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Accounting Department Federal Reserve Bank of New York November, 1979

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POSITION PAPER ON MONITORING BALANCES IN ACCOUNTS MAINTAINED AT THE FEDERAL RESERVE BANK OF NEW YORK

#### EXECUTIVE SUMMARY

The purpose of this paper is to explore the question of monitoring transaction activity in accounts maintained by the Federal Reserve Bank of New York for its member and nonmember account holders. It is necessary for purposes of the discussion that follows to define the term "monitoring." As used here, "monitoring" includes two distinct functions. These are "account oversight"--the ability to know account balance status at any given time; and "control"--the ability to prevent or to directly or indirectly limit debit (overdraft) balances in accordance with some established policy.

The arguments in support of a capability for "account oversight", knowing the status of account balances at any time, are strong. Indeed, the principal issues center on technical and cost considerations that may affect the extent to which "account oversight" should be applied. A Reserve Bank has the right and, it can be argued, the responsibility to practice "account oversight". The matter of the "control" function, however, is considerably more complex. Arguments against monitoring generally center around disagreement about what levels of "control", if indeed any, are appropriate to various institutions and situations, and what the consequences would be of various levels of "control". Nonetheless, it seems clear that the issue of determining an appropriate level of "control" cannot be avoided, because "account oversight" and "control" are inherently linked. Once the "account oversight" function highlighted a daylight overdraft exposure, the Reserve Bank would be politically (and legally?) bound to apply policies to deal with the situation, either by preventing the exposure and thereby assigning the risk elsewhere or by limiting the exposure to reasonable levels. The Federal Reserve System may or may not be the proper party to bear the risks inherent in irrevocable funds transfers and other transactions which represent major sources of debit balance exposure, but such decisions should not be made by default or to accommodate the private sector. Decisions by a Federal Reserve Bank to bear risk should be conscious and deliberate--the Bank should decide when and to whom it is willing to extend credit, and within what limit. Information about the amount of credit exposure must be used with the capabilities to "control" that exposure in a way consistent with a defensible overall policy.

For purposes of this discussion, therefore, the possibility of exercising no "control" by permitting debit balances without restriction of any kind has been disregarded. There appear to be four other general approaches to the question of "control", each of which is discussed: first, to allow unsecured debit balances to occur but to use moral suasion and/or monetary charges after the fact to discourage the practice; second, to allow no debit balances to occur; third, to permit unsecured debit balances to occur up to some specified amount to be determined for individual accounts or groups of accounts; and fourth, to permit unsecured debit balances to occur up to a level determined by the amount of collateral or other security provided to this Bank by the account holder. There are, of course, innumerable possible variations of these four general alternatives which could make the level of "control" variable by type of transaction, by category of account, or by a combination of those

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factors, including credit risk and other considerations. As one example, the third and fourth approaches might be combined so that debit balances above a predetermined, unsecured credit limit would not be permitted unless the excess above that limit were protected by collateral or some other form of security. Similarly, any of the alternatives mentioned could be selectively or randomly applied to individual accounts or classes of account.

The position taken in this paper for the purposes of discussion is that:

- It is appropriate for the Federal Reserve Bank of New York to monitor transactions in the accounts it maintains for member and nonmember institutions.
- The Bank should include the capabilities for full "account oversight" and "control" of all accounts and all transactions in the detailed user requirements which serve as the basis for development of its future accounting system.
- In the short term, and to the extent possible, "account oversight" and "control" should be established within existing computer capabilities, supplemented by manual procedures, and should be phased-in in consideration of the risk associated with various classes of account, with various types of transaction, and with special circumstances which may exist from time to time.  $\frac{1}{2}$
- The preferred method of "control" would be to limit debit balances to the secured amount of daylight credit established

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<sup>&</sup>lt;sup>1</sup>/ These interim measures could be further supplemented by requiring depositors to provide some level of collateral to secure daylight overdrafts that are expected to occur, as recommended in the report of this Bank's Ad Hoc Committee on Securing Daylight Overdrafts.

by each individual account holder within some limit which may be established for monetary or other policy reasons.

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### CURRENT MONITORING ENVIRONMENT

#### The Federal Reserve System

No Federal Reserve Bank currently has fully automated account monitoring capabilities, although all Federal Reserve Banks monitor securities balances involved in wire transfers of securities, and any Reserve Bank should be able to implement some form of manual monitoring for the account of an institution considered to be in financial difficulty.

#### The Federal Reserve Bank of New York

At New York, besides the monitoring of wire transfers of securities, there is a limited, automated account monitoring facility in operation. All wire transfers of funds transactions affecting Edge Act corporation reserve accounts are monitored daily and any other account can be monitored in this manner on an ad hoc basis as necessary. The system works as follows: After Edge Act corporation opening balances are entered into the monitoring system, incoming wire transfers of funds are automatically added to the monitoring system's account balance for the receiving Edge Act corporation. Outgoing transfers are first checked against the monitored account balances. If there are sufficient funds, the transfer is sent and that amount is deducted from the account balance. If funds are insufficient to cover the transfer, the transfer is rejected and cancelled, and the Edge Act corporation is promptly informed of this fact. The system is flexible. If there are network problems, if special circumstances exist, or if this Bank can establish that an "off-line" credit is available to cover a wire transfer of funds transaction, the monitor can be overridden to allow outgoing transfers to be made even if the monitor reflects insufficient funds to cover the transfer.

Accounts maintained at the New York Reserve Bank for foreign central banks and international organizations have long been subject to manual monitoring, primarily for investment decision purposes. The agreements between the Federal Reserve Bank of New York and the holders of such accounts specify that payments will only be made on a collected funds basis. ("Account oversight" and "control" are extended to all transactions in these accounts.) With the exception of this restriction, however, the New York Bank's management of these foreign accounts can be quite discretionary. When a requested payment is not covered by an adequate account balance, depending on the circumstances, that request may be suspended while subsequent, smaller requests for payment are honored, or that request may be partially honored. In any case, immediate notification of the foreign or international account holder is not made (generally, because time differences make instantaneous notification pointless). Often, suspended requests will be honored later in the day, as deposits are made to an account. At the end of the day, each account holder is notified of all transactions honored and of any transactions rejected, and is given the closing account balance.

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U.S. Commercial Banks

Internal monitoring of customer account status or "account oversight" (be it automated, manual, or a combination of those methods) is an integral part of the control operations of most U.S. commercial banks. For a commercial bank, the monitoring system is a business requirement which is applied differently to different types of customer. Every monitored transaction reaches a critical decision point at which a "go," delay," or "no-go" action, the "control" function, is initiated. The determinants of this decision are profitability, effective customer demand, and the intensity of market competition for the particular transaction or type of transaction, tempered by the lending institution's attitudes towards risk and its assessment of the borrower's creditworthiness.

The more sophisticated commercial bank monitoring systems are very complex, covering thousands of accounts and encompassing different degrees of availability. For example, large New York City banks track both Federal funds (same-day availability) and clearing house funds (next-day availability) for monitored accounts, and one large bank even keeps track of "anticipated" funds for thousands of accounts.

Monitoring is used by commercial banks, not merely to prevent exposure, but to control it in an "eyes open" environment. The costs of calculated, acceptable credit risks are reflected in the pricing of services.

### Private Interbank Networks

The Federal Reserve Communications System (FEDWIRE) links Federal Reserve Banks, member commercial banks, Edge Act corporations, and the U.S. Treasury through the Culpeper switch in Virginia, providing government securities wire transfers and Federal funds wire transfers. Transfers of funds made via FEDWIRE are final upon the giving (or receipt) of advice to (by) the receiving bank.

In contrast, settlement for payments made via a private transfer system such as the Clearing House Interbank Payments System (CHIPS) is conditional on the transaction date and is actually effected only when (and if) the settlement is made on the following day via FEDWIRE. Similarly, the proposed Bankwire II network envisions a conditional settlement arrangement through accounts maintained with the Reserve Banks. Settlement would be contingent on the existence of positive balances in the reserve accounts of settling institutions. Actions on instructions

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to make payment received via private communications networks such as Bankwire and the Society for Worldwide Interbank Financial Telecommunications (SWIFT) are conditioned on the existence of sufficient funds in the correspondent's account, or on an assessment of the credit risk involved.

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Centralized monitoring by private networks is very limited. At the most, "account oversight" of the reciprocal obligations among the participant group is maintained. The "control" function of monitoring is not centralized. "Control" is exercised by each individual participant through its account relationship with its customers based on information provided by the participant's internal monitoring system and the participant's assessment of the creditworthiness of its customers.

## IMPLICATIONS OF MONITORING BY THE CENTRAL BANK

The Federal Reserve System's evaluation of the need to monitor is, of necessity, functionally different from that of either the U.S. commercial banking industry or the private interbank payments or communications networks.

The first distinction between the Federal Reserve System's posture with respect to the issue of monitoring and that of commercial banking institutions is that, in their role as regulators of banks, the Reserve Banks might, in the absence of systematic monitoring, be criticized for being incapable of identifying and dealing with the risk presented by daylight overdrafts. As regulators of banks, the Reserve Banks might be said to hold commercial banks to a more rigid standard in this regard than the Reserve Banks themselves adhere to. Moreover, the Reserve Banks' unwillingness or inability to monitor account activity could subject the System to GAO and Congressional criticism.

Second, the existence of an overdraft in an account maintained by a Federal Reserve Bank results in the assumption by the Bank of a risk of financial loss because of the uncertainty of recovery of an overdraft that remains in the account of an institution that is closed subsequently by regulatory or other authority. (We recognize that, thus far, no Reserve Bank has ever incurred actual financial loss as a result of such exposure.) One statutory implication of the existence of such overdrafts is different for the Federal Reserve System. The Reserve Bank is placed in a position of unknowingly extending credit to the overdrawn account, and while even commercial banks are exposed when an unanticipated customer account overdraft occurs, the Reserve Bank's position is not the same. In the absence of back-up credit arrangements, such extensions of credit could be considered to be contrary to the intent of the Federal Reserve Act, which prohibits unsecured lending by Reserve Banks and, except for certain U.S. branches and agencies of foreign banks subject to Federal Reserve requirements, prohibits lending to nonmember institutions. (A Reserve Bank's relationships with its account holders also differ in that, historically, in providing services, Reserve Banks have delt with their depositors in an arm's length, commercial basis.)

Third, as the central bank, the Federal Reserve System has responsibilities to facilitate the smooth functioning of the domestic and international payments mechanisms. These responsibilities, while not necessarily inconsistent with the monitoring of account activity as discussed above, would indicate a need for flexibility in the account monitoring "control" function. Such flexibility, however, should be balanced by the corresponding need to minimize risk.

Finally, the Reserve Banks, while clearly not responsible for managing the daily positions of financial institutions with legal reserve

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requirements, could enhance services to account holders if they were in a position to alert those financial institutions when debit transactions might result in either overdraft or deficiency status. In fact, from the account holders' point of view, the ability to inquire about account status (or to receive on-line advisement of account status) would be beneficial.

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#### CONTROL OF RISK

There are two types of risk that could be lessened through the "control" function of a monitoring system. Financial risk is the possibility that some of the debit balances that occur might be uncollectible or only partially collectible and might result in monetary losses. Nonfinancial risk stems from the economic or political ramifications that any Federal Reserve action or failure to act in response to the occurrence of debit balances might have on the efficient functioning of the payments mechanism. For example, restrictive action by the Federal Reserve could impair the ability of a particular financial institution to function competitively. Similarly, Federal Reserve action could adversely affect the use of a particular financial instrument or type of transaction. On the other hand, in the absence of action by the Federal Reserve to deal with the monitoring issue, Congressional or GAO criticism of the Federal Reserve could affect its options for dealing with the issue, and this could affect its ability to continue to facilitate smoothly functioning payments mechanisms.

Neither financial risk nor nonfinancial risk is easily quantified, but it is clear that the rapid acceleration of payments in the domestic and international financial systems in the past decade, combined with actual and imminent changes in the structure of U.S. banking, have greatly increased both types of risk.

The magnitude of transactions processed by FEDWIRE alone is extremely large. In 1978, the Federal Reserve Communications System processed over 28 million messages aggregating in excess of \$50 trillion. $\frac{2}{}$ The New York Reserve Bank handled 6.4 million funds transfers amounting to more than \$19 trillion and 2.4 million transfers of securities amounting to \$9 trillion, in 1978. (Approximately 100,000 funds transfer transactions totalling \$200 billion were processed by the national network on an average day in 1978.) Each outgoing transfer is irrevocable when advised and, except in a relatively small number of cases at New York, each transfer is made without regard to the status of the account from which it is being sent. The communications traffic processed by the national network during 1978, consisting of transfers of funds and securities, increased over 19 percent over 1977, which is consistent with a five-year average increase of about 18 percent compounded annually. The U.S. banking environment is becoming more and more competitive and international in nature. Recent years have seen an acceleration in the number, dollar value, and velocity of wire and non-wire tranactions and in the efficiency and sophistication of customer cash management. Largely as a result of these developments, the Federal Reserve is reassessing its attitudes towards risk and the need to control it.

The Federal Reserve System, which has traditionally left the administration of overdrafts in member bank and in Edge Act corporation and other nonmember accounts maintained at Federal Reserve Banks to the discretion of the individual Reserve Banks, after debating the efficacy of such an approach over the last three years, has decided to establish a

Dollars refer to funds transfers only. Dollar value of securities transfers is not regularly reported on a System basis.

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uniform, but flexible, policy calling for monetary charges on overdrafts. The related issue of account monitoring is now under active review within the System.

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The Federal Reserve Banks must make the decision to monitor or not to monitor account balances in consideration of their roles as depositaries for legal reserves, regulators of banks, and facilitators of the U.S. and international payments mechanisms. Moreover, consideration must be given to the extent of potential exposure in each account and to whether the appropriate Reserve Bank action would be to act on debit balances after the fact, to allow no debit balances to occur, to permit unsecured debit balances to occur up to some amount determined to be appropriate for individual acounts or groups of accounts, or to permit debit balances to occur up to levels limited by the amount of collateral or other security provided by the account holder.

#### EXTENT OF CURRENT AND POTENTIAL EXPOSURE

According to an April 9, 1979, Subcommittee on Accounting Systems, Budgets and Expeditures (SASBE) report to the Committee on Management Systems and Support Services, during 1978 approximately 6,200 "overnight" overdrafts totalling \$9.1 billion occurred in member bank reserve accounts maintained in all 12 Reserve Districts. Systemwide, the average size of such overdrafts was \$1.5 million, although in New York, Philadelphia and San Francisco, the average member bank overdraft was between \$3.0 and \$4.0 million.

