have different vantage points here, we need something more than we've already done in the way of monetary policy, and it can be a combination of further monetary policy help and some fiscal activity on the margin.

I say that because when you were talking earlier, you were talking about the fact that a lot of this problem is a balance sheet problem and is about unwinding the excesses of the past and so forth. It is very importantly a balance sheet problem, but it's also an
income statement problem, and that's what in my mind Senator Mack was getting to in some of his comments, and I see it in other ways in terms of the part of the country I come from.

The income statement side of the problem is that you've got businesses failing at a very rapid rate: they are just not making it because the economy right now is performing so poorly and so weakly. It's hurting a vast number of individual citizens, workers of all sorts.

You saw the scene I'm sure in Chicago the other day where in sub-zero temperatures thousands of people lined up to compete for a job in a hotel that was opening there. We're seeing unemployment among people of all skill levels. We're seeing permanent job reductions that are putting engineers out of work, putting teachers out of work, putting skilled tradesmen and women out of work—all kinds of people with all kinds of high level operational talents that can't find re-employment in the economy today because there are just not enough jobs to go around.

Virtually every major company, as you know, is announcing not just layoffs but permanent job reductions. You're seeing it in financial services in the areas that you regulate. United Technologies last week announced that it was shedding some 14,000 jobs. Most of those are professional jobs. You are as familiar as I am and others here would be with the announcements that IBM has made, GM has made and so forth.

We've got a rather urgent problem on our hands about making sure that we really get some lift under this economy and get people back to work. It's really serious when people are not able to find work no matter how aggressively they search for it, and if they do find something, it's at a lower skill level. In other words, you have an engineer driving a taxi cab or you have a teacher working in a hamburger place. That in the employment statistics would appear as if somebody has found a job, but clearly we've notched down and we're underperforming as a society.

I don't see much of a lift occurring right now. You've cited the beginnings a little bit in housing. When you were here in July you thought maybe we were coming out of the recession, and you testified that you saw some glimmers of hope on the horizon and you cited those.

Well, those essentially evaporated and then we stayed down at a very low level and, as you say now, we're sort of flat and you see no bounce. That was your comment a few minutes ago, you don't see any bounce yet.
show, are, in effect, the people of the country saying to all of us in policy making positions—to you, to us, to the President—that they don’t feel good about the economic track we’re on. They don’t have the confidence, because too many things are going wrong out where they live.

It is the situation in Florida where Senator Mack comes from, it’s an industrial base problem in the region of the country that I come from, and I suspect it’s a multitude of layoffs that we see here in the metropolitan Washington area and in the area that Senator Sarbanes represents. It’s a 50-State problem. It’s in California. It’s everywhere.

I’m concerned that there is some kind of a disconnection between the gravity of the situation as it’s actually happening in people’s lives, as they are struggling to articulate it through polls and through every manner of way in which the public can try and find its voice and say it, and the message here at the policy levels at the top, which in effect is hang in there, we think we’ve got it right this time and we think it’s going to work; be patient.

I don’t know how you say to somebody who is out there in quite a desperate situation, whether it’s a blue collar worker or a white collar worker, somebody with a high professional training level or someone with a lower level, single parent, man or woman who is out there trying to make ends meet, that if they are just patient a little longer the thing is going to work out. You said a while ago that to get to a good long-run sustained balanced growth, it’s a series of short-run steps, and I agree with you exactly.

We’re in the midst of some terrible, terrible short-run steps, and I don’t feel it’s being reflected in what we are doing, in either the sense of urgency that we have at the top policy levels or the steps we are taking.

I think we have to now add some things on the margin to make certain we start to pull the country out of this recession. We’ve got to get some lift under our wings here. I don’t see that lift today. So I’m stating a view, and I’m going to ask you to respond to it. I think more is needed. We can debate what part might come from monetary policy and what part might come from fiscal policy, but something more is needed.

To drive the inflation rate down another half a percentage point or a quarter of a percentage point or keep it from going up a half a point or a quarter of a point I think is to create a kind of damage of a size and dimension that is really causing the country to lose confidence in where we’re going and who’s in charge.

Mr. Greenspan. Senator, let me say you articulate your position exceptionally well, and I have great sympathy for the issues you’re raising because it’s a very difficult judgment.

Let me say this though, that we are not interested in whether the inflation rate is up a half a point or down a half a point. That is not what the issue is. The issue is whether or not long-term rates continue to fall because, in my judgment, that is a necessary condition for the reliquification of the system.

What we wish to be sure of is when we move in the short end that the long-term interest rates fall as well, because if that doesn’t happen, then we create more problems than we know. While I fully understand and in fact am in substantial agreement with the posi-
tion you have just outlined, I want to be sure that whatever it is we do in monetary or fiscal policy works, and it's that area which I find myself most concerned upon. I don't think we can afford to do things which don't work, and that's my major concern at this stage.

The Chairman. Well, if I may say, we know we've got at least 16 million people unemployed out there right now, and Lord knows how many businesses that are either going into Chapter 11 or are one half step away from it, and they can't wait 6 weeks, 6 months or another year.

In other words, there comes a point when the size of the problem is so large and so acute for real people—for individuals and families and their children—that we've got to have a response that starts to change their situation now.

It's not a future expectations issue. It's about being able to go down to the grocery store this afternoon and buy bread and milk and the basic things. We have millions of people right now who are in a situation where they are not able to meet their basic circumstances. It's a miserable, cruel, genuine fact of life and everybody is seeing it. That's why these polls that are coming in are so severe in what they're saying.

You talk about seeing a condition that's outside the scope of what you've seen professionally. That's what the public is telling us through the polling data. They are giving polling results about the Nation being on the wrong economic track that we've never seen before, and at some point we all have to recognize that the people are telling us something that is real and that they are feeling. They are right on this and that we've got to do more to respond to it.

Mr. Greenspan. I understand what you're saying, Mr. Chairman.

The Chairman. Well, we need a stronger answer. We've got to come up with a strategy to respond to the country's economic situation. It has got to be bigger and stronger and it has got to kick in now, and the people who can help make it happen are going to have to sit down around a table together and come up with a plan that is believable and starts to work.

We're out of time. I don't think we can continue to gamble that what we've done may or may not work. We've got to be absolutely certain that what we're doing will work.

Senator Mack, I appreciate your patience.

Senator Mack. Thank you, Mr. Chairman.

I want to continue along the line of my focus here this morning with respect to real estate and pick up on comments made with respect to confidence.

There has been, and I think John Rutledge has written about this as well, there has been a decline in the value of real estate, and let me now focus on single-family homes. For the first time since World War II there has been a decline in the value of someone's equity, and a great amount of the equity that people hold in this country is in their home. If they see that for the first time since 1945 that there has been a decline in their only real savings account, this is a real discouragement about any future purchases.
I was wondering whether you share that feeling or do you concur in that idea that real estate values in fact are undermining the confidence of the average American?

Mr. Greenspan. Clearly on the business sector the commercial real estate is unambiguously doing that. The data on residential real estate and the observations we have is mixed. The actual levels of values, if one can add them up from coast to coast, which I have some doubts about, don’t show very much change.

But what has happened is that the expectation of the continued rise in home equity values has been altered in recent years, and that has had the effect of removing a sense of security which a number of householders have had looking at years of very significant rises in values of their properties.

So that what you're observing, and I think correctly, when you sense that there is a loss of confidence, is that it’s not that the values are going down very much, but there is a definite removal of a plus that has existed for a number of years and couldn’t go on indefinitely. I mean the values were rising beyond long-term possibilities.

Fortunately, there is not any really nationwide decline in residential values, although in a number of regions they are down, and in some specific areas down quite appreciably.

Senator Mack. So this concern about real estate values affects the level of confidence in the economy?

Mr. Greenspan. I think it does.

Senator Mack. I want to ask a series of short questions now related to, and again it’s pretty obvious my concern is what is happening to real estate. I just think it’s the fundamental focal point of what we are experiencing.

The proposals that the President has made range from allowing IRA withdrawals for the purpose of purchasing a home, a tax credit for the first-time homebuyer. In your opinion, will that stimulate additional activity with respect to home purchases and is there any correlation between let’s say an increase in new construction and housing purchasing and confidence?

Mr. Greenspan. Oh, yes. I have no doubt that if the President’s program on home purchase is implemented, that it will have a positive effect on construction. It’s likely that a goodly part of the increase will be borrowing from the future, but I'm not sure that’s all bad.

Senator Mack. With respect to the President’s proposal to make pension funds more available for real estate investment, should that help the real estate market?

Mr. Greenspan. Senator, I’m not fully aware of what the exact proposal is, but the principal is something that we should be looking at and something which could be helpful in supplying funds outside the banking system to legitimate real estate projects. Without knowing the full details, it’s something which certainly should be looked at by the Congress.

Senator Mack. So again that’s addressing this credit crunch that we’ve been talking about that maybe this would be an additional source of lending in the real estate market?

Mr. Greenspan. Yes, Senator.
Senator Mack. I think you've already referred to it a couple of times, but I just want to make sure I'm clear about it. I recall asking you some time ago about capital gains, and you made basically the same comment this morning, that you would go further than my proposal, which was a 15 percent rate, and you would eliminate it. But it was asked in the context of both I believe you and also at that time Bill Seidman as to whether lower taxes on capital gains in essence is a stimulus for pushing up the value of assets.

I guess my question is a fairly straightforward economic one. I would assume that you would agree that lower tax rates mean asset values increase?

Mr. Greenspan. Yes, Senator.

Senator Mack. So by lowering the capital gains rate, that is another way to add value to the real estate market?

Mr. Greenspan. It should have that effect, yes.

Senator Mack. And my last question along this line has to do with the passive loss, to which you've addressed some comments this morning, and again I haven't had a chance to look at all the details of the President's proposal either with respect to passive loss, but I have a feeling it does not go back to pre-1986, that in essence what it says is that those who are actively engaged in the real estate business would receive these changes with respect to passive loss.

Mr. Greenspan. They would have the capability of employing passive losses to offset gains.

Senator Mack. And that should encourage more investment in real estate and I would assume help values of real estate as well?

Mr. Greenspan. Yes.

Senator Mack. The only other question that is on my mind really kind of goes back to Senator Kerry. He raised on a couple of occasions this morning the idea of deflation. Do you have a sense that the economy is experiencing deflation?

Mr. Greenspan. Not at this stage. It's a severe case of disinflation. With the exception of certain regions and certain industries, such as New England and real estate, I would not describe the American economy as in a state of deflation.

Senator Mack. Is there a risk of that occurring?

Mr. Greenspan. Certainly.

Senator Mack. How high is that risk?

Mr. Greenspan. I have no idea, but it's other than zero.

Senator Mack. Pardon?

Mr. Greenspan. It's other than zero. We know that there are those risks.

Senator Mack. And it's not quite a hundred I guess, is it?

Mr. Greenspan. No, it is not, Senator. It is small, but not something to be dismissed out of hand.

Senator Mack. In conclusion, I gather from the response to the various questions I raised with respect to IRA's and pension funds that the suggestions that have been made by the President with respect to the economy should have a positive impact on real estate and real estate values?

Mr. Greenspan. I would assume so.

Senator Mack. Thank you, Mr. Chairman.
The CHAIRMAN. Thank you, Senator Mack.

Senator SARBAINES. Thank you very much, Mr. Chairman.

Chairman Greenspan, your bottom policy conclusion here this morning is that nothing should be done in a sense that the actions that the Fed has taken to reduce the interest rate will provide the impetus to move the economy out of the recession.

Some articles on occasion have referred to the Chairman of the Federal Reserve Board as the most powerful economic policymaker in the world, and of course if your policy prescription now were followed, it would be in effect your policy, the Fed's policy on interest rates that was being relied upon to get us out of the recession.

In a democratic society where does your legitimacy come from? On what basis are you accountable and where does the legitimacy come from that places such really awesome power in your hands and that of your colleagues to make such basic decisions that will affect the economic circumstance of every one of our citizens, and indeed citizens all around the world?

Mr. GREENSPAN. First of all, let me emphasize what you just indicated. It's not the Chairman or even the Board of Governors that has that authority. It's the Federal Open Market Committee which comprises a much larger group, as you have addressed in some detail.

The issue rests with a very difficult problem in a democratic society when you have a central bank, as indeed every industrialized, civilized society must have.

The basic problem that you have when you're confronted with the question of how does a central bank function and who does it is very difficult for our type of society, because while I don't agree with you that we have as much power as you're implying, there is no question that a central bank does have significant impact on the economy and of necessity on the citizens of our Nation.

This is an issue which, as you well know, has been a major debate within our country since its founding, and indeed in the early stages when we had the Bank of the United States and a variety of concerns about central banking, we did not have a central bank from 1836 to 1913.

Senator SARBAINES. Andrew Jackson put it out of business.

Mr. GREENSPAN. He put the concept out of business for precisely that reason, that is, the issue of the question of what is the role of a central bank in a democratic society.

Our legitimacy comes from the statutes, the Federal Reserve Act of 1913 passed by the Congress in which certain very specific authorities are granted and the process that we're going through today is part of that action.

Senator SARBAINES. Exactly. Your accountability essentially derives from the judgments made by officials elected by the American public, namely, the President has nominated you, and now you must be confirmed by the Senate, and to that extent you become publicly accountable. Now you get a long term and so forth, but nevertheless.

That's also true of all of your colleagues on the Federal Reserve Board; is that correct?

Mr. GREENSPAN. Yes.
Senator SARBANES. Now I want to ask you about the members of the Federal Open Market Committee which after all makes the most fundamental decisions on monetary policy. The seven members of the Federal Reserve Board are on the Open Market Committee. They are all nominated by the President and confirmed by the Senate, but the representatives or the presidents of the banks, the Federal Reserve Banks, are simply private people picked in a private way, and yet they exercise major public power.

Now we don’t find that in other central banks. In fact, in German where the central bank is reputed to have such independence, the 11 landbank presidents who participate in monetary policy decisions are all appointed by the Upper House of the German Parliament.

Senator Riegle and Senator Sasser and I have joined in introducing a bill that would in effect put the power of the Federal Open Market Committee in the Federal Reserve Board, those that are publicly accountable, and let these bank presidents serve as an advisory committee to you.

I don’t see where their legitimacy comes from to be making these major public decisions when they clearly represent a private interest.

Mr. GREENSPAN. Senator, I would not say that they represent a private interest because these are full-time Government employees with top secret clearances and all of the arrangements relevant to Government employment conflicts of interest and all of the issues which relate to the members of the Federal Reserve Board.

Senator SARBANES. They are picked by the board of directors of the regional banks and those boards are dominated by the local commercial banks, are they not?

Mr. GREENSPAN. Yes and no. I would say that the combination of the Board of Governors and the individual banks choose the presidents. We at the Federal Reserve Board have the authority to remove individuals, and indeed as a practical matter have a very strong voice, if not the ultimate voice, as to who those individuals are.

Now the issue that you raise is an issue, as you know, which has essentially concerned all of us who were involved in this activity since the beginning of the Federal Reserve System. My own view of this is that while I recognize a number of the difficulties that you have raised and for which I have some sympathy, as a practical matter we would do considerable damage to the Federal Reserve System as a functioning entity if we effectively removed the voting power of the individual members, the presidents who serve in a rotating basis on the FOMC.

Senator SARBANES. Well, I am hard put to find any basis on which they ought to be accorded voting authority. They are not accountable to the public. They go through no process that constitutes a public selection as do you and your other colleagues on the Federal Reserve Board.

Now let me simply ask you. Just before Christmas Alan Murry and David Wessal in the Wall Street Journal wrote a story that starts off: It was a Christmas Eve conversion that rivaled that of Ebenezer Scrooge. Abandoning his long cherished gradualism, Alan Greenspan, Chairman of the Federal Reserve Board, Friday pre-
presented the Nation with a surprisingly large interest rate reduction. Seventeen months after the beginning of the recession and less than a year from the Presidential election the Fed cut the discount rate, and it then goes on to discuss the amount by which you cut the discount rate and so forth.

Now I'm confident that you've read this article I assume more than once and are familiar with it, and it sort of details, you know, having to fly to Chicago to get the Chicago Fed to make a request for a full point cut and the previous articles that detailed the problems, internal problems within the making of policy in the Federal Reserve System that were being posed by some of the bank presidents, reserve bank presidents.

First of all, let me ask you is this article essentially accurate in its reporting of what took place? It's a very fascinating article.

Mr. Greenspan. I don't recall it in detail. It is partly correct and partly incorrect as my recollection serves me on it.

Senator SARBANES. Well, I'm sure we're going to visit it once again at some hearing, and before that occasion if you would familiarize yourself with the article. I won't press you on it now. I would like to take out of it those elements that you think are incorrect, because it certainly sounds very plausible to me, and I'm struck in reading it by again this power that has been put in the hands of private individuals. They have no accountability. At least you're accountable.

The CHAIRMAN. That's why you're in here today.

Senator SARBANES. And your colleagues are accountable. In fact, I at some point may suggest to the Chairman that not only the Chairman but perhaps some of his colleagues should come with him to some of these hearings because I have to say I perceive a greater sensitivity on your part individually to some of the concerns that are being raised here by members of the committee than I perceive on the part of some of your colleagues on the Board, let alone these presidents of the Federal Reserve Banks across the country.

I mean most of them are hard money people, as they used to say when we debated monetary policy in those terms. There is just no question about it, and given the sort of constituency from which they come and which has placed them there, that's understandable.

The CHAIRMAN. And to which it's fair to say that they are beholden if they want to stay where they are.

Senator SARBANES. You know, Government policymakers may split over what policy should be. I mean that's the purpose of public debate. In fact, there is not necessarily agreement here, but to have a small handful of individuals representing private interests who in effect in some instances within the Fed system, as I understand it, have impeded the efforts of those members of the Fed system who are publicly accountable to conduct a monetary policy in a certain direction which would be perceived to be in the best interests of the country, I find no basis—they have no legitimacy.

Now let me ask one other line of questioning.

Paul Volker when he was Chairman supported the notion that the Chairman's term should be a fixed 4-year period to begin, Volker wanted a year after a Presidential election. I think there was some discussion and no one wanted it to begin immediately,
even those who wanted a change in Congress, and so essentially the discussion was should it come 6 months after or a year after. That was the range of discussion. But he accepted the proposition that the Chairman's term should be fixed so that even if you change Chairmen during the 4-year period they wouldn't get a new 4-year lease. That's the current arrangement.

If you are confirmed as Chairman, your 4 years will begin to run from the time of taking the oath of office, as I understand it. Now that means under the current circumstance your Chairmanship would extend through into the last year of whoever is elected President.

Now obviously, again to go back to my public accountability problem, if the President is going to nominate the person to be the Chairman and he is to be confirmed, obviously there has been some thought that the President ought to be able to make an indication amongst the seven members who he thinks ought to be the Chairman. Otherwise if you didn't think that mattered, you would have the Board itself pick its Chairman.

So the fact that you've brought the President into the process indicates that there is some sensitivity to the notion that the President ought to have at least that limited degree of influence to name the Chairman of the Fed.

Now how do we address this problem? Now the November election may turn out so that the President for the subsequent 4 years is the man who nominated you to be the Chairman, and if that's the case then the practical issue I'm raising isn't presented.

But the election may also turn out that someone else becomes the President, and that person, who may want a different Chairman of the Federal Reserve, in effect has been handed a Chairman for virtually his entire first term in office.

Why wouldn't the notion of setting a fixed 4-year period, and I'm prepared to have a period at the beginning, I mean I wouldn't have it begin coincident with the beginning of the President's term, but keep sort of a, whatever you want to call it, a cooling down period or whatever you want, but I don't think that the possibility that a newly elected President would have to serve virtually his entire term of office with a Chairman of the Fed, given the great power and influence of the Chairman, that was simply handed to him by the previous President meets the test of accountability.

Mr. Greenspan. Senator, I have no strong objection to that. The only concern that I have had and still have really rests on the issue of a Federal Reserve Chairman resigning or leaving for whatever reason, say, 6 months or so or 9 months before the term ends and creating essentially an interim Chairmanship. That is a very inefficient means of handling the particular job that I have.

But the arguments that you raise are important arguments from an accountability point of view, and I can't say to you honestly that I have strong convictions on this issue one way or the other, and if the issue of this potential short-term Chairman could be resolved in a satisfactory way, then I would have no difficulty whatever in supporting the point of view that you've just expressed.

The Chairman. Are you going to move off that subject?
Senator Sarbanes. I was, yes.
The Chairman. Would you yield to me?
Senator SARBANES. Certainly.

The CHAIRMAN. I admire the fact that you are a very dedicated public man. You've shown that through service going at least as far back as the Ford administration and I suspect even before that.

Would it be appropriate for me to assume in line with the philosophy you've just outlined that if you found yourself in the kind of situation, the hypothetical that he describes, that we got a new President and some number of months passed and the new President indicated a desire to be able to appoint a Chairman of the Fed more to that President's liking, would that be something you would be prepared to respond to?

Mr. GREENSPAN. Frankly, Senator, I've never given it any thought because I——

The CHAIRMAN. I don't imagine you have. I hadn't either until listening to the argument.

Mr. GREENSPAN. In fact until the Senator raised the issue I hadn't thought about that issue in any great detail. So I would not be prepared at this stage to give you an answer to that.

Senator SARBANES. Well, I do commend the issue to you for some thought I guess I would say.

Mr. GREENSPAN. OK.

Senator SARBANES. I'm interested in the hiring activities at the Federal Reserve in terms of trying to advance minorities in professional positions.

Mr. GREENSPAN. So are we.

Senator SARBANES. What has been done there, how successful has it been and is there an action program underway to try to accomplish that?

Mr. GREENSPAN. There is, indeed, and we have worked quite diligently on that question, and I would say with modest success.

We have had difficulty holding qualified minority PhD's and other high-qualified people I would suspect in large part because we are delimited in what we can pay. We tracked I would say the best people. They get stolen away on occasion, like the gentleman who is sitting right directly behind you—but that's not occurring very often. In the minority case it's tough, but we have a special program and we've discussed this at the Board of Governors quite often.

Senator SARBANES. Do you have a program to reach back earlier in the development process to find really bright people say in college and find some way to try to put them on a track that will bring them along so you're not then simply looking for the PhD's who might otherwise have been produced, because that becomes very difficult?

Mr. GREENSPAN. We do part of that, but let me just consult quickly.

[Chairman Greenspan consults with his staff.]

Currently we have a minority dissertation fellowship program in conjunction with the American Economics Association.

Senator SARBANES. I commend you for that, and I urge you on with it.

Do you think any purpose would be served—you come here and you hear from, well you hear from a lot of members here, in the House, before this committee and before other committees, and you
have a personal exchange which gives you a flavor of the concerns that motivate members, some of them to my judgment very reasonable and rational and others perhaps not so much so, but that's what public debate is all about.

You then have to go back to these meetings and you become the sole translator of this experience to your colleagues who are ranked as equals in making the public policy decision. Now you're the Chairman and presumably you have a greater degree of influence, but nevertheless they have a vote whether it's within the Board itself or in the Open Market Committee when you get there.

Now maybe they read about these hearings if they get reported or perhaps they might look at a transcript, but that still doesn't accomplish the same interchange that takes place, and I'm frankly coming more and more to the point of view that these other policymakers ought to come in and sit at that table on occasion.

I mean why should the whole burden fall on your shoulders to be the translator or the interpreter of the concerns and the thinking that is being reflected by the elected representatives of the people to your colleagues? Why shouldn't they get it directly?

Mr. Greenspan. No reason that I'm aware of.

Senator Sarbanes. Now one final question. When was the last time you met with President Bush to discuss the economic situation and economic policy?

Mr. Greenspan. I would say a couple of weeks ago.

Senator Sarbanes. Do you meet would you say on a periodic basis, I mean not necessarily regularly, but frequent enough to constitute ongoing consultation?

Mr. Greenspan. I would think so. I'm not aware there is a deficiency particularly that is gross in that area, and I try to communicate as best I can with his colleagues and try to get some discussion of the economic outlook. We, for example, meet once a month at the Council of Economic Advisers and with the senior Treasury officials.

Senator Sarbanes. That's on a regular basis?

Mr. Greenspan. A regular basis.

Senator Sarbanes. Formalized regular meetings.

Mr. Greenspan. Yes.

Senator Sarbanes. Thank you very much, Mr. Chairman.

The Chairman. Just one thing on that point, and then we'll recess until about 3 o'clock. On an occasion several weeks ago, you and I and FDIC Director Taylor met to talk about some of the problems in the banking system and some of the aspects of banking legislation that was then pending.

Out of that conversation relevant to what Senator Sarbanes has just touched on I asked you to have a conversation with the President on the matters that we had been discussing. Did that conversation take place?

Mr. Greenspan. In part, yes.

The Chairman. Pardon?

Mr. Greenspan. Yes, in part. I mean I discussed some of the issues that you and I discussed.

The Chairman. In part. Can you give me a percentage? Was it 10 percent, 50 percent, 70 percent?
Mr. GREENSPAN. The most important issues that we discussed I would say.

The CHAIRMAN. Have been conveyed directly to the President?

Mr. GREENSPAN. Yes.

The CHAIRMAN. The committee stands in recess until approximately 3 o'clock. Let me just inquire is that workable from your point of view and your schedule?

Mr. GREENSPAN. Sure.

The CHAIRMAN. All right. Let me also announce that the committee has voted by a vote of 21 to 0 to report the nomination of Mr. Casey favorably to the Senate.

Senator SARBAÑES. Mr. Chairman, on Mr. Casey it's my understanding that in response to the inquiries that we put to Mr. Casey that they are making a real effort there to find a way to try to meet what was contained in the law about enabling employees and retirees from institutions they have taken over to keep their group coverage with respect to their health insurance, which is a very important issue.

The CHAIRMAN. Well, let me report that that's correct, and I assume we'll have an answer on that forthwith.

Mr. GREENSPAN. I was wondering can we possibly make it 3:15 p.m.?

The CHAIRMAN. Yes.

The committee will stand in recess until 3:15 p.m.

[The committee recessed at 2:15 p.m., to reconvene at 3:15 p.m.]

AFTERNOON SESSION

[3:15 p.m.]

The CHAIRMAN. The committee will come to order.

Chairman Greenspan, this afternoon I want to move through a series of questions that we were not able to get into earlier. I'm interested in your views on investments by foreign interests in U.S. banks. This is occasioned not only by the BCCI case, but other issues related to that.

What is your general view of foreign investments in American banks and financial institutions.

Mr. GREENSPAN. I would say, so long as they adhere to the laws of the United States and engage in practices which are legal in all respects, that they clearly have made a contribution and should continue to make a contribution to the financial system of this country.

The CHAIRMAN. Now, do you think it rises to a different level of significance if the foreign investors actually control a U.S. bank?

Mr. GREENSPAN. They do that, in large respect, in most cases where they have wholly owned subsidiaries, American chartered banks, and with the egregious exception, which you raise with respect to BCCI, and a few others which have been creating great concern for us, foreign owners have been largely, as best we can judge, good corporate citizens, and have served the banking community and their customers in this country in an exemplary fashion.

The CHAIRMAN. What about applying the same issue to the question of the largest banks in the country? Does it make any differ-
ence if the foreign investment is concentrated in the biggest American banks, as opposed to medium-sized or small banks?

Mr. GREENSPAN. In principle, it shouldn’t, but I certainly recognize that there are certain conditions in which interests can arise which could induce the Congress, for public policy purposes, to want to make changes.

I mean, for example, as we do with airlines or broadcast networks. If you’re asking me, as an economist, or somebody interested strictly in this context, in the financial integrity of our system and its functioning, I would see no need to make any difference. The only need would have to occur for other reasons similar to those of national security or with respect to related concerns.

The CHAIRMAN. Now, as a matter of practice, if a bank holding company under the supervision of the Fed was considering, or being approached with respect to, significant foreign investment in the bank holding company, would that be an issue that the bank would normally come to the Fed and talk about, or come to you or other Fed board members to talk about?

Mr. GREENSPAN. Yes. Obviously, any major change of ownership or any significant investment would require our surveillance.

The CHAIRMAN. Now, back in 1987, when Bank of America raised capital, it sought hundreds of millions of dollars from foreign interests, as I’m sure you know.

Was the Fed aware of that at the time? Was the Fed alerted to that before the fact?

Mr. GREENSPAN. I don’t think I was around at that time, as I recall. My colleagues are shaking their heads, no.

The CHAIRMAN. Is it, no, that they’re not sure, or, no, that there was no contact from Bank of America.

Is there someone there that can help?

[Discussion off the record.]

Mr. GREENSPAN. It’s a little fuzzy. They did not have to come to the Board for an application, which meant that the form of the potential borrowing was not of an ownership nature.

But if you would like, I could make certain that we clarify that and answer that in writing officially.

The CHAIRMAN. I would like a clarification on that, and we would like to see that answer, to see if it’s complete enough in terms of what we want to establish.

Now, Citicorp is another instance of a major bank holding company that’s raised billions of dollars in capital from foreign interests, as you well know.

Did Citicorp come and discuss that with the Fed ahead of time?

Mr. GREENSPAN. Yes.

[Chairman Greenspan subsequently submitted the following information for the record:]

In October 1987, BankAmerica Corporation issued $425 million of capital securities to a large group of foreign, primarily Japanese, investors. The interest of Japanese investors in purchasing capital securities of BankAmerica was made known to the Federal Reserve Bank of San Francisco as early as January 1987 in the context of discussions with BankAmerica as to its capital position. No applications were required to be filed.

Twenty-six Japanese financial institutions purchased $250 million of subordinated capital notes and warrants to purchase 6.25 million common shares. Twenty Japanese life insurance companies, 11 casualty insurance companies, and 2 securities
companies purchased $100 million of convertible preferred stock. Bank of America International Limited in London underwrote another $75 million of notes and warrants which were presumably distributed to European and other Asian investors. The $425 million of capital securities comprised approximately 5.3 percent of BankAmerica's resulting primary capital.

The CHAIRMAN. Did they discuss that with you?

Mr. GREENSPAN. Yes.

The CHAIRMAN. Can you give us a sense as to how that works? What happens when they come in?

Mr. GREENSPAN. They came in and discussed it with us, unofficially, since they sold preferred stock, which does not require an application. But when and if it converts to common, then it does require an application. Even though the application wasn't required, that issue was discussed with us.

The CHAIRMAN. I would think, if a bank was going to sell a preferred issue that had a conversion aspect to it, that that ought to trip the wire, and there ought to be a requirement that it meet whatever the test is for an equity investment.

Would I be incorrect in assuming that that's how it works?

Mr. GREENSPAN. I would say, as a practical matter, that is how it works.

The CHAIRMAN. BCCI was involved with several American banks, as you know. The committee is interested in not only the banks that were secretly owned by BCCI, like First American, but also banks that had significant transactions with BCCI.

So far, the Federal Reserve has cooperated completely with us in terms of our initial inquiries along those lines, and we thank you for that cooperation. As we continue to look at that issue, and at the BCCI relationship with other American banks, I assume that we can count on your continued complete cooperation in providing us with whatever information we need?

Mr. GREENSPAN. Yes.

The CHAIRMAN. Thank you.

Now, according to published reports, which you've probably seen, in national magazines like Time Magazine in October 1991. There's an indication that Bank of America was performing correspondent services in the amount of about a billion dollars a day for BCCI, as late as 1988.

Do you have any awareness of that fact, or anything relating to that?

Mr. GREENSPAN. No, except that, as I recall, they were an original shareholder, and basically backed out at a point. The particular transactions they were involved with is not something I would be specifically familiar with. I was not aware of this particular phenomenon.

Is that in a published document?

The CHAIRMAN. Yes.

Let me just inquire. Is that covered in this Time Magazine story?

[Discussion off the record.]

The CHAIRMAN. According to Time Magazine, the San Francisco-based bank, Bank of America, concedes that during the 1980's, it handled some $1.3 billion a day of BCCI money. This is the source of the information that's the basis for the question that I posed to you.
Mr. GREENSPAN. We have no official knowledge of that, as far as I know.

The CHAIRMAN. Is there anybody with you that has any knowledge of it?

Mr. GREENSPAN. There’s an implication that they had deposits with the Bank of America, but certainly a billion dollars sounds like a very high number, and that’s actually transactions, that’s not deposits.

The CHAIRMAN. Well, what we’ll do in that area is submit any further questions we have, and I’d then ask that—you’ve given us the assurance that any information that we need along that line you’ll readily provide. I thank you for that.

Let me ask you about the degree to which the Federal Reserve monitors, in an active way, the foreign activities of American banks.

Is that something you keep close track of, as a matter of course?

Mr. GREENSPAN. Well, in examining a holding company, we are obviously involved in the full operation, and inevitably, are looking at all aspects of a particular institution, abroad as well as at home.

The CHAIRMAN. Would that involve sending regulators or examiners into operations, overseas operations of American banks?

Mr. GREENSPAN. We do that on occasion, yes.

The CHAIRMAN. Is that on a special situation basis, or is it done as a matter of course?

Mr. GREENSPAN. It’s a continuing examination process.

The CHAIRMAN. So there’s a formal, regular process by which that’s done, on-site exams in foreign countries?

Mr. GREENSPAN. Yes. It may not be scheduled in any systematic manner, but it’s done on a continuous basis.

The CHAIRMAN. Now, with respect to American banks that have agencies or subsidiaries, say, that would be active in Columbia, or elsewhere in South America, does the Federal Reserve monitor those operations, too, with on-site examinations?

Mr. GREENSPAN. They’re in Columbia and they are subsidiaries’ agencies?

The CHAIRMAN. Pardon?

Mr. GREENSPAN. We do, yes. But let me check on that and add to the record.

The CHAIRMAN. The reason that I ask, as you well know, we’ve had lots of situations arise with respect to money laundering operations as it relates to drug traffic and a lot of the drug traffic that comes up out of those areas of South and Central America. It’s a problem throughout the United States.

Certainly Florida’s had to contend with the problem. We get it in a certain form in the State of Michigan, and so forth.

But it would be your testimony, today, that with respect, say, to a major banking operation by an American company in a place like Columbia, where we know we have a serious drug problem, that you do on-site examinations there of those American banking operations, and really track what they’re doing, so you’re confident about what’s going on in those banks?

Mr. GREENSPAN. Yes. I mean, it would be essentially the primary regulator, though it may be either the Federal Reserve, working through the holding company, or the OCC, generally.
The CHAIRMAN. I’m concerned a bit about whether you can have a catch-22 situation. If the OCC is looking at the national bank, and if the Fed is looking at the holding company that the bank is a part of, does that gives you a nice, tight examination process?

In other words, it seems to me, you could run into a situation, at least potentially, where you go and do your work, and they go and do their work, and that may not be a sufficient combined effort.

Mr. GREENSPAN. But there is a general awareness of that particular problem amongst the agencies. And, as I understand it, we endeavor to coordinate in a manner so that we do get an integrated appraisal without something falling through the cracks.

The CHAIRMAN. Well, let me ask you this question with respect to bank holding companies that have large operations in countries that are major drug centers. Is it fair for the committee to conclude that the Fed, for its part of the oversight and regulatory process, could state, with a very high degree of confidence, that they’re monitoring those kinds of situations with great care to make sure that nothing improper is going on?

Mr. GREENSPAN. I should certainly hope so, because that’s the basic purpose of the activity.

The CHAIRMAN. I would hope so, too. But I guess what I’m asking is for something more than that. I’m asking for professional certification that there is an extra effort applied in situations like that, where it would seem the potential for a problem could be quite large.

Mr. GREENSPAN. That is my understanding of the way we operate.

The CHAIRMAN. Now, your staff is with you here. I just want to be absolutely clear about this on the record, because you’re relying in part on their assertions, and if that’s the case, fine. But I may ask them to put that assertion on the record, too, so it isn’t just your reliance on somebody else.

Mr. GREENSPAN. I see no reason to qualify that statement. That’s our basic purpose, and so far as we know, it’s being done well.

[Chairman Greenspan subsequently submitted the following information for the record:]

Regulation K, the Board’s regulation governing international banking operations, requires that U.S. banks operating foreign branches or subsidiaries maintain a system of records and controls that would ensure the effective management of these offices by the parent U.S. banking institution. The regulation requires that “Such systems shall provide, in particular, information on risk assets, liquidity management, operations, internal controls, and adherence to management policies.” Such reports would include internal and external audits of the foreign operations.

The Regulation further requires that the management information described above shall be made available to bank examiners. Using this information, examiners review the international operations of U.S. banks during the regular examination of the bank’s overall operations. As with U.S. operations, such examinations are conducted largely at the head office of the U.S. bank. Examiners seek to determine not only that the foreign operations are being operated in a safe and sound manner, but also that the bank has sufficient assurances that these offices are conforming to all of the bank’s policies and procedures.

The Federal Reserve supplements the annual examinations at the head office with a program of conducting periodic onsite examination of significant foreign offices in those countries where local law and regulation permits examinations by foreign authorities. Generally, significant foreign branches of State member banks and significant foreign subsidiaries of all Edge Corporations (including those owned by national banks) are examined at least once every 3 years on site. The System conducts about 30-50 foreign examinations and visitations a year. In addition, the
Comptroller of the Currency and some State regulatory authorities also conduct periodic overseas examinations. Onsite examinations are designed largely to verify that the information on foreign operations available at the U.S. head office accurately reflects the financial and operating conditions at the foreign branch or subsidiary. The examinations verify the adequacy of internal and external audit procedures, and the ability of head office management to assure adherence to all of the bank’s policies and procedures by the bank’s foreign offices. In 1987 the Board specifically mandated that overseas examinations of foreign branches include procedures to determine how a bank is implementing safeguards against money laundering.

In general the Federal Reserve believes that this combination of head office examinations supplemented by periodic onsite examinations of significant offices provides reasonable assurances that overseas operations are adhering to bank policies, including those policies designed to prevent involvement in money laundering operations. However, I should make it clear that not all foreign offices are examined. In Colombia, for example, only 2 U.S. banks have subsidiaries which are allowed under local law to accept deposits. Because the nature and scope of the subsidiaries’ activities are small in relation to the total assets and capital of the banks, they have not been examined onsite.

Some countries in which U.S. banks operate do not allow onsite examination of branches or subsidiaries in their jurisdiction by U.S. or other foreign supervisory authorities. In such cases the Board has determined that, in view of the other supervisory tools available, the benefits to U.S. banking and commerce from allowing U.S. banks to operate in these jurisdictions outweigh the problems resulting from the inability to conduct onsite examinations. However, the Board has urged and continues to urge such countries to permit examinations by the Federal Reserve. In addition to legal barriers, some foreign offices of U.S. banks have not been examined because it was determined that onsite examination of such offices may not be cost effective in view of the small size of the offices.

The Chairman. All right.
I’m going to go to one other issue, now, and then I’m going to yield to my colleagues, and we’ll try to move along as quickly as we can.

I want to refer, again, to something we touched on this morning, but I want to nail it down a little more clearly than we were able to then.

The President said, last night, and I quote here again:

The banking credit crunch must end. I won’t neglect my responsibility for sound regulations that serve the public good, but regulatory overkill must be stopped, and I have instructed our Government regulators to stop it.

Specifically, in terms of the part of the banking system that the Fed supervises, has there been a pattern of regulatory overkill in your supervisory and regulatory activities?

Mr. Greenspan. It’s difficult to say very specifically in individual cases. We, of course, are the smallest part of this, so it’s difficult to judge.

The Chairman. I understand.

Mr. Greenspan. But it’s my impression that there have been fairly broad swings, from the status of regulation in the mid-sixties, through where it is today. And I personally have been very specifically concerned about the issue of marking real estate to market specifically, and issues of appraisals based on liquidating value of properties, which I judge to be the key supervisory issue which is creating what I consider to be difficulties in this particular area.

But I would say that while there are differences amongst us about the degree of the swing in regulatory zeal, if you wish to put it that way, we’re all aware of the fact that there has been a significant switch, to a greater or lesser extent. And we don’t think generally, if that is the case in a particular institution, that it is
proper, and that is why we, as a group, have engaged in a series of actions and promulgations which we are hopeful will change this situation and the culture of examination in a manner which makes it more rational and stable, and not subject to volatility.

The CHAIRMAN. Now, I want to narrow the question down. I hear what you’ve said. I want to narrow it down now just to the banks that are under Federal Reserve supervision. Leave out, for the moment, those that the FDIC supervises or those that the OCC supervises.

When I look at a comparative listing of the losses by banks, according to who the primary regulator is, the Fed has a very tiny percentage of the charges against the bank insurance fund from banks under your direct supervision.

Mr. GREENSPAN. We’re net plus in the fact that contributions are greater than losses.

The CHAIRMAN. I would think that’s right, that your contributions are actually greater than your losses. But taking it either way, even if you just take the raw losses, they’re a very tiny percentage.

Now, you might look at that, and you might say, that’s because you fellows run a tight ship and you’ve done a good job of regulating your part of the banking system, and they’ve done a good job of disciplining themselves, so you haven’t had very many losses.

Somebody else might look at that and say, there aren’t many losses because you’ve been so tight, so tough, some of this regulatory overkill. I don’t make that presumption, but I can see how one might put that construction on it.

I guess the question that I want to address to you, just as it relates to your bank supervisory activities and the people under your jurisdiction, is it your judgment that the Fed has been involved, to any significant degree worth talking about, in regulatory overkill?

Mr. GREENSPAN. It’s clearly been less in the Fed to a substantial extent than what I hear is going on in the community at large.

Why that is subject to a number of interpretations. My suspicion is that we did not go to the other extreme as much in the 1980’s as the system as a whole.

The CHAIRMAN. You mean, from something like regulatory underkill to regulatory overkill?

Mr. GREENSPAN. Yes. Although I can hardly imagine that we fully escaped that cycle. It just doesn’t seem credible to me that we would have been immune.

But it is the case, at least it has been told to me, that there’s less of a problem in the State member banks than in the other commercial banks.

The CHAIRMAN. Well, I have two other things related to this, and then I’ll yield to Senator Mack.

Am I to understand that the President has instructed you, as one of the three regulators. His words are: I have instructed our Government regulators to stop it.

Do I assume that what you’ve been asked to stop doing, or the practices that you’ve now been asked to adopt are ones that would be fully within the bounds of Generally Accepted Accounting Practices?

Mr. GREENSPAN. Oh, indeed.
The CHAIRMAN. There is no suggestion of moving outside Generally Accepted Accounting Principles, to any contrived accounting values, or anything of that kind?

Mr. GREENSPAN. No. I, myself, have argued about certain accounting practices, but those are fully GAP-type accounting principles. It’s a question of, which are the appropriate application of specific evaluation processes to an examination process. But certainly, it’s within professional——

The CHAIRMAN. We’re not going to regulatory accounting or anything of that sort?

Mr. GREENSPAN. Certainly not.

The CHAIRMAN. Or inventing values that would be outside the normal scope of Generally Accepted Accounting Practice?

Mr. GREENSPAN. Most certainly not. Were we to do that, we would be defeating the purpose of going to a stabilized examination procedure.

The CHAIRMAN. All right. Now, the second and last question is related to this.

What are the instructions, then, that you’ve been given by the President?

Mr. GREENSPAN. There are no explicit instructions, other than his request that we examine all of this, and work on it. And we’ve been doing that, now, for several months, and originally at his behest. So it’s essentially his initiation which led to an Ad Hoc Committee of regulators to sit down and approach this problem in a manner which could resolve the issues about practices which we consider to be inappropriate.

And in that sense, it is the President’s initiative, but the specifics of what went on, or what is being done, has been wholly in the hands of the regulators. In other words, neither the President nor any of his associates has endeavored to force any particular actions which we, as a group, thought inappropriate.

The CHAIRMAN. It’s sort of like, heal thyself. In other words, instruct thyself.

Mr. GREENSPAN. We agree with him on the concerns. If we didn’t, the issue would never have arisen.

The CHAIRMAN. The changes that are to be made, or the new practices that have been put in place—can you enumerate those for us, briefly and specifically?

Mr. GREENSPAN. We have, over the last several months, initiated a series of specific actions, the latest of which is the HLT change, the most important one originally referred to the issue of how the appropriate procedures to evaluate real estate, as a detailed examination processes to coordinate means of doing that.

The CHAIRMAN. Is this all in writing?

Mr. GREENSPAN. Yes, it is, and I’d be most delighted, if you would like, Mr. Chairman, to make it available to you for the record.

The CHAIRMAN. I think we need it for the record, and we ought to make it part of the record.

That listing, when we receive it, in writing, does that cover the entire scope? Is that 100 percent of what has been done? Or is there anything in addition to that that has not been put in writing that would constitute a change in practice?
Mr. GREENSPAN. There may be others. What we will do is try to flag those and make you aware of it, and try to put them in writing to the extent that we can.

There may be a number of things that are in the works which have not been completed. We can make you aware of the fact that we're thinking about them, but unless and until we come to a conclusion, we would not have a written document which we could employ.

[Chairman Greenspan subsequently submitted the following information for the record:]

Examination Guidelines and Related Materials (Letters and Statements)
1. HLTs—Federal Reserve Press Release on the Discontinuance of the Supervisory Definition of HLTs. (2/6/92)
2. Intangibles—Federal Reserve Proposal on Regulatory Capital Treatment of Identifiable Intangible Assets. (1/16/92)
4. AD–Letter 91–85—Letter Announcing the National Examiners’ Conference. (12/5/91)
11. SR–Letter 91–19—Communication Efforts Regarding Credit Availability Concerns. (“Town Meeting,” 10/2/91)
12. AD–Letter 91–72—Meetings with Senior Bank Executives on Credit Availability Issues. (10/7/91)
13. SR–Letter 91–18—Classification Guidelines For An Asset When a Substantial Portion Has Been Charged Off. (9/23/91)

Other Initiatives Under Consideration Regarding Credit Availability
1. Insubstance Foreclosure—Concern has been expressed by bankers and accountants that some borrowers, who are willing to work out their debts, are being forced into non-performing status prematurely, and in some cases, are being forced into foreclosure due to an interpretation of an SEC financial reporting standard (FRR 28 Insubstance Foreclosure). The bank and thrift regulatory agencies have met with the SEC to clarify this rule and to issue specific examples of the rule which bankers and accountants can use to interpret the rule. Specifically, the OCC has provided the SEC with examples for their review.

2. Risk Weight for Presold Residential Construction Loans—It has been proposed that presold residential construction loans be assigned a 50 percent risk weighting, rather than 100 percent. This provision was included in the recent banking legisla-
tion (Federal Deposit Insurance Corporation Improvement Act, Section 474). The proposal has been presented to the Federal Financial Institutions Examination Council and amendments to the risk-based capital guidelines are being drafted to implement this revision.

The CHAIRMAN. Senator Mack?
Senator MACK. Thank you, Senator Riegle.

Mr. Chairman, I want to try to get you to reconcile, for me, several different comments this morning.

One of the things that I believe that you indicated this morning was that, you felt that monetary policy was going to be sufficient to get the economy moving again, that there are indicators out there now, right early stages, but you're hopeful that monetary policy will in fact solve the problem that we're in now. And you gave the impression that a fiscal package was not something that you would encourage.

And then I asked you a series of questions with respect to the President's initiative, having to do with capital gains, passive loss, IRA's, tax credits, pension funds, and whether you thought that those would be helpful in the real estate market.

It was fair that we concluded that what's happening in the real estate market is clearly one of the major factors that's affecting the economy.

So I'm a little——

Mr. GREENSPAN. I understand what your problem is. It's a definitional issue, Senator. When I talk about a fiscal package, I'm talking about something which is macroeconomic, in other words, some basic, overall tax policy or expenditure policy.

This is a specific set of proposals for a specific industry which you could, I guess, call fiscal. I had not been thinking of it in those terms. Because I would, in fact, be in favor, as I've indicated earlier, of doing those individual items, because they would be useful.

But I did not mean that to be included with or part of, or essentially a fiscal package, in the sense that I would consider these other types of broad tax expenditure policy initiatives.

Senator MACK. So those four or five items that I mentioned that are part of the President's package you feel would be helpful to the economy?

Mr. GREENSPAN. They would be helpful, even if we did not have—leaving aside the residential purchase $5,000 credit. Talking about commercial real estate, the pension fund issue, the issue of passive losses, and any of the associated elements involved with that, I suspect would be desirable with or without concerns about the economy, because they are probably the correct thing to do for the system as a whole, independently of the current period.

Senator MACK. So you see those both being good for the economy on both the short-term and long-term basis?

Mr. GREENSPAN. Yes.

Senator MACK. And anybody who may have gone from here this morning thinking that you'd really not encourage some fiscal package, if they concluded that meant that these items had been proposed by the President, you were not talking about them at all.

Mr. GREENSPAN. No. In fact, I would say, most of the items that I've heard on the issue of commercial real estate make sense to me, both short-term and long-term. The only item being some general
passive loss change, which I don’t think is required in this particular context, and wouldn’t create something which we do not need, mainly large, empty, newly constructed office buildings.

Senator Mack. Right. But it’s not your conclusion that the President’s proposal is what you just referred to?

Mr. Greenspan. No, I don’t think it is.

Senator Mack. I have a follow-on question to the series of questions that Chairman Riegle raised a minute ago.

And I was just kind of struck by your comment that you think that the regulatory practices in the Fed have not been, let’s say, as zealous as some other regulatory organizations.

I’m curious. The banks that the Fed regulates, is there a substantial difference in the make-up of the assets of those banks, compared to the banks say that the OCC or the FDIC are regulating?

Mr. Greenspan. I would be doubtful of that. Remember, however, we have a much smaller sample than they, and there could be differences, but I’m not aware really of any systematic type differences.

Senator Mack. I’m not trying to be critical. I’m just saying if there really is a substantial difference between the two, maybe there’s some things that we can identify, specific actions that we can respond to, that—

Mr. Greenspan. My recollection is, when I’ve seen the balance sheets of the various groupings, I mean, they are not different in a substantial manner.

Senator Mack. Do the banks that the Fed regulates not invest heavily in commercial real estate?

Mr. Greenspan. No. They did and they’ve got problems.

Let me tell you what my evidence is, which is really less than scientific. It’s that I hear, certainly from all of the anecdotal evidence and the complaints that one gets, there’s a disproportionately low number coming from State member banks. Now, I emphasize that that may be biased in one form or another, but when I check with the people, they don’t find that surprising.

But I do not wish to convey to you that we’ve engaged in some scientific sample and have concluded that is in fact the case. That has not been done.

Senator Mack. Yes. I didn’t get that impression, but I just was struck by your comment.

Mr. Greenspan. My basic view is that I was sort of pleased by the fact but I didn’t pursue it too far.

Senator Mack. I understand.

Thank you, Mr. Chairman.

The Chairman. Thank you, Senator Mack.

The Chairman. Senator Sarbanes.

Senator Sarbanes. Thank you, Mr. Chairman.

Chairman Greenspan, at the pre-recession peak, the unemployment rate was down to 5.3 percent.

Mr. Greenspan. 5.2 percent, I believe.

Senator Sarbanes. 5.2 percent. OK, I stand corrected. And the economy was operating at about 84 percent of capacity.

Since then, over the intervening months, the unemployment has risen to 7.1 percent and capacity utilization has fallen down into the high seventies.
Now according to the Fed, capacity is growing at an annual rate of 2.6 percent. I think you have just come out with a study that shows capacity growing at 2.6 percent annually.

The President's budget projects that real GDP will grow only 3 percent per year from 1993 through 1997, even assuming all of his policy recommendations are adopted.

Now at that rate, how many years will it take to restore the economy to its level of performance prior to the start of the recession?

Mr. Greenspan. There is a statistical problem here which we have not been able to resolve and it is the following: that the industrial production index—at least until recently, I haven’t seen this updated—but the industrial production index that we publish relative to the value in constant dollars of the industrial production index that is in the gross national product, has been rising. Meaning that our index based on the physical volume indicators is rising relative to the implicit part of the GNP which includes that.

It is several tenths of a percent, as I recall, so that the reconciliation would require making that adjustment, and without knowing exactly what it would be it is hard to answer the question that you suggest.

But I find it difficult, if the overall growth rate stays at 1.6 percent no matter what you do with the numbers, that you can bring the operating rate up in any significant manner on our statistical base.

I may be mistaken. It is conceivable. I don’t expect the share of manufacturing to increase significantly in the GNP.

Senator Sarbanes. Well now, when you testified before this committee in 1989, you said, and I quote:

*When the economy is operating below capacity, bringing demand in line with supply can involve real GNP growth that is faster for a time than its long-run potential.*

Mr. Greenspan. Yes.

Senator Sarbanes. End of quote.

I take it that one could conclude from that coming out of a recession, the economy should grow faster than its long-run potential. Is that a fair conclusion?

Mr. Greenspan. Yes.

Senator Sarbanes. How much faster and for how long?

Mr. Greenspan. I would say it depends on how far beneath potential you are. I mean, it is clearly a function of assuming that you get back to high operating levels.

If you start off in a deep recession, obviously you can go quite a while at above normal growth.

Senator Sarbanes. Now do you see any prospect that coming out of this recession, the economy is going to grow faster than its long-run potential?

Mr. Greenspan. It could for a short period, but it couldn’t for anything other than a short period.

Senator Sarbanes. When do you expect that to happen? We knew in the fourth quarter, well, basically GDP was unchanged, virtually. A sensible point.
Mr. GREENSPAN. We have recovered a little over half of the decline in GDP, so that we have still got something under a percent to go back to where we were when the recession began. And if you assume at that point that we were already somewhat suppressed, there is additional room on top of that, so that one can readily see that we have an additional 1 to 1½ percent, perhaps maybe more, which could move in excess of potential. And obviously if that is concentrated in a couple of quarters, you can get a rather vigorous number.

But that is not something which I am forecasting at this particular stage. I think that—

Senator SARBANES. Well, where's this going to come from? Domestic demand was off 1.6 percent last quarter, the last quarter of 1991. Government purchases were down. Non-residential fixed investment was down.

