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U.S. DEPARTMENT OF THE TREASURY

PRESS RELEASES

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the Morning Session of
the Interim Committee
of the International Monetary Fund
Washington, D.C.
September 24, 1989

The World Economic Outlook and International Policy Coordination, the Access Limits for 1990 and SDR Allocations

The World Economic Outlook and Policy Coordination

As we approach the end of the decade of the 1980s, we can take satisfaction in the record we have established of sustained economic growth, while reducing inflation. This augurs well for continued prosperity in the 1990s.

The economic policy coordination process has contributed importantly to this record. It has provided the framework for promoting policies that achieve sound economic fundamentals. The world economy is now in its seventh year of expansion. World inflation, the scourge of the previous decade, has been brought down. There has been rapid growth of world trade, while high interest rates early in the decade have come down. And external imbalances have been reduced substantially in recent years.

This performance has been achieved through policies that have reined in public spending, reformed our tax systems, removed excessive regulation of economic activities and liberalized our financial markets. The result has been an increase in efficiency and competition. We have also embarked on a new chapter of trade liberalization in the Uruguay Round. This favorable world economic environment has created a climate which has benefited the developing countries.

But we cannot afford to rest on our laurels. Our coordination efforts must continue and must be strengthened to deal with remaining problems.

In the United States, we are continuing to reduce the federal budget deficit. The deficit in fiscal year 1990 should amount to 2 percent of GNP for the federal government, in contrast with a peak of over 6 percent in the early 1980s.

Both the Executive Branch and the Congress are continuing to work to reduce the fiscal year 1990 deficit to the Gramm-Rudman-Hollings ceiling. We fully expect to succeed. However, a reduction in the U.S. fiscal deficit alone will not be enough to reduce our dependence on foreign savings to an appropriate level. The Administration is now studying the broader question of overall national savings in this country to determine ways in which to strengthen our overall saving and investment performance.

The United States cannot solve the world's problems alone. We cannot reduce our external deficit unless surpluses elsewhere decline. The surplus countries must also implement policies to sustain domestic growth and open their economies.

The rise in recent months of the dollar is inconsistent with longer run fundamentals. The Group of Seven have agreed that a further rise above current levels or an excessive decline could adversely affect prospects for the world economy. Therefore, we are agreed that we will cooperate closely in exchange markets.

Access Limits for 1990 and SDR Allocations

Let me turn briefly to the access limits for 1990 and the question of an SDR allocation.

We are prepared to extend temporarily the enlarged access policies at the current limits, pending decisions on the Ninth General Review of Quotas. We continue to believe, however, that the enlarged access policies are temporary and should be phased out over time.

Finally, with respect to an SDR allocation, the United States continues to have reservations as to whether the criteria specified in the IMF Articles of Agreement -- particularly the long-term global need to supplement existing reserve assets -- are now being met. The question of an SDR allocation, however, merits our continued consideration. In particular, we should continue to study carefully the costs and benefits of various proposals to allocate SDRs.

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TEXT AS PREPARED

Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the Interim Committee
of the International Monetary Fund
Washington, D.C.
September 24, 1989

The Ninth General Review of Quotas

The United States strongly supports the IMF and the central role it plays in the world economy and the international monetary system. We recognize that the Fund must have adequate resources to fulfill these responsibilities and to continue to provide its strong leadership in the strengthened debt strategy. We will work cooperatively with you in the hope of reaching a decision on the quota issue by the end of this year. At the same time, however, we need to recognize that considerable differences of view remain and that difficult issues still must be resolved.

The United States has considered carefully the arguments that have been made to support an increase in IMF quotas. The Fund must be in a position to fulfill its role in the strengthened debt strategy. And, we must not forget that the Fund's resources represent claims of the creditors which must remain liquid. In addition, some have argued that the IMF must grow along with the world economy in order to ensure that it has adequate resources and flexibility to respond to uncertainties in the global economic environment. The case has also been made that a large quota increase is needed to maintain members' access to IMF financing, while reducing reliance on borrowing.

While many of the arguments that have been advanced to support a quota increase have merit, there are also mitigating considerations. Importantly, we must remember that it is our taxpayers who are being asked to provide these resources. It is they who must be convinced that there is a pressing need for additional funds and that the money will be used efficiently and effectively.

In addition, the IMF currently has available a significant amount of loanable resources to meet current and prospective financing needs. The traditional measures of financial strength and liquidity are also at a comfortable level. The United States recognizes that the IMF's financial

position can change quickly and that the IMF's unique monetary character requires that it have more liquid resources relative to potential claims than other international financial institutions. Nevertheless, a fully persuasive case has not been made that there is a pressing need for additional resources at this time.

In addition, as I stated last September and again in April, a decision on quotas must be based on an agreed vision of the role of the Fund in the 1990s and on fundamental progress being made in resolving the arrears problem in order to strengthen the revolving, monetary character of the institution.

The Fund's efforts to implement the strengthened debt strategy, which have been most encouraging, represent an important step forward in achieving this agreed vision of the Fund's role in the 1990s. Progress has also been made in developing a process for addressing arrears and we commend the Fund for what it has accomplished in dealing with this difficult problem. There is also broad agreement that the preservation of the Fund's monetary character and the revolving nature of its resources are an essential basis for its future role.

At the same time, we believe that further progress should be made in clarifying the role of the Fund in the 1990s. For example, we need to examine actions which can resolve the problem of prolonged use and thereby help strengthen the revolving character of IMF resources.

And, while progress has been made in dealing with arrears, particularly through the support group process, arrears remain large and growing, already twice the size of the Fund's reserves, and threaten to undermine public support and willingness to provide resources to the IMF. We believe that further study of additional significant measures to address the arrears problem should be undertaken by the Executive Board.

In conclusion, I believe that the decision on a quota increase requires our full and thorough attention. The United States is committed to giving it this attention and will make a decision on the issue by the end of the year.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the Afternoon Session
of the Interim Committee
of the International Monetary Fund
Washington, D.C.
September 24, 1989

The Strengthened Debt Strategy

Last spring this Committee agreed on major innovations in the debt strategy in order to reinforce the resolve of debtor countries to pursue their economic reform efforts, and to encourage debtor countries and commercial banks to negotiate new financial packages that incorporate debt and debt service reduction in addition to new money. It should be a source of satisfaction for all of us that, over a relatively short period of time, we have been able to turn the broad outline of the strengthened strategy into clear progress in individual countries.

Our experience to date reaffirms that the basic thrust of this strategy is sound and has benefits for both debtors and creditors. Incentives for reform in debtor countries have been increased; there are signs that flight capital will return to countries making major adjustment efforts; and the strategy is working to improve both the quality of creditors' assets and creditworthiness in debtor countries.

Our progress is due to the cooperation of many parties. We should pay special thanks to the IMF and World Bank for moving promptly to adopt guidelines governing their support for debt and debt service reduction, and to help a number of debtor countries develop medium-term economic reform programs as the basis for extending this support. With these programs in place, and prompt action by the Paris Club, the banks and debtor nations have been able to negotiate financial support packages. Both Mexico and the Philippines have reached agreement with their commercial bank advisory committees. We look forward to the early completion of these understandings as banks make the choice among the options agreed.

However, to be successful, the strategy must also reach other debtors. Several other countries are now discussing financial packages with their commercial bank creditors. We are optimistic that these discussions will lead to agreements that take advantage of the new debt strategy.

Priority needs to be given by all parties to negotiating agreements

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that assure financial support for those countries carrying out significant reform programs. This will require the engagement of top level policy people on both sides. Perhaps it will also require improvements in the process presently followed in negotiations, including the efficacy of the current Bank Advisory Committee structure.

However, the main challenge at the moment appears to be the problem of unrealistic expectations -- both among the debtor countries and the banks. In one sense, improving expectations was essential to restoring forward momentum in the debt strategy. Progress had come to a halt and there was a growing sense of hopelessness. In another sense, however, we must recognize that rising expectations need to be tempered by realism on the part of both debtor countries and the banks. This is part of the negotiating process -- but in this case time is money. Excessive expectations can only promote delays, increase the risk of breakdown in negotiations and ultimately raise the economic costs both to the banks and debtor countries.

The foundation for external financial support -- and for improving growth in debtor nations -- is the adoption of sound macroeconomic and structural reform programs. These should include measures which improve the climate for foreign and domestic investment and encourage the repatriation of flight capital. Workable debt/equity programs can also play a useful role in this process.

IMF and World Bank technical and financial support for these reform efforts is critical to the success of the debt strategy. I continue to believe both institutions can do more to address the problem of capital flight. Mexico's experience after agreement was reached with its creditors is a compelling example of the result we should seek. This is a strong reason why debtor countries should accelerate their implementation of policies that help repatriate flight capital and liberalize domestic capital markets. Bold measures will produce big results and reduce the need for external bank financing. It will also lower financing costs and improve the management of external obligations.

Conclusion

In conclusion, the process that we have put in place over the past six months is working. I am heartened by the decisive actions taken to date, but we must persevere. Important work remains. With continued cooperation, we can extend the beachhead. Working together, the debt problem can be made better and we can advance our ultimate objectives of sustained growth in the developing world and a stronger international financial system.

TREASURY NEWS

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ROOM 5310

STATEMENT OF
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY FOR FINANCE
BEFORE THE
NATIONAL COUNCIL OF SAVINGS INSTITUTIONS
SEPTEMBER 25, 1989

I am delighted to be here with you today to discuss some major provisions in the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), particularly as they relate to the outlook for the savings and loan industry.

FIRREA's Focus

The responsibility to ensure that the thrift crisis does not reoccur required the Administration to craft legislation that focused on four major areas -- improved capital standards, structural reform, enhanced enforcement, and resolution of insolvent thrifts.

Improved capital standards focused on changing the incentive structure under which thrifts are owned and managed, requiring private sector capital at risk, up front. In addition, higher premiums for commercial banks and thrifts will strengthen insurance fund integrity. Both changes increase the resources available before taxpayer funds are called on.

Structural reform focused on the separation of the FSLIC insurance function from its chartering function, by assigning the former to the FDIC and the latter to a newly-reconstituted Office of Thrift Supervision (OTS), which is located in the Treasury and operates under Treasury's general oversight.

Enhanced enforcement provisions made available $65 million a year for three years to the Justice Department to help it better address financial institution fraud and other illegal activities. Maximum legal penalties for such actions were also greatly increased, in some cases to $1 million per day.

Finally the need to <u>resolve insolvent thrifts</u> resulted in the creation of the Resolution Trust Corporation (RTC), with its policies to be established and monitored by the Oversight Board. Industry and taxpayer funds totaling $50 billion are to be spent to dispose of the institutions that fail over the next three years and their assets.

<u>Oversight Board and RTC Accomplishments</u>

FIRREA was enacted just six weeks ago and the resolution process is well underway. The RTC and the Oversight Board have already accomplished much. To clarify the role of each of these agencies, let me take a moment to describe their respective duties and responsibilities.

The RTC, which will be managed exclusively by the Federal Deposit Insurance Corporation (FDIC), will execute the thrift cleanup. The RTC will determine the prioritization of the thrift caseload, carry out the resolutions and sell any residual assets. In doing so, it must fulfill the legislation's objectives of (1) maximizing returns on the sale of institutions and assets, (2) minimizing the effects of its activities on distressed local markets and (3) maximizing the affordability and availability of low-income housing. The RTC, therefore, must meet objectives which will require unavoidable tradeoffs.

The Oversight Board, chaired by the Secretary of the Treasury, provides the policies to guide the RTC's activities, furnishes funds, and monitors the RTC's execution of its responsibilities. The Oversight Board does not work on case-- specific matters.

Here are some of the RTC and the Oversight Board's accomplishments to date:

- The Oversight Board has authorized and released to the RTC over $18 billion for thrift resolutions, liquidity needs and replacement of high cost funds. These funds are available from the FIRREA funding plan, $20 billion in Treasury and industry funding in fiscal year 1989, and $30 billion to be raised by REFCORP in 1990 and 1991. The funding plan makes dollars immediately available to resolve thrift cases, retains the full industry "self-help" contribution, and avoids dismantling Gramm-Rudman-Hollings budget discipline.

- The RTC has used its funds to close, or transfer the deposits of, 24 insolvent thrifts and to lower the cost of funds at other institutions.

- The Oversight Board has issued 12 interim policies for the RTC, covering topics ranging from financial procedures to

the terms of RTC funding of thrift resolutions. One interim policy just adopted last Thursday deals with limitations on guarantees. It would allow the RTC to enter into asset guarantees, capital loss coverage, or asset puts to accommodate completion of an acquiror's due diligence but for no longer than six months. This policy is to limit the RTC's financial risk and is in sharp contrast to earlier FSLIC guarantees that stretched up to ten years.

- The Oversight Board has established a joint Oversight Board-RTC policy development task force to make recommendations concerning strategies, policies and goals for the RTC, as well as the strategic plan for the RTC which the Oversight Board must submit to Congress by December 31, 1989.

- Most importantly, the Oversight Board and the RTC have successfully begun an orderly, cooperative and professional working relationship. This may be the most significant initial step in getting the job done well.

Questions about FIRREA

Although the thrift resolution process is well underway, some have raised certain ongoing questions about FIRREA. First, with regard to capital standards, a dispute apparently exists as to the meaning of the leverage limit capital standard. FIRREA requires that S&L's maintain core capital to assets of no less than three percent and that the standard be no less stringent than that for national banks.

Chairmen Gonzalez and Riegle have recently sent letters to the Treasury setting forth their views that the thrift standard in FIRREA is different from the existing OCC standard of 5.5 percent primary capital to assets and 6 percent total capital to assets.

The final regulations establishing the thrift capital standard must reflect a careful reading of both the statutory language and Congressional intent. OTS is currently drafting these regulations and, after receiving Treasury review and approval, they will become effective by the statutory deadline of December 7, 1989.

RTC Caseload and Adequacy of Funding

Second, some have raised concern whether FIRREA provides for adequate funding for case resolutions. We expect the RTC to merge or liquidate approximately 450 to 550 insolvent thrifts, with total assets of about $300 billion. These are institutions

that have failed or will fail from January 1989 through August 1992.

The $50 billion available in the Legislation is in line with estimates of the size of the problem from the FDIC, Federal Reserve, and OTS; also the General Accounting Office did not determine this amount to be inadequate. The numbers and assumptions underlying this estimate were examined fully during Congress' consideration of the bill and were not adjusted.

The ultimate cost of resolving such a large number of institutions depends on the relative stability of a number of factors -- for example, future interest rates, real economic growth, inflation, real estate prices. Should an unexpected economic scenario occur, such as a sharp recession or a significant rise in interest rates, which would markedly increase the cost of the RTC resolution task -- either by increasing the cost of resolving the institutions or by adding a large number of presently solvent institutions to the caseload -- some portion of an additional $24 billion in FIRREA funding would be available for resolutions from 1992-99. This amount is in addition to about $9 billion which is allocated to capitalizing SAIF.

What is most important, however, is that the RTC gets on with the job, for delay is costly. To ensure additional funds are available for resolutions, Treasury expects to begin marketing REFCORP bonds early in the next quarter. At the Administration's request, the Securities and Exchange Commission (SEC) has exempted the REFCORP bonds from registration under the 1933 Securities Act and from regulation of trading under the 1934 Exchange Act. The exemptions recognize that the credit of the United States stands behind REFCORP interest, industry funds having defeased the principal. That will permit the bonds to trade as government securities. The marketing of REFCORP bonds by Treasury and the SEC exemptions should further reduce the spread between Treasury securities and REFCORP bonds.

The Future for Thrifts

What of the future for thrifts? The problem institutions may make better press copy, but from a long-run perspective the more relevant statistic is the large number of profitable, well-managed savings and loans operating today.

OTS reported that, at the end of the second quarter of 1989, approximately 2000 thrifts were profitable -- over 80 percent of all thrifts with tangible capital. These S&L's had an average return on assets of a respectable 56 basis points. And raising individual thrift capital levels will lead to new capital from outside the industry and consolidation within.

Will a thrift industry survive? I think the answer is: yes, a system of housing finance will survive. Although no one knows the precise future form of the industry, it will largely depend on providing a product the customer wants at a reasonable price.

We can be sure that demand will continue to exist for home mortgages, as well as for the other financial products that S&L's offer. Therefore, it seems reasonably clear that there will be institutions successfully and profitably specializing in housing finance.

The well-capitalized, well-managed savings and loans that provide these services surely will be the greatest beneficiaries of FIRREA. The industry that emerges from the resolution process will be one with an attractive and viable charter, with a clean, recapitalized insurance fund, and one prepared to provide its traditional support for home financing. The benefits of FIRREA are appearing already -- the cost of funds for thrifts is declining and the prices of many institutions' stocks have begun to rise.

Despite the landmark changes in thrift supervision and regulation, the legislation preserves many of the special benefits of being a savings association.

- Thrifts can still engage in insurance and real estate brokerage activities denied to commercial banks.

- Thrifts can continue to diversify their portfolios, which will help reduce their traditional vulnerability to interest rate risk.

- Thrifts will retain special access to Federal Home Loan Bank (FHLBank) advances, even though commercial banks and credit unions are now allowed to join the System.

Future Organization of the Financial Services Industry

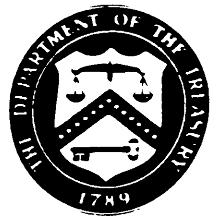
And what of the broader financial landscape? It is logical that as financial institutions continue to diversify their portfolios -- and the Administration is actively supporting responsible financial reform legislation that would encourage this process -- certain types of institutions will group together. This grouping may not be based on artificial distinctions, such as membership in a particular deposit insurance fund, but rather on the financial services the institutions provide.

I expect that community bankers could well find the thrift charter attractive given the markets that they serve. Likewise, some of the large savings and loans might have more in common with their commercial bank counterparts.

Conclusion

We have discussed today the tangible impact of FIRREA on the future of the thrift industry. However, the legislation also has an effect at a more intangible level -- what the President called "restoring public confidence." This may be one of the bill's most important legacies, since Americans must have faith in the savings and loan industry in order for it to serve the purpose for which it was created -- financing the American dream of homeownership.

TREASURY NEWS



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CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
September 25, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,409 million of 13-week bills and for $7,405 million of 26-week bills, both to be issued on September 28, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing December 28, 1989			26-week bills maturing March 29, 1990		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	7.68%	7.94%	98.059	7.77% a/	8.20%	96.072
High	7.73%	7.99%	98.046	7.81%	8.24%	96.052
Average	7.72%	7.98%	98.049	7.79%	8.22%	96.062

a/ Excepting 2 tenders totaling $2,685,000.

Tenders at the high discount rate for the 13-week bills were allotted 78%.
Tenders at the high discount rate for the 26-week bills were allotted 11%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 24,975	$ 24,975	$ 33,030	$ 33,030
New York	21,075,900	6,533,400	19,292,635	6,283,985
Philadelphia	24,270	24,270	20,325	18,325
Cleveland	45,240	45,240	35,100	35,100
Richmond	28,180	28,180	31,775	31,775
Atlanta	30,560	30,560	33,555	33,555
Chicago	1,229,660	52,460	1,011,250	111,250
St. Louis	43,195	23,195	36,205	30,425
Minneapolis	6,700	6,700	8,120	8,120
Kansas City	36,330	36,330	60,265	60,265
Dallas	33,465	27,365	34,480	24,480
San Francisco	805,660	51,660	865,610	118,110
Treasury	525,030	525,030	616,810	616,810
TOTALS	$23,909,165	$7,409,365	$22,079,160	$7,405,230
Type				
Competitive	$20,596,195	$4,096,395	$17,507,085	$2,833,155
Noncompetitive	1,130,060	1,130,060	1,225,875	1,225,875
Subtotal, Public	$21,726,255	$5,226,455	$18,732,960	$4,059,030
Federal Reserve	1,766,810	1,766,810	1,650,000	1,650,000
Foreign Official Institutions	416,100	416,100	1,696,200	1,696,200
TOTALS	$23,909,165	$7,409,365	$22,079,160	$7,405,230

1/ Equivalent coupon-issue yield.

NB-468

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 10:00 AM EST
September 26, 1989

STATEMENT OF
THOMAS S. NEUBIG
DIRECTOR AND CHIEF ECONOMIST
(OFFICE OF TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON
THE COAST GUARD AND NAVIGATION
OF THE COMMITTEE ON
MERCHANT MARINE AND FISHERIES
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to present the views of the Treasury Department regarding the tax implications of H.R. 3277, the "Trans-Alaska Pipeline System Reform Act of 1989". The Administration opposes H.R. 3277, for reasons I will discuss after briefly reviewing the provisions of the bill.

H.R. 3277 would establish the Trans-Alaska Pipeline System Trust Fund (the "new TAPS fund") as a fund to be administered as a separate account in the U.S. Treasury. The bill would also make a number of amendments to the rules governing the Trans-Alaska Pipeline Liability Fund (the "existing TAPS fund"), which was established pursuant to 1973 legislation authorizing construction of the Alaskan pipeline. The new TAPS fund would be funded by a five cent per barrel fee imposed on all crude oil flowing through the Alaskan pipeline. The new TAPS fund would be used for various purposes relating to the delivery system for Alaskan crude oil and for the study of related environmental issues.

H.R. 3277 has been proposed in the context of the national debate over the serious and recurring problem of spills of crude oil and oil products on our nation's waterways. The Administration is committed to working with the Congress to enact comprehensive oil spill liability legislation. The Administration proposed such legislation in H.R. 2325. Other comprehensive oil spill liability proposals are found in H.R.

1465 and H.R. 3027. These bills have a number of objectives, including the consolidation of several existing oil spill liability funds into a single national fund.

Funding under the Administration's bill would be provided by means of a 1.3 cent per barrel fee imposed on, broadly speaking, all oil produced in or imported into the United States. This 1.3 cent fee is found in section 4611 of the Internal Revenue Code, and was enacted in 1986. The fee has never been collected because authorizing legislation has not been enacted. Under section 4611, the fee terminates at the end of 1991, or, if sooner, when $300 million in revenues have been collected. Under the Administration's bill, the fee would be collected commencing 30 days after enactment of the bill, and would continue through June 30, 1994, a term consistent with the term foreseen in 1986 when the tax was originally enacted. Furthermore, under the Administration bill, as under current law, the fee would terminate when $300 million in revenues had been collected. Under the revenue provisions of the budget reconciliation package approved by the Ways and Means Committee, the section 4611 fee would increase to a rate of 3 cents per barrel; however, as under current law, the maximum amount of revenue that could be collected would be $300 million.

When construction of the Alaskan pipeline was authorized by 1973 legislation, a fee of five cents per barrel was imposed on each barrel of crude oil passing through the pipeline. The revenues funded the existing TAPS fund. Under the terms of the 1973 legislation, this fee terminated when the balance in the existing TAPS reached $100 million. If the balance dropped back below $100 million, the fee would be automatically reinstated. The fund's balance reached $100 million a number of years ago, and the fee has not been collected since then. The balance in the fund has since grown to about $280 million. The maximum amount that may be paid out of the existing TAPS fund for any single incident is $86 million.

Any fee imposed on Alaskan crude oil under H.R. 3277 would be in addition to any nationwide fee imposed under comprehensive oil spill liability legislation. Thus, Alaskan oil would be subject to total fees of 6.6 cents per barrel (8 cents per barrel if the section 4611 rate is increased to 3 cents). Although H.R. 3277 appears to have a technical flaw in that the commencement and termination date of the Alaskan oil fee would occur on the same day, it is our understanding that it is intended that the fee would commence upon passage of the legislation and would not terminate. Thus, there would be no cap on the collection of revenues under H.R. 3277.

We oppose H.R. 3277 for the following reasons. The 1973 Alaskan pipeline legislation imposed a fee that terminated when the existing TAPS fund balance reached $100 million; the balance in the fund is well above that figure and will apparently remain so (although the existing TAPS fund may be merged with a

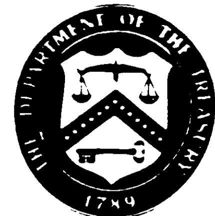
nationwide fund under comprehensive oil spill liability legislation). Thus, under the terms of the enacting legislation, the 1973 fee could not be reimposed under existing facts. Furthermore, the purposes that the new TAPS fund would be used for differ considerably from the purposes of the existing TAPS fund. Thus, we think that the fee proposed by H.R. 3277 is not properly viewed as a restoration of the five cent fee formerly imposed on Alaskan crude oil.

We also continue to believe that the overall cap of $300 million on revenues for oil spill liability purposes should be retained. Such a limitation was initially enacted in section 4611 in 1986, and was retained by the Administration and Ways and Means Committee bills. We believe it is appropriate to set a limit on the revenues that may be raised under such a fee, rather than having a perpetual revenue generating provision.

We also believe that establishing a special purpose fund would defeat one of the purposes of comprehensive oil spill liability legislation--the establishment of a single nationwide federal fund. Currently, there are a number of such funds that are limited in purpose: the existing TAPS fund, the Deepwater Port fund, and the Offshore Oil Pollution Compensation Fund. Thus, a spill may or may not qualify for assistance by one of these funds depending on the location and circumstances surrounding the spill. The creation of a nationwide fund would eliminate such distinctions. Establishing a fund dedicated to Alaskan issues would encourage the creation of other special purpose funds dedicated to spills with particular geographic or other factors.

Finally, I would like to offer a single technical comment. Under section 201(b)(3) of the bill, the Secretary of the Interior is to be granted authority to approve investments of balances in the new TAPS fund. We believe that investment decisions concerning federal trust funds should, absent unusual circumstances, be made by the Secretary of the Treasury.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR IMMEDIATE RELEASE
September 26, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $9,754 million of $26,773 million of tenders received from the public for the 2-year notes, Series AE-1991, auctioned today. The notes will be issued October 2, 1989, and mature September 30, 1991.

The interest rate on the notes will be 8-3/8%. The range of accepted competitive bids, and the corresponding prices at the 8-3/8% rate are as follows:

	Yield	Price
Low	8.37%*	100.009
High	8.40%	99.955
Average	8.39%	99.973

*Excepting 1 tender of $10,000.

Tenders at the high yield were allotted 29%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 47,445	$ 47,445
New York	24,151,325	8,464,615
Philadelphia	31,270	29,270
Cleveland	65,575	65,575
Richmond	130,530	78,700
Atlanta	40,230	38,520
Chicago	985,445	330,195
St. Louis	114,710	93,870
Minneapolis	57,195	56,595
Kansas City	112,865	110,865
Dallas	16,270	16,265
San Francisco	816,580	218,580
Treasury	203,170	203,170
Totals	$26,772,610	$9,753,665

The $9,754 million of accepted tenders includes $1,131 million of noncompetitive tenders and $8,623 million of competitive tenders from the public.

In addition to the $9,754 million of tenders accepted in the auction process, $980 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $650 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-470

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.

September 26, 1989

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,800 million, to be issued October 5, 1989. This offering will provide about $350 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $14,442 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, October 2, 1989. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,400 million, representing an additional amount of bills dated July 6, 1989, and to mature January 4, 1990 (CUSIP No. 912794 TK 0), currently outstanding in the amount of $6,704 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,400 million, to be dated October 5, 1989, and to mature April 5, 1990 (CUSIP No. 912794 TY 0).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing October 5, 1989. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $2,919 million as agents for foreign and international monetary authorities, and $4,221 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

8/89

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

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Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the IMF/IBRD Plenary Session
Washington, D. C.
September 26, 1989

Chairman Lee, Managing Director Camdessus, President Conable, fellow Governors, and distinguished guests.

This 44th annual meeting, the last of the 1980's, brings to a close a decade of both great challenges to, and significant achievements by, the international community. As we move from the 1980's into the last decade of the twentieth century, it is fitting that we reflect upon several of the major challenges we have faced together and how together we have met them. It is appropriate that we do so in this forum because the past decade holds both achievements to inspire our future endeavors, as well as continuing issues of mutual concern which compel us to greater cooperative efforts.

The foundation of our successful endeavors to date, and the key to our future success, remains non-inflationary economic growth. The sustained economic growth of the past seven years is a remarkable accomplishment. Just as we all will ultimately share in the benefits from economic growth, we also all share in the responsibility for the continued expansion of the world economy. The industrial countries must continue to play a leading role in this effort.

The IMF estimates that the industrial countries will achieve average growth of 3 1/4 percent and world trade will expand by some 6 1/2 percent this year. The expansion of trade at a rate greater than that of economic growth is particularly significant because world trade is the engine of world growth. Both are essential to meeting our global economic objectives.

One of our principal economic objectives is the reduction of external imbalances. We have made progress. The U.S. trade deficit narrowed by more than 20 percent in 1988 and is continuing to decline this year. While we can take satisfaction in what has been accomplished so far, we must also acknowledge that further progress is required. Surplus and deficit countries must exercise greater discipline in reducing internal and external imbalances. Achieving continued reduction in these imbalances and sustained low-inflationary economic growth is a

challenge that our nations face both individually and together.

Policy coordination is the process which we have used to support growth in the international economy. And policy coordination has paid off. However, when we measure the success of coordination we must maintain a sense of perspective. We must not confuse the short-term fluctuations in currencies or statistics with an effective policy coordination process that produces lasting results. Pundits would have us judge ourselves in terms of yesterday's rally or drop in the exchange markets. In truth, policy coordination should be judged by whether the world economy is experiencing solid growth. And it is.

Sustained economic expansion is, and will remain, crucial to the strengthened debt strategy which the Interim and Development Committees endorsed last spring. We should be heartened by the progress achieved in implementing our new approach. The recent agreement reached between Mexico and its commercial bank creditors stands as an important illustration of the progress debtor countries and their creditor banks can achieve.

The combined effect of solid economic policies and a new financing package is already providing a major boost to Mexico's economy. Mexico's experience since reaching agreement with its creditors is a compelling example of the result we should seek. Domestic interest rates have dropped from 55% to 34%. This has cut government interest payments by over $10 billion a year, reducing the fiscal deficit by 5% of GDP. Reserves have increased by over $2 billion due to reflows of private capital.

Confidence in Mexico's economy is clearly on the rise--businesses and individuals are investing in Mexico's future. The message is plain, the benefits to Mexico go well beyond the terms of the agreement. A cloud has been removed from Mexico's horizons, and the world knows it.

Preliminary agreement has also been reached between the Philippines and its commercial bank creditors. Again, this holds great promise for the Philippine economy and further illustrates progress in bringing parties together in realistic negotiations where they can seek solutions to their common problems.

A dynamic process is underway--the strategy's key elements can be implemented to fit the individual needs of a wide range of countries. There is no one right way. Some may seek a broad package including debt and debt service reduction, and new money, fully negotiated up front. Other countries may prefer a more market-based approach, with flexibility in bank waivers to permit buybacks and development of other instruments over time. And some may choose to pursue limited debt reduction without entering into broad negotiations with commercial banks.

Several countries--including Costa Rica, Venezuela, Morocco, Uruguay, and Chile--are already working toward new financing packages consistent with the strengthened strategy. As they discuss their needs and options with the international financial institutions and commercial banks, their varied interests have become increasingly clear. While reducing debt burdens has been the emphasis of many, new financing is still important for many countries. Although the elements and the mix will vary from case to case, it is important that there be a proper balance between new money, debt and debt service reduction.

Priority needs to be given by all parties to negotiating agreements that assure financial support for those countries carrying out significant reform programs. This will require the engagement of top level policy makers on both sides. However, an important challenge at the moment appears to be the problem of unrealistic expectations--both among the debtor countries and the banks.

In one sense, improving expectations was essential to restoring forward momentum in the debt strategy. Progress had come to a halt and there was a growing sense of hopelessness. In another sense, however, we must recognize that rising expectations need to be tempered by realism. This is part of any negotiating process--but in this case time is money. Excessive expectations can only promote delays, increase the risk of breakdown in negotiations and ultimately raise the economic costs to the banks and debtor countries.

However, debt reduction cannot be seen as a cure-all for the economic problems of debtor countries. It cannot assure economic prosperity. Rather, debt reduction is meaningful only if it supports the economic reforms that are the key to long-term sustained growth. Economic reform must be the foundation on which financial support is built.

Increased investment and return of flight capital are essential objectives of the strategy. And debt/equity swaps offer debtor countries important vehicles to channel such resources into their economies. Privatization programs and reduction of barriers to foreign investment can also signal that private capital will be welcome.

In the judgment of the financial markets, the impact of the new strategy on both borrowers and banks has been positive. The secondary market value of bank debt has increased for most key debtors, as has the value of the shares of many international banks with significant LDC loan exposure.

While concentrating on the individual elements of our debt strategy, we must not lose sight of the larger accomplishment.