Records maintained by the Federal Reserve Bank of New York over the last few years reveal an interesting aspect of the overdraft exposure question. In 1977, ten overdrafts in the accounts of eight large New York City banks totalled over \$2.1 billion, an average overdraft of over \$210.0 million. In 1978, nine overdrafts in the same eight accounts totalled only \$403.4 million, an average occurrence of \$44.8 million. Thus far in 1979, five overdrafts have occurred in the large New York City bank accounts, and the total of these, \$479.8 million, already exceeds the 1978 "exposure". This data reinforces the 1978 SASBE study referred to above, which showed that 2.5 percent of the System's member bank overdrafts caused 57.2 percent of the dollar exposure.

A related issue is whether or not the occurrence of "daylight" overdrafts constitutes exposure of the same magnitude. Theoretically, the risk of loss would be as likely during the course of the day as at the close of business for any financial institution. (In fact, when foreign financial institutions operating branches and agencies in the U.S. are considered, the likelihood of a midday loss could be greater if the foreign parent were closed or declared bankrupt at its normal "opening" or "closing" time.)

Studies done at the New York Reserve Bank to measure the size and frequency of "daylight" overdrafts in the eight largest New York City bank accounts suggest that the incidence of "daylight" overdrafts is common and that the exposure is extremely large. The experience varied from bank to bank: Only one bank had no "daylight" overdrafts; all others experienced "daylight" overdrafts amounting to over \$100 million; a good number amounted to over \$1 billion; and one bank had a \$3.5 billion overdraft. The analysis referred to above included some of the largest banks in the U.S. Past experience might be interpreted to indicate that despite their magnitude, such debit balances do not create a great financial risk; nonetheless, these debit balances do confront the Reserve Bank with a tremendous exposure to both financial and non-financial risks.

With respect to the addition of foreign branch and agency reserve accounts under the International Banking Act, there would appear to be significant potential for large "daylight" and "overnight" overdrafts in such accounts. While the activity of any individual branch or agency may vary, generally such institutions are active in the money markets and handle sizable international funds flows, often on behalf of their parent banks. It is anticipated that the reservable liabilities of foreign branches and agencies will be small relative to those of the large domestic banks which conduct the same type of business.<sup> $\frac{3}{}$ </sup> The financial risk of loss would differ from that associated with domestic banks in another sense. If a domestic bank were experiencing serious financial difficulties, the Federal Reserve often would have some advance warning, affording an opportunity to take steps to contain the risk of financial loss due to an overdraft situation. This would not necessarily be true of the branches and agencies of foreign banks. Notice of the imminent insolvency of a foreign parent might not occur timely. Moreover, in the event of the insolvency of both the domestic office and the foreign parent, there would be a significantly smaller asset base against which the Federal Reserve System could proceed to cover any losses in the sense that the domestic asset base may be small and that the foreign asset base may be unreachable.

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<sup>3/</sup> A recent study of turnover (the volume of outgoing wire transfer of funds activity compared to opening reserve account balance) in selected Second District accounts revealed some interesting relationships. Edge Act corporation and limited trust company accounts exhibited turnover ratios ranging roughly from less than once per day to over 2,500 times per day with a mean ratio approximating 200, whereas large city bank accounts exhibited a tighter range of roughly 2 times per day to 200 times per day with a mean ratio approximating 22 times per day. The branches and agencies of foreign banks are generally expected to be similar to Edge Act corporations in terms of ratio of activity to opening balances.

With respect to the possible implementation of "membership" legislation similar to H.R. 7, expansion of access to Federal Reserve services to nonmember banks, thrifts and credit unions, combined with generally lower reserve requirements, would also tend to increase exposure to financial risk to the extent that the required reserve cushions against overdrafts were decreased.

#### MONITORING ALTERNATIVES

The strongest arguments against monitoring are, in fact, arguments against a rigid "control" function. U.S. commercial banks, despite their very different role in the international financial mechanisms, have opted for strong "account oversight" and flexible, but carefully designed "control" functions. The resolution of the debate about what levels of "account oversight" and "control" are appropriate for the central bank probably could be found in the use of a flexible "control" function.

Conceptually, the ideal approach would be extension of "account oversight" to all tranactions, regardless of on-wire/off-wire status or size; this option would feature a discretionary "control" function with the flexibility to permit debit balances within parameters discussed later. Unlike the less comprehensive approaches discussed below, however, such a monitoring system would assume immediate, on-line entry of all work processed by various operating areas to the accounting system. This comprehensive approach would be preferable from the standpoint of providing complete coverage, but while the technology to accomplish such comprehensive "account oversight" and flexible "control" is clearly available, this kind of monitoring system would not be feasible for this Bank in the short term because of existing technological and procedural constraints

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which are discussed briefly in a later section. Therefore, a comprehensive monitoring system must be regarded as a longer-term objective and other options should be considered for the short term.

If the question of the appropriate level of monitoring were approached from the premise that risk should be reduced, there would be two basic methods for minimizing risk. First, "account oversight" and "control" could be limited to (or phased-in in the relative order of) the categories of transaction which represent the greatest risk because of structural or dollar-exposure characteristics. Second, "account oversight" and "control" could be limited to (or phased-in in the relative order of) the categories of account which represent the greatest risk because of structural or activity characteristics or other special circumstances. Clearly, a combination of these methods is also possible. This Bank's current monitoring environment already reflects three different combinations of the methods described above. All transactions are monitored for the accounts maintained by the Foreign Department for foreign central banks and international organizations (and, while certain of these accounts may be more "risky" than others, as has been mentioned, these foreign accounts are monitored primarily for investment control purposes). The wire transfer of securities transactions are monitored for all of the Bank's account holders, and the wire transfer of funds transactions are monitored for a certain category of accounts. MONITORING BY TRANSACTION TYPE IN CONSIDERATION OF RISK

Wire transfers of funds are the most risky of all transactions for two reasons. First, funds transfers are final upon advisement to the recipient which for the most part occurs automatically and, second, wire transfers of funds represent the greatest average dollar exposure of any

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type of transaction. For similar reasons, wire transfers of securities are also high risk transactions.

One option, therefore, would be for this Bank to extend limited "account oversight" to wire transfers of both funds and securities. This approach has the advantage of providing information on the highest value, highest risk transactions. The level of "control" exercised over these transactions could be variable according to certain go/suspend/no-go parameters such as: (1) the dollar value of the debit exposure, (2) the risk classification of the account, (3) a predetermined estimate of probable off-wire balances, (4) time of day, and (5) prearranged credit line or collateral considerations. The operation of each of these decision parameters is discussed below.

If the <u>dollar value</u> of the debit balance that would be created by a particular wire transfer of funds or securities was considered excessive by the Bank, that transfer would not be executed. (The transfer systems would be programmed to classify as excessive any debit balance higher than some arbitrary level established by the Bank. That level could be set so high as to reject no transfer; at zero, so as to reject all transfers that would result in debit balances; or anywhere in between.) If the negative balance that would be created by the transfer was above the arbitrarily established ceiling, either the Reserve Bank could reject the transfer outright, or other considerations such as those discussed below might become operative as decision parameters.

The transfer systems would access a list of on-line and offline <u>accounts classified as to risk</u>. (The sophistication of this classification would be at the discretion of the transferring Reserve Bank.

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Again, the criteria could be set to reject all, selected, or no transfers.) $\frac{4}{}$  If the transferor were classified as high risk, the request could either be rejected outright or could become contingent on other factors.

It would seem reasonable, if monitoring were limited to wire transfers of funds and securities transactions, that transfers might be permitted (depending on the Reserve Bank's position on the dollar exposure and risk classification parameters), despite debit balance considerations if net credit <u>off-wire balances</u> were adequate to cover those transfers. In fact, a Reserve Bank probably should not deny member banks and other account holders with significant off-wire account activity the use of such balances. Clearly, a monitoring system which was limited to on-line balances would not include information about off-line balances unless that information were manually entered onto the system. This input could be accessed in one of two ways. Either the Reserve Bank could program the system to reference a list of "educated guesses" about the existence of any off-line credits (in various accounts on various days of the week, etc.) or the monitoring system could be notified of any significant off-line transactions as they occur.

<u>Time of day</u> might be a decision parameter in two senses. First, as the business day draws to a close, a Reserve Bank with any concern about overnight overdrafts might be expected to be less willing to permit a debit balance (or debit balance over a certain size). Second, and this relates to the discussion of off-wire balances, if the daily

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<sup>4/</sup> Risk classification is discussed in greater detail in the section on monitoring by account category which follows.

timing of certain significant off-wire transactions is fairly predictable, the "educated guesses" discussed above might be modified to reflect this.

Finally, the question of the amount of debit exposure that is permissible could be resolved by following debit balances on on-wire transactions up to a predetermined maximum of a <u>credit line arrangement</u> or of available collateral.

An extension of this approach would be to expand automated "account oversight" to certain off-wire transactions on a dollar prioritized basis. Stated simply, all operating areas processing entries (other than wire transfers of funds or securities which would be handled automatically) larger than some defined dollar floor would enter such transactions into the accounting system immediately rather than accumulating them with other work for batch processing. Summary information on these large-dollar debit and credit off-line transactions would be transmitted to the monitoring facility to "update" account balances. "Control" under this expanded monitoring system would be at the discretion of the Reserve Bank as described above. This approach is appealing because it covers the exposure question even more thoroughly than could a monitoring system limited only to wire transactions.

A significant dollar amount could operate as a flag for operating areas which do not normally process very large entries, but it would make sense to automatically enter certain other transaction types on a daily basis because of the frequency with which such transactions significantly affect the position of various accounts. Among the transactions types which might merit this treatment are settlement for clearing house and other local cash letter clearing arrangements, Federal funds

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check debits and credits, securities issued and redeemed, and other cash letter entries. For example, while the wire transfer monitoring system currently applied to Edge Act corporation accounts has been successful in eliminating most overdrafts, overdrafts still occur occasionally in the reserve accounts of these monitored banks, primarily because of the posting of clearing house debits. It would seem that the addition of settlement transactions to the monitored balance would do much to further reduce the incidence of overdrafts in these accounts, while at the same time ensuring the finality of the settlement.

Clearly, the routine inclusion of the other transactions mentioned above would also enhance the exposure coverage of a monitoring system. The addition of each type would, naturally, present different operating difficulties. For instance, cash letter debits and credits would have to be screened for availability and Federal funds entries would require some special processing. None of these obstacles would appear to be insurmountable, however, especially if this approach were chosen as an interim solution.

#### MONITORING BY ACCOUNT CHARACTERISTICS IN CONSIDERATION OF RISK

If the New York Reserve Bank decides to change the current level of account monitoring, should the Bank apply the same levels of "account oversight" and "control" to all accounts? And, if not, what criteria should be used to single out groups of accounts or individual accounts for more comprehensive "account oversight" or more rigid "control"?

Arguments for universal treatment can be based on the principle of equity (national treatment) and the need for more complete information about the status of accounts, while arguments for selective treatment

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hinge almost exclusively on considerations of risk and interim practicality.

If criteria are used to select accounts for different monitoring procedures the following would merit consideration:

1) <u>Nonfinancial risk</u>, the economic or political implications of Federal Reserve actions, would be a desirable criterion, but would not appear to be easily quantified; and, even if nonfinancial risk were measurable, it would be difficult to attribute different levels of nonfinancial risk to a particular account or group of accounts.

2) <u>Financial risk</u> might be analyzed using several variables. As discussed earlier, transaction activity vs. balance turnover ratios, as well as the adequacy (and availability) of assets might be considered. If these two variables were used as measures of risk and as determinants of the levels of "account oversight" and "control", Edge Act corporations, limited purpose trust companies and the branches and agencies of foreign banks would appear to merit more extensive monitoring than some other types of account.

In the same context, there does not seem to be a good case for applying different levels of "account oversight" or "control" on the basis of membership status alone. It can be argued that exposure to financial risk is generally lower where member banks are concerned because of the relatively lower turnover ratios (and presumably because of the fact that member bank assets would be more readily available as an offset to obligations) nevertheless, because this is not universally true, it would appear to be a better strategy to select accounts for more extensive "oversight" and "control" strictly on the basis of relative financial risk. For example, certain medium-sized members in the Second

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District have turnover ratios which are far greater than those of most banks in their size category--and in fact exceed the turnover ratios of some Edge Act corporation accounts. On the same theory, the requirement that legal reserves be maintained, might, in conjunction with other variables, such as evidence of financial difficulty or the history of overdraft and deficiency problems, be used as a criterion for different treatment.

The International Banking Act and the recent revisions to Regulation K embody the principle of equality of treatment among various categories of account. These provisions need not be interpreted to preclude the establishment of different procedures for minimizing the risk of loss so long as the procedures adopted are reasonable and do not unduly inhibit the operations of monitored financial institutions. Moreover, the International Banking Act stipulates that the provision of services to the branches and agencies of foreign banks should be relative to balances maintained. If the balances of such accounts prove to be as low as anticipated relative to transaction volume, placing a more restrictive limit on daylight overdrafts in such accounts would not seem to violate the intentions of the Act.

#### ALTERNATE LEVELS OF CONTROL

It seems reasonable to assume that the Bank, in designing its future accounting system, could establish a level of "account oversight" similar to one of those described. As was noted, however, the issue of the appropriate level of "control" is one which is not so easily resolved. All discussions of the alternate levels of monitoring in this paper assume that the "control" function should be flexible. Such an approach is operationally practical, conceptually preferable, and, it would seem,

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politically acceptable. Any monitoring system at this Bank which includes flexible "control" features will be more readily adaptable in a changing financial environment and can be more quickly converted to a uniform approach should the System decide to move in that direction.

As has been mentioned, there are four general approaches to the issue of the level of "control" to be included in a monitoring system which will be discussed here: first, to allow unsecured debit balances to occur but to apply moral suasion and/or monetary charges after the fact; second, to allow no debit balances to occur; third, to permit unsecured debit balances to occur up to some specified amount to be determined for individual accounts or groups of account; and fourth, to permit debit balances to occur up to a maximum level determined by the amount of collateral or other security provided to the Bank by the account holder.

The first approach is similar to this Bank's current policy for overnight overdrafts in member bank accounts. This approach can be faulted, however, for addressing the overdraft problem only indirectly and post hoc. While the current policy has proven to be a deterrent to "avoidable" overnight overdrafts, in a bank failure or bank closing situation, this level of "control" would certainly be found lacking. Moreover, the application of monetary charges would weaken as a deterrent for "daylight" or "overnight" overdrafts if the charges fell below market rates and might result in a shifting to "more lenient" private transfer networks if the charges became too onerous relative to the market rates. Furthermore, failure to deal directly with the issue of daylight overdrafts would continue to subject the System to potential outside criticism.