Mr. GREENSPAN. You can get increases in capital investment. You can get increases in exports. That, in turn, would engender an increase in real incomes which would move consumption expenditures up some.

Obviously you could get for the short-term, inventory investment. And finally, residential building probably has got some upside potential.

Senator SARBANES. How long do you think the unemployment rate is going to stay above 6 percent? What do you expect the unemployment rate to be for 1992?

Mr. GREENSPAN. I would say certainly above 6 percent.

Senator SARBANES. Would it be at 7 percent?

Mr. GREENSPAN. I wouldn't try to guess at this stage. I think that at the moment, unless this economy begins to pick up at a pace faster than I suspect it is going to, we are not going to get very much progress on the unemployment rate. We'll get some, but not a lot.

The CHAIRMAN. Does that mean then it could stay above 7 percent for the year?

Mr. GREENSPAN. I would doubt that, and if it did then I would say the recovery is non-existent. If it stays above 7 percent, especially if it hedges higher, that is suggestive of a very weak growth rate, or in fact even a decline.

Senator SARBANES. How do you address this too late and too little criticism which has been leveled at the Fed?

Let me put the question to you this way. When you testified here in August of 1989, discussing the possibility of a recession and what could cause a recession, you said amongst other things:

Moreover, I cannot rule out a policy mistake as the trigger for a downturn. We at the Federal Reserve might fail to restrain a speculative surge in the economy, or fail to recognize that we were holding reserves too tight for too long.

I guess I really want to put the question to you whether there has been a policy mistake, and I want to be very careful to concede up front that I am asking you to look back, so it's not sufficient to answer the question to say: “Well, at the time we made the judgment, it looked reasonable. Reasonable people might have differed, but this constituted a reasonable judgment on our part.”
And I understand that and I respect that. But I want now the benefit of hindsight, as you look back on how the economy has moved and what has transpired, whether in fact there was a policy mistake in that the Fed should have moved sooner and with a greater degree of action in terms of addressing the economic situation.

Mr. Greenspan.

Mr. GREENSPAN. Let me answer that question in two ways.

Through the period, say 1989 through the spring of 1991, I would argue that we could not have gotten long-term rates down materially more than occurred under those conditions. Indeed, in 1989, it worked against us.

And if you conclude, as we did, that the crucial issue was to get the balance sheet strain which had evolved during the 1980’s to unwind in a manner which would free the economy to function in a more effective manner, then we are looking at a question of: is it possible that if we had moved sooner, let’s assume, that long-term rates would have come down faster?

If I were to conclude that, I would say yes, there was a policy mistake. But I honestly cannot say that. In retrospect as well as at the time, I don’t think we can say that we could have gotten long-term rates down appreciably more, enough, certainly, to have made a difference.

Now it is the case that we very purposefully stopped easing as the economy was coming back in the spring of 1991. We might have eased during that period. I’m not sure whether or not we would have had bad market reaction as a consequence.

But it is the case that we had not anticipated that the economy would essentially fizzle out, as it did, toward the end of the third quarter.

So it is a tricky question of whether, even were we to know what was going to happen, it would have made a major difference.

I do know that looking back without the hindsight question, in other words, even asking ourselves were we misled by certain figures, I cannot say that I can honestly agree to that. I don’t recall any such action.

We may have been wrong on the question of our judgments of where the long market would go relative to the short market. I know of no evidence to suggest that we were wrong, but I cannot give you ironclad evidence that we weren’t.

Senator SARBANES. Well, did the long market react positively when you did the one-point cut in late December?

Mr. GREENSPAN. Yes. Very much so.

Senator SARBANES. Very much so.

Mr. GREENSPAN. Yes. Much better than I would have expected.

Senator SARBANES. Now, why wasn’t there reason to think that it might have acted better if you had done that sooner?

Mr. GREENSPAN. Largely for the reason which I indicated here earlier, and which I may have discussed a couple of weeks ago, that it has only been in the recent period when the—let me retrace for a minute. I hate to get too technical, but let me try to see if I can simplify something to clarify exactly how we were functioning in that period.
We endeavor to take the long-term U.S. Treasury bond, the 30-year bond, and break it into parts so that we in effect have got the equivalent of that, but essentially in pieces which reflect inflation expectations, in part long-term, intermediate-term and short-term.

Technically, what we were doing was looking at one year maturities of Treasury issues 26 years in the future, 28 years in the future, 30 years in the future, 10 years, 5 years.

Algebraically, you can define the 30-year bond as effectively the sum, weighted sum, of those individual tranches of Treasury debt.

The reason why that is very useful to look at is it tells you why long-term interest rates are falling. The decline in long-term interest rates that was occurring up until the fall of 1991 was predominantly, in fact completely, the result of declines in the short ends of the markets.

In other words, to an extent that inflation expectations were relevant, it was caused by a decline in inflation expectations 2, 3, 4, 5 years out, but not 8, 10, 12, 15. Those inflation expectations, as we would measure them, were flat, unresistant to the decline.

It is our judgment that were we to make a major move at that point, say earlier on, we would not have gotten a significant response in the long end of the market, and conceivably could have gotten an adverse response.

Senator SARBANES. Is the inflation target that your standard—that you are bearing in mind as you go through this exercise in terms of what is desirable, a zero inflation?

Mr. GREENSPAN. No. There are two issues here. One is what we think would be a desired inflation rate which, as I have put it before at this committee, would be one in which individual businessmen would no longer be concerned about the rate of inflation for business decision making. That's not what I am talking about here.

Senator SARBANES. You went further than that in some of your testimony. You said in October 1980:

I think that inflation could be brought down to levels which are closer to zero without putting the economy into recession, though I do suspect there might be some modest loss of economic growth relative to what would otherwise have been the case.

If the Fed looks out as you are trying to shape this economic landscape, I mean, is one of your goals a zero inflation rate?

Mr. GREENSPAN. No. One of our goals is, as I said in my opening remarks this morning, reasonably stable prices. Reasonably stable prices being defined in a manner which contributes to long-term economic growth potential.

But in any event, the issue I was raising here is not our judgments as to what inflation expectations are, but trying to make a judgment of what the market's expectations are and therefore how markets would respond, how long-term issues specifically would respond to monetary policy.

We're not making judgments as to whether that is desirable or undesirable, but really as a forecasting tool.

Senator SARBANES. Well, those buzzers that are ringing is the sign of a vote. Chairman Riegle is, as I understand it, planning to return to continue the hearing, and since I have to leave to vote, I will put the committee in a recess until then.
Thank you very much. The committee will stand in recess.
[Recess at 4:10 p.m.]
[The committee reconvened at 4:24 p.m.]

The CHAIRMAN. The committee will resume, and I hope we can finish up here promptly. You have been very patient and it is all to the good if we can finish in one day rather than have to go over to a second day, so that is why we are proceeding with the afternoon session.

With interest rates coming down as much as they have, and people who have savings in banks, financial institutions, certificate of deposit and other kinds of insured savings accounts are taking their money out of the banks and they are either taking it to the stock market or to a mutual fund or somewhere else. They are searching for higher yields.

Can you tell us a little bit about the volume and the degree to which the migration of that money, the disintermediation, is having any appreciable effect on the deposits at institutions that you are aware of?

Mr. GREENSPAN. Some, yes. The volume of mutual fund sales, both bond and stock funds, are very large, and they have been so for quite a while.

The anecdotal discussions relate to basically the process you are concerned about, namely a very large part of that is coming out of banks into the mutual funds strictly on the issue of yield.

The orders of magnitude are really quite large. For example, the total of equity and bond funds was almost $12 billion in November, $16 billion in October, $13 billion in September and my impression of December was that it continued at a very high rate.

So there is no evidence of diminution and these are rather large numbers relevant to the money supply.

The CHAIRMAN. Does that create any problems with respect to moving money out of the banking system? Is that creating any pinches within the banking system or for individual institutions?

Mr. GREENSPAN. I would doubt it, because at this particular stage there is a very large liquid position in the banking system, essentially U.S. Treasuries that are being held. And I am not aware that that is creating a lending problem or a supply of funds problem from the banks to their customers.

The CHAIRMAN. Now yesterday, as you know, the stock market hit a new high. Price/earnings ratios for stocks have climbed over 20 recently, and it is approaching the peak that preceded the crash of 1987.

That isn't to say that we will get a crash of 1992, but it is interesting that the price/earnings ratio is getting into the same range we saw back then.

Now when you started your last term, you expressed your concern about excess in the stock market. You are on the record in that regard. Your fears proved to be justified because the market went through a very major crash and adjustment about 2 months later. And I and others on this committee also were expressing concerns at that time.

I am wondering what observation or thought you have as we are seeing this large movement of money out of savings accounts and
banks, with the banks quite liquid because they are not making a lot of loans, and into mutual funds, stocks, and bonds.

Isn't that part of what is driving the market up?

Mr. Greenspan. The major thing that is driving the market is the fall in inflation expectations. History tells us that when inflation expectations fall, price/earnings ratios rise and vice versa.

And so while it is true that the level of P/E ratios currently is not significantly different from where it was back in 1987, a little more sophisticated analysis—in other words, trying to get at the real rates of return and evaluating that in the context of inflation expectations, has the current levels still short of where they were back then.

That says nothing about where, obviously, the market is going, but using price/earnings ratios per se, that does not give you a full picture of what the relative values are.

The Chairman. What do inflation expectations look like in Germany these days, West Germany?

Mr. Greenspan. They are rising.

The Chairman. United Germany. Pardon?

Mr. Greenspan. They are rising.

The Chairman. Are they more severe than ours?

Mr. Greenspan. I would certainly say that they are rising relative to ours. Remember, for a very long time, they were down quite a good deal.

I can't differentiate except to say that whereas in the most recent past their expectations, whatever they were, were rising, ours were falling.

The Chairman. Well, they have been raising their interest rates, have they not?

Mr. Greenspan. Yes.

The Chairman. I have a concern about that. Where would their rates be now relative to ours?

Mr. Greenspan. Higher in both the long and the short end of the market. Currently the German 3-month rates are at 9.40 percent and ours, obviously, are——

The Chairman. 9.40 percent? Three-month rate.

Mr. Greenspan. 9.40 percent. This is the interbank loan rate. Ours are 4.10 percent.

The Chairman. So ours are less than half.

Mr. Greenspan. Yes.

The Chairman. Now, do they have an inflation expectation over there that is twice ours?

Mr. Greenspan. No. I would say their real rates are higher than ours. So it's not wholly inflation expectation.

The Chairman. Yes, it's something else. I am not sure that one could always make the relationship between the level of interest rates and inflationary expectations. Isn't that just part of the mix?

Mr. Greenspan. It's only part of the mix. That's correct. You can't do it for the short end of the market. It's a much more relevant evaluation issue when you are dealing in the long end.

For example—this is more relevant to this particular question—for example, long-term government yields of 10-year maturities show Germany at 7.9 percent. This is yesterday's data, and the
United States 7.2 percent. Now that's more of a reflection of what the real differences are.

The CHAIRMAN. So the longer-term inflation expectations would seem to be roughly comparable, if you measure by the differences in those rates.

Mr. GREENSPAN. The reason I hesitate to make a judgment is it is very difficult to extract long-term inflation expectations out of these markets. But roughly comparable, obviously cannot be all that wrong with long-term rates sitting where they are.

The CHAIRMAN. With respect to the problems in the banking system, which we have discussed before, is it fair to say that the problems are still with us and, in fact, it may take 2, 3, 4, 5 years to really move through the period of the accumulation of stress, financial stress, on a significant number of banks in the banking system and certainly some key banks?

Mr. GREENSPAN. I would certainly say it is going to take a while but we are moving in the right direction. I am quite pleased by the extent to which new equity offerings amongst the bank holding companies are being taken down rather well. That's adding to their capital position and it is curing a lot of problems in a lot of areas.

But there is no question we still have got a way to go and I would scarcely want to argue that we are going to be out of this nonperforming loan difficulty, the credit crunch, the associated issues, in a period that is a matter of a few months. I think it is longer than that.

The CHAIRMAN. Yes, it's longer than that.

Mr. GREENSPAN. But it is improving. It is the only hopeful issue with respect to this problem.

The CHAIRMAN. Now, when you lowered the discount rate recently by a full percentage point, that had the effect, did it not, of helping the banks by lowering the cost of funds to the banks? Doesn't that give the banks some oxygen?

Mr. GREENSPAN. Well, actually, in that particular case, maybe not. Because you may recall that the prime rate moved down a full percentage point at that point, but that CD rates and Fed funds rates did not go down a full point. So it may at a particular time, have squeezed them slightly, but that is from a level which had already opened up quite significantly.

The CHAIRMAN. Don't most of the banks today have a pretty good spread between the cost of funds and what they are paying out on deposits and such?

Mr. GREENSPAN. I'm sorry?

The CHAIRMAN. Aren't banks being helped by the fact that their costs of funds are down and they are not paying as much?

Mr. GREENSPAN. Yes.

The CHAIRMAN. Hasn't the Fed, in fact, helped the banks in that way?

Mr. GREENSPAN. I would say that is correct.

The CHAIRMAN. Would that have been part of the reason the Fed made the moves it did?

Mr. GREENSPAN. I believe in public testimony before this committee at the time, I was suggesting as one of the reasons for the moves was to approach the credit crunch in part by trying to open up the profit margins of the lending operation. And that clearly
has occurred and it has been of assistance in preventing the crunch from getting worse at a crucial point.

But those margins are still open, earnings are accordingly large, and I would suspect that when the credit crunch begins to ease, those margins are going to start to come down again.

The Chairman. I have heard you say that before. That will be the time when there is really competition out there and the banks are really going out and competing with one another for those good loans.

All of my colleagues keep telling me they are waiting for that day to arrive. None of them are seeing it anywhere around the country, so——

Mr. Greenspan. We are waiting, too, Mr. Chairman.

The Chairman. Earlier this month, there was an article in the Federal Reserve Bulletin that I am sure you saw and were aware of, that reported that while average family incomes rose modestly during the 1980’s, the gains were concentrated almost entirely among the very wealthy, and that the median income hardly moved at all during that decade.

Is there any explanation for why the concentration of gains are found in the upper income groups, in terms of the work the Fed has done on this?

Mr. Greenspan. I wouldn’t necessarily say it is the Fed work, but there is a significant amount of academic work in this area. And what we know is that there has been a major opening up in the spread of income relevant to education, so that college graduates versus high school graduates now earn more relative to what they would have earned say 10 years ago.

My suspicion of the cause of this phenomenon is the tremendous increase in technology and the major move toward conceptual output, if I may put it that way. That is, a far greater degree of technological products as the major elements in the value added of our economy, has put a premium on education and that, in turn, has reflected itself in the marketplace and opened up the wage patterns in the manner which those data seem to suggest.

The Chairman. Does tax policy seem to have any impact on it?

Mr. Greenspan. These are pre-tax data, and I doubt if the tax policy indirectly would have impacted it, although obviously, if you then reconverted those data on an after tax basis, you would find that there was a somewhat wider gap.

The Chairman. Yes. I’m afraid so. Hopefully one of these days we’ll muster the votes to do something about that.

I want to get into one other area, and then we’ll finish. This has to do with foreign banking, again, in the United States.

A fellow by the name of Michael DeStefano, who is the Vice President of Standard & Poor’s Corporation, testified before this committee in September 1990. And he told us at that time that foreign banks have had, and I quote him:

Tremendous penetration in the commercial and industrial areas of lending in this country here in the United States.

Continuing, he said:

Something like 25 percent of commercial and industrial assets are held by foreign banks, and they tend to be the better quality assets. Foreign banks are willing to
compete on price and go after good quality business, the result of which is that many U.S. banks have had to seek earnings opportunities elsewhere, notably in areas which, we all recognize as high-risk areas.

I then asked him if our domestic banks were losing out to foreign banks for good quality industrial and business customers principally because of price competition. He replied, and I again quote him:

Pure and simple. Price competition.

I am wondering if you would agree with his observation that price competition by foreign banks for the better quality loans has forced our own U.S. banks to go after higher risk loans, whether in commercial real estate or in other areas, which in turn may well be the reason, or one of the reasons, why they have sustained a higher pattern of losses, which has weakened their capital position, and helped empty the deposit insurance fund.

Do you know whether we have any laws or regulations in effect that permit foreign banks to raise funds more cheaply in this country than domestic banks and enable them to compete for better customers solely on price?

Mr. GREENSPAN. I don’t see how they can. I mean, there’s an open market for funds, and I can’t see how they can basically obtain a significantly lower cost of funds unless they are AAA-type institutions, and they may get an edge our AAA institutions tend to get, but I don’t think it would reflect itself in enough of a price advantage to really make a difference.

I think we can explain very readily why we’ve had the problems that we’ve had.

The CHAIRMAN. Wouldn’t one of the reasons be who pays for Federal deposit insurance and who doesn’t?

Mr. GREENSPAN. Well, I would assume that the ones we are talking about are paying for Federal deposit insurance, if that’s the case.

If it is not, then there is another cost involved.

The CHAIRMAN. My understanding is that on wholesale deposits they don’t pay any deposit insurance premiums.

Mr. GREENSPAN. That’s right. These are essentially the foreign branches. Foreign subsidiaries do pay.

The CHAIRMAN. Yes. These are foreign operators that come in and have a financial advantage in that respect, and can cherry-pick the good customers, and go after them, and develop the primary—the best, the premium banking relationships—and leave the rest of the business to the American competitors, who then in turn have to reach out, I think, for probably a higher-risk profile loan.

Mr. GREENSPAN. My impression is that the higher-risk profile that has occurred is a result of many other factors, not the least of which was the LDC loan issue, and the desire to pick up a significant amount of commercial mortgages, because they were very profitable at the time they were accumulated. I must say I would be doubtful that a considerable amount of the problem we confront occurs as a consequence of this, although your figures are correct.

And it is, as I recall—I haven’t checked these numbers, but 25 percent strikes me as about the right order of magnitude.

The CHAIRMAN. If that continues to grow, on the one hand, somebody might say, that’s fine. If foreigners want to come in and set
up banking operations and offer credit opportunities to Americans and so forth, so be it.

But if it has the effect of growing in such a way that it weakens the indigenous American system in ways like I have spoken about, they are also not under the burden of complying with CRA investment requirements, you can have a situation where eventually our dependence on foreign credit is such that the provider of foreign credit can accumulate a kind of economic power in our system to decide who gets loans and who doesn't, and what they pay for them and what they don't. I have to tell you, in watching how some countries operate, I'm not comfortable with that.

I like the idea of keeping our banking system and the integrity of it in terms of the availability of credit very much in the hands of people in this country whose overriding interest would be the well-being of this country.

Mr. GREENSPAN. The risk-based capital guidelines are going to adjust for that in part although it doesn't fully respond to your concerns.

The interesting issue, however, is that one would have thought that if that were a major problem, we would begin to see an extraordinarily large amount of foreign loans coming in here as a consequence of our credit crunch, which we don't.

And one observes that the Japanese, who have been a very big part of that, have actually not been expanding. They have been caught, as you know, by their problems at home, and have pulled back considerably in their lending practices abroad.

So to the extent that the problem exists, and I frankly am not sufficiently aware of it to give you a firm judgment about its order of magnitude, it does not appear to be increasing. But if you would like, I will look into that and try to give you a much more informed response.

[Chairman Greenspan subsequently submitted the following information for the record:]

The Federal Reserve collects weekly data on U.S. commercial and industrial loans in U.S. offices of large banks, including branches and agencies of foreign banks. These data show that in 1991 such loans by U.S. branches and agencies of Japanese banks actually declined by about 7 percent compared to a decline of about 3 percent in all banks. Commercial and industrial loans booked in the U.S. offices of all foreign banks increased substantially in 1991; however, most of the reported increase reflected a transfer of existing loans from off-shore branches of these banks to their U.S. offices following the reduction of reserve requirements by the Board. If this effect is factored out, it is estimated that branches and agencies of foreign banks increased their U.S. commercial and industrial loans by about 7 percent in 1991.

The CHAIRMAN. I am going just to raise two other questions, and then we will finish.

We had Alex Sheshunoff here, and of course you know he's a noted banking analyst. He testified before the committee in October 1989. Now, this would be 2½ years ago.

He told us then that we ought to balance our trade deficit with Japan by selling them things, and I quote him:

Not assets, nor banks.

Then he went on to say:
Many major Japanese banks through strategic acquisitions have acquired the marketing skills and physical presence that will enable them to provide low cost loans to American businesses.

And furthermore:

Banks end up controlling who gets credit and who doesn't, and the idea that a foreign-owned financial institution would then be determining which industries and which customers grow in a particular part of the country is a risk that I do not think we need to incur.

So here's a fellow looking at it from a different vantage point, but expressing his concern about an accumulation of power in the banking sector of our economy, where who gets credit and who doesn't and what they pay for it is a terribly important issue.

I do have a concern about it, and it is multiplied by the fact that, as you well know, we maintain a relatively open market here in the United States for Japan and others, and we don't find the same attitude and same circumstance abroad, particularly in Japan.

Although, as you say, Japan has its own current financial market problems, about 15 percent of all the banking assets in America today are under the control of Japanese banks. Does that square with your numbers?

Mr. Greenspan. It sounds approximately right.

The Chairman. About 15 percent. A lot of people in America would be surprised to know that. In California, I understand, it's about 25 percent. Is that about right?

Mr. Greenspan. Yes.

The Chairman. Do you know what the percentage of American banking assets are in Japan? It's less than 1 percent.

Mr. Greenspan. I can attest to the fact that it's quite small.

The Chairman. Yes.

They have here in this country a very substantial share. There we have virtually no share.

And that's not unique to the United States. The entire foreign share of banking assets in Japan—the United States and the whole rest of the world—is only about 3 percent.

We don't have a reciprocal, open, two-way relationship with Japan in terms of financial services. Shouldn't we have?

Mr. Greenspan. Well, I think we should.

The Chairman. Shouldn't we insist on that?

Mr. Greenspan. I certainly would say that it would be beneficial to Japan. It would be beneficial to the United States if that were to happen.

The Chairman. It seems to me when the percentages become that extreme—and you see it in a lot of other areas. It's also true in manufactured, high value-added goods, whether it's cars, computer chips, or other kinds of things.

Japan maintains a closed market. We can't get in. They have access to an open market here that provides opportunities for them—profit opportunities, which they make full use of. We don't have those same opportunities there.

Is it fair, then, to say that it would be your position and the position of the Fed that we ought to be asking for and expecting the same market access in Japan for financial services that we provide the Japanese here?
Mr. Greenspan. I can’t speak for my colleagues, because we haven’t discussed this in particular.

All I would suggest to you is that it would be to everybody’s advantage if there was more inter—I should say cross-border—financial institution location.

I would defer at the moment in trying to evaluate the means by which that would best be accomplished, but—you asked me whether it would be desirable if it were to happen, and the answer is, probably yes.

The Chairman. Japan’s now at 15 percent of the market nationwide, and 25 percent of the market for banking in California. It’s tapered off for reasons that you and I both just discussed.

Suppose it were 50 percent? Would that bother you?

Mr. Greenspan. It bothers me when it’s 25 percent. But that bothers me for different reasons.

It’s an issue of—I would like to see our assets owned by Americans, and in fact I would like to see the United States as a viable operation.

But I’m also acutely aware of the fact that what is occurring, and has been occurring, is an increasing flow of imports as shares of GNP, and as a consequence, an ever increasing degree of cross border flows and ownership.

And I recognize that there has to be, if the world continues to integrate, as it does, an ever increasing amount of cross-border financial institution locations as well.

So, if you are saying to me should we have a public policy which restricts that, I would be quite hesitant because I’m not sure it serves American interests to do it.

I would like to see us on a competitive basis—if I may put it that way—but I’m not sure I would like to change the goal posts enough to make it easier for us to do that.

The Chairman. Well, you’ve just said a minute ago that you certainly think we ought to have access to the other fellow’s market. You don’t have any problem with that.

Mr. Greenspan. No.

The Chairman. And we ought to have the same access there that he has here.

This question is about strategic areas of the economy, I would argue that banking is a strategic area of the economy. We are seeing that right now. That’s one of the reasons the economy is in trouble.

Hypothetically, if I saw another country—it wouldn’t matter which country—reaching the point where they had 50 percent of the banking assets in the United States, I would be troubled by that, all the cross-border theory notwithstanding, because it’s a key industry.

We ought to keep essential control of that in our own country.

Suppose it got to 75 percent? We’re not there yet, but we were at one time at a very low level. We weren’t up to 15 percent with respect to just one country, namely Japan.

Wouldn’t it be troubling to you if we found a situation where, say, more than half the control of the banking assets of this country were in the hands of foreign banks?
Mr. Greenspan. I'd be concerned about it, Mr. Chairman. I am not sure that I would want to initiate legal action to change that.

But that is a national security question, and it is essentially a public policy question, which goes beyond the issue of what is an efficient banking system.

The Chairman. I agree with you. But that's why it brings it right into this room, because you and I are public policymakers, and it is a strategic issue, and this is the place where this kind of thing ought to be thought about and talked about.

We ought to talk about it before the fact and not after the facts where we wake up one day and find out that we're in a situation we don't want to be in.

I would hope the Fed would take a look at it. And I would hope the Fed would take a very aggressive position that if any nation begins to move significantly into financial services in this country—banking services, part of your responsibility—that the Fed would be very outspoken and aggressive in suggesting that we ought to have equivalent opportunities in the home market of that same country.

There really is no acceptable basis for arguing for a double standard that says that our market is wide open, but we will tolerate a closed market condition in the other fellow's market.

I would hope that the Fed would find its voice on this issue because I think that this is a strategic industry.

Mr. Greenspan. I will communicate your views to my colleagues.

The Chairman. I know there are other members who could not be here who have questions for you, and we would ask you to respond to those fully for the record. And I know you will.

We thank you for your testimony today. The committee stands in recess.

[Whereupon, at 4:55 p.m., the hearing was adjourned.]

[Response to written questions and additional material supplied for the record follow:]

...
Statement by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

of the

United States Senate

January 29, 1992
Mr. Chairman members of the committee, I want to thank you for scheduling this hearing to consider my nomination to a second term as Chairman of the Federal Reserve Board and to a full 14-year term as a member of that Board. I am especially grateful to President Bush for the confidence he had in me to make these nominations.

I have testified before you frequently on the state of the economy and the conduct of monetary policy, including as recently as two weeks ago. I also have given you my views and those of the Federal Reserve Board on a wide range of specific regulatory and supervisory matters pertaining to banks over the last several years. I would expect to be addressing your questions on these issues again here today.

In my brief opening statement, however, on the occasion of these hearings on my confirmation, I thought it might be appropriate to step back a little from the application of policy in specific circumstances and discuss some general principles that I believe should guide decisions on the monetary policy and banking structure of this country.

I see the fundamental task of monetary policy as fostering the financial conditions most conducive to the American economy performing at its fullest potential. As I have often noted before, there is every reason to believe that the main contribution the central bank can make to the
achievement of this national economic objective over long periods is to promote reasonable price stability. Removing uncertainty about future price levels and eliminating the costs and distortions inevitably involved in coping with inflation will encourage productive investment and saving to raise living standards. Monetary policy is uniquely qualified to address this issue: Inflation is ultimately determined by the provision of liquidity to the economy by the central bank; and, except through its effect on inflation, monetary policy has little long-term influence on the growth of capital and the labor force or the increase in productivity, which together determine long-run economic growth.

But a central bank must also recognize that the "long run" is made up of a series of "short runs". Our policies do affect output and employment in the short- and intermediate-terms, and we must be mindful of these effects. The monetary authority can, and should, lean against prevailing trends not only when inflation threatens, but also when the forces of disinflation seem to be gathering excessive momentum. That is, in fact, what has concerned us in recent months, and we have been taking actions designed to assist in returning the economy to a solid growth path.

However, the Federal Reserve, or any other central bank, must also be conscious of the limits of its capabili-
ties. We can try to provide a backdrop for stable, sustainable growth, but we cannot iron out every fluctuation, and attempts to do so could be counterproductive. What we have learned about monetary policy since the beginnings of the Federal Reserve System is that the longer-term effect of a policy action may be quite different from its initial impact; what we don’t know with precision is the size and timing of these effects, especially in the short run. Uncertainty about the near-term twists and turns of the economy along with the awareness of the potential differences between long- and short-term effects suggest both flexibility in the conduct of monetary policy and close attention to the longer-term context in conducting day-to-day operations.

Monetary policy actions are transmitted to the economy through the financial system, and the influence of weakness in that system on how the economy responds has been all too evident in recent years. A structurally sound and vigorous financial system not only facilitates monetary policy implementation, but is itself no less important to support an economy operating at its highest potential. Such a system must effectively and efficiently gather savings and distribute them to where they will be of most value to society in promoting productive investment and supporting consumption. Banks and other depositories have a key role
to play in this system. They are the channels through which payments pass, they are the chief repositories of households' liquid savings, and they extend credit to many who have limited, if any, access to alternative sources of financing. Our nation's banking system must be strong—not only in the sense of safe and sound, but also in the sense of being efficient and innovative in delivering vital services to the economy. That strength undoubtedly has eroded in recent years, in part through errors of judgment by depositories and their regulators, but also through the combined effects of a stiffer competitive environment and continued legal restraints on the ability of depositories to respond and adapt.

Against that background I, and the Board of Governors, have brought three interrelated principles to bear on our approach to banking structure and regulation. First is the importance of a strong capital position. Capital brings market discipline to bear on institutions that otherwise might be tempted to take excessive risk by their access to the federal safety net. And, it insulates the taxpayers holding up that safety net from the losses associated with unwise risk taking, should that occur nonetheless. Second is the need for more certain and prompt supervisory actions when capital and other key indicators of the financial
health of an institution decline. This not only will pro-
tect the taxpayers, but it also gives depositories planning
their financial structures more certainty about governmental
reactions, and induces them to take early action to
strengthen those structures.

Congress and the regulators have gone a long way in
acting on these first two principles. Unfortunately, pro-
gress on the third is more limited. That principle embraces
the necessity for greater competitive scope for well-capit-
talized banking organizations—across boundaries of geog-
raphy and product line. Both sets of boundaries have been
made increasingly arbitrary and artificial by innovation and
internationalization of financial services. An ability to
deliver desirable services to the public is a prerequisite
for generating the profits necessary to build capital and
for keeping an innovative banking system capable of meeting
the changing needs for credit and deposit services of a
dynamic economy.

The last four years have seen no paucity of chal-
lenges at the Federal Reserve. As much as we sometimes
might wish otherwise, I suspect the years ahead will be no
less challenging. While much remains to be done, important
strides have been made—in private markets and in government
policies to restore the normal vigor of the American economy
and our banking system. To that end, I believe the Banking
Committees' oversight and our continuing consultations have been a most helpful and constructive factor. Should the Senate choose to confirm me for a second term as Chairman of the Federal Reserve Board, I would look forward to working with this Committee to assure the sound financial system and vital economy the American people rightfully expect.
For immediate release March 1, 1991

A series of supervisory steps designed to reduce impediments to lending by banks and thrifts to credit-worthy borrowers was announced today by the Federal bank and thrift supervisors.

In announcing the changes, the agencies said the intent of this effort is to contribute to a climate in which banks and thrifts will make loans to credit-worthy borrowers and work constructively with borrowers experiencing financial difficulties, consistent with safe and sound banking practices.

The agencies issuing a statement on the changes are the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision.

The joint policies clarify that the supervisory evaluation of real estate loans is based on the ability of the collateral to generate cash flow over time, not upon its immediate liquidation value; encourage banks to disclose additional information about nonaccrual loans; encourage banks to make sound loans to credit-worthy borrowers; and facilitate the workout of problem loans.

The agencies are also considering the merits of proposed guidelines that address the accrual of income on certain loans that have been partially charged off. The agencies and the Securities and Exchange Commission will both solicit public comment on the proposed guidelines. Any formal guidance issued will be based on the comments received from the public and on-going discussions between the agencies and the SEC.

(OVER)
The supervisory statements and clarifications will be sent to field examiners and supervisory personnel. Copies of a general statement and the joint policy guidelines are attached.

Attachments
Recent credit problems have underscored the importance of prudent lending practices to the overall safety and soundness of the nation's financial system. The emergence of credit problems in a number of sectors of the economy has prompted many depository institutions to review their lending practices as well as their capacity to meet credit demands. Many institutions have wisely tightened credit standards where such standards had become too loose. Others have reduced the pace of lending in response to the need to shore up their capital positions and strengthen their balance sheets.

It is possible, however, that some depository institutions may have become overly cautious in their lending practices. In some instances this caution has been attributed to concerns on the part of lenders that the regulators of depository institutions are applying excessively rigorous examination standards.

The Federal banking and thrift regulators do not want the availability of credit to sound borrowers to be adversely affected by supervisory policies or depository institutions' misunderstandings about them. As a result, the agencies today are issuing a series of guidelines and statements that are intended to clarify regulatory policies in a number of areas and reduce concerns depository institutions may have about extensions of credit to sound borrowers. Specifically, the guidelines and statements released today: (1) encourage enhanced disclosure to
the public, (2) facilitate extensions of credit to sound borrowers and the workout of problem loans, and (3) better assure sound assessments of the value of real estate by depository institutions and Federal examiners.

Recent concerns related to a tightening of credit have focused the agencies' attention on regulatory policies and their effects on institutions' willingness to extend new credit and to work with troubled borrowers. The guidelines and statements released today, which have been under development for some time, are not intended, nor are they expected, to "solve" all credit availability problems. When combined with other steps that have been taken (such as lower money market interest rates and changes in reserve requirements), these initiatives should help facilitate prudent credit extensions to sound borrowers.

Enhanced disclosure will help to ensure that the public is better informed about the nature of institutions' portfolios. The new guidance recently issued by the Office of the Comptroller of the Currency (OCC) on suggested disclosures of more detailed information about nonaccrual loans in public financial statements, and recent banking agency guidelines on Highly Leveraged Transactions, should help by differentiating among broad groups of assets with varying degrees of risk.

Depository institutions have traditionally worked with their borrowers who are experiencing problems. In the current economic environment, it is especially important for institutions to avoid shutting off credit to sound borrowers, especially in sectors of the economy that are experiencing temporary problems.

Consistent with sound banking practices, depository institutions, including those with low capital positions, should work in an appropriate and constructive fashion with borrowers
who may be experiencing temporary difficulties. Such efforts may include reasonable workout arrangements or prudent steps to restructure extensions of credit. Institutions that have in place effective internal controls to manage and reduce excessive concentrations over a reasonable period of time, need not automatically refuse credit to sound borrowers because of the borrower's particular industry or geographic location.

The documents released today by the Federal bank and thrift regulatory agencies aim to facilitate the workout of problem loans by addressing the income accrual treatment of formally restructured debt and acquired nonaccrual loans consistent with generally accepted accounting principles. Further, there is a clarification of the accounting treatment of multiple loans to a single borrower when some, but not all, of the loans to the borrower are troubled.

The agencies have also clarified when payments may be recognized as income on a cash basis for loans that have been partially charged-off. In addition, the agencies are developing guidelines that address how institutions can accrue income on loans that have been partially charged-off.

Finally, the agencies are also clarifying their policies on the supervisory valuation of real estate. The policies provide that the evaluation of loan loss reserves or net carrying values for real estate loans should reflect a realistic market analysis and not be based solely on liquidation values.

1. Enhanced Disclosure to the Public

A. Disclosure of Nonaccrual Loans

Nonaccrual loans vary widely with respect to their quality and cash generating capacity. Consequently, the simple total of such
loans on an institution's books may not be a good indicator of the institution's financial position. One method to address this is to provide more information to the public on these assets. For example, useful supplemental disclosures might include information on the amount of charge-offs taken on nonaccrual loans, the amount of cash payments received on these assets, and the portion of these loans that generate substantial cash flow.

OCC recently issued a Banking Bulletin that contains suggestions for the voluntary disclosure of additional information on nonaccrual loans. The Federal regulatory agencies fully support the voluntary disclosures of the type suggested by the OCC and described in the attached statement.

B. Disclosure of Highly Leveraged Transactions (HLTs)
The Federal banking agencies have previously developed a uniform supervisory definition for HLTs. The purpose of the definition is to provide a consistent means to monitor loans to HLT borrowers. The agencies have recently provided the attached additional guidance to examiners and bankers on the application of this definition. This guidance stresses that the HLT designation does not imply a supervisory criticism of the credit.

The guidance also makes clear that certain extensions of credit, such as loans to debtors-in-possession (DIPs), do not fit the definition of HLT loans and should not be so reported. The criteria for the removal of a loan from HLT status have been expanded in the attached document. The agencies will continue to review these criteria to determine if other steps are warranted in view of the characteristics and performance of HLT credits, including the quality and
reliability of the borrower's cash flow.

2. Other Lending Issues

There appears to be some concern that any new lending by institutions that fail to meet minimum capital requirements will result in supervisory criticism. While it is essential that depository institutions that fail to meet minimum capital standards take effective and timely steps to address this deficiency, such institutions are not necessarily required to cease prudent, low-risk lending activities. Institutions should attain capital compliance in a prudent manner that strengthens their financial conditions. Institutions that seek to improve their capital-to-assets ratios through shrinking their balance sheets should avoid actions that raise their risk exposure, such as the sale of all high-quality assets or of core deposits. Such actions by themselves, or the refusal to lend to sound borrowers, fail to achieve the important objective of improving the quality of under-capitalized institutions' portfolios.

The agencies share common procedures to address capital deficiencies at depository institutions. In general, each agency requires such institutions to prepare a plan that details the steps they will take to attain the minimum capital levels. Approved plans generally do not preclude a continuation of sound lending activities, including prudent steps to work with borrowers encountering financial difficulties.

Similarly, there appears to be some concern that institutions with loan concentrations are automatically turning down good loans. The benefits of adequate portfolio
6

diversification are well recognized by depository institutions and their regulators. Although the regulatory agencies have not established rigid rules on asset concentrations, they are in agreement that, as a matter of sound operating policy, depository institutions should establish and adhere to policies that control "concentration risk."

Institutions that have in place effective internal controls to manage and reduce undue concentrations over a reasonable period of time, need not automatically refuse credit to sound borrowers. The purpose of institutions' policies should be to improve the overall quality of their portfolios. The replacement of unsound loans with sound loans can enhance the quality of a depository institution's portfolio, even when concentration levels are not reduced.

3. Recognition of Income on Certain Nonperforming Loans

Questions have been raised regarding the recognition of income on loans that have been partially charged-off. This subject is not explicitly addressed in the agencies' regulatory reporting requirements. The agencies wish to clarify that payments can be recognized as income on a cash basis for loans that have been partially charged-off, without requiring that the prior charge-off first be recovered, so long as the remaining book balance is deemed fully collectible.

The agencies, along with the Securities and Exchange Commission (SEC), each plan to solicit public comment on proposed guidelines which would allow certain nonperforming loans to be placed back on accrual status once the loans are reduced to an appropriate level through charge-offs. Any
formal guidance issued will be based on the comments received from the public and on-going discussions between the agencies and the SEC.

The agencies have released today supervisory guidance on a variety of other issues related to nonaccrual assets and formally restructured debt. These guidelines include a discussion of regulatory requirements related to cash basis income recognition, multiple loans to one borrower, and the acquisition of nonaccrual assets.

4. Valuation of Real Estate Loans

In recent months, there have been significant declines in real estate values in certain markets. In response to these declines, examiners have reviewed the adequacy of institutions' loan loss reserves and, where they believed it appropriate, have required additional reserves based on, in part, their estimates of real estate values.

These actions have focused attention on the techniques used to assess the value of real estate, especially commercial real estate. It is important that valuation techniques reflect not only existing market conditions, but also reasonable expectations of the property's performance in the market over time. The Federal regulatory agencies are reiterating their policy on the assessment of real estate values and the establishment of loan loss reserves.

The basic thrust of this guidance is to ensure that income property loans not be assessed solely on the basis of liquidation values but also on the income-producing capacity of the properties over time. Supervisory evaluations should take into account the lack of liquidity and cyclical nature
of real estate markets and the temporary imbalances in the supply and demand for real estate that may occur.

5. **Review of Supervisory Findings**

The agencies want to make clear their policy that any institution may request a review of any major decision reached as part of the supervisory process, including those related to asset classification and required reserve levels.
DISCLOSURE OF NONACCRUAL ASSETS

The purpose of the attached schedule is to provide a suggested format to banking and thrift organizations for reporting more information in public disclosures about nonaccrual assets, including loans, leases, and securities. The additional disclosures presented in this guidance are not required. However, financial institutions are encouraged to disclose publicly this type of information or other information deemed useful or relevant, in order to improve understanding of the impact of nonaccrual assets on the institution’s financial condition and results of operations. Such disclosures may utilize whatever format is considered appropriate by the financial institution.

In recent months, the financial institutions industry and their analysts have placed increasing emphasis on the amount of nonaccrual assets at banking and thrift organizations. Current public disclosures about these assets have generally been limited to the total amount of nonaccrual assets, interest income, and interest foregone. Such information may not be sufficient to fully explain the impact of nonaccrual assets on the earnings and financial condition of financial institutions. As a result, some financial institutions have said they want to make additional disclosures about nonaccrual assets in their annual reports.

Attached is an example of a format that could be used to provide additional information on the characteristics of nonaccrual assets and their contribution to net income. This information may prove useful in assessing the prospects for the orderly workout and ultimate repayment of assets placed in nonaccrual status. Nonaccrual loans to developing countries are
not intended to be included in the attached example, because these are generally disclosed separately.

The detail provided in the example may not be considered appropriate or necessary for all banks. Some banks may elect to disclose more specific categories of nonaccrual assets or only part of the data in the example. Others may wish to disclose principal payments on nonaccrual assets, associated collateral values, or other significant facts. Financial institutions may also consider providing appropriate similar disclosures related to other real estate owned, including net cash inflows from the properties, and a segregation of properties with significant net cash inflows.

Attachment
SAMPLE DISCLOSURE

Generally, the accrual of income is discontinued when the full collection of principal or interest is in doubt, or when the payment of principal or interest has become contractually 90 days past due unless the obligation is both well secured and in the process of collection. Nonaccrual loans amounted to $ at December 31, 1990. This amount is net of aggregate charge-offs on these loans of $.

Further information regarding the balance of nonaccrual loans at December 31, 1990, and related interest payment information, is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book balance at December 31, 1990</th>
<th>Contractual balance at December 31, 1990</th>
<th>Cash interest payments applied as of (6) (7)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(5)</td>
<td>(6)</td>
<td>recovery of income</td>
</tr>
<tr>
<td>Contractually past due with:</td>
<td></td>
<td></td>
<td>$</td>
</tr>
<tr>
<td>o substantial performance (1)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>o limited performance (2)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>o no performance</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Contractually current, however,:</td>
<td></td>
<td></td>
<td>$</td>
</tr>
<tr>
<td>o payment in full of principal or interest in doubt (3)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>o other (4)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Total</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>
EXPLANATIONS REGARDING SAMPLE NONACCRUAL DISCLOSURE FORMAT

(1) While unable to cure contractual delinquency, the borrower in this category would be consistently making substantial periodic payments relative to the required periodic payments due. If substantial performance is disclosed, management should be able to identify a threshold of performance which it considers to be substantial. While there is not a specified minimum, the threshold should be sufficient to provide a meaningful distinction within the information disclosed. This threshold or definition used should also be disclosed.

The determination of substantial performance will differ depending upon the loan repayment terms. For amortizing loans, both principal and interest payments would likely be considered. For loans with contractual interest-only payments and then a single principal payment at a specified time, interest performance only might be considered. However, if a significant principal payment were missed, then performance would likely be considered something less than substantial. In any event, management should disclose its definition of "substantial" performance.

(2) Borrower is demonstrating less than substantial performance, as defined, but is making some periodic payment.

(3) While not contractually past due, the loan has been placed on nonaccrual status due to doubt as to the full collection of principal or interest. Interest payments on such loans are being applied to reduce principal to the extent necessary to eliminate doubt as to full collectibility of the book balance.

(4) There is no longer doubt as to full collectibility of principal or interest. However, for other reasons, the loan is reported as nonaccrual. For example, interest income is being
recorded on a cash basis, while the borrower demonstrates a period of performance or interest payments are recorded as loan loss recoveries.

(5) Net of charge-offs to-date and interest payments applied to principal. The book balance should not include any reductions for any allocations of the allowance for loan and lease losses, if such allocations are made.

(6) Represents the application of cash interest payments during 1990, on the loans in nonaccrual status at December 31, 1990, from the time those loans were placed on nonaccrual status. The amount should not include the cash interest payments during the year from any of these loans prior to their placement on nonaccrual status.

It will be likely that some loans will move between categories between reporting dates. In such cases, year-to-date cash interest payment data would be reclassified to the same category where the period-end balance is reported.

(7) Additionally, management may consider it useful to disclose the yield provided from cash payments of interest on nonaccrual loans. A simple rate might be disclosed or data provided to allow the reader to determine the yield, as follows:

(a) As the cash interest data in the table relates to year-end balances only, the disclosure might provide a weighted average book balance of loans on nonaccrual status at December 31, 1990, for the period they were in nonaccrual status during the year then ended. The average balances would be properly weighted when aggregated, to reflect the relative amount of time within the year that individual loans were in nonaccrual status.
(b) It may prove difficult to monitor and report weighted average balances suggested in (a), above, because they relate to period-end balances. Alternatively, management might supplement the suggested tabular disclosure with the following two disclosures related to nonaccrual activity for the entire reporting period:

-- Cash interest payments on all nonaccrual loans while in nonaccrual status during the period (including loans no longer in nonaccrual status at period end). The amount of payments applied to principal should generally be distinguished from those which contributed directly to income to facilitate the determination of yields.

-- Average balance of all nonaccrual loans during the period.
SUPERVISORY GUIDANCE REGARDING THE DEFINITION OF HIGHLY-LEVERAGED TRANSACTIONS (HLTs)

The guidelines below are intended to supplement the uniform interagency definition of HLTs and the existing procedures for applying this definition.

Overview. A highly-leveraged transaction is a type of financing which involves the restructuring of an ongoing business concern financed primarily with debt. The purpose of an individual credit is most important when initially determining HLT status. Once an individual credit is designated as an HLT, all currently outstanding and future obligations of the same borrower are also included in HLT totals until such time as the borrower is removed from HLT status.

The regulatory purpose of the HLT definition is to provide a consistent means of aggregating and monitoring this type of financing transaction. The HLT designation does not imply a supervisory criticism of a credit. Before any HLT or any other credit is criticized, an examiner reviews a whole range of factors on a credit-by-credit basis. These factors include cash flow, general ability to pay interest and principal on outstanding debt, economic conditions and trends, the borrower’s future prospects, the quality and continuity of the borrower’s management, and the lender’s collateral position. Participation of banking organizations in highly-leveraged transactions is not considered inappropriate so long as it is conducted in a sound and prudent manner, including the maintenance of adequate capital and loan loss reserves to support the risks associated with these transactions.
Treatment of Debtor-In-Possession (DIP) Financings.
The agencies have further considered the question of whether some DIP loans should be included in the HLT portfolio. One important consideration in this regard is that the bankruptcy estate is considered a legally separate and distinct borrower from the pre-bankruptcy borrower. In addition, loans to DIPs generally do not meet the HLT purpose test. Further, the Chapter 11 bankruptcy code is designed to promote DIP lending and, thereby, affords significant protection to DIP lenders in order to preserve the value of the bankruptcy estate and to promote rehabilitation of the debtor. Therefore, court-approved debtor-in-possession (or trustee-in-possession) financing for a business concern in Chapter 11 reorganization proceedings will generally be exempt from HLT designation. All pre-petition debt of an HLT borrower and any post-reorganization debt (after a company emerges from Chapter 11 bankruptcy) will continue to be included in HLT exposure until delisting occurs.

Guidance on Delisting Credits from HLT Status. Options are being added to the specific HLT delisting criteria that make borrowers eligible for delisting from HLT status when all direct buyout, acquisition, or recapitalization debt satisfying the HLT purpose test has been paid and when companies perform well for an extended period of time, despite operating with high leverage. Further, the wording of the specific delisting criteria pertaining to exposures designated as HLTs because of the 75 percent leverage test is being made consistent with these new options. The general delisting criteria are reiterated below along with the four specific ways to become eligible for delisting from HLT status.

(a) General Criteria -- For credits to become eligible for removal from HLT status, a company must demonstrate an ability to operate successfully as a highly-leveraged
company over a period of time. Under normal circumstances, two years should be sufficient for the credit to show performance and to validate the appropriateness of projections. The banking organization should conduct a thorough review of the obligor to include, at a minimum, overall management performance against the business plan, cash flow coverages, operating margins, status of asset sales, if applicable, reduction in leverage, and industry risk.

(b) **Specific Criteria** -- In addition to these general criteria, at least one of the following specific criteria must be met to become eligible for delisting:

1. For exposures that were included because of the 75 percent leverage test, exposures are eligible for delisting from HLT status when leverage is reduced below 75 percent, and the company has demonstrated an ability to continue servicing debt satisfactorily without undue reliance on unplanned asset sales.

2. If two years have passed since a company's most recent acquisition, buyout, or recapitalization satisfying the HLT purpose test, then the borrower's credits are eligible for delisting from HLT status if all debt satisfying the HLT purpose test is repaid in full, even if the borrower's total liabilities to total assets leverage ratio continues to exceed 75 percent. The refinancing of HLT purpose-related debt through additional borrowings does not constitute a repayment of HLT debt. Rather, the repayment of debt must occur from cash generated from operations, planned sales of assets, or a capital injection.
(3) For exposures that were included because of the 75 percent leverage test, a borrower's credits are eligible for delisting when the borrower satisfies the general performance criteria for delisting for at least 4 (four) consecutive years since its last buyout, acquisition, or recapitalization involving financing; the company has a positive net worth; and the company's leverage ratio does not significantly exceed its industry norm. Although this criteria does not require leverage to be reduced to less than 75 percent, the borrower must demonstrate an ability to continue servicing debt satisfactorily without undue reliance on unplanned asset sales.

(4) For those exposures that arose under the "doubling of liabilities to greater than 50 percent" leverage criteria, delisting is acceptable based upon the general criteria in (a) above and a demonstrated ability to satisfactorily continue to service the debt.

As was stated in previous guidance, any significant changes in the borrower's financial condition after delisting should cause the exposure to be reviewed for relisting.
SUPERVISORY GUIDANCE ON CERTAIN ISSUES RELATING TO NONACCRUAL ASSETS AND FORMALLY RESTRUCTURED DEBT

Cash basis income recognition. Current regulatory reporting requirements do not preclude the cash basis recognition of income on nonaccrual assets (including loans that have been partially charged off), provided that the remaining book balance of the loan is deemed fully collectible. Recognition of interest income on a cash basis should be limited to that which would have been accrued on the recorded balance at the contractual rate. Any cash interest received in excess of this limit should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered.

Multiple loans to one borrower. As a general principle, nonaccrual status for an asset should be determined based on an assessment of the individual asset's collectibility and payment ability and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a depository institution does not automatically have to place all other extensions of credit to that borrower in nonaccrual status. When a depository institution has multiple loans or other extensions of credit outstanding to a single borrower, and one loan meets criteria for nonaccrual status, the depository institution should evaluate its other extensions of credit to that borrower to determine whether one or more of these other assets should also be placed in nonaccrual status.

Acquisition of nonaccrual assets. A depository institution (or the receiver of a failed institution) may sell loans or debt securities that the institution had maintained in nonaccrual
status. Such loans or debt securities that have been acquired from an unaffiliated third party by a depository institution should be reported by the purchaser in accordance with AICPA Practice Bulletin No. 6. When the criteria specified in this Bulletin are met, these assets may be placed in accrual status.¹

**Treatment of formally restructured debt.** A loan or other debt instrument that has been formally restructured in accordance with FASB Statement No. 15 so as to be reasonably assured of repayment and of performance according to a reasonable repayment schedule need not be maintained in a nonaccrual status.² In returning the loan to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account.

A FASB 15 restructuring may result in a market yield on the recorded investment in the loan, i.e., an effective interest rate that is equal to the rate that the depository institution is willing to accept for a new loan with comparable risk. While a loan or other debt instrument that qualifies as a FASB Statement No. 15 restructuring must be disclosed as such in the year that the restructuring took place, restructured assets that yield market rates of interest need not continue to be reported as FASB 15 troubled debt restructurings in subsequent years.


Other issues. Because an analysis of the Allowance for Loan and Lease Losses (ALLL) requires an assessment of the relative credit risks in the portfolio, many depository institutions attribute for analytical purposes portions of the ALLL to loans and other assets classified "substandard" by management or a supervisory agency. Management may do this because it believes, based on past history or other factors, that there may be unidentified losses associated with loans classified in this category in the aggregate.

Furthermore, management may use this analytical approach in estimating the total amount necessary for the ALLL and in comparing the ALLL to various categories of loans over time. As a general rule, an individual loan classified substandard may remain in accrual status as long as the regulatory reporting requirements for accrual treatment are met, even when an attribution of the ALLL has been made.
For immediate release

March 25, 1991

The Federal Reserve Board today announced revisions to Regulation P (Minimum Security Devices and Procedures for Federal Reserve Banks and State Member Banks).

The revisions become effective May 1, 1991.

The revisions update the current rules adopted in 1969, simplify and clarify the rule's existing areas of flexibility, eliminate many obsolete or technical requirements particularly those in Appendix A, and delete references to required reports following elimination of reporting requirements in this area by the Financial Institution's Reform, Recovery and Enforcement Act of 1989.

The revisions do not otherwise substantively change the regulation, which is already relatively brief and flexible, and add no new regulatory burden.

A copy of the Board's notice is attached.