Working together, we have opened the windows of hope for debtor nations. And we have done so by recognizing that just as we were all party to the creation of the debt problem, we must all be party to the creation of the solution. There is now a growing sense of understanding that while no solution will be perfect for all parties, there can be no resolution beneficial to any party without the full cooperation of every party.

The World Bank and the International Monetary Fund have critical roles to play in the debt strategy. The centerpiece of their efforts is to assist the debtors in shaping and implementing the economic policies that are central to establishing economic growth. These institutions have shown increasing effectiveness in doing just that. As we look to the future, they will need to put even more emphasis on policies designed to promote foreign investment, repatriate flight capital and reduce government interference in the marketplace.

The Fund and the Bank also provide important financial support for the debt strategy. President Conable and Managing Director Camdessus, I commend you and your staffs for your first-rate work in moving swiftly to provide financial and policy support.

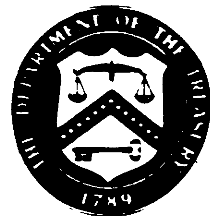
Fundamentally, economic growth is important for one reason -- to improve the quality of life for us all. But this quality cannot be assured by growth alone. It also depends upon protecting and renewing our environment. Our land, our air, our waters, and our national resources must be protected.

It is essential that the World Bank exercise strong leadership as the global community strives to grow and conserve our scarce resources for the future. The Bank has already accomplished much in this area, but the time has come for it to establish as a guiding principle of its activities the precept that development and environmental protection must go hand in hand. We must redouble its efforts toward this end.

Preserving the environment is just one of the many great challenges we face as we move into the last decade of the twentieth century. As we face those challenges together, the IMF and World Bank will play a pivotal role in our efforts to build a prosperous world economy and a stable international financial system.

These institutions will continue to be central to our efforts to achieve sustained development and growth. We will look to them as a forum for discussion, coordination and implementation of our initiatives. And we will look to them for the kind of multilateral leadership and cooperation that they have so ably demonstrated during the past decade.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

Remarks of
Secretary of the Treasury
Nicholas F. Brady
Delivered by Assistant Secretary
Charles H. Dallara
at the Afternoon Session
of the Development Committee
of the World Bank and the International Monetary Fund
Washington, D.C.
September 25, 1989

World Bank Support for the Environment

I am pleased to participate in this afternoon's session of the Development Committee Meeting. The relationship between environment and development presents a large and rapidly expanding set of issues. We need to focus our attention on those issues and provide greater guidance to the Bank.

Environmental issues are of particular and paramount importance to the United States. At the meeting of heads of state and government in Paris in July, President Bush expressed his concern about the dangers to the environment that now exist and his commitment to seek higher levels of protection for the environment. Other heads of state were clearly in agreement and the Summit countries have received a strong mandate specifically encouraging the World Bank and the regional development banks to integrate environmental considerations into their activities.

First, let me say that the World Bank has made significant progress on environmental reform over a period of several years. In addition to the Operational Directive on Environmental Assessments -- to which I will return -- there are many examples of those reforms: environmental issue papers, environmental action plans, regional studies, policy and research initiatives, efforts to mitigate or eliminate the adverse effects on the environment of individual programs, and the provision of environmentally-beneficial loans in several sectors. I congratulate the Bank management and staff on what they have achieved thus far.

However, there is an urgent requirement for us to deal more effectively with environmental issues. Serious threats to the atmosphere could lead to permanent changes in our climate. Pollution is fouling our air, lakes, rivers, seas, and oceans. Desertification and deforestation undermine our natural resource base and threaten our prospects for greater growth in the future. Left unattended, they could have devastating and far-reaching effects in those countries and throughout the world. We need to develop more innovative and imaginative solutions to these problems and we need to act more quickly and decisively.

NB-473

Last spring, we called for the establishment of environmental impact assessment procedures and for increasing public access to environmental information about specific projects and programs. We are particularly pleased that an Operational Directive on those procedures has now been put into effect. We encourage the Bank to release the Directive to the public and to solicit comments from public interest groups and non-governmental organizations that are directly involved in environmental issues.

It is important that the Bank also make progress in making available to the public information on the environmental impact of individual projects. We therefore call on the Bank to make comprehensive summaries of Environmental Assessments about specific projects and programs available to the public at least 120 days in advance of board consideration. Public participation is an essential element of the environmental impact assessment process. Local community groups that are directly affected by the Bank's projects and programs should have the chance to provide comments. Other outside sources can provide much-needed expertise. Neither can contribute unless they have the information to participate effectively. They can help us avoid costly mistakes that will have to be corrected later on.

I also encourage the Bank to accelerate its efforts to promote energy efficiency and conservation. End-use efficiencies, renewable energy technologies, and least-cost planning in borrowing countries all need added impetus. Technical staff with expertise in these areas should be brought on board. The studies and reports now being produced by the Energy Sector Management Assistance Program should become better-integrated into the Bank's lending operations.

The staff background paper indicates that greater attention is now being paid to environmental considerations in forestry projects. A number of new forestry projects are said to be under way, all of them with environmental elements. Yet the Bank does not yet have specific standards for evaluating projects that might adversely affect tropical moist forests. It should develop an appropriate set of standards and it should work cooperatively with other donors to secure wider international acceptance for those standards.

In negotiations for the replenishment of IDA resources, my government has actively pursued agreement on a set of environmental goals. I have already mentioned some of these goals today:

-- environmental impact assessment;

-- public access to environmental information;

-- energy efficiency and conservation.

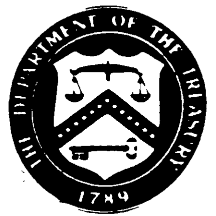
There are, however, two other particularly worthy environmental goals that need to be pursued. The Bank has completed few environmental action plans. These plans provide an important framework for environmental work.

They can be extremely useful not only to the Bank but also to other donors. I encourage the Bank to increase the number of such plans it will complete over the next several years.

I also encourage the Bank to become more active in promoting debt-for-nature swaps. In some countries, such swaps could be funded as part of project or sector loans that include environmental components. In other countries, the Bank would not need to fund debt buybacks, but could serve as a catalyst in bringing government officials and private parties together.

I recommend that we discuss environmental issues again at our meeting in the Spring, reviewing the progress report that will be prepared. In that report, we would be particularly interested in reviewing progress in implementing environmental impact assessments, access to information, energy efficiency, conservation and forestry programs, and environmental action plans.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

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TEXT AS DELIVERED

Remarks by
Nicholas F. Brady
Secretary of the Treasury
at the Morning Session
of the Development Committee
of the World Bank and the International Monetary Fund
September 25, 1989
Washington, D.C.

This morning, I want to review progress under the strengthened debt strategy with a particular focus on economic policy reform.

We have cause today to note with satisfaction the early achievements made in addressing debt problems through the strengthened strategy we endorsed in this forum last spring.

These early moments of the new strategy take on added importance because they have given us a first glimpse of its potential benefits. The prospects of debt reduction and new money, supporting major economic reforms, has altered dramatically the atmosphere surrounding this issue. As I discussed yesterday, the benefits of the strategy can be immediate and they can be striking. This should give us all encouragement to persist in our efforts to sustain the momentum that has been achieved and to broaden the application of the strategy to a wide range of countries making serious reform efforts. This can be done if the banks, debtors and multilateral institutions all work together.

At the heart of the revitalized strategy is the need for strong economic reforms in debtor countries. Solid macroeconomic and structural reforms are a first priority. However, more open investment regimes are also essential to attract and retain capital. Foreign direct investment must be attracted and flight capital brought home. I would urge the World Bank in particular to include measures which stimulate foreign direct investment as key elements of its sector and structural adjustment loan programs.

Efforts to open economies to investment -- paired with financial sector reform, trade liberalization and specific measures to encourage the repatriation of flight capital -- can reap benefits for developing

countries which extend well beyond the immediate financial support involved. Private capital flows also require a vibrant private sector to contribute effectively to growth. Debt/equity swaps and privatization efforts offer important vehicles for attracting and channeling these funds to productive use. They are vital complements to debt and debt service reduction and continued private finance in achieving stronger growth.

Such measures would strengthen growth-oriented reform programs, not just in those countries pursuing reduced commercial debt burdens, but in all developing countries. Wherever investors, public and private, feel confident about the prospects of return, they will look eagerly for creative opportunities to invest.

Much has already been done to assist the poorest countries among us. The agreement last year at Toronto on new, more generous terms for rescheduling was an important step. The creation of the IMF's Enhanced Structural Adjustment Facility has also provided new resources to support the economic reform efforts of the poorest countries. As we consider replenishment of IDA resources, we must look for additional ways to ensure that these funds are used effectively to promote growth and help the poor in the developing world.

An open world trading system is vital to a vibrant global economy. The industrial countries have a major stake in and bear the greatest responsibility for the successful conclusion of the Uruguay Round. The GATT system cannot prosper, however, if developing countries do not also move ahead toward trade liberalization. They can maximize the benefits to their economies by participating actively in the Uruguayan Round of negotiations and liberalizing their trade regimes.

Conclusion

In conclusion, important progress is being made within the strengthened debt strategy. We must now push ahead to ensure that the benefits of the strategy reach a broad range of countries. This will require commitment and perseverance from each of us, but it is the only hope for achieving our common goal of extending prosperity throughout the world.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
September 27, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 4-YEAR NOTES

The Department of the Treasury has accepted $7,787 million of $21,675 million of tenders received from the public for the 4-year notes, Series Q-1993, auctioned today. The notes will be issued October 2, 1989, and mature September 30, 1993.

The interest rate on the notes will be 8-1/4%. The range of accepted competitive bids, and the corresponding prices at the 8-1/4% rate are as follows:

	Yield	Price
Low	8.34%	99.699
High	8.35%	99.666
Average	8.35%	99.666

Tenders at the high yield were allotted 86%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

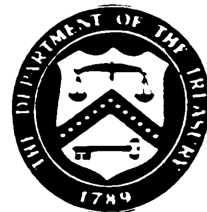
Location	Received	Accepted
Boston	$ 17,047	$ 17,047
New York	19,699,375	7,268,835
Philadelphia	13,302	13,302
Cleveland	37,120	37,120
Richmond	37,686	34,886
Atlanta	14,955	14,949
Chicago	890,822	184,722
St. Louis	47,915	27,355
Minneapolis	31,425	11,083
Kansas City	34,038	34,038
Dallas	8,996	8,996
San Francisco	813,756	106,056
Treasury	28,608	28,608
Totals	$21,675,045	$7,786,997

The $7,787 million of accepted tenders includes $474 million of noncompetitive tenders and $7,313 million of competitive tenders from the public.

In addition to the $7,787 million of tenders accepted in the auction process, $620 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $316 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-475

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

<u>FOR RELEASE ON DELIVERY</u>
EXPECTED AT 9:30 A.M.
September 28, 1989

STATEMENT OF THE HONORABLE
MICHAEL E. BASHAM
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
(FEDERAL FINANCE)
BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

I am happy to be here today to participate in this hearing on Government-sponsored enterprises and to discuss the GSE studies which Treasury will perform, as required under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

At the outset, let me say that we share your view that it is essential that Congress and the Administration exercise close oversight over all uses of Federal credit. As you may recall, Assistant Secretary Mullins in his April 18 testimony before the full Committee recommended that a Federal entity be asked to study the relationship between risks and GSE capital and to consider whether capital standards should be established for the GSEs. Thus, we are pleased that GAO will be conducting a study on capital requirements for GSEs, and we welcome the opportunity to perform Treasury studies to assess the financial safety and soundness of GSEs and the impact of their operations on Federal borrowing.

Over the years the Treasury has been involved in a number of policy initiatives designed to control the growth and cost of Federal and federally-assisted credit. The Federal Government is the largest financial intermediary in the United States. At the end of 1988, the Government held $222 billion of outstanding direct loans (including $124 billion financed by the Federal Financing Bank) and had another $550 billion in outstanding guaranteed loans (including $451 billion of FHA and VA mortgages and $48 billion of guaranteed student loans). Government-sponsored enterprises, such as the Federal National Mortgage Association and the Farm Credit Banks, had an additional $666 billion of outstanding loans at the end of the year (approximately $615 billion in the housing area and $51 billion in the agricultural sector). Thus, directly or indirectly, the Government had influenced the allocation of $1.4 trillion of outstanding credit to farmers, homeowners, small businesses,

exporters, utilities, shipbuilders, and State, local and foreign governments.

While much public attention is focused on direct Treasury borrowing to finance budget deficits, much less attention has been focused on federally-assisted borrowing in the form of off-budget guaranteed loans and borrowing by off-budget Government-sponsored enterprises. Yet, of the estimated $205 billion of net Federal and federally-assisted borrowing in FY 1990 (excluding prospective REFCORP borrowing), 50 percent is for financing the budget deficit, 16 percent for financing off-budget Federal loan guarantee programs, and 34 percent for financing off-budget GSEs. Taken together, it is clear that off-budget credit assistance from the Federal Government will be roughly half of total borrowing under Federal auspices in FY 1990.

The Gramm-Rudman-Hollings legislation, which was enacted in December 1985, has prompted a renewed interest, after a 15-year hiatus, in the creation of off-budget Government-sponsored enterprises. Prior to GRH, the last GSE to be created was the Student Loan Marketing Association. Sallie Mae was created in 1972 as a part of the effort to shift the financing of guaranteed loans from the bank loan market to the securities market. Beginning in 1987, five new GSEs have been created:

- The College Construction Loan Insurance Association, (Connie Lee), created to guarantee bonds issued for college construction to fill the void which would be left by the proposed termination of on-budget direct loan programs conducted by the Department of Education.

- The Financing Corporation (FICO), created to recapitalize the Federal Savings and Loan Insurance Corporation.

- The Farm Credit System Financial Assistance Corporation (FAC), created to provide a financing mechanism for the Farm Credit System.

- The Federal Agricultural Mortgage Corporation (Farmer Mac), created to shift the financing of farm loans from the bank loan market to the securities market.

- The Resolution Financing Corporation (REFCORP), created to provide a financing mechanism for the Resolution Trust Corporation.

The five new GSEs differ from the older, traditional GSEs. The traditional GSEs serve as financial intermediaries to facilitate the flow of credit to private borrowers in three major areas: (1) agriculture, (2) housing, and (3) higher education.

Unlike the traditional GSEs, the five new enterprises were either established primarily to assist a Federal agency or an existing GSE in financial distress, or to encourage increased lending to their targeted constituencies through loan insurance, rather than by financial intermediation.

GSEs are privately owned entities, but are distinguished from fully private financial intermediaries by their close, favored relationship with the Federal Government. Like Government agencies, GSEs have special tax exemptions, their obligations are eligible for open market purchase by the Federal Reserve and, with the exception of securities issued or guaranteed by Farmer Mac and guaranteed by Connie Lee, they are exempt from SEC registration. GSEs typically have authority to borrow limited amounts from the U.S. Treasury which helps to reinforce the market's perception of an implicit Federal guarantee of their outstanding debt, allowing them to borrow at interest rates lower than those available to fully private firms.

The value to the GSE of the Government's implicit guarantee depends largely on the operating policies adopted by the individual GSE. For a fully private firm, its borrowing costs are positively related to the market's perception of the risks that the firm undertakes and its activities. The implicit Government guarantee of agency debt, however, weakens the relationship between a GSE's cost of funds and the risks assumed by it. The larger the gap between a GSE's actual cost of money and the cost it would have to pay if the Government were not seen 2as absorbing the risk of default, the greater the value of the implicit guarantee. Thus, GSEs have an incentive to take more risks, which could increase the taxpayer's exposure to potential loss.

As Assistant Secretary Mullins stated in April 18 testimony before the Committee, GSE credit activity poses risks to the taxpayer both directly and indirectly. Our two studies of GSE activities will, where possible, quantify the risks associated with each GSE. In quantifying such risks, we will, as required under FIRREA, determine the volume and type of securities outstanding which are issued or guaranteed by each GSE, the capitalization of each GSE, and the degree of risk involved in the operation of each GSE due to such factors as credit risk, interest rate risk, management and operation risk, and business risk. We will also report on the quality and timeliness of information currently available to the public and the Government concerning the extent and nature of GSE activities and the financial risks associated with such activities. In addition, we will examine the growth and nature of GSE borrowing in the market and assess its impact on Federal and federally-assisted borrowing.

Although we are in the early, formative stages of the initial study, we have made considerable progress in establishing a broad framework for the study. As described above, FIRREA has clearly defined the parameters of the studies. Since the nature of a GSE's business and the operating policies of its management determine the risk exposure to the taxpayer, it is necessary to analyze each GSE separately. We have, therefore, decided to adopt a case study approach under which direct and indirect costs posed by the activities of each individual GSE will be studied in-depth. The case study approach will allow us to apply a common framework of analysis to each GSE, while recognizing that each GSE operates in a unique manner and environment.

The studies will require the cooperation of various Federal agencies and all the GSEs. We have already held two meetings with GAO staff which will be involved in conducting their study. While the focus of the GAO study is different from the focus of ours, we have agreed to coordinate our data collection efforts. Over the past two months, we have collected various data which will be needed for the studies. We have also contacted several GSEs and have scheduled meetings with two GSEs in early October. The GSEs which we have contacted to date have been very cooperative. In addition, we have talked to private sector firms which may be of some help to us in analyzing the business and management risks posed by various GSE activities.

As you can see, our work on the studies has begun. Given our recent experience with the savings and loan crisis and the magnitude of GSE financial activities, we believe that the proposed studies of GSE activities are both timely and extremely important. By clearly identifying the risks of GSE activities to the taxpayer and assessing the impact of such activities on Federal and federally-assisted borrowing, we will be in a much better position to anticipate any potential problems in the GSE area.

We look forward to working with the GSEs and other entities involved in conducting the studies and to your continued interest in our efforts on the studies during the coming months.

This concludes my prepared statement. I will be happy to answer any questions that you may have.

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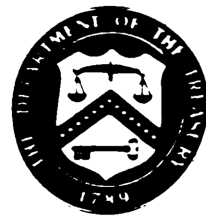
TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

ROOM 5310

FOR IMMEDIATE RELEASE
Expected at 10:00 AM
September 28, 1989

STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS

BEFORE THE SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SEPTEMBER 28, 1989

Mr. Chairman, thank you for the invitation to discuss the Treasury Department's views on the effects of the European Community's 1992 program on U.S. financial institutions. I applaud your initiative in holding hearings on this important topic.

The Treasury Department strongly supports the EC's objective of economic liberalization. The reinvigoration of the EC's efforts towards the eventual goal of economic and monetary union has significant implications for the United States and world economy. We have followed closely the full range of issues relating to European economic integration, with a focus on financial issues.

Last June, EC leaders reaffirmed the goal of full economic and monetary union and agreed to begin a first stage in 1990. As outlined in the Delors Committee Report, steps in the first stage include completion of the 1992 program; greater coordination of macroeconomic policies; and inclusion of all currencies of the EC member states in the exchange rate mechanism of the European Monetary System.

At this point, progress beyond the initial stage appears uncertain. EC leaders have been unable to agree fully on either the substance or timing of any subsequent stages. Institutional changes, such as a possible European central bank or single currency, are very sensitive politically for EC members because they imply ceding national sovereignty in core areas of economic policy to an as yet unknown and untested central authority. It is not surprising that many Europeans want to proceed cautiously, so as to ensure that changes are beneficial rather than harmful.

The stakes for the world economy, for the adjustment process and for the international economic system are high. If implemented in an open and market-oriented way, EC 1992 could result in significant benefits for the EC and the world economy. However, if the program results in greater EC protectionism, this would not only be harmful to Europe, but could stall our external adjustment efforts, weaken the multilateral trading system, and result in a spiral of damaging retaliation. I do not believe that the Europeans want to create a Fortress Europe. However, it is crucial that European economic integration result in a growing, outward focused Europe that accepts its leadership role and responsibilities, including the adjustment of external imbalances.

Key Aspects of EC Financial Services Liberalization

The EC's plan to liberalize European financial markets would:

- o eliminate remaining barriers to international capital flows within the Community,
- o move all EC member states towards a system of universal banking,
- o create a single banking license, under which a bank or investment firm incorporated under the laws of one member state would have the right to establish branches or supply cross-border services in any other member state while remaining under the control of home country supervisory authorities,
- o liberalize regulation of mutual funds, and
- o establish a new approach to financial regulation and supervision, under which agreement on minimum EC-wide standards would provide the basis for mutual recognition of EC national supervisory systems.

These changes should lead to more efficient and competitive capital markets and a more efficient allocation of capital, spreading benefits throughout the EC economy. While it is obviously difficult to quantify the benefits with precision, an EC Commission study estimated that the liberalization of financial services would boost EC GDP by 1.5 percentage points over about five years. This is roughly one-third of the total EC GDP gains anticipated from the entire 1992 program.

U.S. financial institutions are well placed to compete in a unified European financial market, as long as Europe is open to non-EC firms. After 1992, European markets which are now closed or undeveloped will be opened. However, U.S. firms would need to establish a subsidiary in one EC country in order to obtain the single banking license, and then could open branches in other member states.

Proposed Reciprocity

EC proposals for reciprocity in financial services continue to concern us, but less so than last year at this time. Clearly, the recent improvements in the proposed reciprocity provisions in banking are a significant step in the right direction and reflect a willingness on the part of the EC to listen to U.S. views. The scope of the proposed EC reciprocity has been redefined to approximate a national treatment standard. There will no longer be an automatic suspension of applications pending a reciprocity review. Existing foreign subsidiaries will be "grandfathered." Greater political control will be exerted over the use of reciprocity powers.

Even the name of the reciprocity provision has been changed to a rather benign sounding title, "Relations with Third Countries." But unfortunately, the principle of reciprocity survives, whatever it is called, because access to the EC market will still be conditional on the treatment of EC firms in third country markets.

In contrast to the EC, U.S. policy is to provide national treatment, which we define in financial services as "equality of competitive opportunity." In principle, our version of national treatment is unconditional, while the EC's formulation allows for reciprocity. In the United States, foreign financial institutions have basically the same opportunities to establish themselves and then to compete in the U.S. financial market as domestic financial institutions.

We appreciate the reassurances given by the EC Commission on this issue, particularly by Sir Leon Brittan. I understand why the EC wishes to be able to exert pressure on other countries to open up or liberalize their own markets so that EC firms can conduct those modern and efficient activities which financial firms of third countries can undertake in EC markets. However, notwithstanding the modifications to the reciprocity provision which the EC has already made, we still see dangers in the EC concept of reciprocity.

Despite the softening of reciprocity, the implied threat remains a potentially powerful instrument, which makes us uneasy. In considering the history of the improvement of the reciprocity provision, we cannot forget that it began as an extremely crude reciprocity effort. We are also mindful that the original, more restrictive version of reciprocity remains in the investment services and insurance directives.

Moreover, once this "club in the closet" is on the books, there will be a temptation to use it, especially given the EC's desire to promote changes in the U.S. financial system. If actually used -- or rather "misused" -- this would run the risk of provoking a retaliation action from U.S. authorities. We want to

preserve our policy of national treatment because we believe it is the most sensible and pragmatic way to preserve free and open financial markets. However, there should be no illusions about the consequences of possible EC actions. If U.S. firms are discriminated against in the EC, there would likely be consequences for EC national institutions. An obvious first step might be to scrutinize the "better than national treatment" privileges which many European financial institutions currently enjoy in the United States.

In part, the EC desire for leverage over U.S. institutions relates to EC concern about discriminatory treatment in the U.S. at the state level. It is true that a few individual U.S. states have practices which discriminate against foreign financial institutions. The Treasury Department has worked and will continue to work within the constraints of our federal system to change these practices. However, any attempt by the EC to take an aggressive stance on individual states' practices could be counterproductive and could lead to a federal response because of the nature of our government structure.

I believe that both sides are reasonable and well intentioned. I have no doubt that we can work out these difficulties. But officials come and go, and there are always risks of misunderstandings. I ask the Europeans: Wouldn't it be better to lay these reciprocity weapons aside?

Future Efforts

Mr. Chairman, I know of your concerns about the European Community and its impact on the United States. Let me assure you that the Administration, under the leadership of the Treasury Department, is analyzing and developing a national financial services strategy in order to be ready for the challenges of the post-EC 1992 era. The issues go beyond Europe; they focus on the structure and competitiveness of the U.S. financial industry worldwide.

The monetary, financial and regulatory issues relating to EC integration efforts will be of paramount importance in years to come. Secretary Brady recently established an Economic Policy Council (EPC) Policy Group on European Monetary Reform and Financial Liberalization, with participation from the key economic agencies, including the Departments of State and Commerce and the Office of the U.S. Trade Representative. The Secretary has directed me to chair this group. Although this is an EPC Group, I plan to have on board all of the relevant financial regulators in an advisory capacity.

As a separate effort, the Treasury Department is currently directing work on a 1990 National Treatment Study. This gives us a new opportunity to encourage other countries to liberalize their barriers to foreign financial institutions. As this Subcommittee is aware, the 1988 Trade Act mandates that the Secretary of the

Treasury report to Congress by December 1, 1990 on the extent to which foreign countries maintain significant denials of national treatment against U.S. banks and securities firms. A chapter analyzing the EC banking and securities directives will be included.

We are also working in the Uruguay Round to achieve significant liberalization in financial markets abroad that will provide U.S. financial institutions a fair and effective opportunity to compete in and for those markets. Our challenge is to convince others that free and open financial markets are something to which they should aspire, not something which they should try to avoid or restrict.

Over the long term, a unified EC financial market and EC movement towards a universal banking system mean that U.S. financial institutions will face more formidable foreign competitors. This raises a number of questions. What steps can we take to ensure that U.S. financial institutions remain competitive without jeopardizing high regulatory and prudential standards? To what degree should we consider eliminating or amending Glass-Steagall and interstate banking restrictions? Should we consider easing restrictions on cross ownership between financial institutions and industrial companies? Between banks and insurance firms? How do we achieve and maintain open and competitive capital markets in the United States, Europe and Asia? These questions are very much in the Administration's mind and on a priority list for consideration.

Conclusion

Our partnership with Europe is strong and rooted in close economic ties, based on free market principles and extensive financial and commercial relations. We will of course have differences of view from time to time on important economic and financial issues. But the ties that bind us are far stronger than the forces that divide us. Thus, I am confident that the United States and the European Community will continue to work cooperatively to reconcile differences and strengthen the world economic system on which the well-being of all of our nations depends.

It is equally important that the Administration, regulatory agencies and Congress work together to ensure that our own domestic financial structure and competitive environment are adequate and prepared to meet the challenges ahead. Mr. Chairman, we look forward to working with you and your Subcommittee on these issues.

RTC

/ O V E R S I G H T B O A R D

Resolution Trust Corporation

1825 CONNECTICUT AVENUE, N.W. WASHINGTON, D.C. 20232

FOR IMMEDIATE RELEASE
September 12, 1989

Contact: Arthur Siddon
(202) 387-7667

DIRECTORS APPOINTED TO REFCORP BOARD

Secretary of the Treasury Nicholas F. Brady, as chairman of the Oversight Board, announced today the appointment by the Board of Brian D. Dittenhafer and Ronald R. Morphew to serve as directors of the Resolution Funding Corporation (REFCORP).

Mr. Dittenhafer, president of the Federal Home Loan Bank of New York, was appointed to a three-year term on the Directorate of the REFCORP and was designated chairman of the Directorate. Mr. Morphew, president of the Federal Home Loan Bank of Indianapolis, was appointed to a two-year term on the Directorate.

REFCORP was established by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 primarily to issue up to $30 billion of long-term bonds to fund the resolution of insolvent thrifts by the Resolution Trust Corporation.

Under the statute, the members of the Directorate are to be the director of the Office of Finance of the Federal Home Loan Banks and two of the presidents of the 12 Federal Home Loan Banks. Austin C. Dowling is the current director of the Office of Finance and will be the third member of the Directorate.

Mr. Dittenhafer has been president and chief executive officer of the Federal Home Loan Bank of New York since 1985. He joined the bank in 1976 as vice president and chief economist and later served the bank as senior vice president and chief financial officer as well as executive vice president. Prior to joining the bank, he was a business economist with the Federal Reserve Bank of Atlanta.

Mr. Morphew has served as president and chief executive officer of the Federal Home Loan Bank of Indianapolis since 1979. A CPA, Mr. Morphew spent 19 years with Peat Marwick Main & Co. in Detroit, the last 10 years as a partner, before joining the Indianapolis Bank.

Mr. Dowling has been director of the Office of Finance of the Federal Home Loan Banks since 1984. He joined the office in 1980 as deputy director and became acting director in 1983. From 1966 to 1979, he was with Westpac Pollock Government Securities, Inc., first as vice president and then as president.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

JM 5310

FOR IMMEDIATE RELEASE September 28, 1989

DEPARTM...

Statement of
Nicholas F. Brady
Secretary of the Treasury

Today's House vote shows strong bipartisan support for strengthening America's economy, creating new jobs, and giving American small businesses and entrepreneurs a fair chance to compete internationally. A lower capital gains tax rate can create incentives for the kind of risk-taking that leads to new technology and a competitive edge.

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NB-478

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
September 28, 1989

CONTACT: Peter Hollenbach
(202) 376-4302
or
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(202) 755-1591

TREASURY AND HUD CALL FHA INSURANCE FUND DEBENTURES

The Departments of Treasury and Housing and Urban Development announced today the call of all Federal Housing Administration (FHA) debentures, outstanding as of September 30, 1989, with interest rates of 8 1/2 percent or higher. The date of the call for the redemption of the more than $109 million in debentures is January 1, 1990, with the semi-annual interest due January 1, paid along with the debenture principal.

Debenture owners of record as of September 30, 1989, will be notified by mail of the call and given instructions for submission. Those owners who cannot locate the debentures should contact the Federal Reserve Bank of Philadelphia, (215) 574-6684 for assistance.

No transfers or denominational exchanges in debentures covered by this call will be made on or after October 1, 1989, nor will any special redemption purchases be processed.

The Federal Reserve Bank of Philadelphia has been designated to process the redemptions and to pay final interest on the called debentures. To insure timely payment of principal and interest on the debentures, they should be received by December 1, 1989, at:

The Federal Reserve Bank of Philadelphia
Securities Division
P.O. Box 90
Philadelphia, PA 19105-0090

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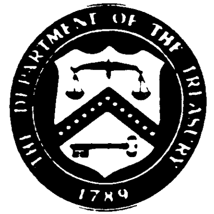
TREASURY NEWS



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TREASURY

For Release Upon Delivery
Expected at 10:00 a.m. EST
September 29, 1989

STATEMENT OF
NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Administration on the implications of our low national savings rate and on the proposed expansion of the Individual Retirement Accounts (IRAs), and in particular the 50 percent deductible IRA proposal. My written statement is divided into five main parts: a discussion of the implications of our low national savings rate; a description of current-law IRA provisions and their development; a description and discussion of the 50 percent deductible IRA proposal; and a discussion of our current knowledge of the effect of IRAs on savings; and design considerations for evaluating IRA proposals. I will close with a discussion of why the Administration supports a capital gains tax reduction.

The Bush Administration is concerned about the nation's low savings rate, and currently has a comprehensive study underway on how to raise the savings rate fairly and effectively. But we believe the 50 percent deductible IRA proposal is too expensive at a time when reaching Gramm-Rudman deficit-reduction targets is our first concern. IRA expansion could prove desirable, but only when we have achieved a consensus on the effectiveness of IRAs in promoting future savings.

NB-480

National Savings

There is widespread agreement among business, labor, government, and academic analysts that investment in human and material resources is necessary in preparing for the future. Such investment depends upon an adequate supply of savings drawn from domestic and foreign sources.

The data demonstrate that there is a positive relationship between a nation's saving rate and its economic growth rate. As Exhibit 1 illustrates, countries that save more grow more. Saving and investment are crucial factors for promoting economic growth and meaningful jobs; for enhancing the nation's ability to compete in the rapidly integrating world economy; and for adjusting to the changing demographics of the workplace as the baby boom generation ages.

The U.S. economic record is impressive. We are about to enter the eighth year of sustained economic growth - a unique achievement. Americans enjoy a high standard of living, relatively low rates of inflation and unemployment, and progress has been made in reducing the unacceptable budget deficit and foreign trade deficit, although we need to go much further in correcting these two economic problems.

Despite the overall economic progress achieved, however, there is justifiable concern that the United States is not adequately preparing to compete in an integrated world economy. Its rates of national saving and investment are too low relative to our future growth goals and relative to the performance of other industrial nations.

The long-term savings performance of the U.S. economy from 1898 to 1988, measured as gross savings as a percent of the gross national product, has been stable, except for the 1930s and 1940s (Exhibit 2). From 1946 through 1988, the U.S. gross savings rate has averaged 15.9 percent per year. Since the late 1970s, however, a disturbing downward trend in the gross savings rate has become evident.