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The second approach, to allow no debit balances to occur, can be criticized for its potential for impeding the smooth flow of the payments mechanisms and possibly, for having the potential of being an impediment to international trade. Furthermore, this very rigid approach would involve serious nonfinancial risks insofar as the Reserve Bank's refusal to permit a transfer (or to recognize a debit transaction) which could be covered later in the business day could create serious credibility problems for the Bank and/or the financial institutions involved.

The third approach, allowing debit balances up to a predetermined, unsecured "credit limit", can be criticized as being unfairly discriminatory and unadaptable to special circumstances. It would, however, be consistent with general banking practice and would probably cover the exposure question adequately in most situations. Nevertheless, this approach may raise questions in view of the Federal Reserve Act's restrictions on unsecured lending.

The fourth approach to the level of "control", which would allow debit balances up to a level determined by the amount of collateral or other security provided by the account holder, would appear to be preferable to the others discussed. It could not be faulted for being inequitable; nor could it be eliminated from consideration on the basis of disrupting the payments mechanisms or the conduct of international trade since the reduction of substantial financial risks in the domestic and international payments mechanisms would appear to be an adequate answer to such criticism.

An Ad Hoc Committee on Securing Daylight Overdrafts at the Federal Reserve Bank of New York has prepared a paper, "An Approach to Requiring Collateral Against Daylight Overdrafts", which explores the

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availability and adequacy of collateral to cover current and anticipated levels of daylight exposure. This paper recommends that, as an interim measure, until the communications system can be modified to conduct surveillance of available account balances on a real-time basis, each depositor incurring "daylight" overdrafts be required to provide collateral to cover possible "daylight" overdrafts equal to three percent of the depositor's assets. The Ad Hoc Committee's report is consistent with the fourth approach and would supplement it during any period needed to phase in that approach for all accounts.

If "other security" rather than collateral were provided to secure debit balances under the fourth approach, this might include lines of credit arranged with other U.S. banks that could be drawn on by the Reserve Bank if necessary. The level of such security might be set by the Bank using FEDWIRE in light of its own needs. The Federal Reserve would, thus, not be required to make a credit judgment about the amount of other security which was appropriate. While this line arrangement would probably be adequate for the needs of the smaller account holders, the possibility of a "domino effect" if a very large line were called on a bank with insufficient balances with the Federal Reserve Bank would probably limit its usefulness for larger banks.

#### TECHNICAL AND COST CONSIDERATIONS

In determining what the characteristics of a monitoring system should be and in assessing technical and cost considerations, it is important to distinguish between long and short term limitations. Given the fact that large U.S. commercial banks have already created monitoring systems that are more complex (in terms of the number of accounts subject to monitoring and in terms of the different types of funds availability

-24-

tracked) than even the most sophisticated option discussed herein, i.e., the on-line accommodation of all transactions and all accounts with flexible "control", it would not appear that technical or cost considerations would prohibit the Federal Reserve Bank of New York (or the Federal Reserve System) from implementing the type of monitoring system required in the long term. The User Task Force on Interdistrict Accounting of the Subcommittee on Accounting Systems, Budgets and Expenditures, which is charged with developing business definitions and general system requirements for future Federal Reserve accounting systems, has already included "determining account status at any time of the day and providing for the ability to limit 'daylight overdrafts'" in its description of the functions of Member Bank and Other Deposits Accounting.

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In the short term, however, there are certain technical difficulties. Current capability to extend the wire transfer of funds monitor at this Bank to accounts other than Edge Act corporations has been estimated to be limited to approximately two hundred accounts. "Retrofitting" the current wire transfer of funds monitor to include "off-wire" balances, however, could probably be done with limited cost for even that additional number of accounts. (The Accounting Function is currently investigating this option.) Also, in the short term, it may be difficult to try to link automated transfer of funds monitoring with the funds associated with transfers of securities. (Most Edge Act corporations have minimal securities transfer activity so this has not been a serious limitation in the monitoring of Edge Act corporation reserve accounts.)

#### CONCLUSIONS

Against the background of the rapid acceleration of the domestic and international financial environment, major structural changes to the U.S. banking system as a result of the International Banking Act, and potential changes to membership and reserve requirements as a result of proposed legislative changes; and in consideration of the Federal Reserve Bank's role and responsibilities as the central bank and the availability of automated monitoring capabilities, it should be the position of this Bank that:

 Monitoring of the member and nonmember accounts maintained by the Bank is appropriate.

2) The capabilities for full "account oversight" and "control" of all accounts and all transactions should be included in the detailed user requirements which will serve as the basis for development of the Bank's future accounting system.

3) Similarly, the capabilities to satisfy the full "account oversight" and "control" requirements of the accounting system, covering all accounts and all transactions, should be included in the user requirements of all systems which will supply input to that accounting system.

4) As a short term effort, the wire transfer monitoring system currently operative for Edge Act corporations should be retrofitted to include information about certain significant "off-wire" transactions with the intention of achieving as close an approximation as possible of the preferred levels of "account oversight" and "control" described herein.

5) In addition to the Edge Act corporations currently being monitored, the accounts maintained for limited purpose trust companies, branches and agencies of foreign banks, and similarly situated member banks should be phased onto this "interim" monitoring system in order of the relative risk of handling transactions for an institution in light of

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required balances, although any institution in financial difficulty should also be added to the system.

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6) The monitoring system which is part of the future accounting system should feature a "control" function which limits debit balances to secured levels of credit established by each account holder.

7) The provision for secured "daylight" overdraft balances might be appropriately limited in amount for monetary or other policy reasons.

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Prepared by: Accounting Department

November 1979

MISC 3.4 (1/77)

# OFFICE CORRESPONDENCE

To Legal Files FROM Bradley K. Sabel DATE October 15, 1979 SUBJECT Marginal reserves --"pass-through" lending.

FEDERAL RESERVE BANK OF NEW YORK

Kate O'Neill asked about the correctness of her reading of the new marginal reserve requirement on branches and agencies of foreign banks concerning borrowing from parent banks. A branch officer asserted that a branch that borrows funds from its parent bank and makes loans with these funds to foreign borrowers for foreign purposes will be unfairly penalized if it cannot deduct the amount of such loans from its claims on its parent; such a parent borrowing is not used for United States lending and therefore need not be subject to the new requirement. I agreed with Kate that there is no provision for such a deduction and noted that foreign banks may be able to avoid this problem by funneling the funds for such lending to non-United States offices rather than through a United States office. What that branch officer in effect is seeking is an "international banking facility."

BKS:ETP/dld

cc: Messrs. Gray Oltman Sloane Fujarski Patrikis Korobow Gelson

Brally K. Sabel

MISC 3.4 (1/77)

# OFFICE CORRESPONDENCE

To Legal Files

FROM Ernest T. Patrikis

DATE October 15, 1979

FEDERAL RESERVE BANK

OF NEW YORK

SUBJECT Marginal reserves on

unmanaged liabilities -- repos.

We have received two related inquiries on repurchase agreements. The first asked whether a member bank could act as undisclosed agent of a dealer in a repo with the bank's customer without the bank maintaining marginal reserves. We indicated that such a transaction would have to be a bona fide agency and, also, that it would have to be clear that the member bank was acting only in an agency capacity and bore no risk on behalf of either part to the repo. We also suggested that the member bank ascertain whether it had the power to act in such a capacity.

I now note that Section 374a of Title 12 of the United States Code prohibits a member bank acting as an agent of a nonbank in making loans secured by stock or investment securities to brokers and dealers. The member bank's Reserve Bank can impose a \$100 a day fine for violations of that provision.

The second question involved as a member bank acting as agent of a nonmember bank in making repos with the bank's customers. In these transactions the member bank again enters into a repo with the nonmember bank and does not disclose the agency. I indicated that the transaction, in order to escape the marginal reserve requirement, must be a bona fide agency transaction and not involve two back-to-back repos.

ETP/dld

Et CPA

cc: Messrs. Gray Oltman Sloane Sternlight Fujarski Korobow Gelson Sabel

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# OFFICE CORRESPONDENCE

FEDERAL RESERVE BANK OF NEW YORK

DATE October 15, 1979

To\_ Legal Files

SUBJECT\_\_\_

FROM Ernest T. Patrikis

Some observers have questioned whether banks may circumvent the marginal reserve requirement by issuing floating rate CD's with original maturities in excess of one year, which rates would be adjusted periodically during the year.

ETP/dld

cc: Messrs. Gray Oltman Sloane Fujarski Korobow Gelson Sabel

LT. Patil-

MISC 3.4 (1/77)

FEDERAL RESERVE BANK OF NEW YORK

# OFFICE CORRESPONDENCE

To Legal Files

DATE October 15, 1979

SUBJECT Marginal reserves on

FROM Ernest T. Patrikis

unmanaged liabilities.

1. Reference is made to the question whether sale of funds or a repo by a trust department of a member bank with another member bank are subject to the new marginal reserve requirement. Such borrowings are subject to a reserve requirement unless the institution on whose behalf the trust department is acting is itself maintaining reserves. See, Published Interpretations ¶¶ 2735 and 2736.

2. With respect to the question of why only borrowings from branches abroad are netted and no other borrowings, Gil Schwartz informed me that the Board had considered netting of Fed fund transactions but had rejected that proposal because it would create a loophole. Without explaining the matter in detail, he stated that it would somehow permit member banks to act as brokers for nonmembers.

3. I asked Gil whether the Board had considered the so-called "Burns--Martin" letters. In those letters, the then Chairman of the Board stated that offshore branches of member banks were not aggressively to seek deposits in the United States. Gil thought that Chairman Volcker's letter to member banks was a reaffirmation of the "Burns--Martin" letters. I indicated to Gil that that was not that clear to me.

4. I mentioned to Gil that some have read Mr. Volcker's letters to each member bank as setting forth a policy that United States banks should not lend abroad. The letter states that "this is not the time to finance activities that have little to do with the performance of the American economy." Gil agreed with my interpretation that this was not intended to discourage lending abroad but was intended to limit loans not for productive purposes, such as gold speculation.

5. With respect to access by United States branches and agencies of foreign banks at the discount window, Gil indicated that the marginal reserves were supposed to be constant and that branches and agencies were not to rely on the Fed fund market to support their reserve requirement. I stated and he agreed that his explanation was inadequate.
MISC 3.4 (1/77)

DATE October 15, 1979

#### OFFICE CORRESPONDENCE

To Legal Files

SUBJECT\_\_\_\_

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FROM Ernest T. Patrikis

-2-

6. I raised the question of why reserves on borrowings from foreign offices were not limited to maturities of less than one year. Gil indicated that the Board had considered this issue and that the 8 percent capital equivalent granted to branches and agencies was intended to be the equivalent of borrowings of more than one year. If loans of more than one year were excluded, then the 8 capital equivalent would have to be eliminated. In addition, he indicated that a foreign branch would merely book all loans to its head office as being longer than one year. We agreed that, in this regard, between borrowings from a related office and an unrelated entity were different and that the related office would not be concerned about labeling the borrowing as being for more than one year, whereas the unrelated entity might reach a higher rate of return for a longer maturity.

ETP/dld

cc: Messrs. Gray Oltman Sloane Fujarski Sabel MISC 16 (11/78)

#### OFFICE CORRESPONDENCE

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On October 12, 1979, I was asked whether the imposition of the marginal reserve requirement constituted a total preemption of a State's reserve requirement on branches of foreign banks. In a September 26, 1979 letter to Roderick L. Housenga, Chief Examiner of the Chicago Reserve Bank, Edward Ettin, the Board's Deputy Staff Director, stated that Pederal Reserve reserve requirements imposed under Section 7 of the International Banking Act of 1978 preempt State reserve requirements. It could be argued that the imposition of the marginal reserve requirement preempts all State requirements. I responded that, in my opinion, the Doard of Covernors had not intended to preempt completely all State reserve requirements but, if Federal Reserve requirements indeed do preempt State requirements, they only would preempt State marginal reserve requirements on managed liabilities.

ETP/dld

cc: 'Hessrg. Gray Oltman Sloane Fujarski Korobow Gelson Sabel ETY FEDERAL RESERVE BANK OF NEW YORK

October 15, 1979

#### OFFICE CORRESPONDENCE

FEDERAL RESERVE BANK OF NEW YORK

DATE October 15, 1979

To Legal Files

FROM Ernest T. Patrikis

SUBJECT Marginal reserves on managed liabilities -- borrowings from foreign persons.

Mr. Sloane and I in recent discussions have questioned whether United States branches and agencies of foreign banks will have an advantage over member banks regarding marginal reserves on borrowings from unrelated foreign persons. A member bank must maintain standard reserves on demand and time deposits received from both domestic and foreign persons. A branch or agency does not maintain such reserves with a Reserve Bank. Certain time deposits booked by member banks and branches and agencies are subject to the marginal reserve requirement. "Borrowings" -- that is, deposits that are not demand or time deposits -- from foreign persons are subject to marginal reserve requirements by both member banks and branches and agencies.

From this description, there is an incentive for branches and agencies to book borrowings from unrelated foreign persons as demand deposits because no Federal Reserve reserves are imposed on those deposits. This suggests that consideration should be given to including demand deposits from foreign persons as a part of the managed liabilities of a branch or agency, until a full reserve requirement is imposed.

The same could be said of demand deposits of domestic persons. A branch or agency could characterize some domestic borrowings as demand deposits to escape the marginal reserve requirement. Once a full reserve requirement is imposed, then the branch or agency will have an incentive to characterize it as a time deposit.

This would permit branches and agenices to manipulate their base. They could count the foreign borrowings as borrowings for the purpose of establishing their reserve free base and then shift the borrowings to demand deposits, thus permitting them to reise additional funds within their base.

#### ETP/dld

cc: Messrs. Gray

Oltman Sloane Fujarski Korobow Gelson Sabel SV

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MISC	16	(11/78)
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### OFFICE CORRESPONDENCE

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To\_\_\_\_\_Ernest T. Patrikis

FEDERAL RESERVE BANK OF NEW YORK

October 11, 1979 -Date Reserves on unmanaged SUBJECT

liabilities

One potential loophole in the Doard's marginal reserve requirement on unmanaged liabilities relates to foreign subsidiaries, a number of which are foreign banks, do not maintain reserves with Reserve Banks. These companies will be able to borrow funds in the Eurodollar market and lend those funds in the United States.

The extent to which those companies can make domestic loans is not clear. Requests for an interpretation in this area have been pending at the Board of Governors for a number of years. Under Section 211.5(b)(5)(i)(C) of newly revised Regulation K, such a company may not transact business in the United States that is not incidental to its international or foreign business. The Board sought comment on this matter but intentionally did not further define that limitation at this time. Such a company can at least make the same kinds of loans in the United States that can be made by Edge Act corporations.