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Attachment
AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System ("Board"), in coordination with the other federal bank supervisory agencies, has reviewed Regulation P -- Security Devices and Procedures -- and determined that it is appropriate to revise the regulation to reflect changes in the technology of security devices, and to implement changes made by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"). The proposed revision was published for comment by the Board in April 1990. (55 F.R. 12859, April 6, 1990). The revision incorporates amendments made to the Bank Protection Act of 1968 by FIRREA and provides banks with the flexibility to avoid the technical obsolescence that occurred with the existing regulation.

DATE: This regulation is effective May 1, 1991, except renewal of the recordkeeping requirement FR 4004 and discontinuance of the FR 4003 and FR 4005 reports, which will be effective March 31, 1991.

FOR FURTHER INFORMATION CONTACT: Elaine M. Boutilier, Senior Attorney (202/452-2418), Legal Division, or Thomas A. Durkin, Regulatory Planning and Review Director (202/452-2326), Office of
the Secretary, Board of Governors of the Federal Reserve System, Washington, D. C. 20551. For the hearing impaired only, Telecommunication Device for the Deaf ("TDD"), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: The Bank Protection Act of 1968 requires the federal financial institution supervisory agencies to establish minimum standards for bank security devices and procedures to discourage bank crime and to assist in the identification of persons who commit such crimes. 12 U.S.C. § 1882. To implement this statute a uniform regulation was adopted in 1969 by each of the supervisory agencies -- Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board (now known as the Office of Thrift Supervision), and the Board. With the exception of minor changes in 1973 and 1981, this regulation has not been modified since it was first adopted. The Board, along with the other federal financial institution supervisory agencies, requested comments on a proposed revision of this regulation last year. (55 F.R. 12850, April 6, 1990).

The Board received a total of 43 comments on the proposed changes to Regulation P. Twenty-nine of these comments were received from banks; five were received from manufacturers of security equipment; six were received from associations connected with banks (e.g., trade associations); and three were received from Reserve Banks. The overall response to the changes was supportive: 32 of the comments expressed support for the
revisions, while only 11 comments were not supportive. Four of
the five equipment manufacturers opposed the changes, but twenty-
five of the twenty-nine commenting banks were generally
supportive. The primary objection of those opposing the changes
was that the revised standards were too vague; in particular,
some commenters opposed deletion of Appendix A and Appendix B.
One of the trade associations opposed the deletion of these
appendices because, in its view, small institutions have security
officers that depend on these appendices for guidance.

Appendix A set forth specifications for security
devices to be used in banks. The Board is deleting this appendix
because it is too specific and has become obsolete. The Board
believes that any standards that continue to reference specific
security devices are also likely to become obsolete because
technology is continuing to advance at a rapid pace. To avoid
the necessity of constantly updating required security devices,
the revised regulation requires each bank to designate a security
officer to administer a written security program, which would
require, at a minimum, that four specific security devices be
installed, but leaves it to the discretion of the security
officer to determine which additional security devices will best
meet the needs of the program. In this way the security officer
can choose the most up-to-date equipment that meets the
requirements of his particular bank. Some commenters recommended
referring to Underwriters Laboratory ("UL") approval or ANSI
specifications as a substitute for Appendix A. Because the level
of risk varies from institution to institution, the Board does not believe that it is appropriate to specify particular features of security devices as mandatory. Nevertheless, security officers would be expected to identify the level of risk to their institution and adopt an appropriate security program, taking into consideration applicable ANSI and UL standards.

Appendix B concerned proper employee conduct after a robbery. Although this appendix has been eliminated, the Board believes that training of employees should be included in a bank's security program and notes that several organizations offer training programs for bank employees and security officers.

Some letters that were generally supportive of the revision commented that the regulation was too narrow and should cover "white-collar crime" as well. Regulation P is promulgated in response to the Bank Protection Act, which is specifically intended to "discourage robberies, burglaries, and larcenies." While the Board agrees that white-collar crimes such as fraud and embezzlement are problems, these crimes are covered by other laws outside the scope of Regulation P.

The revised regulation establishes a minimum standard by requiring four specified security devices: a secure space for cash; a lighting system for illuminating the vault; an alarm system; and tamper resistant locks on exterior doors and windows. In addition, the proposed regulation establishes the contents of a security program, e.g., procedures for opening and closing for business, for safekeeping of valuables, and for identifying
persons committing crimes. These are the minimum procedures that should comprise a bank's security program. To assist banks in establishing their program, the regulation suggests certain factors to be considered when selecting additional security devices. In making these suggestions, the Board notes that in the 22 years since passage of the Bank Protection Act, trade associations and other vendors have produced security manuals and information designed for banks of various sizes.

To ensure that a bank's security program is reviewed on a regular basis for effectiveness, the regulation requires a report to be made by the security officer to the bank's board of directors at least annually. This changes the previous requirement, which was eliminated by FIRREA, that reports must be filed periodically with a bank's primary supervisory agency. Nevertheless, the annual reports to the board of directors should still contain information such as the status of employee training, the number of offenses against the bank, and the success of prosecution for such offenses.

When requesting comments on the proposed amendments to Regulation P, the Board also proposed elimination of three reports relating to recordkeeping and reporting requirements of the regulation: FR 4003 (Statement Regarding Security Devices That Do Not Meet the Minimum Requirements of Regulation P), FR 4004 (Written Security Program for State Member Banks as Required by Regulation P), and FR 4005 (Annual Statement of Compliance with the Bank Protection Act of 1968). Only two
comments were received on this issue, and both supported the elimination of the reports. Because the revised regulation still requires a written security program, however, the Board has decided to discontinue only two of these reports -- the FR 4003 and FR 4005 reports -- effective on March 31, 1991. The FR 4004 report, a recordkeeping requirement, has not been discontinued, because banks are still required to maintain a written security program. In accordance with section 3507 of the Paperwork Reduction Act of 1980, (44 U.S.C. § 3507, and 5 CFR 1320.13), the discontinuance of the FR 4003 and FR 4005 reports has been reviewed and approved by the Board under Office of Management and Budget delegated authority after consideration of the comments received during the public comment period.

Renewal of FR 4004 is approved by the Board under delegated authority (5 CFR 1320.9) to be effective on March 31, 1991, which is less than 30 days from publication of this ruling. The Board finds good cause for an effective date less than 30 days from publication because the authority for the recordkeeping

1 For purposes of the Paperwork Reduction Act, the recordkeeping requirement of this regulation for establishment of written security programs is described as follows:

(1) Report title: Written Security Program for State Member Banks; (2) Agency report number: FR 4004; (3) OMB Docket number: 7100-0112; (4) Frequency: recordkeeping; (5) Reporters: State member banks; (6) Annual reporting hours: 513; (7) Estimated average hours per response: 0.5 per year; (8) Number of respondents: 1025. The information collection is mandatory (12 U.S.C. § 1882(b)).
requirement expires on March 31, 1991 and a period of time without it would be disruptive to the institutions required to maintain such records. Furthermore, this is a continuation of an existing recordkeeping requirement, so an effective date with less than 30 days prior notice has no harmful effect on the institutions involved.

Regulatory Flexibility Act Analysis. Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. No. 96-354, 5 U.S.C. § 601 et seq.), the Board certifies that this final rule will not have a significant economic impact on a substantial number of small entities. Small entities already were complying with the security standards established in the prior regulation, and this revision provides for more flexibility in devising security programs, which should help minimize the existing costs to the institutions. The amendment also deletes two of the three reports required by the government, which should ease the regulatory burden on small institutions.

List of Subjects in 12 CFR Part 216:

Banks, Banking, Federal Reserve System, Reporting and recordkeeping requirements, Security measures, state member banks.

For the reasons set out in the preamble, Title 12, Part 216 of the Code of Federal Regulations is proposed to be amended as follows:
PART 216 - SECURITY PROCEDURES

Sec.

216.1 Authority, purpose, and scope.

216.2 Designation of security officer.

216.3 Security program.

216.4 Report.

216.5 Federal Reserve Banks.

AUTHORITY: 12 U.S.C. §§ 1881 - 1884

Section 216.1 Authority, purpose, and scope.

(a) This regulation is issued by the Board of Governors of the Federal Reserve System (the "Board") pursuant to section 3 of the Bank Protection Act of 1968 (12 U.S.C. § 1882). It applies to Federal Reserve Banks and state banks that are members of the Federal Reserve System. It requires each bank to adopt appropriate security procedures to discourage robberies, burglaries, and larcenies, and to assist in the identification and prosecution of persons who commit such acts.

(b) It is the responsibility of the member bank's board of directors to comply with this regulation and ensure that a written security program for the bank's main office and branches is developed and implemented.

Section 216.2 Designation of security officer.

Upon becoming a member of the Federal Reserve System, a state bank's board of directors shall designate a security officer who shall have the authority, subject to the approval of the board of directors to develop, within a reasonable time, but
no later than 180 days, and to administer a written security program for each banking office.

216.3 Security program.

(a) **Contents of security program.** The security program shall:

1. establish procedures for opening and closing for business and for the safekeeping of all currency, negotiable securities, and similar valuables at all times;

2. establish procedures that will assist in identifying persons committing crimes against the institution and that will preserve evidence that may aid in their identification and prosecution. Such procedures may include, but are not limited to:
   
   (i) maintaining a camera that records activity in the banking office;

   (ii) using identification devices, such as prerrecorded serial-numbered bills, or chemical and electronic devices; and

   (iii) retaining a record of any robbery, burglary, or larceny committed against the bank;

3. provide for initial and periodic training of officers and employees in their responsibilities under the security program and in proper employee conduct during and after a burglary, robbery, or larceny; and
provide for selecting, testing, operating, and maintaining appropriate security devices, as specified in paragraph (b) of this section.

(b) Security devices. Each member bank shall have, at a minimum, the following security devices:

(1) a means of protecting cash and other liquid assets, such as a vault, safe, or other secure space;
(2) a lighting system for illuminating, during the hours of darkness, the area around the vault, if the vault is visible from outside the banking office;
(3) tamper-resistant locks on exterior doors and exterior windows that may be opened;
(4) an alarm system or other appropriate device for promptly notifying the nearest responsible law enforcement officers of an attempted or perpetrated robbery or burglary; and
(5) such other devices as the security officer determines to be appropriate, taking into consideration:
   (i) the incidence of crimes against financial institutions in the area;
   (ii) the amount of currency and other valuables exposed to robbery, burglary, and larceny;
   (iii) the distance of the banking office from the nearest responsible law enforcement officers;
   (iv) the cost of the security devices;
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(v) other security measures in effect at the banking office; and
(vi) the physical characteristics of the structure of the banking office and its surroundings.

Section 216.4 Report.

The security officer for each member bank shall report at least annually to the bank's board of directors on the implementation, administration, and effectiveness of the security program.

Section 216.5 Federal Reserve Banks.

Each Reserve Bank shall develop and maintain a written security program for its main office and branches subject to review and approval of the Board.


(signed) Jennifer J. Johnson

Jennifer J. Johnson
Associate Secretary of the Board
The Federal Reserve Board today approved a proposal to lift the limit on the amount of noncumulative perpetual preferred stock that bank holding companies may include in Tier 1 capital for purposes of calculating their risk-based and leverage capital ratios.

There currently is no limit on the amount of noncumulative perpetual preferred stock that state member banks may include in Tier 1 capital.

Cumulative perpetual preferred stock will continue to be included in Tier 1 capital for bank holding companies, up to the current limit of 25 percent of Tier 1 capital.

The Board's order is attached.

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Attachment
Agency: Board of Governors of the Federal Reserve System.

Action: Revisions to Capital Adequacy Guidelines.

Summary: The Board is amending its risk-based and leverage capital guidelines to remove the limit on the amount of noncumulative perpetual preferred stock bank holding companies may include in Tier 1 capital. Cumulative perpetual preferred stock will continue to be included in Tier 1 capital for bank holding companies, up to a limit of 25 percent of Tier 1 capital. This change to the guidelines will afford banking organizations greater flexibility in raising capital.

Effective Date: The amendments to the capital adequacy guidelines are effective [upon publication in the Federal Register.]

For Further Information Contact: Roger T. Cole, Assistant Director (202/452-2618), Roger H Pugh, Manager (202/728-5883),
Norah M. Barger, Supervisory Financial Analyst (202/452-2402),
Robert E. Motyka, Senior Financial Analyst (202/452-3621),
Division of Banking Supervision and Regulation; and Michael J.
O’Rourke, Senior Attorney (202/452-3288), Legal Division. For
the hearing impaired only, Telecommunication Device for the Deaf
(TDD), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

I. BACKGROUND

The international bank capital standards (Basle Accord)¹ allow banks to include noncumulative perpetual
preferred stock in Tier 1 capital and place no formal limit on
the amount of such instruments that may be included in Tier 1.²

The Basle framework, which by its terms applies only to
internationally active banks, was adopted by the Federal Reserve
for state member banks. In addition, the Board chose to apply a
risk-based capital framework similar to the Basle Accord to U.S.

¹ The Basle Accord is a risk-based capital framework that was
proposed by the Basle Committee on Banking Regulations and
Supervisory Practices and endorsed by the central bank governors of
the Group of Ten (G-10) countries in July 1988. The Committee is
comprised of representatives of the central banks and supervisory
authorities from the G-10 countries (Belgium, Canada, France,
Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United
Kingdom, and the United States) and Luxembourg.

² Noncumulative perpetual preferred stock is perpetual
preferred stock whose dividends, if missed, do not accrue and will
never be paid. Cumulative perpetual preferred stock is preferred
stock whose dividends, if missed because of insufficient earnings
or any other reason, accumulate until all arrearages are paid out.
Cumulative preferred dividends have preference over common
dividends, which cannot be paid out as long as any cumulative
preferred dividends remain unpaid.
bank holding companies generally on a consolidated basis. Under the Federal Reserve's bank holding company capital guidelines, holding companies are allowed to include both noncumulative and cumulative perpetual preferred stock in Tier 1 capital, but the total of all perpetual preferred stock includable in Tier 1 capital is limited to 25 percent of Tier 1. Amounts of such stock in excess of the limitation may be included in Tier 2 capital. The limit on preferred stock is consistent with the Board's long-standing view that common equity should remain the dominant form of a banking organization's capital structure.

A principal reason for the Board's decision to limit the amount of perpetual preferred stock in bank holding company Tier 1 capital is the fact that cumulative preferred, the type of perpetual preferred most prevalent in U.S. financial markets, normally involves preset dividends that can only be deferred, not cancelled. An institution that passes dividends on cumulative preferred stock must pay off any accumulated arrearages before it can resume payment of its common stock dividends. Thus, undue reliance on cumulative perpetual preferred stock and the related

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3 For bank holding companies with consolidated assets of less than $150 million in assets, the risk-based capital guidelines generally are applied on a bank-only basis.

4 Under the risk-based capital guidelines, certain types of perpetual preferred stock do not qualify for inclusion in Tier 1 capital. For example, perpetual preferred stock in which the dividend is reset periodically based, in whole or in part, upon the banking organization's credit standing is excluded from Tier 1 capital, but may be included in Tier 2 capital.
possibility of large dividend arrearages could complicate an organization's ability to raise new common equity in times of financial difficulty. On the other hand, dividends on noncumulative preferred, like dividends on common stock, may be cancelled. Thus, with respect to dividends, noncumulative preferred stock has characteristics that are consistent with common stock, the principal component of Tier 1 capital.

Conditions in the banking industry underscore the desirability of affording banking organizations greater flexibility in raising capital. This can assist organizations in strengthening their capital positions and expanding their ability to extend credit to sound borrowers. In view of these considerations, on October 31, 1991, the Board proposed removing the limit on the amount of noncumulative preferred stock that bank holding companies may include in Tier 1 capital. This was consistent with other steps initiated by the Federal bank regulatory agencies, in conjunction with the Treasury Department, to address concerns relating to the availability of credit to sound borrowers.

By removing the limit for noncumulative perpetual preferred stock, the Board noted, the proposal would achieve parity with regard to the treatment of noncumulative perpetual preferred stock between the U.S. risk-based capital guidelines for bank holding companies and the Basle framework for banks. Thus, the proposal would place U.S. bank holding companies on a more equal footing with foreign banks subject to the Basle Accord
with regard to their ability to augment Tier 1 capital through the issuance of noncumulative perpetual preferred stock. The proposal also would conform the treatment of noncumulative preferred for holding companies to the treatment for state member banks, which, consistent with the Basle Accord, may include noncumulative perpetual preferred stock in Tier 1 without any formal limit. The Board indicated that the additional flexibility provided by this proposal could assist bank holding companies to strengthen their capital positions and expand their lending capacity.

The Board noted that, although it was proposing to remove the limit on noncumulative perpetual preferred stock, it continued to believe that bank holding companies should avoid overreliance on preferred stock within Tier 1 capital. In this regard, the Board noted that the capital structure of a bank holding company is subject to quarterly review (through the analysis of financial reports filed with the Federal Reserve), and the composition of an organization's capital base and its capital plans are subject to in-depth assessment during annual inspections and as part of the Federal Reserve's consideration of applications. The Board further stated that the language of the Federal Reserve's risk-based capital guidelines makes clear the Board's long-standing belief that banking organizations should avoid overreliance on nonvoting equity instruments, including preferred stock, in Tier 1 capital. Capital structures that are inconsistent with this principle may result in supervisory or
enforcement actions, including possible denial of applications filed with the Federal Reserve. In addition, rating agencies take the amount of common equity and preferred stock an organization has, as well as the overall composition of the organization's core capital, into account in determining the organization's financial ratings. Thus, the Board concluded in its proposal that there are a number of mechanisms in place to monitor banking organizations' use of preferred stock and to discourage undue reliance on such instruments.

The comment period for this proposal ended on November 22, 1991. The Board received comments from twenty-one public respondents. None of the commenters opposed the proposal and fourteen commenters, or two-thirds of the total, supported it. Two of these commenters, however, questioned the language in the Board's proposal that overreliance by a banking organization on preferred stock and other nonvoting equity elements within Tier 1 could result in supervisory or enforcement actions. These commenters asked for specific guidance on the permissible upper limit within Tier 1 for such nonvoting instruments.

Seven commenters neither supported nor opposed the proposal but expressed the view that removal of the limitation on noncumulative preferred stock includable in Tier 1 capital would provide little or no benefit to bank holding companies' ability to raise capital because they view the market for noncumulative preferred as limited. Three of the commenters that explicitly supported the proposal expressed similar reservations on the
benefits provided by the proposal. Five of the commenters that did not explicitly support the proposal put forth alternative proposals to increase this ability. One of these suggestions was the removal of the limit on cumulative perpetual preferred stock bank holding companies may include in Tier 1. Another suggestion was to include in capital some amount of identifiable intangible assets such as purchased credit card intangibles and core deposit intangibles.\(^5\)

Based on the comments received, the Board is now issuing in final form amendments to its risk-based and capital leverage guidelines to remove the limitation on the amount of noncumulative perpetual preferred stock bank holding companies may include in Tier 1 capital. Bank holding companies will continue to be able to include cumulative perpetual preferred stock in Tier 1 capital, up to a limit of 25 percent of Tier 1. The Board believes that a limitation on cumulative perpetual preferred stock is appropriate because dividends on this type of instrument can only be deferred, not cancelled. Since the existence of large dividend arrearages could complicate an organization's ability to raise common equity in times of financial difficulty, the Board believes that the amount of cumulative preferred stock bank holding companies can include as Tier 1 capital should continue to be limited to 25 percent.

\(^5\) The Board is currently reviewing the capital treatment of intangible assets together with the other federal financial institutions regulatory agencies and will address this matter separately at a later date.
Although the Board is removing the limit on noncumulative preferred, it continues to believe that common equity should remain the dominant form of a banking organization's capital structure. Thus, the Board will retain the language in its risk-based capital guidelines stating that banking organizations should avoid overreliance on nonvoting equity instruments, including perpetual preferred stock, in their Tier 1 capital. Any determination of overreliance depends on a number of factors including the overall financial condition of the institution, the existence of multiple classes of common shareholders, the level and quality of minority interests in equity accounts of consolidated subsidiaries, and the level and quality of preferred stock. Since these factors can vary greatly among banking organizations, the Board will continue to make a final determination on overreliance on nonvoting equity elements on a case-by-case basis.

II. Effective Date

The amendments to the risk-based and leverage capital guidelines are effective upon publication. The provisions of 5 U.S.C. 553(d) generally prescribing 30 days' prior notice of the effective date of a rule have not been followed in connection with the adoption of this amendment. Section 553(d) also provides that such prior notice is not necessary whenever a rule reduces regulatory burdens or there is good cause for finding that such notice is contrary to the public interest. As noted
above, by removing the limitation on the amount of noncumulative perpetual preferred stock bank holding companies may include in Tier 1 capital, this rule does reduce such a regulatory burden.

II. Regulatory Flexibility Act Analysis

The Federal Reserve Board does not believe that adoption of this proposal would have a significant economic impact on a substantial number of small business entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). In that regard, the proposed amendment would reduce certain regulatory burdens on bank holding companies. In addition, because the risk-based and leverage capital guidelines generally do not apply to bank holding companies with consolidated assets of less than $150 million, this proposal will not affect such companies.

List of Subjects

12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, banking, Branches, Capital adequacy, Confidential business information, Currency, Dividend payments, Federal Reserve System, Flood insurance, Publication of reports of condition, Reporting and recordkeeping requirements, Securities, State member banks.
Administrative practice and procedure, Appraisals, Banks, banking, Capital adequacy, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities, State member banks.

For the reasons set forth in this notice, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956 (12 U.S.C. 1844(b)), and section 910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3909), the Board is amending 12 CFR Parts 208 and 225 by revising them to read as follows:

PART 208 - MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM

1. The authority citation for Part 208 continues to read as follows:

AUTHORITY: Sections 9, 11(a), 11(c), 19, 21, 25, and 25(a) of the Federal Reserve Act, as amended (12 U.S.C. 321-338, 248(a), 248(c), 461, 481-486, 601, and 611, respectively); sections 4 and 13(j) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1814 and 1823(j), respectively); section 7(a) of the International Banking Act of 1978 (12 U.S.C. 3105); sections 907-

Appendix A - [Amended]

2. The footnote designator in the text is removed and footnote 6 is removed and reserved.

PART 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

1. The authority citation for Part 225 continues to read as follows:

AUTHORITY: 12 U.S.C. 1817(j) (13), 1818, 1831i, 1843(c) (8), 1844(b), 3106, 3108, 3907, 3909, 3310, and 3331-3351.

Appendix A - [Amended]

2. Appendix A is amended by revising paragraphs (ii) and
(iii) and adding paragraph (iv) in II.A.1., by revising the last three sentences of the third paragraph and the entire fourth paragraph in II.A.1.b., by revising the third entry under the heading and by adding a new entry directly after the newly revised third entry in Attachment II, and by revising footnote 1 in Attachment VI, to read as follows:

II. ***
A. ***
1. ***
   (i) ***
   (ii) Qualifying noncumulative perpetual preferred stock (including related surplus).
   (iii) Qualifying cumulative perpetual preferred stock (including related surplus), subject to certain limitations described below.
   (iv) Minority interest in the equity accounts of consolidated subsidiaries.
      a. ***
      b. *** However, the aggregate amount of cumulative perpetual preferred stock that may be included in a holding company's tier 1 is limited to one-third of the sum of core capital elements, excluding the cumulative perpetual preferred stock (that is, items i, ii, and iv above). Stated differently, the aggregate amount may not exceed 25 percent of the sum of all core capital elements, including cumulative perpetual preferred...
stock (that is, items, i, ii, iii, and iv above). Any cumulative perpetual preferred stock outstanding in excess of this limit may be included in tier 2 capital without any sublimits within that tier (see discussion below).

While the guidelines allow for the inclusion of noncumulative perpetual preferred stock and limited amounts of cumulative perpetual preferred stock in tier 1, it is desirable from a supervisory standpoint that voting common equity remain the dominant form of tier 1 capital. Thus, bank holding companies should avoid overreliance on preferred stock or nonvoting equity elements within tier 1.

Attachment II.

| Qualifying noncumulative perpetual preferred stock | No limit |
| Qualifying cumulative perpetual preferred stock | Limited to 25% of the sum of common stock, qualifying perpetual preferred stock, and minority interests |

Attachment VI.

1 Cumulative perpetual preferred stock is limited within tier 1 to 25% of the sum of common stockholders' equity, qualifying perpetual preferred stock, and minority interests.
Appendix D - [Amended]

3. Appendix D is amended by revising the first two sentences in footnote 3 to read as follows:

II. ***

3 At the end of 1992, Tier 1 capital for bank holding companies includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of Tier 1 capital.)***

Board of Governors of the Federal Reserve System,

(signed) William W. Wiles

William W. Wiles
Secretary of the Board
For immediate release February 6, 1992

The Federal Reserve Board has voted to discontinue use of the supervisory definition of highly-leveraged transactions (HLTs) after June 30, 1992. The Board will also discontinue the reporting of HLT exposure by banking organizations it regulates after the June 30, 1992, reporting date.

In the interim, the Board has approved revisions to the supervisory definition of HLTs to be used by banks and bank holding companies for reporting their HLT exposure as of March 31, 1992, and June 30, 1992.

Although the Board will phase out the use of the formal supervisory definition of HLTs, guidance previously issued by the Board for assessing individual credits that finance corporate restructurings and for evaluating internal processes for initiating and reviewing these credits will continue to be used by examiners for this purpose.

Due to the complex nature and level of risk associated with such HLT financings, boards of directors and management at banking organizations will be expected to continue to monitor carefully their banking organization's risk exposure to these credits.

Similar action to discontinue use of the HLT definition and reporting has also been approved by the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

The Board's notice is attached.

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Attachment
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY
[DOCKET NO. 91-7]

FEDERAL DEPOSIT INSURANCE CORPORATION
[DOCKET NO. 050984]

FEDERAL RESERVE SYSTEM
[Docket No. R-0734]

The Supervisory Definition of
Highly-Leveraged Transactions

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Federal Deposit Insurance Corporation (FDIC); and Board of Governors of the Federal Reserve System (Board).

ACTION: Notice.

SUMMARY: The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System have approved: (1) the discontinuance, after June 30, 1992, of the supervisory definition of highly-leveraged transactions (HLT's); and (2) the discontinuance of the reporting of HLT exposure by banking organizations regulated by the agencies after the June 30, 1992 reporting date. In the interim, the agencies have approved revisions to the supervisory definition of HLT's to be used by banks and bank holding companies for reporting their HLT exposure as of March 31, 1992 and June 30, 1992.

Although the agencies will phase out the use of the formal supervisory definition, guidance previously issued by each agency for assessing individual credits that finance corporate restructurings and for evaluating internal processes for initiating and reviewing these credits will continue to be used by examiners for this purpose. Due to the complex nature and level of risk associated with such financings, boards of directors and management at banking organizations will be expected to continue to monitor carefully their banking organization's risk exposure to these credits.

DATES: Effective Date. The notice is effective on February 12, 1992.

Compliance Dates. The use of the supervisory definition of highly-leveraged transactions by the agencies will be discontinued effective after the June 30, 1992 financial reporting date for banking organizations regulated by the agencies. In the period preceding discontinuance of the definition, revisions to the definition have been approved for reporting HLT exposure as of March 31, 1992 and June 30, 1992.
FOR FURTHER INFORMATION CONTACT:
OCC: John W. Turner, National Bank Examiner, (202/874-5170),
Chief’s National Bank Examiner’s Office.

FDIC: Garfield Gimber, Examination Specialist, (202/898-6913),
Division of Supervision.

Board: Todd Glissman, Supervisory Financial Analyst (202/452-
3953), or William Spaniel, Senior Financial Analyst (202/452-
3469), Division of Banking Supervision and Regulation. For the
hearing impaired only, Telecommunications Device for the Deaf
("TDD"), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: On July 10, 1991, the agencies
published for comment the supervisory definition of highly-
leveraged transactions [56 FR 31464, July 10, 1991]. The
agencies sought comment on all aspects of the HLT definition and
criteria, as well as comments on specific issues raised by
questions which the agencies had received. The comment period
expired on September 26, 1991. The agencies received over 265
comments on the proposal.

After reviewing the status of the HLT definition,
considering comments received from the public, and evaluating
proposed revisions, the agencies have approved the phase out of
the supervisory definition of HLT's and the discontinuance of
reporting of HLT's after the June 30, 1992 financial reporting by
banking organizations. The agencies have also approved revisions
to the definition for use by banking organizations in reporting
their HLT exposure as of March 30, 1992 and June 30, 1992.

The agencies, in approving the phase out of the supervisory
definition of HLT's, have taken under consideration the public
comments received on the HLT definition, the current status of
HLT credits, the reduced level of merger and acquisition activity
in recent months, and the reluctance of lenders, in some cases,
to extend credit to sound borrowers. The agencies considered all
options for maintaining or phasing out supervisory oversight of
highly-leveraged transactions. These included phasing out the
definition, giving banks the flexibility to establish their own
individual definitions, and proposing revisions to the
supervisory definition.

While the agencies did not favor the immediate
discontinuance of the definition, the agencies believe that the
HLT definition has largely accomplished its purposes and have
approved the phase out of the definition. The definition
encouraged financial institutions to focus attention on the need
for internal controls and review mechanisms to monitor these
types of financing transactions. The definition also encouraged
financial institutions to structure highly leveraged credits in a
manner consistent with the risks involved. The HLT definition
has played a role in helping the bank regulatory agencies identify these credits and monitor the risks associated with HLT portfolios over time. At the same time, the supervisory definition of highly-leveraged transactions was not intended to impart supervisory criticism.

With the phase out of the definition, the agencies’ examiners will continue to evaluate, on an annual basis, those credits meeting the Shared National Credit Program criteria to assess the risk posed to insured depository institutions and holding companies by the individual credits, and such credits will be subject to supervisory criticism when appropriate. All other credits will be reviewed, as appropriate, through the normal examination process. Examiners will continue to thoroughly review each borrower’s financial condition, income and cash flow; the value of any collateral or guarantees; the quality and continuity of the borrower’s management; the borrower’s ability to service its debt obligations; and other credit quality considerations. Consistent with sound banking practice, banking organizations will continue to be expected to have systems in place to monitor the risks associated with segments of their lending portfolios, including highly leveraged credits.

The agencies have adopted revisions to the definition to address concerns raised by the application and content of the definition. These revisions in the definition are to be used by banking organizations during the period preceding the discontinuance of the definition to report the level of their HLT exposure as of March 30, 1992 and June 30, 1992. These revisions include: (1) allowing banking organizations to delist certain companies from HLT status that adequately service debt and clearly demonstrate superior cash flow, relative to their respective industry or peer group; (2) reducing the timeframe in which a company’s performance is evaluated before being delisted from HLT status; (3) delisting companies, previously designated as HLT’s, emerging from Chapter 11 bankruptcy that are no longer highly leveraged; and (4) excluding certain loans from HLT reporting when fully collateralized by cash or cash equivalent securities.

Cash Flow Test:

A cash flow test was not included in the original supervisory HLT definition or delisting criteria. Although delisting criteria state that cash flow coverage is to be taken into consideration when reviewing the overall performance of a borrower for delisting, a specific measure was not defined. The reason for not incorporating a specific cash flow test was because (1) the definition was implemented to provide a consistent means of aggregating and monitoring a type of financing transaction, thus relying heavily on a purpose test and an easily-calculated leverage test; (2) it was deemed problematic
to develop a universal cash flow measure that could be used for all industries; and (3) there was a desire to avoid any impression that the definition implied a supervisory criticism of a credit, noting that cash flow is a primary factor in credit quality reviews.

The agencies, in publishing the supervisory definition of highly-leveraged transactions for comment, specifically sought comment on the appropriateness of the inclusion of a cash flow measure. A majority of comments from both companies and banks strongly favored the use of a cash flow test in the HLT definition, particularly for delisting purposes. Some favored a standardized cash flow test; others favored an industry-specific cash flow test; and some expressed a preference for both. Several banks stated, however, that it would be difficult to implement a cash flow measure for initially designating credits as HLTs because the analysis would have to be based on cash flow projections and not on historical performance.

In light of the comments received, the agencies reviewed potential cash flow measures including a debt service coverage ratio, an interest coverage ratio, and a ratio measuring the magnitude of debt in relationship to operating cash flow. All measures proved difficult to define adequately, particularly for use in analyzing companies in different industries. Moreover, it was found to be extremely difficult to establish a standardized level of "acceptable" cash flow that could be applied to all industries.

The agencies concluded that it was not appropriate to adopt a standardized cash flow test; rather, the agencies believe that banking organizations should analyze pertinent cash flow ratios for individual HLT companies, then make a determination as to the quality and strength of each company's cash flow performance, subject to examiner review. Under the revision approved by the agencies, the credits of a highly leveraged company could be considered eligible for delisting by banking organizations on a case-by-case basis, if the company demonstrates superior cash flow coverage, relative to the company's industry or peer group, and the company has adequately serviced debt for a reasonable period of time since its last buyout, acquisition or leveraged recapitalization.

Reduce Timeframes for Delisting:

Presently, a borrower designated as an HLT must show good performance for a minimum of two years from the date of the transaction before being eligible for delisting from HLT status.
After two years, if leverage\(^1\) has been reduced below 75 percent, a borrower becomes eligible for delisting. If a borrower remains highly leveraged, however, the borrower must demonstrate performance for a period of up to four years before being eligible to be delisted from HLT status.

Upon considering the comments received, the agencies have determined that the delisting criteria should be amended by:

(a) Reducing the delisting timeframe from two years to one year for companies that deleverage below 75 percent or were designated as HLTs under the "doubling of liabilities to greater than 50 percent" leverage test. Under this standard, companies would have to continue to meet general performance criteria to be delisted.

(b) Reducing the delisting timeframe from four years to three years for companies that remain highly leveraged. A company would have to demonstrate performance for three consecutive years since its last highly-leveraged transaction and have a positive net worth in order to be eligible for delisting. The requirement that a company's leverage ratio not significantly exceed its industry norm in order to be delisted would be eliminated.

The agencies believe that allowing companies that deleverage themselves to be delisted sooner from HLT status should encourage companies to improve their capitalization and credit standing by reducing leverage and issuing additional equity. These substantive changes to HLT delisting criteria are expected to allow a significant number of companies to be removed from HLT status, given the number of companies recently issuing equity and the number of HLTs that have now aged beyond three years.

**Delist Certain Companies Emerging From Chapter 11 Bankruptcy:**

In previous guidance, post-reorganization debt (after a company emerges from Chapter 11 bankruptcy) of a company that was designated HLT prior to bankruptcy proceedings retained an HLT designation until the company became eligible for delisting. Although a company was often deleveraged as a result of the reorganization, the company could not be delisted for at least two years from the date it was designated as an HLT.

Several comments stated that a company should not be designated HLT upon emerging from Chapter 11 reorganization if leverage is below 75 percent. It was indicated that continuing

\(^1\)The leverage ratio is defined as total liabilities divided by total assets as reflected on financial statements prepared in accordance with generally accepted accounting principles (GAAP).
the HLT designation could interfere with these companies' ability to obtain post-reorganization financing. The agencies recognize that the purpose of Chapter 11 of the bankruptcy code is to help reorganize companies pursuant to a court-approved plan. Further, many reorganized companies emerging from bankruptcy are no longer highly leveraged and are, in essence, operating with a new balance sheet.

Reflecting these views, the Congress in the recently passed banking legislation "Federal Deposit Insurance Corporation Improvement Act of 1991" (Section 474) amended the Federal Deposit Insurance Act to prohibit a federal banking agency from designating by regulation or otherwise a corporation as a highly-leveraged transaction (HLT) solely because such corporation is or has been a debtor or bankrupt under Title 11, if after confirmation of reorganization, such corporation would not otherwise be highly leveraged. In implementing the Congressional intent underlying this amendment, the agencies believe that this should serve to emphasize the role played by the bankruptcy code and remove any implied hindrance to this type of lending.

Exclude Certain Fully-collateralised Loans from HLT Status:

Comments were received on the inclusion of certain loans fully-collateralized by cash or cash equivalent securities in an HLT company's aggregate HLT exposure. It was indicated that the purpose of these fully-collateralized loans is generally not to take on additional debt for acquisition or restructuring purposes. It was also noted that a company arranging such a loan had sufficient liquid resources available on its balance sheet and, therefore, would not have needed to borrow such funds. Given these reasons, the agencies have found it appropriate to exclude certain fully-collateralized loans from HLT reporting by banking organizations.

Other Comments

Comment letters expressed support for several additional revisions to the HLT definition that the agencies have decided not to adopt at this time. Potential revisions that were not adopted include (1) exempting companies with investment-grade senior debt from HLT designation and (2) excluding debt of certain subsidiaries from a consolidated company's HLT designation.

Under HLT guidelines, it is possible for a company with investment-grade senior debt to be designated an HLT if the company has been involved in significant merger and acquisition activity and has very high leverage. Comment letters indicated, however, that very few such companies exist.
To date, investment-grade companies have not been exempted from the HLT definition because of a desire to (1) avoid including credit quality criteria in the definition; (2) avoid inequitable treatment for companies that may meet investment grade criteria but are too small to be evaluated by the major rating agencies; and (3) avoid dependence on outside credit rating agencies, noting that credit quality of a company can quickly deteriorate under the burden of heavy debt.

Based on comment letters received, the agencies have determined that exempting companies with investment-grade senior debt from HLT designation would appear to have little impact on the number of companies designated as HLTs, but it would serve to reinforce the perception that an HLT designation conveys credit quality information or criticism. Some comments noted that financial institutions could publicly disclose the level of investment-grade companies in their HLT portfolios, thus mitigating criticism by analysts of this portion of their portfolios. Given that exempting investment-grade companies from HLT designation could further reinforce negative perceptions concerning the overall credit quality of HLT loan portfolios, the agencies decided not to adopt such a change.

Comments were also received on the inclusion of the debt of subsidiaries as part of the aggregate HLT exposure. According to the HLT guidelines, if a company satisfies the HLT purpose and leverage tests on a consolidated basis, then a loan to any part of the organization is designated HLT. Also, if a subsidiary satisfies the HLT criteria and its debt level is significant enough to cause the consolidated organization to meet HLT leverage criteria, then all debt of the entire organization is designated HLT.

The review of financial statements and calculation of the leverage ratio for HLT purposes is conducted using generally accepted accounting principles (GAAP). Analyzing companies on a consolidated basis when determining HLT status is considered consistent with GAAP. Moreover, experience with consolidated organizations has shown that when one aspect of a company's operations becomes imperiled, the entire organization may be negatively impacted.

Although a significant number of comments favored excluding debt of certain subsidiaries from a parent company's HLT designation if appropriate protective covenants are maintained between the parent and subsidiary, the agencies found significant problems related to the use and review of protective covenants. Protective covenants cited as examples include restrictions on the movement of assets between parent and subsidiary companies, limitations on the payment of dividends to a parent company, restrictions on inter-company debt, and so forth. Each protective covenant, however, is unique, thus requiring a very
difficult and time consuming review and evaluation process to
determine its strength. Also, protective covenants may not work
as specified when a company is in financial difficulty or enters
bankruptcy proceedings. Experience has shown that technical
separation of companies through the use of loan covenants has not
always been effective in protecting a company against liabilities
emanating from its parent, subsidiary, or affiliate, especially
in bankruptcy situations where the separation between parent and
subsidiary can and has been breached.

Given a desire to adhere closely to GAAP whenever possible,
the influence that parent companies can exert over so-called
"stand alone" subsidiaries when financial needs arise, and the
difficulties involved in evaluating and enforcing protective
covenants, the agencies have determined not to exclude certain
subsidiaries of HLT parent companies from the HLT designation.

Definition and Guidance Regarding
Highly-Leveraged Transactions ("HLTs"), As Revised

Summary of Definition

A bank or bank holding company is considered to be involved
in a highly-leveraged transaction when credit is extended to or
investment is made in a business where the financing transaction
involves the buyout, acquisition, or recapitalization of an
existing business and one of the following criteria is met:

(a) the transaction results in a liabilities-to-assets leverage
    ratio higher than 75 percent; or
(b) the transaction at least doubles the subject company's
    liabilities and results in a liabilities-to-assets leverage
    ratio higher than 50 percent; or
(c) the transaction is designated an HLT by a syndication agent
    or a federal bank regulator.

Additional Guidance on the Definition of HLTs

A highly-leveraged transaction is a type of financing which
involves the restructuring of an ongoing business concern
financed primarily with debt. The purpose of an individual
credit is most important when initially determining HLT status.
Once an individual credit is designated as an HLT, all currently
outstanding and future obligations of the same borrower are also
included in HLT totals. This includes working capital loans and
other ordinary credits, until such time as the borrower is
delisted.
The regulatory purpose of the HLT definition is to provide a consistent means of aggregating and monitoring this type of financing transaction. It must be pointed out that the HLT designation does not imply a supervisory criticism of a credit. Before any HLT or any other credit is criticized, an examiner should review a whole range of factors on a credit-by-credit basis. These factors include cash flow, general ability to pay interest and principal on outstanding debt, economic conditions and trends, the borrower's future prospects, the quality and continuity of the borrower's management, and the lender's collateral position. Participation of banking organizations in highly-leveraged transactions is not considered inappropriate so long as it is conducted in a sound and prudent manner, including the maintenance of adequate capital and loan loss reserves to support the risks associated with these transactions.

Borrowers having questions regarding the HLT definition should first refer these questions to their bankers. Bankers should then refer questions they cannot answer to the bank's primary federal regulator.

Purpose Test

To become eligible for designation as an HLT, a financing transaction must involve the buyout, acquisition, or recapitalization of an existing business, domestic or foreign. This definition encompasses traditional leveraged buyouts, management buyouts, corporate mergers and acquisitions, and significant stock buybacks. Leveraged Employee Stock Option Plans (ESOPs) are also included when used to acquire or recapitalize an existing business.

For purposes of satisfying the HLT purpose test, a leveraged recapitalization involves a replacement of equity with debt on a company's balance sheet by means of a stock repurchase or dividend payout. Refinancing existing debt in a company is not deemed to be a leveraged recapitalization.

Exclusions from the HLT Definition:

Single Asset or Lease: This purpose test excludes the acquisition or recapitalization of a single asset or lease (e.g., a large commercial building or an aircraft), or a shell company formed to hold a single asset or lease, from the HLT definition. Although such an acquisition may be highly leveraged, the asset or lease, in and of itself, is not considered an ongoing business concern and, therefore, is not intended to be included in the HLT category. However, the acquisition or recapitalization of a leasing corporation which invests in fleets of equipment for leasing, or a building company which invests in real estate projects would satisfy the HLT purpose test.
Threshold Test: Loans and exposures to any obligor in which the total financing package, including all obligations held by all participants, does not exceed $20 million, at the time of origination, may be excluded from HLT designation. Nonetheless, there may be some banking organizations that in the aggregate have significant exposure to transactions below the threshold level. It is expected that those organizations would continue to monitor these transactions as part of their aggregate HLT exposures.

Historical Cutoff Date: An HLT transaction not included in the Shared National Credit Program, that meets or exceeds the $20 million test, may be excluded from HLT designation if it originated prior to January 1, 1987, the original terms and conditions of the credit are materially unchanged, the credit has not been criticized by examiners, and the financial condition of the debtor has not deteriorated.

Debtor-in-Possession Financings: Court-approved debtor-in-possession (or trustee-in-possession) financing for a business concern in Chapter 11 reorganization proceedings will generally be exempt from HLT designation. All pre-petition debt of an HLT borrower and any post-reorganization debt (after a company emerges from Chapter 11 bankruptcy) will continue to be included in HLT exposure until delisting occurs.

Loans Fully-Collateralized With Cash or Cash Equivalents: All loans (credit facilities) that are fully-collateralized with cash or cash equivalents are excluded from HLT reporting by banking organizations. Cash collateral consists of a deposit in the financial institution advancing the loan proceeds, segregated and under the control of the financial institution, and unequivocally pledged to secure the loan. Cash equivalents are deemed to include U.S. Government and certain other readily-marketable securities qualifying for a zero risk-weight under risk-based capital standards. Cash equivalents must be held in custody by and unequivocally pledged to the lending financial institution.

Leverage Tests

In addition to the purpose test, one of the following criteria must be met for the transaction to be considered an HLT:

1) The transaction at least doubles the subject company's liabilities and results in a total liabilities to total assets (leverage) ratio higher than 50 percent.

NOTE: The purpose of this leverage test is to capture transactions in which a company must suddenly deal with a substantially higher debt burden. The greatest risk in a credit exposure is not necessarily the absolute level of debt but may be the impact on a company of significant new
A key HLT success factor is ability to handle a sudden, large increase in debt.

The "doubling of liabilities" is intended to capture those transactions where new debt is used to facilitate the buyout, acquisition, or recapitalization of a business. If the sum of the acquiring and acquired companies' liabilities would double as a result of the new debt taken on to effect the combination of the companies, then the transaction is considered an HLT, and all exposure to the company is designated an HLT. It is not intended to cover a doubling resulting from the simple addition of the existing liabilities of the two companies.

Any refinanced portion of old debt in a transaction should continue to be treated as old debt for purposes of applying this leverage test. Further, if there was no debt in either company prior to the transaction, then any new debt will result in a "doubling of liabilities."

In an acquisition involving one or more operating divisions of a company (as opposed to stand-alone subsidiaries), existing liabilities of the seller associated with specific operating assets being transferred in the transaction may be allocated to the resulting company for purposes of applying the "doubling of liabilities" test. The burden of proof is on the resulting company and its financial institution(s) to substantiate that the allocation of the seller's liabilities to the resulting company is appropriate.

When calculating a company's leverage for the purpose of this test, captive finance company subsidiaries and subsidiary depository institutions should be excluded from the consolidated organization.

The transaction results in a total liabilities to total assets (leverage) ratio higher than 75 percent.

NOTE: When a company's leverage ratio exceeds 75 percent, the determination of whether exposure to the company is designated an HLT further depends on the composition of the company's total liabilities after the transaction. If a significant portion of the liabilities (generally 25 percent or more of total liabilities) derives from buyouts, acquisitions, or recapitalizations, either past or present, then all exposure to the company is designated an HLT. If, after the transaction, debt related to buyouts, acquisitions, or recapitalizations, either past or present, represents less than 25 percent of total liabilities, then the exposure to the company need not be designated an HLT.
Again, when calculating a company's leverage for the purpose of this test, captive finance company subsidiaries and subsidiary depository institutions should be excluded from the consolidated organization.

3) The transaction is designated an HLT by a syndication agent.

In specific cases, the bank supervisory agencies may also designate a transaction as an HLT even if it does not meet the conditions outlined above. (It is anticipated that this would be done infrequently and only in material cases.)

**Definition of the Leverage Ratio**

The leverage ratio is total liabilities divided by total assets as reflected in financial statements prepared in accordance with generally accepted accounting principles (GAAP). Total assets of the resulting enterprise include intangible assets (such as goodwill). Total liabilities include all forms of debt (including any new debt taken on to facilitate the transaction) and claims, including all subordinated debt and non-perpetual preferred stock. Perpetual preferred stock is generally considered equity for purposes of calculating HLT leverage. However, exceptions could be made on a case-by-case basis if the stock has characteristics more akin to debt than equity.

Off-balance sheet exposure, including claims related to foreign exchange contracts, interest rate swaps, and other risk protection or cash management products may normally be excluded from HLT exposure as long as their credit equivalent exposure is small relative to other types of obligations. (It is expected, however, that internal management information and control systems be in place to capture these exposures.)

If a parent company uses "double leverage" (that is, takes on debt and downstreams it as equity to a subsidiary) to assist a subsidiary in an HLT purpose-related transaction, then the debt at the parent company will be considered HLT purpose-related debt when calculating leverage for the company on a consolidated basis.

In an acquisition involving a pure assumption of debt with no new debt issued, the transaction is not designated an HLT unless the resulting company's aggregate outstanding HLT purpose-related debt (from all previous transactions) is significant (generally 25 percent or more of total liabilities) and the 75 percent leverage test is satisfied.
Consolidation of HLT Exposure

All credit extended to, or investments made in an HLT should be aggregated with any ordinary business loans to, or investments in, the same obligor.

If a company satisfies the HLT purpose and leverage tests on a consolidated basis, then a loan to any part of the organization is deemed to be an HLT. On the other hand, if only a subsidiary of a company satisfies the HLT tests, then the subsidiary could "stand alone" as an HLT; however, if the subsidiary's debt level is significant enough to cause the consolidated organization to meet HLT leverage criteria, then all debt of the entire organization is designated HLT.

Guarantees of Payment

If a parent company supplies an irrevocable, unconditional guarantee of payment on behalf of its subsidiary and the leverage of the consolidated organization does not meet HLT leverage criteria, then the subsidiary will generally not be designated an HLT. On the other hand, if the subsidiary's leverage is significant enough to cause the consolidated organization to meet HLT leverage criteria, then all debt of the entire organization is accorded HLT status. (NOTE: Third-party guarantees and guarantees by related subsidiaries of a company have no effect on the HLT designation. While these types of guarantees offer credit enhancement benefits which will be taken into consideration during the review of individual credits by examiners, they generally lack the stronger bonds of support inherent in the relationship between a parent and its subsidiary.)

When a foreign parent company provides the equivalent of an irrevocable and unconditional guarantee of payment on behalf of a subsidiary, the subsidiary's debt will normally not be designated as HLT debt as long as the consolidated organization does not meet HLT leverage criteria and the following two conditions are met:

(1) Written opinions from legal counsel in the country of origin and the United States are provided which state that the equivalent of a written guarantee of debt repayment exists which is irrevocable and unconditional; and

(2) The credit files in the U.S. banking organizations lending to the subsidiary contain consolidated financial statements for the foreign parent stated in U.S. dollars under U.S. accounting rules.
Agent and Lead Bank Responsibility

To ensure consistent application of the definition, the agent or lead bank is responsible for determining whether or not a transaction qualifies as an HLT. The agent or lead bank is charged with the timely notification to participants regarding the status of the transaction and of any change in that status, i.e. designation as an HLT or delisting as an HLT.

The responsibility of the agent or lead bank to determine HLT status does not preclude a participant bank from designating a transaction as an HLT or relieve a participant from performing its own credit analysis. Examiners will review transactions for compliance with the HLT definition in the context of the Shared National Credit Program and during regular on-site examinations.

Delisting Criteria

HLT exposure of a given borrower may be removed from HLT status upon satisfying one of the following criteria:

(a) Credits of a company emerging from protection under Chapter 11 of the U.S. Bankruptcy Code at the consummation of a court-approved plan of reorganization will be immediately delisted from HLT status, if the company's leverage ratio is less than 75 percent at the time of reorganization.

(b) A borrower's credits that were designated as HLTs under the "doubling of liabilities to greater than 50 percent" leverage test or that have reduced leverage to less than 75 percent will be considered eligible for delisting if the company has performed well for one year (since its last buyout, acquisition, or leveraged recapitalization involving financing) and demonstrates an ability to continue satisfactorily servicing debt. To verify adequate performance and validate the appropriateness of financial projections of a company, the lender should conduct a thorough review of the obligor to include, at a minimum, overall management performance against the business plan, cash flow coverages, operating margins, industry risk, and status of asset sales, if applicable.

(c) Credits of a company whose leverage continues to exceed the 75 percent leverage test will be considered eligible for delisting by banking organizations on a case-by-case basis, if the company demonstrates superior cash flow coverage, relative to the company's industry or peer group, and the company has adequately serviced debt for a reasonable period of time since its last buyout, acquisition, or leveraged recapitalization involving financing. To verify strong performance, the lender should conduct a thorough review of the obligor to include, at a minimum, the quality and
strength of cash flow coverages, operating margins, reduction in leverage, appropriateness of the company's financial projections, overall management performance against the business plan, industry risk, and status of asset sales, if applicable. Credits delisted in this manner will subsequently be reviewed, and potentially subject to relisting, by examiners during the normal course of an examination.

(d) Credits of a company whose leverage continues to exceed the 75 percent leverage test will be considered eligible for delisting if the company has performed adequately for at least three years since its last buyout, acquisition, or leveraged recapitalization involving financing; and the company has a positive net worth. To verify adequate performance and validate the appropriateness of financial projections of a company, the lender should conduct a thorough review of the obligor to include, at a minimum, overall management performance against the business plan, cash flow coverages, operating margins, industry risk, and status of asset sales, if applicable.

It is expected that banks will maintain records of delisted exposures and reasons for delisting. After delisting, any significant changes in the obligor's financial condition should cause the exposure to be reviewed for relisting. Records pertaining to delisting and relisting of ETLs will be reviewed by examiners in the context of the Shared National Credit Program and/or regular on-site examinations.

Date
Robert L. Clarke
Comptroller of the Currency

Date
Hoyle L. Robinson
Executive Secretary of the Federal Deposit Insurance Corporation

2/6/92
(signed) William W. Wiles

Date
William W. Wiles
Secretary of the Board of Governors of the Federal Reserve System
BILLING CODES:

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ACTION REQUESTED: The Board's approval to request public comment for a 30-day period on a proposal developed on a coordinated basis by the staffs of the OCC, FDIC, OTS, and the Federal Reserve to achieve uniformity in the treatment of intangible assets for regulatory capital purposes.

As described below, the interagency staff proposal would establish the types of and quantitative limits on intangible assets includable in capital for purposes of calculating risk-based and leverage capital ratios. Purchased mortgage servicing rights ("PMSRs") and purchased credit card relationships ("PCCRs"), subject to an overall aggregate limit of 50 percent of Tier 1 capital and a separate sublimit of 25 percent of Tier 1 capital for PCCRs, would qualify for inclusion in capital. The proposal excludes all core deposit intangibles ("CDIs") from capital. In addition, goodwill will continue to be excluded from capital consistent with longstanding policy and the risk-based capital framework. Staff is also proposing that the

* Messrs. Struble, Cole, Pugh, and Holm and Ms. Barger.
suggested changes in the capital treatment of intangible assets be incorporated into the capital ratios used for both examinations and applications purposes. Consistent with the Board's existing capital guidelines, however, the Board may in certain cases continue to evaluate an organization's tangible capital ratios (after deducting all intangibles) in assessing its overall capital adequacy, if warranted by the condition of the organization.