The same pattern of erosion is evident when considering net saving as a share of net national product, as we demonstrate with Exhibit 2. This figure removes depreciation from the calculation to create a better measure of the net additional resources available for expanding investment beyond the mere replacement of existing assets. As indicated in Exhibit 3, total net saving, including all levels of government, has declined steadily since the late-1970s and is now well below the 1950-1989 average level.

This erosion is attributable to the deteriorating trend of both private savings and the dissaving created by chronic federal government budget deficits.

The pace of personal saving has deteriorated as the baby boom generation has matured, resulting in a national emphasis upon consumption. This measure declined to a 40-year low point of 3.2 percent in 1987, before recovering somewhat to 4.4 percent in 1988. During the first eight months of this year there has been improvement -- up to an annualized pace of 5.5 percent -- but this figure is still well below the long-term average of 6.8 percent reported for the 1948 to 1988 period. It is too early to announce that Americans are reversing their recent habits, though the future aging of the baby boom generation may gradually improve the figure.

The negative effects of the government budget deficits are even more distressing. The deterioration of fiscal conditions is evident when the size of the chronic Federal budget deficits is compared to the overall output of goods and services (Exhibit 4).

The unfortunate diversion of private savings--the total accumulation of households and business--to finance public consumption is a fundamental risk for the future of the U.S. economy. This is particularly important if we are to improve national productivity by expanding capital investments to enhance our international competitive position. The summary table of national saving and investment rates contained in Exhibit 5 describes the challenge.

This exhibit points out that private savings have eroded in recent years at the same time that public dissaving (Federal budget deficits) have increased -- leading to a large net reduction of national savings (the combination of private and public figures). This unfortunate combination has constrained net domestic investment.

Our challenge is twofold. First, we must make significant reductions in the prospective Federal budget deficits. Second, we must identify efficient incentives for encouraging increased saving and investment.

<u>Current Law</u>

The current law for IRAs grants married taxpayers who do not participate in a qualified retirement plan or who have adjusted gross incomes below $50,000 the right to make deductible contributions to an IRA. There are lower thresholds if the taxpayer is single or is married but does not file a joint return. Taxpayers who do participate in a qualified retirement plan and

who have adjusted gross incomes above these thresholds may make only non-deductible contributions to an IRA. Both deductible and non-deductible IRA contributions are limited to the lesser of $2,000 or the individual's taxable compensation for the year.

Withdrawals from an IRA prior to age 59-1/2 are subject to a 10 percent excise tax. In addition, most IRA withdrawals are subject to regular income tax. The exception is for distributions of amounts which were not deductible when contributed.

The current rules governing IRAs were adopted in the Tax Reform Act of 1986 (the "1986 Act"). Under prior law, all taxpayers, regardless of income or participation in a qualified retirement plan, could make deductible IRA contributions up to the lesser of $2,000 or taxable compensation. The Joint Committee on Taxation's General Explanation of the 1986 Act listed a number of reasons for the change: the determination by Congress that IRAs had not discernibly increased aggregate personal savings; the increasing availability of other tax-favored retirement savings plans which are subject to non-discrimination rules; the concentration of IRA utilization among higher-income taxpayers; the belief that higher-income taxpayers would have saved without tax benefits; and the belief that the lower tax rates provided by the 1986 Act would in themselves stimulate savings. Many of these questions still exist.

The 50-Percent Deduction IRA for Higher Income Taxpayers Proposal

Under this proposal, as we currently understand it, individuals who are not now eligible to make deductible IRA contributions would be allowed to deduct 50 percent of their IRA contributions. In addition, penalty-free withdrawals would be allowed for first-time home buyers and for qualified higher-education expenses.

This proposal needs clarification on two important issues. First, it is not clear from descriptions we have seen whether these penalty-free withdrawals would be limited to new IRA contributions made after the effective date or whether they would also be permitted from existing IRA balances (which may include large distributions from qualified retirement plans that have been rolled over into IRAs). We do not support permitting penalty-free withdrawals of retirement plan rollovers.

Second, it is not clear to us how the 50 percent proposal would characterize early withdrawals: could taxpayers claim that

their first dollar withdrawn represents the part of the contribution previously taxed, would withdrawals be pro-rated, or would some other rule apply?

Beyond these two technical questions, the Administration cannot support the 50 percent proposal because of its cost. The proposal, if effective in 1990, would cost $15.3 billion in FY 1990-94. Even if delayed until 1991, it would still cost more than $11 billion over the same period. In the current environment requiring budget stringency, we do not have the funds to pay for such an expenditure.

It should also be noted that more than 88 percent of all taxpayers had adjusted gross incomes of less than $50,000 in 1987. But under the 50 percent deductible IRA proposal more than 80 percent of all benefits will go to those who make more than $50,000, as Exhibit 6 demonstrates.

Saving Incentives

The Bush Administration feels that high rates of saving are fundamental to sustained long-run growth and the general competitiveness of the U.S. economy.

One of our efforts in this area is a study of personal saving and the cost of capital that is being prepared for the Cabinet's Economic Policy Council. The study will include a full discussion of private saving incentives, including IRAs. The Administration believes that IRAs deserve full and careful study and discussion, and that any proposal adopted should be a carefully structured program likely to achieve a real increase in saving.

The original intent of the expansion of IRAs under the 1981 Act was to provide uniformly available retirement income for individuals and to stimulate private saving. However, at this time, there is no firm consensus over whether IRAs were effective in meeting those goals. Furthermore, we simply cannot say at this time whether IRAs are the best vehicle for encouraging individual saving. Before we conclude that we should spend well over $10 billion to expand the existing IRA program, a number of questions about the effectiveness of IRAs as currently structured will have to be answered.

The question of whether IRAs stimulate personal savings is related to the more general question of whether personal saving is responsive to the after-tax rate of return. Economists have not been able to reach a firm consensus on this point. Early studies

seemed to indicate that personal savings did not increase in response to tax incentives. More recent studies suggest that they may have encouraged more savings.

IRAs generally have a contribution limit of $2,000 per year. Many taxpayers already save more than this limit and thus IRAs may provide little incentive for additional savings. In addition, there is no requirement that IRA contributions come from new savings. If someone simply moves money from a taxable savings account to an untaxed IRA - but does not increase his or her other savings - then the result of IRA expansion will simply be lost revenue. Hence, some people question whether expanding IRAs to higher income taxpayers will result in significant increases in personal savings.

One of the reasons that the verdict is still out on IRAs is that they were available to a broad part of the population for only a limited period of time. While we agree that this time was too short to tell whether or not IRAs were really effective in stimulating savings, it does provide a data base which deserves careful analysis.

Design of Saving Incentives

Ideally, saving incentives should provide a benefit to lower income households as well as higher income taxpayers. Under old law as in effect from 1981 to 1986, most benefits went to higher income taxpayers. Post-1986 IRAs have achieved better distribution. The 50 percent proposal which would restore fifty percent of the deductibility of contributions for permitted under old law for couples with income over $50,000 would have the distributional characteristics of old law. More than 80 percent of its benefits go to taxpayers with incomes over $50,000.

One possible alternative for lowering the current cost of IRAs is to allow tax-free build-up of interest income on non-deductible deposits. This type of "backloaded" IRA has recently been proposed by Senator Roth in S. 1256. Although the timing of taxes and deductions is different, a backloaded IRA is economically equivalent to a fully deductible IRA (provided the individual's tax rate does not change). This means that the value of taxes collected on the two types of accounts is essentially the same: the revenue costs of the fully deductible IRA are up front; those of the backloaded IRA arise in the future. However, out year losses under such a proposal will be large.

A good saving incentive should also be as flexible as possible. Current IRAs are structured as vehicles for retirement saving only. Younger savers faced with a "lock-up" of their funds until age 59 1/2 may not participate for this reason. There may

be some merit in the provisions of the proposals under consideration which would allow penalty-free withdrawals for first-time home purchases, college education expenses, and catastrophic medical expenses. Permitting loans from IRAs for these purposes might also be considered. Provisions such as these make IRAs more flexible saving devices and may be desirable in that they give individuals more freedom of choice over what to do with their savings. Moreover, they may be far less expensive than reinstating deductible contributions.

The idea of opening up IRAs to other than retirement saving is new and intriguing, and certainly deserves further study. However, this expanded penalty-free withdrawal should not be available for rollover IRAs from qualified retirement plans. These amounts derived from retirement plans should be preserved for retirement. Further, we should consider limiting borrowing for purposes of funding IRAs. Borrowing is simply the opposite of saving, and borrowing to set up an IRA is nothing more than a tax arbitrage gimmick.

If we take the time for careful deliberation, we can design saving incentives that work, that we can afford, and that won't be repealed when Congress feels the bite of lost revenue.

IRAs Are Not an Alternative to Capital Gains

Lastly, we do not believe that 50 percent deductible IRAs for higher-income taxpayers are a substitute for capital gains. A lower capital gains tax rate helps small and growing businesses, which create most of our new jobs. Because new ventures often have difficulty raising start-up capital, lower rates can create incentives for the kind of risk-taking that leads to new technology and a competitive edge.

Relative to our developed trading partners, the United States has among the highest taxes on capital gains. Belgium, Italy and the Netherlands don't tax capital gains at all. West Germany doesn't tax the gain on assets held more than six months. And France and Japan provide a differential rate for long-term capital gains that is considerably below ours. Why should we be the exception?

Yesterday, the House of Representatives took the first step toward redressing this competitive disadvantage by passing a capital gains tax reduction. The Bush Administration welcomes this step and urges the Senate to take that step as well.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
September 29, 1989

Contact: Bob Levine
(202) 566-2041

THOMAS C. DAWSON SWORN IN AS U.S. EXECUTIVE DIRECTOR OF THE IMF

The Department of the Treasury announced today that Thomas C. Dawson has been confirmed by the Senate and sworn in for a term of two years as U. S. Executive Director of the International Monetary Fund.

Mr. Dawson, who succeeds Charles H. Dallara in that position, since 1987 has been Executive Vice President of Regdon Associates in Alexandria, Virginia. From 1985 to 1987 he was Deputy Assistant to the President and Executive Assistant to the Chief of Staff at the White House.

In 1984-85 he was Assistant Secretary for Business and Consumer Affairs at the Department of the Treasury and from 1981-1984 Deputy Assistant Secretary for Developing Nations. He was an associate at McKinsey and Company in Washington, D.C. from 1978 to 1981 and served in the Foreign Service of the United States from 1971 to 1976.

Mr. Dawson has M.B.A. and B.A. degrees from Stanford University. He is married, has three children and currently resides in Washington, D.C.

NB-481

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press 566-2041
FFB 566-2468

FOR IMMEDIATE RELEASE September 29, 1989

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of August 1989.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $137.7 billion on August 31, 1989, posting a decrease of $1,124.8 million from the level on July 31, 1989. This net change was the result of decreases in holdings of agency debt of $11.1 million, in agency assets of $300.3 million, and in agency-guaranteed debt of $813.4 million. FFB made 47 disbursements during August.

The Continuing Appropriations Resolution for 1988 allowed FFB borrowers under foreign military sales (FMS) guarantees to prepay at par debt with interest rates of 10 percent or higher. Pursuant to this Resolution, FFB received FMS prepayments of $789.5 million in August 1989. FFB suffered an associated loss of $111.2 million.

Attached to this release are tables presenting FFB August loan activity and FFB holdings as of August 31, 1989.

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FEDERAL FINANCING BANK

AUGUST 1989 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #499	8/8	$ 9,160,000.00	11/6/89	8.339%	
+Note #500	8/24	28,800,000.00	11/21/89	8.405%	
+Note #501	8/24	45,000,000.00	9/26/89	8.405%	
TENNESSEE VALLEY AUTHORITY					
Advance #1064	8/4	354,000,000.00	8/11/89	8.022%	
Advance #1065	8/7	245,000,000.00	8/15/89	8.259%	
Advance #1066	8/8	6,000,000.00	8/15/89	8.341%	
Advance #1067	8/11	351,000,000.00	8/17/89	8.254%	
Advance #1068	8/15	203,000,000.00	8/21/89	8.457%	
Advance #1069	8/15	6,000,000.00	8/18/89	8.457%	
Advance #1070	8/16	24,000,000.00	8/21/89	8.435%	
Advance #1071	8/17	346,000,000.00	8/23/89	8.340%	
Advance #1072	8/17	18,000,000.00	8/22/89	8.340%	
Advance #1073	8/21	200,000,000.00	8/28/89	8.248%	
Advance #1074	8/23	308,000,000.00	8/31/89	8.458%	
Advance #1075	8/28	51,000,000.00	9/1/89	8.356%	
Advance #1076	8/28	179,000,000.00	9/5/89	8.356%	
Advance #1077	8/31	100,000,000.00	9/5/89	8.266%	
Advance #1078	8/31	297,000,000.00	9/8/89	8.266%	
AGENCY ASSETS					
FARMER'S HOME ADMINISTRATION					
RHIF - CBO # 57528	8/1	300,000,000.00	8/1/04	8.000%	8.160% ann.
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Greece 17	8/7	5,135,799.93	2/25/14	8.196%	
Greece 16	8/11	766,244.99	9/3/13	8.201%	
Greece 17	8/11	869,688.71	2/25/14	8.201%	
Morocco 9	8/11	11,842.00	3/31/94	8.076%	
Greece 17	8/15	2,031,676.65	8/25/14	8.357%	
Greece 17	8/18	918,459.75	8/25/14	8.288%	
Greece 17	8/24	3,408,284.42	8/25/14	8.325%	

+rollover

FEDERAL FINANCING BANK

AUGUST 1989 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
*Miami, FL	8/1	$ 5,958,400.00	8/1/95	7.705%	7.853% ann.
*Newburgh, NY	8/1	343,000.00	8/1/91	7.692%	7.840% ann.
Florence, SC	8/8	4,898.59	7/2/90	8.292%	8.445% ann.
*Andersen, SC	8/14	55,319.78	10/2/89	8.354%	
Rochester, NY	8/16	680,000.00	8/15/90	8.457%	8.635% ann.
Syracuse, NY	8/18	2,787,000.00	7/2/90	8.429%	8.581% ann.
Syracuse, NY	8/21	213,000.00	7/2/90	8.418%	8.567% ann.
*Guaynabo, PR	8/30	2,333,334.00	8/30/94	8.491%	8.671% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
New Hampshire Electric #270	8/2	83,000.00	1/2/18	7.926%	7.849% qtr.
S. Mississippi Electric #330	8/7	2,125,000.00	12/31/19	8.164%	8.082% qtr.
W. Farmer Electric #285	8/7	1,561,000.00	1/3/17	8.175%	8.093% qtr.
Basin Electric #232	8/10	264,000.00	1/2/24	8.231%	8.148% qtr.
*Wabash Valley Power #206	8/14	7,193,000.00	1/2/18	8.247%	8.164% qtr.
Oglethorpe Power #320	8/17	2,322,000.00	12/31/19	8.251%	8.168% qtr.
Telephone Util. E. Oregon #256	8/21	2,187,000.00	1/2/24	8.276%	8.192% qtr.
*Colorado-Ute Electric #203A	8/24	1,125,000.00	1/3/17	8.351%	8.266% qtr.
Chugach Electric #321	8/30	5,371,000.00	12/31/19	8.350%	8.265% qtr.
New Hampshire Electric #270	8/30	196,000.00	1/2/18	8.354%	8.269% qtr.
*N.W. Electric #176	8/30	770,000.00	1/3/22	8.345%	8.260% qtr.
*Colorado-Ute Electric #203A	8/31	517,000.00	1/3/17	8.350%	8.265% qtr.
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-89-11	8/31	743,736,284.22	11/30/89	8.298%	

*maturity extension

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	August 31, 1989	July 31, 1989	Net Change 8/1/89-8/31/89	FY '89 Net Change 10/1/88-8/31/89
Agency Debt:				
Export-Import Bank	$ 11,007.6	$ 11,007.6	$ 0.0	$ 50.0
NCUA-Central Liquidity Facility	116.8	117.9	-1.1	-1.3
Tennessee Valley Authority	17,352.0	17,362.0	-10.0	221.0
U.S. Postal Service	6,195.0	6,195.0	-0-	602.8
sub-total*	34,671.4	34,682.6	-11.1	872.5
Agency Assets:				
Farmers Home Administration	54,611.0	54,911.0	-300.0	-3,885.0
DHHS-Health Maintenance Org.	74.7	74.7	-0-	-4.8
DHHS-Medical Facilities	88.1	88.1	-0-	-8.3
Rural Electrification Admin.-CBO	4,076.0	4,076.0	-0-	-63.2
Small Business Administration	11.9	12.2	-0.3	-3.5
sub-total*	58,861.7	59,162.0	-300.3	-3,964.8
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	10,684.9	11,472.4	-787.5	-5,326.8
DEd.-Student Loan Marketing Assn.	4,910.0	4,910.0	-0-	-0-
DOE-Geothermal Loan Guarantees	-0-	-0-	-0-	-50.0
DHUD-Community Dev. Block Grant	297.8	306.3	-8.5	-20.3
DHUD-Public Housing Notes +	1,995.3	1,995.3	-0-	-41.7
General Services Administration +	378.1	378.1	-0-	-9.4
DOI-Guam Power Authority	31.5	31.5	-0-	-0.6
DOI-Virgin Islands	25.9	25.9	-0-	-0.6
NASA-Space Communications Co. +	995.2	995.2	-0-	96.4
DON-Ship Lease Financing	1,720.5	1,720.5	-0-	-38.3
Rural Electrification Administration	19,270.0	19,256.6	13.4	64.7
SBA-Small Business Investment Cos.	556.0	574.5	-18.5	-76.6
SBA-State/Local Development Cos.	802.2	830.9	-28.7	-68.7
TVA-Seven States Energy Corp.	2,274.5	2,258.0	16.5	112.1
DOT-Section 511	37.3	37.5	-0.2	-8.9
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	44,156.4	44,969.8	-813.4	-5,368.6
grand total*	$ 137,689.5	$ 138,814.3	$ -1,124.8	$ -8,461.0

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
October 2, 1989

Contact: Peter Hollenbach
(202) 376-4302

TREASURY REQUIRES DIRECT DEPOSIT OF INTEREST PAYMENTS FOR NEW ISSUES OF SERIES HH SAVINGS BONDS

The Department of the Treasury announced today that effective October 1, 1989, interest payments for new issues of Series HH savings bonds will be made only by electronic funds transfer. Investors will be required to furnish account and financial institution information at the time of exchange or reinvestment to arrange for direct deposit of interest. Interest will be paid directly to the account specified by the bond owner.

Series HH savings bonds are only available on exchange for accrual type savings bonds (Series E&EE bonds and Savings Notes) or, by reinvesting the proceeds of maturing Series H savings bonds. Bond owners opting to reinvest their Series H proceeds will also be required to have their interest paid by direct deposit.

Owners of Series H and Series HH bonds issued through September of 1989 who are receiving checks can elect to receive their interest by ACH payment. The Treasury encourages bond owners to switch to direct deposit for their interest payments because it means more convenience for investors by eliminating trips to the bank and the possibility of lost, stolen or delayed checks.

Treasury took this step as part if its continuing effort to improve the effectiveness of the savings bonds program. This action is similar to steps taken in 1986, requiring ACH payments for new issues of marketable securities.

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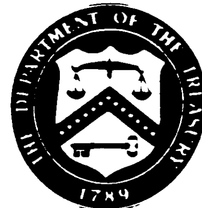
TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
October 2, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,408 million of 13-week bills and for $7,401 million of 26-week bills, both to be issued on October 5, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing January 4, 1990			:	26-week bills maturing April 5, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.82%	8.09%	98.023	:	7.88% a/	8.32%	96.016
High	7.84%	8.11%	98.018	:	7.93%	8.38%	95.991
Average	7.83%	8.10%	98.021	:	7.92%	8.36%	95.996

a/ Excepting 1 tender of $1,300,000.

Tenders at the high discount rate for the 13-week bills were allotted 29%.
Tenders at the high discount rate for the 26-week bills were allotted 59%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 32,305	$ 32,305	:	$ 22,410	$ 22,410
New York	24,719,550	6,430,950	:	18,855,745	5,838,445
Philadelphia	18,600	18,600	:	17,570	17,570
Cleveland	42,420	38,090	:	32,425	32,425
Richmond	45,280	45,280	:	45,485	45,485
Atlanta	47,180	38,650	:	26,165	26,165
Chicago	1,322,625	52,625	:	1,061,595	466,095
St. Louis	43,910	23,405	:	32,790	26,790
Minneapolis	10,565	10,565	:	9,620	9,620
Kansas City	39,080	39,080	:	48,340	48,340
Dallas	37,630	27,630	:	34,750	24,750
San Francisco	814,365	89,365	:	959,755	154,255
Treasury	560,955	560,955	:	688,540	688,540
TOTALS	$27,734,465	$7,407,500	:	$21,835,190	$7,400,890
Type					
Competitive	$23,967,130	$3,940,165	:	$16,658,275	$2,523,975
Noncompetitive	1,262,100	1,262,100	:	1,247,515	1,247,515
Subtotal, Public	$25,229,230	$5,202,265	:	$17,905,790	$3,771,490
Federal Reserve	2,121,435	1,821,435	:	2,100,000	1,800,000
Foreign Official Institutions	383,800	383,800	:	1,829,400	1,829,400
TOTALS	$27,734,465	$7,407,500	:	$21,835,190	$7,400,890

1/ Equivalent coupon-issue yield.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
October 3, 1989

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,800 million, to be issued October 12, 1989. This offering will provide about $225 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $14,566 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Tuesday, October 10, 1989. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,400 million, representing an additional amount of bills dated July 13, 1989, and to mature January 11, 1990 (CUSIP No. 912794 TL 8), currently outstanding in the amount of $6,984 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $7,400 million, representing an additional amount of bills dated April 13, 1989, and to mature April 12, 1990 (CUSIP No. 912794 TZ 7), currently outstanding in the amount of $9,075 million, the additional and original bills to be freely interchangeable.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing October 12, 1989. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,781 million as agents for foreign and international monetary authorities, and $3,522 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

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Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
October 4, 1989

Testimony of the Honorable
Nicholas F. Brady
Secretary of the Department of the Treasury
and
Chairman of the Oversight Board
of the Resolution Trust Corporation
Before the
Senate Committee on Banking, Housing, and Urban Affairs
Wednesday, October 4, 1989

Chairman Riegle, Senator Garn, and Members of the Committee, thank you for inviting us here today to discuss the progress made by the Resolution Trust Corporation (RTC) and the Oversight Board over the past two months. Only forty business days have passed since the President signed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which established the RTC and the Oversight Board, yet we have accomplished a good deal during this very short period of time.

As you pointed out in your letter of invitation, the Administration decided early in the legislative process that the RTC should "hit the ground running" as soon as the legislation was enacted -- and it did. An interagency "ramp-up" committee chaired by John Robson, Treasury's Deputy Secretary, planned and coordinated the numerous governmental changes required by FIRREA, but paid particular attention to the start-up of both the Oversight Board and the RTC.

As a result, only an hour after President Bush signed FIRREA, the Oversight Board held its first meeting and completed the necessary organizational actions; promulgated its initial policies for the RTC; authorized the first disbursement of RTC funds; and appointed its interim officers and staff. Within hours on the same day, the RTC held its first board meeting as well and swiftly began the case resolution process.

In the eight weeks since these initial actions, the RTC and the Oversight Board have continued to tackle the immense job that lies before us, one challenge at a time. The Board has met four

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times, including our first public meeting on September 21, to adopt policies and resolutions addressing some of the initial issues facing the RTC. Speaking for the Oversight Board, we are pleased with our progress, but have no illusions about the magnitude of the task that still lies ahead.

As you know, while the RTC is charged with operational responsibility for the implementation of the thrift cleanup, the Oversight Board sets general policies for the RTC and oversees its operation. As a result, our testimony will describe what the Oversight Board has accomplished in the last eight weeks, focusing on three key subjects: organization and personnel; oversight and auditing; and policy development. Chairman Seidman will describe the activities of the RTC during the same period.

Before turning to these subjects, however, let me say that we are very pleased with the professional and cooperative working relationship that has developed between the Board and the RTC. No joint enterprise of any magnitude is without its healthy frictions, and ours is no exception. But overall we have gotten off to an excellent start.

I. Organization and Personnel

As an organization with general policy making and oversight duties, rather than operational responsibilities, the Oversight Board expects to maintain a lean staff of skilled personnel. To fill these positions, the Board has the ability both to hire its own employees and to draw on the expertise of other government agencies. While over time the Board expects to fill most of the positions with its own employees, the start-up phase has been largely managed by personnel detailed from other agencies.

At our first meeting, we named John Robson to act as interim President and CEO of the Board. He recruited a small group of senior government executives to begin the Oversight Board's operations immediately.

This has worked out extremely well. One of the real advantages of having department heads serve directly on the Oversight Board has been the ability to make use of some of our best and most experienced government personnel. The different missions of our respective departments and agencies have provided an extraordinary balance of expertise.

The Federal Reserve Board has provided much-needed banking expertise, as has the Treasury Department through the Office of the Comptroller of the Currency. Treasury's new Office of Thrift Supervision has provided hands-on knowledge about the thrift industry, while Treasury personnel have provided overall

financial advice in connection with REFCORP borrowing and issues related to working capital. Finally, Congress's wisdom in putting the Secretary of HUD on the Board is now apparent, since we will very much need the counsel of his department in connection with issues involving the disposition of mortgages, consultation with other asset disposition agencies, and setting policies for the disposition of low-and moderate-income housing.

The Oversight Board will probably continue to dip into this pool of agency talent going forward, but we are pleased to report that the most important step toward developing a permanent staff has been completed: the Board has chosen Daniel P. Kearney as the permanent president and CEO of the Oversight Board.

Mr. Kearney brings to this position substantial expertise and relevant experience in both the private and public sector. In his government role he was Associate Director of the Office of Management and Budget; President of the Government National Mortgage Corporation; Deputy Assistant Secretary of the U.S. Department of Housing; and Director of the Illinois Housing Development Authority. In the private sector he has specialized in real estate finance at both Aldrich, Eastman & Waltch and Salomon Brothers, where he was one of the founders of the Mortgage Securities Department. He has practiced law and has received degrees in business administration, economics, and law.

We expect Mr. Kearney to move quickly over the coming months to develop a top-notch professional staff, while at the same time continuing to draw on agency personnel as necessary.

Appointments to the Oversight Board and the Advisory Boards

As you know, the two independent members of the Oversight Board must still be appointed. This process has been given top priority, and selections have been made pending the Presidential appointment clearance process. Just as soon as it is appropriate the nominations will be submitted to this Committee for the beginning of the confirmation process.

Likewise, the Oversight Board has begun the process of selecting members for the regional and national advisory boards that will advise both the RTC and the Oversight Board on asset disposition. The Board must appoint five members to each regional advisory board, which will report to the RTC, and the chairperson of each regional board will serve on the national advisory board, which will report to the Oversight Board. The chairperson of the national advisory board must also be appointed by the Oversight Board.

On August 9, the Board passed a resolution that led to the establishment of six regional advisory boards that will be

headquartered in New York, Atlanta, Chicago, Dallas, Denver, and Los Angeles. The boundaries of the six regions have been defined according to a number of factors, including the concentration of distressed assets, the coordination of RTC regional headquarters for asset sales, and the similarity of types of problem assets.

Again, the selection process for advisory members is well underway, although no final appointments have yet been made.

II. Oversight and Audits

FIRREA expressly provides that "[t]he Oversight Board shall oversee and be accountable for the Resolution Trust Corporation." This is a responsibility that requires continuing review of RTC actions and the disposition of RTC funds.

We have taken our oversight responsibility seriously from the very first day of operation. A priority has been to establish systems and controls to document the need for funds, to trace their use, and to determine that RTC spending and other activities conform with policies established by the Oversight Board. While the process is an evolving one, the Board is satisfied with the progress made.

Advance Controls: At the Oversight Board's first meeting, we adopted a policy regarding procedures and documentation for approving RTC financing requests that was later supplemented by a policy for the prioritization of funds disbursed by the RTC. These procedures require the RTC, in advance, to support the need for authorization and disbursements of funds by the Oversight Board for case resolutions, high cost funds replacement, liquidity advances, and administrative expenses.

This has evolved into a two-step process. The first step is the RTC's submission to the Board of a general business plan that describes its projected need for funds over succeeding weeks and requests a general authorization to spend the projected amount. After staff review and recommendation, the request is submitted to the Board for a general authorization for the RTC to draw all or part of the requested funds.

The Board's general authorization does not release the funds, however. That comes during the second step of the process, when the RTC submits a written request for funds needed for actual spending consistent with the Oversight Board's general authorization and the RTC's general business plan. These actual spending requests do not involve the Oversight Board in specific case resolutions or spending actions -- that is prohibited by FIRREA. The only time the Board reviews individual

instances of amounts spent is during the auditing phase after the transaction is completed.

Each actual spending request is reviewed to determine if it includes all the required information, is signed by a Certifying Officer, and conforms with the uses of funds permitted by FIRREA and Oversight Board policies. If the Oversight Board has authorized sufficient funds to meet the request, a staff memorandum including recommended action is prepared and sent to the Oversight Board CEO. Only upon his approval are funds actually transferred to the RTC account.

This disbursement process generally takes place quickly and efficiently, while at the same time ensuring that RTC funds are properly accounted for.

Audits: The Oversight Board's audit responsibility extends to the overall performance of the RTC, including its operations, management activities, internal controls, and budget performance. It also requires the RTC to submit the reports or documents necessary for the Board to carry out its oversight responsibilities. For example, the RTC must provide reports to the Board within two days on the status of any funds extended by the RTC for emergency liquidity or to replace high cost liabilities, as described below.

To begin to fulfill the Oversight Board's audit role we have conducted periodic RTC account reconciliations and developed verification and documentation requirements for RTC advances. In addition, we are currently developing more comprehensive audit and review procedures. Finally, we have recently conducted a few random on-site audits at selected thrift institutions to verify that RTC advances were used in accordance with Oversight Board authorizations and policies.

Priorities for Initial Spending: At our August 29 meeting, the Board adopted a policy that listed the priorities that were to guide RTC outlays during the period ending September 30, 1989. We determined that the RTC should expend funds first to resolve institutions under its jurisdiction as quickly and cost effectively as possible.

The second priority was to accommodate the emergency liquidity needs of RTC institutions under RTC's jurisdiction. As part of this process the RTC must require institutions to promptly file a plan describing the funding steps to be taken to replace the emergency liquidity funding.

The final priority was to replace high cost liabilities of RTC thrifts, such as brokered deposits, with lower cost loans from the RTC. This immediate reduction in interest costs reduces thrift operating losses until the institutions are

resolved. So long as funds are available that cannot be used immediately for case resolutions (because the numerous thrifts that are currently insolvent cannot be resolved simultaneously), every dollar that is spent to reduce high cost liabilities creates direct savings for the RTC. The relatively simple transactions involved make it possible for the RTC to spend large sums of money quickly, responsibly, and for the direct benefit of the taxpayer.

The Board also established that the first high cost funds to be replaced should be liabilities that mature at institutions that are expected to be resolved in the near term (i.e., by the end of 1989) -- this makes the funds replacement a kind of "down payment" for imminent case resolutions. Preference was also to be given to institutions that ceased new lending and investments so that their lowered cost of funds would not be used to compete unfairly with healthy institutions.

Finally, in providing emergency liquidity and replacing high cost funds, the Board required RTC to take back notes that: (1) established an interest rate sufficient to cover both the government's borrowing costs and any RTC administrative costs; (2) had a maturity of no more than one day to ensure RTC liquidity; and (3) did not diminish the RTC's creditor position. The RTC was also required to establish controls so that insolvent thrifts would only use the funds for the intended purposes and in a prudent and safe and sound manner.

Amounts Authorized and Disbursed to RTC: With these procedures and policies in place, and based on its review of RTC business plans, the Oversight Board in six separate actions generally authorized a cumulative total of $20 billion to be disbursed to the RTC. All of this $20 billion has subsequently been disbursed to the RTC based on specific funding requests that were consistent with the general authorizations. We understand that the RTC will provide in its testimony the details about amounts actually spent, including a description of the institutions that received the funds and for what purposes, so we will not repeat these details here.

Results of Audits: Over the last several weeks, the Oversight Board has begun to send staff of the Audit and Review Division to selected RTC institutions that: (1) have been resolved; (2) have received funds for emergency liquidity; and (3) have received funds to replace high cost liabilities. The purpose of the audits is to verify that appropriate RTC financial controls are in place and that the Oversight Board's policies and procedures are being followed.

These random audits provided the basis for discussions with the RTC on how to maintain and improve its funds disbursement and

documentation procedures. The Oversight Board has been satisfied with these discussions.