ETP/ib

cc: Messrs. Cray Oltman Sloand MISC 3.4 10/77

OFFICE CORRESPONDENCE

FEDERAL RESERVE BANK OF NEW YORK

DATE October 11, 1979

 To\_\_\_\_\_Legal Files

 FROM\_\_\_\_Ernest T. Patrikis

SUBJECT\_\_\_

One matter which the Board did not cover with its marginal reserve requirement is those parties covered under the former voluntary Eurodollar reserve program. In the International Banking Act of 1978, Congress did not grant authority to impose reserves on Article XII investment companies. I understand that these companies did maintain voluntary reserves under the old program. Therefore, companies such as Nordic Banking Corporation and Baer Banking Corporation will be able to raise funds domestically and abroad and lend them in the United States without being subject to any marginal reserve requirement.

In addition, American Express International Banking Corporation, a Connecticut bank chartered to engage in banking except in Connecticut, has an agency in New York City and will be able to make domestic loans without being subject to a marginal requirement reserve. Consideration could be given to imposing a voluntary reserve requirement on AEIBC.

ETP/is

Sol, Cat

cc: Messrs. Gray Oltman Sloane

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## Federal Reserve Bank of St. Louis

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FEDERAL RESERVE BANK OF NEW

Date 10/29

#### Other remarks:

This is the result of a suggestion you made to me last year. It was sent to the BIS on 10/29/79 for distribution to members of the Cooke Committee. COMMITTEES CONTENTION DE THE CONTENTION DE THE CONTENTION DE THE CONTENTION DE THE SYSTEME CONTENTION CONTENTION DE THE SYSTEME CONTENTION DE THE SY

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Cost to International Banks of Supervision and Regulation: Maintenance of Reserve and Capital Ratios

The first part of this paper sets forth a framework to help supervisors understand the cost to banks of reserve and capital ratios and was prepared without reference to current official reviews of methods by which a greater degree of control over the Euro-markets might be attained. The framework is used to examine the competitive and location effects of imposing a reserve requirement on offshore banking operations and the effect of attempting to equalize the competitive effect of reserve requirements by paying interest on reserves held. The last part of the paper applies this framework to data for large New York banks.

#### Overview

Capital ratios and reserve ratios can affect both the soundness of banks and the way they operate. A capital ratio is usually seen as primarily supervisory in nature and a reserve ratio as a means of monetary control. National banking authorities may not, however, prescribe fixed capital or reserve ratios; even without required ratios of any kind, banks would, no doubt, maintain some reserves and would have some capital. The officially imposed burden of capital and reserve ratios in a narrow sense would be the difference between the ratios as imposed and as otherwise voluntarily maintained. More narrowly, imposed costs become a burden when a bank cannot pass them along to customers in the form of higher lending rates or to correspondents in the form of lower deposit rates or when banks do pass such costs along and thereby lose business to financial intermediaries without these burdens.  $\frac{1}{}$  Because international lending is highly competitive, those banks with higher reserve ratios or capital ratios are less likely to be able to pass along such costs to customers than would be the case in a less competitive environment.

Whether or not capital ratios and reserve ratios may be attributable directly to supervision and regulation, they can reduce an international bank's profitability. The effects on profits of these ratios depend importantly on the rates paid for deposits and capital. The rates assumed in the text would seem especially relevant for illustrating the competitive situation of U.S. banks' international operations.

The examples that follow in Part I can be adapted, as may be necessary, to the situation of banks from other countries than from the United States. The examples illustrate how profitability is affected by different reserve and capital ratios and the lending rate required just to cover the cost of financing under different ratio assumptions.

An increase in reserve requirements can greatly cut a bank's profitability, as the bank must purchase additional deposits to meet these requirements and hold them in nonearning form.

<sup>1/</sup> Supervision and regulation may also impose other costs or provide benefits to banks and to society, but no attempt is made in this paper to form a method for comparing complete net supervisory and regulatory burdens or benefits.

Capital requirements can also impair profitability. Reserve requirements are not levied against capital, but this advantage of capital financing over deposit financing is usually outweighed by tax and other considerations. While the interest paid on deposits is usually tax deductible, neither dividends nor the opportunity cost of retained earnings are deductible in most countries. At a 50 percent corporate tax rate, the rate paid to acquire capital is effectively doubled. For capital financing to have an after-tax rate advantage over deposit financing, its rate must be quite low in relation to the interest rate paid on deposits. To this rate disadvantage of capital financing may be added subjective disadvantages, such as the hesitancy of many banks to avoid the dilution of earnings per share that occurs when additional shares are sold to the public. The buildup of capital by retaining earnings avoids dilution, but reduces the funds available for paying dividends and also suffers from the tax disadvantage noted above. A capital ratio requirement can thus provide both profit and subjective deterrents to asset expansion.

Capital, of course, also has desirable attributes for a bank. It provides a cushion against losses and gives confidence to depositors, enabling a bank to obtain favorable terms for its borrowings. When banks are government-owned, such ownership may be seen as a substitute for capital, both by a bank and its depositors. This difference does not alter the profitability advantage government-owned banks may have over private banks maintaining a higher capital ratio. The calculations that

follow ignore both the favorable characteristics of capital and its subjective disadvantages.

Calculations of the effects on bank after-tax profits from either the capital ratio or the reserve ratio show that both have a strong influence on profits available for reinvestment or to cover possible losses. The effects depend on the rates at which capital and deposits can be acquired as well as on the ratios themselves.

The examples illustrate the interest rate differentials required to cover the cost of acquiring the capital and reserves needed under different ratios. A one percent margin between the gross rate of return and the rate of financing is needed to cover the costs imposed by 5 percent reserve and capital ratios. Even without a reserve ratio, a margin of 1/2 percent is needed to cover the cost of a 5 percent capital ratio. These differentials are larger than on many international loans currently being granted.

Capital and reserve ratios have often been small or nonexistent for offshore operations of banks. Part II examines the profit advantage given by an assumed absence of reserve and capital requirements.<sup>2/</sup> The cost advantage of operating offshore without a reserve ratio on deposits is largely offset by an assumed higher rate of interest paid to acquire deposits offshore; this rate assumption seems consistent with reality. The absence of reserve requirements does not mean that all banks operating in an offshore location are under the same competitive pressures. Those offshore bank operations with a low capital ratio have a distinct profitability advantage. Such advantages may be reduced or eliminated

<sup>2/</sup> Other factors also influence the desirability of offshore versus domestic banking operations, such as taxes, convenience of location and country risk.

by adoption of a capital ratio covering a bank's consolidated operations as has been favored by G-10 central banks. (U.S. supervisors evaluate a bank's capital needs upon its worldwide operations.)

If a common reserve ratio were applied by all home authorities to their banks operating offshore, the profitability of offshore business would be considerably diminished, unless offshore deposit rates dropped or lending rates rose to compensate for this change. The "passing along" of such costs would seem far more possible in the case of a common requirement than in the case of a requirement restricted to particular banks.

The adverse profit effect of home reserve ratios can be eliminated if the home authority pays appropriate interest on reserves held. This rate need not be high if the only objective is to shift the cost advantage of deposit financing from offshore to home, although subsequent market adjustments could easily offset a small return on reserves.

In Part III, this method is applied to the assets and liabilities of large New York banks. Application of the framework suggests that the relative profitability of home or offshore financing is closely dependent on rates paid and whether a bank chooses an average reserve ratio or the ratio applicable to a specific type of borrowing. Other, nonrate and ratio, factors can also be important. Part III ends with some New York bank data that may be useful for comparison with similar data in other countries.

6

#### A. The Framework

To express the relation among capital, reserves and other major balance sheet items, a simple framework has been devised. In this framework, a bank's assets are of two kinds, "earning", i.e., loans and investments of various kinds and "reserves", which are assumed initially to be nonearning. A bank's liabilities are also of two kinds, "deposits" and "capital".

Before the addition of new earning assets or reserves, and given a capital ratio to risk assets of 5 percent, the following balance sheet may be shown:

#### Assets

#### Liabilities

1000	earning	950	deposits
0	reserves	50	capital
1000	total	1000	total

From this simplified example of a bank's balance sheet, profit from the addition of net assets, given certain rate assumptions, can be calculated. The calculations in the remainder of Part I show the effects of different capital ratios, reserve ratios and rates on earnings, given an increase of 15 in reserve assets. Profit calculations for increments in assets, deposits and capital rather than for the respective balance sheet totals give a business decision flavor to the examples that follow. An Appendix sets forth the formulas used for these calculations.

#### B. Addition of a Reserve Ratio

New earning assets of 15, given a 5 percent ratio of capital to earning assets and a zero ratio of reserves to deposits,

are financed by additional capital and deposits as shown in 1.

7

Assets

1.

#### Liabilities

1015	earning	964.25	deposits
0	reserves	50.75	capital
1015	total	1015.00	total

The additional capital as compared with the example above is, of course, 5 percent of the new earning assets. The deposit addition is the amount of new earning assets to be financed (15) less the additional capital financing (.75). If one assumes an 11 percent return on the additional earning assets and a 10 percent before-tax rate for obtaining both additional deposits and additional capital, net before-tax earnings of .15 result (see Appendix B(4)).

For the purpose of comparing the effects on profitability from capital and reserve ratios, after-tax earnings calculations are needed because of the nondeductibility of capital cost and the deductibility of interest paid to obtain deposits. In example 1, a 50 percent tax on the difference between gross earnings and the cost of deposits, .5 x (1.65-1.425) is .1125. If this tax, the cost of additional capital (.075) and the cost of additional deposits (1.425) are subtracted from gross earnings (1.65), the result is after-tax net earnings of .0375. The same figure can be derived by doubling the rate paid for acquiring capital in formula B(4) and dividing the result by 2. This change is shown as formula B(5).

In the remaining examples only after-tax earnings calculations are made.

The addition of a reserve ratio calls for extra deposits to finance the reserves. (See Appendix A(2).) The result is as follows, given a ratio of reserves to deposits (for both "old" and "new" deposits) of 5 percent:

8

2.

#### Liabilities

· · ·

1015.00 earning 50.75 reserves 1065.75 total

Assets

1015.00 deposits <u>50.75</u> capital 1065.75 total

Of the increase in reserves, .75 results from the reserve ratio applied to deposits needed to finance the new assets (.05 x 15) and 50 from the reserve ratio applied to deposits needed to finance pre-existing earning assets (.05 x 1000). The reserves are nonearning, but must be financed from deposits on which interest is paid.

The result of imposing a 5 percent reserve requirement is to wipe out earnings beyond the cost of funding as shown in the first example. Although there is some return on the additional capital, there would be little reason for a bank to add to its assets unless the rate of return on new assets were higher, the cost of deposits or capital lower, or the required ratios smaller.

#### C. Smaller Ratios

The sensitivity of the earning calculation to one percentage point reductions in the capital ratio and in the reserve ratio can be seen from the following two examples.

3.

Assets

Liabilities

1015.00 earning 51.28 reserves 1066.28 total 1025.68 deposits <u>40.60</u> capital 1066.28 total With the reduction in the capital ratio (while maintaining the same reserve ratio, interest rate and tax assumptions as in example 2) small after-tax earnings on the new assets result (.007).

Given a reserve ratio of 4 percent (but the same capital ratio, interest rate and tax assumptions as in example 2) the balance sheet becomes:

4.

#### Liabilities

1015.00 earning 40.18 reserves 1055.18 total

Assets

1004.43 deposits 50.75 capital 1055.18 total

With the reduction of the reserve ratio there is a small net profit on the added earning assets of .008. The net profit in example 4 is slightly larger than in example 3; a one percentage point change in reserve requirements has in this example a greater effect on profits than a one percentage point change in capital requirements. This results in part from the assessment of reserve requirements on deposits and the need to hold deposits for financing both earning assets on reserves. The result also depends in part on the interest rates assumed; if interest rates on deposits were higher the effect on profits shown would be stronger, but the reverse is also true. Also of note is the interrelation between the capital ratio and the reserve ratio; a change in the capital ratio will alter the amount of needed deposit financing. Different reserve ratios will thus have profit effects that depend in part on the size of the capital ratio.

#### TABLE 1

#### After-tax Profitability Measures

		Exa	mple:	
	_1	2	3	4
Net earnings on new assets (E <sub>n</sub> )	.038	-	.007	.008
Ratio of net earnings to new assets $\frac{E_n}{A}$	.002	-	-	.001
Given:				
Capital ratio (R <sub>k</sub> )	.05	.05	.04	.05
Reserve ratio (R <sub>d</sub> )	-	.05	.05	.04

Although the net profit measures in Table 1 allow for a return on additional capital of 10 percent (the assumed rate needed to acquire new capital) the remaining earnings on new assets after paying for additional deposits and capital are small--zero in example 2--and offer little or no excess for reinvestment or for cover of potential losses.

The interest rate differentials needed to cover the after-tax cost of acquiring capital and deposits attributable to reserve requirements can be calculated from formula  $B(5)^{3/}$  and are shown in Table 2.

 $<sup>\</sup>frac{3}{1}$  The net earnings formula B(5) is solved for an additional cost variable, setting both R and R to o and using the net income originally calculated.

#### TABLE 2

#### Ratios and Rate Differentials (in percent)

Example	Capital ratio	Reserve ratio	Differential to cover cost of maintaining ratios
1	5	0	0.5
2	5	5	1.0
3	4	5	0.9
4	5	4	0.9

The differential needed to cover the cost of these example ratios is larger than on many international loans currently being granted. Fees and income indirectly associated with such credits may be sufficient to make up the shortfall, but it is also possible that some banks are making unprofitable loans to gain or maintain market share. Booking loans and deposits offshore where required ratios may not exist or may be less than at home may reduce the cost of maintaining capital and reserves.

#### II. Offshore Booking

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The approach in the examples above can be extended to cover the case of offshore booking of earning assets and deposits. In the cases that follow, a gross earnings rate of 11 percent for additional earning assets, booked offshore or at home, is assumed; it is also assumed that the same home corporate tax rates apply offshore and at home. The rate paid for offshore deposits is assumed to be 10.5 percent (see below) and that paid for home deposits 10 percent. As in examples 1-4, capital costs are assumed to be 10 percent.

#### A. No Offshore Reserve Ratio

The case in which the offshore branch of a bank is not subject to a reserve requirement on deposits, while there is a 5 percent reserve ratio on deposits booked at home offices and a 5 percent capital ratio on assets booked at home or offshore, is example 5.