The attached draft Federal Register notice requesting public comment sets forth in detail the revisions to the Board's risk-based and leverage capital guidelines that would be necessary if, after reviewing the comments and further consideration, the Board decides to implement the interagency staff proposal.¹

**SUMMARY:** With the Board's approval, public comment will be sought on proposed revisions to the Federal Reserve's capital adequacy guidelines that would provide explicit guidance to state member banks and bank holding companies on the treatment of identifiable intangible assets for purposes of calculating their risk-based and leverage capital ratios. The proposal was developed and is being released for public comment on a

¹Prior to publication of this proposal in the Federal Register, Board staff will consult upon the final wording of the proposal with the staffs of the FDIC, OCC, and OTS. Accordingly, staff seeks approval to make insignificant changes in wording, if and as necessary, to achieve final interagency agreement. Any significant changes would be referred to the Board for discussion or notation vote as appropriate.
coordinated basis with the FDIC, OCC, and OTS in order to achieve uniformity among the banking agencies in the capital treatment of these assets in a manner that is consistent with the international risk-based capital standards.

The proposal would permit banking organizations to include in capital (that is, not deduct from capital) purchased mortgage servicing rights ("PMSRs") and purchased credit card relationships ("PCCRs"), provided that, in the aggregate, they do not exceed 50 percent of Tier 1 capital. PCCRs would be subject to a separate sublimit of 25 percent of Tier 1. PMSRs and PCCRs in excess of these limits, as well as core deposit intangibles and all other identifiable intangible assets, would be deducted from Tier 1. A reasonably active and liquid market exists for the identifiable intangible assets that are being proposed for inclusion in Tier 1 capital, i.e., PMSRs and PCCRs. In addition, the market values of these assets generally are not affected by the financial condition of the organization that owns them.

In order to implement a provision of the Federal Deposit Insurance Corporation ("FDIC") Improvement Act of 1991 and to achieve consistency with current FDIC and OTS rules regarding the valuation of PMSRs, the proposal states that the fair market value and book value of PMSRs must be determined at least quarterly in accordance with certain criteria and that, for purposes of calculating regulatory capital (but not for financial statement purposes), the amount of PMSRs reported on the balance sheet would be reduced to the lesser of: 90 percent of their
fair market value, 90 percent of their original purchase price, or 100 percent of their remaining unamortized book value. The proposal would also require banking organizations to subject their PCCRs to the same valuation and discounting approaches as those proposed for PMSRs.

BACKGROUND: Currently, the four federal banking agencies differ somewhat with regard to the treatment of identifiable intangible assets (that is, intangible assets other than goodwill) in the calculation of regulatory capital ratios. The FDIC and OCC fully deduct all intangibles other than PMSRs from Tier 1 capital. The Federal Reserve does not automatically deduct any identifiable intangible assets from Tier 1 capital, but determines the appropriateness of their inclusion in an organization's capital position on a case-by-case basis and has long considered the level and quality of identifiable intangible assets in assessing the capital adequacy and overall asset quality of banking institutions. In addition, in reviewing expansionary proposals by banking organizations, the Federal Reserve considers both an organization's stated capital as well as its tangible capital. The OTS deducts all intangibles other than PMSRs unless an institution can document that its holdings of other intangibles meet certain criteria, in which case they may be included in capital.

All the agencies specify limits for the amount of intangibles that institutions can include in capital. The OCC
permits PMSRs to account for up to 25 percent of Tier 1 capital, while the FDIC permits them to account for up to 50 percent of Tier 1. The OTS also permits PMSRs to be included up to 50 percent of Tier 1 capital and limits other qualifying intangibles (e.g., CDIs) to 25 percent of Tier 1 capital. The Board's current risk-based capital guidelines indicate that while all intangible assets will be monitored, identifiable intangible assets in excess of 25 percent of Tier 1 capital are subject to particularly close scrutiny.

The FDIC and OTS also subject PMSRs to certain valuation and discounting requirements. These agencies require institutions to determine the fair market value of PMSRs by applying an appropriate market discount rate to the net servicing cash flows, taking into account any significant changes in original valuation assumptions such as prepayment estimates. The FDIC and OTS rules also require that the book value of PMSRs be reviewed quarterly. If an institution wishes to allow PMSRs to be recognized for inclusion in regulatory capital, it must carry them at a book value equal to the discounted value of their future net servicing income.

For some time, the banking agencies have been reviewing the capital treatment of identifiable intangible assets with the aim of developing greater uniformity among the agencies in the treatment of these assets for capital adequacy purposes. On the basis of this review, the staff is proposing to issue for public comment revisions to the Board's capital adequacy guidelines to
provide explicit guidance on the types of intangible assets that state member banks and bank holding companies may include in capital and specifications on appropriate limits within capital. The proposal, which is set forth in the attached draft Federal Register notice, is based on a tentative agreement on the treatment of intangible assets reached by the staffs of the Federal Reserve, the FDIC, the OCC, and the OTS. The proposal is released for public comment on a coordinated basis with these other agencies in order to achieve uniformity among the banking agencies in the capital treatment of these assets. The proposal is consistent with international capital standards.

The proposal states that banking organizations would be permitted to include PMSRs and PCCRs in capital, provided that, in the aggregate, the amount of these assets included does not exceed 50 percent of an organization's Tier 1 capital. PCCRs would be subject to a separate sublimit of 25 percent of Tier 1. Amounts of PMSRs and PCCRs in excess of these amounts, as well as all other identifiable intangible assets, including CDIs, would be deducted from Tier 1 for purposes of calculating regulatory capital ratios. As set forth in more detail in the attached Federal Register notice, the exclusion of CDIs from Tier 1 capital reflects the interagency staff consensus that these intangible assets have many of the characteristics of goodwill.

For purposes of calculating the limitations on PMSRs and PCCRs includable in capital as a percentage of Tier 1 capital, Tier 1 is defined as the sum of core capital elements net of goodwill and identifiable intangible assets other than PMSRs and PCCRs.
and that their value tends to fall significantly when a depository institution experiences financial difficulty.

Staff believes that this proposal represents a reasonable compromise among the banking agencies' current rules with regard to the types and amounts of intangible assets that may be included in capital. In staff's view, the proposed approach offers a basis for achieving consistency among the banking agencies in their capital treatment of identifiable intangible assets while preserving the integrity of the capital definition.

The proposal also deals with the valuation of PMSRs consistent with provisions of the FDIC Improvement Act of 1991, which was recently signed into law. Section 475 of the Act requires that the value of PMSRs included in calculating an institution's capital not exceed 90 percent of their fair market value and that such value be determined at least quarterly. In order to implement the valuation provisions of section 475 and in the interests of achieving consistency in the treatment of intangible assets among the banking agencies, the proposal states that institutions must determine the fair market value and the book value of their PMSRs at least quarterly in accordance with the criteria discussed above that the FDIC and OCC currently employ in their rules regarding PMSRs. The proposal also indicates that the discount rate used for the calculation of book value should not be less than that derived at the time of acquisition, based upon the estimated cash flows and the price
paid for the asset at the time of purchase.

In order to implement the discount on PMSRs required under section 475, the proposal states that, for purposes of calculating regulatory capital (but not for financial statement purposes), the amount of PMSRs reported on the balance sheet asset would be reduced to the lesser of:

(i) 90 percent of the fair market value of the PMSRs; or
(ii) 90 percent of the original purchase price paid for the PMSRs; or
(iii) 100 percent of the remaining unamortized book value of the PMSRs.

This discounting approach is the same as that which the FDIC and OTS currently require state nonmember banks and savings associations to apply to their holdings of PMSRs. Staff is proposing that the Board seek specific public comment on the approach discussed above to the valuation and discounting for PMSRs includable in capital.

Since the calculation of the fair market value for PCCRs is at least as subjective as it is for PMSRs, the proposal also would require that PCCRs be subject to a discount. In order to achieve consistency in the valuation of identifiable intangible assets included in capital, the proposal indicates that banking organizations will also be required to determine the fair market value and book value of their PCCRs at least quarterly, using the same criteria as those proposed for PMSRs, and to subject their PCCRs to the same value adjustment as that proposed for PMSRs. In this connection, the proposal
specifically seeks public comment on this approach to the valuation and discounting for PCCRS.

Staff is also proposing that the suggested changes in the capital treatment of intangible assets be incorporated into the capital ratios used for both examinations and applications purposes. Consistent with the Board's existing capital guidelines, however, the Board may in certain cases continue to evaluate an organization's tangible capital ratios (after deducting all intangibles) in assessing its overall capital adequacy, if warranted by the condition of the organization.

Attachment
AGENCY: Board of Governors of the Federal Reserve System.
SUMMARY: The Board is seeking comment on a proposal to revise the Federal Reserve's capital adequacy guidelines for bank holding companies and state member banks to provide explicit guidance on the types of intangible assets that may be included (i.e., not deducted) in the Tier 1 capital calculation for risk-based and leverage capital purposes. The proposal also includes limits and discounts that would be applicable to such intangibles includable in capital. The proposal, which was developed in conjunction with the staffs of the four federal banking agencies, is aimed at achieving greater consistency among the agencies with respect to the capital treatment of intangible assets and is being released for public comment on a coordinated basis with these agencies. The proposal is consistent with the international capital standards.

Under the proposal, purchased mortgage servicing rights ("PMSRs") and purchased credit card relationships ("PCCRs") would be includable in the Tier 1 capital computation provided that, in
the aggregate, they do not exceed a limit of 50 percent of Tier 1 capital and provided that PCCRs not exceed a sublimit of 25 percent of Tier 1. PMSRs and PCCRs in excess of these limits, as well as core deposit intangibles ("CDIs") and all other intangible assets, would be deducted from the sum of the core capital elements in determining Tier 1 capital.

In order to implement a provision of the Federal Deposit Insurance Corporation ("FDIC") Improvement Act of 1991 and to conform to the current rules of the FDIC and the Office of Thrift Supervision ("OTS"), the Board also is proposing that institutions be required to determine the fair market value and book value of their PMSRs at least quarterly in accordance with certain criteria. In addition, for purposes of calculating regulatory capital (but not for financial statement purposes), institutions would be required to reduce the amount of PMSRs reported on the balance sheet to the lesser of 90 percent of their fair market value, 90 percent of their original purchase price, or 100 percent or remaining unamortized book value.

The proposal states that organizations must also determine the fair market value and book value of PCCRs at least quarterly, in accordance with certain criteria, and subject PCCRs to the same value adjustment as that proposed for PMSRs. The Board is specifically seeking comment on this approach to valuing and discounting PMSRs and PCCRs.

The proposed changes in the capital treatment of intangible assets would be incorporated into the capital ratios
used for both examinations and applications purposes. Consistent with the Board's existing capital guidelines, however, the Board may in certain cases continue to evaluate an organization's tangible capital ratios (after deducting all intangibles) in assessing its overall capital adequacy, if warranted by the condition of the organization.

DATE: Comments on the proposed revisions to the Federal Reserve Board's risk-based capital guidelines and leverage capital guidelines should be submitted on or before [30 days after publication].

ADDRESS: Comments, which should refer to docket No. _____, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenues, N.W., Washington, D.C. 20551; or delivered to Room B-2223, Eccles Building, between 8:30 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in section 2612.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Rhoger H Pugh, Manager (202/728-5883), Norah M. Barger, Supervisory Financial Analyst (202/452-2402), Charles H. Holm, Supervisory Financial Analyst (202/452-3502), Division of Banking Supervision and Regulation;
SUPPLEMENTARY INFORMATION:
I. Background

The Board is proposing to revise the Federal Reserve's capital adequacy guidelines for bank holding companies and state member banks to provide explicit guidance on the types of intangible assets that may be included in (i.e., not deducted from) the Tier 1 capital calculation for risk-based and leverage capital purposes and the limits and discounts that would be applicable to such intangibles includable in capital. The proposal is based on a tentative agreement on the treatment of intangible assets reached by the staffs of the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency ("OCC"), and the OTS. It is being released for public comment on a coordinated basis with these other agencies in order to achieve uniformity among the banking agencies in the capital treatment of these assets in a manner that is consistent with the international capital standards (Basle Accord).¹

¹The Basle Accord is a risk-based capital framework that was proposed by the Basle Committee on Banking Regulations and Supervisory Practices and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Committee is comprised of representatives of the central banks and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.
The Basle Accord requires that banks deduct goodwill from their core capital elements in determining Tier 1 capital for risk-based capital purposes. The Basle framework, which by its terms applies only to internationally active banks, was adopted by the Federal Reserve for all state member banks. In addition, the Board chose to apply a risk-based capital framework similar to the Basle Accord to U.S. bank holding companies, generally on a consolidated basis. Under this framework, bank holding companies are also required to deduct goodwill from Tier 1 capital. Furthermore, the Board has adopted a leverage capital standard for state member banks and bank holding companies. Since Tier 1 capital serves as the numerator of the leverage ratio, goodwill also is deducted from the core capital elements for purposes of the leverage standard.

The Basle Accord does not address the treatment of intangible assets other than goodwill, that is, identifiable intangible assets. Consequently, U.S. bank regulators have discretion in specifying the treatment of these other intangible assets.

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2The risk-based capital guidelines utilize the ratio of a banking organization's Tier 1 capital, which is composed of core capital elements such as common and perpetual preferred stock, and Tier 2 capital, which is composed of supplementary capital elements such as the allowance for loan and lease losses and subordinated debt, to the organization's total on-balance sheet assets and off-balance credit arrangements, adjusted for their relative risks.

3For bank holding companies with consolidated assets of less than $150 million in assets, the risk-based capital guidelines generally are applied on a bank-only basis.

4The leverage capital guidelines utilize a ratio of the bank's Tier 1 capital elements to its total on-balance sheet assets.
assets, provided that such treatment is consistent with the spirit of the Basle Accord. The basic approach taken by the Federal Reserve and the other U.S. banking agencies in determining the treatment of identifiable intangible assets has been to evaluate them on the basis of the following criteria:

1. The reliability and predictability of any cash flows associated with the asset and the degree of certainty that can be achieved in periodically determining the asset's useful life and value;

2. The marketability of the asset, i.e., the existence of an active and liquid market; and

3. The salability of the asset, i.e., the feasibility of selling the asset apart from the banking organization or from the bulk of its assets.

All the agencies have determined that PMSRs generally meet these criteria and all allow such assets in Tier 1 capital, subject to certain limits. The agencies differ on the extent to which other intangibles meet the criteria and follow somewhat different procedures regarding their treatment.

The FDIC and OCC fully deduct all intangibles other than PMSRs from Tier 1 capital. The Federal Reserve does not automatically deduct any identifiable intangible asset from Tier 1 capital, but determines the appropriateness of their inclusion in the calculation of an organization's capital position on a case-by-case basis. Because even those intangible assets that meet the above criteria generally contain a high degree of risk,
the Board has long considered the level and quality of identifiable intangible assets in assessing the capital adequacy and overall asset quality of banking institutions. The OTS has concluded that, at least in some cases, certain other identifiable intangible assets (e.g., CDIs) may meet the three criteria and, therefore, has not required the deduction of some of these other identifiable intangible assets in calculating capital ratios.

All the agencies specify limits for the amount of intangibles that institutions can include in capital. The OCC permits PMSRs to account for up to 25 percent of Tier 1 capital. The OTS permits PMSRs to be included up to 50 percent of Tier 1 capital, and other qualifying intangibles (e.g., CDIs) are limited to 25 percent of Tier 1 capital. The FDIC permits PMSRs up to 50 percent of Tier 1 capital. The Board's current risk-based capital guidelines indicate that while all intangible assets will be monitored, identifiable intangible assets in excess of 25 percent of Tier 1 capital are subject to particularly close scrutiny, both through the inspection and examination process and by other appropriate means.

The FDIC and the OTS also impose certain valuation requirements for determining the fair market value and book value of PMSRs. In addition, their capital rules state that for purposes of calculating regulatory capital (but not for financial statement purposes) the amount of PMSRs reported on the balance sheet will be reduced to the lesser of:
(i) 90 percent of the fair market value of the PMSRs; or
(ii) 90 percent of the original purchase price paid for the PMSRs; or
(iii) 100 percent of the remaining unamortized book value of the PMSRs.

For some time, the banking agencies have been reviewing the capital treatment of identifiable intangible assets with the aim of developing greater uniformity among the agencies in the treatment of these assets for capital adequacy purposes. On the basis of this review, the Board is now proposing to issue for public comment revisions to its capital adequacy guidelines to provide explicit guidance on the types of intangible assets that may be included in capital and specifications on appropriate limits within capital. The proposed revisions are based on a tentative agreement reached by the staffs of the four federal banking agencies with respect to the regulatory capital treatment of intangible assets.

The Federal Reserve is also proposing that PMSRs be subject to certain valuation requirements that are consistent with provisions of the FDIC Improvement Act of 1991 and with the current FDIC and OTS rules regarding PMSRs. The Act requires that the value of readily marketable PMSRs included in the calculation of an institution's capital not exceed 90 percent of their fair market value and that such value be determined at least quarterly. The current FDIC and OTS rules regarding PMSRs set down criteria for determining both the fair market value and
book value of these assets. Since the calculation of the fair market value for PCCRs is at least as subjective than it is for PMSRs, the Federal Reserve is also proposing that PCCRs be subject to the same valuation requirements as PMSRs.

The proposed changes in the capital treatment of intangible assets would be incorporated into the capital ratios used for both examinations and applications purposes. Consistent with the Board's existing capital guidelines, however, the Board may in certain cases continue to evaluate an organization's tangible capital ratios (after deducting all intangibles) in assessing its overall capital adequacy, if warranted by the condition of the organization.

II. Proposal

The Board is proposing the following treatment for identifiable intangible assets for purposes of the risk-based and leverage capital guidelines:

1. PMSRs and PCCRs would be considered qualifying intangible assets. As such, they would not have to be deducted from capital provided that, in the aggregate, they do not exceed 50 percent of Tier 1 capital and provided that PCCRs do not exceed a sublimit of 25 percent of Tier 1 capital. PMSRs and PCCRs in excess of these limits would be deducted from the core capital elements in determining Tier 1 capital.

2. The limits on PMSRs and PCCRs would be based on a
percentage of Tier 1 capital before excess holdings of these assets are deducted, but after goodwill and all other nonqualifying identifiable intangible assets (e.g., CDIs) are deducted.

3. Institutions would be required to determine the fair market value and to review the book value of their PMSRs and PCCRs at least quarterly. Banking organizations that wish to include these assets in capital will be not be able to carry them at a book value that exceeds the discounted value of their future net income.

4. For purposes of calculating regulatory capital (but not for financial statement purposes) the amount of PMSRs and PCCRs reported on the balance sheet asset would be reduced to the lesser of 90 percent of their fair market value, 90 percent of their original purchase price, or 100 percent of their remaining unamortized book value. The Board is seeking specific public comment on the proposed approach to discounting PMSRs and PCCRs, which is currently employed by the FDIC and the OTS for PMSRs.

5. CDIs and all other identifiable intangible assets would be deducted from the core capital elements for purposes of calculating an institution’s Tier 1 capital, just as, in accordance with the Basle Accord, goodwill is deducted.
Including and Limiting PMSRs and PCCRs within Capital

The Board believes that PMSRs and PCCRs for the most part meet the three criteria outlined in the previous section that the agencies use to evaluate identifiable intangible assets. Thus, deduction of such assets for purposes of calculating the risk-based and leverage capital ratios generally would not be necessary provided these assets do not exceed specified limits.

With regard to the two criteria that pertain to the marketability and salability of intangible assets, the Board believes that fairly active and liquid markets exist for PMSRs and credit card portfolios, and thus it is feasible to sell these assets apart from the banking organization or the bulk of its assets. Since the reliability of cash flows and market value of these assets can vary significantly, however, the Board is proposing to limit the amount of PMSRs and PCCRs includable in capital.

The uncertainty associated with the cash flows and market value of PMSRs stems from the fact that changes in the level of interest rates can have a significant effect on mortgage prepayment expectations. Furthermore, the cash flows and value of PMSRs are affected by credit quality risks and operating risks associated with mortgage servicing rights. Because the servicer is generally obligated to provide a steady cash flow to the owner of the mortgage and undertake normal collection efforts and foreclosure, the servicer can incur a significant increase in collection and administrative costs when a mortgage becomes
delinquent. In addition, under some arrangements, known as "recourse" servicing arrangements, the servicer also guarantees the repayment of the loans. The ability of borrowers to repay the loans can have the greatest impact on the value of the servicing in such arrangements.

The value and cash flows associated with PCCRs, like those associated with PMSRs, are affected by changes in interest rates and credit quality factors. They also can be significantly affected by the amount of future borrowings under the credit card lines of credit; the attrition rate, \( \lambda \), the rate at which credit cardholders terminate their relationships, which could be due to the failure of the bank to offer competitive terms and features; and other factors.

Given the volatility of the cash flows and market values associated with PMSRs and PCCRs, the Board is proposing that the aggregate amount of such assets includable in capital be limited to 50 percent of Tier 1 capital. Furthermore, since the value of PCCRs is dependent upon many assumptions and the market for PCCRs is less mature and liquid than the market for PMSRs, the Board is proposing that PCCRs be subject to a separate sublimit of 25 percent of Tier 1 capital. During the period in which this proposal is out for public comment, the Board believes that it would be inadvisable for a banking organization to acquire intangible assets in an amount that would cause its total holdings of identifiable intangible assets, including PMSRs and PCCRs, to exceed 25 percent of Tier 1 capital, above which limit
intangible assets are subject to particularly close scrutiny under the Board’s current risk-based capital guidelines.

In order to provide for a simple method of calculating these limits, the Board is proposing that the limits be based on a percentage of Tier 1 capital before excess holdings of these assets are deducted, that is, the sum of core capital elements (e.g., common and perpetual preferred equity) less goodwill and other nonqualifying intangible assets. This method of calculation could result in the inclusion in capital of PMSRs and PCCRs in an amount far greater than 50 percent, and of PCCRs in an amount far greater than 25 percent of Tier 1 capital net of goodwill, other nonqualifying intangible assets, and deductible amounts of PMSRs and PCCRs. It would be possible for an institution to report positive Tier 1 capital even though its PMSRs and PCCRs exceed the sum of its core capital elements.

Accordingly, the Board is proposing to add cautionary language to its capital adequacy guidelines regarding excessive holdings of intangible assets included in capital, which may be viewed as an unsafe and unsound practice.

**Valuation of PMSRs and PCCRs**

Section 475 of the FDIC Improvement Act of 1991 requires that the amount of PMSRs included in the calculation of an institution’s capital not exceed 90 percent of their fair market value, determined on a quarterly basis. The FDIC and OTS rules regarding PMSRs at present require institutions to
determine the fair market value of these assets by applying an appropriate market discount rate to the net servicing cash flows, taking into account any significant changes in original valuation assumptions such as prepayment estimates. The FDIC and OTS rules also contain certain requirements with regard to the determination of the book value of PMSRs, which is to be reviewed quarterly. Under these rules, if an institution wishes to include PMSRs assets in regulatory capital, the book value of these assets may not exceed the discounted amount of their estimated future net servicing income.

In order to implement the valuation provisions of Section 475 and in the interests of achieving consistency in the treatment of intangible assets among the banking agencies, the Board is proposing to require institutions to determine the fair market value and the book value of their PMSRs at least quarterly in accordance with the criteria established by the FDIC and the OTS in their rules regarding PMSRs. The discount rate used for the calculation of book value should not be less than that derived at the time of acquisition, based upon the estimated cash flows and the price paid for the asset at the time of purchase.

In order to implement the discount on PMSRs required under Section 475, the Board is also proposing to use the discounting approach currently employed by the FDIC and the OTS for state nonmember banks and savings associations. Under this approach, for purposes of calculating regulatory capital (but not for financial statement purposes), institutions would be required
to reduce the amount of PMSRs reported on the balance sheet asset to the lesser of:

(i) 90 percent of their fair market value; or
(ii) 90 percent of the original purchase price paid for the assets; or
(iii) 100 percent of their remaining unamortized book value.

If both the application of the limit on PMSRs and the adjustment of the balance sheet asset for PMSRs would result in an amount being deducted from capital, the banking organization would deduct only the greater of the two amounts from the sum of its core capital elements in determining Tier 1 capital. While the Board is seeking public comment on all aspects of its proposal, it seeks specific comment on the approach discussed above to the valuation and discounting of PMSRs includable in capital.

As indicated earlier, the calculation of the fair market value for PCCRs is considered to be at least as subjective as the related calculation is for PMSRs. Consequently, the Board believes the valuation of PCCRs should be subject to the same requirements as those proposed for PMSRs and that these assets should also be discounted. In order to maintain consistency in the valuation of identifiable intangibles included in capital, the Board is proposing that organizations be required to determine the fair market and book value of their PCCRs at least quarterly, using the same criteria as those proposed for PMSRs, and to subject these assets to a value adjustment identical to
that proposed for FMSRs. The Board is seeking specific public comment on this approach to valuation and discounting of PCCRs.

**Deduction of CDIs**

The proposal would require a full deduction of other identifiable intangible assets, including CDIs, from Tier 1 capital, which is the same treatment as that accorded to goodwill. This treatment reflects the Board's general conclusion that CDIs have many of the same characteristics as goodwill, which the Basle Accord requires to be deducted from capital.

Although CDIs have value when an organization is financially strong, their value tends to fall significantly when the organization experiences financial difficulty. Depositors who are concerned about the viability of a problem institution are more likely to withdraw their funds, thus diminishing core deposits and the value of the related intangible asset. Moreover, a troubled institution may be required to raise the interest rates on its core deposits along with other sources of funds in order to retain depositors, which in turn can also reduce the value of CDIs. Thus, CDIs provide little protection for an institution in times of stress or for the bank insurance fund if the institution fails. This lack of protection has been evident in closed and assisted transactions handled by the FDIC and the Resolution Trust Corporation ("RTC") where the amount of the premium received on deposit transfer transactions is typically very low.
Moreover, CDIs are not purchased separately but as part of an acquisition of a depository institution or the purchase of some of its branches and the assumption of related deposits. Accordingly, CDIs are not generally salable apart from the branches of the depository institution and, thus, provide little liquidity to the institution. Consequently, CDIs do not fully meet the salability criterion the Board uses to evaluate identifiable intangibles, as described above. Furthermore, because CDIs are often acquired in a merger along with goodwill, institutions would have an incentive to assign higher amounts of the acquisition cost to CDIs rather than to goodwill if CDIs were to be included in the capital computation.

Active and liquid markets do not exist for CDIs and, thus their value is derived based on many highly subjective assumptions, which may be difficult for examiners to assess. Such assumptions include the length of time acquired deposits may remain with the acquiring organization, the expected future interest rate on funds generated by the deposits or on alternative sources of funds, and the expected future interest rate and servicing costs on the core deposits.

The Board has not yet determined that other identifiable intangibles meet the three criteria discussed above that the Board uses to evaluate intangible assets. Accordingly, the Board is proposing to deduct all these other intangible assets from Tier 1 for purposes of calculating risk-based and leverage capital ratios.
III. Regulatory Flexibility Act Analysis

The Federal Reserve Board does not believe adoption of this proposal would have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations), in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). In this regard, the vast majority of small banking organizations have very limited amounts of identifiable intangible assets, which are the subject of this proposal, as a component of their capital structures. In addition, because the risk-based and leverage capital guidelines generally do not apply to bank holding companies with consolidated assets of less than $150 million, this proposal will not affect such companies.

List of Subjects

12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, banking, Branches, Capital adequacy, Confidential business information, Currency, Dividend payments, Federal Reserve System, Flood insurance, Publication of reports of condition, Reporting and recordkeeping requirements, Securities, State member banks.
12 CFR Part 225

Administrative practice and procedure, Appraisals, Banks, banking, Capital adequacy, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities, State member banks.

For the reasons set forth in this notice, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956 (12 U.S.C. 1844(b)), and section 910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3909), the Board is amending 12 CFR Parts 208 and 225 to read as follows:

PART 208 - MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM

1. The authority citation for Part 208 continues to read as follows:

AUTHORITY: Sections 9, 11(a), 11(c), 19, 21, 25, and 25(a) of the Federal Reserve Act, as amended (12 U.S.C. 321-338, 248(a), 248(c), 461, 481-486, 601, and 611, respectively); sections 4 and 13(j) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1814 and 1823(j), respectively); section 7(a) of the

Appendix A - [Amended]

2. Appendix A is amended by removing the first three paragraphs of II.B.1.b. and replacing them with five new paragraphs, to read as follows:

*****

II. ***

A. ***

B. ***

1. a.***

b. Other intangible assets. In determining the appropriateness of including particular types of intangible assets other than goodwill, that is, identifiable intangible assets, in a bank's capital calculation, the Federal Reserve considers a number of factors, including--
1. the ability to establish a market value for the asset on an annual basis through an identifiable stream of cash flows, the reliability and predictability of these cash flows, and the degree of certainty that the asset will hold this market value notwithstanding the future prospects of the bank;

2. the existence of an active and liquid market for the asset; and

3. the feasibility of selling the asset apart from the bank or from the bulk of its assets.

The Federal Reserve has determined that readily marketable purchased mortgage servicing rights and purchased credit card relationships generally meet these three criteria and, thus, may be included in (that is, not deducted from) a bank's capital, provided that, in the aggregate the total amount of these assets included in capital does not exceed 50 percent of tier 1 capital. Purchased credit card relationships are subject to a separate sublimit of 25 percent of tier 1 capital. Amounts of purchased mortgage servicing rights and purchased credit card relationships in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a bank's core capital elements in determining tier 1 capital.

For purposes of calculating these limitations, tier 1 capital is defined net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights.
and purchased credit card relationships. This method of calculation could result in the inclusion in capital of purchased mortgage servicing rights and purchased credit card relationships in an amount greater than 50 percent, and of purchased credit card relationships in an amount greater than 25 percent, of the amount of tier 1 capital used to calculate an institution's capital ratios. In such instances, the Federal Reserve may determine that a bank is operating in an unsafe and unsound manner because of overreliance on intangible assets in tier 1 capital.

Banks should determine the fair market value of their purchased mortgage servicing rights and purchased credit card relationships at least quarterly. The quarterly determination of the fair market value of these assets shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates. The valuation shall be based on an analysis of the current fair market value of the intangible assets, determined by applying an appropriate market discount rate to the net cash flows.

Banks should also review the book value of their purchased mortgage servicing rights and purchased credit card relationships at least quarterly and make adjustments to these values as necessary. These assets should be amortized over their estimated useful life, not to exceed 15 years. The book value of these assets shall not exceed the discounted amount of their capital.
estimated future net income. At no time should the discount rate used for this calculation be less than that derived at the time of acquisition, based upon the estimated cash flows and the price paid for the asset at the time of purchase. If unanticipated prepayments occur, a writedown of the book value of intangible assets included in capital should be made to the extent that the discounted amount of future net income is less than the asset's carrying amount. An institution that includes purchased mortgage servicing rights and purchased credit card relationships in its regulatory capital may not carry these assets at a book value that exceeds the discounted value of their future net income. Examiners will review both the book value and the fair market value assigned to these assets, together with supporting documentation, during the examination process.

For regulatory capital purposes (but not for financial statement purposes), the amount of purchased mortgage servicing rights and purchased credit card relationships reported on a bank's balance sheet will be reduced to the lesser of:

(a) 90 percent of their fair market value;
(b) 90 percent of the original purchase price paid for the assets; or
(c) 100 percent of their remaining unamortized book value.

If both the application of the limits on purchased mortgage servicing rights and purchased credit card relationships and the adjustment of the balance sheet amount for these intangibles
would result in an amount being deducted from capital, the bank would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

Whenever necessary—in particular, when assessing applications to expand or to engage in other activities that could entail unusual or higher-than-normal risks—the Board will, on a case-by-case basis, continue to consider the level of an individual bank's tangible capital ratios (after deducting all intangible assets), together with the quality and value of the bank's tangible and intangible assets, in making an overall assessment of capital adequacy.

Appendix B - [Amended]

2. Appendix B is amended by revising footnote 2 and revising the last sentence of the second paragraph in II., to read as follows:

II. ***

2 At the end of 1992, Tier 1 capital for state member banks includes common equity, minority interests in the equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, Tier 1 capital excludes goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate,
exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; and all other intangible assets. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

***

***Average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income ("Call Report"), less goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other intangible assets; and any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital. 3 ******

PART 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

1. The authority citation for Part 225 continues to read as follows:

AUTHORITY: 12 U.S.C. 1817(j) (13), 1818, 18311, 1843(c) (8), 1844(b), 3106, 3108, 3907, 3909, 3310, and 3331-3351.
2. Appendix A is amended by removing the first three paragraphs of II.B.1.b. and replacing them, to read as follows:

****

II. ***

A. ***

B. ***

1.a.***

b. Other intangible assets. In determining the appropriateness of including particular types of intangible assets other than goodwill, that is, identifiable intangible assets, in a bank holding company's capital calculation, the Federal Reserve considers a number of factors, including—

1. the ability to establish a market value for the asset on an annual basis through an identifiable stream of cash flows, the reliability and predictability of these cash flows, and the degree of certainty that the asset will hold this market value notwithstanding the future prospects of the banking organization;

2. the existence of an active and liquid market for the asset; and

3. the feasibility of selling the asset apart from the bank or from the bulk of its assets.
The Federal Reserve has determined that readily marketable purchased mortgage servicing rights and purchased credit card relationships generally meet these three criteria and, thus, may be included in (that is, not deducted from) a bank holding company's capital, provided that, in the aggregate the total amount of these assets included in capital does not exceed 50 percent of tier 1 capital. Purchased credit card relationships are subject to a separate sublimit of 25 percent of tier 1 capital. Amounts of purchased mortgage servicing rights and purchased credit card relationships in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a banking organization's core capital elements in determining tier 1 capital.

For purposes of calculating these limitations, tier 1 capital is defined net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships. This method of calculation could result in the inclusion in capital of purchased mortgage servicing rights and purchased credit card relationships in an amount greater than 50 percent, and of purchased credit card relationships in an amount greater than 25 percent, of the amount of tier 1 capital used to calculate a banking organization's capital ratios. In such instances, the Federal Reserve may determine that a banking organization is operating in
an unsafe and unsound manner because of overreliance on intangible assets in tier 1 capital.

Banking organizations should determine the fair market value of their purchased mortgage servicing rights and purchased credit card relationships at least quarterly. The quarterly determination of the fair market value of these assets shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates. The valuation shall be based on an analysis of the current fair market value of the intangible assets, determined by applying an appropriate market discount rate to the net cash flows.

Banking organizations should also review the book value of their purchased mortgage servicing rights and purchased credit card relationships at least quarterly and make adjustments to these values as necessary. These assets should be amortized over their estimated useful life, not to exceed 15 years. The book value of these assets shall not exceed the discounted amount of their estimated future net income. At no time should the discount rate used for this calculation be less than that derived at the time of acquisition, based upon the estimated cash flows and the price paid for the asset at the time of purchase. If unanticipated prepayments occur, a writedown of the book value of intangible assets included in capital should be made to the extent that the discounted amount of future net income is less than the asset's carrying amount. A banking organization that
includes purchased mortgage servicing rights and purchased credit card relationships in its regulatory capital may not carry these assets at a book value that exceeds the discounted value of their future net income. Examiners will review both the book value and the fair market value assigned to these assets, together with supporting documentation, during the inspection process.

For regulatory capital purposes (but not for financial statement purposes), the amount of purchased mortgage servicing rights and purchased credit card relationships reported on a banking organization's balance sheet will be reduced to the lesser of:

(a) 90 percent of their fair market value;
(b) 90 percent of the original purchase price paid for the assets; or
(c) 100 percent of their remaining unamortized book value.

If both the application of the limits on purchased mortgage servicing rights and purchased credit card relationships and the adjustment of the balance sheet amount for these intangibles would result in an amount being deducted from capital, the banking organization would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

Whenever necessary—in particular, when assessing applications to expand or to engage in other activities that could entail unusual or higher-than-normal risks—the Board will,
on a case-by-case basis, continue to consider the level of an individual bank's tangible capital ratios (after deducting all intangible assets), together with the quality and value of the bank's tangible and intangible assets, in making an overall assessment of capital adequacy.

Appendix D - [Amended]

2. Appendix D is amended by revising the last two sentences in footnote 3 and revising the last sentence of the second paragraph in II., to read as follows:

*** In addition, Tier 1 capital excludes goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; and all other intangible assets. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

Average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the banking organization's Consolidated Financial Statements ("FR Y-9C Report"), less goodwill; amounts
of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other intangible assets; and any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital.

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Board of Governors of the Federal Reserve System,


______________________________
William W. Wiles
Secretary of the Board
TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Supplementary Examination Guidelines on Real Estate Loans and Certain Reporting Issues Pertaining to Nonaccrual Loans

On March 1, 1991, the Federal bank and thrift regulatory agencies jointly issued a statement clarifying certain supervisory and accounting policies. The statement was issued in response to concerns that some supervisory policies, or depository institutions' misunderstandings about the policies, were inhibiting the extension of loans to sound, creditworthy borrowers. The guidelines and clarifications contained in the March 1st statement establish a framework, consistent with safe and sound banking practices, within which banking organizations can make loans to creditworthy borrowers and work in a constructive and prudent fashion with borrowers experiencing temporary financial difficulties. The statement was based upon the principle that prudent lending practices on the part of banks and timely and effective supervisory actions on the part of regulators should not inhibit banking organizations from playing an active role in financing the needs of creditworthy borrowers.

This letter supplements the contents of the March 1st statement and provides guidance to supervisory and examination personnel regarding certain supervisory policies or practices that may have an impact on credit availability. As was true with the earlier interagency statement, the guidance contained in this letter is consistent with sound banking practices and generally accepted accounting principles.

Supervisory asset assessments

Concerns have been expressed that problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, could lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors. The March 1st statement reiterates that real estate loans should not be assessed solely on the basis of the liquidation value of the
underlying collateral; rather, consideration should also be given
to a property's stabilized capacity to generate cash flow to
service its debt. Consistent with this principle and
longstanding supervisory practice, loans or credits that are
adequately protected by the current sound worth and debt-service
capacity of the borrower or the underlying collateral generally
should not be subject to examiner classification.

These principles hold for individual credits, even if
portions or segments of the industry to which the borrower
belongs are experiencing financial difficulties. The evaluation
of each credit should be based upon the fundamentals of the
particular credit, that is, the borrower’s (or the collateral’s)
current and stabilized cash flow, earning and debt service
capacity, financial performance, net worth, guarantees, future
prospects, and other factors relevant to the borrower’s ability
to service and retire its debt.

Real estate construction and mini-perm loans

The March 1st guidance states that institutions that
have in place effective controls to manage and reduce undue
concentrations over time, need not refuse credit to sound
borrowers simply because of the borrower’s industry or geographic
location. It is important to emphasize that this principle
applies to prudent loan renewals and rollovers, as well as to new
extensions of credit that are underwritten in a sound manner.

Many banks have made construction loans that upon
completion of the construction phase of the project will require
longer-term or take-out financing. In addition, during the 1980s
some banks made medium term (up to 7 years to maturity) loans to
finance commercial real estate after completion of the
construction phase. Many of these construction and so-called
"mini-perm" loans are now coming due or will be coming due over
the next 12 to 24 months.

Under current conditions, obligors on these loans may
continue to find it difficult to obtain adequate sources of long-
term credit. In some cases, banks may determine that the most
desirable and prudent course is to rollover or renew loans to
those borrowers who have demonstrated an ability to pay interest
on their debts, but who may not be in a position, at the present
time, to obtain long-term financing for the principal. The act
of refinancing or renewing loans to sound borrowers, including
creditworthy commercial or residential real estate developers,
generally should not be subject to supervisory criticism in the
absence of well-defined weaknesses that jeopardize repayment of
the loans. Refinancings or renewals should be structured in a
manner that is consistent with sound banking, supervisory, and
accounting practices, and that protects the bank and improves its prospects for collecting or recovering on the asset.

Assessment of asset concentrations

The March 1st statement indicates that while the regulatory agencies have not established specific rules on asset concentrations, depository institutions should establish and adhere to policies that control concentration risk. One aspect of such a system of risk control is the definition of asset concentrations. Traditionally, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry often have been included in homogeneous risk groupings when assessing asset concentrations.

In identifying asset concentrations, commercial real estate loans and residential real estate loans can be viewed separately when their performance is not subject to similar economic or financial risks. In the same vein, commercial real estate development loans need not necessarily be grouped with residential real estate development loans, especially when the residential developer has firm, reliable purchase contracts for the sale of the homes upon completion. Even within the commercial development and construction sector, distinctions for concentration purposes may be made, when appropriate, between those loans that have firm take out commitments and those that do not. Groups or classes of real estate loans should, of course, be combined and viewed as concentrations when they do share significant common characteristics and are similarly affected by adverse economic, financial, or business developments.

Institutions with asset concentrations are expected to put in place effective internal policies, systems, and controls to monitor and manage this risk. Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. Banking organizations with a need to reduce asset concentrations are normally expected to develop a plan that is realistic, prudent, and achievable in view of the bank’s particular circumstances and market conditions. In situations where concentration levels have been built up over an extended period, it may take time, in some cases several years, to achieve a more balanced and diversified portfolio mix. What is critical is that banking organizations have in place adequate systems and controls for reducing undue or excessive concentrations in accordance with a prudent plan, strong credit policies and loan administration standards to control the risks associated with new loans, and adequate capital to protect the institution while its portfolio is being restructured.
Issues relating to restructured debt and partially charged-off loans

Working in a prudent manner with borrowers experiencing financial difficulties may involve formally restructuring loans and taking other measures in recognition of the borrowers' condition and repayment prospects. Such actions, if done in a way that is consistent with prudent lending principles and supervisory practices, can improve a bank's prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements, provide a framework for reporting that, in some cases, may alleviate certain concerns that lenders may have about working in a constructive fashion with borrowers experiencing financial difficulties.

The March 1, 1991 interagency policy statement presented a number of clarifications of supervisory policies regarding issues relating to nonaccrual assets and restructured loans. Three of these clarifications indicated that when certain criteria are met, (i) interest payments on nonaccrual assets can be recognized as income on a cash basis without first recovering any prior partial charge-offs, (ii) nonaccrual assets can be restored to accrual status when subject to formal restructurings in accordance with Financial Accounting Standards Board (FASB) Statement No. 15, and (iii) restructurings that yield a market rate of interest would not have to be included in restructured loan amounts reported in the years subsequent to the year of the restructuring. These clarifications, which are consistent with GAAP, have been fully incorporated into the instructions for the Reports of Condition and Income ("Call Reports") filed by banks and the "Y Reports" filed by bank holding companies, as of June 30, 1991. Additional clarifications on issues relating to the restoration to accrual status of restructured debt and nonaccrual assets with partial charge-offs are set forth below.

Nonaccrual assets subject to FASB Statement No. 15 restructurings. The March 1st policy statement indicated that a loan or other debt instrument that has been formally restructured so as to be reasonably assured of repayment and performance according to its modified terms need not be maintained in nonaccrual status. Furthermore, the interagency policy indicated that in returning the asset to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account.

For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. In so doing, the borrower's restructured terms may require payments that do not exceed the amount and frequency that have been demonstrated by the sustained historical payment performance of the borrower for a reasonable time before the loan
was restructured. In this situation, assuming that the restructured loan is reasonably assured of repayment and performance according to its modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether prior to or subsequent to the date of the restructuring, is a very important factor in determining whether there is reasonable assurance of repayment and performance according to the loan's modified terms. In certain circumstances, evidence may exist regarding other characteristics of the borrower that may be sufficient to demonstrate a relative improvement in the borrower's condition and debt service capacity, thereby reducing the degree of reliance on the borrower's performance to date in assessing prospects for future performance and collectibility under the modified terms. For example, substantial and reliable sales, lease or rental contracts obtained by the borrower or other important developments that are expected to significantly increase the borrower's cash flow and debt service capacity and strengthen the borrower's commitment to repay may be sufficient to provide this assurance. In certain circumstances, a preponderance of such evidence, in and of itself, may be sufficient to warrant returning a restructured loan to accrual status, provided the loan under its restructured terms is reasonably assured of performance and full collectibility.

It is imperative that the reasons for the restoration of restructured debt to accrual status be documented. Such actions should be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This documentation will be subject to review by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways which improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule. When restructuring loans, regulatory reporting requirements and GAAP do not require banking organizations to grant excessive concessions, forgive principal, or take other steps not commensurate with the borrower's ability to repay, in order to use the reporting treatment specified in FASB Statement No. 15. Furthermore, regulatory reporting requirements and GAAP do not preclude institutions from including in the restructured terms prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions involved in the restructuring.

1 When a restructured loan is not reasonably assured of repayment and performance under its modified terms in accordance with a reasonable repayment schedule, the loan may not be restored to accrual status.
the restructuring should the borrower's condition substantially improve.

Treatment of Nonaccrual Loans with Partial Charge-offs. Questions have been raised regarding whether partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) must first be fully recovered before a loan can be restored to accrual status. GAAP and regulatory reporting requirements do not explicitly address this issue.

In accordance with the Call Report instructions, restoration to accrual status is permitted when (a) the loan has been brought fully current with respect to principal and interest and (b) the bank expects that the full contractual balance of the loan (including any amounts charged-off) plus interest will be fully collectible under the terms of the loan. Thus, in determining whether a partially charged-off loan that has been brought fully current can be returned to accrual status, it is important to determine whether the bank expects to receive the full amount of principal and interest called for by the loan's terms.

When a loan has been brought fully current with respect to contractual principal and interest, and the borrower's financial condition and prospects for repayment have improved so that the full amount of contractual principal (including any amounts charged-off) and interest is expected to be repaid, the loan may be restored to accrual status without having to first recover the charge-off. On the other hand, this treatment would not be appropriate when the charge-off is indicative of continuing doubt regarding the collectibility of principal or interest. Since the criteria for nonaccrual status include the requirement that loans or other assets be placed in nonaccrual status when repayment in full of principal or interest is not expected, such nonaccrual loans could not be restored to accrual status.

It is imperative that the reasons for the restoration of a partially charged-off loan to accrual status be documented. Such actions should be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including

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2 The instructions for the Call Reports and "Y Reports" discuss the criteria for restoration to accrual status in the glossary entries for "nonaccrual status." This guidance also permits restoration to accrual status for nonaccrual assets that are both well secured and in the process of collection. In addition, this guidance permits restoration to accrual status when certain criteria are met, for formally restructured debt and acquired nonaccrual assets.
any amounts charged-off) and interest. This documentation will be subject to review by examiners.

A nonaccrual loan or debt instrument may have been formally restructured in accordance with FASB Statement No. 15 so that it meets the criteria for restoration to accrual status presented in the previous section (that addresses restructured loans). Under GAAP, when a charge-off was taken prior to the date of the restructuring, the charge-off does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed in the previous paragraphs in this section are applicable.

Richard Spillenkothen
Deputy Associate Director
TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Classification Guidelines For An Asset When A
Substantial Portion Has Been Charged Off

In some cases, institutions with loans to financially
troubled borrowers have charged off substantial portions of these
credits. Questions have been raised regarding the appropriate
supervisory treatment of the remaining recorded balance of these
loans. This examination guidance is intended to clarify existing
supervisory practices regarding the classification of partially
charged-off loans.

Consistent with long standing supervisory practice, the
evaluation of each extension of credit should be based upon the
fundamentals of the particular credit. That is, the evaluation
of each credit should be based upon the borrower's (or the
collateral's) current and stabilized cash flow, earning and debt
service capacity, financial performance, net worth, guarantees,
future prospects, and other factors relevant to the borrower's
ability to service and retire its debt.

Based upon consideration of all of the above relevant
financial factors, this evaluation may indicate that a credit has
well-defined weaknesses which jeopardize repayment in full, but
that a portion of the loan may be reasonably assured of
repayment. When an institution has taken a charge-off in a
sufficient amount so that the remaining recorded balance of the
loan is being serviced (based upon reliable sources of cash flow)
and is reasonably assured of repayment, this remaining recorded
balance would generally be classified no more severely than
substandard. Consistent with long standing classification
guidelines, a substandard classification of the remaining
recorded balance would only be appropriate when well-defined
weaknesses continue to be present in the credit. For example,

The accrual/nonaccrual status of the loan must continue to be
determined in accordance with the glossary to the current Call
Report instructions. Thus, while these partially charged-off loans
may qualify for nonaccrual treatment, cash basis recognition of
income will be appropriate when the criteria specified in the Call
Report guidance are met.
when the remaining recorded balance of an asset is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be classified.

This approach would generally be appropriate when an institution maintains sufficient controls over its lending function and maintains adequate current documentation to support the credit analysis of the loan. This classification approach could not be utilized for loans for which the loss exposure cannot be reasonably determined, e.g., loans collateralized by properties subject to environmental hazards. This approach would also not be justified when sources of repayment are considered unreliable.

Extensions of credit that have not been subject to partial charge-offs should continue to be classified in accordance with existing supervisory guidelines.

Richard Spillonkothen
Deputy Associate Director
TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Communications Efforts Regarding Credit Availability Concerns

As discussed on several occasions with Reserve Banks, the federal banking agencies are proceeding on a number of fronts to strengthen communications with bankers regarding general issues affecting credit availability and the March 1st interagency policy statement. Senior Reserve Bank officials and Board staff have participated in numerous meetings with bankers, businessmen and members of Congress to discuss credit availability concerns, hear the views of bankers and borrowers, and explain the rationale and context of supervisory policies. This letter describes these ongoing efforts, provides some related background information, and sets out some additional steps to broaden communication with bank management.

The attached letter from the Secretary of the Treasury to a member of Congress provides additional information on the regional "town meetings" in which the System has participated to discuss credit availability concerns. We believe these meetings have proven useful so far and it is important that we continue this constructive program with the involvement of senior Federal Reserve officials.

In order to stay apprised of these discussions, we ask that each Reserve Bank prepare a summary memorandum of any of these public meetings attended. It would be helpful if the summary included the following information:

- a list of the participants in the congressional delegation and from the regulatory agencies, and a list of the industries represented by any other participants;
- a summary of the topics discussed; and
- an overview of the general tenor of the meeting.

These memoranda may be forwarded to other federal agencies as part of the effort to monitor and share meaningful information on developments affecting credit availability.
Another ongoing objective is to ensure that any questions bankers have regarding the March 1st statement are answered in a timely manner. To assist in the achievement of this objective, the following procedures should be implemented immediately to further strengthen our communication efforts.

1. During each on-site bank examination, the examiner-in-charge or another Reserve Bank official should determine if the bank’s senior management has any questions regarding the general content or specific provisions of the March 1 interagency policy statement or related guidance.

2. If so, the examiner or Reserve Bank official should discuss the March 1 statement with, and answer any questions posed by, the bank’s senior management.

3. These issues can be discussed during the examination or at the exit meeting with senior management. If appropriate, these matters can also be discussed at any meetings with the bank’s directors or the board’s examination or audit committee.

4. Board staff should be consulted if Reserve Banks have any questions regarding specific aspects of the March 1st statement or related policies.

The summaries of the regional town meetings should be forwarded to Bill Spaniel (mail stop 186) at the Board. Any questions regarding the March 1st policy statement should be referred to Roger Cole (202-452-2619).

Richard Spillenkothen
Deputy Associate Director

Attachment

Cross Reference: SR 91-16, SR 91-18, and March 1, 1991 Interagency Policy Statement
Dear Ms. Johnson:

As a follow-up to my letter dated April 24, 1991, Treasury officials have discussed with the financial institution regulators your concept of a national seminar. The purpose of the sessions would be to enhance the national effort to communicate the regulators' guidelines released on March 1, 1991. The regulators believe that this effort will further their objective that credit availability for sound borrowers not be adversely impacted by supervisory policies or bankers' misunderstandings about them.

Logistically, the regulators believe it would be best if the local Congressional delegation were to serve as host in a "town meeting" format, perhaps, in several regional locations. Participants could include local bankers, business people, and officials from the regional office of the Federal Reserve, Comptroller of the Currency, FDIC, and the Office of Thrift Supervision. Ground rules will be established which preclude "case specific" regulatory matters from being discussed, but, of course, a detailed general discussion should take place.

Additionally, each agency has provided me with an assessment of its communications effort, and a report of how effective, in its view, the March 1, 1991 guidelines have been. While it is too early for the regulators to provide concrete results or cite empirical evidence of a change in the willingness or ability of banks to increase their lending activities, the regulators cited some positive impressions. The Office of Thrift Supervision reported credit availability in the residential real estate area has not been impaired over the last several months as thrifts have increased their lending in residential real estate. Moreover, through communicating and clarifying supervisory policy guidelines to each field examiner across the country, the agencies believe that there is more consistency among field examiners' practices leading to a more balanced approach to conducting on-site examinations.

While we see signs that the credit crunch is improving, this is a critical time, a time when access to credit by sound borrowers to finance business inventories and homebuilding as demand increases is fundamental to a rebound in economic growth.
The regulatory agencies have committed to review other suggestions that could facilitate credit to sound borrowers and to assist in maintaining a balanced regulatory environment.

Again, thank you for your constructive suggestion. The regulators look forward to working with Members and local officials to facilitate a set of productive meetings. Please contact the congressional affairs offices of the regulators to continue preparations for the meetings.