As Chairman Seidman said recently, the RTC will probably be the most audited agency in United States history. That appears to be exactly what Congress intended, and the Oversight Board intends to carry out its auditing and oversight duties under both the letter and the spirit of FIRREA.

III. Policy Development

The Oversight Board has established a two-track system to develop policies for the RTC. The first track is to develop individual policies on an ongoing basis to address various issues that require decision in order for RTC to carry forward its work. The second is to develop an overall strategic plan, as required by FIRREA, for conducting the RTC's functions and activities. This will incorporate individual policies already adopted and at the same time address a broader range of issues confronting the RTC. The strategic plan will be submitted to Congress by the end of this year.

FIRREA requires the Oversight Board to consult with the RTC in establishing overall strategies, policies and goals. As a result, one of the Board's first actions was to establish a joint policy development task force consisting of personnel from both the Oversight Board and the RTC. This group has met regularly over these past weeks and has worked well together in developing the initial Oversight Board policies and the foundation for the strategic plan. We believe that continued cooperation and consultation are critical to the successful completion of the RTC's mission.

A. Strategic Plan

Before discussing the individual policies, let me say a brief word about the strategic plan. As you know, the plan must be filed with Congress by December 31, 1989, and both the Oversight Board and the RTC must testify on its contents by January 31, 1990.

In the plan we will undertake to address all of the major issues confronting the RTC (the minimum contents required for the strategic plan by FIRREA are attached -- see Attachment 1). The joint policy development task force has already begun the intensive preliminary work necessary to prepare a draft plan.

FIRREA does not require the Board to publish the strategic plan in the Federal Register for public comment. Nevertheless, the Board believes that it is important to receive public comment

on the plan before it is submitted to the Congress. At our open Board meeting two weeks ago we voted unanimously to do exactly that, and we intend the draft to be published in the Federal Register by late October.

Throughout the development of the plan, our staff will continue to meet informally with interested groups to ensure that their views are taken into account in adopting the final version.

B. Individual Policies Adopted

Thus far the Oversight Board has adopted 12 individual policies, all of which are attached to this testimony. (See Attachment 2) These are only a beginning, but they do address five categories of pressing issues confronting the RTC: ethics and conflicts of interest concerns; start-up issues; case resolution methods; initial asset disposition policies; and the review of the 1988 FSLIC transactions. Policies for other major issues -- such as overall asset management and disposition, especially with respect to low income housing -- will be developed as the case resolution process progresses and substantial amounts of assets come under RTC control.

1. Ethics and Conflicts of Interest

Because of the importance of ethics and conflicts of interest issues, and because the Committee's letter of invitation specifically asked us to focus on it, we will address this issue first. Let us assure you that the Oversight Board is as anxious as this Committee to protect against conflicts of interest, political favoritism, and other improper actions by employees, agents, independent contractors, and all others who perform services for both the Oversight Board and the RTC.

FIRREA expressly requires the Board and the RTC to promulgate regulations within 180 days of enactment governing conflicts of interest, ethical responsibilities, and post-employment restrictions for their officials and employees that will be no less stringent than analogous FDIC standards. The Act also requires the issuance of regulations applicable to independent contractors governing conflicts of interest, ethical responsibilities, and the use of confidential information consistent with the goals and purposes of the Federal conflict and procurement statutes. Finally, the Act requires the Board to establish procedures to ensure that all contractors and others who perform services for the RTC meet minimum standards of competence, experience, fitness and integrity.

To assure adherence to these standards until regulations can be promulgated, the Board established interim ethics and conflicts of interest policies for itself and the RTC at its

first meeting on August 9. For Oversight Board members and those employees who are detailed to the Board from other Federal agencies, the Board adopted the applicable agency's standards of conduct regulations until the Board's own regulations are issued. For those employees who are not covered by Federal standards, and for employees performing services for the RTC, the Board adopted the FDIC's standards of conduct regulations as the interim code of conduct. In addition, the Board directed the RTC to take immediate steps to assure that all its contractual and other actions are consistent with applicable provisions of FIRREA.

An ethics task force was also established consisting of senior ethics officials of the Treasury Department, the Board of Governors of the Federal Reserve, the Department of Housing and Urban Development, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation, who also represent the RTC. This group is charged with developing employee standards of conduct regulations for approval by the Oversight Board and the RTC. These regulations will also set standards for such special government employees as the members of the national and regional advisory boards and individuals working under contractual arrangements under the direct supervision of RTC employees. Simultaneously, the task force is developing regulations governing the conduct of independent contractors consistent with FIRREA.

In addition to its own work and meetings, the task force has alerted senior officials of the Office of Government Ethics of the project. The target date for issuing proposed regulations for public comment is mid-November.

In the meantime, however, working with the task force, the RTC developed an interim statement establishing principles of ethical conduct for independent contractors. This interim statement, which was submitted to the Oversight Board in advance, was adopted by the RTC Board at its meeting on September 26. The statement outlines the general ethical principles to which all contractors will be required to adhere. It also places them on notice that any of their actions that result or may create the appearance of a conflict of interest or political favoritism could lead to termination of their contracts. Furthermore, where any such action indicates a possible violation of Federal conflict or other criminal statutes, the matter will be referred to the Justice Department for investigation and prosecution.

2. <u>Start-Up Policies</u>

The second group of policies adopted by the Oversight Board addressed start-up issues that immediately confronted both the Board and the RTC. These include three policies that have already been described: procedures to document funding requests;

priorities for initial RTC spending; and the establishment of the joint policy development task force. A fourth policy that has been adopted confirms, as provided by FIRREA, that in any area where the Oversight Board has not adopted specific policies, the RTC is to be governed by the existing policies of the FDIC.

The adoption of these policies has enabled the RTC to move forward quickly without needing guidance from the Board for every issue it confronts. For example, in the area of asset disposition where the Oversight Board has not yet issued a comprehensive policy, the RTC may proceed under the existing asset disposition policies of the FDIC.

At its first Board meeting the RTC adopted a group of specific FDIC policies.

3. Case Resolution Policies

The Board has adopted three case resolution policies. The first was an interim policy adopted at the first Board meeting concerning complex and controversial financing techniques that had been used by either FSLIC or the FDIC in recent years. These included long-term asset guarantees; yield maintenance agreements; and substantial equity interests taken by the government.

The interim policy directed the RTC to avoid these techniques in its initial case resolutions so that the Oversight Board could fully consider the complex issues involved and adopt specific policies addressing them. This policy did not prevent the RTC from moving forward with any transaction, large or small, that did not involve these controversial financing techniques.

With this interim policy in place, the joint policy development task force examined the issues involved in complex long-term financing and recommended that the Board adopt two policies addressing both RTC guarantees and RTC equity stakes in resolved institutions. These were adopted by the Board at its September 21 public meeting and essentially supersede the interim policy adopted earlier.

Limitation on Guarantees: Because of its shortage of cash, FSLIC resolved cases in 1988 through long-term assistance agreements, such as yield maintenance and asset guarantees, that exposed the government to ongoing risk of loss and established complex incentive arrangements that may be difficult to supervise over time. The Oversight Board's policy will essentially stop this practice.

The guarantee policy curtails the use of financial guarantees and open-ended assistance agreements in connection with individual case resolutions. Instead, resolution

agreements are to be structured to place responsibility for the future financial success of the acquired institution on the acquirer. Such an approach reduces the complexity of the resolution transaction and avoids the need to structure comprehensive incentive agreements to protect the ongoing financial interest of the RTC.

The Board recognizes, however, that to expedite the resolution process, the RTC may find it appropriate to enter into agreements in which the acquirer initially accepts assets of unknown quality but reserves the right to return such assets to the RTC once the acquirer has had the opportunity to fully analyze the assets. In general, however, any such asset guarantees, capital loss coverage, or asset puts are to have a short-term maturity (i.e., no longer than six months) and should cover only the period required by the acquirer to complete its due diligence.

Equity Positions: In seeking to resolve institutions in an expeditious manner, the RTC may encounter situations where at the time of resolution there remains uncertainty over the value of the institution being resolved and, therefore, the appropriate amount of assistance required. This uncertainty creates the potential for extraordinary profits accruing to an acquirer.

Because of this potential for substantial or extraordinary profits, FIRREA gives the RTC the authority to "take warrants, voting and nonvoting equity, or other participation interests in institutions, assets or properties of institutions" under RTC jurisdiction. Such an ownership interest would allow the RTC -- and, therefore, the taxpayer -- to share in any extraordinary profits.

Equity ownership in a private company by a government agency, however, raises potential conflicts regarding the fair and equitable treatment of competing companies that must also deal with the government agency. This is especially true where the government has a substantial interest or actively participates in the management of the company.

True equity ownership can also expose the RTC to risk of loss over time as well as substantial gain. Such ongoing risk of loss is essentially identical to the ongoing risk attached to long-term asset guarantees or asset puts. Therefore, the Oversight Board adopted a policy giving the RTC guidance on ownership interests.

This policy directs the RTC to generally avoid taking equity positions that subject the RTC to ongoing risk of loss. It also directs the RTC to avoid taking active equity positions in institutions that it resolves. Recognizing the potential for extraordinary profits, however, the policy directs the RTC to

consider passive equity positions through the use of warrants or other devices that permit the taxpayer to share in upside gains (as in the Chrysler bailout) without being exposed to downside losses.

4. Initial Asset Disposition Policies

The development of comprehensive asset disposition policies is one of the most challenging policy tasks facing the Oversight Board. As mentioned above, we have tended to focus initially on the more immediate issues of start-up questions and case resolution issues.

Nevertheless, the Oversight Board has adopted three initial policies that directly or indirectly concern asset disposition. The first is a policy directing the RTC to establish a working group with other federal agencies involved in asset sales. It is obviously important to have consultation where different government agencies dispose of assets in the same distressed real estate markets.

Consultation among these agencies should assist the RTC in maximizing the net present value of real estate sold while minimizing the adverse effect of its transactions in distressed areas. It will also help the RTC achieve its statutory goal of making affordable housing available to low-income and moderate-income individuals.

The Board's second asset disposition policy involves the statutory requirement for the RTC to utilize the services of the private sector, particularly for asset management and disposition, if it determines that it is practicable and efficient to do so. (As a practical matter we believe the RTC will have no choice but to use the private sector extensively because of the sheer magnitude of assets involved.) The policy adopted at the first Board meeting directed the joint policy development task force to develop explicit standards for determining the availability, efficiency, and practicability of using the private sector and standards for choosing among competing private sector firms. This process is underway and the Board expects to consider staff proposals in the near future.

Finally, the Board adopted a policy requiring the RTC to provide a proposal to the Oversight Board for the appropriate disposition of the Federal Asset Disposition Association within 180 days after enactment. Once this proposal is received we fully expect to take Board action in time to satisfy FIRREA's liquidation deadline of 180 days from the date of enactment.

Again, these policies are only the beginning of a comprehensive plan to establish guidelines for the management and disposition of assets. The joint policy development task force

is already hard at work on these issues, and we expect such issues to be a key element of the strategic plan submitted to Congress.

The Board is also keenly aware of the low and moderate income housing issues that are involved in asset disposition and some of the tensions raised between maximizing returns to the RTC and achieving housing objectives. We are fortunate to have the Secretary of HUD and his staff to provide us assistance in this area. Our staff has also begun informal meetings with groups representing low-income housing interests (as we have with other groups affected by the legislation) and we expect that consultation process to continue.

5. Review of FSLIC Deals

The Board recognizes the substantial interest that Congress has in reviewing the FSLIC transactions to achieve cost savings. As you know, the RTC must file a report with the Board and with Congress concerning its comprehensive review of the FSLIC transactions that occurred between January 1, 1988 and August 9, 1989, and steps that can be taken to achieve taxpayer savings. The Oversight Board's role is to develop and establish overall strategies policies and goals in connection with any restructuring of 1988 transactions.

The Board at its first meeting requested the RTC to furnish by September 30 an initial draft of the methodology it intends to use to conduct its review of the 1988 transactions. We expect to receive this draft soon.

C. Working Capital Policies

In addition to asset disposition, a number of important issues will need to be addressed in the coming months either individually or as part of the strategic plan. These include asset management issues; the fairness and openness of bidding procedures for RTC thrifts and RTC assets; and issues concerning the types of institutions that can acquire thrift institutions.

One issue that will need resolution quickly relates to working capital and the use of RTC notes and guarantees. The RTC currently spends funds for two purposes: (1) to fill in the negative net worth "hole" of an insolvent thrift so that its assets cover its liabilities; and (2) to acquire certain assets (that are typically non-performing) resulting from either a liquidation or a so-called "clean bank" transaction (where bad assets are stripped out of a failed thrift before it is sold).

Funds spent for the first purpose, to fill the negative net worth "hole," are gone and will not be returned to the

government; the amount spent is the true cost of resolving an institution.

Funds spent to acquire assets are not gone, however; they are simply replaced by illiquid assets. Theoretically, until the assets are sold the RTC cannot use these resources to resolve other institutions. This would put tremendous pressure on the RTC to sell assets in order to unlock the cash or working capital necessary to resolve more cases.

Acknowledging this potential problem, FIRREA specifically authorizes the RTC to borrow funds against the assets acquired, subject to a borrowing cap based on the fair market value of the assets and other restraints. The Board and the RTC are currently examining a range of options for the best means of unlocking this working capital through different financing techniques.

A related issue that has recently been raised concerns FIRREA's borrowing cap. Suggestions have been made that the literal language of the statute permits the RTC to spend more than $50 billion to resolve cases, as opposed to borrowing funds for working capital purposes.

We disagree. The statute provides $50 billion to fill the negative net worth hole of currently insolvent thrifts and thrifts that fail over the next three years. RTC will not use RTC borrowings to increase that ultimate amount above $50 billion.

IV. REFCORP

During the first two months, the Oversight Board has also carried out its responsibilities in connection with the Resolution Funding Corporation (REFCORP), which is charged with raising $30 billion for thrift resolutions.

First, as required by FIRREA, the Oversight Board has selected two presidents of the Federal Home Loan Banks to serve as members of the REFCORP directorate along with the director of the Office of Finance of the Federal Home Loan Banks.

Second, as anticipated by FIRREA, the Oversight Board has requested and received a ruling from the Securities and Exchange Commission (SEC) that REFCORP bonds are exempt from registration under the Securities Act of 1933 and from regulation of trading under the Securities Exchange Act of 1934. The SEC found that the exemptions were consistent with the public interest and the protection of investors. These exemptions will reduce the cost of financing thrift resolutions by narrowing the spread between Treasury securities and REFCORP bonds.

Finally, in consultation with REFCORP staff, the Oversight Board drafted regulations for assessing the Federal Home Loan Banks as provided for by FIRREA. These regulations will be published shortly in the Federal Register. In addition, the Oversight Board asked the REFCORP directorate to assess the $1.2 billion that FIRREA directed the FHL Banks to pay to REFCORP in fiscal year 1989. The $1.2 billion was received by REFCORP on September 22, 1989, and has been disbursed to the RTC.

VI. Conclusion

Thank you again for giving us the opportunity to review the Oversight Board's activities since the passage of FIRREA. Chairman Greenspan, Secretary Kemp, and I would be glad to answer any questions you may have.

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FIRREA-MANDATED CONTENTS OF THE STRATEGIC PLAN

Title V, Section (a)(14)(B), of FIRREA requires the strategic plan to contain, at a minimum, the following:

1. Factors for determining order of resolutions.
2. Standards to select type of resolution.
3. Factors to consider in deciding treatment of nonperforming assets in assisted acquisitions.
4. Plan for disposition of assets.
5. Management objectives for measuring progress.
6. Plan for organizational structure, staffing, and use of third-party contracts.
7. Incentives to promote efficient asset management.
8. Standards for competition among and fair treatment of offerors.
9. Standards to prohibit discrimination in solicitation and consideration of offers.
10. Procedures for active solicitation of offers from minorities and women.
11. Procedures for notification of rejected offers.
12. Procedures for establishing market value of assets.
13. Procedures requiring timely evaluation of purchase offers.
14. Procedures for bulk sales and auction marketing of assets.
15. Guidelines for determining which assets have no reasonable recovery value.
16. Guidelines for conveyance of assets to state and local government agencies for use in HUD urban homesteading programs.
17. Policies and procedures for avoiding political favoritism and undue influence in contracts and decisions made by the Oversight Board and RTC.

Attachment 2

POLICIES FOR RTC ESTABLISHED AT OVERSIGHT BOARD MEETINGS

1. Establishment of joint Oversight Board-RTC policy development task force.

2. Procedures and documentation for approving RTC funding requests and the use of notes and guarantees.

3. Priorities for initial case resolutions (revised).

4. Interim ethics and conflict of interest standards.

5. Utilization of private sector.

6. Restructuring 1988 FSLIC deals to save taxpayer costs.

7. Disposition of Federal Asset Disposition Association (FADA).

8. Adoption of existing FDIC policies for RTC in other areas until the Oversight Board establishes appropriate general policies.

9. Priorities for RTC expenditures through September 30, 1989.

10. Guidance on Ownership Interests.

11. Interagency Consultation on Asset Sales.

12. Limitations on Guarantees.

POLICY 1

ESTABLISHMENT OF JOINT POLICY DEVELOPMENT TASK FORCE

To augment the policies adopted at this Oversight Board meeting, a joint policy development task force will be established immediately with personnel from both the Oversight Board and the RTC. This task force will make specific recommendations to the Oversight Board concerning overall strategies, policies and goals for the RTC and concerning the strategic plan that the Oversight Board must develop and submit to Congress by December 31, 1989. The policy areas to be addressed will include: (1) least cost case resolution methods; (2) asset disposition, including procedures concerning the right of first refusal granted to certain qualified buyers; (3) sources and uses of funds for RTC activities; (4) Oversight Board audit, review, and monitoring of RTC activities; (5) other policy areas specifically mentioned in the statute concerning the strategic plan; and (6) such other areas as deemed appropriate. The task force will provide an initial draft of recommended policies in each of these areas to the Oversight Board by September 15, 1989.

The Oversight Board staff will review these recommended policies and consult further with the RTC, if necessary, before the Oversight Board establishes additional policies.

POLICY 2

PROCEDURES AND DOCUMENTATION FOR APPROVING RTC FINANCING REQUESTS

A. <u>RTC Case Resolutions</u> (includes Asset Liquidations)

The following documentation from RTC will be required, in advance, to support the authorization of disbursements of funds by the Oversight Board for case resolutions:

a) projected dates of the transactions (initiation and completion)

b) face amount and estimated fair market value of assets and liabilities (including contingent liabilities) at latest available valuation date, for each institution

c) projected cost of case resolutions

d) method of resolution chosen (such as liquidation, "clean bank" or "whole bank")

e) estimated amount and nature of assets and liabilities expected to be retained

f) amount of funding requested to cover expected cost (and explanation of any overage funds sought beyond expected cost)

B. <u>RTC Working Capital</u> (notes, guarantees, and other obligations)

The following documentation from RTC will be required, in advance, to support working capital requests:

a) projected dates of the transactions

b) face amount and estimated fair market value of assets and liabilities (including contingent liabilities) at latest available valuation dates

c) projected net amount of working capital required

d) amount of funding or guarantee to cover expected working capital needs (and explanation of any overage funds or guarantee sought beyond expected amount)

e) nature and source of working capital (such as notes, guarantees or other obligations). If guarantee is sought, nature of entity whose financial obligations are guaranteed and its intended source of funds, if any.

f) collateral behind financing, if any.

C. RTC Operation Costs and Disbursements

The following documentation from RTC will be required to support projected operating expenditures and internal disbursements for which Oversight Board funding approval is requested:

-- personnel salaries and benefits

-- cost of outside contractors (asset management, asset disposition, etc.)

-- office overhead

-- other

In all cases, documentation shall be submitted with appropriate detail and categorization, as determined by the Oversight Board. In addition, documentation shall be submitted within an appropriate timeframe as determined by the Oversight Board.

POLICY 3

PRIORITIES FOR INITIAL CASE RESOLUTIONS

In order to provide an opportunity to address important policy issues that may have long-term implications, the Resolution Trust Corporation (RTC) should initially concentrate on case resolutions that do not involve complex asset disposition and financing techniques such as long-term asset guarantees, yield maintenance agreements, or substantial RTC equity interests.

This policy is not intended to preclude the RTC from implementing resolutions of institutions of any size or from initiating efforts to resolve institutions that might require complex asset disposition and financing techniques. If significant issues do arise during the resolution process that are not addressed by current Oversight Board or FDIC policies, these issues should be referred to the Oversight Board for immediate attention.

Revised August 29, 1989

POLICY 4

INTERIM ETHICS AND CONFLICTS OF INTERESTS STANDARDS

The Oversight Board and RTC are required to promulgate, within 180 days, regulations governing conflicts of interests, ethical responsibilities, and post-employment restrictions applicable to their members, officers, and employees, that are no less stringent than those applicable to the FDIC. The Oversight Board must also promulgate, together with RTC, regulations applicable to independent contractors governing conflicts of interests, ethical responsibilities, and the use of confidential information consistent with the goals of titles 18 and 41 of the U.S. Code. Finally, regulations must be promulgated by the Oversight Board that establish procedures for ensuring that any individual who is performing any function or service on behalf of RTC meets minimum standards of competence, experience, integrity and fitness.

Since the Oversight Board and the RTC must begin their operations immediately, it is necessary to establish interim policies and standards for ethics and conflicts of interests pending the promulgation of the necessary regulations.

Accordingly, pending the promulgation of these regulations, the members, officers, and employees of the Oversight Board who are subject to the standards of conduct regulations of another Federal agency shall be subject to the regulations of their respective agencies with regard to Oversight Board activities. In addition, during this interim period the regulations governing the responsibilities of the FDIC shall apply to those members, officers, and employees of the Board who are not subject to the standards of conduct regulations of any other Federal agency. Finally, the Oversight Board staff shall analyze the respective agency regulations applying to its members, officers, and employees in relation to the FDIC's regulations and submit to the Board proposed regulations that meet the relevant provisions of the FIRRE Act.

With respect to the RTC, pending the promulgation of regulations pursuant to the FIRRE Act, members, officers and employees shall be subject to existing regulations governing the responsibilities and conduct of the FDIC's members, officers and employees.

In addition, the RTC shall take immediate steps to ensure that all actions taken, and contractual or other arrangements entered into to carry out the purposes of section 21A of the Federal Home Loan Bank Act (which establishes the RTC and the Oversight Board), are generally consistent with the conflicts of interests and ethics provisions of that section. The RTC shall

advise the Oversight Board in 10 days, or sooner if practicable, of the steps it intends to take or the procedures it has adopted. Finally, pending the promulgation of regulations, any individual performing a function or service for RTC must abide by the specifications set forth in section 21A to meet minimum standards of competence, experience, integrity, and fitness.

POLICY 5

UTILIZATION OF PRIVATE SECTOR

The statute requires the RTC to utilize the services of the private sector if the services are available and if the RTC determines that it would be practicable and efficient to use them. The specific services mentioned are real estate and loan portfolio asset management, property management, auction marketing, and brokerage services.

This policy applies to the RTC immediately. Even during the initial period of action pursuant to an interim operating plan, the RTC must seek to use private sector services pursuant to the statutory standard. At the same time, the Oversight Board should develop more explicit standards for using private sector services, including:

-- A standard for determining the availability of such services;

-- A standard for determining whether the use of available services would be practicable and efficient; and

-- A standard for choosing among competing private sector firms.

An initial draft of these suggested standards shall be provided by the joint policy task force to the Oversight Board no later than September 30, 1989.

POLICY 6

RESTRUCTURING 1988 FSLIC DEALS TO SAVE TAXPAYER COSTS

The Oversight Board has the duty and authority to develop and establish overall strategies, policies, and goals for the RTC, in consultation with the RTC, for restructuring the insolvent institution cases resolved through agreements by FSLIC between January 1, 1988, and the date of enactment of the FIRRE Act. The goal of any restructuring is to achieve cost savings that will in turn reduce taxpayer costs.

Accordingly, the RTC should provide to the Oversight Board, by September 30, 1989, an initial draft of the general methodology to be used by the RTC in reviewing and analyzing such cases in order to determine whether restructuring would achieve savings. This methodology shall include an evaluation and review of costs under the FSLIC agreements with respect to capital loss coverage, yield maintenance guarantees, forbearance, tax consequences, and any other relevant and ascertainable cost considerations (including reasonable provision for contingencies), and shall further include a review of the bidding procedures used in resolving such cases in order to determine whether the bidding and negotiating processes were sufficiently competitive.

The Oversight Board will thereafter review the analytical methodology in consultation with the RTC and will develop and establish such strategies, policies, and goals as are necessary to achieve savings by RTC under such agreements.

POLICY 7

DISPOSITION OF FADA

The statute requires the RTC to liquidate the Federal Asset Disposition Association (FADA) within 180 days after enactment. Accordingly, the RTC shall provide a proposal to the Oversight Board by September 30 for the appropriate disposition of FADA and the handling of FADA's personnel.

POLICY 8

EXISTING FDIC POLICIES TO BE USED BY RTC DURING TRANSITION

It is the intention of the Oversight Board that the RTC will carry out its responsibilities under basic strategies, policies, and goals adopted by the Oversight Board. However, during the initial transition period, as the Oversight Board develops and establishes strategies, policies, and goals for the RTC, the RTC may carry out its responsibilities in accordance with the strategies, policies, goals, regulations, rules, operating principles, procedures, and guidelines of the FDIC existing at this time. As soon as practicable, but no later than August 15, 1989, the RTC shall provide the Oversight Board for its review, such FDIC strategies, policies, goals, regulations, rules, operating principles, procedures, and guidelines under which it is operating, and the Oversight Board will take such actions to develop, establish or modify such items as authorized and appropriate.

POLICY 9

PRIORITIES FOR RESOLUTION TRUST CORPORATION EXPENDITURES THROUGH SEPTEMBER 30, 1989

The following priorities should guide outlays by the Resolution Trust Corporation (RTC) during the period ending September 30, 1989:

I. Resolutions

The RTC shall, as first priority, resolve (purchase and assumption, transfer deposits, and/or liquidate) institutions under its jurisdiction as quickly and cost effectively as possible.

II. Deployment of Other Available Funds

To the extent funds available to RTC are not employed for first priority cases, RTC shall deploy such excess funds (A) to accommodate the emergency liquidity needs of institutions under its jurisdiction and (B) to replace high cost deposits and borrowings as they mature at institutions under its jurisdiction.

A. Emergency Liquidity

1. For institutions under RTC jurisdiction, the RTC should serve as "lender of last resort", that is RTC should provide funds to institutions experiencing liquidity difficulties when it determines that such institutions can neither liquidate assets nor raise funds from any other sources at reasonable rates to meet immediate liquidity needs.

2. The RTC should require institutions receiving emergency liquidity funds to promptly file with the RTC a plan describing the funding steps to be taken by the institution to replace the emergency liquidity funding.

B. Replacement of High Cost Liabilities

1. The RTC should use its best efforts to first replace high cost liabilities as they mature at institutions under its jurisdiction that are expected to be resolved by the end of 1989;

2. The RTC should then replace high cost liabilities as they mature at other institutions under RTC jurisdiction. Preference should be given to institutions that have ceased new lending and investments.

C. Terms of Funding Provided by the RTC

Funding for emergency liquidity or to replace high cost liabilities by the RTC to institutions under its jurisdiction should:

1. Be at an interest rate sufficient to cover the government's cost of borrowing such funds, plus an amount required to cover any related administrative costs of the RTC;

2. Have a maturity of one (1) day or on demand;

3. Be structured so that the RTC is a secured creditor or has a priority in liquidation equal to that of an insured depositor; and

4. Require assurances and appropriate internal controls so that funds provided will be used only for the intended purposes and in a prudent and safe and sound manner.

To allow proper monitoring and for cash management purposes, the RTC should, as soon as practicable, provide weekly reports to the Oversight Board on the status of any funds extended by RTC for emergency liquidity or to replace high cost liabilities.

POLICY 10

GUIDANCE ON OWNERSHIP INTERESTS

The Resolution Trust Corporation (RTC) should generally avoid taking equity interests in resolved institutions that expose the RTC to risk of loss over time. Such ongoing risk of loss is essentially identical to the ongoing risk attached to long-term asset guarantees or asset puts.

The RTC should also avoid taking equity interests that permit the RTC to exercise control or actively participate in the management of resolved institutions. This type of government participation invariably involves potential conflicts of interest and interference with the private sector that are undesirable.

The foregoing would not preclude the RTC from taking passive equity positions, through the use of warrants or other devices, so as to permit the RTC to share in any substantial gains by a resolved institution without subjecting itself to the ongoing risk of loss.

POLICY 11

INTERAGENCY CONSULTATION ON ASSET SALES

The RTC may be disposing of real estate assets in the same geographical markets as other federal agencies. In some cases, the real estate markets in these areas are currently distressed. As the RTC formulates its asset disposition strategies in these areas, it would be beneficial for the RTC to establish an informal working group to consult with other agencies that are selling assets in these same markets.

Such consultation would assist the RTC in maximizing the net present value of real estate sold while minimizing the adverse effect of its transactions in distressed areas. Such consultation might also assist the RTC in the preservation of the availability and affordability of housing for low-income and moderate-income individuals.

POLICY 12

LIMITATIONS ON GUARANTEES

In order to minimize the ongoing risk to the RTC arising out of resolved institutions, the RTC should minimize its use of any forms of financial guarantees and open-ended assistance agreements in connection with individual case resolutions. Notwithstanding the foregoing, indemnity agreements that serve to insulate or otherwise protect acquirers from the acts or omissions of the failing institutions may be utilized to facilitate resolution transactions. Resolution agreements should be structured so as to place full responsibility for the future financial success of the acquired institution on the acquirer. Such an approach reduces the complexity of the resolution transaction and avoids the need to structure comprehensive incentive agreements to protect the ongoing financial interests of the RTC.

The Board recognizes, however, that to expedite the resolution process, the RTC may find it appropriate to enter into agreements in which the acquirer initially accepts assets of unknown quality but reserves the right to return such assets to the RTC once the acquirer has had the opportunity to fully analyze the assets. In general, however, any such asset guarantees, capital loss coverage, or asset puts should be short-term (i.e, no longer than 6 months) and should cover only the period required by the acquirer to complete its due diligence.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

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STATEMENT OF
JOHN G. WILKINS
SENIOR ADVISOR (ECONOMICS)
OFFICE OF TAX POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Treasury Department on H.R. 1150 and H.R. 2493, both of which would repeal certain normalization requirements for public utility property.

H.R. 1150, "The Utility Ratepayer Refund Act of 1989," and H.R. 2493, "The Utility Customer Refund Act of 1989," both would repeal the requirements of section 203(e) of the Tax Reform Act of 1986 (the "1986 Act"), but with different effective dates. Section 203(e) requires that excesses in deferred tax reserves attributable to the use for tax purposes of accelerated depreciation for public utility property be normalized over the remaining useful life of the property. These excess deferred taxes resulted from the reduction in Federal income tax rates under the 1986 Act.

We believe that it was appropriate for Congress to decide in 1986 to impose limits on the regulatory treatment of excess deferred tax reserves. It is appropriate for Congress to decide whether to impose restrictions on the use by regulated utilities of benefits provided through the tax system. Although Federal tax law is not concerned with purely regulatory issues, it is properly concerned with the regulatory treatment of benefits provided by Congress through the tax system. In general, Congress has allowed the market to determine the use of benefits provided through the tax system. The constraints of the market are absent in the case of regulated utilities, however, and this creates the possibility that ratemakers may require utilities to

respond to such benefits in a way that diverges sharply from the way in which unregulated enterprises would respond. The intended purpose of these benefits could therefore be frustrated, and unintended economic distortions might result.

Moreover, we believe that the policy considerations that motivated Congress to impose the restrictions included in section 203(e) were rational ones. If this issue were left to be decided by the Treasury Department on policy grounds, we would resolve it in the same way that Congress did. In sum, we approve of the result produced by section 203(e). We believe that gradual flowthrough of excess deferred tax reserves over the remaining life of the appropriate assets is preferable to a more rapid flowthrough.

Although we believe that Congress's original decision on this issue was the correct one, we recognize that countervailing considerations--in particular a desire not to preempt the role of State utility commissions in setting rates--might now lead Congress to reconsider it. We can understand why Congress might decide to allow State regulators to decide the appropriate treatment of excess deferred tax reserves; however, we believe that a decision to repeal section 203(e) could have the adverse consequences discussed in this testimony.