Assets	5		Liabil	ities	. *
Offshore	Home		Offshore	Home	
15	1000	earning	14.25	1000	deposits
15	1050	reserve total	14.25	50.75	capital total

Since the same capital ratio applies to assets booked offshore or onshore, there is no capital-ratio incentive to book the assets offshore. Tax or customer considerations may dictate the offshore booking. The decision to book deposits offshore is very narrow, in that the cost advantage of no reserve requirements

on offshore deposits is almost offset by the higher deposit interest prevailing offshore. This higher rate comes about because of competitive pressures forcing offshore banks to share with depositors the profit from more advantageous ratio requirements abroad and by arbitrage between the two deposit markets. The after-tax next profit in this case (.002) is very small, but would have been zero (the same as example 2) if the deposits had been booked at home.

The absence of reserve requirements at an offshore location does not mean that all banks operating there will be under the same competitive pressures. A bank with a lower capital ratio, say 2 percent, would register for the same offshore transactions a profit of .023. A bank with both a capital ratio of 2 percent and a lower capital acquisition rate of 5 percent, would have a profit of .038, about twenty times greater than that for the bank in example 5.

#### B. No Offshore Reserve or Capital Ratios

The profit advantage to booking assets and deposits in a ratio-free offshore location is evident from example 6, which also assumes home ratios of 5 percent for both capital and deposits.

Asset	cs		Liabilit	ies	
Offshore	Home		Offshore	Home	
15	1000	earning	15	1000	deposits
15	1050	reserves total	15	$\frac{50}{1050}$	capital total

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In this case the absence of capital requirements provides a profit incentive for holding assets offshore. The after-tax net profit (.0375) is much larger than in example 5. The financial advantage to offshore banking when home authorities exclude offshore offices from the home capital ratio is apparent, as is the competitive advantage over offshore banks governed by consolidated reserve requirements for their parents.

#### C. Common Offshore Reserve Ratio and Different Capital Ratio

If the assumptions for examples 5 and 6 are altered so that in both there is an offshore reserve requirement of 3 percent, the profitability of adding additional assets is turned to a loss or greatly reduced unless, as would seem quite possible in this common ratio situation, offshore deposit rates adjust to compensate.

Case 5, with an offshore capital ratio of 5 percent becomes, with the addition of a 3 percent offshore reserve ratio:

Asset	S		Liabili	ities	
Offshore	Home		Offshore	Home	
15	1000	earning	14.69	1000.00	deposits
15	$\frac{50.44}{1050.44}$	reserve total	14.69	$\frac{50.75}{1050.75}$	capital total

Calculation of after-tax profitability reveals a net loss once the offshore reserve ratio is imposed. Since the alternative of booking the new assets and needed deposit financing at home would not be very profitable (see example 2), the business would presumably not be done. This assumes that offshore

deposit rates remain at 10.5 percent. A more likely scenario in the case that an offshore reserve requirement of 3 percent were imported on all or most offshore banks would be a reduction in the deposit rate, or an increase in the lending rate to restore the profitability of banks in the market. If the deposit rate were to fall to something less than 10.2 percent the profit situation of example 5 would be restored. The restoration could be incomplete, despite this "favorable" market adjustment, as banks on which the common ratio is imposed might lose share of market to other banks or to nonbanking forms of finance, such as bonds.

A similar exercise applied to the no offshore capital ratio case of example 6 gives:

Ass	ets		Liabilities			
Offshore	Onshore		Offshore	Onsh	ore	
15	1000	earning	15.46	1000	deposits	
15	$\frac{50.46}{1050.46}$	reserve total	15.46	$\frac{50}{1050}$	capital total	

After-tax net profit in example 8 is reduced by nearly two thirds from that in example 6 because of the 3 percent offshore reserve requirement. As in 7, however, an adjustment of the offshore deposit rate could restore the profit situation of example 6.

The effect of imposing a general offshore reserve ratio is thus to reduce profit to the extent that offshore rates do not compensate for this change. The profit reduction would fall on banks already in an unequal profit position and could make the business of some offshore banks unprofitable.

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### D. Payment of Interest on Reserves

The competitive inequalities arising from different reserve and capital ratios for different countries could, of course, be eliminated by all countries adopting the same ratios. This is highly unlikely, although some movement in this direction has been taking place as capital ratios are increasingly viewed on a consolidated basis and reserve requirements in the United States have been reduced, at least until the October 1979 addition of marginal reserve requirements.

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Another possibility is for high reserve ratio countries not paying interest on reserves to do so. This can affect bank profitability and the location, offshore or at home, of banking business.

To illustrate this effect, example 5 can be reexamined assuming the payment of interest on the reserve required against deposits acquired at home. (The formula for these calculations is under "C" in the Appendix.)

If interest on reserves is paid at a market rate, there is a considerable profit advantage for a bank to fund assets at home rather than abroad. (It is assumed in example 5 that factors unrelated to capital or reserve ratios lead banks to book assets abroad.) A rate for reserves the same as the gross rate earned on other assets (11 percent) raises the after-tax income from .002 to .62. If the rate on reserves is the same as that paid for deposits, 10 percent, the net income becomes .56. These calculations assume that the bank retains the full advantage of the new return. If the advantage is passed to depositors or borrowers, the bank's profit advantage would be less.

To influence the location of deposit funding, the rate of return paid on reserves can be much less than the above "market" rates. Solving formula C for this rate, given the same small profit as in example 5 suggests a rate of only .03 percent would be sufficient to equalize the profit difference between booking deposits offshore without reserves and at home with a reserve ratio. An earnings rate on reserves greater than .03 percent would shift the profit advantage to onshore financing. This calculation makes the unlikely assumption that rates of deposit interest, offshore and onshore, do not shift once interest is paid on reserves, but illustrates the sensitivity of funding decisions to small rate changes.

It should be noted that payment of interest on reserves tends to improve the profitability of acquiring deposits at home and, if the interest paid is sufficiently high, will improve the overall profitability of lending, thereby tending to encourage additional lending.

#### III. Data for New York Banks

Data for nine large New York banks have been organized into categories comparable with the example. (See Table 3.) Admittedly this is a highly simplified format that conceals many complexities. Earning assets are all assets except for nonearning reserve holdings at the Federal Reserve Bank of New York. Not all would be "risk assets" upon which Federal Reserve formulas for calculating recommended capital are based. 4/ Capital is treated by supervisors on a consolidated bank basis, including overseas branches. An additional complication in interpreting the data is that the capital shown represents in part an equity interest in the banks of bank holding companies, which in turn have their own capital. Not all the "deposit and other" liabilities would be reserveable deposits. Actual reserve requirements varied in the spring of 1979 with the size and type of deposit, ranging from 16 1/4 percent, for large gross demand deposits less cash items in process of collection and demand balances due from domestic banks, to 1 percent on certain time deposits with a maturity of four years or more. $\frac{5}{}$  There was no reserve requirement, however, on overnight purchases of Federal funds.

At the end of 1978, offshore assets for these banks were nearly as large as those booked in home offices. Similar

<sup>4/</sup> These "capital adequacy" formulas suggest different capital ratios for different types of risk assets, higher capital ratios being suggested for higher risks.

<sup>5/</sup> Federal Reserve System reserve requirements are imposed on banks that are members of the System, as are the nine large New York banks included in Table 3. The cost burden of reserves has been the major reason for some banks to resign their membership in the System.

### TABLE 3

Assets and Liabilities of Nine Large New York Banks as of December 31, 1978 (millions of dollars)

	Assets			Liabil	ities
Offshore	Home		Offshore	Home	
149,094	155,340 ear	rning	139,041	157,926	deposits and other liabilities
	5,998 res	serves		941	subordinated notes and debentures
Child Street	2			12,524	equity capital including reserves
149,094	161,338 tot	al	139,041	171,391	total

Note: Data for offshore assets and liabilities are derived by subtraction of home assets and liabilities (from which due from and due to foreign branch figures are excluded) from consolidated assets and liabilities. data for 1969 suggest that offshore assets have grown at an annual rate of 24 percent, while home assets have risen at 8 percent. The faster booking of earning assets offshore than at home would in part be a natural outgrowth of the internationalization of many U.S. companies, but, it no doubt also results from a number of advantages related to New York City and State taxes and to tax treatment abroad.

The offshore deposit liabilities shown in Table 2 were, however, less than offshore assets, the difference being funding from home offices. At first look, this would seem contradictory, as reserve requirements in the United States are levied on home deposits and not on those taken offshore. Offshore deposit rates have risen to compensate at least in part for this difference. The imposition in November 1978 of a 2 percent supplementary reserve requirement on large time deposits has, along with rate factors, worked to change the net asset position of home offices shown on the table for year-end 1978 to a net liability position in May 1979, the time the rates cited in this paper prevailed. 6'

Because the arbitraging between offshore and home deposit rates largely compensates for home reserve requirements; actual deposit rates vary by maturity and constantly fluctuate in the market; and individual bank deposit needs, reserve ratios and capital ratios differ, simple generalizations such as presented by the examples in the preceding two parts of this paper must be interpreted with caution. Application, of the framework to actual data is, nevertheless, instructive.

<sup>6/</sup> Also important was the reduction to zero in late August 1978, of the reserve requirements on borrowings of member banks from their foreign branches and other foreign banks.

In mid-May 1979, the annual rate on 90-day CDs issued in the United States was about 10.2 percent, and that on overnight borrowing (Federal funds) 10.3 percent. Euro-dollar deposit rates ranged from about 10.05 (overnight) to 10.8 percent 90 days. The average capital to assets ratio calculated from the table was 4 percent (whether or not "debt capital" is included)<sup>2/</sup> as was the ratio of reserves to home deposits. The specific reserve for domestic time deposits of more than \$5 million for maturities of 30-179 days would, however, be 8 percent.

To calculate the cost of financing, an acquisition rate for capital is needed. This rate could be as low as the mid-May 1979, average yield on common stock for the nine banks, 6.8 percent, or as high as the average earnings/price share ratio, 17 percent. The lower rate is used in the calculations, although U.S. banks' emphasis on retained earnings could justify use of the higher rate. Each bank might see its capital cost differently, with the view depending in part on its willingness to issue new shares and public acceptance of these.

The estimated profitability of additional assets and the choice of financing, offshore or at home, depend very much on deposit maturity and choice of reserve ratio. Given the mid-May rates above, overnight financing would clearly have been more profitable from domestic sources, since the rate at homewas lower and there were no reserves on purchases of Federal funds, the form

<sup>7/</sup> The interest on debt is tax deductible, while dividends are not, giving banks an incentive to add capital funds through debt rather than the sale of additional equity.

such borrowing at home would take. If the bank sees its cost of deposit financing as governed by its average reserve ratio of 4 percent the rate of return needed to cover home capital and deposit costs would be 10.6 percent. This calculation would also support a home financing decision as the rate to cover offshore financing costs would be 10.9 percent. If, however, the bank considers its reserves to be the specific requirement for home time deposits of more than \$5 million for maturities of 30-179 days (8 percent) the rate of return to cover home capital and deposit cost is 11.2 percent, a rate that would suggest the use of offshore financing.

Other, non-rate and ratio, factors can also influence the location of financing. An international bank may wish to avoid an overconcentration of liabilities in the home market or in the offshore market. During 1979 some banks, fearing a reimposition of marginal reserve requirements on offshore borrowing, were reportedly building up a high level of such borrowing to serve as a "reserve-free base" from which additional and reserveable borrowing would be calculated. (This expectation was partially fulfilled in October, when a marginal reserve requirement of 8 percent was imposed on "managed liabilities". These liabilities included, however, not only offshore borrowing but also purchases of Federal funds, large certificates of deposit, and other domestic sources of funding.)

For international comparisons, similar data for large banks in other countries might be compared to the results shown

for U.S. banks. For consistent comparison, lending denominated in dollars should be assumed. Adjustment for forward cover of home financing rates, which would presumably be in local currency, could be made to the extent that covering is the usual procedure.

To facilitate such a comparison, the U.S. data presented are summarized in the following table:

#### TABLE 4

#### Summary data for large U.S. banks (as of May 1979)

Average reserves to deposits ratio (R <sub>r</sub> )	4	percent
Average capital to earning assets ratio $(R_k)$	4	percent
Home deposit acquisition rate (three-month's maturity) (r <sub>d</sub> )	10.2	percent
Offshore deposit acquisition rate (three- month's maturity) (r <sub>d</sub> )	10.8	percent
Capital acquisition rate (r <sub>k</sub> )	7	percent
Rate on earning assets to cover capital and home deposit financing (r <sub>a</sub> )	10.6-	percent
Rate on earning assets to cover capital and offshore deposit financing	10.9	percent

\* See text.

D. Willey October 29, 1979

## APPENDIX

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# Method of Calculating the Examples

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## Definitions

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P	=	new earning assets
ra	=	rate of return on new earning assets
Eg	=	gross earnings on new earning assets - raP
En	=	pre-tax net earnings on new assets
E'n	=	after-tax net earnings on new assets
K	=	new capital
K R <sub>k</sub>	=	new capital capital ratio on new earning assets = $\frac{K}{P}$
K R <sub>k</sub> r <sub>k</sub>	= =	new capital capital ratio on new earning assets = $\frac{K}{P}$ rate paid to obtain new capital

D	=	new deposits
R	=	additional reserves
Rd	=	reserve ratio on new deposits = $\frac{R}{D}$
rd	=	rate paid to obtain new deposits
c <sub>d</sub>	=	deposit cost of financing new assets and reserves = $r_d D$
E <sub>n</sub>	=	after - tax net earnings on new assets and earning reserves
rr	=	rate of return on reserves
A	=	total new assets = $P + R$

(1) 
$$D = (P - R_k P) + R_r (P - r_k P) + R_r^2 (P - R_k P) \dots + R_r^{n-1} (P - R_k P)$$

2

The new deposits are the sum of a diminishing series. The first term,  $P-R_kP$ , is the amount of the new assets

less the financing by additional capital. The remaining terms are extra deposits needed to finance reserves. Each term is less than the preceding term, as reserves are kept on additional deposits required by reserves. This series may be summed more simply as

$$(2) \quad D = \frac{P\left(1-R_{k}\right)}{1-R_{r}}$$

в.

Calculation of net earnings on new assets

(1)  $E_n = E_g - C_k - C_d$ 

(2) 
$$E_n = r_a P - r_k K - r_d D$$

1-

(3) 
$$E_n = r_a P - r_k R_k P - r_d \left( \frac{P(1-R_k)}{1-R_r} \right)$$

(4) 
$$E_n = P \left[ r_a - r_k R_k - r_d \left( \frac{1 - R_k}{1 - R_r} \right) \right]$$

Assuming a tax rate of 50 percent and deductible deposit interest,  $E_n$  becomes

(5) 
$$E'_{n} = P \left[ r_{a} - 2r_{k}R_{k} - r_{d} \left( \frac{1-R_{k}}{1-R_{r}} \right) \right]$$

C. Calculation of after-tax net earnings on new assets and earning reserves

$$\mathbf{E}_{n}^{"} = \mathbf{P} \left[ \frac{\mathbf{r}_{a} + \mathbf{r}_{r} \mathbf{R}_{r} \mathbf{D} - 2\mathbf{r}_{k} \mathbf{R}_{k} - \mathbf{r}_{d} \left( \frac{1 - \mathbf{R}_{k}}{1 - \mathbf{R}_{r}} \right)}{2} \right]$$

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#### ROBERT H. BETHKE

#### CHAIRMAN OF THE BOARD

DISCOUNT CORPORATION OF NEW YORK

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DISCOUNT CORPORAVION

58 PINE STREET New York, N.Y. 10005

ROBERT H. BETHKE CHAIRMAN OF THE BOARD

August 3, 1979

Mr. Robert H. Knight Shearman & Sterling 53 Wall Street New York, N. Y.