Sincerely,

Nicholas F. Brady

cc: Messrs. Clarke, Greenspan, Seidman, Ryan
TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Meetings with Senior Bank Executives on Credit Availability Issues

As previously discussed with Reserve Banks, the Federal Reserve, the Office of the Comptroller of the Currency and the other federal regulators have had under consideration a program of meetings with senior bank executives to review issues affecting bank loan portfolios and credit availability. Both the OCC and the Federal Reserve have decided to pursue this program for commercial banks under their respective jurisdictions that have large commercial real estate loan portfolios. It is our desire to conduct these meetings over the next four weeks.

Staff will be contacting each Reserve Bank regarding the commercial banks that it is contemplated at the present time will be involved in this effort. The selection has been based upon the size of the banks' real estate loan portfolios with some refinements to achieve a measure of geographic distribution. Several Reserve Banks currently do not have banks included in this effort. For these Reserve Banks, the attachment is being provided for background information on the nature of the program. If the scope of this program is expanded, there is also the possibility that some banks from these other districts may be involved.

The purpose of these meetings is to strengthen our understanding of issues affecting the availability of credit and the conditions banks are facing, determine any questions bankers have regarding our policies related to these issues, and solicit the banks' views on further steps that could be taken to address credit availability concerns. The meetings are not examinations and are not intended to reiterate supervisory matters already being addressed in the normal supervisory process.

Attached is a letter that you are asked to send to the chief executive officer of the specified state member bank(s) in order to implement this initiative. The enclosed letter describes the purpose of the meetings and contains as an attachment an agenda outline and a request for information the bank is asked to provide prior to the meeting to serve as a starting point for the discussion. As noted in the letter to the state member bank, we are seeking the involvement of the bank's

October 7, 1991
CEO or other high level executive and its chief lending officer. A senior official from the Board's Division of Banking Supervision and Regulation would also attend, along with the Reserve Bank's senior officer in charge of supervision, and a senior examiner or examining officer.

Reserve Banks are asked to send the letter as soon as possible and to coordinate scheduling through Roger Cole's office at the Board to ensure the availability of a senior official from the Board staff. At this time, we anticipate that Fred Struble, Steve Schemering or Rich Spillenkothen will participate in these meetings from the Board, with possibly one other member of the Board's staff.

As noted in previous communications with Reserve Banks, this initiative has evolved out of discussions the banking agencies have conducted in Washington concerning supervisory policies, bank lending activities, and the availability of credit to sound borrowers. While this program represents a significant commitment of time and resources, we believe that it will be helpful in strengthening our understanding of developments affecting bank loan portfolios and credit availability. Moreover, it is consistent with our commitment to take appropriate steps to improve communications with banking organizations on supervisory policies that pertain to, or may affect, the availability of credit. Questions on this effort may be addressed to me or Roger Cole.

Richard Spillenkothen
Deputy Associate Director
TO THE CHIEF EXECUTIVE OFFICER (CEO) OF THE STATE MEMBER BANK ADDRESSED

Dear :

For well over a year, the Federal Reserve has been concerned about the availability of credit to sound borrowers and the potential impact of regulatory or supervisory policies in this important area. In March of this year, as you may be aware, the federal banking agencies adopted a set of supervisory guidelines designed to reduce impediments to lending to credit-worthy borrowers and to clarify regulatory policies that could be having an adverse effect on banks' willingness to extend credit. The banking agencies stated that they did not want the availability of loans to credit-worthy borrowers to be adversely affected by supervisory policies or depository institutions' misunderstandings about them.

In adopting the March 1st policy statement and implementing related examination guidelines, the Federal Reserve has attempted to communicate these policies in an effective and clear manner to both the banking industry and its district supervisory and examination staffs. The Federal Reserve, together with the other banking agencies, has also sought to monitor the impact and effect of these supervisory policies, as well as other developments that may be having an impact on bank loan portfolios and credit availability.

In connection with this overall effort, the Federal Reserve would like in the near future to meet with senior officials of your bank. The purpose of this meeting would be to discuss credit availability issues and solicit your views on the conditions or challenges your bank currently faces and expects to encounter over the next year or so in carrying out its lending activities. An outline of the topics we would like to cover in this meeting is set forth in the enclosed agenda.

As reflected in the agenda, we would like to focus on real estate loan portfolios. In this connection, we would ask your cooperation in providing to us prior to the meeting the information requested in the attachment to the agenda. This information, or, if not available in this form from your internal reporting systems, comparable data or estimates along these
lines, would be helpful in serving as a starting point for our discussions. While the agenda emphasizes real estate lending issues, we would appreciate hearing your views and concerns on any other components of the loan portfolio that you believe would be relevant.

I want to stress that this meeting is not an examination; nor is it intended to be used as a forum to reiterate supervisory comments or concerns that have already been discussed in-depth in the normal examination and supervisory follow-up process. Rather, the purpose of the meeting is to hear your views on, and thus enhance our understanding of, developments that are affecting the availability of credit to bank customers. Such developments may include, for example, changes in lending standards over the last year, challenges posed by the need to rollover or restructure credits in the absence of long-term take-out financing, changes in real estate markets and the assumptions going into real estate appraisals, and the application and impact of supervisory policies and procedures. Your views on other possible steps to address credit availability concerns would also be welcome.

Participants in this meeting from the Federal Reserve will include a senior official from the Board of Governors in Washington and a senior supervisory official and examiner from the Federal Reserve Bank of __________. In order to maximize the value of this session, we would appreciate your participation, or another senior executive of your bank, and the bank's chief lending officer in the meeting. We would like to hold this meeting in the next few weeks, and I will be calling your office in the next few days to establish a mutually convenient date and time.

I want to thank you for your cooperation in this effort. As I have indicated above, we believe this session can enhance the Federal Reserve's understanding of the challenges you are facing, as well as the potential impact of the supervisory process on bank lending activities and credit availability.

Sincerely,

Senior Vice President
Federal Reserve Bank of __________
Agenda for Discussion at Meetings on Credit Availability Issues

1. Overview of commercial real estate loan portfolio characteristics; composition, maturity structure, and performance (See Attachment 1).

2. Bank's views on the current status and outlook for commercial and residential real estate sectors.
   a. Assessment of current and future demand for commercial and residential real estate loans.

3. Policies for restructuring or rolling over existing commercial real estate loans.
   a. Terms, conditions, and requirements for rolling over and restructuring construction and land development, mini-perm, and residential development loans.
   b. Changes in these policies, requirements and practices within last two years and any future anticipated changes.
   c. Prospects for permanent take-out financing within next 12 months.

4. Underwriting standards for new real estate loans.
   a. Current posture toward extending new loans: construction and land development; mini-perms; other commercial real estate; loans to residential developers; and residential mortgages.
   b. Underwriting standards (regarding requirements for net worth, loan-to-value, pricing, maturity, collateral, cash flow, guarantees, etc.) for new loans of the types in 4.a. above.
   c. Changes in these standards within the last two years and any future anticipated changes.
5. Appraisal assumptions for commercial real estate loans.
   a. Changes in the last two years in appraisal assumptions regarding occupancy rates, lease-up periods, rental fees, discount or cap rates. Address assumptions used by external appraisers, as well as for in-bank evaluations.

6. Credit availability concerns, lending standards, and outlook for credit demand pertaining to other aspects of the portfolio. (e.g., commercial and industrial, HLT, small business, etc.)

7. Bank’s views on the factors that may be contributing to constraints on institution’s lending activities.
   a. Additional steps that could be taken to address credit availability concerns.

Attachment
ATTACHMENT 1

The information requested by this attachment is confidential and is for use by the Federal supervisory agencies. In answering the following questions, please use reasonable estimates when certain information requested is not readily available from your information systems.

1. Overview of commercial real estate loan portfolio characteristics; composition, maturity structure, and performance.

Please provide the following information on certain characteristics of the commercial real estate portfolio in domestic offices, as of June 30, 1991.

a. How large is the commercial real estate portfolio?

b. Of the total commercial real estate portfolio, how much is made up of:

i) commercial construction and land development loans

ii) mini-perms (loans secured by commercial real estate that are intended to come due some time after the completion of the project being financed and that may have original maturities of up to seven or eight years)

iii) residential development loans

iv) other commercial real estate loans

c. Provide a breakdown of remaining maturity for the commercial real estate portfolio (indicated at item 1.a. above) along the following lines:

i) under 1 year

ii) 1 - 3 years

iii) 3 - 5 years

iv) over 5 years
d. Of the total commercial real estate loan portfolio, what amounts are:

i) performing -- servicing both interest and amortize principal as agreed ____________

ii) past due and not in nonaccrual status ____________

iii) in nonaccrual status ____________

[Note: The amounts for items i) through iii) should total the amount shown for item 1.a. above]

iv) already restructured, and able to service both interest and amortize principal under modified terms ____________

v) current (or can be serviced) as to interest, but cannot amortize principal as agreed under modified terms ____________

vi) in process of, or expected to result in, foreclosure ____________

e. What percentage of the commercial real estate loans maturing within the next 12 months [item 1.c.i) above] are likely to be:

i) rolled over at a market rate of interest ______

ii) restructured or rolled over where a concession is granted ______

iii) foreclosed upon ______

f. If the responses to questions 1.c., 1.d., or 1.e. for the individual components of the commercial real estate portfolio set forth in 1.b. above would differ significantly from the portfolio as a whole, please provide separate answers to questions 1.c., 1.d., and 1.e. for those components of the portfolio.

g. What is the cash yield on that portion of the commercial real estate portfolio that is in nonaccrual status [item 1.d.iii) above]?

1 For purposes of this question, a "concession" by the lending institution includes (a) a reduction of principal, (b) a reduction of the stated interest rate to a level below market rates for loans of similar terms and risk, (c) a combination of (a) and (b), etc.
WASHINGTON, D.C., Nov. 7, 1991 -- The four federal regulators of bank and thrift institutions issued a joint statement today on the review and classification of commercial real estate loans. Today's action is another step by the agencies to ensure that misunderstandings about supervisory policies do not impede the availability of credit to sound borrowers. Development of this document was announced in the Administration's October 8th statement on "Easing The Credit Crunch To Promote Economic Growth."

The policy statement provides clear and comprehensive guidance on the review and classification of commercial real estate loans. The detailed guidelines, which will be sent to all depository institutions and examiners, cover loan portfolio review procedures, indicators of troubled loans, analysis of loans and collateral values, and the review of institutions' loss allowances.

The four regulatory agencies that issued today's guidelines are the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board.
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(FRB), and the Office of Thrift Supervision (OTS). Together, the four agencies supervise the activities of the nation's 12,000 commercial banks and 2,200 thrift institutions.

In addition to today's issuance, the regulatory agencies are undertaking three other actions:

- **National Meeting of Examiners**
  
  The agencies will hold a national meeting of senior examination personnel in Baltimore, Md., on December 16 and 17 to review the policy statement and other initiatives related to credit availability.

- **Random Audit Program**
  
  To assess the quality of examiners' review of collateral value, the regulatory agencies will implement a random audit program to determine how examiners review and analyze the assumptions contained in appraisals as part of their loan review process.

- **Holding Company Preferred Stock**
  
  The Federal Reserve Board, in a move designed to grant bank holding companies greater flexibility in raising capital, has issued for public comment a proposal to lift the limit on the amount of noncumulative preferred stock that bank holding companies may include in Tier 1 capital. This proposal, if adopted, can assist organizations in strengthening their capital positions and expanding their ability to extend credit to sound borrowers.

All of these steps follow previous actions by the regulatory agencies in March and July to address credit availability concerns.

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The recent decline in credit extended by depository institutions has been attributed to many factors. These factors include the general slowdown in the economy, the overbuilding of commercial real estate properties in some markets, the desire of some household and business borrowers, as well as some depository institutions, to strengthen their balance sheets, changes by lenders in underwriting standards, and concerns about the potential impact of certain supervisory policies or actions. To ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers, the four Federal regulators of banks and thrifts have taken a number of steps to clarify and communicate their policies. The attached policy statement is a further step in this effort.

On March 1, 1991, the four agencies — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision — issued general guidelines that addressed a wide range of supervisory policies. Included in the March issuance were brief discussions of the workout of problems loans, lending by undercapitalized institutions, and a general statement on the valuation of real estate loans.

The attached policy statement expands upon the March 1 and subsequent guidance as it relates to the review and classification of commercial real estate loans.

The intent of the statement by the agencies is to provide clear and comprehensive guidance to ensure that supervisory personnel are reviewing loans in a consistent, prudent, and balanced fashion and to ensure that all interested parties are aware of the guidance.

The policy statement emphasizes that the evaluation of real estate loans is not based solely on the value of the collateral, but on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the properties.
The policy statement also provides guidance on how supervisory personnel analyze the value of collateral. In general, examiners consider the institution's appraisals of collateral (or internal evaluations, when applicable) to determine value and they review the major facts, assumptions and approaches used in determining the value of the collateral. Examiners seek to avoid challenges to underlying assumptions that differ in only a limited way from norms that would generally be associated with the property under review. Nonetheless, when reviewing the value of the collateral and any related management adjustments, examiners ascertain that the value is based on assumptions that are both prudent and realistic, and not on overly optimistic or overly pessimistic assumptions.

The policy statement covers a wide range of specific topics, including:

- the general principles that examiners follow in reviewing commercial real estate loan portfolios;
- the indicators of troubled real estate markets, projects, and related indebtedness;
- the factors examiners consider in their review of individual loans, including the use of appraisals and the determination of collateral value;
- a discussion of approaches to valuing real estate, especially in troubled markets;
- the classification guidelines followed by the agencies, including the treatment of guarantees; and
- the factors considered in the evaluation of an institution's allowance for loan and lease losses.

This statement is intended to ensure that all supervisory personnel, lending institutions and other interested parties have a clear understanding of the agencies' policies.
Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans

Introduction

This policy statement addresses the review and classification of commercial real estate loans by examiners of the federal bank and thrift regulatory agencies. Guidance is also provided on the analysis of the value of the underlying collateral. In addition, this policy statement summarizes principles for evaluating an institution’s process for determining the appropriate level for the allowance for loan and lease losses, including amounts that have been based on an analysis of the commercial real estate loan portfolio. These guidelines are intended to promote the prudent, balanced, and consistent supervisory treatment of commercial real estate loans, including those to borrowers experiencing financial difficulties.

The attachments to this policy statement address three topics related to the review of commercial real estate loans by examiners. The topics include the treatment of guarantees in the classification process (Attachment 1); background information on the valuation of income-producing commercial real estate loans in the examination process (Attachment 2); and definitions of classification terms used by the federal bank and thrift regulatory agencies (Attachment 3).

Examiner Review of Commercial Real Estate Loans

Loan Policy and Administration Review. As part of the analysis of an institution’s commercial real estate loan portfolio, examiners review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough...
loan documentation are essential to the institution's management of the lending function.

The policies governing an institution's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The institution must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the institution's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness. In order to evaluate the collectibility of an institution's commercial real estate portfolio, examiners should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

Available indicators, such as permits for — and the value of — new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.
• Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.

• Delinquent lease payments from major tenants.

• Land values that assume future rezoning.

• Tax arrearages.

As the problems associated with a commercial real estate project become more pronounced, problems with the related indebtedness may also arise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound or a liberal basis. Common examples of these types of problems include:

• Loans with no or minimal borrower equity.

• Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.

• Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.

• Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.

• Loans to borrowers with no development plans or noncurrent development plans.

• Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.4

Examiner Review of Individual Loans, Including the Analysis of Collateral Value.

The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources if necessary. In evaluating the overall risk associated with

4 As discussed more fully in the section on classification guidelines, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.
a commercial real estate loan, examiners consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral. However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral’s value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met. Management is responsible for reviewing each appraisal’s assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property. Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic.

An examiner analyzes the collateral’s value as determined by the institution’s most recent appraisal (or internal evaluation, as applicable). An examiner reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the examiner may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of an examiner’s analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral. This approach is discussed in more detail in Attachment 2. This analysis should not be based solely on the current performance of the collateral or similar properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

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2 The treatment of guarantees in the classification process is discussed in Attachment 1.

4 Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90-16); Board of Governors of the Federal Reserve System, 12 CFR Parts 208 and 223 (Regulation H and Y; Docket No. R-0685); Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064-AB00); Department of the Treasury, Office of Thrift Supervision, 12 CFR Part 564 (Docket No. 90-1495).

7 Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today’s actual market conditions.

The real estate appraisal regulations of the federal bank and thrift regulatory agencies include a requirement that an appraisal (a) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (b) reconcile these approaches; and (c) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.
When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners may evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization ("cap") rates.9

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Examiners do not make adjustments to appraisal assumptions for credit analysis purposes based on worst case scenarios that are unlikely to occur. For example, an examiner would not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today’s market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and "cap" rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, "cap" rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be

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9 Attachment 2 includes a discussion of discount rates and direct capitalization rates.
given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and "cap" rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

Classification Guidelines

As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or criticized unless well-defined weaknesses exist that jeopardize repayment. An institution will not be criticized for continuing to carry loans having weaknesses that result in classification or criticism as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these loans.

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions (Attachment 3). In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and cash flow provided by, all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan's record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics

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10 These definitions are presented in Attachment 3 and address assets classified "substandard," "doubtful," or "loss" for supervisory purposes.

11 Another issue that arises in the review of a commercial real estate loan is the loan's treatment as an accruing asset or as a nonaccrual asset for reporting purposes. The federal bank and thrift regulatory agencies have provided guidance on nonaccrual status in the instructions for the Reports of Condition and Income (Call Reports) for banks, and in the instructions for the Thrift Financial Report for savings associations, and in related supervisory guidance of the agencies.
affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

Classification of troubled project-dependent commercial real estate loans. The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment.

As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified "loss." The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than "substandard." The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified "doubtful" when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined.

If warranted by the underlying circumstances, an examiner may use a "doubtful" classification on the entire loan balance. However, this would occur infrequently.

Guidelines for classifying partially charged-off loans. Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When an institution has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than "substandard."

A more severe classification than "substandard" for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

The discussion in this section is not intended to address loans that must be treated as "other real estate owned" for bank regulatory reporting purposes or "real estate owned" for thrift regulatory reporting purposes. Guidance on these assets is presented in supervisory and reporting guidance of the agencies.

For purposes of this discussion, the "value of the collateral" is the value used by the examiner for credit analysis purposes, as discussed in a previous section of this policy statement.
Guidelines for classifying formally restructured loans. The classification treatment previously discussed for a partially charged off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms. Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit review system, and closely monitored by management.

Review of the Allowance for Loan and Lease Losses (ALLL)\textsuperscript{15}

The adequacy of a depository institution's ALLL, including amounts based on an analysis of the commercial real estate portfolio, must be based on a careful, well documented, and consistently applied analysis of the institution's loan and lease portfolio.\textsuperscript{16} The determination of the adequacy of the ALLL should be based upon management's consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient without further analysis and cannot produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should also consider other factors, including changes in the nature and volume of the portfolio; the experience, ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans and commitments. In addition, this analysis should consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems. Furthermore, management should consider external factors such as local and national economic conditions and

\textsuperscript{14} An example of a restructured commercial real estate loan that does not have reasonable modified terms would be a "cash flow" mortgage which requires interest payments only when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

\textsuperscript{15} Each of the federal bank and thrift regulatory agencies have issued guidance on the allowance for loan and lease losses. The following discussion summarizes general principles for assessing the adequacy of the allowance for loan and lease losses.

\textsuperscript{16} The estimation process described in this section permits for a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.
developments; competition; and legal and regulatory requirements; as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the institution and provide for sufficient flexibility to accommodate changing circumstances.

Examiners will evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL in order to assure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the overall estimate of the ALLL and the range of possible credit losses estimated by management will be reviewed for reasonableness in view of these factors. This examiner analysis will also consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems.

As discussed in the previous section on classification guidelines, the value of the collateral is considered by examiners in reviewing and classifying a commercial real estate loan. However, for a performing commercial real estate loan, the supervisory policies of the agencies do not require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL during examinations, it is important to recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of anticipated losses may not be precise due to the wide range of factors that must be considered. Further, the ability to estimate anticipated loss on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. When management has (a) maintained effective systems and controls for identifying, monitoring and addressing asset quality problems and (b) analyzed all significant factors affecting the collectibility of the portfolio, considerable weight should be given to management's estimates in assessing the adequacy of the ALLL.
Initially, the original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets. The federal bank and thrift regulatory agencies will, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a "financially responsible guarantor," as described below, may be sufficient to preclude classification or reduce the severity of classification.

For purposes of this discussion, a guarantee from a "financially responsible guarantor" has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

Considerations relating to a guarantor's financial capacity. The lending institution must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by a guarantor, in order to determine that the guarantor has the financial capacity to fulfill the contingent claims that exist.

Considerations relating to a guarantor's willingness to repay. Examiners normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified.

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1 Some loans are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the loan based upon the guarantor's ability to repay the loan.

2 Some guarantees may only provide for support for certain phases of a real estate project. It would not be appropriate to rely upon these guarantees to support a troubled loan after the completion of these phases.
based on the "track record" of the guarantor, including payments made to date on the asset under review or other obligations.

Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. However, examiners give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review.

Examiners also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
- Where the guarantees are collateralized by readily marketable assets that are under the control of a third party.

Other considerations. In general, only guarantees that are legally enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor’s financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners also consider the institution’s intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.
Approaches to the Valuation of Real Estate

Appraisals are professional judgments of the market value of real property. Three basic valuation approaches are used by professional appraisers in estimating the market value of real property -- the cost approach, the market data or direct sales comparison approach, and the income approach. The principles governing the three approaches are widely known in the appraisal field and were recently referenced in parallel regulations issued by each of the federal bank and thrift regulatory agencies. When evaluating the collateral for problem credits, the three valuation approaches are not equally appropriate.

1. **Cost Approach.** In the cost approach, the appraiser estimates the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land. The cost approach is particularly helpful when reviewing draws on construction loans. However, as the property increases in age, both reproduction cost and depreciation become more difficult to estimate. Except for special purpose facilities, the cost approach is usually inappropriate in a troubled real estate market because construction costs for a new facility normally exceed the market value of existing comparable properties.

2. **Market Data or Direct Sales Comparison Approach.** This approach examines the price of similar properties that have sold recently in the local market, estimating the value of the subject property based on the comparable properties’ selling price. It is very important that the characteristics of the observed transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data are typically available. When adequate sales data are available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties are not sufficient to justify a conclusion.

3. **The Income Approach.** The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in markets that are thin or subject to disorderly or unusual conditions, market value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property.
The income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is often used to estimate the present value of future income streams. For troubled properties, however, examiners typically utilize the more explicit discounted cash flow (net present value) method for analytical purposes. In that method, a time frame for achieving a "stabilized", or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Valuation of Troubled Income-Producing Properties

When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales often are difficult to obtain. Troubled properties may be hard to market, and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity — not just in today's market but over time — offers the most appropriate method of valuation in the supervisory process.

Estimates of the property's value should be based upon reasonable and supportable projections of the determinants of future net operating income: rents (or sales), expenses and rates of occupancy. Judgment is involved in estimating all of these factors. The primary considerations for these projections include historical levels and trends, the current market performance achieved by the subject and similar properties, and economically feasible and defensible projections of future demand and supply conditions. To the extent that current market activity is dominated by a limited number of transactions or liquidation sales, high "capitalization" and discount rates implied by such transactions should not be used. Rather, analysts should use rates that reflect market conditions that are neither highly speculative nor depressed for the type of property being valued and that property's location.
Technical Notes

In the process of reviewing a real estate loan and in the use of the net present value approach of collateral valuation, several conceptual issues often are raised. The following discussion sets forth the meaning and use of those key concepts.

The Discount Rate. The discount rate used in the net present value approach to convert future net cash flows of income-producing real estate into present market value terms is the rate of return that market participants require for this type of real estate investment. The discount rate will vary over time with changes in overall interest rates and in the risk associated with the physical and financial characteristics of the property. The riskiness of the property depends both on the type of real estate in question and on local market conditions.

The Direct Capitalization ("Cap" Rate) Technique. The use of "cap" rates, or direct income capitalization, is a method used by many market participants and analysts to relate the value of a property to the net operating income it generates. In many applications, a "cap" rate is used as a short cut for computing the discounted value of a property's income streams.

The direct income capitalization method calculates the value of a property by dividing an estimate of its "stabilized" annual income by a factor called a "cap" rate. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The "cap" rate — usually defined for each property type in a market area — is viewed by some analysts as the required rate of return stated in terms of current income. That is to say, the "cap" rate can be considered a direct observation of the required earnings-to-price ratio in current income terms. The "cap" rate also can be viewed as the number of cents per dollar of today's purchase price investors would require annually over the life of the property to achieve their required rate of return.

The "cap" rate method is appropriate if the net operating income to which it is applied is representative of all future income streams or if net operating income and the property's selling price are expected to increase at a fixed rate. The use of this technique assumes that either the stabilized income or the "cap" rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

1 Regulatory policy of the Office of Thrift Supervision specifies that, for supervisory purposes, thrifts are to use discount rates that are consistent with generally accepted accounting principles for thrifts (which allow the use of an average-cost-of-capital-funds rate to calculate net realizable value) or discount rates that are consistent with the practices of the federal banking agencies.
This method alone is not appropriate for troubled real estate since income generated by the property is not at normal or stabilized levels. In evaluating troubled real estate, ordinary discounting typically is used for the period before the project reaches its full income potential. A "terminal" "cap" rate is then utilized to estimate the value of the property (its reversion or sales price) at the end of that period.

**Differences Between Discount and Cap Rates.** When used for estimating real estate market values, discount and "cap" rates should reflect the current market requirements for rates of return on properties of a given type. The discount rate is the required rate of return including the expected increases in future prices and is applied to income streams reflecting inflation. In contrast, the "cap" rate is used in conjunction with a stabilized net operating income figure. The fact that discount rates for real estate are typically higher than "cap" rates reflects the principal difference in the treatment of expected increases in net operating income and/or property values.

Other factors affecting the "cap" rate used (but not the discount rate) include the useful life of the property and financing arrangements. The useful life of the property being evaluated affects the magnitude of the "cap" rate because the income generated by a property, in addition to providing the required return on investment, must be sufficient to compensate the investor for the depreciation of the property over its useful life. The longer the useful life, the smaller is the depreciation in any one year; hence, the smaller is the annual income required by the investor, and the lower is the "cap" rate. Differences in terms and the extent of debt financing and the related costs must also be taken into account.

**Selecting Discount and Cap Rates.** The choice of the appropriate values for discount and "cap" rates is a key aspect of income analysis. Both in markets marked by lack of transactions and those characterized by highly speculative or unusually pessimistic attitudes, analysts consider historical required returns on the type of property in question. Where market information is available to determine current required yields, analysts carefully analyze sales prices for differences in financing, special rental arrangements, tenant improvements, property location, and building characteristics. In most local markets, the estimates of discount and "cap" rates used in income analysis should generally fall within a fairly narrow range for comparable properties.

**Holding Period vs. Marketing Period.** When the income approach is applied to troubled properties, a time frame is chosen over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). That time period is sometimes referred to as the "holding period." The longer the period before stabilization, the smaller will be the reversion value included in the total value estimate.

The holding period should be distinguished from the concept of "marketing period" — a term used in estimating the value of a property under the sales comparison approach.
and in discussions of property value when real estate is being sold. The marketing period is the length of time that may be required to sell the property in an open market.
Glossary

Appraisal. A written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.

Capitalization rate. A rate used to convert income into value. Specifically, it is the ratio between a property's stabilized net operating income and the property's sales price. Sometimes referred to as an overall rate because it can be computed as a weighted average of component investment claims on net operating income.

Discount rate. A rate of return used to convert future payments or receipts into their present value.

Holding period. The time frame over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income).

Market value. The most probable cash sale price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated (i.e., motivated by self-interest);
2. both parties are well informed or well advised, and acting in what they consider their own best interests;
3. a reasonable time is allowed for exposure in the open market;
4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Marketing period. The term in which an owner of a property is actively attempting to sell that property in a competitive and open market.

Net operating income (NOI). Annual income after all expenses have been deducted, except for depreciation and debt service.
The federal bank and thrift regulatory agencies currently utilize the following definitions for assets classified "substandard," "doubtful," and "loss" for supervisory purposes:

**Substandard Assets.** A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any.Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful Assets.** An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

**Loss Assets.** Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

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TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Interagency Examination Guidance on Commercial Real Estate Loans

The Federal Reserve and the other federal bank and thrift regulatory agencies have issued today an interagency policy statement on the review and classification of commercial real estate loans (enclosed). This policy statement expands upon guidance presented in the March 1, 1991 joint policy statement on the supervisory treatment of commercial real estate loans and is consistent with the Federal Reserve’s existing examination policies and practices.

The policy statement addresses a wide range of topics relating to the supervisory evaluation of commercial real estate loans. These topics include: the review of management’s policies pertaining to the commercial real estate loan portfolio; indicators of troubled real estate markets, projects, and related indebtedness; the factors examiners consider in their review of individual loans; and their assessment of the value of the collateral. The policy statement also presents classification guidelines for troubled commercial real estate loans and addresses the treatment of guarantees. Furthermore, the policy statement discusses general principles for the evaluation by examiners of the allowance for loan and lease losses, including portions based on an analysis of the commercial real estate loan portfolio.
A copy of this policy statement should be given to each officer, manager, examiner, and other professional involved in the supervision of state member banks. In addition, a copy of this guidance should be sent to the chief executive officer of each state member bank in your district. We will also be providing to you shortly a copy of the joint interagency press release and joint staff memorandum issued in connection with the guidelines.

Richard Spillenkothen
Director

Enclosure
Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans

Introduction

This policy statement addresses the review and classification of commercial real estate loans by examiners of the federal bank and thrift regulatory agencies. Guidance is also provided on the analysis of the value of the underlying collateral. In addition, this policy statement summarizes principles for evaluating an institution’s process for determining the appropriate level for the allowance for loan and lease losses, including amounts that have been based on an analysis of the commercial real estate loan portfolio. These guidelines are intended to promote the prudent, balanced, and consistent supervisory treatment of commercial real estate loans, including those to borrowers experiencing financial difficulties.

The attachments to this policy statement address three topics related to the review of commercial real estate loans by examiners. The topics include the treatment of guarantees in the classification process (Attachment 1); background information on the valuation of income-producing commercial real estate loans in the examination process (Attachment 2); and definitions of classification terms used by the federal bank and thrift regulatory agencies (Attachment 3).

Examiner Review of Commercial Real Estate Loans

Loan Policy and Administration Review. As part of the analysis of an institution’s commercial real estate loan portfolio, examiners review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough

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1 For purposes of this policy statement, "commercial real estate loans" refers to all loans secured by real estate, except for loans secured by 1 - 4 family residential properties. This does not refer to loans where the underlying collateral has been taken solely through an abundance of caution where the terms as a consequence have not been made more favorable than they would have been in the absence of the lien.

2 The agencies issuing this policy statement are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

3 For analytical purposes, as part of its overall estimate of the allowance for loan and lease losses (ALLL) management may attribute a portion of the ALLL to the commercial real estate loan portfolio. However, this does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

For savings institutions, the ALLL is referred to as the "general valuation allowance" for purposes of the Thrift Financial Report.
loan documentation are essential to the institution's management of the lending function.

The policies governing an institution's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The institution must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the institution's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness. In order to evaluate the collectibility of an institution's commercial real estate portfolio, examiners should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

Available indicators, such as permits for — and the value of — new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.
• Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project’s income potential, resulting in protracted repayment or default on the loan.

• Delinquent lease payments from major tenants.

• Land values that assume future rezoning.

• Tax arrearages.

As the problems associated with a commercial real estate project become more pronounced, problems with the related indebtedness may also arise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound or a liberal basis. Common examples of these types of problems include:

• Loans with no or minimal borrower equity.

• Loans on speculative undeveloped property where the borrowers’ only source of repayment is the sale of the property.

• Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.

• Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.

• Loans to borrowers with no development plans or noncurrent development plans.

• Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.  

Examiner Review of Individual Loans, Including the Analysis of Collateral Value.

The focus of an examiner’s review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower’s willingness and capacity to repay under the existing loan terms from the borrower’s other resources if necessary. In evaluating the overall risk associated with

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4 As discussed more fully in the section on classification guidelines, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.
a commercial real estate loan, examiners consider a number of factors, including the
class, overall financial condition and resources, and payment record of the
borrower; the prospects for support from any financially responsible guarantors; and
the nature and degree of protection provided by the cash flow and value of the
underlying collateral. However, as other sources of repayment for a troubled
commercial real estate loan become inadequate over time, the importance of the
collateral’s value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require
institutions to obtain appraisals when certain criteria are met. Management is
responsible for reviewing each appraisal’s assumptions and conclusions for reasonableness.
Appraisal assumptions should not be based solely on current conditions that
ignore the stabilized income-producing capacity of the property. Management should
adjust any assumptions used by an appraiser in determining value that are overly
optimistic or pessimistic.

An examiner analyzes the collateral’s value as determined by the institution’s most
recent appraisal (or internal evaluation, as applicable). An examiner reviews the major
facts, assumptions, and approaches used by the appraiser (including any comments
made by management on the value rendered by the appraiser). Under the
circumstances described below, the examiner may make adjustments to this assessment
of value. This review and any resulting adjustments to value are solely for purposes
of an examiner’s analysis and classification of a credit and do not involve actual
adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of
income-producing real estate collateral. This approach is discussed in more detail in
Attachment 2. This analysis should not be based solely on the current performance of
the collateral or similar properties; rather, it should take into account, on a discounted
basis, the ability of the real estate to generate income over time based upon reasonable
and supportable assumptions.

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1 The treatment of guarantees in the classification process is discussed in Attachment 1.

2 Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90-16); Board
of Governors of the Federal Reserve System, 12 CFR Parts 208 and 225 (Regulation H and Y; Docket No. R-0683);
Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064-AIB0); Department of the Treasury, Office of Thrift
Supervision, 12 CFR Part 564 (Docket No. 90-1695).

3 Stabilized income generally is defined as the yearly net operating income produced by the property at normal
occupancy and rental rates; it may be adjusted upward or downward from today’s actual market conditions.

4 The real estate appraisal regulations of the federal bank and thrift regulatory agencies include a requirement that an
appraisal (a) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches
to market value; (b) reconcile these approaches; and (c) explain the elimination of each approach not used. A discounted
cash flow analysis is recognized as a valuation method for the income approach.
When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners may evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization ("cap") rates.\(^9\)

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Examiners do not make adjustments to appraisal assumptions for credit analysis purposes based on worst case scenarios that are unlikely to occur. For example, an examiner would not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today’s market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and “cap” rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, “cap” rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be

\(^9\) Attachment 2 includes a discussion of discount rates and direct capitalization rates.
given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and "cap" rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

Classification Guidelines

As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or criticized unless well-defined weaknesses exist that jeopardize repayment. An institution will not be criticized for continuing to carry loans having weaknesses that result in classification or criticism as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these loans.

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions (Attachment 3). In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and cash flow provided by, all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan's record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics.

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10 These definitions are presented in Attachment 3 and address assets classified "substandard," "doubtful," or "loss" for supervisory purposes.

11 Another issue that arises in the review of a commercial real estate loan is the loan's treatment as an accruing asset or as a nonaccrual asset for reporting purposes. The federal bank and thrift regulatory agencies have provided guidance on nonaccrual status in the instructions for the Reports of Condition and Income (Call Reports) for banks, and in the instructions for the Thrift Financial Report for savings associations, and in related supervisory guidance of the agencies.
affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

Classification of troubled project-dependent commercial real estate loans. The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment.

As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified "loss." The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than "substandard." The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified "doubtful" when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined.

If warranted by the underlying circumstances, an examiner may use a "doubtful" classification on the entire loan balance. However, this would occur infrequently.

Guidelines for classifying partially charged-off loans. Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When an institution has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than "substandard."

A more severe classification than "substandard" for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

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12 The discussion in this section is not intended to address loans that must be treated as "other real estate owned" for bank regulatory reporting purposes or "real estate owned" for thrift regulatory reporting purposes. Guidance on these assets is presented in supervisory and reporting guidance of the agencies.

13 For purposes of this discussion, the "value of the collateral" is the value used by the examiner for credit analysis purposes, as discussed in a previous section of this policy statement.
Guidelines for classifying formally restructured loans. The classification treatment previously discussed for a partially charged off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner’s analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms. Troubled commercial real estate loans whose terms have been restructured should be identified in the institution’s internal credit review system, and closely monitored by management.

Review of the Allowance for Loan and Lease Losses (ALLL)

The adequacy of a depository institution's ALLL, including amounts based on an analysis of the commercial real estate portfolio, must be based on a careful, well documented, and consistently applied analysis of the institution’s loan and lease portfolio.

The determination of the adequacy of the ALLL should be based upon management’s consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient without further analysis and cannot produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should also consider other factors, including changes in the nature and volume of the portfolio; the experience, ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans and commitments. In addition, this analysis should consider the quality of the institution’s systems and management in identifying, monitoring, and addressing asset quality problems. Furthermore, management should consider external factors such as local and national economic conditions and

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14 An example of a restructured commercial real estate loan that does not have reasonable modified terms would be a "cash flow" mortgage which requires interest payments only when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

15 Each of the federal bank and thrift regulatory agencies have issued guidance on the allowance for loan and lease losses. The following discussion summarizes general principles for assessing the adequacy of the allowance for loan and lease losses.

16 The estimation process described in this section permits for a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.
developments; competition; and legal and regulatory requirements; as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the institution and provide for sufficient flexibility to accommodate changing circumstances.

Examiners will evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL in order to assure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the overall estimate of the ALLL and the range of possible credit losses estimated by management will be reviewed for reasonableness in view of these factors. This examiner analysis will also consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems.

As discussed in the previous section on classification guidelines, the value of the collateral is considered by examiners in reviewing and classifying a commercial real estate loan. However, for a performing commercial real estate loan, the supervisory policies of the agencies do not require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL during examinations, it is important to recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of anticipated losses may not be precise due to the wide range of factors that must be considered. Further, the ability to estimate anticipated loss on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. When management has (a) maintained effective systems and controls for identifying, monitoring and addressing asset quality problems and (b) analyzed all significant factors affecting the collectibility of the portfolio, considerable weight should be given to management's estimates in assessing the adequacy of the ALLL.
TREATMENT OF GUARANTEES IN THE CLASSIFICATION PROCESS

Initially, the original source of repayment and the borrower’s intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets. The federal bank and thrift regulatory agencies will, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a “financially responsible guarantor,” as described below, may be sufficient to preclude classification or reduce the severity of classification.

For purposes of this discussion, a guarantee from a “financially responsible guarantor” has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

Considerations relating to a guarantor’s financial capacity. The lending institution must have sufficient information on the guarantor’s financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor’s financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by a guarantor, in order to determine that the guarantor has the financial capacity to fulfill the contingent claims that exist.

Considerations relating to a guarantor’s willingness to repay. Examiners normally rely on their analysis of the guarantor’s financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified

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1 Some loans are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the loan based upon the guarantor’s ability to repay the loan.

2 Some guarantees may only provide support for certain phases of a real estate project. It would not be appropriate to rely upon these guarantees to support a troubled loan after the completion of these phases.
based on the "track record" of the guarantor, including payments made to date on the asset under review or other obligations.

Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. However, examiners give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review.

Examiners also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
- Where the guarantees are collateralized by readily marketable assets that are under the control of a third party.

Other considerations. In general, only guarantees that are legally enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.
THE VALUATION OF INCOME-PRODUCING REAL ESTATE

Approaches to the Valuation of Real Estate

Appraisals are professional judgments of the market value of real property. Three basic valuation approaches are used by professional appraisers in estimating the market value of real property -- the cost approach, the market data or direct sales comparison approach, and the income approach. The principles governing the three approaches are widely known in the appraisal field and were recently referenced in parallel regulations issued by each of the federal bank and thrift regulatory agencies. When evaluating the collateral for problem credits, the three valuation approaches are not equally appropriate.

1. **Cost Approach.** In the cost approach, the appraiser estimates the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land. The cost approach is particularly helpful when reviewing draws on construction loans. However, as the property increases in age, both reproduction cost and depreciation become more difficult to estimate. Except for special purpose facilities, the cost approach is usually inappropriate in a troubled real estate market because construction costs for a new facility normally exceed the market value of existing comparable properties.

2. **Market Data or Direct Sales Comparison Approach.** This approach examines the price of similar properties that have sold recently in the local market, estimating the value of the subject property based on the comparable properties' selling price. It is very important that the characteristics of the observed transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data are typically available. When adequate sales data are available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties are not sufficient to justify a conclusion.

3. **The Income Approach.** The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in markets that are thin or subject to disorderly or unusual conditions, market value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property.
The income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is often used to estimate the present value of future income streams. For troubled properties, however, examiners typically utilize the more explicit discounted cash flow (net present value) method for analytical purposes. In that method, a time frame for achieving a "stabilized", or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

**Valuation of Troubled Income-Producing Properties**

When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales often are difficult to obtain. Troubled properties may be hard to market, and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity — not just in today's market but over time — offers the most appropriate method of valuation in the supervisory process.

Estimates of the property's value should be based upon reasonable and supportable projections of the determinants of future net operating income: rents (or sales), expenses and rates of occupancy. Judgment is involved in estimating all of these factors. The primary considerations for these projections include historical levels and trends, the current market performance achieved by the subject and similar properties, and economically feasible and defensible projections of future demand and supply conditions. To the extent that current market activity is dominated by a limited number of transactions or liquidation sales, high "capitalization" and discount rates implied by such transactions should not be used. Rather, analysts should use rates that reflect market conditions that are neither highly speculative nor depressed for the type of property being valued and that property's location.
Technical Notes

In the process of reviewing a real estate loan and in the use of the net present value approach of collateral valuation, several conceptual issues often are raised. The following discussion sets forth the meaning and use of those key concepts.

The Discount Rate. The discount rate used in the net present value approach to convert future net cash flows of income-producing real estate into present market value terms is the rate of return that market participants require for this type of real estate investment. The discount rate will vary over time with changes in overall interest rates and in the risk associated with the physical and financial characteristics of the property. The riskiness of the property depends both on the type of real estate in question and on local market conditions.

The Direct Capitalization ("Cap" Rate) Technique. The use of "cap" rates, or direct income capitalization, is a method used by many market participants and analysts to relate the value of a property to the net operating income it generates. In many applications, a "cap" rate is used as a short cut for computing the discounted value of a property's income streams.

The direct income capitalization method calculates the value of a property by dividing an estimate of its "stabilized" annual income by a factor called a "cap" rate. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The "cap" rate — usually defined for each property type in a market area — is viewed by some analysts as the required rate of return stated in terms of current income. That is to say, the "cap" rate can be considered a direct observation of the required earnings-to-price ratio in current income terms. The "cap" rate also can be viewed as the number of cents per dollar of today's purchase price investors would require annually over the life of the property to achieve their required rate of return.

The "cap" rate method is appropriate if the net operating income to which it is applied is representative of all future income streams or if net operating income and the property's selling price are expected to increase at a fixed rate. The use of this technique assumes that either the stabilized income or the "cap" rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

1 Regulatory policy of the Office of Thrift Supervision specifies that, for supervisory purposes, thrifts are to use discount rates that are consistent with generally accepted accounting principles for thrifts (which allow the use of an average-cost-of-capital-funds rate to calculate net realizable value) or discount rates that are consistent with the practices of the federal banking agencies.
This method alone is not appropriate for troubled real estate since income generated by the property is not at normal or stabilized levels. In evaluating troubled real estate, ordinary discounting typically is used for the period before the project reaches its full income potential. A "terminal" "cap" rate is then utilized to estimate the value of the property (its reversion or sales price) at the end of that period.

Differences Between Discount and Cap Rates. When used for estimating real estate market values, discount and "cap" rates should reflect the current market requirements for rates of return on properties of a given type. The discount rate is the required rate of return including the expected increases in future prices and is applied to income streams reflecting inflation. In contrast, the "cap" rate is used in conjunction with a stabilized net operating income figure. The fact that discount rates for real estate are typically higher than "cap" rates reflects the principal difference in the treatment of expected increases in net operating income and/or property values.

Other factors affecting the "cap" rate used (but not the discount rate) include the useful life of the property and financing arrangements. The useful life of the property being evaluated affects the magnitude of the "cap" rate because the income generated by a property, in addition to providing the required return on investment, must be sufficient to compensate the investor for the depreciation of the property over its useful life. The longer the useful life, the smaller is the depreciation in any one year; hence, the smaller is the annual income required by the investor, and the lower is the "cap" rate. Differences in terms and the extent of debt financing and the related costs must also be taken into account.

Selecting Discount and Cap Rates. The choice of the appropriate values for discount and "cap" rates is a key aspect of income analysis. Both in markets marked by lack of transactions and those characterized by highly speculative or unusually pessimistic attitudes, analysts consider historical required returns on the type of property in question. Where market information is available to determine current required yields, analysts carefully analyze sales prices for differences in financing, special rental arrangements, tenant improvements, property location, and building characteristics. In most local markets, the estimates of discount and "cap" rates used in income analysis should generally fall within a fairly narrow range for comparable properties.

Holding Period vs. Marketing Period. When the income approach is applied to troubled properties, a time frame is chosen over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). That time period is sometimes referred to as the "holding period." The longer the period before stabilization, the smaller will be the reversion value included in the total value estimate.

The holding period should be distinguished from the concept of "marketing period" — a term used in estimating the value of a property under the sales comparison approach.
and in discussions of property value when real estate is being sold. The marketing period is the length of time that may be required to sell the property in an open market.
Glossary

Appraisal. A written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.

Capitalization rate. A rate used to convert income into value. Specifically, it is the ratio between a property’s stabilized net operating income and the property’s sales price. Sometimes referred to as an overall rate because it can be computed as a weighted average of component investment claims on net operating income.

Discount rate. A rate of return used to convert future payments or receipts into their present value.

Holding period. The time frame over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income).

Market value. The most probable cash sale price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated (i.e., motivated by self-interest);
2. both parties are well informed or well advised, and acting in what they consider their own best interests;
3. a reasonable time is allowed for exposure in the open market;
4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Marketing period. The term in which an owner of a property is actively attempting to sell that property in a competitive and open market.

Net operating income (NOI). Annual income after all expenses have been deducted, except for depreciation and debt service.
Attachment 3

Classification Definitions

The federal bank and thrift regulatory agencies currently utilize the following definitions for assets classified "substandard," "doubtful," and "loss" for supervisory purposes:

Substandard Assets. A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets. An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss Assets. Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Examination Review Procedures—Program for Evaluating and Reviewing Use of Appraisals

As part of continuing efforts to assure balance and consistency, the federal banking agencies are taking certain steps to review and monitor the use of appraisals in the examination process. The purpose of this effort is to promote consistency with interagency guidelines on the evaluation of real estate loans and with related examination policies and procedures, including the March 1st interagency policy statement on credit availability. (The relevant policies and guidelines are set forth in the cross reference section at the end of this letter.) Among the steps to be taken is the establishment of a random review or audit program by each Reserve Bank to encourage appropriate use of appraisals in the loan evaluation process. Each Reserve Bank is asked to implement this program immediately.

It is suggested that the program be conducted on a random basis by an examination officer, a review examiner or an examiner designated by the Reserve Bank to administer the program. The reviewer should determine that examination guidelines and policies have been consistently applied to real estate credits and to the analysis of appraisals and loan values. Under this program, the reviewer should select a sample of real estate credits, review the work papers and assess the use of appraisals in the loan classification process.

As part of this effort, the reviewer should consider any adjustments to the value of the collateral by examiners or management in arriving at collateral values for use in loan classifications. If adjustments are deemed necessary for credit analysis purposes to accurately assess the value of collateral, the reviewer should note the justification and frequency of any such adjustment made by the examiner or management and the assumptions used in making the adjustments. The reviewer should ascertain that the examiner has given consideration to the income producing capacity of the property when evaluating income property loans, and that the use of the value of the collateral in the loan evaluation process is consistent with supervisory policies regarding the review of real estate loans.
The objective of the program is to promote the use of consistent, reasonable assumptions in assessing the value of real estate collateral. Examination staff should be advised of the results of these reviews and the need for careful documentation in the use of the value of collateral as a basis for loan classifications. Each Reserve Bank should maintain documentation on this program and be prepared to provide summary data for review during the operations review or as otherwise required.

Questions regarding this SR letter can be referred to Roger Cole (202/452-2618), Steve Lovette (202/452-3622), Bill Spaniel (202/452-3469) or Jack Jennings (202/452-3053).

Richard Spillenkothen
Director

TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Interagency Meeting of Federal Financial Regulatory
Examination Staff - December 16 - 17, 1991

An Interagency Examiners Conference is scheduled to be held
December 16 - 17, 1991, at the Omni Inner Harbor Hotel, 101 West
Fayette Street, Baltimore, MD (301) 752-1100. The conference will
begin at 1:00 p.m. on December 16th and will be followed by a
dinner that evening. The conference will resume on December 17th
with a continental breakfast at 7:45 a.m. and will last until 5:00
p.m. The purpose of the conference is to provide a forum for
senior examination staff to discuss regulatory policies and
procedures and their effects on the availability of credit. The
Federal Reserve will hold a one-day meeting of senior officers in
charge of supervision at the Baltimore Branch of the Federal
Reserve Bank of Richmond on December 18, 1991, and will adjourn at
4:00 p.m.

In addition to the senior officer in charge of supervision,
each Reserve Bank is asked to send to the interagency conference
three or four additional examination personnel. The group should
include review and senior field examiners — individuals who have
responsibility for supervising and conducting on-site examinations.

An agenda for the senior vice presidents' meeting to be held
on December 18th will be forwarded in the near future.

A limited number of rooms have been reserved for Sunday,
December 15th, primarily for staff travelling from the West Coast.
Reservations have been made for all attendees for Monday and
Tuesday nights at the Omni. Accommodations for staff are also
available Wednesday night.
Please send a list of attendees from your Reserve Bank by November 15, 1991, with room reservation requirements to Alison Waldron (202) 452-2538, or Mark Benton (202) 452-5205, FAX number (202) 452-2770. Further information, including agenda items, will be provided to Reserve Banks. Questions may be directed to Ms. Waldron, or Mr. Benton.

Richard Spillenkothen
Director
TO THE OFFICER IN CHARGE OF SUPERVISION  
at each Federal Reserve Bank

SUBJECT: Interagency Examination Guidance on Commercial Real Estate Loans

Enclosed for your information is a copy of the joint interagency press release and joint staff memorandum issued in connection with the guidelines.

Richard Spillenkothen
Director

Enclosure
WASHINGTON, D.C., Nov. 7, 1991 — The four federal regulators of bank and thrift institutions issued a joint statement today on the review and classification of commercial real estate loans. Today’s action is another step by the agencies to ensure that misunderstandings about supervisory policies do not impede the availability of credit to sound borrowers. Development of this document was announced in the Administration’s October 8th statement on “Easing The Credit Crunch To Promote Economic Growth.”

The policy statement provides clear and comprehensive guidance on the review and classification of commercial real estate loans. The detailed guidelines, which will be sent to the chief executive officer of each depository institution and each bank and thrift examiner, cover loan portfolio review procedures, indicators of troubled loans, analysis of loans and collateral values, and the review of institutions’ loss allowances.

The four regulatory agencies that issued today’s guidelines are the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board. —more—
Supervisory policy statement - 2

(FRB), and the Office of Thrift Supervision (OTS). Together, the four agencies supervise the activities of the nation’s 12,000 commercial banks and 2,200 thrift institutions.

In addition to today’s issuance, the regulatory agencies are undertaking three other actions:

- **National Meeting of Examiners**
  The agencies will hold a national meeting of senior examination personnel in Baltimore, Md., on December 16 and 17 to review the policy statement and other initiatives related to credit availability.

- **Random Audit Program**
  To assess the quality of examiners’ review of collateral value, the regulatory agencies will implement a random audit program to determine how examiners review and analyze the assumptions contained in appraisals as part of their loan review process.

- **Holding Company Preferred Stock**
  The Federal Reserve Board, in a move designed to grant bank holding companies greater flexibility in raising capital, has issued for public comment a proposal to lift the limit on the amount of noncumulative perpetual preferred stock that bank holding companies may include in Tier 1 capital. This proposal, if adopted, can assist organizations in strengthening their capital positions and expanding their ability to extend credit to sound borrowers.

All of these steps follow previous actions by the regulatory agencies in March and July to address credit availability concerns.

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Office of the Comptroller of the Currency  
Federal Deposit Insurance Corporation  
Federal Reserve Board  
Office of Thrift Supervision

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans

November 7, 1991

The recent decline in credit extended by depository institutions has been attributed to many factors. These factors include the general slowdown in the economy, the overbuilding of commercial real estate properties in some markets, the desire of some household and business borrowers, as well as some depository institutions, to strengthen their balance sheets, changes by lenders in underwriting standards, and concerns about the potential impact of certain supervisory policies or actions. To ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers, the four Federal regulators of banks and thrifts have taken a number of steps to clarify and communicate their policies. The attached policy statement is a further step in this effort.

On March 1, 1991, the four agencies — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision — issued general guidelines that addressed a wide range of supervisory policies. Included in the March issuance were brief discussions of the workout of problems loans, lending by undercapitalized institutions, and a general statement on the valuation of real estate loans.

The attached policy statement expands upon the March 1 and subsequent guidance as it relates to the review and classification of commercial real estate loans.

The intent of the statement by the agencies is to provide clear and comprehensive guidance to ensure that supervisory personnel are reviewing loans in a consistent, prudent, and balanced fashion and to ensure that all interested parties are aware of the guidance.