As I will explain in more detail, the excess in deferred tax reserves created by the 1986 Act is not properly viewed as money that "belongs" to utility customers. Deferred taxes may be thought of as interest-free loans from the Federal Government to utilities for the ultimate benefit of their customers. When corporate tax rates were reduced by the 1986 Act, a portion of these loans was, in effect, forgiven, and a windfall was provided to taxpayers that previously had used accelerated depreciation for tax purposes. Thus, the excess in deferred tax reserves created by the 1986 Act is appropriately viewed as a benefit provided by the Federal Government, and thus by all taxpayers. Therefore, it was proper for Congress to impose conditions on the use of this excess by regulated companies to ensure that this benefit does not produce economic distortions.

Normalization of excess deferred tax reserves ensures that the full benefit of the reduction in tax rates resulting from the 1986 Act is available in a consistent and equitable pattern over time to all consumers of products and services of regulated utilities. If this benefit had been flowed through immediately, then the 1986 Act rate reductions would have had, in the case of regulated utilities, several undesirable consequences, none of which would be expected to occur in the case of unregulated companies. Under flowthrough accounting, the current generation of utility consumers would be unnecessarily favored over future generations of consumers. Unjustified and economically undesirable swings in utility rates would result; current customers would be undercharged and future customers would be overcharged,

resulting in distortions in the consumption of utility services over time and creating problems of intergenerational equity. Moreover, repeal of the normalization requirements for excess deferred tax reserves could place additional and unnecessary strains on utilities and their customers as they are forced to raise large amounts of additional new debt or equity to replace the financing that these excess reserves currently provide. Finally, we expect that repeal of section 203(e) could lead to some loss of Federal revenues.

Background and Description of Present Law

Congress first provided accelerated depreciation in the Internal Revenue Code in 1954. By the mid-to-late 1960s, certain problems had developed with respect to regulated utilities. Some regulators were immediately flowing through the benefits of accelerated depreciation, thereby offsetting the capital-subsidy effects of accelerated tax depreciation and also benefiting current consumers at the expense of future consumers of utility products. The Tax Reform Act of 1969 provided that accelerated depreciation would be available to regulated utilities only if normalization were followed for ratemaking purposes. Other normalization provisions regarding depreciation and the investment tax credit followed the 1969 Tax Reform Act.

In the Tax Reform Act of 1986, Congress extended the normalization requirements of prior law to the modified accelerated cost recovery system ("modified ACRS") provided in section 168 of the Internal Revenue Code of 1986. Under modified ACRS, a regulated utility is allowed to use accelerated depreciation for Federal income tax purposes only if the utility (i) uses the same depreciation method both in computing its regulatory accounting ("book") tax expense and in computing its book depreciation allowance recoverable in the cost of service, and (ii) maintains and adjusts a reserve for deferred taxes to reflect the difference between the method of depreciation used for book purposes and the method used for Federal income tax purposes. These normalization requirements are basically identical to those of prior law under section 168 of the Internal Revenue Code of 1954. The effect of the normalization requirements is to provide utility customers with the benefit of the zero-cost financing made possible by accelerated tax depreciation over the economic life of the assets to which it relates.

In addition, section 203(e) of the 1986 Act provided a new normalization rule concerning the transitional effects on utility regulatory accounting of the reduction in corporate tax rates provided under the 1986 Act. Section 203(e) of the Act does not apply to excess deferred taxes resulting from any decreases in tax rates occurring prior to the 1986 Act, for example, the

decrease in top corporate tax rates from 48 percent to 46 percent under the Revenue Act of 1978.[1]

Section 203(e) limits the rate at which the excess balance in a utility's reserve for deferred taxes, created by the reduction in tax rates under the 1986 Act, may be reduced and flowed through to ratepayers in the form of reduced prices. Any flowthrough or reduction of the excess deferred tax reserve that is more rapid than allowed under this normalization rule results in the taxpayer's public utility property being ineligible for accelerated depreciation. The effect of this rule is to require that the benefit of the rate reduction be flowed through over the remaining life of the assets in service at the time of the rate reduction.

Although the normalization provisions of the Internal Revenue Code may appear to preempt some element of discretion that would otherwise be left to ratemaking authorities, these provisions may help to insulate regulators from economic and political pressure to keep current rates as low as possible. The normalization provisions are necessary to ensure that the benefits provided through the tax system in the form of accelerated depreciation are used as Congress intended--as additional zero-cost capital to improve or maintain service.

Description of H.R. 2493 and H.R. 1150

Both H.R. 2493 and H.R. 1150 would remove the restrictions imposed by section 203(e). H.R. 1150 would repeal section 203(e) as though it had never been enacted, and would not substitute any other restrictions. H.R. 2493 would effectively repeal section 203(e), effective January 1, 1991. H.R. 2493 generally would require that the balance of the excess tax reserve as of January 1, 1991, be flowed through no more rapidly than ratably over a 36-month period beginning not earlier than January 1, 1991. H.R. 2493 also would permit this balance to be flowed through under the rules of section 203(e) if these rules would permit more rapid flowthrough.

Accounting For Federal Tax Subsidies

In setting the rates that utilities may charge their customers, utility regulators have two basic goals: (1) to establish rates that adequately cover the cost of providing utility services; and (2) to minimize the cost of providing those services.

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1 The Internal Revenue Service has issued several private letter rulings holding that accelerated flowthrough to ratepayers of the excess deferred taxes created under the Revenue Act of 1978 would not violate the normalization rules in effect at that time.

The rates that utilities charge for services must be sufficient to cover current expenses such as labor, fuel, and taxes, and the cost of acquiring and using capital assets to provide those services. The total costs attributable to the use of capital include a charge for depreciation, as estimated by regulatory authorities, interest payable to creditors, and a sufficient return to shareholders to maintain and attract equity capital. Stated in another manner, rates are set so that consumers are charged a price that reflects a fair, but not excessive, rate of return to equity.

Thus, under regulatory accounting, the size of the rate base--that is, the total book value of all assets used to provide utility services (all of which is financed by lenders and shareholders)--determines all components of the cost of capital used to produce utility services. The rate of return to lenders and shareholders is some "fair return" expressed as a percentage of the share of the rate base they have financed. Depreciation represents the fraction of the rate base used up in each year's production that must be replaced if the service output is to be maintained.

When utilities are allowed to use accelerated methods of depreciation for tax purposes, tax depreciation is more rapid than the actual economic or physical deterioration of capital assets and the economic effect is the deferral of taxable income and tax liability. The result is the same as if the Treasury were to extend a series of interest-free loans during the early years of an asset's life, which are repayable in the later years. If the amount of these loans is flowed through to current customers in reduced rates, these customers will pay too little for service; future customers, who will be both required to repay these loans and denied the benefit of interest-free financing of rate base, will pay too much for service. In contrast, normalization accounting correctly treats these loans in accordance with their economic substance and results in correct pricing of utility services. Under accounting practices required by the normalization rules, the deferrals of tax resulting from the use of accelerated depreciation are explicitly recognized as interest-free loans from the Government and are termed "deferred taxes," or "reserves for deferred taxes." The utility is not permitted to earn a return on assets financed by these deferred tax reserves. Thus, the utility's cost of service and the corresponding rates charged to the utility's customers are reduced by virtue of the benefits obtained through this "zero-cost" financing represented by deferred tax reserves. Accordingly, utility customers do receive a significant benefit from utility deferred tax reserves.

Normalization is designed to spread the benefits resulting from accelerated depreciation among the ratepayers using the assets that generated the subsidy. An asset used to produce utility services will be used by ratepayers over the entire

useful life of that asset. These same ratepayers should share in the benefits produced by the tax subsidy for that asset.

In contrast, if a procedure that permits a faster flow-through than normalization is applied to accelerated depreciation, the result will frustrate the congressional purpose in providing accelerated depreciation. If the income tax expenses for which ratepayers are charged are reduced immediately by the capital subsidy inherent in accelerated depreciation, current ratepayers will be undercharged because the proceeds of the interest-free loans will be treated as a current reduction in cost of service. Future ratepayers will be required to pay higher charges for two reasons. First, future customers must repay those interest-free loans through a higher cost of service. Second, they will have been deprived of the benefit of interest-free financing.

Under flowthrough, current ratepayers are undercharged because their rates are based on only Federal income tax payments currently due to the Government, and not on the full tax expense. Deferred tax liabilities relating to current economic income but payable in later periods are not charged to current ratepayers; instead they are charged to future ratepayers only when the deferred liabilities become due. Thus, future ratepayers are overcharged because they are required to pay a portion of the Federal income tax expense economically incurred by the utility when it was providing services to current ratepayers, but which was deferred because accelerated depreciation was used.

In contrast, normalization results in both current and future ratepayers being charged for their proper share of the income tax expense incurred by the utility over the economic life of the depreciable property providing utility services to the ratepayers. By recognizing that deferred taxes are interest-free loans, both current and future ratepayers benefit from the reduction in cost of service achieved by the interest-free financing that is used by the utility in lieu of equity and interest-bearing debt, which demand a rate of return and thus increase cost of service.

In sum, the normalization rules recognize that, when current customers pay prices for utility services that are based on tax expense computed using book depreciation rather than tax depreciation, they are paying the correct economic price for those services. The excess of the amount that utilities collect from current customers for tax expense over current taxes due and payable (that is, deferred taxes) is properly viewed as money that eventually will be repaid to the Federal Government.

Normalization of Excess Deferred Taxes

Under the 1986 Act, Federal income tax marginal rates were significantly reduced for both corporate and individual taxpayers. The maximum tax rate for corporate taxpayers was reduced

from 46 percent to 34 percent, while the maximum tax rate for individuals was reduced from 50 percent to 28 percent.

When former President Reagan first proposed sharp rate reductions to Congress in the process leading to passage of the 1986 Act, his proposal recognized that these rate reductions would have the effect of forgiving a portion of the "interest-free loans" previously made to all taxpayers--both regulated utilities and unregulated businesses--using accelerated depreciation for tax purposes. This loan forgiveness would, in effect, result in a windfall to taxpayers in proportion to their deferred tax reserves. For this reason, in May 1985 the President proposed to Congress that taxpayers using accelerated depreciation for tax purposes be required to pay additional tax to offset this windfall benefit.[2] Consequently, there was no need for a provision similar to section 203(e). Congress did not include this proposal in the legislation eventually enacted.

Although close consideration was not given in 1986 to the likely response of unregulated businesses to this windfall, such businesses would not have been expected to respond by temporary reductions in the prices of their goods and services. Moreover, it is unlikely that Congress or the Administration would have agreed to this windfall if they had anticipated such reactions. In the case of regulated utilities, however, if Congress had not enacted normalization requirements, then the 1986 Act rate reductions could have been misperceived as the basis for such temporary price reductions.

These requirements--contained in section 203(e) of the Tax Reform Act of 1986--ensure that the effect of the rate reductions on regulated utilities will not diverge sharply from their expected effect on unregulated businesses. Such businesses generally could be expected to retain the windfall as cost-free capital to be used to maintain productive capacity, rather than to finance a temporary price reduction.

Section 203(e) does not require utilities to mirror the behavior of unregulated companies. Instead it allows the return of this windfall to ratepayers, but not in the form of a one-time price cut. Thus it ensures that the windfall will benefit customers over the remaining life of the depreciable property to which it relates. Such treatment helps avoid the fluctuations in both utility rates and the demand for utility services that would result from the flow-through of the excess tax reserves to current ratepayers on an accelerated basis.

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2 The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity at 192-96 (May 1985).

The windfall created by the 1986 Act rate reductions should be viewed as an additional subsidy to users of accelerated depreciation. While all of this subsidy will eventually go to utility customers, it still provides utilities with low-cost financing, which they can use over the remaining useful life of the assets producing the subsidy. Repeal of section 203(e) might result in denial of this benefit to future customers.

Adverse Effects of Repeal of Section 203(e)

Rapid flowthrough of excess deferred tax reserves, which would be permitted if either H.R. 1150 or H.R. 2493 were to be enacted, would have a number of adverse effects. The first would be a temporary, unsustainable reduction of utility rates and an increase of utility output spurred by higher demand from price-sensitive customers. This would be followed by sharp increases in rates and reduction of output. This artificial "roller coaster" effect could create severe economic distortions and misallocation of resources.

The second effect would be a strain on utilities, which would be forced to resort to the capital markets to replace the financing (in the form of deferred taxes) that may be lost if section 203(e) is repealed with additional debt and equity capital. We estimate that immediate flowthrough, as would be permitted if H.R. 1150 were enacted, would require utilities to replace approximately $17 billion in financing. We estimate that flowthrough over 36 months, beginning January 1, 1991, as would be permitted if H.R. 2493 were enacted, would require utilities to replace about $16 billion over that period.

Third, we are concerned that rapid flowthrough of excess deferred tax reserves may lead to loss of government revenues. In the case of the Federal Government, flowthrough reductions in telecommunication charges could reduce excise tax collections by an estimated $70 million, or, on average, about $23 million per year, if telecommunication industry excess deferred tax balances are flowed through over the period permitted under H.R. 2493. Further, to the extent that benefiting ratepayers would spend some of their cost savings on goods and services produced by lower-taxed sectors of the economy, there could be some additional Federal revenue loss.

Fourth, rapid flowthrough of excess deferred tax reserves would effectively reduce the nation's aggregate savings, because such flowthrough would be spent, in large part, on consumption rather than saved. Our concern about this effect is a close corollary of our view that future consumers should not have to pay unwarranted higher prices to support a temporary increase in consumption by the current generation of consumers.

Conclusion

The normalization of capital subsidies provided through the tax system, which has been established in the tax laws for two decades, represents the correct regulatory accounting method for public utilities. By preventing the improper flowthrough of tax benefits to current ratepayers at the expense of future ratepayers, normalization requirements--whether relating to the benefit of interest-free loans provided through accelerated depreciation, or relating to the partial forgiveness of those loans by the tax rate reductions of the 1986 Act--ensure that tax benefits are allocated fairly among different generations of ratepayers. Normalization also ensures that the expectations of Congress in granting those benefits is not frustrated, and that regulated utilities respond to those benefits in a way that does not diverge sharply from the way in which unregulated companies would be expected to respond.

In the 1986 Act, Congress permitted utilities to use the benefit provided by excess deferred tax reserves to reduce utility rates, but required that they do so only in an even and consistent fashion. Section 203(e) represents a judgment that the windfall provided through the 1986 Act rate reductions should not be used by utilities to finance a sharp, temporary drop in prices. For these reasons, we believe that Congress's decision to enact section 203(e) was a good one. Although we understand why Congress might reconsider this decision, we hope that it will not be reversed.

Mr. Chairman, that concludes my formal statement. I will be happy to answer questions that you and Members of the Committee may wish to ask.

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FOR RELEASE UPON DELIVERY
Expected at 9:00 a.m., E.S.T.
October 4, 1989

Testimony of
Deputy Assistant Secretary
(Regulatory, Tariff, and Trade Enforcement)
Department of the Treasury
John P. Simpson
Before the Committee on Small Business
House of Representatives
October 4, 1989

Mr. Chairman and Members of the Committee: I am pleased to be invited to discuss with you the rules of origin of the U.S.-Canada Free Trade Agreement and the procedures established for certifying the eligibility of goods for preferential treatment under the Agreement.

A. Rules of Origin and Certification Procedures

The rules of origin to determine whether imported goods qualify for U.S.-Canada Free Trade benefits are different from the rules previously used by Customs to determine origin of goods. The rules, which were drafted to preclude third countries from obtaining tariff preference by merely passing their goods through Canada or the United States, are stipulated in Chapter Three of the Agreement.

As expected, the origin of some goods is much easier to determine. Natural substances, such as minerals extracted from Canadian soil, are wholly of Canadian origin and would qualify under the Agreement. When third country materials or components are incorporated into the goods, a substantial amount of processing or assembly must occur in the United States and/or Canada to result in a tariff classification change, as specified in Annex 301.2 of the Agreement.

NB-488

For some goods, a 50 percent value content requirement must also be met. The U.S. and/or Canadian materials and the direct cost of processing the Canada and/or the United States must be at least 50 percent of the cost of manufacturing the goods. The rules in Annex 301.2 specify when this requirement applies.

The rules of origin are commodity-specific in Annex 301.2. This Annex is broken down into 21 section, with each section covering a group of commodities. For example, Section 1 contains the specific rules for live animals and animal products; Section XI covers textiles and textiles articles. To determine whether goods qualify for preferential treatment, one must apply the rules in the section covering the goods.

Annex 406 of the Agreement makes the exporter responsible for certifying in writing the origin of the goods. The importer makes a declaration that the goods meet the rules of origin and therefore should received preference based upon the exporter's certification.

During the negotiation of the Agreement, U.S. and Canada Customs established a working group to develop uniform methods of implementing the Agreement. Although minor differences exist in the U.S. and Canadian versions of the implementation certificate, either form can be used. U.S. exporters can use either U.S. Customs form 353 or Canada Customs Form B-151 to certify. The same is true for Canadian exporters.

Customs does not require the presentation of the certificate in order to obtain release of the goods or to file an entry summary. The importer and exporter must maintain copies of certificates. Periodically, Customs may request copies for verification purposes.

The U.S. Customs Service is aware of the impact a new trade program of this magnitude has on business. In order to mitigate the impact of implementation, Customs took the following actions:

- interim Customs regulations were published in the Federal Register of December 23, 1988, with the comment period being extended at public request. Comments are being analyzed and regulations will be finalized soon.

- The Headquarters Office of Trade Operations ran a "help desk" to respond to questions from the public from

December 19, 1988, through the end of March 1989. The "help desk" handled over 2,000 free trade inquiries.

- The Office of Trade Operations began issuing telex fact sheets to field offices in December. The telexes provide guidance to the public on free trade issues, where to obtain information on importing to Canada and how to complete a certificate of origin. To date, seventeen facts sheet have been issued.

- Fact Sheet 9, which was issued in February, requested that field officers review certificates of origin in order to advise importers where information was deficient or erroneous. Such reviews were conducted to assist importers in understanding certificate requirements.

- Representatives from district offices were trained to be free trade instructors early in November of last year. Most trainers were from Canadian border ports; however, training was provided to all districts to ensure that all offices could provide assistance to the importing and exporting communities.

- Training seminars were conducted at 40 locations for U.S. importers and brokers from November 1988 through January 1989. since that time, additional training programs have been conducted by field offices, as needed.

- The U.S. Customs Service participated in 12 seminars for Canadian exporters during January of this year. The seminars were attended by 2,100 exporters throughout Canada. In addition, Customs participated in 26 seminars for U.S. exporters, which were sponsored by the U.S. Department of Commerce.

- A Customs booklet on free trade procedures and documentation requirements was published in May. This publication, which explains how to enter goods under the Agreement, is available to the public through all Customs district offices.

- In June, in the Buffalo, N.Y. District, U.S. Customs provided guest speakers for a workshop session and an exhibit booth. district personnel responded to inquiries from the approximately 2,000 representatives who attended

the conference sponsored by the U.S. Small Business Administration and AT&T.

Customs efforts to assist the importing and exporting community have been rewarded with a smoother implementation of the agreement than had been anticipated. We will continue to assist the public in learning how to apply the rules or origin and how to make preference claims. Given the anticipated increase in Canadian trade, Customs role will become more critical though it is too early to predict the volume of this increase.

The Customs Service recently completed an analysis of Canadian trade for the first 3 months of 1989. The analysis indicated an increase in overall Canadian trade of approximately 15 percent over the previous year. This is in line with the first quarters of 1987 and 1988 though analysis was inconclusive concerning the cause for the increase. Presumably the implementation of the free trade agreement is a contributing factor. We will continue to monitor trade data on a periodic basis to obtain a clearer picture of the impact.

B. Changes in Customs Procedures and Regulations at the Border

Procedurally, the changes due to free trade implementation have been minimal. An importer with a properly executed certificate or origin makes a preference claim at the time of entry summary by placing "CA" before the Harmonized Tariff classification for the goods. Since exporters are responsible for certifying origin, they are also responsible for maintaining supportive documentation for verification, and for providing a copy of the certificate to Customs upon request.

Though procedural changes have been minimal, there are other changes occurring on the border. One of the most significant is the testing and implementation of automated selectivity to assist our inspectors in the cargo inspection process. Automated cargo selectivity, in conjunction with our Line Release System, will permit us to quickly release the majority of arriving cargo, while providing the means for effectively and reliably targeting high-risk merchandise for preventing certain commodities from being transshipped through Canada in an attempt to illegally take advantage of the Agreement.

Our current plans are to conduct a 6-month test of the system at two locations (Blaine, Washington, and Champlain, New York) beginning in June of 1990. If the results of the test are

positive, we intend to gradually expand automated selectivity to other locations along the Canadian border.

Prior to discussing the border selectivity system in greater detail, I believe some background information will be helpful in understanding how it has evolved.

In an effort to respond to the ever increasing volume of cargo entering the United States each year, Customs developed the Automated Commercial System (ACS) to track imported cargo through all stages of the entry process, from the arrival of the merchandise in the U.S. to final liquidation of each entry. One module of ACS is the Automated Cargo Selectivity module, which was designed to permit our inspectors to quickly and accurately assess the risk associated with each commercial entry and to reliably determine the appropriate level of examination required.

The selectivity data base includes essential information concerning suspect shipments, special enforcement and marking initiatives, first-time relationship within a district, and other federal agency requirements. It also builds historical files which are critical to the development of productive examination criteria and the collection of reliable trade statistics.

Selectivity processing was initially implemented at several seaport locations in 1981 under a program called Automated Cargo Clearance and Enforcement Processing Techniques (ACCEPT). This Selectivity Module, which became operational in 1985, was gradually expanded to all major seaports and airports.

Implementation of this system on the Canadian border will be the final step in the achievement of a truly nationwide and uniform cargo release system.

I would like to assure you that the Customs Service clearly recognizes the fact that the Canadian border is a unique environment in comparison to airport and seaport locations, especially in terms of the critical need to avoid processing delays and traffic congestion. Consequently, we have taken the following actions to properly prepare the northern border for the implementation of cargo selectivity.

- We have instituted the Line Release System, which provides for the rapid release of repetitive cargo which our research has shown to be low-risk. This system utilizes bar code technology which identifies the shipper,

importer, filer, and commodity. Unless the inspector overrides the system, merchandise is directly released from the primary inspection booth, resulting in a large portion of imported cargo being removed from the selectivity processing workload.

- We have identified 27 commercial centers along the Canadian border where the vast majority of cargo enters the U.S. and where Customs is able to provide efficient 24-hour service through the existence of ACS capability, adequate inspector staffing, and sufficient facilities and equipment to effectively process the arriving cargo. In addition, provisions have been made to permit certain low-risk cargo to enter at other locations if routing to a commercial center presents and unreasonable hardship.

- During the expansion of automated selectivity processing, we have consistently made every effort to coordinate with and consider input from Customs brokers and other members of the importing community. In fact, our intention to automate our border cargo operations through selectivity was clearly explained to all interested parties as early as September of 1986, when the standard border cargo release from (CF-3461 ALT) was introduced.

I would like to emphasis the fact that this selectivity system will in no way affect the current procedures for conducting cargo inspections. For example, any shipment designated by Customs for examination will be presented for inspection at either the port facility or the nearly central examination station. As described previously, the automated system will simply assist our inspectors in determining those entries which require examination.

Because of the substantial improvements in efficiency derived from the use of the Line Release System and the Automated Cargo Selectivity Module, we anticipate no increase in our inspectional staff even though the total volume of imports from Canada is expected to grow significantly as a result of the Canadian Free Trade Agreement.

Since all of the necessary preparations have been completed, we believe that the time has come to achieve national uniformity of cargo processing expanding automated cargo selectivity to the Canadian Border. To this end, we will continue to work closely with the importing community to resolve any remaining concerns

and thereby ensure a smooth and methodical transition to this national system.

This concludes my statement. I will be happy to answer any questions you have.

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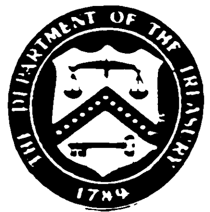

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STATEMENT OF JOHN NIEHUSS
SENIOR DEPUTY ASSISTANT SECRETARY
FOR INTERNATIONAL ECONOMIC POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON
INTERNATIONAL ECONOMIC POLICY
AND TRADE OF THE
FOREIGN AFFAIRS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
OCTOBER 4, 1989

Mr. Chairman. It is a pleasure to participate in this oversight hearing on the environmental impact of World Bank lending. We welcome the opportunity to 1) discuss Treasury's initiatives to move the World Bank's environmental agenda forward and 2) provide our assessment of the Bank's progress to date in the environmental area.

Bush Administration Policy

We want to note at the outset the great emphasis that President Bush and Secretary Brady have placed on environmental issues in the World Bank and in the regional development banks. In Building A Better America, released at the start of his administration in February 1989, the President directed the Treasury Department "to promote environmental considerations as a factor in the lending decisions of the multilateral development banks." At the Economic Summit Meeting in Paris in July 1989, he asked other heads of state to join with him in "encouraging the World

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Bank and the regional development banks to integrate environmental considerations into their activities." At the annual meetings of the World Bank and the IMF, completed just last week, the President called on the Bank and its member countries "to develop constructive solutions to global warming, including measures to promote energy efficiency and conservation and greater protection of forest resources."

Recent Treasury Department Initiatives

Secretary Brady has raised environmental issues at numerous high level international meetings, including the ministerial meeting of the Organization for Economic Cooperation and Development in May, at the World Bank's Development Committee meetings in May and September, and in his speech at the recent World Bank/IMF annual meeting.

Last Spring, Secretary Brady called on President Conable and members of the Bank's Development Committee to develop procedures for assuring that environmental impact assessments are completed for projects that have a significant effect on the environment. The World Bank formally adopted a set of these procedures last week and is preparing to implement them over the next several months. In addition, the Bank has announced its intention to review the experience in the implementation of these procedures in one year's time.

We believe that establishment of those procedures is an important step forward. However, the key will be in their implementation. At our urging, the Bank will provide an

opportunity for comment by interested outside parties. I am hopeful that non-governmental organizations from many member countries will do so.

Secretary Brady has also encouraged the Bank to make information on environmental aspects of individual projects and programs available to the public at least 120 days in advance of board consideration. Our colleagues at the Council on Environmental Quality and the Environmental Protection Agency also raised this issue at a meeting of the Governing Council of the United Nations Environment Programme in Nairobi in May. Unfortunately, other countries, with the single exception of Australia, have not supported this initiative. While most countries, including European countries, do not give their citizens the same degree of access to information as the United States, we were able to convince the Development Committee to agree, at its recent meeting, to encourage the World Bank to increase public access to environmental information on projects and programs.

In negotiations for the replenishment of the International Development Association, we have made it clear that our participation is contingent upon progress on environmental reform. Specifically this means: 1) adoption and serious implementation of environmental impact assessment procedures; 2) an increase in public access to environmental information; 3) greater emphasis on energy efficiency and conservation, including end-use efficiencies, renewable

energy technologies, and least-cost planning in borrowing countries; 4) more support for debt-for-nature swaps; 5) more rapid progress on environmental action plans; and 6) closer collaboration and cooperation with local community groups and non-governmental organizations in borrowing countries.

Again, other donor countries have not always supported us sufficiently on these issues. They have been, as noted above, particularly reluctant to embrace the concept of increased public access to information as they place great weight on the need for confidentiality in the World Bank's operations. We respect this need but believe the Bank can increase access to environmental information without jeopardizing needed confidentiality. We will continue to pursue this and other environmental issues at the next meeting of the IDA Deputies in Kyoto in November, and at the Spring 1990 meeting of the Development Committee.

Treasury Collaboration with Other Government Agencies

Within the U.S. Government we have worked to improve our monitoring of the environmental performance of the World Bank and the Regional Development Banks. My colleague from AID will discuss the workings of the early warning system that has been established to help identify potentially problematic projects. Treasury and AID collaborate closely in preparing a semi-annual listing of such projects. That list is submitted to Congress and made available to other members of the boards of executive directors. It is the starting point

of a dialogue between the U.S. Government and Bank management on problematical projects. The U.S. Executive Director's office begins by calling a meeting with Bank staff and U.S. experts, sometimes including members of NGOs. New studies and mitigation measures are often proposed to deal with the environmental issues identified. Other members of the board of directors are asked to look at the problems and express concern to the Bank.

The mobilization of technical expertise from other U.S. Government agencies is an important part of our management of environmental issues in the multilateral development banks. The Environmental Protection Agency, for example, is now very actively involved in our loan review process. A representative from EPA participates in weekly meetings of the inter-agency group that is chaired by Treasury with representation from State, AID, Agriculture, and Transportation, among others. This group examines each loan just before the U.S. Executive Director votes. The EPA representative also participates in the early-warning process, meeting informally with Treasury, AID and other agencies to discuss upcoming loans that may be problematic from an environmental viewpoint. Experts from Agriculture's Forest Support Program and the National Park Service were particularly helpful recently in our review of a World Bank loan to Mexico for forestry development.

Involvement of Non-governmental Organizations (NGOs)

We have also worked closely with NGOs and other outside experts. These efforts have included advice from an NGO from the Sudan on an integrated pest management program for that country and work with an NGO from Sri Lanka, on suggested changes to a World Bank loan for that country's forestry development. We are anxious to increase our collaboration in other areas with NGOs in this country and overseas, and to encourage them to present their concerns directly to us. Our door is open to them. For example, Pat Coady, our new U.S. Executive Director at the World Bank, has met on a number of occasions with U.S. Groups and with groups from other countries and is available to continue to do so.

In April of 1988, Treasury promulgated standards for U.S. Government evaluation of Multilateral Development Bank loans that might adversely affect tropical moist forests. Those standards were promulgated with technical assistance from over fifty NGOs, including leading academic authorities. Similar standards have been approved for projects affecting wetlands and Sub-Saharan savannas, also with technical assistance from the NGOs. Treasury recently met with representatives of other NGOs to discuss U.S. standards for projects affecting marine areas.

This collaboration with the NGOs has been a very useful exercise from our point of view, focussing attention on specific eco-systems that may need an added element of protection from development projects. In May, 1989 we

presented the tropical moist forest standards at an ad hoc meeting of experts of the Organization for Economic Cooperation and Development. At that time, we encouraged the adoption of similar standards by other countries and by the multilateral development banks. I now understand that the World Bank expects to release its own standards on projects affecting tropical moist forests early in 1990 and that it will be making those standards available to other donors as well. Standards are also being prepared for other ecosystems. We believe that the exercise that we started with the help of NGOs almost two years ago is having a beneficial outcome.

Energy efficiency and conservation is a another area on which we have placed particular emphasis. As I have noted, this issue is high on our agenda in the IDA 9 negotiations. In October, 1988, Treasury convened an informal working group comprised of representatives from AID, Energy, State, EPA, Treasury and several NGOs to exchange views on how the United States might encourage greater emphasis on energy efficiency and conservation in the multilateral development banks. A second meeting of that working group took place in March, 1989, and we have drawn on ideas that were generated as a result of those meetings.

Treasury is also working closely with the Committee on Renewable Energy Commerce and Trade (CORECT) in a related effort to encourage greater reliance on renewable energy

technologies in developing countries. CORECT is to target key utilities in those countries seeking to provide technical assistance services to identify opportunities for applying renewable energy technologies in projects that are to be funded by the multilateral development banks. Treasury, as part of its overall approach to energy efficiency and conservation, will draw on CORECT for technical expertise and will encourage more of a private sector focus for renewables.

International Coordination

We need to continue our efforts to mobilize greater support from the other countries for our environmental initiatives within the MDBs. We have made a start over the past two years at the annual meetings of the World Bank and the regional development banks, at the Development Committee, the Organization for Economic Cooperation and Development, the United Nations Environment Program, and very importantly, at the Summit meeting of heads of state or government in Paris this past July.

The United States can not resolve these international environmental issues by itself. It is not possible or desirable for us to seek to impose a U.S. unilateral solution on other countries or on multilateral organizations such as the World Bank. Attempts to do so may even be counter-productive. For example, legislative requirements which virtually force us to oppose loans would severely diminish our ability to improve the environmental aspects of projects

before they are voted on. Over the longer term, if we are to succeed in effecting further environmental reforms in the World Bank, we will have to have the cooperation of other member countries.

<u>Summary of World Bank Progress</u>

The World Bank has made significant progress in the environmental area over the past few years. As noted above, it has recently approved procedures for environmental impact assessment which we consider a major positive step. In addition, the Bank has established a central environmental department and four regional units that review environmental elements of specific projects and programs. It has hired additional staff for its environmental work, and now estimates that the staff time equivalent of approximately 100 staff members are being devoted directly to environmental tasks each year. We are encouraging the Bank to hire additional staff as that becomes appropriate over the next several years. Preliminary budgetary planning documents indicate that they will do so.