Dear Mr. Knight:

This is to strongly recommend to your "Search Committee" the nomination of Mr. as President of the Federal Reserve Bank of New York.

My reasons for believing in his superior qualifications are based on this Corporation's work with Federal Reserve and Treasury Offices, in our capacity as major dealers in the prime money and bond markets. I have known for almost twenty years, initially through service on several Government Securities Industry Advisory Committees.

Listed below are eight reasons to support my recommendation:

1) He is intellectually brilliant (Harvard Ph.D.) and makes sound judgments.

2) He is well and favorably known to many foreign central bankers, and domestic leaders, dating back to his service as Deputy Under Secretary of The Treasury for Monetary Affairs in 1969-71. He has a significant edge on immediate public recognition and stature, having been a finalist in recent searches for a Board Chairman.

3) He is admired by the Fed's professional staff, Board members, and regional Federal Reserve Bank Presidents---many of whom he worked with during his service as President of the Federal Reserve Bank of Minneapolis.

4) He completely knows the Federal Reserve System. This is not a time when it seems necessary to reach outside. Drawing on proven System talent parallels the naming of Paul Volcker as Chairman of the Board. In both cases, no transition period is involved.

5) He most definitely holds deep anti-inflation views. I would label his philosophical thinking being in the center. It would be a mistake to conclude that his Presidency of The Brookings Institution means he is a liberal. Actually, one of his changes at that Institution has been to bring conservatives to its professional staff.
Mr. Robert H. Knight Shearman & Sterling August 3, 1979

6) In meetings and discussions, he is quite ready to stand-up and firmly speak his mind, talking directly to the point. At the same time, I have observed that when he is negotiating with people, his calm, articulate word choice and manner promotes agreement.

- 2 -

7) I confidently sense that because spent much of his career in the Federal Reserve System, and believes in its work and responsibilities to a free market society, he would accept the position, if asked.

8) In addition to all these points, he is a complete gentleman, supported by an attractive wife and two fine sons.

Sincerely,

In Welsethe

Robert H. Bethke President

RHB:vs

P.S. Implicit in my reasons for recommending is his broad knowledge of both (1) the domestic economy and its markets, and (2) foreign exchange markets.

These dual attributes should be "musts" for a President of the New York Fed.

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Letter to Paul Volcker from Thomas M. Timlen, August 24, 1979.

Federal Reserve Bank of New York. "Legislative Proposals Arising out of Foreign Banking in the United States," August 24, 1979.

https://fraser.sti<del>ouisfed.org</del> Federal Reserve Bank of St. Louis October 3, 1979

Dear Tom:

Thanks for bringing us up to date on the situation with regard to the New York savings banks. I know you will stay on top on developments over the coming months.

Sincerely,

Mr. Thomas M. Timlen First Vice President Federal Reserve Bank of New York New York, New York 10045

PAV/tn #2052

### September 25, 1979

Dear Tom:

I appreciate the letter on membership. My testimony is written, but there is, I hope, still room for negotiation.

Sincerely,

Mr. Thomas M. Timlen First Vice President Federal Reserve Bank of New York New York, New York 10045

PAV:mrk #1993

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Federal Reserve Bank of New York. "Elements of an Alternative Approach to Membership Issue," September 21, 1979.

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To\_\_\_\_\_Mr. Kubarych FROM\_\_\_\_\_\_Balance of Payme DATE August 10, 1979 UBJECT Foreign Lending by U.S. Banks

FEDER

SERVE BANK

Balance of Payments Division

in 1978-79

Cerry

U.S. bank lending abroad continued to expand in 1978, but the pattern of this expansion reflected changing economic conditions in the international marketplace. Spreads on Eurocurrency loans narrowed through the year, squeezing profits on foreign lending (Table 1). Although international earnings of ten of the largest U.S. banks continued to grow, the share of foreign business to total profits declined (Table 2). In 1978 international earnings fell to 45.7 percent of total profits from 50.8 percent in 1977. This is the first decline in that measure in the 1970s. Many U.S. banks resisted doing business at the lower spreads. Although the overall volume of foreign lending by U.S. banks in 1978 was comparable to that of 1977 (Table 4), the pace of foreign lending by U.S. banks was significantly slower than foreign lending by banks of other industrial countries (Table 5). Data so far available for 1979 are less comprehensive than 1978 data. They suggest a slowdown in U.S. bank lending (Tables 6 and 7), but a slight pickup in lending of banks generally (Table 8).

Three measures of U.S. bank lending to foreigners in 1978 are available. Treasury and Federal Reserve foreign branch data indicate outstanding loans of \$266.6 billion at the end of 1978, an increase of \$37.2 billion, or 16 percent during the year. By comparison, loans had increased 15 percent in 1977 and 24 percent in 1976 (Table 4). The country exposure lending survey provides two other measures of U.S. bank lending which show somewhat smaller increases in loans outstanding in 1978. Allocated by the country of residence of the borrower, loans were 12 percent (\$22.8 billion) higher at \$217.3 billion; allocated by the country guaranteeing the loans, they were \$196.4 billion, up 13 percent (\$22.0 billion) (Table 9). The difference between the latter two measures reflects an \$800 million or 4 percent increase in net U.S. guaranteed loans. In contrast to the past few years when domestic lending lagged foreign lending, loans of large banks at least kept pace in 1978, rising 16 percent.

In 1979 U.S. bank lending to foreigners has been sluggish. Loans by U.S. chartered banks and their foreign branches declined \$1.7 billion in the first quarter (Table 4). Head office loans to non-banks (claims on banks are too volatile to show a reliable trend over a short period) of all U.S. banks rose only \$2.7 billion in the first half. Moreover, combining such loans with foreign branch loans to non-banks, the increase through May was \$2.1 billion (Table 7).

#### Bank Safety

Given the concern over the safety of international lending by U.S. banks, it is interesting to look at changes in the structure of banks' portfolios for clues of greater caution on the part of bankers. There may have been some movement in that direction, but the pattern is by no means conclusive.

One measure of restraint in U.S. bank lending is the growth of U.S. bank loans relative to lending by banks of other countries. Viewed in these terms, U.S. banks were very conservative. BIS data for 1978 (Table 5) show that loans of banks of 14 industrial countries to other areas increased 31 percent. On the same geographical basis, loans by U.S. banks were up 13 percent. The BIS total includes a 36 percent rise in loans to developing countries (including oil producers) compared with a 17 percent increase for U.S. banks. Moreover, commitments to lend grew 40 percent in the BIS group compared with a 17 percent overall increase for U.S. banks. Undoubtedly,

2

their willingness to accept a lower spread on loans accounts for the large share of lending taken by foreign banks.

3

Another barometer of bank attitudes is the share of major country groups in bank portfolios. The group with the greatest increase in 1978 was oil exporting countries, reflecting their increased financing needs. The current account surplus of OPEC countries dipped to \$7.5 billion in 1978 from \$29.5 billion in 1977 (Table 10). They now represent 9.2 percent of bank portfolios, compared with 7.6 percent in 1977. However, the offset occurred primarily among the developed countries. Overall, the share of loans to non-oil developing countries was unchanged. This partly reflects the better opportunity for many LDCs to borrow from non-U.S. banks (Table 3). Mexico, for example, reduced its borrowing from U.S. banks, but increased its borrowing from foreign banks. Other LDCs increased their borrowing from U.S. banks, but increased their borrowings from foreign banks much more sharply. Data for 1979 indicate that this trend has not abated.

U.S. bank lending to seven countries (Iran, Turkey, Peru, Portugal, Nicaragua, Jamaica, and Zaire) with actual or potential debt servicing problems shows a conservative stance (Table 3). The total size of such loans outstanding (\$7.3 billion) is small compared with overall lending. Loans to those areas increased roughly \$0.4 billion in 1978, but mainly because of increased lending to Iran. Moreover, data for 1979 (Tables 3 and 4) show declines in lending. By contrast, non-U.S. banks have been very active in lending to five of the seven countries. U.S. bank lending to a broader group of 21 countries involved in IMF stabilization programs is likewise conservative. The 5 percent growth in such loans is less than half the overall rate of growth in lending. Changes in the maturity distribution of loans could also indicate bank attitudes towards risk, but here the result is ambiguous. The proportion of loans with less than one year to maturity (68 percent) increased in 1978 (from 67 percent), but so did loans with over 5 years to maturity (from 6 to 7 percent). On balance, no clear pattern is evident.

By contrast, the type of institution to which U.S. banks lend changed significantly in 1978. The proportion of loans outstanding to both public borrowers and to non-bank borrowers both declined, while loans to banks rose sharply. The increase in loans to banks, \$20.3 billion, accounts for the major share of the total \$22.8 billion in lending. Bank loans now constitute almost 54 percent of banks' portfolios compared with 49 percent at the end of 1977. To the extent that lending to banks is less risky than lending to public borrowers and private borrowers other than banks, U.S. banks portfolios have been upgraded.

One final measure of risk, capital coverage, declined again in 1978. Capital of large banks grew 7.5 percent during the year, about half the rate of increase in loans. In 1976 and 1977 it had grown 3.5 percent and 8.5 percent, respectively.

### U.S. Bank Lending and the Dollar

The quarterly pattern of bank lending suggests some positioning against the dollar by borrowers. The volume of lending was small, \$5.2billion, in the first half of 1978. However, it picked up considerably by year-end-\$17.5 billion in lending occurred in the second half. At the same time, downward pressure on the dollar had intensified. In 1979, the scenario reversed. The dollar recovered during most of the first

4

half. At the same time, lending by U.S. banks has been sluggish as discussed above. The pattern indicates that some leads and lags adverse to the dollar may have been financed by borrowing from banks.

#### Bank Intermediation

BIS data show a \$39.1 billion increase in 1978 in liabilities of the banks in its survey group of 14 industrial countries to other countries. This rise is somewhat more than half the corresponding \$67.9 billion increase in loans. It indicates net funding through banks by the 14 industrial countries of the remainder of the world totaling \$28.8 billion. More generally, however, it is a reminder that international banks are an important vehicle for moving funds internationally. In the current instance, the 14 industrial countries and some of the oil producing countries were net suppliers of funds and LDCs were net borrowers. Industrial countries other than the 14 survey countries were in approximate balance.

#### Conclusions

The data on bank lending during the last year and a half suggest several conclusions. Banks continued to act as intermediaries of funds between the industrial and oil producing countries with payments surpluses, on the one hand, and the LDCs, on the other. In the process, U.S. banks continued to lend to LDCs, but selectively. Lending to identifiably risky areas was restrained. And much of U.S. bank lending was to other banks rather than public or other private borrowers. Finally, with respect to the dollar, the timing of U.S. bank lending suggests that some funding of payments leads and lags adverse to the dollar may have occurred.

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### Spread on Eurodollar Loans to Public Borrowers (percent)

	U.K	France	Mexico
1070	-	4	
19/3	1	*	0.75
	11	0.50	0.75
	III	0.50	0.65
	IV	0.50	0.58
1974	I	0.65	0.69
	II	0.58	0.71
	III	0.69	0.96
	IV	0.94	1.22
1975	I	1.75	1.50
	II	1.25	1.50
	III	*	1.50
	IV	*	1.43
1976	т	*	1 38
	TT	1 25	1.50
	TTT	*	1.50
	TV	1 25	1.50
	IV	1.23	1.00
1977	I	0.96	1.59
	II	0.92	1.59
	III	*	1.63
	IV	0.63	1.75
1978	I	0.66	1.19
	II	*	1.02
	III	0.59	0.99
	TV	0.50	0.82
			0.02

\*Denotes no new credits during the period. Source: Borrowing in International Capital Markets, IBRD.

### International Earnings: 1970-1978 (millions of dollars)

Years	International Earnings*	Percent of Total Earnings*
1978	1,043	45.7
1977	913	50.8
1976	834	50.9
1975	818	51.5
1974`	612	41.4

\* Based on earnings of 10 major banks.

Source: "U.S. multinational banking: semi-annual statistics" Salomon Brothers, 1979.

Note: Somewhat different data for 1970-1975 was previously published by Salomon Brothers. It is based on prior reports of earnings of 13 major banks.

Years	International Earnings	Percent of Total Earnings
1975	835.9	47.7
1974	616.3	37.8
1973	477.5	34.2
1972	337.0	28.2
1971	245.3	22.1
1970	177.3	16.7

Source: T. Hanley "United States multinational banking: current and prospective strategies" Salomon Brothers, 1976.

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#### Table 3

#### Bank Loans to Selected Countries (billions of dollars)

							U.S. Bank					
			U.S. Bank	ts by Gu	arantor		(Head Offic	:e)			Syndic	cated
							Lending to	Bank	ts of Four	teen	Eurocur	rency
		Loans	3	Cont	ingency	Claims	Non-Banks	Indust	rial Cour	itries	Credi	Lts
	19/1		/8	19/1	19	18	1979	19/1	19/	Dee	197	1.1.1.
	Dec.	June	Dec.	Dec.	June	Dec.	IH	Dec.	June	Dec.	IH	July
Top Ten Developing												
Countries:												
Brazil	11.7	11.8	12.9	1.3	1.9	2.1	0.2	25.0	27.6	31.7	3.1	0.1
Mexico	10.9	10.4	10.3	1.5	2.1	2.0	0.6	20.3	21.0	23.3	4.3	0.9
Venezuela	5.2	5.8	7.3	1.4	2.3	2.6	0.5	9.1	11.4	14.0	2.4	1.3
South Korea	3.3	3.1	3.9	1.4	1.2	1.8	0.2	5.2	6.1	6.9	1.6	0.0
Taiwan	2.7	2.6	3.2	1.3	1.4	1.6	0.2	2.7	3.5	3.7	0.7	0.1
Philippines	2.0	2.4	2.6	1.2	1.5	1.6	-0.1	3.4	4.3	4.2	0.8	0.3
Argentina	2.4	2.6	2.7	0.5	0.7	0.9	0.5	4.9	6.1	6.7	1.6	0.0
Iran	2.3	2.5	2.8	1.2	1.1	0.7	-0.1	6.4	7.2	8.9	0.0	0.0
Hong Kong	1.3	1.4	1.9	0.4	0.6	0.7	0.3	n.a.	10.4	10.2	n.a.	n.a.
Indonesia	1.9	2.0	2.0	0.6	0.7	0.6	0.0	5.0	5.4	5.8	0.6	0.4
Problem Areas:												-
Iran	2.3	2.5	2.8	1.2	1.1	0.7	-0.1	6.4	7.2	8.9	0.0	0.0
Turkey	1.4	1.5	1.5	0.2	0.2	0.4	-0.1	3.1	3.6	3.8	n.a.	n.a.
Peru	1.8	1.6	1.5	0.3	0.1	0.2	-0.1	3.4	3.5	3.6	0.1	0.4
Portugal	0.6	0.6	0.6	0.3	0.3	0.4	0.0	1.7	2.3	3.1	n.a.	n.a.
Nicaragua	0.5	0.5	0.6	0.1	0.1	0.1	0.0	0.8	0.8	0.8	n.a.	n.a.
Jamaica	0.2	0.3	0.2	0.0	0.1	0.1	0.0	0.6	0.6	0.5	n.a.	n.a.
Zaire	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.6	1.2	1.3	n.a.	n.a.