The policy statement emphasizes that the evaluation of real estate loans is not based solely on the value of the collateral, but on a review of the borrower’s willingness and capacity to repay and on the income-producing capacity of the properties.
The policy statement also provides guidance on how supervisory personnel analyze the value of collateral. In general, examiners consider the institution's appraisals of collateral (or internal evaluations, when applicable) to determine value and they review the major facts, assumptions and approaches used in determining the value of the collateral. Examiners seek to avoid challenges to underlying assumptions that differ in only a limited way from norms that would generally be associated with the property under review. Nonetheless, when reviewing the value of the collateral and any related management adjustments, examiners ascertain that the value is based on assumptions that are both prudent and realistic, and not on overly optimistic or overly pessimistic assumptions.

The policy statement covers a wide range of specific topics, including:

- the general principles that examiners follow in reviewing commercial real estate loan portfolios;
- the indicators of troubled real estate markets, projects, and related indebtedness;
- the factors examiners consider in their review of individual loans, including the use of appraisals and the determination of collateral value;
- a discussion of approaches to valuing real estate, especially in troubled markets;
- the classification guidelines followed by the agencies, including the treatment of guarantees; and
- the factors considered in the evaluation of an institution's allowance for loan and lease losses.

This statement is intended to ensure that all supervisory personnel, lending institutions and other interested parties have a clear understanding of the agencies' policies.
TO THE OFFICERS IN CHARGE OF SUPERVISION AT EACH
FEDERAL RESERVE BANK

SUBJECT: National Examiners' Conference

Enclosed is information regarding the National Examiners' Conference sponsored by the Office of Thrift Supervision to be held at the Omni-Inner Harbor Hotel in Baltimore, Maryland on December 16 - 17, 1991, and the meeting of the Federal Reserve Senior Officers in Charge of Supervision to be held at the Baltimore Branch of the Federal Reserve Bank of Richmond on December 18, 1991.

Registration for the National Examiners' Conference for staff travelling to Baltimore on Sunday will be held in the Promenade area of the Omni from 3:00 p.m. to 5:00 p.m. Individuals arriving on Monday should register between 8:00 a.m. and 1:00 p.m. in the Promenade area.

The National Examiners' Conference will begin on Monday, December 16th at 1:00 p.m. with an address by Secretary of the Treasury Nicholas Brady. A reception and dinner will be held for conference attendees at the Omni on Monday evening. The conference will adjourn at 5:00 p.m. on Tuesday.

The OTS has arranged for transportation to BWI Airport for conference participants immediately following adjournment. In addition, transportation is available by shuttle express van ($6.50 per trip) or taxi ($15 to $17 per trip).

The Federal Reserve will hold a reception and dinner at the Omni on Tuesday evening for the Federal Reserve Senior Officers in Charge of Supervision. The Federal Reserve meeting will begin at the Baltimore Branch on Wednesday at 8:00 a.m. and will adjourn at 4:00 p.m. The Branch cafeteria will be open for...
breakfast at 7:00 a.m. The Branch will provide transportation to BWI Airport following the Wednesday meeting. Please complete the attached departure form and fax it to Mark Benton at 202-452-2770.

If you have any questions, please call Roger Cole at 202-452-2618.

Richard Spillenkothen
Director

Attachments
MEMORANDUM

TO: National Examiners' Conference Participants

FROM: Jonathan Fiechter

DATE: November 22, 1991

SUBJECT: Federal Financial Institution Regulators' Examination Staff Conference

The four Federal regulators banks and thrifts -- the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), and the Office of Thrift Supervision (OTS) -- have joined together to sponsor a National Examiners' Conference to be held on December 16 and 17 in Baltimore, Maryland. The purpose of the meeting is to review and discuss the recently issued interagency policy statement on the review and classification of commercial real estate loans and to communicate other initiatives and policies related to credit availability with senior examiners of the four regulatory agencies. This meeting should prove to be both productive and informative.

As the agency that has been designated to coordinate the conference, we at OTS are providing you with the necessary information for you to finalize your travel plans. The conference will be held at the OMNI Inner-Harbor Hotel, 101 W. Fayette Street, Baltimore, Maryland. The general meeting will begin at 1:00 p.m. on Monday, December 16 and adjourn at 5:00 p.m. on Tuesday, December 17. In addition, the OTS, FDIC, and a limited number of FRB staff will host separate agency meetings on Wednesday, December 18. Your agency coordinator will provide further details on the individual group meetings.

Attached hereto is information concerning hotel reservations and conference registration. Hotel rooms at the OMNI have been reserved for each participant. A block of rooms has been reserved beginning Sunday, December 15, for those travelers who cannot arrive by the 1:00 p.m. start of the conference.

Enclosure
NATIONAL EXAMINERS' CONFERENCE

General Information

Dates:

Monday, December 16:
1:00pm-6:00pm  Interagency Conference
7:30pm-9:30pm  Interagency Dinner

Tuesday, December 17:
8:30am-5:00pm  Interagency Conference
6:30pm-8:30pm  FRB individual dinner meeting
7:00pm-9:00pm  OTS individual dinner meeting

*No dinner meetings planned by OCC or FDIC

Wednesday, December 18:
8:30am-10:30am  FDIC individual meeting
8:30am-1:00pm  OTS individual meeting
8:00am-4:00pm  FRB individual meeting (held at FRB Baltimore office)

*No agency meeting planned by OCC

Place:

OMNI-Inner Harbor Hotel
101 W. Fayette Street
Baltimore, MD 21201
(301) 752-1100

RESERVATIONS HAVE BEEN VERIFIED BY BOARD STAFF

Blocks of rooms have been reserved beginning Sunday, December 15 for travelers who cannot arrive by 1:00pm on December 16. Please call the OMNI Hotel directly at (301-752-1100) in order to confirm or cancel your reservation. They will require your full name, group affiliation, arrival and departure times, preference for smoking or non-smoking rooms, and whether you need to guarantee late arrival (after 6:00pm).

Transportation:

Shuttle service is available from BWI airport to the hotel for $6.50. Transportation will be provided to the OTS off-site dinner on December 17. Bus service will be available from the OMNI to the airport on December 17 and 18.
Billing:
A room rate of $71.00/per night for single occupancy has been negotiated with the OMNI hotel and will be billed to each guest. Please note that the OMNI hotel has agreed not to charge any additional taxes to this room rate. A government issued credit card should be used for payment. In the event that you do not have such credit card, present your government identification when settling your bill.

Parking:
Valet- and self-parking is available at the hotel at the rate of $9.00 per day. Valet service is recommended since it includes in/out privileges and may be charged to your hotel bill, unlike self-parking service.

Registration/Information:
Registration will be held in the Promenade area on Sunday, December 15 (3:00pm-5:00pm) and on Monday, December 16 (8:00am-1:00pm). Please check-in at the Registration area prior to the start of the conference to pick up materials and for further information.

In addition, an office will be staffed during the conference to take telephone messages and send/receive fax transmissions.

Conference Coordinators:
For additional information, you may contact:

FDIC: Mike Hovan (202-898-6851)
OTS: Louise Bartok (202-306-6280)
FRB: Mark Benton (202-452-5205)
OCC: Inga Swanner (202-874-5352)
National Examiners Conference
Omni Inner Harbor Hotel, Baltimore, Maryland
December 16 - 17, 1991

AGENDA

December 16, 1991

GENERAL SESSION
(International Ballroom)

1:00pm Opening Remarks (Secretary Brady)

1:20pm Overview of U.S. Economy and Commercial Real Estate Markets

U.S. Economy (M. Boskin, Chairman of the Council of Economic Advisors)

Condition of the Commercial Real Estate Market (R. Larson, President and Chief Executive Officer, the Taubman Company and Member, Resolution Trust Corporation Oversight Board)

2:45pm Overview of Economic Factors and Financial Regulatory Policies on the Availability of Credit (J. Robson, Deputy Secretary, Department of the Treasury)

3:00pm Break (Promenade)

3:40pm Review of Various Statements on Credit Availability

(Chair: Piechter, Fritts/Spillenkothen/Cooney)

- Concentration of credit
- Non-use of liquidation accounting
- Recognition of income for certain non-performing loans
- Other issues relating to non-accrual assets & formally restructured debts
- Policy concerning refinancing of commercial real estate loans
- Clarification on Highly Leveraged Transactions (HLT) Policy
4:40 pm  New Regulatory Initiatives (Chair: Schesmaring, Downey, Steinbrink, Stone)

Enhanced Examination Appeals Process

- Description of each agency’s current regional and/or district procedures for handling disputes
- Review of each agency’s new appeals program

Communication of Policies to Ensure that Examination Findings are Consistent with Recent Guidance on Credit Availability

5:40 pm  Adjournment

6:30 pm  Reception (Promenade)

7:30 pm  Dinner (James C. Miller, III, Chairman, Citizens for a Sound Economy) (International Ballroom)

December 17, 1991

7:00 am  Continental Breakfast (Liberty Ballroom)

8:30 am  New Regulatory Initiatives (Chair: Krause; Cole, Mialovich, Fishman) (International Ballroom)

- Indicators of troubled real estate
  -- Analysis of collateral value
  -- Use of appraisals and random audits of appraisals

- Classification guidelines
  -- Treatment of guarantees
  -- Project-dependent commercial real estate
  -- Partially charged-off loans
  -- Use of insubstance foreclosure

- Examiner review of allowances for loan and lease losses (ALLL)

Draft:  December 2, 1991
9:30am Break (Promenade)

**BREAKOUT SESSIONS**

10:10am Breakout Sessions (4 Concurrent Sessions, all of which would have a case study or examples, with the exception of session #4)

**Session 1:** Valuation of Troubled Real Estate (30 minutes) (FDIC lead)

**Session 2:** Accounting for Nonaccrual Assets (30 minutes) (FRB lead)

**Session 3:** Classification of Troubled Real Estate and Allowance Policy (30 minutes) (OCC lead)

**Session 4:** Outlook for Real Estate (30 minutes) (OTS lead)

12:00pm Lunch (International Ballroom)

1:30pm Resume Breakout Sessions

3:20pm Break (Promenade)

4:00pm **GENERAL SESSION** (International Ballroom)

Review of Conference Sessions
Question and Answer - Open Forum

Panel Members:

FDIC Taylor
FRB Laware
OCC Clarke
OTS Ryan

4:45pm Conference ends

Draft: December 2, 1991
TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Communication and Examination Procedures Concerning
Credit Availability

The Federal Reserve has a longstanding policy of maintaining appropriate communications with bankers and addressing legitimate issues concerning the availability of credit. In this regard, Federal Reserve officials are participating in a number of regional "town meetings" with bankers and borrowers, meeting with banks and their senior management, and stressing the importance of effective and proper communications during on-site examinations.

Obtaining Views on the Examination Process and Credit Availability

These efforts have been beneficial in understanding the views of bankers, businessmen, and local community leaders concerning the availability of credit and the performance of examiners in maintaining a prudent, balanced and consistent approach to examinations. In order to foster these beneficial exchanges of information, the Federal Reserve is encouraging its staff to continue these initiatives as set forth below:

- During examinations, Reserve Bank officials and examiners should stand ready to discuss with bankers any legitimate concerns or questions regarding on-site examinations. Such discussions could be held at any time during the examination process. Both examination personnel and senior Reserve Bank officials responsible for the examination process should be available to discuss the progress of the examination, examiner findings and any policies or procedures relating to the examination.

- Reserve Banks should continue to meet with bankers and borrowers in the "town meeting" format discussed in SR 91-19. These meetings provide a useful opportunity to obtain the
views of borrowers and bankers. Each Reserve Bank should maintain records of these meetings including a summary of each meeting, a representative list of attendees, and the time, date and location of the meeting. These summaries should be available for review as needed and a copy of each summary should be sent to the Board.

- Reserve Banks are participating in a series of meetings with bankers as discussed in AD 91-72. The purpose of these meetings is to strengthen our understanding of the issues affecting the availability of credit and the conditions banks are facing, to respond to any questions bankers have regarding our policies, and to consider further appropriate steps that could be taken to address credit availability concerns.

- Reserve Bank officials meet frequently with bankers on a wide variety of subjects. If appropriate and circumstances permit, Reserve Banks should take the occasion in these meetings to solicit the bankers' views on the possible impact of examination policies on credit availability.

With respect to each of the above programs, comments and suggestions made by bankers for improving the examination process in a manner that is consistent with safe and sound practices should be forwarded to Board staff for consideration.

**Communication with Examiners**

Each Reserve Bank is responsible for assuring that the March 1st interagency policy statement and all subsequent related guidance have been effectively communicated to each safety and soundness examiner. Reserve Banks have already had the March 1st statement explained to each examiner by a senior officer. In addition, Reserve Banks should ensure that subsequent and related guidance is adequately communicated to examiners on an ongoing basis, and that any new examiners are fully and appropriately informed of the contents of these policies.

On October 2, 1991, Reserve Banks were asked to implement additional procedures to strengthen communication efforts with bankers regarding the March 1st statement and related credit availability policies. This letter expands upon the instructions contained in SR 91-19 in the following respects:
During the next on-site examination of each state member bank, the examiner-in-charge or another Reserve Bank official is asked to explain or discuss the content and provisions of the March 1st interagency policy statement and related guidance with the bank's senior management.

If the bank's senior management has any questions or comments regarding the general content or specific provisions of the March 1st interagency policy statement or related guidance, these issues should be addressed during the examination or at the exit meeting with senior management. If appropriate, these matters can also be discussed at meetings with the bank's board of directors or the board's examination or audit committee.

Managing Implementation of Examination Procedures

Reserve Banks have long had effective procedures and practices for reviewing examination reports and for assuring that the System's examination policies and guidelines are followed in the conduct of the examination and the preparation of the report. As part of the review process, Reserve Banks are asked to establish a specific procedure for ensuring that the March 1st and related policy guidance (set forth in the Cross Reference section below) is followed in each state member bank examination. The procedure should include the following:

At the conclusion of the next examination, the examiner-in-charge should prepare and sign a memorandum to the files stating that the policies are reflected and incorporated in the report contents and findings. This memorandum should also be signed by the review examiner.

This memorandum should be retained in the examination file and be available to provide summary data for review during the operations review or as otherwise required. In addition, the confidential section of the examination report should also note that the report incorporates the credit availability policies and procedures and that the review procedures outlined above were followed by the examiner and the review examiner. This should be noted as part of the response to question 5 on page D of the confidential section of the examination report.
Questions regarding this SR letter can be referred to Roger Cole (202/452-2618), Steve Lovette (202/452-3622) or Bill Spaniel (202/452-3469).

Richard Spillenkothen
Director

In carrying out its supervisory responsibilities over the years, the Federal Reserve System has developed effective informal practices for discussing and resolving differences between bankers and examiners that arise in the context of on-site safety and soundness examinations. The existing process affords opportunities for bank management and directors to communicate their views and concerns to examiners and Reserve Bank officials during the course of the examination and follow-up process. These practices are intended to ensure that examination findings are based upon a balanced, fair and prudent consideration of all relevant information. The objective of the process is to produce an accurate and clear report of the bank's condition and operations.

Currently, a state member bank that believes an error has been made in its examination may request that the matter be reviewed by supervisory personnel. If in the judgment of the Reserve Bank the matter has merit, consideration is given to the issue and an attempt is made to resolve the question in a fair and satisfactory manner. For example, bank management may discuss examination findings and loan classifications with the examiner-in-charge or other supervisory officials during the on-site examination. At the completion of an examination, examiners and/or supervisory officials meet with bank management and, as appropriate, the board of directors to discuss the examiner's findings and conclusions. These practices, taken together, are designed to address potential differences that arise during the examination and have proved effective in maintaining appropriate lines of communication between bank management and directors, examiners and supervisory personnel.

This informal process has worked well over the years and has provided a means for assuring that significant concerns or questions bankers have regarding examination findings are given
reasonable consideration by the Federal Reserve. Recent developments regarding the potential impact of examination policies and procedures on credit availability underscore the ongoing importance of this process. Consequently, Reserve Banks are encouraged to continue to provide bank management and directors with suitable opportunities to discuss and resolve questions or concerns relating to examination findings.

Consistent with longstanding practice, this process should remain an informal one that is intended to bring legitimate bank concerns or questions arising in connection with safety and soundness examinations to the attention of supervisory personnel or other Reserve Bank officials. In some cases, questions or concerns may be referred by the bank directly to senior Reserve Bank officials or, on occasion, to the Reserve Bank president. These officials have the discretion to decide whether the circumstances of the particular situation, including the views of the bank involved, suggest that the matter should be resolved by individuals who did not participate directly in the particular decision or examination finding under review. This could include the Reserve Bank president or a designee directly accountable to the president for this purpose. In these situations, if the examiner might be consulted, the examiner would generally not be involved in making the final determination regarding the resolution of the matter. The Reserve Bank president or designee also has the discretion to decide whether an effort should be made to resolve the issue in a manner that is confidential, from the examiner involved and how this effort, if appropriate, should be undertaken.

Matters or questions considered by the president generally should be limited to those that are significant and that have an effect on the safety and soundness of the institution; or have an impact on the operation, management, or financial standing of the institution; or ill have a material impact on the regulator's supervision of the institution. Requests for review by the Reserve Bank president should be authorized by the state member bank's board of directors and should be made within a reasonable time from the occurrence of the event or decision triggering the request.

The availability of the informal process described in this letter and the manner in which it is carried out is at the sole discretion of the Reserve Bank. The process cannot be used to appeal or impede any enforcement actions since such actions have their own formal appeals procedures. In addition, nothing in this process prevents the Reserve Bank from taking any supervisory or enforcement action -- formal or informal -- that the Reserve Bank deems appropriate to properly discharge its supervisory or examination responsibilities.
Attached is a letter outlining this process that should be forwarded to each state member bank in your district. Questions regarding this process may be directed to Stephen C. Schemering, Deputy Director, Division of Banking Supervision and Regulation at (202) 452-2893 or Roger T. Cole, Assistant Director, Division of Banking Supervision and Regulation at (202) 452-2618.

Sincerely,

William W. Wiles
Secretary

Attachment

TO THE PRESIDENTS OF ALL FEDERAL RESERVE BANKS AND THE OFFICERS IN CHARGE OF BRANCHES
TO THE CHIEF EXECUTIVE OFFICER OF ALL STATE MEMBER BANKS

In carrying out its supervisory responsibilities over the years, the Federal Reserve System has endeavored to ensure that examination findings are based upon a balanced, fair and appropriate consideration of all relevant information, including the views and perspectives of bank management. The existing process affords opportunities for bank management and directors to communicate their views and concerns to examiners and Reserve Bank officials during the course of the examination and follow-up process. The objective of the process is to produce an accurate and clear report of the bank's condition and operations.

Currently, a state member bank that believes an error has been made in its examination may request that the matter be reviewed by supervisory personnel. If in the judgment of the Reserve Bank the matter has merit, consideration is given to the issue and an attempt is made to resolve the question in a fair and satisfactory manner. For example, bank management may discuss examination findings and loan classifications with the examiner-in-charge or other supervisory officials. Upon completion of an examination, examiners and/or supervisory officials meet with bank management and, as appropriate, the board of directors to discuss the examiner's findings and conclusions. These practices, taken together, have provided an avenue for maintaining appropriate lines of communication between bank management and directors, examiners and supervisory personnel.

We believe this process has played an important role over the years in helping to assure that significant concerns or questions bankers have regarding examination findings are given reasonable consideration by the Federal Reserve. Recent developments regarding the potential impact of examination policies and procedures on credit availability underscore the ongoing importance of this avenue of communication.

Consistent with longstanding practice, this informal process remains available to bank management for the purpose of bringing legitimate bank concerns or questions arising in connection with safety and soundness examinations to the attention of supervisory personnel or other appropriate Reserve Bank officials. In some
cases, questions or concerns may be referred by bank management directly to senior Reserve Bank officials or, on occasion, to the Reserve Bank president. These officials have the discretion to decide whether the circumstances of the particular situation, including the views of the bank involved, suggest that the matter should be resolved by individuals who did not participate directly in the particular decision or examination finding under review. This could include the Reserve Bank president or a designee directly accountable to the president for this purpose. In these situations, while the examiner might be consulted, the examiner would generally not be involved in making the final determination regarding the resolution of the matter. The Reserve Bank president or designee also has the discretion to decide whether an effort should be made to resolve the issue in a manner that is kept confidential from the examiner(s) involved and how this effort, if appropriate, should be undertaken.

Matters or questions addressed to the president should be limited to those that are significant and that i) have an effect on the safety and soundness of the institution; ii) have an impact on the operation, management, or financial standing of the institution; or iii) have a material impact on the regulator's supervision of the institution. Requests for review by the Reserve Bank president should be authorized by the state member bank's board of directors and be made within a reasonable time from the occurrence of the event or decision triggering the request.

The availability and implementation of this informal process is at the discretion of the Reserve Bank. It is intended for discussing and resolving legitimate concerns or good faith differences pertaining to material examination findings. It is not to be used to appeal or impede any formal supervisory or enforcement actions. Moreover, the existence of this informal avenue for communication and resolution does not prevent the Federal Reserve from taking any supervisory or enforcement action -- formal or informal -- it deems appropriate to discharge the System's supervisory and examination responsibilities.

Questions regarding this process may be directed to...
Examination Appeal Process

The four federal regulatory agencies have chosen to adopt a supplementary process to address issues arising out of examinations of financial institutions. Guidelines for this process are set forth below.

1. The appeal process is a program that supplements or expands upon other established supervisory review practices or processes that are available to the institution in the normal course of business. The availability and manner in which this process is carried out is left to the discretion of the individual agencies.

2. This process cannot be used to appeal or impede any formal or informal supervisory or enforcement actions. In addition, nothing in this process prevents an individual agency from taking any supervisory or enforcement action that the agency deems appropriate.

3. The appeal process is available to address significant issues arising from an examination finding or supervisory action.

4. The use of this appeal process is to be authorized by the institution. This would normally involve the institution's board or its designee with prior knowledge of the board.

5. Matters addressed by the appeal process should be limited to significant issues that:
   - are material to the safety and soundness of the institution, or
   - have a significant impact on the operation or management of the institution, or
   - have a material impact on the regulator's supervision of the institution.

   The materiality of the matter being appealed remains within the discretion of the senior regulator.

6. Appeals are to be made within a reasonable period of time since the occurrence of an examination finding or supervisory action which is the subject of the appeal. Initiating the appeal promptly will assist in timely resolution.

7. The senior regulator will make a good faith effort to evaluate and resolve the issue in a confidential manner. In situations where the appeal cannot be resolved confidentially, the examiner may need to be consulted. However, the examiner will not make recommendations regarding, or be involved in deliberations concerning, the final determination or resolution of the matter under appeal.

8. The appeal process will be handled by a high level of agency management.
The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am pleased to respond to your letter of January 31 asking additional questions in connection with my renomination hearing.

My response to your questions and those submitted by other members of the Banking Committee are provided in the enclosure. Please let me know if I can be of further assistance.

Sincerely,

Enclosure
QUESTIONS FROM CHAIRMAN DONALD W. RIEGLE, JR.

Q.1. You are a busy man, with a lot of important responsibilities. One of your tasks is to serve on the RTC's Oversight Board. Last year, when we restructured the management of the RTC, the Administration insisted on the Federal Reserve Chairman remaining on that board. How valuable do you feel your contributions are as an Oversight Board Member? Do they justify the time taken away from your other responsibilities?

A.1. The activities of the RTC and the Oversight Board can have effects on the condition of financial institutions and on real estate-related markets in many regions of the country. As Chairman of the Federal Reserve, I have an obvious interest in these effects and believe I bring insights to the Oversight Board in its deliberations of its operations. Thus, I believe my continued involvement at the Oversight Board is on balance beneficial.

Q.2. As an Oversight Board member, you approved the RTC's program to securitize assets. As I understand it, these deals are structured so that the RTC retains nearly all the risk, while selling securities at interest rates above Treasury rates to fund a part of these assets. What is the advantage in doing that? What does it accomplish?

A.2. The Oversight Board has encouraged the use by the RTC of securitization as a means of disposing of financial assets. In offering the RTC encouragement, the Oversight Board asked the RTC to make sure that it had in place a policy that requires a determination, prior to the issuance of any mortgage-backed securities, that the return to the RTC will be higher than if the mortgages were disposed in another way.

Through December 31, the RTC had sold approximately $10.2 billion in securities backed by performing single family and multifamily mortgage loans. In this process, the rating agencies have required the RTC to set aside as a credit enhancement, approximately 20 percent of the proceeds from the sale of the securities in a reserve fund, in the event of possible defaults on the underlying mortgages. This is the absolute limit of the "risk" that the RTC is taking. The actual losses resulting from mortgage defaults, however, will likely be much lower so
A.2. that the great bulk of the funds placed in reserve will be recovered. The RTC estimates that even after accounting for the losses likely to occur on the mortgages it has securitized, over $600 million has already been saved through these transactions. The RTC has determined that in general, asset securitization provides higher returns to the RTC, has a readily available market, and is a reasonably efficient method of asset disposition, relative to other forms.

Q.3. Secretary Brady has indicated that he is considering reducing the size of 30-year Treasury bond auctions. That looks like an easy way to reduce Treasury interest costs and lower long-term interest rates critical to investment decisions. The Fed could supplement such a program by purchasing more long-term debt and less short-term debt. Is there any reason why we shouldn't do it?

A.3. Academic studies on whether reducing the supply of Treasury debt would help lower long-term interest rates do not give a clear indication that such a policy would be successful. This is because expectations of future short-term rates are by far the principal determinant of long-term rates, not relative supplies of securities. Nevertheless, some empirical evidence supports the proposition and, given the potential benefits of reduced long-term interest rates, I concur with the recent decision of the Treasury to cut back on bond and long-term note issuance. However, the scope for cutting back in one maturity sector is limited. Given the huge size of the deficit, considerable sales will likely be needed in all maturities, and large shifts toward the short end could distort yields, thereby dissipating any advantage to the Treasury. A major shortening of Treasury debt also would alter the liquidity profile of the economy, with possible implications for the stance of monetary policy.
QUESTIONS FROM CHAIRMAN DONALD W. RIEGLE, JR.

A.3. With regard to the possible participation by the Federal Reserve in such a program, we are active in purchases in all segments of the market, including the longer end, and I would expect that to continue. Last year, the Federal Reserve added $11-1/2 billion of coupon issues to its portfolio. However, the volume of our purchases of longer-term securities necessarily is limited. The Federal Reserve needs considerable liquidity in its portfolio to ensure that we will be able to meet our reserve objectives in the least disruptive way possible in a variety of circumstances.

Q.4. Some have argued that increased spending for public investments is desirable even if it increases the deficit, on the grounds that the returns to those investments may be substantially greater than the private investment they may displace. Do you agree?

A.4. I agree that some public investments may offer substantial rates of return. However, given the low national saving rate, the most appropriate way to fund these would be by finding outlay or tax offsets elsewhere in the budget.

In general, debt finance is appropriate for most private investment projects because they usually will be funded only if they can generate an earnings stream that is sufficient to service the loan. The market therefore ensures that the debt will be self-liquidating. Most public investments do not, however, generate an identifiable earnings stream that provides a check of the project's viability and can be assigned to service and pay the debt. It is therefore more prudent to fund such projects up front by cutting unproductive spending or raising revenues.
QUESTIONS FROM CHAIRMAN DONALD W. RIEGLE, JR.

Q.5. Have you had a chance to review the Treasury's proposals for reforming the taxation of corporate income? How costly would they be? Who would benefit? Would they contribute significantly to capital formation?

A.5. The double taxation of the return to investment in corporate equity--by the corporate income tax when earnings are realized and again by the individual income tax when shareholders receive dividends or realize capital gains--penalizes the corporate form of business organization, distorts corporations' financial structures by favoring debt finance over equity finance, and creates an incentive for corporations to retain earnings, even if more productive opportunities may exist outside the corporation. These distortions tend to raise the cost of capital for corporations, and the high leverage associated with the preference for debt increases the economy's vulnerability to financial stress.

The Treasury study discusses several prototype plans for integrating corporate and individual income taxes that would ameliorate these distortions. The Treasury reports revenue loss estimates for various plans ranging from a loss of $37 billion (evaluated at 1991 levels of income) for a prototype that allocates corporate income to shareholders to a revenue gain of up to $42 billion for a comprehensive business income tax prototype. The study notes, however, that revenue effects can be offset by changing the overall level of capital taxation. Indeed, the efficiency gain calculations reported in the study assume that such revenue-maintaining tax adjustments are made. If capital tax rates are adjusted to maintain revenue neutrality, the effects on the distribution of tax burdens would be small. The Treasury estimates a significant impetus to capital formation.

I have not had an opportunity to study the details of the Treasury's analysis; I have long felt, however, that our present corporate tax structure is flawed, and I would hope that the Congress would find the occasion to explore these issues once again.
QUESTIONS FROM CHAIRMAN DONALD W. RIEGLE, JR.

Q.6. Are the reported unemployment numbers the best way to measure unused labor resources? Do they understate the costs of this recession relative to previous recessions?

A.6. In general, the unemployment rate provides a useful summary measure of resource utilization in the labor market. However, like all summary measures, it should not be used in isolation. We have, for example, been mindful of the possible "underemployment" of a good many workers, as well as of the unusually sharp decline in labor force participation, which may reflect in part a form of discouragement. In assessing labor market conditions, the Federal Reserve Board and the Federal Open Market Committee look at a wide variety of indicators from both government statistical agencies and non-government sources as well as reports on local conditions gathered through the Federal Reserve Banks. Taken as a whole, this information gives us, I believe, a comprehensive picture of current economic conditions.

Q.7. Economies in Japan, Germany, and the United Kingdom appear to be having problems, as well as our own. How widespread is the economic weakness internationally? Is there a danger of a broad international stagnation or recession?

A.7. During the past 2 years growth in the major foreign industrial countries has slowed from quite rapid rates recorded in the late 1980s. To some extent, deceleration was a reaction to tighter policies designed to counter inflationary pressure and bring economic activity to a more sustainable, non-inflationary pace. Although inflation generally has been reduced, outcomes on growth among the major industrial countries have varied. Canada and the United Kingdom have had fairly pronounced recessions, while growth in Germany and Japan has remained comparatively strong (although growth has slowed somewhat in recent quarters there too).

The finance ministers and central bank governors of the Group of Seven (G-7) countries have agreed that the general slowdown in the major industrial countries has continued longer than had been expected earlier. However, monetary policy stances were eased during the past year in several countries (Japan, the United Kingdom, and Canada). Japan has recognized the need to be alert to a further slowdown in its domestic demand, and additional demand generated by
QUESTIONS FROM CHAIRMAN DONALD W. RIEGLE, JR.

A.7. German unification is expected to contribute to a pick-up (cont) in growth this year in Germany (and its main European trading partners), despite continuation of a fairly tight German monetary stance. The expected recovery of the U.S. economy also should contribute to global recovery. Accordingly, although forecasting is particularly difficult in the current environment, there does not appear to be a significant risk of prolonged stagnation or general recession in the major foreign industrial countries.

Q.8. Recently, Fred Bergsten told us he thinks it is important to get an understanding with the Japanese to raise the value of the yen relative to the dollar, as a way to help stimulate our economy. Do you agree?

A.8. Foreign demand has continued to make a significant positive contribution to U.S. growth over the past several years. Exports have grown at a fairly rapid pace and our trade deficit, including our bilateral deficit with Japan, has narrowed significantly. While the dollar has depreciated substantially in recent months, partly in response to the easing of U.S. monetary conditions, a policy that seeks to depreciate the dollar against the yen or any other currency is not an appropriate way to stimulate the U.S. economy. It may distort the effects of other policies and have adverse effects on our own economy and could lead to a counterproductive pattern of competitive depreciation. Macroeconomic growth objectives should be achieved by pursuing sound anti-inflationary monetary and fiscal policies. On the other hand, such economic and financial variables as growth rates, inflation rates, interest rates, and external payments positions are best left to determine the configuration of exchange rates.
QUESTIONS FROM CHAIRMAN DONALD W. RIEGLE, JR.

Q.9. Is the $70 billion just provided to the Bank Insurance Fund going to be enough?
A.9. Of the $70 billion, $25 billion was made available to absorb losses and $45 billion for working capital, with the latter to be repaid from sale by BIF of assets acquired from failing banks. The BIF itself has access to better information than the Federal Reserve on problem banks and indicated last fall that $70 billion—so allocated—should be sufficient. Our best estimate at that time was that $70 billion would be close, but the outcome was heavily dependent on the pace of recovery in real estate markets.

I note that the Administration's most recent budget did in fact suggest that in fiscal year 1994 more than $25 billion additional loss appropriation might be needed if there were no further banking reform. Without commenting on the benefits of such congressional action, this shortfall is certainly possible.

Q.10. As the economy continues to deteriorate, the effect on real estate prices can only be downward. Crumbling real estate values have spread from Texas to New England and on down the East Coast. How do you assess the current condition of real estate markets in other areas, such as California, and what are the prospects for real estate generally?

A.10. The commercial real estate market in California has deteriorated recently, with extensive overbuilding in a number of locales. Vacancy rates still indicate a broad supply-demand imbalance in commercial markets and in the multi-family rental segment of the residential market. Recent reports do suggest, however, that the single family home market is firming.
QUESTIONS FROM CHAIRMAN DONALD W. RIEGLE, JR.

Q.11. What variation do you perceive exists in the current condition and future recovery prospects of the economies of the different regions of the country?

A.11. Inevitably, some industries and some regions will at any given time be growing faster than others. But, in due course, geographic mobility and changes in relative prices tend to cause these regional differences to even out. Looking forward, I would expect that those parts of the country that have been most heavily reliant on defense spending will face a particularly challenging period of adjustment; one would hope that, in a generally expanding economy, however, the relatively skilled workers in this industry would be readily absorbed in other activities.

Q.12. Please submit for the record, appropriate materials describing actions taken by the Fed to reduce regulatory burden in the past 12 months. What other actions are you contemplating?

A.12. Over the past 12 to 18 months, the Federal Reserve has taken a number of steps within its legal authority to reduce regulatory burden. The action with the broadest impact was the Board’s December 1990 decision to reduce from three to zero percent the reserve requirements on eurocurrency liabilities and short-term nonpersonal time deposits. The Board also revised its Regulation P which sets minimum standards for security devices and procedures for state-member banks. Most recently, the three U.S. banking agencies have agreed to discontinue use of the supervisory definition of highly leveraged transactions (HLTs) after June 30, 1992. As of June 30, 1992, state member banks will not be required to report HLT exposure. The Federal Reserve has recently eased restrictions on the amount of noncumulative perpetual preferred stock bank holding companies may include in their Tier 1 capital.

The Board also continues to support the repeal of the Glass-Steagall and McFadden Acts, as well as limitations on lender liability for environmental problems.
QUESTIONS FROM CHAIRMAN DONALD W. RIEGLE, JR.

A.12. Finally, the Federal Reserve, along with the other federal agencies that supervise depository institutions, will be reviewing all of its regulations as part of the efforts of the Federal Financial Institutions Examination Council (FFIEC) to carry out the provisions of Section 221 of the Federal Deposit Insurance Corporation Improvement Act of 1991. This section directs the FFIEC to perform a study on regulatory burden in consultation with consumer and community groups and other interested parties. A report to Congress is due within one year of enactment of FDICIA. This report may suggest a number of additional actions that could be taken to reduce regulatory burden.
Q.13. Based on materials previously supplied by the Federal Reserve to the Committee, the Federal Reserve lent for 5 or more consecutive days to approximately 220 banks and thrifts that ultimately failed between the time you became Chairman and May 10 of last year. The cost of that lending to the FDIC by some methods of calculation would be more than $1 billion. Has this practice stopped? Can you supply Federal Reserve lending records for any institutions that failed after May 10, 1991, and had borrowed for 5 or more consecutive days within the preceding 12 months?

A.13. In the period from August 11, 1987 through May 10, 1991, 252 federally insured depository institutions failed that had borrowed for at least five consecutive days at some point in the 3 years prior to their failure; of these, 172 were borrowing at time of failure. Subsequently, from May 10 of last year through January 31 of this year, 17 more institutions have failed that had borrowed for 5 or more consecutive days in the 12 months preceding their failure (lending records for each are enclosed); 11 of them were borrowing at the time of failure.

Throughout this entire period, provisions of liquidity to financially troubled institutions have taken place in close cooperation and consultation with the relevant primary regulators and insurance authorities. Federal Reserve credit has provided troubled institutions with an opportunity to restore themselves to financial health and to avoid becoming a drain on the insurance funds; in the many cases where these efforts have been unsuccessful, discount window lending has helped to facilitate orderly resolutions and to reduce the costs to the insurance funds.

In keeping with the intent of the recently passed legislation, the Federal Reserve is striving to control even more closely the provision of credit to financially troubled depositories, and judgments about viability play a particularly prominent role. Where the Federal Reserve, after consulting with the primary regulator and the FDIC, concludes that an institution is not viable, assurances are sought from the FDIC that any extensions of credit would facilitate prompt and orderly resolutions that would reduce costs to the insurance fund. A notable example in this regard is Southeast Bank, N.A., of Miami, Florida. After it became apparent that the bank was no longer viable, provisions of Federal Reserve credit were at the FDIC’s request. As the attached correspondence indicates, the FDIC believed that such credit extensions would support an orderly resolution of the bank and reduce the cost to the Bank Insurance Fund.
Summary Record of Discount Window Lending Over 12-Month Period Prior to Failure of Depository Institution

Name: Atlantic Trust Company
Location: Newington, New Hampshire

Date of conservatorship, receivership, or 13(c) assistance: 1/30/92

<table>
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<tr>
<th>Discount Window Loans</th>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>At time of failure:</td>
<td>1/30/92</td>
<td>Extended</td>
<td>$575,000</td>
</tr>
<tr>
<td>Peak borrowing:</td>
<td>1/30/92</td>
<td>Extended</td>
<td>$575,000</td>
</tr>
</tbody>
</table>

Collateral securing loan at time of failure

| Book value: $ 3,216,921.50
| Lendable value: $ 2,070,713.30
| Consecutive days of borrowing: 5 6-15 16-30 31-60 over 60
| Number of occurrences in the 12-month period before failure: 0 1 0 0 0

Composite CAMEL ratings:

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<thead>
<tr>
<th>&quot;As-of&quot; Date</th>
<th>Date Received from Regulator</th>
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</table>
| At time of failure: 5 7/29/91 N/A
| Previous ratings, if any: 5 2/12/91 N/A 4 5/7/90 N/A

Summary history of collateral pledged:

On October 7, 1991, Atlantic Trust Company (Atlantic) pledged $1.1 MM in commercial and residential mortgages as collateral. These loans were held in our vault and given a collateral value of $584 M. On October 9, 1991, we received a letter from the FDIC requesting our accommodation of any borrowing requests from Atlantic explaining that an orderly resolution process was underway.

By year-end, we had taken possession of additional commercial and residential mortgages, and Atlantic's collateral position increased to a principal value of $2.0 MM and a collateral value of $1.3 MM.
On January 8, 1992, we received an additional letter from the FDIC explaining that our lending in response to a request from Atlantic would assist in arranging "an orderly and less costly solution to the imminent failure" of Atlantic.

In early January, 1992, Atlantic's liquidity position began to deteriorate and we took possession of additional residential and commercial mortgages. On January 16, 1992, Atlantic had collateral in our custody with a principal value of $3.2 MM and a collateral value of $2.3 MM. Borrowing began one week later, on January 23, 1992 and ended on the date of resolution, January 30, 1992. From January 16, 1992 through the resolution date, Atlantic's collateral position remained the same. Throughout the borrowing duration, Atlantic's level of uninsured deposits remained level at $2,000.

The discount window loan was paid by the FDIC on February 4, 1992.
# Detailed Record of Discount Window Lending

**Over 12 Month Period Prior to Failure**

**Name of Failed Institution:** ATLANTIC TRUST COMPANY  
**Location (City and State):** NEWINGTON, MA

<table>
<thead>
<tr>
<th>Loan Date</th>
<th>Credit Type</th>
<th>Loan Amount</th>
</tr>
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<tbody>
<tr>
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</tr>
<tr>
<td>02/02/92*</td>
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</tr>
<tr>
<td>02/03/92*</td>
<td>EXT</td>
<td>575,000</td>
</tr>
</tbody>
</table>

* Miscommunication at the FDIC prevented prompt payment of loan on 01/31/92. On 02/03/92 loan was repaid by FDIC as Receiver.
October 9, 1991

BY FAX AND BY MAIL

Mr. Curtis L. Turner
Vice President
Federal Reserve Bank of Boston
600 Atlantic Avenue
Boston, Massachusetts 02106

SUBJECT: Atlantic Trust Company
Newington, New Hampshire

Dear Mr. Turner:

As per our telephone conversation on October 4, 1991 this office requests that the Reserve Bank accommodate the overnight borrowings of the subject bank. While the bank is in danger of failing please be advised that an orderly resolution process is underway. Please direct any questions you may have to Assistant Regional Director Carl W. Schnapp at 617-449-9080.

Sincerely,

Paul H. Wiechman
Regional Director
Mr. Curtis Turner
Vice President, Loan and Credit
Federal Reserve Bank of Boston
600 Atlantic Avenue
Boston, Massachusetts 02106

Re: Atlantic Trust Company
Durham, New Hampshire

Dear Mr. Turner:

As discussed with Peter Genovich of your office with Deputy Regional Director Jane V. McFarland of my office, this is to confirm that it would assist the Corporation in arranging an orderly and less costly solution to the imminent failure of the subject bank if the discount window of the Federal Reserve Bank of Boston were to provide funds for liquidity purposes to Atlantic Trust Company, should the bank make such a request. As you are aware, the bank is expected to be closed by the New Hampshire Commissioner of Banks and the FDIC named receiver on Friday, January 24, 1992. The bank's liquidity position is approaching the critical stage and while we expect to have an orderly resolution lined up by January 24, 1992, any transaction will be facilitated by the bank having backup liquidity available.

Should you have any questions, please do not hesitate to contact me or Deputy Regional Director McFarland at (617) 449-9080.

Sincerely,

Paul H. Wiedman
Regional Director
Summary Record of Discount Window
Lending Over 36-Month Period Prior to
Failure of Depository Institution

Name: BankEast
Location: Manchester, NH
Date of conservatorship, receivership, or 13(c) assistance: 10/10/91

<table>
<thead>
<tr>
<th>Discount Window Loans</th>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>At time of failure:</td>
<td>N/A</td>
<td></td>
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</tr>
<tr>
<td>Peak borrowing:</td>
<td>11/01/90</td>
<td>Adjustment</td>
<td>$21,600,000</td>
</tr>
</tbody>
</table>

Collateral securing loan at time of failure

| Book value:                                  | N/A       |
| Lendable value:                              | N/A       |

Consecutive days of borrowing: 5 6-15 16-30 31-60 Over 60

Number of occurrences in the 36-month period before failure: 1 2

Composite CAMEL ratings

<table>
<thead>
<tr>
<th>Rating for Rating from Regulator</th>
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</thead>
<tbody>
<tr>
<td>&quot;As-of&quot; Date</td>
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<tr>
<td>At time of failure:</td>
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<tr>
<td>Previous ratings, if any:</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

Summary history of collateral pledged:

All borrowings were secured by state and municipal bonds as well as commercial loans and commercial mortgages. When BankEast started borrowing in October, 1990, the total face value of collateral pledged to this Reserve Bank was $48.3 million. The breakdown was as follows, with lendable value in parentheses: state and municipal securities of $550 thousand ($495 thousand); commercial mortgages of $23.9 million ($11.9 million); and commercial loans of $23.9 million ($11.9 million). From the time intermittent borrowing began on 10/26/90 and ended on 9/10/91, collateral values ranged as high as $64.5 million ($32.2 million) by mid-January, 1991 and fell as low as $34.1 million ($17.1 million) by mid-September, 1991.

At the time of failure, this Reserve Bank held a total of $132.8 million of commercial loans, commercial mortgages, credit card receivables, and home equity loans, with a combined lendable value of $66.4 million, as collateral for potential borrowings and FRB account overdrafts.
### Detailed Record of Discount Window Lending

**Over 36 Month Period Prior to Failure**

**Name of Failed Institution:** Bankeast  
**Location (City and State):** Manchester, New Hampshire

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<th>Date</th>
<th>Credit Type</th>
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<td>11/01/90</td>
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<tr>
<td>11/04/90</td>
<td>ADJ</td>
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<td>11/05/90</td>
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</tr>
<tr>
<td>Date</td>
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<td>Amount</td>
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<tr>
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</table>
Summary Record of Discount Window
Lending Over 12-Month Period Prior to
Failure of Depository Institution

Name: Beacon Cooperative Bank
Location: Brighton, MA
Date of conservatorship, receivership, or 13(c) assistance: 6/21/91

Discount Window Loans

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
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<tbody>
<tr>
<td>At time of failure:</td>
<td>6/21/91</td>
<td>Extended</td>
</tr>
<tr>
<td>Peak borrowing:</td>
<td>6/18/91 - 6/21/91</td>
<td>Extended</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$1,033,000</td>
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</table>

Collateral securing loan at time of failure

| Book value:   | $12,940,117 |
| Lendable value: | $4,941,551   |

Consecutive days of borrowing:

<table>
<thead>
<tr>
<th>Number of occurrences in the 36-month period before failure:</th>
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<tbody>
<tr>
<td>1</td>
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Composite CAMEL ratings

<table>
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<tr>
<th>&quot;As-of&quot; Date for Rating</th>
<th>Date Received from Regulator</th>
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<td>Previous ratings, if any:</td>
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<td>11/28/89</td>
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<td>2</td>
<td>2/26/88</td>
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</table>

Summary history of collateral pledged:

Beacon borrowed for 46 consecutive days leading to its failure on 6/21/91. Borrowings for the first four days were collateralized by $4.0 million of 1-4 family residential mortgages with a 50% lendable value of $2.0 million. The larger than usual haircut for this asset type was the result of questionable lending practices at the bank. Additional collateral, with a $9.0 million book value and a $3.0 million lendable value, was taken on a precautionary basis. The additional collateral consisted primarily of conventional 1-4 family and nonconventional condominium and multifamily mortgages. The bank's deposit base remained relatively stable and the level of borrowing did not significantly escalate.
DETAILED RECORD OF DISCOUNT WINDOW LENDING
OVER 36 MONTH PERIOD PRIOR TO FAILURE

NAME OF FAILED INSTITUTION: Beacon Co-operative Bank
LOCATION (CITY AND STATE): Brighton, MA

<table>
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<th>Loan Date</th>
<th>Credit Type</th>
<th>Loan Amount</th>
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<tr>
<td>06/23/91</td>
<td>EXT</td>
<td>804,000</td>
</tr>
</tbody>
</table>
Detailed Record of Discount Window Lending
Over 36-Month Period Prior to Failure of Depository Institution
(Detailed Record Attached)

Name: CAPITAL BANK
Location: DALLAS, TX

Date of conservatorship, receivership, or 13(c) assistance: 1991-05-16

Discount window loans

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
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<td>At time of failure</td>
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<td>Extended</td>
</tr>
<tr>
<td>Peak borrowing:</td>
<td>1991-05-16</td>
<td>Extended</td>
</tr>
</tbody>
</table>

Collateral securing loan at time of failure

| Book value | 18,492,313.41 |
| Lendable value | 14,088,893.87 |

Consecutive days of borrowing: 5 6-15 16-30 31-60 Over 60

Number of occurrences in the 36-month period before failure: 1

Composite CAMEL ratings

<table>
<thead>
<tr>
<th>Rating</th>
<th>As-of date</th>
<th>Date received from regulator</th>
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</thead>
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</tbody>
</table>

Summary history of collateral pledged:

- U.S Treasury securities
- Customers notes
- One-to-four family mortgages
**Detailed Record of Discount Window Lending**
Over 36-Month Period Prior to Failure

**Name of Failed Institution:** CAPITAL BANK  
**Location (City and State):** DALLAS, TX

<table>
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<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Amount of Loan Outstanding</th>
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<td>150,000.00</td>
</tr>
<tr>
<td>91-03-21</td>
<td>E</td>
<td>75,000.00</td>
</tr>
<tr>
<td>91-03-22</td>
<td>E</td>
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</tr>
<tr>
<td>91-03-23</td>
<td>E</td>
<td>450,000.00</td>
</tr>
<tr>
<td>91-03-24</td>
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<td>91-03-26</td>
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<tr>
<td>91-04-29</td>
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<td>91-04-30</td>
<td>E</td>
<td>150,000.00</td>
</tr>
<tr>
<td>91-05-15</td>
<td>E</td>
<td>3,750,000.00</td>
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<tr>
<td>91-05-16</td>
<td>E</td>
<td>4,000,000.00</td>
</tr>
</tbody>
</table>
Name: Central Bank  
Location: Meriden, CT  
Date of conservatorship, receivership, or 13(c) assistance: 10/18/91

Discount Window Loans

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/19/91</td>
<td>ADJUSTMENT</td>
<td>$11,500,000</td>
</tr>
</tbody>
</table>

At time of failure: NOT APPLICABLE

Peak borrowing: 2/19/91

Collateral securing loan at time of failure

Book value: NOT APPLICABLE

Lendable value: NOT APPLICABLE

Consecutive days of borrowing: 5 6-15 16-30 31-60 over 60

Number of occurrences in the 12-month period before failure: 0 0 0 1 0

Composite CAMEL ratings:

<table>
<thead>
<tr>
<th>Rating</th>
<th>&quot;As-of&quot; Date for Rating</th>
<th>Date Received from Regulator</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>5/11/90 (FDIC)</td>
<td>NOT AVAILABLE</td>
</tr>
<tr>
<td>3</td>
<td>5/11/90 (State)</td>
<td>NOT AVAILABLE</td>
</tr>
</tbody>
</table>

Previous ratings, if any: 2 2/10/89 NOT AVAILABLE

Summary of collateral pledged:

All borrowings were secured by commercial loans totaling $64.4 million, with a lendable value of $32.2 million.

At the time of failure, $90 million of commercial loans and commercial mortgages was held in this Reserve Bank's vault providing a lendable value of $39 million. An additional pledge of commercial loans, with a $149.2 million book value and a $74.6 million lendable value, was taken on a precautionary basis. These notes were not taken into this Reserve Bank's possession.
### Detailed Record of Discount Window Lending Over 12 Month Period Prior to Failure

**Name of Failed Institution:** Central Bank  
**Location (City and State):** Meriden, CT

<table>
<thead>
<tr>
<th>Loan Date</th>
<th>Credit Type</th>
<th>Loan Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/23/91</td>
<td>ADJ</td>
<td>9,600,000</td>
</tr>
<tr>
<td>01/24/91</td>
<td>ADJ</td>
<td>4,800,000</td>
</tr>
<tr>
<td>01/25/91</td>
<td>ADJ</td>
<td>2,200,000</td>
</tr>
<tr>
<td>01/26/91</td>
<td>ADJ</td>
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</tr>
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<td>01/27/91</td>
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<td>01/29/91</td>
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<tr>
<td>01/30/91</td>
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</tr>
<tr>
<td>01/31/91</td>
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</tr>
<tr>
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</tr>
<tr>
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<td>ADJ</td>
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</tr>
<tr>
<td>02/05/91</td>
<td>ADJ</td>
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</tr>
<tr>
<td>02/06/91</td>
<td>ADJ</td>
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<tr>
<td>02/07/91</td>
<td>ADJ</td>
<td>6,400,000</td>
</tr>
<tr>
<td>02/08/91</td>
<td>ADJ</td>
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<tr>
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<tr>
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<td>1,250,000</td>
</tr>
<tr>
<td>03/11/91</td>
<td>EXT</td>
<td>1,200,000</td>
</tr>
</tbody>
</table>
Summary Record of Discount Window Lending Over 12-Month Period Prior to Failure of Depository Institution

Name: Coolidge Bank and Trust Company
Location: Boston, Massachusetts
Date of conservatorship, receivership, or 13(c) assistance: 10/25/91

Discount Window Loans

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>At time of failure: 10/25/91</td>
<td>Extended</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Peak borrowing: 10/25/91</td>
<td>Extended</td>
<td>$10,000,000</td>
</tr>
</tbody>
</table>

Collateral securing loan at time of failure

Book value: $23,776,977.91
Lendable value: $19,021,582.33

Consecutive days of borrowing: 5 6-15 16-30 31-60 over 60
Number of occurrences in the 12-month period before failure: 0 1 0 0 0

Composite CAMEL ratings:

<table>
<thead>
<tr>
<th>&quot;As-of&quot; Date for Rating</th>
<th>Date Received from Regulator</th>
</tr>
</thead>
<tbody>
<tr>
<td>At time of failure: 10/25/91</td>
<td>N/A</td>
</tr>
<tr>
<td>Previous ratings, if any:</td>
<td></td>
</tr>
<tr>
<td>5 4/22/91</td>
<td>4/6/90</td>
</tr>
<tr>
<td>4 3/19/91</td>
<td>7/22/88</td>
</tr>
</tbody>
</table>

Summary history of collateral pledged:

Coolidge Bank and Trust Company (Coolidge) delivered $12.5 MM in one-to-four family residential mortgage notes to the Reserve Bank on April 20, 1990. These loans were held in our vault as collateral for potential Discount Window borrowing and were given a collateral value of $11.2 MM. In late August 1991, Coolidge increased its collateral pledge to $25.8 MM in one-to-four family residential mortgages. This was given a collateral value of $21.7 MM.