Environmental issue papers are being prepared for all of the Bank's borrowing countries. Seventy of these papers have been completed thus far and the remainder are to be completed in the next few months. They are meant to identify key environmental problems and their underlying causes, including loss of biological diversity, watershed erosion and upland degradation, deforestation, air and water pollution, marine

and coastal zone protection, resettlement of displaced people and protection of cultural property.

In addition, Environmental Action Plans are now going forward for seven countries: Madagascar, Lesotho, Mauritius, Rwanda, Ghana, Burkina Faso, and Guinea. The Bank has announced that it intends to have completed thirty of these plans by June 30, 1992. These plans are to provide an overall strategy for each country and make recommendations for specific actions, outlining environmental policies, investment strategies, legislation and institutional arrangements that will be required. Several regional studies are under preparation. These include: the Capital Cities Clean-up Project for the Asia Region, Environmental Program for the Mediterranean, a wastewater re-use and management study in the Mediterranean and Middle East, an Asia Watershed Sector Review, and forestry studies for Asia and Sub-Saharan Africa.

The World Bank estimates that 81 of the 223 projects that it funded in its fiscal year 1989 have an environmental component of one kind or another including watershed management, integrated pest management, agroforestry, energy conservation, water conservation and erosion control or assistance to indigenous peoples. The Bank has also increased its efforts to involve non-governmental organizations and environmental ministries in borrowing countries in the loan development process. The Bank's

monthly operational summary, which provides information on upcoming projects, is being distributed to 150 non-governmental organizations around the World; and, in the future, this summary will contain additional information on environmental issues. More than 150 projects in the Bank's pipeline have been identified as having potential for involvement of NGOs.

In addition, the Bank has become more responsive to specific environmental concerns as they have been identified from its own experience in on-going projects or raised by NGO experts. For example, it has conducted studies on governmental policies and deforestation in the Amazon region and is conducting a study on its own performance in handling large infrastructure and regional development projects in Brazil. The Bank's environmental policy specifically states that the "Bank promotes the use of integrated pest management" which, if implemented, should help avoid some of the problems that have arisen in the Sudan and elsewhere. Other important steps taken by the Bank as part of its increased emphasis on the environment include: establishment of a technical assistance grant program for the environment to aid in project preparation; introduction of an environmental information system to help integrate environmental issues into the Bank's operations; preparation of training films and seminars for its staff; and research on guidelines to include environmental and distributive effects

in cost benefit analysis and project preparation.

Treasury's Reports to the Congress

Treasury has received an extensive legislative mandate from Congress on environmental issues. The steps that Treasury has taken to implement its mandate and the World Bank's responses are spelled out in two separate reports that have been prepared by Treasury and submitted to the Congress, one in January, 1988 and the second in January, 1989. A third report is to be submitted in January, 1990. A summary of our activities is contained in the Annex to this testimony.

Conclusion

Substantial progress has been made by the World Bank. We believe that the Bank takes environmental matters seriously and is making genuine efforts to improve its policies and operations in this area. However, as President Bush noted in his speech at the recent World Bank/IMF annual meeting, "there is more to be done". We at Treasury will continue to work with the Bank, other U.S. Government agencies, the NGOs, and other governments in an effort to ensure that a proper concern for the environment becomes deeply embedded in all aspects of the World Bank's policy development and lending operations.

<u>ANNEX</u>

SUMMARY OF TREASURY DEPARTMENT ACTION
TO PROMOTE INCREASED EMPHASIS ON THE
ENVIRONMENT IN THE WORLD BANK

The Treasury Department's activities in the environmental area fall into four general categories. These broad categories and some of the specific steps taken in each of these areas are summarized in this annex.

(1) <u>Encouraging the World Bank to adopt policies and procedures which ensure that a proper concern for the environment becomes deeply embedded in the Bank's operations.</u>

Treasury participates in an ongoing process of meetings with, and presentations to, Bank officials and Executive Directors from other countries on a broad range of environmental issues. These issues include:

- increasing the size of the World Bank staff and budget devoted to environmental issues;
- acceleration of the Bank's efforts to promote energy efficiency and conservation;
- increase research on the application of cost benefit analysis to environmental issues;
- development of specific standards to evaluate projects affecting tropical forests;
- acceleration of the development of environmental action plans;
- innovative methods for the Bank to promote debt-for-nature swaps;
- procedures for increasing the amount of information that may be made available to the public on projects which may have a significant impact on the environment; and,
- methods for increasing consultation with NGOs to find new ways to tap their expertise in developing policies, shaping overall lending programs and designing individual projects.

(2) <u>Development of, and participation in, a system within the U.S. government to (a) identify environmentally sensitive projects at an early stage and (b) minimize any adverse environmental impact from World Bank projects.</u> Specific steps taken include:

- support of A.I.D.'s "Early Warning System" on prospective World Bank loans which produces a list of environmentally sensitive projects available to the public;

- establishment of an interagency early warning group consisting of representatives of Treasury, A.I.D., State, E.P.A. and C.E.Q.;

- use of the expertise of specialized government agencies to help evaluate and shape individual World Bank projects.

(3) <u>Efforts to obtain the support of other countries for U.S. proposals to increase the emphasis on environmental issues in the World Bank.</u>

The U.S. is only one of many countries who are shareholder members of the World Bank. In order to be successful, our initiatives must have broad support from other countries -- both developed and developing. In an effort to obtain such support, we have:

- shared the results of A.I.D.'s "Early Warning System" with the Bank's Executive Directors representing all other member countries;

- used international meetings (e.g. summits among Heads of State; the O.E.C.D.; the World Bank/IMF Development Committee; and the World Bank/IMF Annual Meetings) to express our concerns and urge international cooperation on environmental issues;

- used bilateral meetings with officials from both developed and developing countries to solicit support for our environmental efforts; and

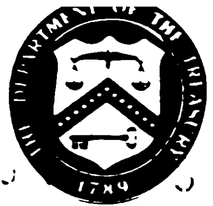
- used the negotiations on IDA Replenishment to attempt to ensure increased emphasis on environmental issues.

(4) Developing procedures to ensure that the expertise of NGOs is made available to the World Bank as it develops its policies and conducts its lending operations.

The expertise of NGOs -- including those in borrowing countries affected by World Bank projects -- can be especially helpful in (1) alerting the Bank to adverse environmental effects and (2) advising on methods to avoid such effects. Specific steps taken with respect to NGOs include:

- adoption of an "open door" policy with respect to meetings with NGOs and encouraging them to make their concerns known directly to us; and,

- as noted in (1) above, urging the World Bank to develop procedures for tapping NGO experience and expertise and for sharing informaton with them in a timely manner.

TREASURY NEWS


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DEPARTMENT

Testimony of the Honorable Salvatore R. Martoche
Assistant Secretary of the Treasury for Enforcement
before the Senate Foreign Relations Committee
Subcommittee on Narcotics, Terrorism and
International Operations
October 4, 1989

Thank you for the opportunity to testify here today about recent activities and programs of the Department of the Treasury to combat international money laundering with special emphasis on recent initiatives to foster international cooperation in this area.

With me today are three key players in Treasury's fight against money laundering, Brian Bruh, Deputy Assistant Commissioner, Criminal Investigation, Internal Revenue Service; William Rosenblatt, Assistant Commissioner for Enforcement, U.S. Customs Service; and Robert B. Serino, Deputy Chief Counsel, Comptroller of the Currency.

The IRS has been delegated a number of Bank Secrecy Act and money laundering functions. The IRS Detroit Computing Center processes all of the forms required under the Bank Secrecy Act, other than the Currency and Monetary Instrument Report (CMIR). The Office of the Assistant Commissioner for Examination is responsible for review of all institutions subject to the Bank Secrecy Act, other than banks and security brokers and dealers regulated by the Securities and Exchange Commission -- for instance, transmitters of funds, check cashers, foreign exchange dealers and casinos. The Criminal Investigation Division has exclusive jurisdiction for all criminal investigations under the Bank Secrecy Act by all financial institutions and their customers. In addition, it has investigatory jurisdiction for money laundering cases related to tax investigations or reporting violations.

Customs similarly performs a wide range of Bank Secrecy Act functions. Customs is responsible for processing the CMIRs and for all investigations of CMIR violations. It also has investigatory authority for money laundering related to CMIR violations, smuggling, and a number of other statutes under Customs jurisdiction. Finally, both IRS and Customs perform the critical analysis function for data collected under the Bank Secrecy Act.

The Office of the Comptroller of the Currency has responsibility for reviewing compliance with the Bank Secrecy Act for the 5000 national banks. It also helped to develop a program for national

banks to report suspicious transactions. The Comptroller of the Currency also has participated in a number of international fora where money laundering has been discussed and has trained foreign bank regulators in Colombia and elsewhere in the techniques of detecting money laundering. It is one of the United States' delegates to the Basle Committee on Banking Regulation and Supervisory Practices, the Committee which developed what has come to be known as the Basle Code of Conduct ("Statement of Principles for the Prevention of the Use of Banking System for the Purpose of Money Laundering.")

These gentlemen will join me in responding to the Committee's questions.

My testimony touches on three areas. First, I would like to report on international anti-money laundering developments, including the progress Treasury has made in complying with section 4702 of the Anti-Drug Abuse Act of 1988. This section requires the Secretary of the Treasury to negotiate with foreign governments to institute currency reporting systems similar to the U.S. requirements under the Bank Secrecy Act. Second, I will discuss the state of cooperation between the banking industry and law enforcement; the ongoing recent regulatory initiative under the Bank Secrecy Act with respect to international wire transfers; and the use and processing of Bank Secrecy Act data. Finally, I will discuss an evolving program which we plan to make a major element in our fight against money laundering -- the Treasury Financial Crimes Enforcement Network.

I want to take this opportunity to clarify the record with respect to certain points which were raised during the hearing before this Subcommittee last Wednesday. During the last session of Congress, the Administration did differ with you on the wisdom of the approach of 4702, but we are complying with that law. We certainly are not "timid" or working at cross purposes with law enforcement. Treasury welcomes innovative ideas in the fight against money laundering. However, we believe that we have a responsibility to assess carefully every legislative and regulatory measure both in terms of the benefit to law enforcement and the economic impact on financial institutions and on the dollar as an international currency and the U.S. as an international financial center. Our scrutiny and balance in no way should be read as complacency.

International Money Laundering Intiatives

Financial Action Task Force

First, I would like to report on what we view as our most important international initiative, the Financial Action Task Force. At the annual G-7 summit held in France this summer, the U.S. worked with our allies to assure that international money laundering was an important agenda item. As a result of this discussion, the Summit participants formed the Financial Action Task Force to be composed of the summit countries and open to other interested participants. The mandate of the Task Force is to evaluate the steps that have been taken internationally to prevent money laundering through banks and other financial institutions and to consider adoption of legal and regulatory measures to enhance multilateral judicial assistance. The task force will complete a report on its activities by April 1990.

A few weeks ago, Deputy Secretary of the Treasury John Robson and I, together with representatives of fourteen other nations, attended the first session of the task force. At this meeting, we discussed the agenda for future meetings and established various working groups and schedules to treat various issues. The work of the task force is underway and we are optimistic that it will have concrete results.

Need for Swift Senate Action on MLATs

A continuing source of confusion in our international efforts is the failure of the Senate to ratify the Mutual Legal Assistance Treaties that have been signed by the United States some time ago. These signed agreements, which of course have no force and effect until ratified, are with Canada, Mexico, Belgium, the Bahamas, and the Cayman Islands. We are indeed sending a curious message to these countries and other prospective MLAT signatories. Countries of good will have every reason to wonder about the wisdom of entering further negotiations with the United States on any law enforcement subject, including currency reporting, until the MLATs are operational. There is no concern of any character that justifies this continuing state of affairs. We urge that the Senate ratify these MLATs as soon as possible.

Canada

We know that Canada is of special concern to the Committee. The United States has excellent law enforcement cooperation with the

Government of Canada. Customs, DEA, and and IRS work daily with the Royal Canadian Mounted Police, Canadian Customs, and other governmental entities. In addition, Treasury is in the process of initiating Operation Northstar, a joint program with Canadian and U.S. federal, state and local law enforcement authorities to intensify and coordinate information and efforts to crack down against cross border trafficking of drugs and other contraband.

We can point to other examples of international cooperation that led to the destruction of money laundering organizations such as the cooperation of the U.K. and France in Operation C-Chase. There are a number of other more quiet, cooperative efforts going on between U.S. and foreign law enforcement agencies every day which succeed in part because they have been able to go forward without the spotlight of publicity.

Section 4702

Section 4702 directs the Secretary of the Treasury to negotiate with countries that do business in U.S. currency to require their financial institutions to keep records of large dollar currency transactions similar to the domestic requirements under the Bank Secrecy Act and to share those records with U.S. law enforcement upon request. The Secretary, in consultation with the Attorney General and the Director of the Office of National Drug Control Policy (ONDCP), is to place highest priority on those countries whose financial institutions may be engaging in transactions involving the proceeds of international narcotics trafficking, particularly U.S. drug sales.

Early this year, working with the State Department, we approached a number of countries through our embassies. The embassies approached the governments of the countries regarding the possibility of negotiation of section 4702 agreements, and evaluated the current authority under the laws of the countries to institute such a regulatory scheme. At the same time, we solicited the views of federal law enforcement and intelligence agencies regarding their views for priority countries. We are now in the process of receiving final concurrence from the Director of ONDCP and the Attorney General and of securing the views of the Department of State on a model agreement. Formal approaches to discuss the details of agreements will proceed as soon as possible. In the interim, as we have advised you, Mr. Chairman, we have had informal discussion with a number of countries without respect to their priority status. We also have

worked extensively with the Australian government to help them set up their currency reporting system modeled on the Bank Secrecy Act.

I hope the Committee will understand that because of the sensitivity of negotiations and the source of the information upon which we have selected countries for negotiation, we can not report in any more detail in an open session of the Subcommittee. Next month, as required by the statute, we will be submitting an interim report to the Senate and House Banking Committees.

Bank Cooperation with Law Enforcement

For the last several years, Treasury has stressed a constant theme that banks must be partners with law enforcement in the fight against money laundering. We have put forth this theme in the numerous training sessions that I and my staff, IRS, Customs, and the OCC have participated in and at every other possible public and private opportunity. I keep an open door to banks that wish to discuss with me their compliance programs or enforcement concerns.

My experience is that if banks understand what is expected of them, they will make every good effort to measure up. What we expect is more than mechanical compliance with the Bank Secrecy Act reporting requirements. We expect that bankers will take every reasonable measure to "know their customers" and to make timely reports of suspicious activities. The good news, as you heard from the industry last week, is that this partnership message has been taken to heart. Industry-wide, we believe Bank Secrecy Act compliance by banks is good. Of equal importance, the number of reports of suspicious transactions is growing all the time. Among the most celebrated examples discussed by the industry last week were the contributions of Wells Fargo Bank to Operation Polar Cap and of Wells Fargo Bank and Bank of America to the seizure of the drug-laden barge Intrepid Voyager.

To protect banks in reporting suspicious transactions, Treasury took the lead in 1986 and 1988 in seeking much needed amendments to the Right to Financial Privacy Act. We also have instituted a toll-free number at the IRS, 1-800-BSA-CTRS, to direct suspicious transaction calls to the appropriate IRS offices and a toll-free Customs number 1-800-BE-ALERT to report possible CMIR violations. As part of recent major revision to the Currency Transaction Form, we have modified the form to facilitate its use for reporting suspicious activities.

Wire Transfers

To the same extent we expect cooperation from the financial institutions, financial institutions should be able to expect Treasury to exercise judiciously its extensive regulatory authority under the Bank Secrecy Act. Treasury takes great care to insure a full hearing and careful assessment of all views expressed in our rulemaking process. Our goal in every instance is to balance law enforcement needs with costs to the financial institutions individually and as competitors on the world market.

In no area has this challenge been greater than in our approach to the complex question of applying our Bank Secrecy Act authority to the problem of money laundering through the use of international wire funds transfers. We have been working closely with the banking industry to educate them to our concerns and to understand how best to formulate a regulatory solution. We have toured the facilities and reviewed the programs of many banks, frequently through the good offices of the Bank Administration Institute. We also have met with the American Bankers Association on this issue.

This week or early next week we are issuing an Advance Notice of Proposed Rulemaking on international funds transfers, seeking the comments and recommendations of all affected parties on a number of regulatory options. Among the options is the proposal discussed before this Committee last week of requiring that all international wire funds transfer messages contain name and account information about the foreign originator or beneficiary of a payment. As soon as the comments received in response to this notice are evaluated, we will issue specific proposed regulatory language for comment, followed by a final rule.

Use and Processing of Bank Secrecy Act Data

Treasury is not "overwhelmed" with Bank Secrecy Act data. This is not the case. The Bank Secrecy Act data base is being used constantly to identify targets and track unusual currency patterns. While it serves an indispensable function for developing ongoing investigations and tracing the financial underpinnings of criminal organizations, the impression given that this is its only use is erroneous.

Analysis is performed ably by the Customs Financial Intelligence Branch. A sophisticated, rule-based artificial intelligence system is applied to the data. This system is constantly being

improved and refined to meet changing law enforcement trends. In the last two years over 700 targets have been identified and cases are ongoing on many of them.

We also must correct any impression left by one witness at last week's hearing that Treasury is somehow reluctant to share data with State and local law enforcement. Last year, we reissued and streamlined our dissemination guidelines to facilitate access by all law enforcement agencies. We have concluded agreements with California and Arizona to provide magnetic tape of all information filled by institutions in or residents of those jurisdictions routinely.

You also have asked us to address the question of processing of Bank Secrecy Act data. We agree that it would be measurably more cost efficient and effective for both Treasury and financial institutions to file other than by paper. Since 1987, we have allowed financial institutions to file by magnetic tape. Frankly, to date, we have been disappointed by the number of institutions that voluntarily have taken advantage of this program. Therefore, shortly we will issue a proposed rulemaking soliciting comments on requiring the large volume filers of Currency Transaction Reports to file by magnetic tape or equivalent media.

Financial Crimes Enforcement Network

Finally, I would like to advise you of Treasury's new initiative -- now in its early phases -- to approach the problem of money laundering that was set forth in the President's Drug Strategy. The Financial Crimes Enforcement Network (FINCEN) is being established within Treasury as an all-source, anti-money laundering intelligence, analysis, and targeting bureau. FINCEN will integrate data from Federal law enforcement and regulatory agencies, state and local governments, foreign governments and financial institutions. It will provide training to law enforcement and financial institutions and operate a 24-hour hotline for suspicious activity calls. FINCEN will build upon our experience with the Bank Secrecy Act data to use artificial intelligence and other methods to identify potential targets as well as money laundering methods, patterns, and trends.

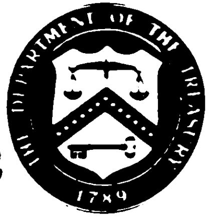
Conclusion

Let me conclude by saying that we have made substantial strides in the area of money laundering both domestically and internationally. If I could sum up in one word how I feel about

the current state of our money laundering initiatives at Treasury and within the Administration generally, the word would be "encouraged". I am encouraged by the prominence of the issue of money laundering in the President's Drug Strategy, the recognition of the principal role of Treasury in this area, and the additional funds that have recently been appropriated for our programs. I am encouraged by our international efforts as more and more countries recognize that international drug trafficking and the money laundering that sustains it are an international problem requiring international solutions. Finally, I am encouraged with the spirit of cooperation within law enforcement and the financial community today that will nurture and assure the success of the Secretary's Financial Crimes Enforcement Network.

This concludes my formal remarks. I welcome the Committee's questions.

TREASURY NEWS



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October 4, 1989

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STATEMENT OF
WILLIAM E. BARREDA
DEPUTY ASSISTANT SECRETARY FOR TRADE AND INVESTMENT POLICY
TO THE SUBCOMMITTEE ON EUROPE AND THE MIDDLE EAST
HOUSE COMMITTEE ON FOREIGN AFFAIRS
ON THE SUBJECT OF UNITED STATES ASSISTANCE
PROGRAMS TO POLAND AND HUNGARY

October 4, 1989

Mr. Chairman:

I am pleased to represent the Treasury Department on this panel to discuss Poland and Hungary. I will first discuss Poland's economic situation and possible assistance from international financial institutions. I will then discuss Hungary's situation.

Poland's Current Economic Situation

Poland is facing severe economic and financial problems, which have been worsening in recent months. Inflation has risen rapidly. It grew at an annualized rate of 182 percent during the first half of 1989 (as compared to 60 percent in 1988).

A major contributing factor to the rapid rise in prices has been the budget deficit which is expected to rise from near balance last year to an estimated 5-10 percent of GNP in 1989. The money supply has increased sharply. Industrial production was down 1% in first half of this year and is expected to decline another 1 - 2% in the rest of the year.

The hard currency current account deficit, originally expected to be $820 million, is now projected to reach $1.7-$2.1 billion.

The problems of the Polish economy are much deeper and more fundamental than is indicated by these macroeconomic imbalances. Much more is needed than changes in existing policies to put Poland on a path of self sustaining economic growth. In addition to correcting macroeconomic imbalances, Poland must make major systemic changes. For example, it must create financial institutions, break up existing state monopolies in industrial production and distribution systems, and end government subsidies to uneconomic firms.

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Poland's Economic Reform Program

We have just received a working outline of the proposed economic and structural reforms which the new Polish government is contemplating. The basic aim of the program is to transform the Polish economy into a market economy.

The program has three phases. During the first one, covering the remainder of 1989, some necessary preconditions for the reform will be introduced, including a new bankruptcy code, anti-monopoly and social safety net measures (i.e. unemployment insurance). The second phase, intended to start January 1990, will include a tightened monetary and fiscal policy, the introduction of systemic changes in the tax system, and continuing the reform of the banking system. These efforts will continue in the third phase to begin in 1991.

We believe the thrust of the program is broadly appropriate. It should provide a good basis for the necessary reforms. Particularly encouraging is the strong commitment to move toward market oriented institutions and processes. Also encouraging is the recognition of the need to attack inflation to promote the proper environment for decontrolling prices. The best way to proceed to implement the program, the decisions regarding what measures are appropriate and politically acceptable in Poland, as well as the order and timing of their implementation has to be worked out. Similarly, the amounts and kinds of financial, material and technical external assistance required to support the reforms will also have to be determined.

The success of Poland's reform effort will depend primarily on the policies chosen by the Polish Government, the implementation of those policies and the response of the Polish people. Nonetheless, international financial institutions and bilateral assistance can make a real difference. I would now like to discuss those institutions: the IMF, the World Bank and IFC, and the Paris Club.

Poland and the IMF

The United States has been actively encouraging the International Monetary Fund to develop with Poland an agreement on an economic reform program that would merit IMF financial support. The Fund is planning to send a Mission to Poland next week to begin discussions on the Polish economic reform and Fund support.

The Fund's role in assisting Poland's restructuring is crucial. The Fund has the expertise and the international standing and credibility to assist Poland in designing policy measures. Fund approval of Poland's policy measures could facilitate other multilateral assistance, such as World Bank loans, as well as bilateral flows.

In considering its support for Poland the IMF will need to ensure that a Polish program meets the same traditional high quality and standards of IMF conditionality that would be expected of all members. Given the enormity of the challenge Poland faces, it is particularly important that the program be a strong one, integrating two aspects: correcting the macroeconomic environment and promoting structural reform to produce sustainable growth.

World Bank Support for Poland

The U.S. Government will support economically and financially sound World Bank loans to Poland as soon as reforms are underway. The World Bank has three project loans and one technical assistance loan worth a total of $555 million in the lending pipeline for Poland. Bank management is working with the Poles, and will bring the loans forward when macroeconomic conditions can assure Poland's creditworthiness. The loans already under preparation include the following:

> Industrial Export Development loan ($250 million) through the National Bank of Poland to finance modernization and expansion of selected export-oriented industrial enterprises in chemical, electroengineering and wood-based industries.
>
> Agricultural Industries Export Development loan ($50 million) through the National Bank of Poland to finance rehabilitation, modernization and expansion of existing agricultural processing industries to increase export earnings.
>
> Energy Resources Development loan ($250 million) through the National Bank of Poland to increase operating efficiency in the coal and gas sectors and maintain coal production and improve the environment.
>
> Environmental Technical Assistance loans ($5 million) to assist in designing a framework to guide future work and investments to improve the environment.

Other possibilities for the future could include formal policy based loans such as a Structural Adjustment Loan which could run to several hundred million dollars and loans targeted on specific sectors such as finance or agriculture.

In addition to these project loans, the Bank may be able to assume a broader role to support the shift from a state controlled -- and owned -- economy to a market economy. For example, the Bank could provide major assistance in reforming state enterprises and in their privatization. We will be discussing these possibilities with Bank management.

The International Finance Corporation (IFC)

The IFC, a part of the World Bank, lends or invests in private enterprises. The United States supports economically and financially viable IFC projects in Poland. Last year, the United States supported the IFC's investment in Hortex, a private Polish cooperative. The project was financially and economically sound, it was in a private enterprise, and it had the means to generate sufficient foreign exchange to meet its obligations. Two other projects are in preparation: the renovation of the Bristol Hotel in partnership with a major international hotelier, and a float glass project with a Japanese co-investor.

Debt Rescheduling in the Paris Club

The Paris Club is the informal multilateral forum for rescheduling of debt owed to governments (official debt). It meets roughly once a month in Paris according to rescheduling needs. The meetings are chaired by France and involve all major creditors with exposure in the rescheduling country who wish to attend.

The Paris Club has been discussing the scope of a rescheduling of Poland's official debt and met with Polish authorities to exchange views on this question last month. The United States' representative has consistently indicated our intention to support an early and generous debt rescheduling for Poland in the Paris Club.

Poland's official debt is $26 billion; scheduled payments on the debt are $3 to $3.5 billion a year. A Paris Club rescheduling would primarily benefit Poland by ending its status of being in default on its official debts. It could thus open the possibility of official institutions providing new credits.

Bilateral Assistance

The United States is also working with its allies to mobilize bilateral support for Poland. Bilateral U.S. efforts, such as food aid and the Administration's proposals your committee is considering, can complement the activities of the international institutions. The Commission of the European Economic Community is hosting meetings to concert the bilateral assistance of the West.

Hungarian Economic Situation

The Hungarian authorities have adopted a series of structural reforms over the last two years that provide a partial basis for a movement to a more market-based system.

-- On January 1, 1988, a Value Added Tax, a comprehensive personal income tax and a corporate income tax were introduced, while a number of existing taxes were abolished.

-- The banking system has been reformed. The commercial and central banking functions of the National Bank of Hungary were separated and a number of competing commercial banks established.

-- The wage determination process has been reformed with the aim of widening the scope for pay differentiation according to performance.

-- Prices have been liberalized, but about 37 percent of prices were kept under administrative control because of concern over inflation and the lack of sufficient financial discipline and domestic competition.

-- A new corporate association law was adopted January 1, 1989, which widened the scope for entry and expansion of small enterprises and private undertakings.

-- Import restrictions have been reduced.

These steps are to be commended. Unfortunately, the Hungarian budget deficit this year has grown faster than planned. Therefore inflationary pressures are growing and the current account deficit has increased.

Further efforts are needed to limit budgetary expenditures and to privatize more of the economy. While there are problems, I should emphasize that Hungary has consistently met its debt obligations. Its debt has not had to be rescheduled.

Hungary in the Fund and the Bank

Hungary became a member of the Fund on May 6, 1982. The Fund has supported three stand-by arrangements since then. The first one was approved on December 8, 1982 for twelve months and was completed as planned. The second one, a thirteen month arrangement, approved January 13, 1984, was also completed as planned. Most recently, a twelve month arrangement was approved on May 16, 1988. This agreement was extended for two months and expired on June 30, 1989. There is no stand-by arrangement in effect for Hungary at present.

The U.S. Government has been supportive of the World Bank's lending program to Hungary. We will continue to support economically and financially sound loans to Hungary. The World Bank is preparing loans worth a total of $665 million for

Hungary. Among them is Hungary's first structural adjustment loan, which will be accompanied by a financial sector loan. The loans in preparation include the following:

Structural Adjustment loan ($200) million to support policy reforms.

Financial System Modernization loan ($65 million) to the National Bank of Hungary to support the modernization of the financial system and improve its ability to mobilize and allocate resources.

Fourth Industrial Restructuring loan ($100 million) to support development of the private sector, and small and medium enterprises.

Human Resources Technology Development loan ($100 million) to build on the institutional, policy and investment foundation established under previous loans for both human resources and technology development.

Second Telecommunications loan ($100 million) to finance a part of the telecommunications sector investment program to build on institutional, financial, and technical improvements initiated under the first Telecommunications loan.

Integrated Agricultural Business loan ($100 million) to finance investments of and technical support to small farmers.

The International Finance Corporation (IFC)

We have been very supportive of IFC's investments in Hungary. During the past fiscal year, IFC made equity investments and loans for two projects in the plastics and packaging industries and exercised its pre-emptive rights to maintain the same share of ownership in a glass wool company. Also, in August 1989, IFC's capital markets department participated in a $50 million fund for investment in Hungarian enterprises. This should help significantly in the development of Hungary's fledgling capital market.

Conclusion

In summary, Poland and Hungary have embarked on an historic undertaking, the conversion of a rigid, centrally planned economy into a pluralistic market based society. This has never been done before. The task is enormous, complex and will take time and effort. We, other Western countries, and the international institutions must actively support this important

endeavor. Our support has to be carefully crafted to enhance the prospects for a successful and lasting transformation of these countries.

The Administration will continue to consider how we can best support, both bilaterally and through the international financial institutions, this process of change as it evolves.

I will be pleased to take your questions.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

5310

FOR RELEASE AT 4:00 P.M.
October 4, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $7,500 MILLION OF 7-YEAR NOTES

The Department of the Treasury will auction $7,500 million of 7-year notes to refund $4,111 million of 7-year notes maturing October 15, 1989, and to raise about $3,400 million new cash. The public holds $4,111 million of the maturing 7-year notes, including $577 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $7,500 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks for their own accounts hold $126 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

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Attachment

NB-492

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 7-YEAR NOTES
TO BE ISSUED OCTOBER 16, 1989

October 4, 1989

__Amount Offered__:

To the public	$7,500 million

__Description of Security__:

Term and type of security	7-year notes
Series and CUSIP designation	H-1996 (CUSIP No. 912827 YB 2)
Maturity date	October 15, 1996
Interest rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	April 15 and October 15
Minimum denomination available ..	$1,000

__Terms of Sale__:

Method of sale	Yield auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None

__Payment Terms__:

Payment by non-institutional investors	Full payment to be submitted with tender
Deposit guarantee by designated institutions	Acceptable

__Key Dates__:

Receipt of tenders	Wednesday, October 11, 1989, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):	
a) funds immediately available to the Treasury ..	Monday, October 16, 1989
b) readily-collectible check ..	Thursday, October 12, 1989

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

October 3, 1989

Bryce L. Harlow
Assistant Secretary of the Treasury
for Legislative Affairs

On June 8, 1989, Mr. Harlow was confirmed by the Senate as Deputy Under Secretary of the Department of Treasury. He was designated by the President as Assistant Secretary for Legislative Affairs on June 9, 1989.

Before joining the Department of Treasury as a consultant in February 1989, Mr. Harlow served as Special Assistant to the President for Legislative Affairs at the White House in Washington, D.C. since 1986. Prior to this, he was Associate Director for Legislative Affairs for the Office of Management and Budget, 1985-1986. He also served as Special Assistant to the President for Legislative Affairs at the White House in 1985.

Mr. Harlow was Director of the Office of Congressional Relations for the Federal Trade Commission, 1981-1985. He was Special Assistant to the Administrator and Acting Director of the Office of Legislation, U.S. Environmental Protection Agency, 1981; Director of Government Relations for the Grocery Manufacturers of America, Inc., 1976-1981; and Legislative Specialist for the Environmental Protection Agency in Denver, Colorado, 1972-1976. From 1969-1971, Mr. Harlow was a Staff Assistant to Senator Howard H. Baker.

Mr. Harlow was graduated from George Washington University (B.A., 1971). He was born January 21, 1949 in Oklahoma City, Oklahoma. He is married, has two children and resides in Vienna, Virginia.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

October 3, 1989

David Michael Nummy
Deputy Assistant Secretary
for Departmental Finance and Management

David Michael Nummy was sworn in as the Deputy Assistant Secretary for Departmental Finance and Management of the Department of Treasury on February 2, 1989.

Mr. Nummy was born April 6, 1957 in Oklahoma City, Oklahoma, the son of James A. and Dorothy A. Nummy. He received both a bachelor of science and a master of science degree from Oklahoma State University in 1979.