Sources: Country Exposure Lending Survey; Treasury International Capital Flows form BC; Bank for International Settlements; World Financial Markets, Morgan Guaranty.

#### CLAIMS ON FOREIGN COUNTRIES Held by U.S. Offices and Foreign Branches of U.S.-Chartered Banks<sup>4</sup> Billions of dollars, end of period

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1075	1076	1977 1978				1979				
1915	1970	Mar.	June	Sept.	Dec.	Mar.	June <sup>2</sup>	Sept.	Dec.	Mar.
167.0 88.0 5.3 8.5 7.8 5.2 2.8 1.0 2.4 36.3 3.8 14.9	207.7 100.1 6.1 10.0 8.7 5.8 2.8 1.2 3.0 41.5 5.1 15.9	206.7 99.7 6.4 10.2 7.8 6.0 2.6 1.4 2.5 40.4 6.1 16.4	217.8 104.1 6.3 10.6 8.2 6.4 3.1 1.7 3.0 41.4 6.4 17.0	226.7 108.8 7.1 10.5 8.6 6.0 3.0 1.9 3.3 44.1 6.6 17.6	239.4 115.3 8.4 11.0 9.6 6.5 3.5 1.9 3.3 46.5 5.8 18.8	247.2 116.6 8.3 11.4 9.0 6.0 3.4 2.0 4.0 46.5 6.9 19.1	246.0 112.8 8.3 .11.4 9.1 6.4 3.4 2.1 4.1 45.0 5.1 17.9	247.3 113.9 8.4 11.7 9.7 6.0 3.5 2.2 4.3 44.4 4.9 18.8	266.6 125.3 9.0 12.4 11.4 6.6 4.4 2.1 5.4 47.2 5.9 20.9	264.9 119.2 9.4 11.7 10.7 5.7 3.8 2.0 4.5 46.4 5.8 19.2
10.7 .6 .9 1.4 1.4 .3 1.9 .6 1.2 1.3	15.1 1.2 1.0 1.1 1.7 1.5 .4 2.8 1.3 .7 2.2 1.2	16.3 1.2 1.2 1.1 1.7 1.7 5 3.0 1.4 .8 2.3 1.4	16.9 1.2 1.4 1.1 1.8 1.7 .5 3.2 1.4 .8 2.3 1.5	18.1 1.3 1.5 1.2 2.0 1.8 3.5 1.4 1.2 2.3 1.5	18.6 1.3 1.6 1.2 2.2 1.9 .6 3.6 1.5 .9 2.4 1.4	20.5 1.5 1.6 1.2 2.7 1.9 .7 3.6 1.5 1.4 2.5 1.9	19.3 1.5 1.7 1.1 2.3 2.1 .6 3.6 1.4 1.2 2.4 1.4	18.7 1.5 1.9 1.0 2.2 2.1 .5 3.5 1.5 1.0 2.2 1.3	19.2 1.7 2.0 1.2 2.3 2.1 .6 3.4 1.5 1.0 2.0 1.4	18.2 1.7 2.0 1.1 2.3 2.1 .6 3.0 1.4 1.0 1.7 1.3
6.9 .4 2.3 1.6 1.6 1.0	12.6 .7 4.1 2.2 4.2 1.4	13.3 .8 3.9 2.3 5.0 1.3	15.0 .9 4.6 2.2 5.5 1.8	16.5 1.1 5.1 2.2 6.3 1.9	17.6 1.1 5.5 2.2 6.9 1.9	19.2 1.3 5.5 2.1 8.3 2.0	19.1 1.4 5.6 1.9 8.3 1.9	20.4 1.6 6.2 1.9 8.7 2.0	22.8 1.6 7.2 2.0 9.5 2.5	22.7 1.5 7.2 1.9 9.5 2.6
34.2 1.7 8.0 1.2 9.0 1.4 2.6 .9 2.4 3 1.7 1.7 .7 .6 .4 .3 .5 .5 .5 .5 .5 .5 .5 .5 .5 .5	43.1 1.9 11.1 .8 1.3 11.7 .2 .2 .3 .7 .4 .4 .2 .6	44.0 2.0 11.5 7 1.2 11.8 3.2 2.4 2.3 2.4 .8 3.2 2.4 .2 .3 1.0	45.8 2.1 11.8 7 1.2 2.0 2.4 2.3 2.7 8 3.4 .4 .3 1.0	47.6 2.4 11.8 1.2 12.6 1.9 2.5 .3 3.6 .7 3.6 .7 2.4 2.9 .9 .4 .4 .3 1.2	50.0 2.9 12.7 .9 1.3 11.9 2.7 .3 3.9 .7 5 3.1 1.7 .3 .3 1.2	49.9 3.0 13.0 1.1 1.3 11.2 1.7 3.5 3.7 .6 3.1 1.1 4 .3 4 .3 1.4	48.9 3.0 13.3 1.3 1.3 1.0 1.8 3.3 .2 .7 3.6 .6 .27 2.5 1.1 .3 .3 .2 1.2	49.5 2.9 14.0 1.3 10.7 1.8 3.4 .3 .7 .7 .5 .6 2.8 2.4 1.1 .3 .4 .5 .2 1.3	52.7 3.0 14.9 1.4 10.8 1.7 3.8 .2 1.0 3.9 .6 2.8 2.9 1.2 .3 .4 .6 1.4 1.4 1.4 1.4 1.4 1.4 1.4 1.4	53.1 2.9 14.6 1.7 1.5 10.9 4.2 .6 3.5 2 1.0 4.2 .6 3.1 1.2 3.1 1.2 3.1 1.2 3.1 1.2 3.1
3.7 1.0 .6 2.1	5.2 1.5 .8 2.8	5.1 1.5 .9 2.8	5.5 1.5 .9 3.1	5.5 1.5 1.0 3.0	6.5 1.6 1.1 3.8	6.3 1.4 1.2 3.7	6.4 1.4 1.3 3.7	6.6 1.4 1.3	6.9 1.3 1.5	6.7 1.1 1.6
19.4 7.3 .5 2.5 .6 2.6 .2 1.6 3.8 .1 4.1	26.2 11.8 .5 3.8 .6 2.7 .1 2.3 4.4 	22.7 8.2 3.7 .6 2.9 .2 2.6 3.9 5.6	25.4 9.5 .5 4.8 .5 2.9 .2 2.8 4.2 5.1	25.3 9.9 .5 4.3 .6 2.8 .1 3.1 3.9 .1 5.0	26.1 9.8 .6 3.8 .7 3.1 .2 3.7 3.7 3.7 .5 5.3	29.0 11.3 .6 4.5 .7 3.2 .2 4.0 4.0 .5 5.7	31.4 11.8 .7 6.3 .6 3.2 .1 4.1 3.8 .8 8.1	29.6 11.3 .7 6.2 .6 3.0 .1 4.0 2.9 .8 8.6	30.6 10.4 .7 6.9 .8 2.6 .1 4.3 3.9 .9	35.4 14.1 .6 7.2 .7 3.2 .1 4.6 4.0 .9
	$\begin{array}{c} 1975 \\ \hline 167.0 \\ 88.0 \\ 5.3 \\ 8.5 \\ 7.2 \\ 2.8 \\ 1.4 \\ 1.4 \\ 3.3 \\ 8 \\ 14.9 \\ 10.7 \\ .6 \\ 1.2 \\ 1.3 \\ 1.9 \\ .6 \\ 1.2 \\ 1.4 \\ 1$	$\begin{array}{c ccccccccccccccccccccccccccccccccccc$	$\begin{array}{c c c c c c c c c c c c c c c c c c c $	$\begin{array}{c c c c c c c c c c c c c c c c c c c $	$\begin{array}{c c c c c c c c c c c c c c c c c c c $	$\begin{array}{ c c c c c c c c c c c c c c c c c c c$	$\begin{array}{ c c c c c c c c c c c c c c c c c c c$	$\begin{array}{ c c c c c c c c c c c c c c c c c c c$	$\begin{array}{ c c c c c c c c c c c c c c c c c c c$	$\begin{array}{ c c c c c c c c c c c c c c c c c c c$

<sup>1</sup> The banking offices covered by these data are the U.S. offices and foreign branches of U.S.-owned banks and of U.S. subsidiaries of foreign-owned banks. Offices not covered include 1) U.S. agencies and branches of foreign banks, and 2) foreign subsidiaries of U.S. banks. To minimize duplication, the data are adjusted to exclude the claums on foreign branches held by a U.S. office or another foreign branch of the same banking institution. The data in this table combine foreign branch claims in table 3.13 (the sum of lines 7 through 10) with the claims of U.S. offices in table 3.17 (excluding those held by agencies and branches of foreign banks and those constituting claims on own foreign branches). However, see also footnote 2.

<sup>2</sup> For June 1978 and subsequent dates, the claims of the U.S. offices in this table include only banks' own claims payable in dollars. For earlier dates the claims of the U.S. offices also include customer claims and foreign currency claims (amounting in June 1978 to \$10 billion).
 <sup>3</sup> Includes Algeria, Bahrain, Gabon, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qutar, Saudi Arabia, and United Arab Emirates in addition to countries shown individually.
 <sup>4</sup> Foreign branch claims only through December 1976.
 <sup>5</sup> Excludes Liberia.
 <sup>6</sup> Includes New Zealand, Liberia, and international and regional organizations.

#### Table 5

### External Positions of Commercial Banks of Fourteen Countries 1/ and Certain of their Foreign Affiliates (billions of dollars)

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		Assets		Undisbursed Credit Commitments				
	December 1977	<u>June</u> 1978	December 1978	December 1977	<u>June</u> 1978	December 1978		
Developed Countries	52.7	58.1	63.2	13.6	14.4	16.9		
Eastern Europe	36.6	42.5	47.6	9.6	10,1	12,1		
Latin America	74.5	83.4	94.9	15.1	20.6	24.8		
Middle East	18.1	21.9	27.4	8.4	10.0	9.6		
Other Africa	12.5	18.4	22.7	5.4	6.8	8.1		
Other Asia	22.6	26.8	29.2	9.0	10.7	14.0		
Total	217.0	251.2	284.9	61.2	72.5	85.6		
			See table?					

I/ Group of Ten countries, Switzerland, Austria, Denmark, and Ireland. Source: Bank for International Settlements.

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# Table 6

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### U.S. Bank Claims on Non-Bank Foreigners (changes during the period; billions of dollars)

	1		1979				
	IIIQ	IVQ	IQ	IIQ	April	May	June
Developed Countries G-10 and Switzerland Other	1.5 1.4 0.1	2.1 2.0 0.1	-0.3 -0.1	0.2	-0.5	0.2	0.5
Eastern Europe	0.0	0.0	0.0	0.1	0.2	-0.3	0.0
Oil Exporting Countries	0.5	0.3	0.4	0.1	0.5	-0.4	-0.1
Non-Oil Developing Countries Latin America Asia Africa	0.4 0.7 -0.3	2.2 1.8 0.3	0.7 0.6 0.1	1.2 1.0 0.3	0.2 0.3 0.0	0.7 0.6 0.1	0.2 0.1 0.1
Offshore Banking Centers	0.2	0.1	0.0	0.0	-0.1	0.0	0.0
International and Regional Organizations	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
Total .	2.6	4.7	0.9	1.8	0.2	0.7	0.9

Source: Treasury International Capital Flow data

		·	4 · · · · · · · · · · · · · · · · · · ·		
o amtelD	n Foreioner	s of U.S. Bank	s and thei	r Foreign Br	anches
Ulality U	I TOLLIGHEI	billions of de	ollars)		
	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>May 1979</u>	June 1979
		Branch Claim	15		
On Unrelated Banks	83.8	91.9	103.1	103.0	n.a.
On Public Borrowers	10.6	14.6	23.7	24.7	n.a.
On Others	64.2	76.6	80.9	80.3	n.a.
Total	158.5	183.2	207.8	208.0	n.a.
		Head Office C	laime		
		neau onne u			
On Unrelated Banks	n.a.	n.a.	40.4	35.5	41.4
On Public Borrowers	n.a.	n.a.	10.1	10.5	11.1
On Others	n.a.	n.a.	23.3	24.7	25.1
Total	n.a.	n.a.	73.8	70.8	77.6
		Total Claim	IS		
On Unrelated Banks	n.a.	n.a.	143.5	138.5	n.a.
On Public Borrowers	n.a.	n.a.	33.8	35.2	n.a.
On Others	n.a.	n.a.	104.3	105.0	n.a.
Total	n.a.	n.a.	281.6	278.9	n.a.
				1	
			00-10	5	
			J. We	<sup>D</sup>	

Table 7

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Sources: Federal Reserve 2502; Treasury Foreign Capital form BC

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### Table 8

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#### Eurocurrency Bank Credits (billions of dollars)

				19	79
	1976	1977	1978	IH	July
Industrial Countries	11.3	17.2	29.0	10.4	1.6
OPEC Countries	4.0	7.5	10.4	5.6	2.1
Non-OPEC Developing Countries.	11.0	13.5	26.9	15.8	3.1
Communist Countries	2.5	3.4	3.8	5.4	0.3
International Organizations	0.1	0.2	0.2	0.1	0.0
Total	28.9	41.8	70.2	37.4	7.0