By late October 1991, the principal value of the collateral had decreased to $23.8 MM, with a collateral value of $19.0 MM. Negative publicity led to deposit outflows at the institution and Coolidge was forced...
to borrow from the Discount Window for nine consecutive days prior to its closing. The FDIC indicated to the Reserve Bank both orally and in writing, that its lending for liquidity purposes would facilitate an orderly resolution of Coolidge. Coolidge was closed on Friday, October 25, 1991. The Discount Window loan was paid by the acquiring institution on Monday, October 28, 1991.
DETAILED RECORD OF DISCOUNT WINDOW LENDING
OVER 12 MONTH PERIOD PRIOR TO FAILURE

NAME OF FAILED INSTITUTION: COOLIDGE BANK AND TRUST COMPANY
LOCATION (CITY AND STATE): BOSTON, MA

<table>
<thead>
<tr>
<th>Loan Date</th>
<th>Credit Type</th>
<th>Loan Amount</th>
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</thead>
<tbody>
<tr>
<td>12/04/90</td>
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<td>12/05/90</td>
<td>ADJ</td>
<td>5,000,000</td>
</tr>
<tr>
<td>10/17/91</td>
<td>EXT</td>
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</tr>
<tr>
<td>10/18/91</td>
<td>EXT</td>
<td>4,000,000</td>
</tr>
<tr>
<td>10/19/91</td>
<td>EXT</td>
<td>4,000,000</td>
</tr>
<tr>
<td>10/20/91</td>
<td>EXT</td>
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<tr>
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<td>EXT</td>
<td>8,500,000</td>
</tr>
<tr>
<td>10/25/91</td>
<td>EXT</td>
<td>10,000,000</td>
</tr>
</tbody>
</table>
October 17, 1991

Mr. Curtis Turner  
Vice President  
Loan and Credit  
Federal Reserve Bank of Boston  
600 Atlantic Avenue  
Boston, Massachusetts 02106

RE: Coolidge Bank and Trust Company  
Boston, Massachusetts

Dear Mr. Turner:

As discussed with Review Examiner James A. Bazylko, this is to confirm that the orderly resolution of the subject bank will be facilitated by the discount window of the Federal Reserve Bank of Boston providing funds to Coolidge Bank and Trust Company for liquidity purposes should the bank make a request. As you are aware the bank is expected to be closed and the FDIC named receiver on Friday, October 25, 1991.

Very truly yours,

[Signature]

Paul H. Wiechman  
Regional Director
Summary Record of Discount Window Lending
Over 36-Month Period Prior to Failure of Depository Institution
(Detailed Record Attached)

Name of failed institution: Cosmopolitan National Bank
Location (city and state): Chicago, Illinois
Date of conservatorship, receivership, or 13(c) assistance: 5/17/91
Discount Window Loans: Date: Loan Type: Amount:
At time of failure: None
Peak borrowing: 06/01/90-06/03/90 A 1,225,000

Collateral securing loan at time of failure
Book Value: N/A
Lendable Value: N/A
Consecutive Days of Borrowing: 5 6-15 16-30 31-60 over 60
Number of occurrences in the 36-month period before failure: 1 0 0 0 0

Composite CAMEL Ratings:

<table>
<thead>
<tr>
<th>Rating</th>
<th>As-of Date</th>
<th>Date Received</th>
</tr>
</thead>
<tbody>
<tr>
<td>At time of failure: 5</td>
<td>12/03/90</td>
<td>*</td>
</tr>
<tr>
<td>Previous Ratings: 5</td>
<td>05/31/90</td>
<td>*</td>
</tr>
<tr>
<td>3</td>
<td>09/30/89</td>
<td>*</td>
</tr>
</tbody>
</table>

Summary History of Collateral Pledged:
Collateral pledged consisted of Treasury Notes and U.S. Agency Securities. On 1/30/91, the par amount of this collateral was $6,760,000 and, after applicable haircuts, had a loan value of $6,394,000. While under extended credit, the par amount of the collateral on 3/4/91 was $4,600,000, with a market value of $4,046,000; the par amount of the collateral on 3/5/91 was $2,100,000, with a market value of $1,878,384.

* Upon completion of the exam.
Detailed Record of Discount Window Lending
Over 36-Month Period Prior to Failure

Name of Failed Institution: Cosmopolitan National Bank
Location (city and state): Chicago, Illinois

<table>
<thead>
<tr>
<th>DATE</th>
<th>TYPE</th>
<th>AMOUNT OF LOAN OUTSTANDING</th>
</tr>
</thead>
<tbody>
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<tr>
<td>02/01/89</td>
<td>A</td>
<td>2,500,000</td>
</tr>
<tr>
<td>02/02/89</td>
<td>A</td>
<td>2,500,000</td>
</tr>
<tr>
<td>05/14/90</td>
<td>A</td>
<td>2,000,000</td>
</tr>
<tr>
<td>05/17/90</td>
<td>A</td>
<td>2,000,000</td>
</tr>
<tr>
<td>05/18/90</td>
<td>A</td>
<td>2,200,000</td>
</tr>
<tr>
<td>05/19/90</td>
<td>A</td>
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<tr>
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<td>A</td>
<td>2,200,000</td>
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<tr>
<td>05/30/90</td>
<td>A</td>
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<tr>
<td>01/30/91</td>
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<td>E</td>
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</tr>
<tr>
<td>03/05/91</td>
<td>E</td>
<td>800,000</td>
</tr>
</tbody>
</table>
Summary Record of Discount Window Lending  
Over 12-Month Period Prior to Failure of Depository Institution  
(Detailed Report Attached)

**Name:** First Hanover Bank  
**Location:** Wilmington, North Carolina  
**Date of Conservatorship, receivership, or 13(c) assistance:** 10/25/91

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/25/91</td>
<td>Extended</td>
<td>$10,000,000</td>
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<tr>
<td>10/23/91</td>
<td>Extended</td>
<td>$10,400,000</td>
</tr>
</tbody>
</table>

**Collateral securing loan at time of failure:**

<table>
<thead>
<tr>
<th>Book value:</th>
</tr>
</thead>
<tbody>
<tr>
<td>$41,415,474.00</td>
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</table>

<table>
<thead>
<tr>
<th>Lendable value:</th>
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<tbody>
<tr>
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</table>

**Consecutive days of borrowing:** 5 6-15 16-30 31-60 over 60

<table>
<thead>
<tr>
<th>Number of occurrences in the 12-month period before failure:</th>
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</thead>
<tbody>
<tr>
<td>0 1 0 1 0</td>
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<table>
<thead>
<tr>
<th>Composite CAMEL ratings</th>
<th>Rating for regulation by regulator:</th>
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<tbody>
<tr>
<td>At time of failure: 5</td>
<td>07/08/91 N/A</td>
</tr>
<tr>
<td>Previous ratings, if any: 4 3 2 2</td>
<td>04/12/91 09/10/90 01/02/90 07/31/88 N/A N/A N/A</td>
</tr>
</tbody>
</table>

**Summary history of collateral pledged:**

August 21, 1991, First Hanover Bank, Wilmington, North Carolina pledged Treasury and Agency securities totaling $2.9 million, with a collateral value of $2.76 million.

On August 22, First Hanover began pledging residential mortgages and commercial loans. The first batch totaled $600 thousand and by month end mortgages totaled $7.6 million with a collateral value of $1.1 million. Some of the files were in the process of being reviewed and others lacked documentation.

Through the month of September First Hanover continued to pledge various notes and provided missing documentation for notes held. As of October 3, the total amount of collateral pledged (notes and securities) was $10.7 million with a value of $4.0 million.

On October 4, a field warehouse was put into place. The loan portfolio amounted to $40.7 million with a collateral value of $12.8 million. The initial valuation for loan portfolio collateral is calculated as a percentage of the total controlled after backing out past due, nonaccruals, classified, and various categories of loans not considered acceptable.

On October 25, the total collateral pledged was $41.4 million with a value of $13.0. Customer notes amounted to $39.6 million with a value of $11.3 million and securities amounted to $1.8 million with a value of $1.7 million.
### Detailed Record of Discount Window Lending Over 12-Month Period Prior to Failure

**Name of failed institution:** First Hanover Bank  
**Location:** Wilmington, North Carolina

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Amount of Loan Outstanding</th>
</tr>
</thead>
<tbody>
<tr>
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<tr>
<td>08/26/91</td>
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<td>08/29/91</td>
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<tr>
<td>10/01/91</td>
<td>E</td>
<td>2,300,000.00</td>
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<tr>
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SUMMARY RECORD OF DISCOUNT WINDOW LENDING
OVER 36 MONTH PERIOD PRIOR TO FAILURE OF DEPOSITORY INSTITUTIONS
(Detailed Record Attached)

Name of Failed Institution: First National Bank of Toms River
Location (city and state): Toms River, NJ
Date of conservatorship, receivership, or 13(c) assistance: May 22, 1991

Discount Window Loans

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<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
</tr>
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<tr>
<td>Peak Borrowing: May 21, 1991</td>
<td>Extended</td>
<td>$86,500,000.00</td>
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Collateral securing loan at time of failure

- Book value: $272,777,055.52
- Lendable value: $160,456,122.34

Consecutive days of borrowing
- 5 days
- 6-15 days
- 16-30 days
- 31-60 days
- over 60 days

Number of occurrences in the 36 mo. period before failure:
- 2 occurrences
- 5 occurrences
- none
- none
- none

Composite CAMEL ratings


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Summary history of collateral pledged:

U.S. Government agency securities were used to secure all borrowings until June of 1990. Institution then pledged residential mortgages totalling $91.5 million. Borrowings for May, 1991 were secured with $272 million of commercial and residential mortgages deposited with the Federal Reserve Bank of Philadelphia.
Detailed Record of Discount Window Lending
Over 36 Month Period Prior to Failure

Name of Failed Institution:  First National Bank of Toms River
Location (city and state):  Toms River, NJ

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Summary Record of Discount Window Lending
Over 36-Month Period Prior to Failure of Depository Institution
(Detailed Report Attached)

Name: Hilton Head Bank & Trust Company, N.A.
Location: Hilton Head Island, South Carolina
Date of Conservatorship, receivership, or 13(c) assistance: 08/30/91

Discount Window loans

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Peak borrowing:

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Collateral securing loan at time of failure:

| Book value  | $6,533,657.96 |
| Lendable value | $2,624,014.97 |

Consecutive days of borrowing: 5 6-15 16-30 31-60 over 60

Number of occurrences in the 36-month period before failure: 1 2

Composite CAMEL ratings

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</table>

Summary history of collateral pledged:

April 25, 1991, Hilton Head B&T Co. (HHB) pledged 6 commercial loans with a collateral value of $900 thousand. On the 29th, 6 residential mortgages were pledged bringing the total collateral value to $1.7 million.

On May 6, 3 commercial loans with documentation deficiencies were received, increasing the par amount to $2.7 million with no change to the collateral value of $1.7 million.

On June 26, 14 additional commercial loans were received for review. Additional documentation was required for a majority of the 14 loan files received. From April 25 to August 4, the collateral values fluctuated between $.9 to $1.7 million.

On August 1, HHB pledged 13 more commercial loans. The new loans, received along with the additional documentation for prior loans, were reviewed and by August 9, the par amount had increased to $6.9 million with a collateral value of $2.1 million.

By August 28, collateral amounted to $6.5 million par amount with a collateral value of $2.6 million.
**Detailed Record of Discount Window Lending Over 36-Month Period Prior to Failure**

Name of failed institution: Hilton Head Bank & Trust Company, N.A.  
Location: Hilton Head Island, South Carolina

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<th>Date</th>
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</tr>
<tr>
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<td>900,000.00</td>
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<tr>
<td>09/02/91</td>
<td>E</td>
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</tbody>
</table>
Summary Record of Discount Window Lending Over 12-Month Period Prior to Failure of Depository Institution

Name: Iona Savings Bank
Location: Tilton, NH
Date of conservatorship, receivership, or 13(c) assistance: 10/11/91

Discount Window Loans

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>At time of failure: N/A</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Peak borrowing: 7/29/91 Extended $2,400,000</td>
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</tbody>
</table>

Collateral securing loan at time of failure

<table>
<thead>
<tr>
<th>Book value</th>
<th>Lendable value</th>
</tr>
</thead>
<tbody>
<tr>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Consecutive days of borrowing: 5 6-15 16-30 31-60 Over 60

Number of occurrences in the 36-month period before failure: 1

Composite CAMEL ratings

<table>
<thead>
<tr>
<th>Rating</th>
<th>&quot;As-of&quot; Date</th>
<th>Date Received from Regulator</th>
</tr>
</thead>
<tbody>
<tr>
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</tr>
<tr>
<td>Previous ratings, if any: 5 5/20/91 N/A</td>
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<tr>
<td>4 4/06/90 N/A</td>
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<td>3 5/26/89 N/A</td>
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</tr>
<tr>
<td>2 2/19/88 N/A</td>
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</table>

Summary history of collateral pledged:

Borrowings from 6/11/91 through 6/26/91 were secured by 1-4 family residential mortgages totaling $1,999,477, with a lendable value of $1,279,582. Amounts borrowed from 6/27/91 through 8/15/91 were secured by 1-4 family mortgages totaling $3,620,458, with a lendable value of $2,896,366.

At the time of failure, 1-4 family residential mortgages totaling $3,604,965 were held providing a lendable value of $2,883,972.
## Detailed Record of Discount Window Lending

**Over 36 Month Period Prior to Failure**

**Name of Failed Institution:** Iona Savings Bank  
**Location (City and State):** Tilton, New Hampshire

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<tr>
<td>08/25/91</td>
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</tbody>
</table>
## Summary Record of Discount Window Lending Over 12-Month Period Prior to Failure of Depository Institution

**Name:** Merchants National Bank  
**Location:** Leominster, Massachusetts  
**Date of conservatorship, receivership, or 13(c) assistance:** December 13, 1991

### Discount Window Loans

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>At time of failure:</td>
<td>not applicable</td>
<td></td>
</tr>
<tr>
<td>Peak borrowing:</td>
<td>1/18/91</td>
<td>Adjustment $6.3 MM</td>
</tr>
</tbody>
</table>

### Collateral securing loan at time of failure

- Book value: not applicable
- Lendable value: not applicable

<table>
<thead>
<tr>
<th>Consecutive days of borrowing:</th>
<th>5</th>
<th>6-15</th>
<th>16-30</th>
<th>31-60</th>
<th>over 60</th>
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</thead>
<tbody>
<tr>
<td>Number of occurrences in the 12-month period before failure:</td>
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<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

### Composite CAMEL ratings:

| At time of failure: | 5 | 2/4/91 | not available |
| Previous ratings, if any: | 5 | 10/12/90 | not available |
|                         | 3 | 2/28/90 | not available |
|                         | 5 | 9/15/89 | not available |

### Summary History of Collateral Pledged

Merchants National Bank (MNB) first borrowed on 12/26 and 12/27/90 collateralized by a $1MM Treasury note. The institution next borrowed on 12/31/90 collateralized by $2MM in Treasury notes.
MNB secured loan advances through the first 22 days of January with various Treasury and Agency securities held for investment in their Federal Reserve Bank safekeeping account. On January 23, 1991, MNB delivered $6.5MM of 1-4 family residential mortgage loans establishing a permanently pledged collateral pool valued at $4.8MM. The delivery of the residential notes freed up MNB's more liquid assets for use in obtaining private sector funding. Loans extended at an amount in excess of the 1-4 family pledged portfolio were secured by Treasury and Agency securities. On January 31, 1991, MNB had collateral pledged to the Reserve Bank with a total principal of $10.6MM, consisting of $6.6MM in 1-4 family mortgages and a $4MM Treasury note. The pledged pool was valued for collateral purposes at $8.2MM.

On February 5, 1991, MNB added $3.8MM of 1-4 family mortgage loans bringing the total principal value pledged to $14.6MM. This afforded MNB a collateral capacity of $11MM.

On February 21, 1991, the Reserve Bank released the $4MM Treasury note for MNB to use in securing private sector repo funds. On February 27, 1991, the Reserve Bank accepted $15.6MM in commercial loans at a 50% discount for collateral purposes. This brought MNB's principal value of pledged assets to $26.2MM and offered a collateral capacity of $14.6MM.

Subsequently, collateral pledged by MNB to the Reserve Bank remained unchanged with the exception of normal principal paydowns. On March 31, 1991, MNB was pledging $26.1MM in commercial real-estate and 1-4 family residential loans. This afforded MNB a collateral capacity of $14.1MM. At June 30, 1991, principal updates had changed the value of the collateral pool to $23.7MM in principal. This was valued at $14.7MM for collateral purposes by the Reserve Bank. On September 30, 1991, MNB's collateral pledged totalled $24.5MM with a collateral value of $14MM.

On December 13, 1991, MNB's closing date, the Reserve Bank held in its vault $9.4MM in 1-4 family mortgage loans and $14.2MM in commercial real estate. The total principal value of collateral held was $23.6MM with a collateral value of $14MM. The FDIC indicated to the Reserve Bank, both orally and in writing, that its lending for liquidity purposes would facilitate an orderly resolution of MNB.
### Detailed Record of Discount Window Lending Over 12 Month Period Prior to Failure

**Name of Failed Institution:** Merchants National Bank  
**Location (City and State):** Leominster, MA

<table>
<thead>
<tr>
<th>Date</th>
<th>Credit Type</th>
<th>Loan Amount</th>
</tr>
</thead>
<tbody>
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</table>
October 21, 1991

Mr. Curtis Turner  
Vice President  
Loan and Credit  
Federal Reserve Bank of Boston  
600 Atlantic Avenue  
Boston, Massachusetts 02106

RE: Merchants National Bank  
Leominster, Massachusetts

Dear Mr. Turner:

As discussed with Review Examiner James A. Bazydio, this is to confirm that the orderly resolution of the subject bank will be facilitated by the discount window of the Federal Reserve Bank of Boston providing funds to Merchants National Bank for liquidity purposes should the bank make a request. As you are aware the bank is tentatively expected to be closed and the FDIC named receiver on Friday, December 13, 1991.

Very truly yours,

[Signature]

Paul H. Wieschman  
Regional Director
SUMMARY RECORD OF DISCOUNT WINDOW LENDING
(Over 36-Month Period Prior to Failure)

NORTHWEST NATIONAL BANK
FAYETTEVILLE, AR

Date of Conservatorship, Receivership or 13(c) Assistance: 8/16/91

Discount Window Loans

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
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<tbody>
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Collateral Securing Loan at Time of Failure:

Par Value $4,662,303
Lendable Value $3,602,112

Consecutive Days of Borrowing

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Composite CAMEL Ratings

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Summary History of Collateral Pledged

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<th>Description</th>
<th>Par Value</th>
<th>Lendable Value</th>
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</thead>
<tbody>
<tr>
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* Lendable value based on presence of past due and nonaccrual notes and overall weakened condition of bank assets.
### Detailed Record of Discount Window Lending
(Over 36-Month Period Prior to Failure)

<table>
<thead>
<tr>
<th>Date</th>
<th>Loan Type</th>
<th>Loan Amount of Loan Outstanding</th>
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## Detailed Record of Discount Window Lending
(Over 36-Month Period Prior to Failure)

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### Detailed Record of Discount Window Lending
(Over 36-Month Period Prior to Failure)

<table>
<thead>
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<th>Date</th>
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Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis
Name: **PEOPLES BANK**  
Location: **HEWITT, TX**

Date of conservatorship, receivership, or 13(c) assistance: **1991-06-13**

<table>
<thead>
<tr>
<th>Discount window loans</th>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
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<tbody>
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<td>Peak borrowing:</td>
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</table>

**Collateral securing loan at time of failure**

| Book value | 3,707,647.80 |
| Lendable value | 1,893,614.11 |

**Consecutive days of borrowing:** 5 6-15 16-30 31-60 Over 60

**Number of occurrences in the 36-month period before failure:** 1

<table>
<thead>
<tr>
<th>Composite CAMEL ratings</th>
<th>Rating</th>
<th>&quot;As-of date&quot; for rating</th>
<th>Date received from regulator</th>
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<td>1991-04-17</td>
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<tr>
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**Summary history of collateral pledged:**

- Book-entry U.S. government agency securities
- Customers notes
### Detailed Record of Discount Window Lending
Over 36-Month Period Prior to Failure

**Name of Failed Institution:** PEOPLES BANK  
**Location (City and State):** HEWITT, TX

<table>
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<tr>
<th>Date</th>
<th>Type</th>
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1
**Detailed Record of Discount Window Lending Over 36-Month Period Prior to Failure**

**Name of Failed Institution:** PEOPLES BANK  
**Location (City and State):** HEWITT, TX

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**Detailed Record of Discount Window Lending Over 36-Month Period Prior to Failure**

Name of Failed Institution: **PEOPLES BANK**  
Location (City and State): **HEWITT, TX**

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Summary Record of Discount Window Lending
Over 36-Month Period Prior to Failure of Depository Institution
(Detailed Record Attached)

Name of Failed Institution: Southeast Bank, N.A.
Location: Miami, Florida
Date of Conservatorship, Receivership, or 13(c) Assistance: 9/19/91

Discount window loans:

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<tbody>
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Collateral Securing Loan at Time of Failure:

- Book Value: $1,582,281,000
- Lendable Value: $1,332,789,000

Consecutive Days of Borrowing:

- Number of Occurrences: 5
- in the 36-Month Period Before Failure: 1

Composite CAMEL Rating:

- At Time of Failure: 5
- "As-Of" Date: IN PROCESS
- Date Received: IN PROCESS

Previous Ratings, if Any:

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Summary History of Collateral Pledged:

In early April of 1991, Southeast Bank pledged to the discount window commercial notes having a face value of $295 million and a lendable value of $254 million. At the same time, the bank also identified a substantial volume of other types of loans that could be pledged quickly in the event of a sudden and unexpectedly large need for Federal Reserve credit. This consisted of $1.1 billion of consumer installment loans, $1.5 billion of residential and commercial real estate mortgages, and $286 million of credit-
card receivables. On June 27, the first day of discount-window borrowing by Southeast, consumer installment loans with a lendable value of $352 million were pledged as additional collateral. On August 19, the remainder of $1.1 billion consumer installment loans were pledged; the total consumer loans had a lendable value of $977 million. Finally, on August 27 commercial notes with a face value of $163 million and a lendable value of $131 million were pledged to the discount window.
SOUTHEAST BANK NA
MIAMI, FL
CLOSED DATE: 09/19/91

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NOTE: Daily outstanding loan balances include weekend days. Also, blank line indicates break in borrowing sequence.
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</table>

**Note:** Daily outstanding loan balances include weekend days. Also, blank line indicates break in borrowing sequence.
Mr. L. William Seidman
Chairman
Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, D.C. 20429

Dear Mr. Chairman:

As you are aware, Southeast Bank, N.A. has been borrowing from the discount window of the Federal Reserve Bank of Atlanta regularly since mid July of this year. In connection with these borrowings, the Federal Reserve Bank of Atlanta has recently conducted an examination of Southeast to determine whether Southeast could be expected to restore normal access to liquidity in the market and therefore be able to repay the Federal Reserve loan.

Although the report of the examination is still being finalized, based on preliminary findings, we are concerned that Southeast may not be able to restore normal access to liquidity without federal assistance. Southeast currently has a Tier 1 leverage ratio of 2.3 percent. Poor asset quality and continuing operating losses are expected to eliminate this capital in the foreseeable future.

Under these circumstances, the Federal Reserve does not consider it to be appropriate for the Federal Reserve to continue to extend credit to Southeast unless such continued extensions of credit will enable the Federal Deposit Insurance Corporation to resolve Southeast in an orderly manner and minimize the cost to the FDIC. Accordingly, the Board is requesting the views of the FDIC as to whether continued extension of Federal Reserve credit would be consistent with these criteria and the duration that such credit might be required.

Very truly yours,

William W. Wiles
Secretary of the Board
August 22, 1991

Gentlemen:

You have requested the views of the FDIC regarding the resolution of Southeast Bank, N.A. Staff is in discussion with a number of prospective acquirors, as well as Southeast Banking Corporation, regarding possible assistance. Our objective is to consummate such a transaction within approximately eight weeks -- or if open assistance proves cost effective to execute an agreement, subject to any necessary stockholder or bondholder consents, within the same time-frame. We believe that, whatever the form of the transaction, it will reduce the costs to the Bank Insurance Fund to avoid having to bridge the bank. Accordingly, we request that the Federal Reserve Bank of Atlanta continue lending to Southeast Bank, N.A. until the 18th of October.

Sincerely,

L. William Seidman
Chairman

Board of Governors of the Federal Reserve System
Washington, D.C. 20551
September 10, 1991

Gentlemen:

You have again requested the views of the FDIC regarding the resolution of Southeast Bank, N.A. Staff is in discussion with a number of prospective acquirors, as well as Southeast Banking Corporation, regarding possible assistance. Based on a revised schedule, our objective is to consummate a cost effective transaction with respect to the bank within the third quarter of 1991. Whatever the form of the transaction ultimately consummated, we believe that providing the assistance to effect such a transaction would not exceed the cost of liquidating the bank at this time. Accordingly, we request that the Federal Reserve Bank of Atlanta continue lending to Southeast Bank, N.A.

Sincerely,

L. William Seidman
Chairman

Board of Governors
Federal Reserve System
Washington, D.C. 20551
**Detailed Record of Discount Window Lending**

**Over 36-Month Period Prior to Failure of Depository Institution**

(Detailed Record Attached)

**Name:** TASCOSA NATIONAL BANK  
**Location:** AMARILLO, TX

Date of conservatorship, receivership, or 13(c) assistance: 1991-06-13

<table>
<thead>
<tr>
<th>Discount window loans</th>
<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>At time of failure</td>
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<td>Peak borrowing:</td>
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</table>

Collateral securing loan at time of failure

- **Book value:** 6,861,557.21
- **Lendable value:** 5,214,783.48

Consecutive days of borrowing: 5 6-15 16-30 31-60 Over 60

Number of occurrences in the 36-month period before failure: 1

<table>
<thead>
<tr>
<th>Composite CAMEL ratings</th>
<th>Rating</th>
<th>&quot;As-of date&quot; for rating</th>
<th>Date received from regulator</th>
</tr>
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</table>

**Summary history of collateral pledged:**

Customers notes
## Detailed Record of Discount Window Lending Over 36-Month Period Prior to Failure

**Name of Failed Institution:** TASCOSA NATIONAL BANK  
**Location (City and State):** AMARILLO, TX

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<tr>
<th>Date</th>
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Summary Record of Discount Window
Lending Over 36-Month Period Prior to
Failure of Depository Institution

Name: University Bank, N.A.
Location: Newton, MA
Date of conservatorship, receivership, or 13(c) assistance: 5/31/91

Discount Window Loans

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<th>Date</th>
<th>Loan Type</th>
<th>Amount</th>
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<tbody>
<tr>
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<tr>
<td>Peak borrowing: 4/30/91</td>
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<td>$28,900,000</td>
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</table>

Collateral securing loan at time of failure

| Book value: | $59,324,700 |
| Lendable value: | $39,863,882 |

Consecutive days of borrowing: 5 6-15 16-30 31-60 Over 60

Number of occurrences in the 36-month period before failure: 1

Composite CAMEL ratings

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<td>2 5/02/89 N/A</td>
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<td>2 9/29/88 N/A</td>
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</table>

Summary history of collateral pledged:

The three loans prior to 4/25/90 were collateralized with government securities with principal values that ranged in total from $600 thousand to $2.5 million. Subsequently, University Bank, N.A. (University) began pledging 1-4 family residential mortgages in lieu of securities. By 12/31/90, University had pledged $27.9 million in 1-4 family residential mortgage loans with a lendable value of $22.1 million. By January's close, University's collateral position decreased slightly due to normal customer balance paydowns. On February 8, 1991, University increased the level of 1-4 family mortgages to $32.6 million, with a lendable value of $26.1 million. On February 14, 1991, University substantially increased its collateral, delivering $25 million of commercial real estate loans and increasing the level of 1-4 family mortgages to $34.8 million. The total value of collateral pledged equalled $59.8 million, providing $39 million in lendable value. Collateral was maintained at this level, with small fluctuations,
until April 5, 1991. On that date, University pledged an additional $64 million of commercial and retail loans. No collateral value was assigned to this pledge because the notes were not in this Reserve Bank's possession. This position was maintained until closure. On April 30, 1991, this Reserve Bank held $22.3 million of commercial loans and $31.4 million of 1-4 family residential mortgages in its vault, with a lendable value of $36.3 million. These figures increased somewhat by the end of May closure date to $25.3 million, $34 million, and $39.8 million, respectively.
## DETAILED RECORD OF DISCOUNT WINDOW LENDING
OVER 36 MONTH PERIOD PRIOR TO FAILURE

**NAME OF FAILED INSTITUTION:** University Bank, National Association  
**LOCATION (CITY AND STATE):** Cambridge, MA

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QUESTIONS FROM CHAIRMAN DONALD W. RIEGLE, JR.

Q.14. During your January 29, 1992 appearance before the Banking Committee in connection with your renomination as Chairman of the Federal Reserve System I asked you whether it would concern you if foreigners owned the largest American banks. You indicated that speaking strictly as an economist it would not although it might raise other issues such as those of "national security" or related concerns.

Can you tell me what type of national security concerns might be raised if the largest U.S. banks were controlled by foreign interests?

A.14. I am not an expert in the "national security" concerns of the United States. This is the reason why I responded to questions on this subject in the way I did at the January 29 hearing. The issue is at what point is the strictly economic interests that the United States has in terms of the efficient functioning of the U.S. and international financial systems outweighed by non-economic concerns of a national security or broader public-policy nature.

Speaking as a citizen as well as an economist, I would be inclined to think of national security concerns in terms of cases where control of the largest U.S. banks might be exercised by citizens of a country or the government of a country with whom the United States is at war, with whom the United States does not otherwise have diplomatic or economic relations, or whose political system is in direct conflict with ours. As you know, I believe the United States will be stronger economically if it has open markets and provides opportunities for investment in this country to all potential investors as long as they do not contemplate and do not have a history of illegal, unsafe or unsound practices or activities that could damage our institutions.

The banking industry is relatively highly regulated and supervised. As such, it would be difficult for the owners of a banking institution to damage either that institution or the financial interests of the United States in a material way without detection unless the owners followed a deliberate policy of fraud, for example, or other types of institutional misconduct, and such behavior is unlikely to go undetected for an extended period. Moreover, as long as we have an open and competitive financial system, I am not particularly concerned about the potential misallocation of bank lending by foreign banks because institutions that make non-economic loans will not survive for long.
QUESTIONS FROM CHAIRMAN DONALD W. RIEGLE, JR.

Q.15. In a follow up to the above question I asked you whether you would be concerned if we found ourselves in a situation where more than half the control of the banking assets of this country were in the hands of foreign banks. You indicated that was a "national security question" that goes beyond the issue of what is an efficient international banking system.

Can you elaborate what is the nature of the national security issue that would be raised by having foreign banks control more than half the banking assets of this country?

A.15. The issue with respect to the share of U.S. banking assets controlled by foreign banks is, again, at what point the strictly economic interests the United States has in terms of the efficient functioning of the U.S. and international financial systems is outweighed by non-economic concerns of a national security or broader public-policy nature.

I would differentiate two cases. The first case is where control over more than half of the banking assets of this country might be exercised by citizens of a country or the government of a country with whom the United States is at war, with whom the United States does not otherwise have diplomatic or economic relations, or whose political system is in direct conflict with ours. In this case, I would have the same concerns as I cited in answering the previous question: efforts to defraud U.S. citizens and directly or indirectly to defraud the U.S. government.

In a second case, where the ownership of U.S. banking assets is spread among a large number of banking institutions from a large number of different countries, such as today when we have approximately 300 foreign banking institutions from about 60 countries operating in the United States, I would be hard pressed to come up with the "national security" concern that might be involved aside from those associated with particular ownership interests. Moreover, I would note that U.S. policy over the years has been one of arguing against such "national security" justifications when they have been advanced by other countries in financial or other areas.
Q.16. In terms of national security concerns over foreign control of U.S. banking assets would any such concerns, in your view, be heightened if the banks exercising control came from a country where our financial institutions had little if any presence? Would an asymmetry in market presence be part of any national security concerns over such matters?

A.16. With the qualification, again, that I am not charged with broad national security responsibilities, my view as an economist is that we should not be concerned on national security or economic grounds if banks operating in this country come from countries in which our financial institutions have little if any presence. There may be many sound economic reasons why financial institutions may operate in the United States to our economic and financial advantage while our financial institutions choose to have little if any presence in the countries in which those foreign institutions are chartered. Moreover, I do not think that an asymmetry in market presence would by itself raise national security concerns.

Q.17. During your testimony on January 29, 1992 I noted that Japan controlled about 15 percent of banking assets in this country as a whole and up to 25 percent in markets such as California. I further noted that U.S. banks have about one percent and in fact all foreign banks have less than three percent of banking assets in Japan and asked you if we should not have a reciprocal, open, two way relationship with Japan in terms of financial services. You stated that "we should" and I agree. Do you think that in order to increase our negotiating leverage with the Japanese to obtain such a relationship we should give our negotiators in the Treasury the discretionary authority, in consultation with the banking regulators, to deny Japanese financial institutions in our market national treatment if their government continues to deny such treatment to our institutions in the Japanese market?

A.17. When I agreed with you that we should have a reciprocal, open, two-way relationship with Japan in terms of financial services, I did not intend to argue that one does not exist today. On the whole, while there are some problems with national treatment in the Japanese financial markets as there are in our market, my sense is that they are relatively minor.
A.17. Regardless of one's view of whether there is national treatment of foreign financial institutions in Japan, I would be hesitant, on that basis, to favor a public policy that restricts access to our financial markets. I also would be hesitant to favor a policy of reciprocal national treatment that would give our negotiators the discretionary authority to deny Japanese financial institutions national treatment in our market if the Japanese government were found to deny such treatment to our institutions in the Japanese market.

While I support encouraging other countries to liberalize access to their financial markets because it would be in their interests as well as the interests of U.S. financial institutions, I think it would be a mistake to abandon our policy of national treatment in an attempt to achieve that end. We essentially would be saying that we are prepared to forego the benefits (for example, lower costs and more varied services) to consumers of banking services in this country of having the participation of foreign banks in our market. I do not think that this would be good public policy. Moreover, I believe that there are better ways to encourage other countries to open their markets such as reliance on market forces favoring liberalization and on patient bilateral and multilateral negotiations.

Q.18. The President of the Federal Reserve Bank of New York, E. Gerald Corrigan, has frequently taken a prominent leadership role in questions of bank supervision and particularly international bank supervision. In these activities, does Mr. Corrigan represent the Federal Reserve System or solely the Federal Reserve Bank of New York? If the System, is that representation based on any formal or informal delegation of responsibility from the Board of Governors?

A.18. Mr. Corrigan is the President of the Federal Reserve Bank of New York which, under delegated authority from the Board, has substantial responsibilities with respect to supervision both of domestic institutions operating here and abroad and of foreign banks operating in the U.S. In view of those responsibilities President Corrigan has a great deal of expertise and experience in the bank supervision area and he has on occasion been requested to share that knowledge and experience in testimony before Congressional Committees. In presenting such testimony
A.18. and in giving speeches on bank supervision issues (cont) President Corrigan has expressed his own views which are not necessarily identical on every issue with those of the Board of Governors but which in the great majority of cases are not dissimilar to the views of the members of the Board. In instances where President Corrigan's views differed from the position espoused by the Board of Governors, it was my judgment that it would be useful for the Congress to be exposed to an alternate view on issues where reasonable and experienced analysts could differ. President Corrigan as a matter of routine always provides draft copies of his testimony and prepared speeches to the senior staff of the Board of Governors and where appropriate to the Chairman.

Because of his expertise in international supervisory matters, President Corrigan was asked to serve as Chairman of the Basle Committee on Banking Supervision. President Corrigan consulted with me before accepting that position, and I urged him to accept it. Before Mr. Corrigan's chairmanship and during it, positions adopted by the Basle Committee, such as the 1988 capital accord, must be independently reviewed and approved by the Board of Governors.
RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM ALAN GREENSPAN

Q.1. I am deeply concerned about an economic factor which often eludes statistical analysis—consumer confidence.

Not too long ago the New York Times ran an article entitled, "Need is seen for the Fed to consider consumers." No matter what statistics reveal, people all over the country feel uneasy about our ability to stage a recovery at any time soon. Many people in my State of Tennessee have lost a sense of job security. In fact, fear of unemployment tops the list of Americans' worries. Such deep public concern certainly affects consumer demand.

At this time, 16 million Americans are unemployed or are working part time because they are unable to locate full-time work. The Bureau of Labor Statistics reports that one in every ten families has someone unemployed and one in every ten individuals is in need of food stamps.

As you are well aware, consumers as a group, represent two thirds of all economic activity. But the public appears more depressed about future economic prospects than at any other time in the past few decades. Dr. Greenspan, you stated last month, "There is a deep-seated concern out there which I have not seen in my lifetime." Certainly, we must address consumer fears and get the public on board if we are to have a successful recovery.

Q.1.a I am interested in how semi-intangible factors like public confidence are measured at the Federal Reserve?

A.1.a Confidence is evaluated in both formal and informal ways. Like others, we look carefully at survey based measures of confidence produced by such groups as the University of Michigan's Survey Research Center, the Conference Board, and Dun and Bradstreet. We also look at the results of surveys conducted by a number of private polling organizations. Finally, we receive anecdotal information on confidence and economic conditions throughout the country in the reports we receive from the boards of directors of the Federal Reserve Banks and branches and in the other contacts the Reserve Banks have with their communities.
QUESTIONS FROM SENATOR JIM SASSER

Q.1.b Is consumer confidence considered equally as important as other economic factors?

A.1.b It is very difficult to define how "important" any particular variable is, but it is fair to say that confidence receives close attention in our analysis.

Q.1.c What can we do to stimulate or at least revive the consumer sector?

A.1.c The recent reductions in interest rates should provide stimulus to the consumer sector over the coming months. Perhaps a more important factor for reviving consumer confidence is for economic policy to be clearly addressing the concerns of Americans about longer-run trends in living standards by ensuring that we have an environment conducive to saving and productivity-increasing capital formation.

Q.2. Last fall the Federal Deposit Insurance Corporation released estimates on its financial viability. The report shows that, under a pessimistic scenario, the $70 billion line of credit that the Bush Administration asked Congress to make available, could be inadequate. The projections show the FDIC running out of money by 1994 under this scenario.

Everyone is wondering--when is this going to stop? You assured us in 1989 that the savings and loan debacle was a $40 billion dollar problem. Instead, we have already spent $80 and another $80 is on the way for S&L's. From past experience, it seems like the pessimistic scenario is the least that will happen.

Of course, we know that the cost of the bank and savings and loan problem is tied to the real estate market. If prices in real estate keep deflating, more loans are going to go belly up, more banks will be in trouble. There's no question--the taxpayers will have to carry this burden.

What you do on interest rates and as the nation's leading bank regulator matters a great deal. Real estate is extraordinarily sensitive. When people ask why we have these great problems in real estate, and in the banking sector, I think it's fair that they examine the policies of the Federal Reserve.
QUESTIONS FROM SENATOR JIM SASSER

Q.2.a In your opinion, what is the adequacy of the $70 billion line of credit?

A.2.a Of the $70 billion, $25 billion was made available to absorb losses and $45 billion for working capital, with the latter to be repaid from sale by BIF of assets acquired from failing banks. The BIF itself has access to better information than the Federal Reserve on problem banks and indicated last fall that $70 billion--so allocated--should be sufficient. Our best estimate at that time was that $70 billion would be close, but the outcome was heavily dependent, as you note in your question, on the pace of recovery in real estate markets. I note that the Administration's most recent budget did in fact suggest that in fiscal year 1994 more than $25 billion additional loss appropriation might be needed if there were no further banking reforms. Without commenting on the benefits of such congressional action, this shortfall is certainly possible.

Q.2.b Will direct taxpayer funding be required for the banks, as well as the savings and loans?

A.2.b The current $70 billion of BIF funding can, I think, be repaid by the sale by BIF of failed bank assets plus the higher deposit insurance premium. If BIF losses exceed the $25 billion of loss funds now authorized, the alternative to taxpayer funding would be still higher premiums on the surviving banks. I am concerned that long-term continuation of the 30 basis point premium contemplated to begin in mid-1993 could be detrimental to the long-run health of U.S. banks; a further increase in premiums would almost certainly be counter-productive. Thus, additional congressional appropriations to cover the costs of the deposit insurance guarantee may be required.

Q.2.c Is the extraordinary real estate hangover of the banks factored into interest rate decisions?

A.2.c The weakness in the real estate sector and its effects on banks have been important considerations in the Federal Reserve's conduct of monetary policy in recent years. As you note, the overbuilding of commercial real estate has contributed substantially to asset quality problems at financial intermediaries, which in turn has been a crucial...
QUESTIONS FROM SENATOR JIM SASSER

A.2.c element behind their heightened reluctance to lend. The (cont) "credit crunch" has interfered with normal credit flows, especially to borrowers lacking access to open markets, and without question has retarded spending and production. In addition, high vacancy rates for commercial real estate have represented the primary cause of the contraction in expenditures on nonresidential construction. Countering the restraining effects of the credit crunch and the plunge in commercial construction on overall economic performance has been one vital motivation behind Federal Reserve policy easing. In the process of providing economic stimulus, these policy easings have acted to cushion the weakness in commercial real estate as well as encourage an upturn in residential construction. The easings also have served to improve the access of banks to capital markets, thereby strengthening their balance sheets and ability to extend credit.
QUESTIONS FROM SENATOR JIM SASSER

Q.3. Dr. Greenspan, looking to see what may have caused this recession, I am struck by the tightening of interest rates that occurred beginning in the spring of 1988 and extending into the summer of 1989. We have talked in the past about this. I stated, at the time, that given the fragility in the economy with highly leveraged corporations, problems in banking and the huge federal budget deficit, that the Fed should be careful not to overreact to inflation.

It is always easier to look back than to look forward, but looking at core inflation, or in particular core consumer prices, over this critical 15-month period, inflation appears remarkably stable.

At the same time, however, the Fed increased interest rates by almost half—3-1/2 percentage points. The federal funds rate went from 6.5 percent to nearly 10 percent.

There was some easing in 1989. But the decline in rates in 1989 was only 1-1/2 percent. Less than half of the increase in 1988 and 89. Rates were then static for most all of 1990—until well after the recession began.

In July of 1989, at the end of this period of tightening rates, you testified that you saw no indication that a recession was imminent. However, you stated that a shock to the economy or a "policy mistake" by the Fed might trigger a downturn. You said "Our job is to keep such errors to an absolute minimum."

Q.3.a Approximately one year later, this recession officially began. Do you blame the recession on the Gulf War and the temporary rise in oil prices that resulted from that event?

A.3.a Disaggregating any set of complex forces which trigger recessions is difficult but it is clear that the sharp contraction in output that began in the latter part of 1990 and lasted until the spring of 1991 was related to the Iraqi invasion of Kuwait and the subsequent effects on oil prices as well as consumer and business confidence.
QUESTIONS FROM SENATOR JIM SASSE

Q.3. Or was there, in your estimation, a "policy mistake" by the Fed? Were interest rates just too high in the 1988-1989 period? Given the underlying problems in the economy—and we knew they existed—does tight money look to you now like it was the right policy choice in the late 1980s? Why did the Fed increase interest rates so steadily over the period? Did the Fed think that 4 percent inflation was too high and decided to risk recession to bring it down?

A.3. In early 1988, in the wake of the stock market crash of October 1987, the Federal Reserve initially extended the monetary easing that it had put in place late in 1987. But as it became clear that the economy still was strong and that the potential for inflation to rise beyond its underlying rate of 4 percent or so was increasing, the Federal Reserve began to tighten reserve conditions. Before the tightening began, the monetary aggregates had been running close to the top of their 1988 growth ranges. Bond yields increased during the early part of the year, as indications of economic strength raised concerns about an uptrend of inflation. With strong growth of employment, the unemployment rate had dropped to 5-1/2 percent, and labor costs accelerated during the year. For example, the employment cost index rose at a 4.8 percent rate during 1988, a considerable advance over the 3-1/4 percent rates of 1986 and 1987. By the end of 1988, the federal funds rate had risen about 2 percentage points. Despite this tightening, M2 and M3 were estimated to have increased 5-1/4 and 6-1/4 percent, respectively, near the middle of their annual ranges, and debt growth, at 8.7 percent, was quite rapid. Consumer prices increased 4-1/4 percent, and real gross domestic product rose 3.3 percent.

During 1989, the risks of an acceleration of inflation appeared to decline somewhat as pressures on industrial capacity diminished, commodity prices softened, and the exchange value of the dollar rose. By midyear, the odds seemed to favor some progress against inflation while economic growth continued at a moderate rate. Consequently, the Federal Reserve began a gradual easing of policy, taking steps that reduced the federal funds rate more than a percentage point by year-end. M2 was estimated to have expanded at a 4.6 percent rate, ending the year near the middle of its range. M3 growth, at 3.3 percent was near the lower end of its range. The slow growth of M3, however, was judged to reflect primarily the shrinkage of the thrift industry and a related rechanneling of funds in mortgage markets that appeared to have little effect on overall credit availability. Indeed,
QUESTIONS FROM SENATOR JIM SASSER

A.3. overall debt continued to expand rapidly, at an 8 percent b-e rate during 1989. The economy also continued to grow, but (cont) at a slower pace than in the preceding years.

Nevertheless, employment continued to expand at a satisfactory pace and the average unemployment rate for the year edged down to 5-1/4 percent, the lowest level since the early 1970s. Despite earlier signs that suggested some deceleration, consumer prices rose about 4-1/2 percent over the year.

The economy continued to expand during the first half of 1990. Over the first two quarters of 1990, GDP growth averaged slightly more than 1-1/2 percent at an annual rate. During this period, the CPI excluding food and energy prices rose about 5-1/2 percent. M2 expanded at a five percent rate during this interval. Over this same period of time, evidence began to accumulate that credit availability was constraining aggregate demand, and in response the Federal Reserve eased policy around mid year. On the whole, though, the Federal Reserve judged that the economy would continue to expand at a moderate pace, consistent with continued growth of employment while putting downward pressure on inflation. However, as discussed in the response to part a) of this question, the sharp run-up in oil prices that accompanied the invasion of Kuwait took a toll on consumer and business confidence and pushed the economy into recession.

In retrospect, it appears that policy adjustments during the 1988-89 period were appropriate. There was a distinct potential for accelerating inflation in 1988 and 1989, which the Federal Reserve was trying to counter. In fact, despite our efforts, the CPI excluding food and energy rose from around 4 percent over the 1985-87 period to over 5 percent in 1990. Nonetheless, when the Federal Reserve, looking forward, saw that inflation pressures were likely to abate, we began to ease policy in 1989. Until the oil shock, it appeared that the nation might have avoided another round of accelerating inflation, without going into a recession, though of necessity growth had slowed as economic output moved into line with its potential.
QUESTIONS FROM SENATOR JIM SASSER

Q.4. The New York Times recently carried an interesting article concerning the statistics that the government uses to measure the condition of the economy. According to the Times, many economists are now saying that the official 6.8 percent U.S. unemployment rate considerably understates the actual level of unemployment. According to these analysts, official statistics provide a false sense of the economy's strength and its potential for rebounding. They believe that the real jobless rate is well into double digits.

Indeed, when you consider the number of workers forced to work part time—6.3 million—and those workers that are so discouraged that they have given up—1.1 million—the broader number of unemployed/underemployed came in at 16.3 million, or 13 percent of the workforce. One out of every six unemployed persons has now been out of work for more than 6 months.

Dr. Greenspan, you are known as the great decipherer of economic data. I believe you learned of the Gulf War by observing a jump in oil prices while at your computer.

Q.4.a Do you think that unemployment is worse than the official rate indicates?

A.4.a One of the economic puzzles of the past two years has been the sharp increase in the number of people who report that they are not looking for work because they are in school, ill, or have home responsibilities. To the extent that some of these individuals are, in fact, out of the labor force because of a perceived lack of job opportunities, the amount of slack in the labor market is greater than official statistics would indicate.

Q.4.b Is the Fed relying on an inaccurate measure of economic performance in making decisions?

A.4.b As I indicated in my written response to a similar question from Chairman Riegle, in general the unemployment rate provides a useful summary measure of resource utilization in the labor market. However, like all summary measures it should not be used in isolation. In assessing economic performance, the Federal Reserve Board
QUESTIONS FROM SENATOR JIM SASSER

A.4.b and the Federal Open Market Committee look at a wide variety of indicators from both government statistical agencies and non-government sources as well as reports on local conditions gathered through the Federal Reserve Banks. Taken as a whole, this information gives us, I believe, a comprehensive picture of current economic conditions.

Q.5. I have long been a proponent of lower interest rates in order to spur economic growth. Therefore, I am pleased with the rate reductions that the Fed has engineered thus far in this recession but I wish that the Fed had acted more quickly and decisively earlier. Indeed, I think the Federal Reserve has room to do more.

In this atmosphere of falling rates, I am struck by the fact that rates on savings instruments are falling faster than those on loans. In other words, the way that the Fed's interest rate policy has filtered through banks, it appears to be more of a detriment to savers than it is a positive for borrowers.

The New York Times recently reported that "a year ago, the average 6-month bank certificate of deposit was paying 7.14 percent, now it is 4.46 percent, a decline of 2.68 percentage points. But the rate for a 30 year fixed-rate mortgage has fallen only 1.10 percentage points, to 8.38 percent."

Q.5.a What is the reason for this?

A.5.a The relative variation you cite for rates on retail CDs versus those of 30-year fixed rate mortgages very closely corresponds to the relative movements of the short- versus long-ends of the Treasury and private yield curves over this period. Investors in and issuers of many short- and long-term instruments enjoy a wide variety of options, making such financial markets quite competitive. The two instruments you mention are good examples. Yields on retail CDs tend to move fairly closely with rates on Treasury bills of comparable maturities. Similarly, rates on long-term mortgages with fixed interest rates have a tendency to follow longer-term bond rates. This tendency has been strengthened by the maturation of markets for mortgage-backed securities, which facilitate investor arbitrage across markets for longer-term instruments.
QUESTIONS FROM SENATOR JIM SASSER

A.5.a Short-term rates generally exhibit wider swings than long-term rates across the interest rate cycle. When short-term rates decline during recessions, the yield curve typically steepens, as longer-term rates fall by less, in part because investors believe short-term rates likely will rise again in the future as the economy recovers. The current episode has followed this general pattern.

Q.5.b Could the banks be using the opportunity of the drop in rates to increase their spreads in order to cover losses on bank loans?

A.5.b The sharp decline in deposit rates reflects the sharp decline in short-term market rates, led by the fall in the federal funds rates induced by monetary policy. Rates on bank loans, which generally tend to fluctuate less over the cycle than do very short-term market yields, have lagged the drop in the federal funds rate. The widening in spreads between rates like the "prime" or consumer loan rates and bank funding costs also reflects a recognition of the risks of loss on new loans in an uncertain economic environment; such a widening is typical of periods of economic weakness, but the change this time may have been greater because lending practices had in many instances been unduly aggressive in earlier years—thus producing the loan losses to which you refer. Competitive pressures work against the kind of direct recovery of past losses to which you refer.
QUESTIONS FROM SENATOR JIM SASSER

Q.6. Many of those who argue against fiscal stimulus, or even monetary stimulus, contend that such action would do more harm than good. These individuals contend that long-term interest rates would rise and choke off activity in key sectors, such as housing. During this recession, long-term interest rates have fallen sluggishly in response to Fed cuts in short rates. Mindful of this, Senator Sarbanes and I have urged the Treasury to shift its borrowing towards the short end of the yield curve. This would make long bonds somewhat more scarce and drive down long-term interest rates. Indeed you told Senator Sarbanes that the Treasury and the Fed were studying such a move. You seemed to indicate that it was a good idea. What is the time-frame for shifting to shorter term securities?

A.6. Academic studies on whether reducing the supply of Treasury debt would help lower long-term interest rates do not give a clear indication that such a policy would be successful. This is because expectations of future short-term rates are by far the principal determinant of long-term rates, not relative supplies of securities. Nevertheless, some empirical evidence supports the proposition and, given the potential benefits of reduced long-term interest rates, I concur with the recent decision of the Treasury to cut back on bond and long-term note issuance. However, the scope for cutting back in one maturity sector is limited. Given the huge size of the deficit, considerable sales will likely be needed in all maturities, and large shifts toward the short end could distort yields, thereby dissipating any advantage to the Treasury. A major shortening of Treasury debt also would alter the liquidity profile of the economy, with possible implications for the stance of monetary policy.

With regard to the possible participation by the Federal Reserve in such a program, we are active in purchases in all segments of the market, including the longer end, and I would expect that to continue. For example, in 1991 the Federal Reserve purchased roughly $11-1/2 billion of U.S. Treasury coupon securities from foreign central banks and the market in the normal course of open market operations.
QUESTIONS FROM SENATOR JIM SASSER

A.6 However, the volume of our purchases of longer-term (cont) securities necessarily is limited. The Federal Reserve needs considerable liquidity in its portfolio to ensure that we will be able to meet our reserve objectives in the least disruptive way possible in all circumstances. As to the time frame for a shortening of maturities of securities in the hands of the public, as noted, the Treasury just announced some shift toward shorter maturities for the series of auctions to be held next week and a continuation of such a tilt in its future offerings. As the Federal Reserve periodically makes additions to its permanent securities portfolio, we will be looking at the possibility of purchasing additional coupon securities, consistent with our liquidity needs.

Q.7. Dr. Greenspan, in November 1990 you wrote a letter to Securities and Exchange Commission Chairman Richard Breeden expressing your strong concern about the imposition of market value accounting on financial institutions. You raised both economic and technical concerns in arguing against market value accounting. I share those concerns. Moreover, I am particularly concerned, in light of the credit crunch and the recession.

Q.7.a In this difficult time shouldn't we be even more cautious about abruptly revising the accounting model for the nation's financial institutions?