After graduation from Oklahoma State University, he joined the accounting firm of Ernst & Whinney and become a Certified Public Accountant in 1980. Mr. Nummy subsequently served on the staff of the Senate Budget Committee for several years as an Analyst for the Federal Credit Programs, as Senior Analyst for Tax Policy, and as Special Assistant to the Staff Director. He served in the private sector as Business Manager for a consulting firm before becoming the Comptroller for the Bush-Quayle campaign. He serve in this capacity for two years.

Mr. Nummy has traveled extensively in Europe and now resides in Washington, D.C.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

4 5310

FOR RELEASE AT 3:OO PM
October 5, 1989

Contact: Peter Hollenbach
(202) 376-4302

TREASURY ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR SEPTEMBER 1989

The Department of the Treasury announced activity figures for the month of September 1989, of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS).

	Dollar Amounts in Thousands
Principal Outstanding (Eligible Securities)	$366,929,254
Held in Unstripped Form	$285,415,644
Held in Stripped Form	$81,513,610
Reconstituted in September	$2,081,680

The accompanying table gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision.

The Treasury now reports reconstitution activity for the month instead of the gross amount reconstituted to date. These monthly figures are included in Table VI of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form." These can also be obtained through a recorded message on (202) 447-9873.

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NB-495

TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, SEPTEMBER 30, 1989
(In thousands)

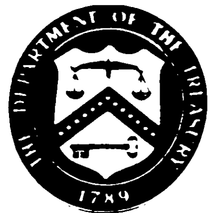
Loan Description	Maturity Date	Principal Amount Outstanding			Reconstituted This Month[1]
		Total	Portion Held in Unstripped Form	Portion Held in Stripped Form	
11-5/8% Note C-1994	11/15/94	$6,658,554	$5,319,354	$1,339,200	$30,400
11-1/4% Note A-1995	2/15/95	6,933,861	6,228,101	705,760	52,000
11-1/4% Note B-1995	5/15/95	7,127,086	5,383,726	1,743,360	41,600
10-1/2% Note C-1995	8/15/95	7,955,901	7,143,501	812,400	-0-
9-1/2% Note D-1995	11/15/95	7,318,550	6,477,750	840,800	-0-
8-7/8% Note A-1996	2/15/96	8,575,199	8,288,799	286,400	1,600
7-3/8% Note C-1996	5/15/96	20,085,643	19,848,843	236,800	-0-
7-1/4% Note D-1996	11/15/96	20,258,810	19,958,810	300,000	-0-
8-1/2% Note A-1997	5/15/97	9,921,237	9,852,037	69,200	-0-
8-5/8% Note B-1997	8/15/97	9,362,836	9,362,836	-0-	-0-
8-7/8% Note C-1997	11/15/97	9,808,329	9,793,929	14,400	-0-
8-1/8% Note A-1998	2/15/98	9,159,068	9,158,428	640	-0-
9% Note B-1998	5/15/98	9,165,387	9,135,387	30,000	-0-
9-1/4% Note C-1998	8/15/98	11,342,646	11,221,046	121,600	-0-
8-7/8% Note D-1998	11/15/98	9,902,875	9,899,675	3,200	-0-
8-7/8% Note A-1999	2/15/99	9,719,628	9,719,628	-0-	-0-
9-1/8% Note B-1999	5/15/99	10,047,103	9,538,303	508,800	30,400
8% Note C-1999	8/15/99	10,163,644	10,163,644	-0-	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	3,588,206	4,713,600	76,800
12% Bond 2005	5/15/05	4,260,758	2,017,708	2,243,050	-0-
10-3/4% Bond 2005	8/15/05	9,269,713	7,357,713	1,912,000	141,600
9-3/8% Bond 2006	2/15/06	4,755,916	4,755,916	-0-	-0-
11-3/4% Bond 2009-14	11/15/14	6,005,584	2,210,384	3,795,200	99,200
11-1/4% Bond 2015	2/15/15	12,667,799	2,830,839	9,836,960	-0-
10-5/8% Bond 2015	8/15/15	7,149,916	2,104,796	5,045,120	208,960
9-7/8% Bond 2015	11/15/15	6,899,859	2,538,259	4,361,600	129,600
9-1/4% Bond 2016	2/15/16	7,266,854	5,449,254	1,817,600	152,800
7-1/4% Bond 2016	5/15/16	18,823,551	16,565,151	2,258,400	148,000
7-1/2% Bond 2016	11/15/16	18,864,448	10,911,088	7,953,360	393,520
8-3/4% Bond 2017	5/15/17	18,194,169	7,496,409	10,697,760	32,800
8-7/8% Bond 2017	8/15/17	14,016,858	9,712,858	4,304,000	428,800
9-1/8% Bond 2018	5/15/18	8,708,639	4,654,239	4,054,400	51,200
9% Bond 2018	11/15/18	9,032,870	3,385,670	5,647,200	-0-
8-7/8% Bond 2019	2/15/19	19,250,793	13,397,993	5,852,800	62,400
8-1/8% Bond 2019	8/15/19	9,953,364	9,945,364	8,000	-0-
Total		366,929,254	285,415,644	81,513,610	2,081,680

[1] Effective May 1, 1987, securities held in stripped form were eligible for reconstitution to their unstripped form.

Note: On the 4th workday of each month a recording of Table VI will be available after 3:00 pm. The telephone number is (202) 447-9873.
The balances in this table are subject to audit and subsequent adjustments.

GPO 941-105

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

ROOM 5310

OCT 11 9 11 AM '89

DEPARTMENT

FOR IMMEDIATE RELEASE
OCTOBER 10, 1989

Michael E. Basham
Appointed Deputy Assistant Secretary
for Federal Finance

Secretary of Treasury Nicholas F. Brady today announced the appointment of Michael Emory Basham to serve as the Deputy Assistant Secretary for Federal Finance. In this capacity, Mr. Basham will serve as principal advisor to the Secretary and other top level officials on the formulation of Treasury and Federal Government debt management policy. In addition, he will advise Treasury officials on a wide range of economic and monetary matters. Mr. Basham also serves as the liaison between the Department of Treasury and dealers of U.S. Government securities.

Prior to joining Treasury, Mr. Basham served as a Vice President in the Government Bond Department of Wertheim Schroder & Company in New York City. Previously, Mr. Basham held a number of management and trading positions in the government bond industry.

Mr. Basham received his B.S. from the University of Southern Mississippi and his M.B.A. from the University of South Carolina.

Mr. Basham, a former resident of Connecticut, currently resides with his wife and four children in Northern Virginia.

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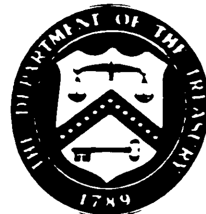
TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
October 10, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,415 million of 13-week bills and for $7,402 million of 26-week bills, both to be issued on October 12, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing January 11, 1990			:	26-week bills maturing April 12, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.59%a/	7.85%	98.081	:	7.58%	7.99%	96.168
High	7.65%	7.91%	98.066	:	7.61%	8.02%	96.153
Average	7.63%	7.89%	98.071	:	7.60%	8.01%	96.158

a/ Excepting 2 tenders totaling $9,720,000.

Tenders at the high discount rate for the 13-week bills were allotted 1%.
Tenders at the high discount rate for the 26-week bills were allotted 81%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 40,060	$ 40,060	:	$ 35,955	$ 35,955
New York	19,808,975	5,451,735	:	18,984,050	6,233,250
Philadelphia	20,640	20,640	:	21,665	19,665
Cleveland	42,630	42,630	:	49,470	49,470
Richmond	44,005	44,005	:	47,245	47,245
Atlanta	37,485	37,485	:	34,810	34,810
Chicago	1,417,710	669,710	:	1,240,870	165,670
St. Louis	47,775	27,825	:	34,620	26,620
Minneapolis	8,445	8,445	:	8,915	8,915
Kansas City	33,620	33,620	:	53,330	53,330
Dallas	23,480	23,480	:	20,530	20,530
San Francisco	719,155	367,155	:	671,045	107,545
Treasury	648,430	648,430	:	599,310	599,310
TOTALS	$22,892,410	$7,415,220	:	$21,801,815	$7,402,315
Type					
Competitive	$19,117,675	$3,840,485	:	$18,380,305	$4,180,805
Noncompetitive	1,329,005	1,329,005	:	1,247,810	1,247,810
Subtotal, Public	$20,446,680	$5,169,490	:	$19,628,115	$5,428,615
Federal Reserve	1,872,330	1,672,330	:	1,650,000	1,450,000
Foreign Official Institutions	573,400	573,400	:	523,700	523,700
TOTALS	$22,892,410	$7,415,220	:	$21,801,815	$7,402,315

1/ Equivalent coupon-issue yield.

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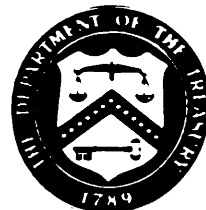
TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

5310

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
October 10, 1989

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $15,200 million, to be issued October 19, 1989. This offering will provide about $1,275 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,917 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, October 16, 1989. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,600 million, representing an additional amount of bills dated January 19, 1989, and to mature January 18, 1990 (CUSIP No. 912794 TM 6), currently outstanding in the amount of $16,150 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $7,600 million, representing an additional amount of bills dated August 15, 1989, and to mature April 19, 1990 (CUSIP No. 912794 UA 0), currently outstanding in the amount of $15,020 million, the additional and original bills to be freely interchangeable.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing October 19, 1989. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,509 million as agents for foreign and international monetary authorities, and $3,383 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

8/89

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE October 11, 1989

MIMA S. NEDELCOVYCH APPOINTED U.S. EXECUTIVE DIRECTOR OF AFRICAN DEVELOPMENT BANK AND AFRICAN DEVELOPMENT FUND

Secretary of the Treasury Nicholas F. Brady today announced the appointment of Mima S. Nedelcovych of Reston, Virginia as U.S. Executive Director of the African Development Bank and the African Development Fund.

Dr. Nedelcovych, 37, was a Principal and lead consultant for Arthur Young's International Management Consulting Group based in Washington, D.C. He has a Ph.D. in Political Science from Florida State University, an M.A. in International Affairs from George Washington University, and a B.A. in Political Science from Yale University.

Dr. Nedelcovych has extensive international experience and has resided in Gabon, Morocco, and Cote d'Ivoire. His areas of specialization include: trade and investment promotion, financial analysis, privatization, and project analysis and evaluation.

In recent years, Dr. Nedelcovych has concentrated on the areas of export promotion, investments, and joint-venture formation in developing countries. He has worked closely with U.S. government agencies, including the Agency for International Development (AID), the U.S. Trade and Development Program (TDP), the Overseas Private Investment Corporation (OPIC), multilateral development organizations, and private companies.

As U.S. Executive Director of the African Development Bank and Fund, Dr. Nedelcovych will be the senior U.S. representative in this institution and will reside in Abidjan, Cote d'Ivoire where it is headquartered.

The African Development Bank was established in 1963 to make loans on near-market terms to promote economic and social development in member countries individually and through regional cooperation. The Bank's lending activities are financed mainly through the paid-in capital subscriptions of member countries and borrowings in international capital markets, as well as repayments and incomes from loans. The soft loan affiliate of the Bank, the African Development Fund, provides development finance on concessionary terms to the poorest African countries.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
October 11, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 7-YEAR NOTES

The Department of the Treasury has accepted $7,531 million of $18,458 million of tenders received from the public for the 7-year notes, Series H-1996, auctioned today. The notes will be issued October 16, 1989, and mature October 15, 1996.

The interest rate on the notes will be 8 %. The range of accepted competitive bids, and the corresponding prices at the 8 % interest rate are as follows:

	Yield	Price
Low	8.07%	99.631
High	8.08%	99.579
Average	8.08%	99.579

Tenders at the high yield were allotted 74%.

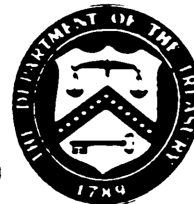
TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 6,262	$ 6,262
New York	17,006,247	7,117,147
Philadelphia	2,669	2,669
Cleveland	5,072	5,072
Richmond	4,334	4,275
Atlanta	3,640	3,640
Chicago	728,993	249,393
St. Louis	4,929	4,929
Minneapolis	2,605	2,570
Kansas City	5,375	5,374
Dallas	4,985	3,725
San Francisco	682,097	124,997
Treasury	749	749
Totals	$18,457,957	$7,530,802

The $7,531 million of accepted tenders includes $221 million of noncompetitive tenders and $7,310 million of competitive tenders from the public.

In addition to the $7,531 million of tenders accepted in the auction process, $160 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $126 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-500

// TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at: 10:00 a.m.
Date: October 12, 1989

NM 5310

STATEMENT OF
KENNETH W. GIDEON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Administration on a number of miscellaneous revenue measures referred to the Select Revenue Measures Subcommittee.

1. Permanent Small Business Exemption from Repeal of the General Utilities Doctrine

Current Law

Sections 336, 337 and 338 of the Internal Revenue Code (the Code), as amended by the Tax Reform Act of 1986 (the 1986 Act), provide for the recognition of gain or loss by a corporation on the sale or distribution of its assets in liquidation. Similarly, section 311, as amended by the 1986 Act, generally provides for the recognition of gain by a corporation in the case of a nonliquidating distribution to its shareholders of appreciated assets. These amendments repealed the statutory codification of the so-called *General Utilities* doctrine under which neither gain nor loss was recognized by a liquidating corporation on the sale or distribution of its assets, nor in some cases, by a corporation on certain nonliquidating distributions. The 1986 Act also provided for the repeal of section 333 which permitted shareholders in certain cases to elect not to recognize gain on a liquidating distribution. A transition rule with respect to these 1986 Act changes preserved the *General Utilities* doctrine through December 31, 1988 for liquidating and nonliquidating distributions in the case of certain small business corporations.

Proposal

The proposal would provide a permanent small corporation exception to the repeal of the *General Utilities* doctrine for transactions occurring on or after January 1, 1989.

NB-501

Administration Position

We strongly oppose this proposal. One major purpose of the repeal of the *General Utilities* doctrine was to curtail transactions through which a purchaser could obtain a stepped-up, cost basis in the assets transferred by a corporate seller without the recognition by the seller of corporate-level gain. The substantial tax preference afforded to corporate liquidations under prior law made appreciated assets more valuable to purchasers than to the historic owners and therefore encouraged tax-motivated corporate liquidations and acquisitions. *See* H.R. Rep. 99-426, 99th Cong. 1st Sess., 281-282 (1985).

The second purpose of the repeal of the *General Utilities* doctrine was that it provided neither efficient nor equitable relief from the two-tier tax on corporate earnings. Accordingly, we do not believe that a permanent exception from the repeal of the *General Utilities* doctrine for small businesses is the appropriate mechanism for providing small business with relief from corporate-level taxation. Many taxpayers have responded to the change in the law by operating their businesses in partnership form or in small business corporations qualifying for treatment under subchapter S, thus avoiding the two-tier tax on corporate earnings. We believe that, in the absence of a systematic change in the way corporations are taxed, these alternative vehicles for business operations provide adequate relief for small business from the two-tier corporate tax.

We are also concerned that this proposal would create substantial additional complexity in the Code. The repeal of the *General Utilities* doctrine greatly affects the operation of many corporate tax provisions. The proposal to permanently reinstate the doctrine for some corporations would require additional statutory changes to accommodate the different consequences to corporations that qualify for relief and those who do not so qualify. Finally, we note that while the special effective date for *General Utilities* repeal for small corporations included in the 1986 Act was consistent with the purposes of tax reform in helping to provide an orderly transition from prior law to current law, a permanent rule would establish a dichotomy in the tax treatment of corporate enterprises fundamentally inconsistent with the intent of the original legislation.

2. Tax Exemption for Certain Blue Cross/Blue Shield Organizations and Qualification of Nonprofit Health Insurance Provider Under Blue Cross/Blue Shield Rules

Current Law

Section 501(c) of the Code specifies various standards that an organization must meet in order to qualify for exemption from federal income tax. These standards vary depending on the type of exemption. An organization described in section 501(c)(4) (a

social welfare organization) is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. Commercial-type insurance generally is any insurance of a type provided by commercial insurance companies, which does not include insurance provided at substantially below cost to a class of charitable recipients. See section 501(m)(3).

In the Tax Reform Act of 1986, Congress generally subjected to tax as property and casualty insurance corporations Blue Cross and Blue Shield organizations (BCBS organizations). Three significant special rules under section 833 apply to certain organizations that were BCBS organizations on August 16, 1986 and that were tax exempt for the last taxable year prior to January 1, 1987. First, these organizations are entitled to a special deduction with respect to their health business equal to 25 percent of the claims and expenses incurred during the year less the adjusted surplus at the beginning of the year. Second, these organizations are not subject to the requirement that 20 percent of the increase in unearned premiums reserves be included in income. Third, the basis of their assets equals (for purposes of determining gain or loss) the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1986. These special rules are available only to those BCBS organizations described above that have not undergone a "material change" in their operation or structure.

The special treatment under section 833 also applies to other organizations (non-BCBS organizations) substantially all of whose activities consist of providing health insurance, if they meet the following requirements. First, at least 10 percent of the health insurance provided by the non-BCBS organization must be provided to individuals and small groups. Second, the organization must provide continuous full-year open enrollment for individuals and small groups. Third, any individual seeking health insurance is required to be offered coverage, including coverage of pre-existing conditions, within a reasonable waiting period. Fourth, at least 35 percent of the organization's health insurance premiums must be determined on a community-rated basis. Fifth, no part of the net earnings of the organization may inure to the benefit of any private shareholder or individual.

Proposals

The first proposal would reinstate the exemption from federal income tax for BCBS organizations that meet the requirements that non-BCBS organizations currently must meet to be entitled to the special treatment under section 833, and certain additional requirements. Among the additional requirements, the BCBS organization would be required to (1) return 85 cents in benefits for every premium dollar received, (2) retain coverage despite heavy usage, and (3) set its premiums on the community-rated basis. The proposal would eliminate the special tax treatment

applicable under section 833 for BCBS organizations that do not meet such requirements.

The second proposal would extend the special tax treatment available to BCBS organizations under section 833, as described above, to those non-BCBS organizations that (1) are organized under and governed by state laws which are specifically and exclusively applicable to not-for-profit health insurance or health service-type organizations, (2) were existing on August 16, 1986, (3) were previously tax exempt under section 501(c)(4), and (4) have not undergone a material change in operation or structure. These non-BCBS organizations would be entitled to the special tax treatment under section 833 without meeting the eligibility requirements applicable to other non-BCBS organizations under section 833(c)(3).

Administration Position

The Administration is concerned that the current law special tax treatment for BCBS and non-BCBS organizations that conduct activities a substantial part of which consists of providing commercial-type insurance may provide such insurers an unwarranted competitive advantage over commercial insurers who do not receive such special tax treatment. As a result, we do not support expansion of the scope of these special rules. However, we would not object to conducting a study of the appropriateness of the eligibility standards for the special deductions provided BCBS and non-BCBS organizations under section 833. In our view, such a study should include an evaluation of (1) whether the special deductions should be provided to any BCBS or non-BCBS organization that does not meet the current standards for tax exemption under section 501, and (2) whether the deductions should be available, if at all, only to those organizations that meet certain health insurance coverage, availability, and pricing requirements, including the requirements currently applicable under section 833(c)(3) to non-BCBS organizations.

3. Accrual Accounting for Personal Service Corporations

Current Law

Generally, accrual method corporations are entitled to currently deduct compensation for services performed during the year (accrued compensation), if the compensation is paid no later than 2 1/2 months following the end of the corporation's taxable year. Accrual method personal service corporations (PSCs), however, may currently deduct accrued compensation payable to employee-owners only if such compensation is paid prior to the end of the corporation's taxable year. Any such compensation paid after the end of the corporation's taxable year (accrued but unpaid compensation) is generally deductible when paid.

For this purpose, an employee-owner is any employee of the

corporation who owns any stock of the corporation. A PSC is any corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners.

Proposal

The proposal would allow certain accrual method PSCs to currently deduct a limited portion of accrued but unpaid compensation payable to employee-owners, provided such compensation is paid no later than 2 1/2 months following the end of the taxable year. Under the proposal, the amount of deductible accrued but unpaid compensation payable to employee-owners would be limited to the sum of (1) regular periodic compensation (i.e., compensation that is payable at least semimonthly), for a period consisting of no more than the last semimonthly period of the corporation's taxable year, (2) non-discriminatory accrued vacation pay, not to exceed five weeks' regular periodic compensation; and (3) a year-end bonuses, not to exceed one month's salary. As under current law, any accrual method PSC would be allowed to deduct both accrued but unpaid compensation payable to non-employee-owners, provided such compensation is paid no later than 2 1/2 months following the end of the PSC's taxable year, and accrued compensation payable to employee-owners that is paid during the taxable year.

Administration Position

The Administration does not object to allowing accrual method PSCs to currently deduct the last semimonthly (or biweekly) payment of regular periodic compensation payable to employee-owners, even though such payment is made following the end of the PSC's taxable year. The small amount of deferral that would be allowed by such a change would not undermine the purpose for the general limitation on deductions for accrued but unpaid compensation payable to employee-owners. Moreover, such a modification to current law would eliminate the pressure on accrual method PSCs to accelerate the regular paycheck for the last pay period of the taxable year. However, the Administration does oppose deviating from current law with respect to vacation pay and bonuses payable to employee owners. Allowing a current deduction with respect to these payments would reintroduce a significant portion of the deferral that certain provisions of the 1986 Act were designed to eliminate.

4. Treatment of Certain Supervisory Mergers of Financially Troubled Thrift Institutions

Current Law

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) retroactively repealed a number of special tax provisions that applied to certain reorganizations of

financially troubled banks and thrift institutions. A generally applicable transition rule preserves prior law for transactions completed pursuant to a binding contract in effect on May 10, 1989.

Proposal

The proposal would permit the tax consequences of certain supervisory mergers of thrift institutions to be governed by the special rules in effect prior to the enactment of FIRREA if the merger application was approved or being processed by the Federal Home Loan Bank Board on May 10, 1989. We understand that the principal effect would be to except such transactions from the generally applicable loss limitation rules of section 382.

Administration Position

The Administration does not support this proposal. The proposal would benefit a narrow category of financial institutions that do not qualify for the generally applicable binding contract transition rule included in the FIRREA legislation. We believe strongly that the goals of FIRREA are best achieved if all financial institutions are equally subject to its provisions.

5. Foreign Trade Zones -- Distilled Spirits Excise Tax

Current Law

An excise tax is imposed on distilled spirits that are produced in or imported into the United States. Domestically produced distilled spirits that are not in bulk containers are taxed when they are removed from a bonded factory or distilled spirits plant. Imported distilled spirits that are not in bulk containers can be entered into either a customs bonded warehouse or a foreign trade zone without payment of tax, but are taxed when they are removed from the warehouse or trade zone in which they are entered.

Proposal

The proposal would postpone imposition of the excise tax in the case of imported distilled spirits that are not in bulk containers and are withdrawn from a foreign trade zone for delivery to a customs bonded warehouse. The tax would be imposed when the distilled spirits are withdrawn from the customs bonded warehouse.

Administration Position

We do not oppose this proposal. Before 1987, distilled spirits could be entered into a foreign trade zone for final processing (*i.e.*, packaging and similar operations), and no tax

would be imposed upon the transfer of the distilled spirits to a customs bonded warehouse for distribution. Under current law, final processors in foreign trade zones are disadvantaged relative to their offshore competitors because distilled spirits can be entered into a customs bonded warehouse free of tax only if the final processing takes place offshore.

The proposal would restore parity between domestic and foreign final processors. We note, however, that the proposal may create a new disparity between domestic and foreign producers of distilled spirits because foreign producers would be permitted to distribute distilled spirits to warehouses without payment of tax while domestic producers would be taxed when the distilled spirits are removed from their place of manufacture. The potential for disparity exists even under current law because foreign producers can ship distilled spirits directly to customs bonded warehouses at various locations, thereby paying the tax further down the distribution chain than is possible for domestic producers. As a practical matter, this is unlikely to occur because the increased costs of such a distribution system generally would outweigh the benefits of tax deferral. The proposal, however, would allow importers to defer the tax without changing their normal distribution system.

6. Employment Tax Treatment of Certain Fishermen

Current Law

Under present law, service as a crew member on a fishing vessel is excluded under certain conditions from the definition of employment for purposes of determining wages subject to employment taxes. See sections 3121(b)(20) and 3401(a)(17) of the Code. In general, among the conditions that must be satisfied under current law are the requirements that the individual receive as compensation for such service only a share of the boat's catch (or a share of the proceeds from the sale of the catch), and that the operating crew of the boat normally be made up of fewer than 10 individuals.

Proposal

Under the proposal, service as a crew member on a fishing vessel would be treated as meeting the exclusion from the definition of employment even if, in addition to a share of the boat's catch, the individual received an additional amount of compensation. This rule would apply provided that (1) the additional amount does not exceed 50 dollars per trip, (2) payment of the amount is contingent on the attainment of some minimum level of catch, and (3) the amount is paid solely in recognition of the individual's performance of additional duties, such as those of mate, engineer, or cook, for which it is traditional in the industry to receive such additional compensation.

In addition, the proposal would modify the present law rule regarding the maximum normal crew size to provide that the operating crew of the boat normally consist of 10 or fewer individuals. This determination would be made at the beginning of each quarter by looking back over the immediately preceding four quarters to see whether the boat's operating crew consisted of 10 or fewer individuals on at least 50 percent of the trips made during that period. If so, the boat would be treated as meeting the requirement regarding maximum normal crew size throughout the current quarter then beginning; if not, the requirement would not be satisfied.

The proposal would be effective for taxable years beginning after December 31, 1989, and no inference would be intended with respect to the correct interpretation of present law.

Administration Position

The Administration does not oppose this provision. Given the existence of the special employment tax exclusion provided under present law, the Administration believes that the proposal would simplify compliance and increase certainty for both taxpayers and the Internal Revenue Service. Congress may, however, at a future time wish to consider the appropriateness of the special employment tax exclusion itself. In this regard, I would like to call your attention to the statement of Gwendolyn S. King, Commissioner of Social Security, submitted to the Subcommittee for this hearing.

7. Modification of $2 million GST Tax Exemption

Current Law

Under present law, a person may transfer $2 million to a grandchild prior to January 1, 1990, without incurring the generation skipping transfer tax (the "$2 million exemption"). For a transfer to a trust to qualify for the $2 million exemption, certain requirements must be met, including that trust income must be distributed annually to the grandchild after he reaches age 21.

Proposal

The proposal would make the $2 million exemption applicable to transfers to step-grandchildren and provide relief from the income distribution requirement, either by adjusting the effective date of the distribution requirement or by raising the age at which income distributions must be made from 21 to 25.

Administration Position

The Administration opposes expanding the transitional $2 million exemption to transfers to step-grandchildren and would

strongly oppose making the $2 million exemption permanent. We believe the exemption should be narrowly applied consistent with its purpose and should not be expanded beyond its present scope. The Administration would not object to a postponement of the age at which trust income must be distributed to the grandchild. We believe donors have a legitimate concern about putting large amounts of income in the hands of beneficiaries at the age of 21. Because the trust property can only be expended for the benefit of the grandchild and all trust property must be includible in the grandchild's estate if the grandchild dies prior to trust termination, we do not believe a postponement of the distribution age would compromise tax policy.

8. Proposals Relating to Gasohol

Current Law

Section 4081(a) of the Code imposes a gasoline excise tax of 9.1 cents per gallon on the earlier of the sale or removal of gasoline by the refiner, importer, or terminal operator. In the case of gasoline to be used in the production of gasohol, the rate of tax is reduced under section 4081(c) to the equivalent of 3.1 cents per gallon of gasohol.

Gasohol is defined by section 4081(c) of the Code as any mixture of gasoline if at least 10 percent of such mixture is a qualifying alcohol (i.e., ethanol). Internal Revenue Service regulations provide a tolerance in determining whether a mixture containing less than 10 percent ethanol nevertheless qualifies as gasohol (the tolerance rules). Under these regulations, the District Director is to take into account the commercial and operational realities of the blending process. However, any mixture containing less than 9.802 percent alcohol does not qualify as gasohol. A mixture containing at least 9.802 but less than 10 percent alcohol does not qualify as gasohol if mixtures produced by the blender "show a consistent pattern of failing to contain 10 percent alcohol." See Treas. Reg. section 48.4081-2(b)(5). Concerns have been raised that the 10 percent requirement, as interpreted by these regulations, is too strict and does not adequately take into account operational realities.

Section 4081(b) of the Code imposes the 9.1 cents per gallon tax on gasoline sold or removed by the blender or compounder thereof, subject to a credit for tax previously imposed under section 4081(a). Internal Revenue Service regulations impose additional excise tax if qualifying gasohol is later blended with gasoline to produce a mixture that contains less than 10 percent ethanol (the later blending rule). See Treas. Reg. section 48.4081-2(e)(3). It has been argued that this rule is inconsistent with the policy of the statute, because the amount of the excise tax subsidy per gallon of ethanol eventually used as fuel is not affected by later blending.

If tax is imposed at the full 9.1 cents per gallon rate on gasoline that is later used to produce gasohol, section 6427(f) of the Code entitles the blender to a refund. Under section 6427(i)(3), if the claim for refund is not paid within 20 days of the date that it is filed, the blender is entitled to interest on the refund from the date that the claim was filed.

Proposals

Tolerance Rule

A mixture would be considered to contain at least 10 percent qualifying alcohol if, immediately after blending, the mixture is at least 9.802 percent alcohol, and no more than 25 percent of the total gallons of the blender's alcohol and gasoline mixtures are less than 9.9 percent alcohol.

Later Blending Rule

If a fuel that meets the requirements of section 4081(c) (i.e., contains at least 10 percent alcohol) immediately after blending is later combined with a fuel subject to tax at a rate of 9.1 cents per gallon, the combination would not be treated as giving rise to a fuel subject to tax under section 4081. We assume that this proposal is intended to apply only to blending of gasohol and gasoline that have already been taxed.

Refund Procedures

Gasohol blenders that purchase gasoline on which tax has been paid at the full 9.1 cents per gallon rate, would be en entitled to interest on all refund claims from the date that the claims are filed, rather than only on claims not paid within 20 days after filing, as under current law. This proposal is intended to treat refund claims of gasohol blenders in the same way that refund claims of persons selling gasoline to gasohol blenders would be treated if H.R. 3299 is enacted. Section 11501(c) of H.R. 3299 provides that persons selling tax-paid gasoline to blenders for production of gasohol may, in certain circumstances, claim a refund, and that interest on such claims accrues from the date of filing regardless of when the claim is paid.

Administration Position

The Administration does not oppose any of these three provisions, based on our understanding that they will have little if any revenue impact.

9. Proposals Related to Nonconventional Fuels Tax Credit

Current Law

Section 29 of the Code provides a tax credit for "qualified

fuels" which are produced by the taxpayer and sold to an unrelated person during the taxable year. Qualified fuels generally include: (1) oil produced from shale and tar sands; (2) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass; (3) liquid, gaseous or solid fuels produced from coal; (4) certain processed wood fuels; and (5) steam produced from certain solid agricultural byproducts.

The tax credit is generally available with respect to qualified fuels which are: (1) produced from a well drilled after December 31, 1979, and before January 1, 1991, or produced in a facility placed in service after December 31, 1979, and before January 1, 1991; and (2) sold after December 31, 1979, and before January 1, 2001. (Special rules apply to qualified processed wood fuels and to solid agricultural byproduct steam.)

Production of natural gas from a tight formation ("tight sands gas") is eligible for the section 29 credit only if the price for which the gas may be sold is regulated by the United States. Under a 1985 order of the Federal Energy Regulatory Commission, most tight sands gas has been deregulated and therefore is not eligible for the credit. This order, which was the subject of litigation, was ultimately upheld by the Supreme Court in _Federal Energy Regulatory Commission v. Martin Exploration Company_ 486 U.S. 204 (1988). Therefore, most production of tight sands gas is ineligible for the section 29 credit.

Proposal to Extend Placed in Service Deadline

The first proposal is to extend the placed in service deadline for facilities by 2 years, such that the credit would be available with respect to qualified fuels which are produced in a facility placed in service after December 31, 1979, and before January 1, 1993.

Administration Position

The Administration does not support this proposal. It is not in accord with the more broadly targeted energy incentives proposed in the President's budget.

Proposal Relating to Tight Sands Gas

The proposal would repeal the price-regulation requirement for tight sands gas for wells drilled after July 1, 1989.

Administration Position

The Administration is not in a position to support this proposal at this time. We note, however, that the Department of Energy is currently studying options for and the potential costs and benefits of extending the availability of the credit to tight

sands gas.

Proposals Relating to Shale Oil

The proposal would make numerous changes to the section 29 credit as applied to oil produced from shale. The proposals relating to shale oil include (1) extending the section 29 credit to gas produced from shale; (2) allowing a three year carryback and fifteen year carryforward of the credit; (3) eliminating the related party rules; (4) providing an exception from the price-related phase out rules; and (5) providing an exception from the restrictions on tax-exempt financing.