Source: World Financial Markets, Morgan Guaranty

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		By Residence			By Guarantor		
	12/77	6/78	12/78	. 12/77	6/78	12/78	
Developed Countries G-10 and Switzerland Other	102.3 83.6 18.6	102.5 83.1 19.4	111.4 92.0 19.4	100.2 81.0 19.2	99.7 80.0 19.6	· 111.2 91.0 20.2	
Eastern Europe	6.8	7.0	7.2	7.0	7.0	7.3	
Oil Exporting Countries	14.7	16.5	20.0	14.2	15.9	19.4	
Non-Oil Developing Countries Latin America Asia Africa	46.9 33.5 11.0 2.4	48.7 34.6 11.5 2.6	52.2 35.5 13.7 2.9	45.0 31.9 11.0 2.2	46.1 32.2 11.5 2.3	50.4 33.8 13.9 2.6	
Offshore Banking Centers	23.6	24.7	26.0	7.8	6.1	7.8	
International and Regional Organizations	0.2	0.4	0.4	0.3	0.5	0.4	
Total	194.6	199.8	217.3	174.4	175.3	196.4	

Cross-Border and Non-Local Currency Claims of U.S. Banks on Foreigners

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(billions of dollars)

Table 9

Source: Federal Reserve Country Exposure Lending Survey

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	and the second second	By Residence		By Guarantor				
	12/77	6/78	12/78	12/77	6/78	. 12/78		
Developed Countries	27.1	25.9	28.9	26.7	26.3	29.5		
G-10 and Switzerland	20.7	19.8	22.1	20.5	20.5	22.0		
Other	6.4	6.1	6.9	6.2	5.8	6.6		
Eastern Europe	1.6	2.1	2.4	1.4	1.7	1.8		
Oil Exporting Countries	6.6	7.9	7.5	. 6.4	7.7	7.3		
Non-Oil Developing Countries	13.5	15.9	17.6	12.7	14.9	16.7		
Latin America	6.1	7.6	8.5	5.7	7.2	8 1		
Asia	5.8	6.4	7.1	5.5	6.0	6.0		
Africa	1.5	1.9	1.9	1.5	1.7	1.6		
Offshore Banking Centers	2.5	2.9	3.6	1.8	2.0	2.5		
International and Regional								
Organizations	0.0	0.0	0.1	0.1	0.1	. 0.2		
Total	51.3	54.7	60.0	49.1	52.7	57.9		
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Cross-Border and Non-Local Currency Contingency Claims of U.S. Banks on Foreigners (billions of dollars)

Table 9-a

Source: Federal Reserve Country Exposure Lending Survey

Table 10	T	ab	1e	10
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	1/			
OPEC	Balance	of	Payment	в 1973-1980
(1)	n billio	ns	of U.S.	dollars)

								1980 <sup>p</sup>		
	1973	1974	<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u> e	<u>1979</u> p	Constant Real Price	Constant Nominal Price	
Merchandise Trade	18.7	82.1	53.4	65.5	61.9	43.4	<u>90</u>	<u>99</u>	. <u>88</u>	
Exports (fob)	38.9	117.9	109.6	133.3	146.3	141.0	197	235	224	
Oil Sector 2/ Non-Oil Sector	34.7	112.0 5.9	103.6	126.0 7.3	137.1 9.2	130.6 10.4	186 11	223 12	. 12	
Imports (fob)	-20.2	-35.8	-56.2	-67.8	-84.4	-97.6	-107	-136	-136	
Services and Private Transfers (Net)	-12.2	-14.3	-18.4	-25.1	- <u>30.1</u>	- <u>33.9</u>	- <u>38</u>	- <u>51</u>	- <u>51</u>	
Payments	-16.5	-23.1	-30.5	-39.6	-48.0	-55.2	-61	-78	-78	
Receipts	4.3	8.8	. 12.1	14.5	17.9	21.3	23	27	27	
Official Transfers	-1.3	-2.5	-3.0	-2.5	-2.3	-2.0	-2.0	-2.0	-2.0	
Current Account Balance	5.2	65.3	32	37.9	29.5	7.5	50.0	46.0	.35.0	

1/ OPEC members are Saudi Arabia, Kuwait, United Arab Emirates, Iraq, Iran, Libya, Algeria, Venezuela, Nigeria, Indonesia, Qatar, Ecuador and Gabon. The balance of payments for 1973-1976 is an IMF series that omits Ecuador and Gabon and includes Oman and Bahrain, non-OPEC producers.

2/ The oil sector includes exports of crude oil, refined petroleum products and natural gas.

e - estimates

p - projections

Q: Why do the figures from Treasury - Federal Reserve (TFR) series on U.S. banking system claims on foreigners differ from those in the Country Exposure Lending Survey (CELS)?

A: In general claims figures on the CELS basis are lower than on the TFR basis. Two factors work in the opposite direction--to make the CELS numbers larger:

- the CELS covers overseas subsidiaries of U.S. banks, not just their overseas branches;
- 2) the CELS also includes some holdings of long-term securities issued to foreigners, which are excluded from the Treasury claims data.

But these factors are more than offset by a major difference in coverage: the CELS counts only cross-border and cross-currency claims on foreigners. For example, cruzeiro - denominated claims of U.S. bank branches located in Brazil on Brazilians are not counted in the CELS.

Also, prior to the second quarter of 1978, Treasury data on bank claims included customer claims on foreigners.

	Non-Oil Developing Countries Current Account 1/ (Billions of Dollars)									
	<u>1973</u>	1974	1975	1976	1977	<u>1978</u> e	<u>1979</u> <sup>p</sup> <u>2</u> /	<u>1980</u> <u>3</u> /		
Exports (f.o.b.)	65	94	92	113	134	152	174	197 .		
Imports (f.o.b.)	72	-116	-121	-128	-147	-175	-208	-241		
Trade Balance	-7	-22	-29	-16	-12	-23	-34	-44		
Net Services and Private Transfers	-5	-8	-10	-10	-9	-9	-13	_14		
Balance on Goods, Services and Private										
Transfers	-11	-31	-38	-26	-21	-32	-47	-58		
Net Official Transfers	5	8	8	7	8	9	10	11		
Current Account Balance	-6	-23	-30	-19	-13	-23	-37	-47		

Table 1

1/ Includes those countries classified by the IMF as non-oil developing countries.

- 2/ Assumes : 1) growth in export volume and price equals 6.5% and 7.5% respectively.
  2) growth in import volume and price equals 6.0% and 12.0% respectively.
- 3/ Assumes: 1) growth in export and import prices equals 10% (real price of oil constant).
  2) growth in export and import volume equal 3% and 5% respectively.
- e- estimated p- projected

-23-

Table 2

# Financing Non-Oil Developing Countries' Current Account Deficits (Billions of Dollars)

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	1973	1974	1975	1976	1977	<u>1978</u> <sup>e</sup>	<u>1979</u> <sup>p</sup>	1980 <sup>p</sup>
Current Account	-6	-23	-30	-19	-13	-23	-37	-47
Direct Investment	4	5	5	5	5	6	6	7
SDR Allocation	-	-	-		10	12	1	1 L
Change in Reserves 1/	-/	-3	-1	-11	-12	-13	-2	U
E Borrowing	9	21	26	25	20	30	32	39
Long-Term Publicly and Publicly Guaranteed	10	14	20	22	27	34	34	37
Official Sources	5	7	11	9	11	12	13	14
Financial Institutions	4	6	8	11	12	17	15	16
Other 2/	1	1	1	2	4	5	6	7
Private Non Guaranteed and Short-Term	-1	6	4	0	-7	-4	-3	0 -2
Reserve Borrowing	0	1	2	· 3	0	0	1	2 1
Memorandum Items								
Total Public and Publicly Guaranteed								
External Debt	80	94	117	144	181	221	251	289
Ratio to mercahndise exports	1.23	1.00	1.26	1.27	1.35	1.45	1.44	1.47
Ratio of Current Account to merchandise exports	.09	.24	.32	.17	.10	.15	.21	.23
Change in BIS Banks' Claims on Non-oil Developing Countries					17.8	24.7	n.a.	n.a.
Change in BIS Banks' Liabilities to Non- oil Developing Countries					12.2	16.0	n.a.	n.a.
Net Change					5.6	8.7	n.a.	n.a.
1/ Minus sign indicates increase. 2/ Includes Suppliers Credits and Bond Issues. e- estimated								

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## **Citation Information**

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Citations: Letter to Paul Volcker from Thomas M. Timlen, September 17, 1979.

Memo to Thomas C. Sloane from Tompkins County Trust Company, "Withdrawal From Federal Reserve Membership," August 20, 1979.

https://fraser.sti<del>ouisfed.org</del> Federal Reserve Bank of St. Louis

#### TOMPKINS COUNTY TRUST COMPANY Ithaca, New York

#### CERTIFIED COPY OF RESOLUTION

At a Regular Meeting of the Board of Directors of the Tompkins County Trust Company of Ithaca, New York, held on the 14th day of August, 1979, at which meeting at least a majority of the Board was present, it was on motion duly made and carried,

- RESOLVED: In accordance with the requirements of the Federal Reserve Bank Regulation H, Sections 208.10 and 208.11, the Tompkins County Trust Company, Tompkins County, Ithaca, New York, voluntarily withdraw from membership in the Federal Reserve System, and be it further
- RESOLVED: That Raymond Van Houtte, President and Chief Executive Officer, and Paul R. Sandefur, Senior Vice President and Treasurer, are authorized to:
  - (a) File such notice;
  - Surrender for cancellation Federal Reserve Bank stock held by the Tompkins County Trust Company;
  - (c) Receive and receipt for any monies due to the Tompkins County Trust Company from the Federal Reserve Bank; and
  - (d) Do such other things as may be necessary to effect the orderly withdrawal of the Tompkins County Trust Company from membership in the Federal Reserve System.

I, Thomas J. Smith, certify that I am Secretary of the Tompkins County Trust Company, that the foregoing is a true copy of a resolution passed at a Regular Meeting of Directors held as aforesaid at which more than a

quorum was present.





TOMPKINS COUNTY TRUST COMPANY 110 NORTH TIOGA STREET ITHACA, NEW YORK 14850 (607) 273-3210

.....

RAYMOND VAN HOUTTE President

August 20, 1979

Federal Deposit Insurance Corporation 345 Park Avenue, 21st Floor New York, New York 10022

ATTENTION: Mr. Bernard J. McKeon Regional Director

RE: Withdrawal From Federal Reserve Membership

Gentlemen:

Enclosed is certified copy of resolution adopted by our Board of Directors at its Regular Meeting held on August 14, 1979. Also enclosed is copy of our letter officially notifying the Federal Reserve Bank of our intention to withdraw as a member bank.

We understand that such notices are subject to a six-month period in accordance with the provisions of Regulation H, although optional on the part of the Federal Reserve System.

As a State-chartered banking institution, we recognize that, once our withdrawal becomes effective, we would become subject to examination by the Federal Deposit Insurance Corporation.

Please advise if your office requires any additional data or information with respect to our anticipated withdrawal from the jurisdiction of the Federal Reserve System.

Sincerely, aymond Van Houth

RAYMOND VAN HOUTTE President and Chief Executive Officer

RVH:db Enclosures cc: Federal Reserve Bank of New York; Superintendent of Banks, State of New York. September 12, 1979

Dear Tom:

Thanks so much for the paper on "Financing LDC Deficits." The material is both timely and useful.

To keep the record intact, I didn't think (or intend) the picture to be particularly friendly.

Sincerely,

Paul A. Volcker

Mr. Thomas M. Timlen First Vice President Federal Reserve Bank of New York New York, New York 10045

EGC:slw #1884

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## **Citation Information**

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Citations: Letter to Paul Volcker from Thomas M. Timlen, September 6, 1979.

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Mr. Timlen

1 .-

TO



### OFFICE CORRESPONDENCE

DATE September 5, 1979

SUBJECT Financing non-OPEC

LDC deficits.

FROM R. M. Kubarych (1111)

Following up on Mr. Volcker's request, we have analyzed the balance of payments outlook for the non-OPEC less-developed countries (LDCs), in the wake of the latest round of oil price increases. We have also made projections of the potential roles of private and official sources of funds in financing the deficits.

This exercise is in the spirit of a rough simulation, rather than a detailed forecast. We have tried to keep the projections internally consistent. But we do not claim to be able to predict with any certainty the behavior of the various classes of lenders.

The principal conclusion is worrying: most of the increases in non-OPEC LDC deficits may be borne by the relatively poorer LDCs which have only recently begun to borrow significant amounts from commercial banks. We wonder how prepared or willing international banks would or should be to expand rapidly their lending to those countries. In short, our scenarios may involve a considerable increase in country risk for the banks.

The projections were based on aggregate statistical relationships for the non-OPEC LDCs. Then, our economists looked closely at each of seven countries which have been among the major borrowers from commercial banks to assess the outlook for each individually. The projections for the other non-OPEC LDCs were derived simply by subtracting the projections for the seven major borrowers from the aggregate amounts.

What turned out to be a major effort in the Developing Economies Division was directed by Bill Gasser, and key contributions were made by Phil Bates, Zdenek Cernohous, Rosalyn Clark, Bob Feldman, Frank Fernandez, Diane Gropper, and Krishan Saini. I drafted the text.

1. \*

RMK:ar

Attachment

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## **Citation Information**

Document Type: Internal research Number of Pages Removed: 24

Citations: Strictly Confidential (F.R.) - Memorandum, "Financing LDC Deficits," September 5, 1979.

## Federal Reserve Bank of St. Louis

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Digitized for FRASER https://fraser.sti<del>ouisfed.org</del> Federal Reserve Bank of St. Louis August 30, 1979

Mr. Thomas M. Timlen First Vice President Federal Reserve Bank of New York 33 Liberty Street New York, New York 10045

Dear Tom:

I appreciate the package of material on interstate banking. A lot of effort and thinking have obviously gone into the project and I am sure it will be useful here and elsewhere in the government.

Many thanks,

Paul A. Volcker

EGC :mhw

August 31, 1979

The Honorable Robert Carswell Deputy Secretary Department of the Treasury Washington, D. C. 20220

Dear Bob:

As I mentioned to you at lunch on Wednesday, the New York Bank has done a "think piece" on interstate banking which is enclosed. I think your staff will find it useful in formulating viewpoints and positions on this issue.

Sincerely,

Paul A. Volcker

Enclosure

EGC :mhw

August 31, 1979

Mr. Orrin Kramer The White House Washington, D. C. 20500

Dear Orrin:

As I mentioned to you on Monday, the New York Fed has completed a "think piece" on interstate banking which I am enclosing. The papers should be viewed as working documents -- only one "early" input into any Federal Reserve consideration. However, I am sure they will be useful in formulating viewpoints and positions on this issue.

Sincerely,

Paul A. Volcker

Enclosure

EGG:slw

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Citations: Letter to Paul Volcker from Thomas M. Timlen, August 22, 1979.

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