A.7.a Yes. At any time, a change to market value accounting could have a major impact on the investing and lending activities of banking organizations. The disruptive effects, however, would tend to be greater during times of economic stress, because it is just at such times that the market values of assets, particularly certain categories of loans, are subject to sharp and temporary fluctuation. Currently, assets held for short-term trading purposes are reported at market value, and assets held for sale are reported at the lower of cost or market value. But these assets generally comprise only a small portion of a banking organization's total assets, which primarily consist of investment securities and loans held for long-term portfolio purposes and so are carried at historical cost.
QUESTIONS FROM SENATOR JIM SASSER

A.7.a There is a move to extend market value accounting to long-term holdings of investment securities (but not to loans). Such a change would likely reduce the amount of securities banking organizations are willing to hold and thus adversely affect bank liquidity. An approach similar to market value accounting for securities was in effect prior to 1938, and serious concerns on the part of the U.S. Treasury and the bank regulators over how this regulatory policy was affecting the financial performance of banks and influencing their investment decisions led to the abandonment of that accounting concept in that year.

A shift to market value accounting for loans would have an even more dramatic effect. There are not active, liquid markets for most types of loans, and thus there is no readily available information on their market values. Estimates of value, therefore, are subject to a wide range of uncertainty. Nor are there established standards for estimating the market values of these assets. Thus, developing estimates of values for loans would impose heavy costs on banks and on regulators alike and would in all likelihood not produce consistent or reliable results.

Moreover, there are many uncertainties involved with the estimation of the market value of loans. Consequently, the market value of loans tends to be volatile and this volatility may be intensified in times of economic change. Thus, banking organizations would likely steer away from certain lending activities, particularly during recessionary conditions. Such actions could hinder credit availability and intensify weaknesses in the economy.

Lastly, the "piecemeal" application of market value accounting to a large segment of a banking organization's assets, as some accountants have advocated, without applying market value accounting to the entire balance sheet would produce a distorted picture of the institution's earnings and capital.

In my view, these issues need to be fully explored and resolved before dramatic moves to work on market accounting for banking organizations are made.
QUESTIONS FROM SENATOR JIM SASSER

Q.7.b What effect do you think that market value accounting will have on the customers of financial institutions?

A.7.b The answer to this question depends in part upon which assets banks might be required to mark to market value. As mentioned in A.7.a, if only investment securities were reported at market value, banks would likely reduce their holdings of these assets. This could adversely affect a bank's liquidity position.

If all loans were required to be reported at market value, banks would likely reduce certain lending activities. Loans to small business firms, farmers, and other borrowers that are particularly subject to cyclical economic conditions are the types of credits that banks might prove less willing to make.

Q.7.c For instance, is a bank going to be more or less likely to buy into a municipal bond offering of a small city or town if it has to mark those bonds to market?

A.7.c A requirement to mark municipal bonds to market would likely make municipal bond offerings by small cities or towns less attractive for banks. Securities issued by small municipalities are more difficult to value since active markets for these assets typically do not exist. As in the case of loans, the absence of a liquid market usually increases price volatility and would require that complex and subjective estimates of market values be used which impose a greater regulatory burden and higher costs.

Q.7.d If a bank is less likely to buy those bonds, what will happen to the locality's ability to finance itself?

A.7.d Banking organizations generally purchase large portions of bonds issued by small municipalities. Thus, if banks are less likely to buy bonds issued by smaller cities and towns, these municipalities would find it more difficult to finance their activities. As a consequence, their financing costs would increase.
QUESTIONS FROM SENATOR JIM SASSER

Q.8. As I travel in my home State of Tennessee, I repeatedly hear about the so-called credit crunch. Small businessmen, in particular, are finding it much more difficult to obtain credit. These are reputable businessmen with solid credit histories, but they cannot get a loan from a bank in the regular course of their business. At the very least, it has become much more difficult for these small businessmen to obtain financing. Paperwork requirements have become much greater and the process takes much longer.

Q.8.a In the estimation of the Federal Reserve how pervasive is this problem and what is being done about it?

A.8.a The general tightening of bank credit standards (and the emergence and persistence of the "credit crunch") is a serious concern of the Federal Reserve and has prolonged recessionary conditions in the economy. Accordingly, through its monetary policy efforts and in its supervision of bank holding companies and state member banks, the Federal Reserve has taken steps to encourage further lending to sound borrowers. Regarding monetary policy, interest rates, as you know, have declined sharply during the past year or so. Regarding supervision, the banking and thrift regulatory agencies have jointly issued statements and taken other actions designed to clarify and communicate their policies to both bankers and examiners in an attempt to reach a better balance in the evaluation and extension of loans. These efforts have stressed the importance of lenders continuing to work with troubled customers and to make sound loans.

Much of the increased paperwork that many borrowers have seen results from the heightened concerns of lenders about risks of new lending in a period of slow economic conditions. In some cases, it also stems from the need to improve documentation that is necessary for the application and enforcement of a sound credit evaluation process. In past years, some institutions had permitted their credit standards and lending procedures to decline, and needed to increase the information available to them about the strength and nature of their borrowers. Although the concerns you raise affect customers of all
QUESTIONS FROM SENATOR JIM SASSER

A.8.a size, small businesses generally have less resources to meet the informational and collateral demands of their lenders and are likely to feel the effect of such changes most dramatically.

The regulatory "call reports," which provide substantial financial information on the condition of depository institutions, do not specifically identify the volume or characteristics of loans to small businesses. Accordingly, one cannot address the full effect of recent conditions on the availability of credit to this particular group of businesses. That situation will soon change. Sections 122 and 477 of the recently enacted Federal Deposit Insurance Corporation Improvement Act of 1991 require bank and thrift regulatory agencies to collect information, such as the number, volume, and losses on loans to small businesses and small farms. Although this legislation may impose still further informational requirements on banks and their customers, it will enable us to track the future volume and pattern of small business loans.

Ultimately, the availability of credit in a particular region or throughout the country rests heavily on the presence of a strong and competitive banking system. In its administration of the Bank Holding Company Act and in meeting its general supervisory responsibilities, the Federal Reserve will continue to take steps that promote the strengthening of the nation's financial sector and that encourage the extension of sound credit.

Q.8.b Does the Fed think that the slowing down of the lending process may be slowing the economy as well?

A.8.b Yes, and we have been working assiduously to make sure that our regulatory and supervisory activities are not unduly inhibiting the flow of credit to creditworthy borrowers. As well, our monetary policy actions have been aimed in part at diminishing these problems and at compensating for their negative effects on economic activity.
QUESTIONS FROM SENATOR JIM SASSER

Q.8.c Another concern of mine is that banks appear to have the funds to lend but are more inclined to invest the funds in securities. Is there anything to this observation? I think it is absolutely vital for banks to be lending if the economy is to grow.

Q.8.d Has there been a discernable increase in bank investment in securities and a decrease in bank lending?

A.8. It is correct that expansion of bank balance sheets last c-d year was concentrated in their securities portfolio. Total securities held by commercial banks expanded 16-1/2 percent last year, entirely reflecting a 23-1/4 percent rise in holdings of U.S. government securities. Bank loans over the same period contracted by just under 1 percent. (A substantial proportion of banks' acquisitions of U.S. government securities last year was accounted for by mortgage-backed securities. Thus, these acquisitions have represented credit extended indirectly to the residential mortgage market.) A pattern of slower loan growth and more rapid securities acquisitions is typical during periods of economic weakness, as loan demand falls off relative to banks' sources of funds and banks lend more cautiously in view of the increased prospect that borrowers will experience financial difficulties and will be unable to service the loan. This pattern has been exacerbated by the current pressures on banking institutions, which have made them unusually reluctant to lend. However, survey evidence indicates that the tightening of loan terms and conditions has stopped. Moreover, wider lending margins seem to be bolstering bank profitability, and banks' capital positions are improving as a result of these better earnings as well as issuance of a substantial volume of securities in the markets. Consequently, banks' ability to lend is improving and they should be better positioned to lend any needed support to a resumed expansion of the economy.
QUESTIONS FROM SENATOR JIM SASSER

Q.9. The President has indicated that he will push once again for comprehensive reform to the nation's banking laws. Most of the more sweeping changes to the laws governing the financial services industry did not pass the Congress last year. It is likely that banking reform proposals including additional securities powers for banks will continue to be deliberated upon slowly by the Congress.

Q.9.a Will the Federal Reserve be taking any action to increase the "gross revenue limitation" for bank ineligible activities of a Section 20 affiliate?

A.9.a The Board has not received any formal request to revise upwards the Board's percentage limitation on the securities underwriting activities of section 20 affiliates, and the Board has not initiated any action to revise this limitation. A proposal to increase the revenue limit raises a number of legal and policy issues, including questions of interpretation of the terms of the Glass-Steagall Act. Without the benefit of analysis of these issues and of the Board's consideration and deliberation, I am unable to say at this time what course of action the Board would take in reviewing a proposal to raise the revenue limit applicable to section 20 affiliates.

Q.9.b The Federal Reserve has proposed several modifications to its firewall restrictions for section 20 affiliates. Will the Board take action regarding these modifications?

A.9.b The Board has proposed three modifications to the firewall restrictions established in the Board's section 20 orders. The Board has sought public comment on whether it should permit certain director interlocks between banks and section 20 affiliates, modify the cross-marketing restrictions imposed on section 20 affiliates, and permit banks to purchase U.S. government agency securities and U.S. government-sponsored agency securities from a section 20 affiliate. In each of these three areas, the modifications that have been proposed are limited and consistent with the legislation considered by both the Senate and the House. The proposals to permit limited director interlocks and to
QUESTIONS FROM SENATOR JIM SASSER

permit the purchase of certain government agency securities are similar to exceptions included in S. 543 as reported by the Senate Banking Committee and adopted by the full Senate. Similar exceptions were also included in the legislation reported by the House Banking Committee and the House Energy and Commerce Committee. The legislation considered by Congress did not contain a restriction on cross-marketing activities similar to the provision in the Board's section 20 order that is under review by the Board.

These proposals have been pending for approximately 18 months, and I would anticipate that the Board would take action on them within the next several months.
Q.1. I applaud the steps you have taken to reduce interest rates. Unfortunately, a consequence of lower interest rates is the significant decline in interest income upon which many people depend. In earlier responses you have expressed hope that the purchasing power of interest income will be sustained.

Is it true that if interest rates and the rate of inflation remain about the same, interest received offsets inflation and preserves the purchasing power only of the invested principal? Many people depend on interest income. As short-term rates have been approximately halved, so too has parallel interest income. The U.S. would have to experience a deflation rate of 50 percent for interest income to maintain its purchasing power. Is this an accurate assessment? Is there such a point that the benefits derived from lower interest rates no longer outweigh the burden taken on by people living on interest, mainly retirees?

A.1. On the narrow quantitative question you raise, consider a one-year CD, for example, with a principal value of $100. Assume that with 5 percent inflation the CD carried a rate of 10 percent but that with zero inflation it yielded 5 percent. At the end of a year, in the first case the investor would have $110, with an inflation-adjusted "real" value of about $105 (in terms of prices prevailing at the beginning of the period). In the second, no-inflation case, the investor would get $105, but that would have lost none of its purchasing power. So it took much less than a "50 percent deflation" to keep the investor in the same wealth position--what was "lost" in lower real interest income was made up in fully maintained real principal. As a more general matter, the fact is that many households that have been "net creditors" have enjoyed historically high real returns on fixed-income investments in recent years. As the economy has softened and monetary policy has sought to buttress demand, real interest rates have declined--especially real short-term rates. This is the phenomenon your question addresses.
QUESTION FROM SENATOR TERRY SANFORD

A.1. Clearly, a good many households have been negatively affected by this rate movement. But, in the current circumstances, the alternative of pursuing a tight monetary policy in order to push real rates higher would be a prescription for economic contraction that would be seriously detrimental to the majority of Americans. Moreover, the lower inflation does benefit a great many retirees who are living on fixed pensions or longer-term fixed-income investments (such as bonds or annuities); in addition, lower real interest rates boost stock price-earnings ratios, so many retirees who own shares also have benefitted.

Ultimately, low inflation will enhance the efficiency of our economy and provide broad benefits to our populace.
INTERNATIONAL TITLE TO S.543, FDIC IMPROVEMENT ACT

Q.1. Mr. Chairman, I would like to cite several sections of an article from Florida Forecast, "Global Commerce Sails Ahead". "For the first time Florida international trade topped $30 billion: Exports totaled $15.5 billion in 1990, surpassing 1989's record $14.4 billion." "Because of Florida's budget woes, the Commerce Department's International Trade Division is looking for ways to stretch limited dollars to help entice foreign investment and trade." "Latin American countries, because of their close proximity to Florida and its nine trade ports, are considered vital to the state's efforts. The leading recipients of Florida exports in 1990—were Venezuela at $1.5 B" and it goes on. "Foreign-owned companies employ about 186,500 or 4.1% of the work force in Florida". Much of that are foreign bank employers. During 1990, Latin America and Caribbean banks provided over $2.4 billion in trade financing through their Florida agencies.

I am concerned that due to the relatively small size of these banks, they may not fare well in the Federal Reserve's approval and termination processes.

How will the Fed ensure that foreign banks from smaller countries and developing regions of the world such as Latin America and the Caribbean Basin are not at a disadvantage in the Federal Reserve's application approval process and termination process?

A.1. I can assure you that the Board will apply all standards relevant to its decisions pursuant to the Foreign Bank Supervision Enhancement Act of 1991 (the Enhancement Act), enacted by the Congress late last year, even-handedly and without discriminating against banking institutions on the basis of their size. The Enhancement Act provides explicitly that the Board is not permitted to make the size of a foreign bank "the sole determinant factor" in acting on a foreign bank's application to establish an office in the United States -- whether the office is a branch, an agency, or a commercial lending company. A similar restriction that size cannot be "the sole determinant factor" applies to
QUESTIONS FROM SENATOR BOB GRAHAM

A.1. findings by the Board with respect to a decision to terminate a foreign bank's office in the United States. In addition, both provisions permit the Board in making its judgments under the Enhancement Act to take into account the needs of the community the foreign bank proposes to serve, or has served, as well as "the length of operation" of the foreign bank and its relative size in its home country.

Q.2. Again, one of the continuing concerns revolves around the definition of "comprehensive supervision on a consolidated basis." While I understand this may be an important factor in approval and termination decisions, it is equally important that there be a reasonable process for imposing this new requirement. Foreign banks must be given notice as to the meaning of this terminology and must be given a fair opportunity to comply. My concerns are primarily with foreign banks or agencies from Latin American and the CBI region. Few of these developing countries have a comprehensive bank regulatory scheme as far as I know.

*Do you know how many Caribbean Basin and Latin American countries currently comply with this requirement?

*How will the Fed treat these countries not now in compliance?

*How will the Fed work with those countries that want to reform their regulatory scheme to provide them with guidance and with an opportunity to make such changes?

A.2. Many countries, including some of those in the Caribbean Basin and Latin America, practice some degree of supervision on a consolidated basis. Practices, however, vary among countries. In this regard, it will be necessary under the Foreign Bank Supervision Enhancement Act of 1991 to conduct an individual assessment of bank supervisory practices in individual countries to determine whether the existing framework ensures comprehensive supervision on a consolidated
QUESTIONS FROM SENATOR BOB GRAHAM

A.2. basis. Without the benefit of a current, thorough analysis of supervisory practices in relevant countries it is difficult to enumerate countries that may have problems in this respect. The Board intends to work closely with those supervisors that may wish to strengthen existing supervisory practices. Efforts are already under way to meet with interested authorities. A conference with a number of supervisors from Latin America has been arranged in Florida in early March to discuss our views on consolidated supervision and to respond to any concerns raised by the participants. In addition, we intend to discuss this issue fully with the Caribbean supervisors at their annual meeting in Trinidad in May. We will also meet with individual supervisors on an individual basis to discuss these issues as opportunities arise or as they request specific meetings.
QUESTIONS FROM SENATOR BOB GRAHAM

Q.3. I understand that there are approximately 30 pending foreign bank applications, for new branches or agencies, which have been delayed in the Fed's administrative process. This delay is having a seriously adverse economic impact.

*What is the current policy and procedure for approving foreign bank applications?

*What is the current time frame for the approval process?

*How do you propose to correct this problem of administrative delays?

A.3. The Federal Reserve has been made aware of about 35 applications by foreign banks to establish branches or agencies. Upon enactment of the Foreign Bank Supervision Enhancement Act, the Federal Reserve contacted state and federal authorities to determine how many applications were pending at those agencies that now require Board approval under the new legislation. We communicated to the licensing authorities, as well as to those foreign banks that contacted us, that the Federal Reserve would begin to process applications immediately and would not delay processing until implementing regulations are adopted. Foreign banks were advised to submit to the Federal Reserve a copy of the information required by the state or federal licensing authority, and that additional information relating to the new statutory factors could be provided in letter form.

At this time, not all of these banks have submitted their applications. With respect to the applications that have been received, we are in the process of conducting background and name checks and gathering other information on the statutory factors that must be considered, including information on home country supervision. Any delays that have been encountered are the result of the necessity of ensuring that the standards and criteria that the legislation establishes are met. The Federal Reserve shall, however, move as expeditiously as possible to review all applications in a timely manner.
QUESTIONS FROM SENATOR BOB GRAHAM

Q.4. I further understand that there are currently several prior pending applications on which the Fed has been consulting with the states.

*Will these applicants have to start the approval process with the Fed all over again?

A.4. No, the Federal Reserve will use as much of the information provided by the foreign banks to the state licensing authorities as is possible and will process applications from these banks on the basis of applications already submitted to the state authorities. To the extent an application contains all information necessary to make a determination under the Foreign Bank Supervision Enhancement Act, the applicant would not need to provide additional information. Similarly, to the extent the state has previously conducted background checks on the foreign bank and related persons, the Federal Reserve will use this information in order to expedite processing. There will be instances, however, in which additional information must be requested from the applicant foreign bank. This type of information could include, for example, commitments to provide information to the Federal Reserve that is necessary to enable a determination to be made that the foreign bank is in compliance with U.S. law, a standard under the Foreign Bank Supervision Enhancement Act.
QUESTIONS FROM SENATOR BOB GRAHAM

Q.5. Mr. Greenspan, is the Basle Committee and the OECD (Organization for Economic Cooperation and Development) working on standards for home country supervision?  
*What do you think they will be?  
*Will the Senate bill put the U.S. in conflict with the efforts of the Basle Committee and the OECD?

A.5. The Basle Committee on Banking Supervision has since its formation in 1974 provided a regular forum for cooperation between member institutions on supervisory concerns in international banking, including home country supervision. The principle of consolidated supervision by home country authorities was endorsed by Committee members in the Revised Basle Concordat of 1983. In 1990 the Committee approved a Supplement to the Concordat, which addressed, inter alia, the authorization of foreign offices, the information needs of parent authorities, and the exchange of information between supervisory authorities.

The Basle Committee, in light of the BCCI experience, is currently conducting a further review of these issues to determine what additional steps might be taken to improve supervision of banks that operate internationally. Groups of bank supervisors from other countries are also discussing the improvement of their bank supervisory processes, especially with respect to their banks that operate internationally. While these discussions are on-going, the consensus among countries seems to be in favor of increasing the comprehensive- ness of bank supervision by home country authorities.

The Foreign Bank Supervision Enhancement Act of 1991 also addresses these areas of concern. FBSEA requires that foreign banks establishing branches, agencies, or subsidiary banks in the United States be subject to "comprehensive supervision on a consolidated basis." This law should not cause conflict with countries that have adopted and are implementing the supervisory approach recommended by the Basle Committee.
QUESTIONS FROM SENATOR BOB GRAHAM

LATIN AMERICAN DEBT:

Q.6. How do you think the Brady Initiative is working on bringing investors back into Latin America?

A.6. A number of Latin American countries have regained access to world capital markets in varying degrees in the last couple of years. Mexico and Venezuela, two countries that have made use of debt reduction schemes for bank debt under the Brady Initiative, have been quite successful in attracting capital flows mostly from non-bank investors through the issuance of bonds and through the sale of state-owned enterprises. Chile, a country that had substantially reduced its debt prior to the Brady Initiative, has perhaps come the furthest toward voluntary access to world capital markets. These three countries have implemented extensive economic adjustment programs for sustained periods of time. A credible shift toward sound economic policies appears to be necessary to attract investments from foreign investors, to mobilize domestic savings for investment, and to induce the repatriation of capital that had been sent abroad during periods of economic uncertainty.

Q.7. How do you think the countries are responding to this program?

A.7. A number of countries have responded to the Brady Initiative, with varying success, including Costa Rica, Uruguay, and the Philippines, as well as the countries mentioned in the answer to Question 6. The key to success over the longer term is the sustained implementation of appropriate economic policies. Argentina and Brazil, two countries with substantial debt to banks, including interest arrears, are currently negotiating with banks to implement a Brady-style debt reduction package. Argentina has been implementing important economic adjustments for a substantial period of time, while the IMF has more recently approved an IMF stand-by program for Brazil. If debt reduction packages with banks are negotiated, and Argentina and Brazil implement economic policies consistent with their IMF-supported adjustment programs while continuing to open their economies to international investors, I would expect that they too would benefit from greater access to world capital markets.
CREDIT CRUNCH AND COLLATERAL CRUNCH

Q.1. In Massachusetts over the past two years, joblessness has been exacerbated through the problem of small businesses being denied credit as a result of shortfalls in their collateral due to the collapse of real estate.

What steps would you undertake if you are reconfirmed to respond to the collateral crunch which continues to dry up credit in New England?

A.1. Problems caused by the tightening in the availability of bank credit have been a serious concern to the Federal Reserve for some time. To some extent, such tightening was needed to correct the deterioration in credit standards over the 1980s that produced costly failures and caused serious asset quality problems at many banks. It is clear, however, that in all too many cases, such corrections have gone too far and have prevented creditworthy borrowers from obtaining the financing they need, with obvious and adverse effects.

These developments have contributed to the Federal Reserve's decision to take steps designed to reduce interest rates and stimulate economic activity. We continue to monitor the situation carefully, and stand ready to take other actions necessary to foster sustainable economic growth.

In the area of bank supervision, the Federal Reserve and the other federal bank and thrift regulatory agencies have during the past year actively and frequently communicated their supervisory policies to bankers and to examiners, alike. These statements were intended to increase the availability of credit to sound borrowers and to encourage banks to work with their financially troubled customers. They also stressed that banks with real estate concentrations and those seeking to improve their capital ratios should not automatically refuse new credit to sound borrowers. We have also taken specific actions to ensure that our supervisory process reflects a balanced review of asset quality and that it does not contribute inappropriately to slow or negative loan growth. In this connection, we have--among other actions--stressed that the...
QUESTIONS FROM SENATOR JOHN KERRY

A.1. the evaluation of real estate loans should not be based solely on the value of collateral, but also on a review of the borrower's willingness and ability to repay and on the income-producing capacity of the properties.

The past few years have clearly been stressful ones to borrowers throughout the country and to much of the U.S. banking system. However, progress has been made in addressing the problems that declining real estate markets and other economic weaknesses have caused. Many banks, for example, have reduced or eliminated dividends and raised significant amounts of new subordinated debt and equity to bolster their capital positions, restructured their activities to improve efficiency, and developed plans to resolve problem credits. The improving condition of many banks provides evidence that the combination of these and other efforts is having positive effects. This improvement, in turn, together with the supervisory initiative described above, should have important positive effects on the availability of credit. The Federal Reserve, however, will continue to closely monitor developments and take additional steps if that appears necessary.

BIF RECAPITALIZATION

Q.2. Last year, you testified that the $70 billion in borrowing from the taxpayer could eventually be repaid by the banks, and that no taxpayer bailout would be necessary. Are you still confident that there will be no taxpayer bailout of the U.S. bank insurance fund?

A.2. Of the $70 billion, $25 billion was made available to absorb losses and $45 billion for working capital, with the latter to be repaid from sale by BIF of assets acquired from failing banks. The BIF itself has access
QUESTIONS FROM SENATOR JOHN KERRY

A.2. to better information than the Federal Reserve on problem banks and indicated last fall that $70 billion—so allocated—should be sufficient. Our best estimate at that time was that $70 billion would be close, but the outcome was heavily dependent on the pace of recovery in real estate markets.

I note that the Administration's most recent budget did in fact suggest that in fiscal year 1994 more than $25 billion additional loss appropriation might be needed if there were no further banking reform. Without commenting on the benefits of such congressional action, this shortfall is certainly possible.

The current $70 billion of BIF funding can, I think, be repaid by the sale by BIF of failed bank assets plus the higher deposit insurance premium. If BIF losses exceed the $25 billion of loss funds now authorized, the alternative to taxpayer funding would be still higher premiums on the surviving banks. I am concerned that long-term continuation of the 30 basis point premium contemplated to begin in mid-1993 could be detrimental to the long-run health of U.S. banks; a further increase in premiums would almost certainly be counter-productive. Thus, additional congressional appropriations to cover the costs of the deposit insurance guarantee may be required.

DEFICITS AND HOW TO PAY FOR THEM

Q.3. What has been the impact of federal borrowing to pay for the S&L bailouts to date on the federal budget and overall domestic economy? What impact do you expect this borrowing to have on the budget and economy this year and next year?

A.3. The budget impact of federal borrowing for the saving and loan bailout is summarized in lines 1 and 2 of the table below. The impact on the budget, other than to increase the unified deficit by around $50 billion per year, has been minimal because the Budget Enforcement Act of 1990, as you know, explicitly excludes outlays to meet deposit insurance liabilities from the deficit and spending constraints of that Act.
QUESTIONS FROM SENATOR JOHN KERRY

A.3. The effects on the economy of borrowing to meet these deposit insurance liabilities are probably quite small. The outlays are for losses that have, for the most part, accumulated in past years and become liabilities of the government's deposit insurance institutions. The deposit insurance outlays being recorded in the budget represent the transfer of federal liabilities from the books of the deposit institution to the Treasury's public debt accounts.

However, significant economic effects may have occurred as these losses were being incurred. The existence of deposit insurance allowed some insolvent thrift institutions to make imprudent loans, loans whose price to the borrower did not reflect the risk borne by federal deposit insurance. This probably contributed to the excessive and wasteful construction of commercial buildings and other risky projects during the 1980s. It thus appears likely that the deposit insurance crisis has affected the economy by stimulating investment during this period, but some of this investment was been diverted into unproductive uses because loan rates did not fully reflect the risks borne by the government.

Q.4. What impact do you believe the $70 billion borrowed for the BIF recapitalization will have on our federal budget and domestic economy?

A.4. The budget impact of the bank resolution activities that will be financed by the $70 billion of borrowing that has recently been authorized for the Bank Insurance Fund is summarized in lines 3 and 4 of the table. Differences in estimates between OMB and CBO appear to reflect different estimates of the pace at which resolution activity will proceed, rather than different estimates of the size of accumulated losses.
QUESTIONS FROM SENATOR JOHN KERRY

A.4. The analysis of economic effects is the same as for the savings and loan bailout discussed above. The outlay figures reflect the recording on Treasury books of liabilities that were incurred in earlier years.

### ESTIMATES OF DEPOSIT INSURANCE OUTLAYS
(Fiscal years, billions of dollars)

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<td>6) CBO</td>
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OMB and CBO are their January 1992 budget estimates.

¹. Resolution Trust Corporation and the FSLIC Resolution Fund of FDIC.
². Bank Insurance Fund of the Federal Deposit Insurance Corporation.

Q.5. What would have been the effects on the economy if the Congress had placed the S&L bailout and the BIF recapitalization on some form of "pay-as-you-go" plan requiring offsetting budget cuts or revenues over a three-year period for these expenditures, as with every other program in government?

A.5. Subjecting deposit insurance outlays to pay-as-you-go constraints would have subjected the budget and the economy to some large and unwarranted shocks. Large swings in taxes or spending programs would be required because the outlay requirements for deposit insurance
QUESTIONS FROM SENATOR JOHN KERRY

A.5. programs are likely to be quite volatile over the next several years. More important, as I noted in my answer to your previous questions, unlike most outlays in the budget, the outlays now being incurred for deposit insurance are largely financial transactions. No real economic activity is occurring as these transactions are being recorded on the budget. The offsetting spending cuts or tax increases required by a pay-as-you-go constraint would, however, have effects on real activity.

Q.6. Would you support placing future federal payments for the S&Ls and banks, if any, on a pay-as-you-go basis rather than through borrowing from the Treasury?

A.6. No, for the reasons stated in my previous response.

SECURITIZATION OF PERFORMING COMMERCIAL LENDING

Q.7. You have written that one of the problems banks have is that they are long-term lenders who can be badly hurt by short-term fluctuations in interest rates and changes in the rate of inflation. Mortgage lending by banks has changed greatly as the result of the securitization of such loans.

Should securitization be more widely applied to commercial lending as a tool in assisting banks to overcome their current problems and facilitate new lending? If so, what steps might the federal government take to facilitate securitization?

A.7. Various attempts have been made by banking organizations and investment banking firms to package and sell high quality corporate debt, debt from corporate restructurings, and commercial real estate credits. But, significant obstacles have been encountered in these efforts. Unlike residential mortgages and consumer debt, the terms of commercial loans vary widely, including differing amortization schedules based on asset disposition, varying collateral or covenant protection, and multiple interest rate options. Such loans do not lend themselves to standardized credit evaluation.
QUESTIONS FROM SENATOR JIM SASSER

A.7. techniques nor to being packaged into pools of loans that can serve as collateral for securities. This lack of standardization has made it very difficult to securitize these loans.

Nevertheless, efforts to develop a basis for securitizing commercial loans are continuing. It should be noted that government played a major role in fostering the securitization of residential mortgages. However, once the pattern was set, the securitization of other types of loans was primarily initiated and developed by the private sector without direct government assistance (although consultation was carried out with the regulatory agencies in order to make certain that securitized products were consistent with safe and sound banking practices). It would seem that this latter approach, where the private sector takes the initiative, but regulatory authorities are consulted on safety and soundness issues, is the best means at this time, of furthering efforts to successfully securitize commercial loans.

BCCI AND FIRST AMERICAN

Q.8. Mr. Chairman, on January 30, 1991 the Federal Reserve voted to issue cease and desist orders to First American Bank and to BCCI. According to public accounts, you abstained from this action. What was the reason for your abstention?

A.8. On January 30, 1991, I abstained from a vote concerning issuance of a cease and desist order against BCCI and CCAH, the parent holding company of First American Bankshares. I was acquainted with Mr. Robert Altman, president of First American, and was unsure in my own mind whether this fact should preclude me from voting on the orders against BCCI and CCAH. Therefore, I decided to abstain until I could resolve the matter. Four other members of the Board were present and my vote was not necessary for the action. Subsequently, I concluded that my limited acquaintance with Mr. Altman did not pose a conflict of interest that would require abstention. I have therefore participated in all subsequent Board deliberations and decisions regarding BCCI and CCAH.
Q.9.  Last spring the Office of the Comptroller of the Currency announced, in essence, that First American was not financially healthy. The OCC gave First American a rating of 4 out of a possible 5, indicating that it was bordering on insolvency. While additional funds were provided the institution last spring by the Sheikh of Abu Dhabi, it is obvious that First American continues to remain under financial pressures as a result of its relationship with BCCI.

Q.9.a What steps has the Federal Reserve taken to reduce the possibility of First American failing?

A.9.a The Federal Reserve has taken a number of steps to stabilize the condition of the First American banking organization. These include the issuance, on March 4, 1991, of a Cease and Desist Order against BCCI severing all ownership relationships between BCCI and the First American banking organization, and requiring divestiture of BCCI's shares of First American. BCCI had proposed to effect the divestiture through a trust arrangement. On July 5, 1991, BCCI was closed and placed in the hands of court appointed liquidators. Since that time, the Board has continued to press the trust arrangement proposed in the divestiture plan.

A second action taken by the Federal Reserve involved the execution of a Written Agreement with the parent company of the First American organization on September 10, 1991. This Agreement, which was executed to complement enforcement actions taken by the primary federal and state regulators of each of the First American subsidiary banks, includes requirements that restrict additional indebtedness and significant cash transactions, and requires the development and implementation of a plan to restore and maintain adequate capital at the holding company and each of its subsidiary banks.

Through this and other actions, additional capital in excess of $140 million was injected into the subsidiary banks by First American in 1991. In addition to funds from the principal shareholders, this capital included proceeds from the sale of certain assets, including the
QUESTIONS FROM SENATOR JOHN KERRY

A.9.a sale of First American's bank in Tennessee. In addition, (cont) approximately $150 million of debt owed by the First American parent companies to various note and debenture-holders has been restructured. This restructuring alleviated financial pressures at the parent companies and allowed them to better serve as a source of financial strength to the subsidiary banks. In fact, no monies have been received by CCAH ownership interests, either in the form of debt payments, dividends, or other considerations.

Over the past year, Federal Reserve staff undertook efforts to address management deficiencies at the senior levels of the First American banking organization. In August, Messrs. Clifford and Altman resigned their positions at First American, and an experienced senior banker has been retained as CEO.

Last, the Federal Reserve staff has been working with the Department of Justice and the District Attorney of New York County on the BCCI Plea Agreement, which was accepted by the U.S. District Court for the District of Columbia on January 24, 1992. Under this agreement, it is anticipated that funds from BCCI will be available within the next several months to support the First American banks, if necessary.

Q.9.b Is First American likely to require assistance from the Federal Reserve?

A.9.b As stated above, we expect that under the terms of the Plea Agreement additional funds would be available to support the First American banks within the next several months if required. At present, we do not foresee any need for immediate Federal Reserve assistance.

Q.9.c What kinds of assistance might the Fed provide?

A.9.c Where necessary, in the Federal Reserve's capacity as the lender of last resort, we are able to provide extended discount window credit to troubled depository institutions that are encountering liquidity pressures and are unable to access alternative sources of funds on
QUESTIONS FROM SENATOR JOHN KERRY

A.9.c reasonable terms and conditions. In such situations, the Federal Reserve works in close cooperation with the primary regulator, either federal or state. The Federal Reserve is particularly sensitive to the responsibilities of the FDIC as insurer and receiver of failed depository institutions in these situations. Therefore, we keep the FDIC fully informed of the status of discount window borrowings and consult closely with that agency in making our decision whether to extend credit.

Q.9.d How substantial is the risk that First American might fail, despite the Fed’s efforts?

A.9.d First American, like some other banking organizations on the East Coast, as well as other companies with high real estate exposure, has experienced asset quality problems and losses stemming from its exposure to commercial real estate markets. Future developments in real estate markets and the general strength of the local and regional economy will, to a large extent, determine the degree to which the capital and earnings of First American will remain under pressure. One positive development is the expected availability of funds within the next several months as a result of the settlement with BCCI’s representatives to enhance the capital of First American if required.

Q.10. Some former Federal Reserve attorneys, after leaving government, provided services to BCCI, to First American, and to their shareholders.

Have you reviewed the role of former Federal Reserve employees in connection with the BCCI affair?

Does the Federal Reserve need to consider additional anti-revolving door provisions in light of its experience in the BCCI affair.

A.10. Former Board employees and officials are subject to the full range of statutory post-employment restrictions applicable to all government employees. Specifically, former Board employees are subject to a lifetime ban on
QUESTIONS FROM SENATOR JOHN KERRY

A.10 representing anyone before the government with regard to a particular matter in which the employee participated personally and substantially while at the Board. Former Board employees are also prohibited for two years from representing anyone before the government with regard to a particular matter that was pending under the employee's responsibility during his or her last year of Board service. Finally, senior Board personnel may not communicate with or appear before any officer or employee of the Board for one year after separation.

The Board's inquiry into the BCCI matter is broad-based and continuing. From what we have learned to date in our investigation, current statutory protections appear to be adequate, and I do not see the need for additional post-employment restrictions for Board employees.
RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
ALAN GREENSPAN

Credit Card Cap

Q.1. On November 13, 1991, I introduced an amendment to the banking bill to put a floating ceiling on the rate credit card issuers could charge on their customer's balances.

I have a letter, dated November 15, 1991, from yourself to Chalmers Wylie, the Ranking Minority Member of the House Banking Committee. This letter, which I would like included in the record, responds to Mr. Wylie's request for the Fed's view on credit card interest rate caps.

In that letter, the Fed states that the cap would cause lenders to cut back on the availability of credit cards, "especially to borrowers who are more likely to encounter problems meeting credit obligations" and that this could adversely affect consumer spending.

Why should individuals who are good credit risks subsidize those individuals who have a higher chance of not paying off their credit card debt? Why would denying credit to individuals who are poor credit risks have an adverse effect on consumer spending? Should we give these people credit cards just to spur consumer activity?

A.1. Obviously good credit risks should not subsidize poorer risks. But credit card issuers do not knowingly extend credit to individuals who have a high probability of failing to repay their debts. In fact, the vast majority of card holders typically repay their debts as scheduled. However, card issuers realize that a small percentage of unknown borrowers likely will default, and they take this into account when pricing card programs. At the same time, there are special card programs designed for customers who are viewed as good credit risks; these programs offer lower rates and are accessible to consumers who qualify. Such customers, therefore, need not subsidize poorer credit risks.
QUESTIONS FROM SENATOR ALFONSE M. D'AMATO

A.1. Credit card issuers do not provide cards to consumers to spur economic activity. Rather they are seeking to earn the highest possible yield on their loanable funds. If some card issuers err and make credit available to too many poor credit risks, their returns will reflect these choices. A broad-brush attempt to screen out all "high risk" customers likely would capture a large number of households who repay debts on time and do not default. In this regard, we believe the allocation of credit is best accomplished by a free competitive market.

Q.2. In the November 15 letter, the Fed states that information about credit card rates is available to consumers. The volume of response from credit card consumers suggests that this is just not so. What can the Fed do to make credit card rate information more available?

A.2. Twice a year the Federal Reserve System prepares for the public a comprehensive list of the terms available on credit cards plans for about 160 large credit card issuers. The report is designated the E.5. Statistical Release and is entitled the "Terms of Credit Card Plans." Many of the card issuers included in the report offer relatively low interest rates and/or no annual fees. The Federal Reserve distributes these reports to members of the public upon request for a nominal fee. Because of our concern that this information has not been as readily available as it might be, we will seek to enhance public awareness and access to this information. The Federal Reserve will, beginning with the March 1992 report, routinely send copies to the 1300 libraries that compose the Government Depository Library System. Also, we plan to distribute a press release announcing the availability of the list, concurrent with the distribution of the March report.
A.2. As we have noted on several occasions, a number of private sector firms make credit card shoppers' guides available to the public. Bank Card Holders of America, for one, regularly advertises the availability of its list of low rate cards on television and magazines with national distribution. The availability of these low rate lists, together with solicitations by new card issuers or those issuers trying to increase market share, provides considerable opportunity for qualified consumers to select a lower rate issuer if they feel it is in their best interest.

Credit Crunch Initiatives

Q.3. Since March 1991, the regulators have been working on a number of initiatives to help ease the credit crunch. On November 7, the Fed, the OCC, the OTS and the FDIC announced a joint statement to specifically address commercial real-estate loans.

How do you think this policy statement will impact on financial institutions treatment of commercial real-estate loans?

A.3. The policy statement should encourage financial institutions to lend to credit-worthy borrowers and to work constructively with borrowers experiencing financial difficulties, consistent with safe and sound banking practices. The statement made it clear that prudent lending practices on the part of banks, and timely and effective supervisory actions on the part of regulators, should not inhibit banking organizations from playing an active role in financing the needs of credit-worthy borrowers.

The statement also addresses concerns about further lending by institutions failing to meet minimum capital requirements. While it remains essential that under-capitalized institutions take effective and timely steps to address this deficiency, such institutions are not required to cease prudent, low-risk lending activities or preclude prudent steps to work with troubled borrowers.
QUESTIONS FROM SENATOR ALFONSE M. D'AMATO

A.3. Similarly, institutions with loan concentrations should not automatically turn down good loans. Institutions that have in place effective internal controls to manage and reduce undue concentrations over a reasonable period of time, need not automatically refuse credit to sound borrowers.

Q.4. Do you anticipate that this policy statement will convince banks they will not be penalized by the regulators for making commercial real-estate loans?

A.4. The statement emphasized that loans would not be criticized simply because they are secured by commercial real estate. Further, the policy statement indicated that the evaluation of real estate loans by examiners will not be based solely on the value of the collateral, but on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the underlying property. The statement further noted that the agencies would take various steps to make sure that examiners clearly understood and are prepared to follow this guidance. We hope and expect that bankers will be more willing to extend loans to credit-worthy borrowers.

Q.5. What, if any, impact will this policy statement have on the earnings statements of banks?

A.5. The policy statement, to the extent that it encourages the extension of safe and sound loans to credit-worthy borrowers, should enhance the earnings of financial institutions.

Q.6. Do the regulators plan to initiate any similar policy statements for other types of loans?

A.6. At this time there are no initiatives underway to address other specific loan categories. However, the underlying lending principles outlined in the November 7 policy statement are certainly relevant to other types of commercial lending. The Federal Reserve, together with the OCC and the FDIC, plan to discontinue use of the
QUESTIONS FROM SENATOR ALFONSE M. D'AMATO

A.6. (cont) supervisory definition of highly-leveraged transactions (HLTs) after June 30, 1992. In approving the phase out of the HLT definition, the agencies recognized that the definition has largely accomplished its purposes, that circumstances have changed since the definition was implemented, and that the definition may be having an undue effect on pricing and availability of credit to certain highly-leveraged borrowers.

Q.7. Do the regulators plan to implement any other measures that will make lending more profitable to banks?

A.7. At this time, the Federal Reserve is closely monitoring developments in the economy and financial markets to see how its recent monetary policy actions and other supervisory initiatives taken by the Federal Reserve and the other supervisory agencies are affecting economic activity and the availability of credit. Should further actions appear necessary, the Board is prepared to take them.

Q.8. What do you think should be done to further ease the shortage of available credit to credit-worthy borrowers?

A.8. The Board will continue to evaluate the effectiveness of its recent policy actions and of the policy statement and related initiatives and take further steps if needed.

Interest Rates

Q.9. The discount rate is at 3.5%, the lowest it has been since 1964, yet the CBO 1992 Report on the Budget suggests that the Fed has room to further ease monetary policy without a great risk of inflation. Do you agree that the Fed could lower interest rates further? Why or why not?

A.9. At the moment, it appears that the substantial easing of monetary policy over recent months will be sufficient to support a satisfactory recovery in economic activity and employment in 1992. But assessing the economic outlook at the present time is extraordinarily difficult. We are, of course, continuing to evaluate whether some additional insurance in the way of further monetary ease would be appropriate.
QUESTIONS FROM SENATOR ALFONSE M. D'AMATO

Section 20 Changes

Q.10. The President has indicated that he will push again for comprehensive changes to the nation's banking laws, particularly broader securities powers. Sweeping changes to the laws governing the financial services industry failed to pass last year. If reform measures languish in Congress will the Federal Reserve Board take any action to increase the "gross revenue limitation" for bank ineligible activities of a Section 20 affiliate?

A.10. The Board has not received any formal request to revise upwards the Board's percentage limitation on the securities underwriting activities of section 20 affiliates, and the Board has not initiated any action to revise this limitation. A proposal to increase the revenue limit raises a number of legal and policy issues, including questions of interpretation of the terms of the Glass-Steagall Act. Without the benefit of analysis of these issues and of the Board's consideration and deliberation, I am unable to say at this time what course of action the Board would take in reviewing a proposal to raise the revenue limit applicable to section 20 affiliates.

Q.11. The Federal Reserve has proposed several modifications to its firewall restrictions for section 20 affiliates. Will the Board take action regarding these modifications?

A.11. The Board has proposed three modifications to the firewall restrictions established in the Board's section 20 orders. The Board has sought public comment on whether it should permit certain director interlocks between banks and section 20 affiliates, modify the cross-marketing restrictions imposed on section 20 affiliates, and permit banks to purchase U.S. government agency securities and U.S. government-sponsored agency securities from a section 20 affiliate. In each of these three areas, the modifications that have been proposed
A.11. are limited and consistent with the legislation considered by both the Senate and the House. The proposals to permit limited director interlocks and to permit the purchase of certain government agency securities are similar to exceptions included in S. 543 as reported by the Senate Banking Committee and adopted by the full Senate. Similar exceptions were also included in the legislation reported by the House Banking Committee and the House Energy and Commerce Committee. The legislation considered by Congress did not contain a restriction on cross-marketing activities similar to the provision in the Board's section 20 order that is under review by the Board.

These proposals have been pending for approximately 18 months, and I would anticipate that the Board would take action on them within the next several months.
RESPONSE TO WRITTEN QUESTIONS OF SENATOR KASSEBAUM FROM ALAN GREENSPAN

Q.1. Chairman Greenspan, Business Week recently ran an article stating the importance of eliminating the tax code's preference for corporate debt over corporate equity. As you know, the interest paid on corporate debt is deductible while the dividends paid on corporate equity are not. The effect is that dividends are taxed twice--once at the corporate level and once at the individual level. Everyone agrees that if cost was not a factor, corporate dividends should not be taxed twice. Unfortunately, the revenue loss is a major problem.

Would there be any merit in making 50 percent of the dividends on new equity issued, say, after December 31, 1992, deductible and offset the revenue loss by restricting to 50 percent the deduction for interest paid on new debt issued after that date? What would be the drawbacks and benefits of such a neutralizing proposal?

If you were drafting legislation to eliminate the tax code's preference for debt over equity--in a responsible manner--how would you offset the revenue loss?

Many have said that the double taxation of dividends is a major obstacle to our long-term growth, something that Congress and the administration do not have the political willpower to address. Do you believe this is something that should be addressed or simply ignored?

A.1. The double taxation of dividends and the favorable tax treatment of debt are undesirable features of our tax code for the reasons you and others have cited and clearly should not be ignored. I would be cautious, however, about piecemeal approaches to dealing with these problems that might create more distortions than they correct. I think it preferable to focus attention on a more comprehensive review of the corporate tax system, including proposals that would fully integrate the corporate and personal income taxes and that would ease the often confiscatory tax rates applied to purely nominal capital gains. In this regard, the recent plans put forth by the Treasury for integrating corporate and individual income taxes deserve careful evaluation. I recognize, of course, that designing and implementing fundamental reforms in this area will be extremely difficult and, I expect, not quickly completed.

On the issue of the revenue loss, many options are available. Congress, of course, must ultimately decide who is to bear the tax burden or which expenditures are to be cut.
This memorandum analyzes Senator Specter’s proposal regarding penalty-free withdrawals from retirement accounts, focusing especially on the issue of how great an impact the action would have on household spending. Section I describes in greater detail the provisions of the proposal; Section II discusses some analytical considerations bearing on the spending issue; Section III presents some relevant estimates derived from the national Survey of Consumer Finance; Section IV offers some conjectures on the likely spending effects.

I. The Proposal

The proposed legislation would allow certain taxpayers to make penalty-free withdrawals from retirement-type accounts, provided the withdrawals are applied toward one or more qualified purchases. Specifically:

- The proposal would allow withdrawals from IRAs, Keoghs, and 401(k)s.

- Eligibility would be restricted to those earning less than $100,000 (if married and filing jointly), $50,000 (if married and filing separately), or $75,000 (all others).

- According to the legislation in its current form, qualified expenditures would include the purchase or improvement of real property, and the purchase of durable goods. In his floor speech and in other communications, Senator Specter has also mentioned medical expenses and college tuition.
• Each taxpayer would be allowed to withdraw no more than $10,000.

• Withdrawals would have to be made on or before December 31, 1992; associated expenditures would have to be made either (a) within six months of the withdrawal, or (b) by the time the taxpayer files his/her return for the relevant tax year (in most cases, no later than April 15, 1993). The more restrictive of (a) or (b) would be the binding rule.

• Regular tax liability on the withdrawn funds would still be owed; however, the liability could be spread over a period of four years following the withdrawal.

• In his floor speech and written communications, Senator Specter also mentions the possibility of allowing those who take advantage of his proposal to replenish the funds in their IRA or 401(k) over the five years following the withdrawal. The existing legislation does not contain this provision.

II. Analytical Considerations

Several analytical points are worth making about the likely impact of the proposal on household spending:

• It is useful to think of qualifying households as falling in one of three categories: not liquidity-constrained, extremely liquidity-constrained, and somewhat liquidity-constrained.

• Households that are not liquidity-constrained will probably not be interested in tapping their retirement savings, because doing so would remove those savings from their current tax-sheltered status.

• Households that are extremely pressed for the funds will be tapping their funds in any event, and would choose to pay the 10 percent penalty in the absence of Senator Specter’s proposal. The
extra spending generated by the Senator's proposal via these households would be only $1,000--smaller by an order of magnitude than the overall amount of $10,000.

- Therefore, the proposal likely would have its greatest impact on the spending of the intermediate group: those households that are somewhat liquidity-constrained, but not too much so. These households will be induced to make a withdrawal that they otherwise would not have made.

- About two-thirds of 401(k)s have borrowing provisions. Therefore, owners of these accounts have access to the wealth they hold in 401(k)s even in the absence of Senator Specter's proposal. Evidence suggests that many households take advantage of these loan provisions. For example, one recent survey found that 9 percent of account-holders initiated a new loan during 1990, while 21 percent had a loan outstanding at the end of 1990. Roughly 90 percent of such plans allow general-purpose loans (and therefore cover a wider range of expenditures than would Senator Specter's plan).

- The tax amortization feature probably will make relatively little difference to the proposal's influence on spending: Standard theories of consumer behavior predict that taxpayers who know that a liability is outstanding will be inclined to set aside most, if not all, of the tax liability upon receipt of the withdrawal. This prediction is supported by available evidence concerning the relationship between ordinary income tax refunds and consumer spending.\(^1,2\)


(Footnote continues on next page)
III. Empirical Evidence

The following estimates from the 1989 Survey of Consumer Finance shed further light on the likely impact of the proposal on household spending:

- According to the SCF, qualified accounts (including IRAs, 401(k)s, Keoghs, thrift, and saving plans) amounted to $1.239 trillion in 1989.\footnote{Low-income taxpayers will experience some benefit from being allowed to smooth some of the liability into lower tax brackets. However, evidence from the Survey of Consumer Finance suggests that eligible families would have higher-than-normal incomes, and so would not benefit from this aspect of the proposal to any great degree.}

- Of this amount, $893 billion was held by families headed by someone aged less than 59 years old. Older people already can withdraw funds from retirement accounts without penalty.

- Next, $736 billion was held by families meeting both the income constraints specified under the Specter proposal and the above-mentioned age cutoff.

- Ownership of that $736 billion was highly concentrated, however. If we count only the first $10,000 in retirement funds per family, then the qualified pool of funds shrinks to only $136 billion.

\footnote{Respondents to the 1989 SCF reported total holdings in IRAs and Keoghs of $398 billion. For comparison, the Employee Benefit Research Institute puts the total for IRAs and Keoghs in 1989 at $494 billion. SCF respondents reported an additional $295 billion in 401(k)s, quite close to the estimate for 1988 of $277 billion based on data from the Department of Labor's Form 5500. Finally, SCF respondents reported $346 billion in thrift or saving plans, or other defined-contribution plans with borrowing provisions.}
Median liquid assets held by all families meeting the proposed age and income criteria were $1,950. Among families reporting ownership of some retirement funds, median liquid asset holdings were $6,180. Among families holding at least $5,000 in retirement funds, median liquid asset holdings were $9,800. This result conforms with the common finding that those who save via IRAs and Keoghs also tend to save by other means. Families that are holding substantial amounts outside their retirement accounts will be less interested in tapping their retirement funds if given the opportunity to do so penalty-free.

Transaction costs could be sufficiently great to persuade some families who otherwise would take advantage of Senator Specter’s proposal not to liquidate their IRAs or 401(k)s. These costs would include, for example, early withdrawal penalties on time deposits and broker commissions.

IV. Spending Effects

A fundamental fact should be kept in mind while assessing the likely influence of the proposed program on household spending: The proposal would do nothing to raise the wealth of households, other than of those who anticipated incurring a withdrawal penalty. Therefore, the proposal would influence household spending mainly by relaxing liquidity constraints currently binding on some households. The above data from the SCF suggest that this impact probably would not be very great, given that a considerable portion of the available retirement-related wealth is owned by families holding substantial amounts of other liquid assets.

5. Liquid assets were defined as the sum of checking accounts, money market accounts, CDs, other bank accounts, mutual fund holdings, saving bonds, other government and private bonds, direct stock holdings, and accounts held at brokers.
Some withdrawals undoubtedly would occur if the proposal were to be adopted, but the incremental effect of the proposal on expenditure will be less than the total amount withdrawn for two reasons: First, some withdrawals would have been taken, even in the absence of the program, by families extremely pressed for liquidity. Second, some withdrawals from 401(k)s will represent, in effect, a substitution of outright withdrawal for borrowing that would have taken place in the absence of the program.

There is no way of predicting with any confidence the amount of additional expenditure that would be forthcoming in response to implementation of the proposal. It seems reasonable to guess, on the basis of the evidence presented here, that the increment to spending would amount to less than one percent of personal consumption expenditure (or $40 billion)--and it quite possibly would be substantially less. If the permissible penalty-free withdrawal were to be raised to $20,000, it would raise the amount released on the estimates above from $136 billion to $206 billion. However, while the spending effect probably would be greater, it would likely be only modestly so, because the additional balances affected would, on average, be held by individuals who are less liquidity-constrained.
GLOBAL COMMERCE SAILS AHEAD

Increase in foreign trade helps state economy achieve diversification

By Jerry Jackson

The commission will share office space with Tallahassee and Coral Gables with the Commerce Department and in West Palm Beach with the Business Development Board of Palm Beach County.

Chiles and Farmer said Florida will have to work hard to compete with other Southern states, such as Georgia, which has lured more Japanese investment than Florida in recent years.

"Because of Florida's budget woes," Farmer said, "the Commerce Department is looking for ways to stretch limited dollars to help sustain foreign investment and trade. For example, the agency is experimenting with a plan to exchange free office space with the government in Taiwan. If the experiment succeeds, similar arrangements may be tried with countries in Central and South America.

The Florida International Affairs Commission is a 26-member board comprising government and business leaders, primarily at the state level. The commission was created last year to coordinate international affairs.

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