Administration Position

These proposals are intended to benefit the UNOCAL Corporation's shale project in Colorado, which is the only potential source of shale oil feedstock for the Department of Defense's Operational Validation Test Program. The Defense Department believes that it is necessary to enhance the availability of the section 29 credit for this project in order for it to continue. In light of these concerns, we do not oppose modifying the shale oil credit to enhance its availability. However, we have not had an opportunity to review statutory language, and thus are not in a position to support specific proposals.

Proposal Relating to Tar Sands

This proposal is addressed separately in a letter from Acting Tax Legislative Counsel Robert R. Wootton submitted to the Subcommittee for this hearing.

10. Municipal Assistance Corporation Bond Refinancing

Current Law

A bond (including a refunding bond) is a private activity bond if an amount exceeding the lesser of five percent or $5 million of bond proceeds is to be used (directly or indirectly) to make or finance loans to any person other than a governmental unit (the "private loan test").

Proposal

Certain bonds issued to refund the currently outstanding obligations of the Municipal Assistance Corporation of the City of New York (MAC) would be exempted from the private loan test if (1) the proceeds of the new issue are used exclusively for the current refunding, (2) the amount of the refunding issue does not exceed the outstanding amount of the refunded bonds, and (3) the final maturity date of the refunding issue does not extend later than July 1, 1995. MAC issued tax exempt obligations the

proceeds of which were used as a source of funds to meet the obligations of the city. The city in return delivered to MAC certain city obligations that financed low income loans to the owners of certain housing projects. The proposal addresses the technical problem created by the fact that under the private loan test this exchange would cause the refunding of the MAC bonds to be treated as a private activity bond.

Administration Position

The Administration does not oppose this proposal.

11. Welfare Benefit Funds

Current Law

Under present law, certain benefits provided to employees, such as employer-provided medical expense reimbursements under section 105(b), are excluded from gross income. Similar exclusions do not apply, however, if such benefits are provided under arrangements under which employees are assured of receiving, in cash or other taxable benefits, amounts that are not used during the year to provide the otherwise excludable benefits, without regard to whether they have satisfied the conditions necessary to receive such benefits.

Proposal

The proposal would affirm the rule that the section 105(b) exclusion does not apply to amounts that the taxpayer is, or could become entitled to receive without regard to whether he or she incurred medical expenses during the period of coverage. The proposal would also relieve certain trusts of any liability for employment taxes for periods prior to January 2, 1987, to the extent that such liability is attributable to the payment of health expense reimbursements or supplemental unemployment benefits under an arrangement that failed to be eligible for an applicable exclusion because participants under the arrangements were assured of receiving (in cash or other taxable benefits) amounts available but not used during the year to provide the excludable benefits.

Administration Position

The Administration does not oppose this proposal.

12. Cash Method of Accounting for Operators of Cotton Warehouses

Current Law

The 1986 Act added to the Code a general requirement that C corporations use the accrual method of accounting. Exceptions

are provided for (1) entities in a farming business, (2) qualified personal service corporations, and (3) entities with average annual gross receipts of $5 million or less.

A C corporation operating cotton warehouses is not in a farming business (as that term is currently defined for this purpose) and is not a personal service corporation. As a result, such an entity must use the accrual method of accounting if its average annual gross receipts exceed $5 million.

Proposal

The proposal would allow corporate operators of cotton warehouses to use the cash method of accounting. Any such entity that changed from the cash method to the accrual method as a result of the 1986 Act would be permitted to retroactively change back to the cash method.

Administration Position

The Administration opposes this proposal.

13. Transition Rules

I would like to note that the following proposals referred to the Subcommittee are essentially targeted transition rules that provide special relief from prior legislation for one or a very small number of taxpayers. We endorse the principle of providing fair and equitable transition from one tax regime to the next and generally defer to the discretion of Congress with regard to targeted rules proposed during the consideration of the changes in the tax law from which transition relief is desired. However, as a general matter, we do not support efforts to reopen the debate on transition relief from prior legislation, although we realize that such relief may be equitable where unusual and unforeseeable circumstances have prevented the use of a transition rule by the intended beneficiary. Accordingly, while we recognize that these are matters uniquely within the province of Congress, we do not support the proposals under consideration by the Subcommittee that provide new transition relief from prior legislation.

A. Accelerated Cost Recovery System Transition Rule

Current Law

The 1986 Act modified the prior law Accelerated Cost Recovery System (ACRS) for property placed in service after December 31, 1986, except for property covered by transition rules. Generally applicable transition rules were provided for property constructed, reconstructed or acquired pursuant to a binding contract entered into as of March 1, 1986 and for several other categories of transitioned property. The 1986 Act also contained

a number of targeted transition rules. Most of the general and specific transition rules contained placed-in-service date requirements.

Proposal

The proposal would extend the placed-in-service date requirement for exception from certain ACRS changes for certain projects the construction of which was delayed due to an Act of God or to delay in receipt of federal funding.

B. Investment Tax Credit and ACRS Transition Rules

Current Law

Current law does not provide a general tax credit for investment in tangible personal property. The prior law provisions for the regular investment tax credit (ITC) were repealed in the 1986 Act, for property placed in service after December 31, 1985. Generally applicable transition rules were provided for property constructed, reconstructed or acquired pursuant to a binding contract entered into as of December 31, 1985 and for several other categories of transitioned property. The 1986 Act also contained a number of targeted transition rules. Most of the general and specific transition rules contained placed-in-service date requirements.

Proposals

One proposal would extend the placed-in-service date requirements for the transitional exception from ITC repeal and ACRS modification for a specific paper mill project. Another proposal would extend the placed-in-service date requirements for certain cogeneration projects.

C. Tax Exempt Obligations Reissued after Effective Date of Section 265(b)

Current Law

Section 265(b), as added by the 1986 Act, disallows a deduction for the proportion of a financial institution's interest expense that corresponds to the institution's proportionate holdings of tax-exempt obligations. This provision is generally effective for obligations acquired after August 7, 1986. If the terms of an obligation acquired on or before August 7, 1986 are materially changed after August 7, the old obligation will be deemed to be exchanged for a new obligation that will be taken into account for purposes of section 265(b). The waiver of a right to an interest adjustment clause constitutes a material change in an instrument. *See* Rev. Rul. 87-19, 1987-1 C.B. 249.

Proposal

The proposal would restore grandfathered status for obligations with respect to headquarters projects constructed by tax-exempt organizations in cases where the obligation was deemed to be reissued by reason of the waiver of an interest adjustment clause.

D. Huntsville Bonds

Current Law

Interest on state and local bonds is taxable if the bonds are private activity bonds unless a specific exclusion is included in the Code. Most private activity bonds for which tax-exemption is specifically permitted, including qualified exempt facilities bonds, are subject to the state private activity bond volume limitations. The annual private activity bond volume limitation for each state is equal to the greater of (1) $50 for every individual who is a resident of the state or (2) $150 million.

Interest on any obligation issued on or on behalf of states and their political subdivisions or that are otherwise described in section 103 of the Code will also be taxable if the obligation is federally guaranteed. An obligation is treated as federally guaranteed if (1) the payment of the principal or interest on the obligation is guaranteed, in whole or in part by the United States or any agency or instrumentality thereof; (2) a significant portion on the proceeds of the issue of which the obligation is a part are to be used in making loans or other investments the payments on which are guaranteed in whole or or in part by the United States or any agency or instrumentality thereof; (3) a significant portion of the proceeds of the issue are to be invested directly or indirectly in federally insured deposits or accounts in a financial institution, or (4) the payment of the principal or interest of the obligation is otherwise indirectly guaranteed, in whole or in part, by the United States or an agency or instrumentality thereof.

Proposal

The proposal would grant an exception from the federal guarantee prohibition and the state volume cap for certain tax-exempt bonds to be issued by the City of Huntsville, Alabama to refinance certain taxable bonds used originally to finance a specified solid waste disposal facility. In addition, the proposal would treat these bonds as qualified exempt facility bonds under section 142.

E. Harlem International Trade Center Bonds

Current Law

Convention and trade show facilities do not qualify under

current law for private activity tax-exempt bond financing. Such facilities could be financed by qualified Industrial Development Bonds (IDBs) under prior law before the 1986 Act. The 1986 Act included a transition rule that would have allowed tax-exempt financing for bonds to finance the Harlem International Trade Center if issued before December 31, 1990.

Proposal

The proposal would extend the Harlem International Trade Center transitional rule to bonds issued prior to July 1, 1993, and provide that the bonds are tax-exempt whether they finance all or a portion of the facility.

F. Stadium and Convention Center Bonds

Current Law

While sports stadiums and convention facilities could be financed as qualified Industrial Development Bonds (IDBs) under prior law, they do not fall within any category of exempt-facility bonds eligible for tax-exemption under current law. A transition rule provided in the 1986 Act provided limited transitional relief for tax exempt bond financing for certain sports stadium and convention facilities. However, these transition rules did not include exceptions from the state volume cap for such bonds.

Proposal

The proposal would extend transition relief to bonds issued to finance a facility not covered by the 1986 transition rules and would provide an exception from the state private activity bond volume limitation for such bonds.

G. Island Park Hydroelectric Project

Current Law

A tax credit is provided under section 46 of the Code for investments in certain "energy property." For "qualified hydroelectric generating property," the tax credit was 11 percent for the period beginning on January 1, 1980 and ending on December 31, 1985. However, if an application had been docketed by the Federal Energy Regulatory Commission before January 1, 1986, with respect to the installation of any qualified hydroelectric generating property, the period of eligibility for the tax credit ends on December 31, 1988.

Proposal

The proposal is to extend the end of the period of eligibility for the tax credit by 3 years (to December 31, 1991) in a case in which: (1) the federal government is required to

give regulatory approval before the qualified hydroelectric generating property can be placed in service; (2) an application for approval was docketed with the applicable federal agency before January 1, 1986; (3) initial approval was granted by such federal agency before January 1, 1989; and (4) such final approval was delayed because of licensing requirements imposed by Congress with respect to the property after the date of final Congressional approval of the Conference Report of the 1986 Act. This proposal is intended to allow sufficient time for the Island Park Hydroelectric project to qualify for the tax credit.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

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Remarks by
Secretary of the Treasury
Nicholas F. Brady
before the
American Council For Capital Formation
Washington, D.C.

The American Council for Capital Formation, Fortune Magazine and the sponsors of this conference on saving in America are providing a great public service by bringing together decision makers and policy experts from government, the private sector and academia in a forum where we can explore together the causes of the low saving rate in the United States and the best, realistic options for addressing the problem.

We in government are particularly grateful for the timing of this conference for several reasons. First, the Bush Administration has been studying saving in America in the Economic Policy Council, which I chair. We plan to make our report to the President later this fall, so this conference will make a valuable contribution to our work. Secondly, as you are aware, the Congress is in the midst of a great debate on a key means of increasing saving and investment in the United States--a cut in the capital gains tax. Your presence in Washington and your discussions this week will surely help focus the attention of Congress and the nation on the importance of steps to encourage increased saving.

I believe we're meeting at the beginning of a new era of thinking about the relationship of government and politics to the economy. Attitudes about economic growth and economic equity in society are changing. Many who used to see achieving "fairness" as the goal of government economic policy now recognize that stimulating economic growth is inextricably linked to this goal.

To see this, you need only look to the House of Representatives, where 64 Democrats joined the Republicans in voting to support a cut in the capital gains tax. They did so because they recognized that a lower capital gains tax will encourage saving and investment and that saving and investment are the foundations upon which growth is built. They recognized that growth is essential to an economically strong and just society. And lastly, they acknowledged that the debate about

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capital gains should be about the benefits of growth for all Americans and not about the politics of division and economic confrontation. I'll have more to say about capital gains later in my remarks, but it is important to recognize here what a significant change in perspective the current Congressional debate represents.

As we look at saving and investment as an essential foundation and engine for growth in our economy, we can do so with the knowledge that there is a burgeoning understanding in the policy realm: just as there is a direct relationship between investment and growth, there is an equally direct correlation between growth and economic well-being throughout our society.

Our impressive economic performance in recent years allows us a positive launching point for analyzing the issue of saving. We're about to enter our eighth consecutive year of economic growth. Americans enjoy a high standard of living and relatively low rates of inflation and unemployment. However, we must not let our pride in these accomplishments distract us from focusing on whether the United States is adequately preparing to compete over the long-term in an integrated world economy.

We're here tonight because we know the answer to the question is, at least in part, that we are not adequately preparing for the future. By any measure, our national saving rate has been declining since the late 1970s. This decline inevitably raises questions about our ability to fund investment and therefore to sustain economic growth in the face of ever-increasing competition from abroad.

Historically, investment capital in the United States has come from foreign capital as well as domestic saving. This combination of sources has served us well. However, our ability to attract foreign capital must not lead us to neglect to foster domestic sources of capital. It would be extremely unwise for us to lose sight of the difference between benefitting from foreign investment capital and being dependent upon it.

The American Council for Capital Formation has been a leader in the effort to make Americans aware that our nation's stock of capital is one of our greatest resources. But because we are not saving at a sufficient rate, the cost of capital in the United States is consistently higher than for our major trading partners. In some cases, our companies face capital costs fully twice as high as their competitors pay. The consequence is clear. If one of the essential inputs of production is so much more expensive in the United States, we're at a disadvantage in world trade. You simply can't pay more than your competitors for a basic component of production and hope to come out ahead. So ultimately, the higher cost of capital endangers the competitive

position of American companies. And if our capital costs are consistently higher than those of our competitors over a long period of time, our leadership in the international economy, and even our standard of living, will be placed in jeopardy.

This is the problem we face. The solutions lie in changing the practices and attitudes of government, of business and of individual Americans. These categories are not independent of one another, nor are the solutions. Tonight I'd like to focus my remarks on the particular steps the government can take and on how these steps will assist and encourage private sector efforts to increase domestic saving and investment.

It's a fundamental fact that the most important step the government can take to increase national saving is to decrease the greatest source of national dissaving--the federal budget deficit. Let me say frankly that until we have eliminated the budget deficit, it will necessarily shape our thinking and dominate our actions across the spectrum of policy issues. Several of the proposals to increase saving that I'll discuss tonight would be constrained by the demands of reducing the deficit. For that reason, some might say we shouldn't discuss them at all because we can't move forward this year. I agree that there is an inevitable tension between prescriptions for increasing saving and investment and the need to maintain the current revenue base. But I don't believe that just because we are grappling with one great problem, we have the luxury of dismissing other great challenges as insolvable. We can't afford to stop planning and working toward worthwhile long-term goals solely because we have to address the budget deficit first. At Treasury, our goal is to deal with the current problems, but at the same time, to plan for the country's future.

We have made progress on the deficit. We've reduced its size as a percent of GNP from 6.3 percent in 1983 to 2.9 percent of GNP in fiscal 1989. If we can meet this year's Gramm-Rudman-Hollings target of a $100 billion deficit, that percentage will decline to 1.8 percent. If we meet the 1991 target of $64 billion, the deficit will be 1.1 percent of GNP. We've achieved this decrease primarily by reducing the rate of increase of federal spending from double-digit levels to single digits, while increasing federal revenues through economic growth.

It hasn't proved to be easy to reach the $100 billion mark this year, even with a bipartisan commitment to do so. Next fiscal year will be even tougher, but the Bush Administration remains committed to meeting the deficit reduction targets set in law.

As I mentioned earlier, as part of the debate over the fiscal year 1990 budget, the Congress and the Bush Administration are engaged in a great debate over another means

of lowering capital costs and promoting capital formation: the reduction of the capital gains tax. For 65 years, from 1922 to 1986, this country gave long-term capital gains a preferential tax rate. The logic was simple and compelling. A permanently lower rate of taxation for capital gains promotes long-term investment and economic growth.

President Bush proposed a restoration of a permanent reduction in the capital gains rate in his budget presentation to Congress last February. The House of Representatives has taken a step in the right direction by approving a temporary reduction. We should build upon their efforts and we encourage the Senate to finish the job by putting in place permanently a capital gains tax which reduces the rate according to the length of the holding period. I ask for your support in the coming days; with your assistance we can get the job done.

The debate in Congress and the support of many Democrats for the reduction in the capital gains rate has made clear in Washington what the majority of Americans already know: that the benefits of a preferential capital gains rate reach across American society. Capital gains are at one time or another received by individuals of all income brackets. For example, in 1987, 70 percent of the taxpayers reporting long-term capital gains had income other than capital gains of less than $50,000. So it can no longer be argued that capital gains are only for the wealthy.

But it definitely can be argued that by not lowering the capital gains tax we are reducing our international competitiveness. We have higher taxes on capital gains than most of our trading partners. Belgium, Italy, and the Netherlands have no tax on capital gains. Nor do Hong Kong, Singapore or South Korea. West Germany doesn't tax the gain on assets held more than six months. And France and Japan provide a preferential rate for long-term capital gains that is considerably below ours. We can't expect to remain competitive when our tax structure provides so little incentive for new investment.

Our trading partners also have the advantage when it comes to the tax treatment of corporate earnings. They all, to some extent, integrate individual and corporate taxes to prevent fully taxing the same income twice. In the United States, as you are all aware, corporate earnings are taxed twice: once when the company pays taxes on its profits and again when the shareholders pay tax on their dividends.

Elimination of the double taxation of dividends obviously would involve a loss of revenue to the Treasury, so our options in this area will be limited by the reality of the budget deficit. However, whenever it could be done, such a change would

lower the cost of capital and help corporations of every size. A lower cost of capital means a corporation can invest in projects with lower returns or longer term payoffs, and still provide the same or better return to its shareholders. Every corporation would benefit, even those that pay no dividends or raise no new equity. Without this extra layer of tax, which reduces returns to shareholders, the stock prices of every corporation would be higher.

Changing the policy of double taxation would provide an incentive for long-term growth by lowering the overall cost of capital. And it would do more. It would end the bias of the tax system toward debt financing and thereby return Americans to active participation in our equity markets. It would also substantially reduce the incentives for leveraged buyouts.

There has been a great deal of concern expressed about the leveraging of America in recent years. Congress has correctly traced much of this increased leverage to the unequal tax treatment of debt and equity. The answer put forth by some in Congress is to limit the deductibility of interest on corporate debt. But in effect this would further increase the cost of capital to American business, which clearly isn't in our national interest. Removing the double taxation of dividends would eliminate the bias toward debt without raising the cost of capital.

Just as there is an important role for the government to play in assisting business, there is also a role for government in encouraging individual Americans to increase their private saving. We at Treasury, along with others in the Administration, are examining ways to improve Americans' private saving rate. Among the ideas we are examining is the possibility of expanding the Individual Retirement Account (IRA). We are exploring a range of options for IRAs, but we can't agree with the proposal that recently passed the Senate Finance Committee, which, through lost revenues, would increase the budget deficit by $11 billion over four years. Options which merit more careful analysis include the following:

- increasing the liquidity of IRAs by permitting early withdrawals without penalty for specific purposes;

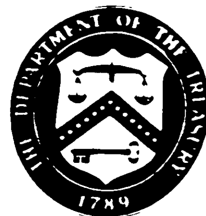
- and delaying the budget impact of IRAs by permitting no tax deduction for contributions, but still allowing the accumulation of interest and the final withdrawal of funds to be tax free.

While we pursue these proposals, we must recognize that there will always be limits to what can be accomplished by government action alone, especially in the realm of individual saving. Thus I believe that government also has a valuable role

to play in educating the American public about the importance of saving and capital formation to our long-term economic well-being. But of course, the government can't do this alone. It must be a truly collaborative effort.

We here tonight have an important role to play in creating a consensus across the country that saving and investment are the foundations upon which economic growth rests, and that economic growth holds the key to a prosperous future for us all. This conference is a very constructive contribution to this endeavor. Together let's go forward to meet this challenge to the U.S. economy.

TREASURY NEWS



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REMARKS OF
JOHN E. ROBSON
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE
ASSOCIATION FOR FOREIGN INVESTMENT IN AMERICA
CONFERENCE ON JAPANESE DIRECT INVESTMENT
IN THE UNITED STATES

Good afternoon. And thank you for inviting me to address you.

Nearly three thousand years ago the Greek poet Hesiod observed that in all things timing is the most important factor. And these days you can't pick up an American newspaper without finding a prominent article on a new Japanese acquisition of a U.S. company. So the timing of this conference is perfect and I am very pleased to be here today to share a few thoughts on matters which have become increasingly urgent -- economically and politically.

U.S. policy toward direct foreign investment dates back to the first Secretary of the Treasury, Alexander Hamilton, who said that such investment "put in motion a greater quantity of productive labor . . . and productive enterprise than could exist without it." And as Hamilton pointed out, it is a policy based not on theory or sentiment, but on economic self interest.

U.S. policy towards foreign direct investment has not changed. We continue to welcome market-driven foreign direct investment in the United States and seek to liberalize investment policies abroad. Underlying our policy are the beliefs that capital must be free to flow to its most efficient use, that free capital movement maximizes productivity, fosters economic growth, and enhances standards of living throughout the world, and that economic nationalism should not undermine the optimum allocation of resources.

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To illustrate the benefits of foreign investment in the United States, at year end 1987 non-bank U.S. affiliates of foreign firms:

- employed 3.2 million Americans;
- had payrolls of $94 billion;
- paid $9.4 billion in U.S. income taxes (plus additional state, county and local taxes);
- spent $6.2 billion on research and development;
- held a foreign direct investment position in the United States of $272 billion which increased in 1988 to $329 billion.

So our basic policy is to welcome foreign investment and encourage the free flow of capital. However, there are instances when we make limited exceptions to protect national security or maintain national control of critical elements of the economic infrastructure.

For example, like many countries, the United States imposes some restrictions on foreign investment in such strategic areas as atomic energy, telecommunications, air transport, and domestic shipping.

The much-debated Exon-Florio provision of the 1988 Trade Act, which empowers the President to suspend or prohibit foreign acquisitions of U.S. companies which threaten to impair national security, falls within that exception.

Some observers have argued that Exon-Florio represents a retreat from openness in U.S. foreign investment policy. I do not share this view. Exon-Florio has not altered our fundamental liberal investment policy. While the President is authorized to prohibit or suspend a foreign acquisition of U.S. firms on national security grounds, he must first find that all other laws are inadequate or inappropriate to protect the national security. He must also find that there is credible evidence that the foreign investor might take action to impair the national security. The record to date shows clearly that the new law is being enforced in a non-restrictive manner. Of approximately 125 cases reviewed under the legislation, only five reached the investigation stage. Of those, one was restructured, one was withdrawn, and three were sent to the President. In each case, the President decided not to intervene in the transaction.

Recently, in connection with acquisitions of Northwest and United Airlines where substantial foreign investment is

present, there have been allegations that our government is retreating from its traditional open stance on foreign investment. Let me clarify the record from the perspective of a former Chairman of the Civil Aeronautics Board. This was the agency which, before airline deregulation, administered the 1938 law that requires at least 75 percent of the voting interest in U.S. carriers to be owned and controlled by U.S. citizens.

The U.S. Department of Transportation's well-publicized scrutiny and intervention in these transactions does not represent xenophobic meddling. Rather, it is only the most recent instance of the U.S. Government's long standing practice of examining foreign investments in U.S. carriers to determine whether the seventy-five percent voting interest limitation is being circumvented by structuring a transaction so as to technically satisfy the voting control rule but effectively vest greater dominion in the foreign investor through other devices.

This is not the fashioning of a new policy hostile to foreign investment. It is simply the normal enforcement of a fifty year old law.

I repeat. The United States has not, through Exon-Florio or its enforcement of the law limiting foreign investment in our airlines, backed away from its commitment to provide free and open opportunities for the world's investors to get a piece of the American action.

There is one area where the United States does not welcome foreign or domestic investment, or any participation in our economy or banking system -- that is where funds represent the proceeds of international narcotics trafficking. Drug money laundering is a global problem that requires a global solution. President Bush has made it a priority of our National Drug Strategy to work with our allies to enact measures aimed at destroying the financial underpinning of drug organizations. We urge Japanese banks and other businesses to join us in taking every possible measure to assure that you do not become unwitting abettors of money laundering.

The second keystone of U.S. foreign investment policy, and the companion of our hospitality to foreign investment at home, is to seek investment liberalization abroad. Our efforts in this respect are extensive and include:

-- working in the Uruguay Round for GATT discipline on government-sponsored trade-related investment measures;

-- encouraging the Organization for Economic Cooperation and Development (OECD) to strengthen the now-voluntary obligation to grant national treatment to foreign-owned establishments;

-- negotiating bilateral investment treaties to provide legal protection for U.S. investors in developing countries; and

-- encouraging the World Bank in its lending and insurance programs, and the IMF in its macroeconomic and structural reform programs, to foster an environment favorable to foreign investment and to press for liberalization of foreign investment regimes.

The openness of U.S. foreign investment policy is dramatically evidenced by the recent flurry of significant Japanese acquisitions in my country: Sony's acquisitions of CBS Records and now Columbia Pictures totalling over $5 billion; Dai-Ichi Kangyo's $ 1 billion plus acquisition of a stake in one of our largest banks, Manufacturers Hanover Corp., and a controlling interest in one of its subsidiaries; Daiwa Bank's purchase of the U.S. banking business of the U.K.'s Lloyds Bank valued at $1.6 billion; and Nippon Mining's $1.1 billion dollar acquisition of Gould, Inc.

Here is the hard proof of U.S. policy that welcomes foreign investment. The Bush Administration will carefully nurture that open environment because we believe it is in our nation's economic interest to do so and because we know that money is a coward. Capital seeks a hospitable environment and flees from restrictive and uncertain investment regimes, as the massive capital flight from a number of third world countries has demonstrated.

However, reaffirming the U.S. commitment to an open foreign investment policy is only half the story. The other half of the story is that this policy is under intense attack in the United States. And I will offer my candid opinion that the prospects of successfully defending our open investment policy against damaging inroads are not certain.

For there are growing doubts about the wisdom of our traditional foreign investment policy held by responsible elements of the U.S. business and political communities. While the origins of these doubts and the economic and political forces that fuel them are complex, they are in significant measure driven by the changing role of the United States in the global economy and a perception, as well-known American companies are acquired by foreign interests, that we may be losing control of our economic independence.

These concerns are emerging in tangible and potentially threatening ways.

For example, there is support in Congress for legislation requiring foreign investors to register and provide detailed information about their proposed investments. Some Americans support the concept of strict reciprocity -- limiting foreign investors' access to the U.S. to reciprocal access for U.S. businesses abroad. And there are a number of legislative proposals to erect tax barriers to U.S. investment by foreign interests.

Those troubled about foreign investment in general seem most concerned with Japanese investment in particular. This stems in part from the rapid acceleration of Japanese investment in the United States (Japan's investment position doubled between 1986 and 1988), in part from the highly visible nature of Japanese investments in entertainment, banking, landmark real estate and consumer electronics, and in part from the belief that Japanese operations in the U.S. tend to import from home both goods and management. And, while at the end of 1988, Japan's U.S. investment position amounted to approximately $53 billion, considerably below the United Kingdom's $102 billion, and about the same as the Netherland's $49 billion, the large U.K. and Netherlands investments were accumulated over a long period of time.

But the most powerful source of political challenge to America's open foreign investment policy is the strong perception that Japan is closed or severely restricted to U.S. investors.

It is difficult for foreigners to invest in Japan. While the rate of foreign investment in Japan is increasing, it remains substantially below that of other advanced industrialized countries. For instance, in 1987, the ratio of foreign investment in Japan compared to Japanese investment abroad was 12 percent. In comparison, the ratio of inward to outward investment was 54 percent in the U.K. and 85 percent in the U.S. Similarly, in 1986, the share of domestic sales in Japan by foreign-owned firms was only two percent, compared to 10 percent in the U.S., 20 percent in Britain and 27 percent in France.

Let me elaborate on some of the perceptions of barriers to investment in Japan.

Like a number of industrialized countries, Japan restricts foreign investment in certain sensitive sectors. However, Japan also requires prior notification of any foreign

investment by requiring investors to inform the government 30 days prior to closing a transaction. Japanese officials have broad legal authority to review and block proposed investments that might threaten the "smooth" operation of the economy, disturb the public order, adversely affect Japanese competitors, or impair the safety of the general public.

Although Japanese officials have not abused or extensively employed this power, its presence gives the appearance that Japan does not welcome foreign investment and it provides a convenient argument for protectionists in the United States to press for similar authority to restrict foreign investment. Would it not be more consistent with Japan's outward looking economy if its foreign investment law were revised to bring it more in line with actual practice and narrow the authority to review or block foreign investment only as necessary to protect national security?

U.S. businesses also find that there are informal barriers to investment in Japan.

For example, the tightly interwoven system of corporate relationships in Japan deters foreign investment. These relationships, called keiretsu, involve both horizontal and vertical groupings, including ties between contractors and assemblers, and suppliers and distributors. The system effectively deters or blocks competition by newcomers, be they foreign or Japanese firms.

One manifestation of the keiretsu system, and one of the greatest obstacles to investing in Japan, is the scarcity of freely traded shares of Japanese firms: the practice of "cross-shareholding" by which Japanese companies hold non-controlling stock in each other not only cements the relationships among these companies, but makes outside investment or competitive penetration extremely difficult. Some estimate that nearly 70 percent of the outstanding shares of Japanese companies are held by networks of loyal cross shareholders.

The presence of these and other real or apparent barriers to foreign investment in Japan is a major factor in generating hostility by a growing number of Americans to our long-standing open investment policy.

It is precisely these sorts of informal barriers that we are focusing on in the new U.S.-Japan Structural Impediments Initiative -- or SII as we call it. Because of the importance that the U.S. Government attaches to this initiative, I would like to briefly review its status and goals.

The SII stemmed from our concern that changes in domestic demand patterns in both the United States and Japan, together with a significant exchange rate realignment, have failed to produce a commensurate adjustment in our payments imbalances.

At the same time, the net effect of product-by-product trade negotiations on U.S. or Japanese trade imbalances has not been -- and cannot be expected to be -- anything but modest compared with the potential impact of macroeconomic policies and structural reforms.

This led us to conclude that other factors, such as structural rigidities in both economies, were inhibiting the adjustment process.

The objective of the SII, then, is to identify -- and resolve -- deep-rooted structural problems in the Japanese and U.S. economies that cannot be addressed as effectively in the traditional mechanisms for handling trade and macroeconomic issues.

At the first round of SII talks held here in Tokyo in September, the U.S. and Japanese sides each outlined the structural problems they perceive in the other's economy, and began to explore methods to address these problems.

The U.S. points of interest fell under six broad categories, which include the keiretsu relationships that I've already described, as well as savings and investment patterns in Japan, land-use policies, the distribution system, pricing mechanisms, and exclusionary business practices.

In our presentation on savings and investment patterns, we stressed the need to adjust policies and practices that artificially suppress Japanese consumption and investment or promote excess saving in Japan, which leads to continuing large external surpluses and, among other economic burdens, penalizes the Japanese consumer. We highlighted the opportunity -- indeed the necessity -- over the medium term for a higher level and quality of public investment in social infrastructure, including roads, sewers, and parks.

Another U.S. concern is Japanese land use policy. Here we pointed out that inefficient policies and practices that are not neutral with respect to alternative uses of land and exacerbate the natural scarcity of land in Japan and contribute to higher costs for land, commercial facilities, housing, and public investment.

We are also concerned about the Japanese distribution system. There we find inefficiencies that create high costs and other obstacles that hinder foreign trade and investment in the Japanese market and raise prices for Japanese consumers.

As to pricing mechanisms, we observed that changes in the yen/dollar exchange rate have not been fully reflected in lower prices for U.S. products in the Japanese domestic market, nor in higher prices for Japanese exports, suggesting the existence of cross subsidy and structural rigidities in Japan.

Finally, we highlighted a number of exclusionary and competition-deterring business practices, such as bid-rigging and inadequate intellectual property protection, that exclude foreign firms from the Japanese domestic market.

We recognize that many of the issues we have raised are complex, deep-rooted, and may not be easy to resolve. We are also aware that the SII process is a two-way street and that the United States needs to consider structural problems that may exist in its own economy. At the September talks, we responded frankly to the Japanese concerns about our economy, including weaknesses in U.S. saving and investment patterns, short-term perspectives of corporate management and workforce training and education. Many of these issues are already the subject of intense public debate at home and are being addressed in concrete actions by the U.S. government. We hope that over the coming months, the Japanese Government will be equally open in responding to and acting upon the structural issues we have raised.

Let me stress the seriousness with which the U.S. Government views the SII process. The stakes in these talks are high; so too, are the expectations. President Bush himself has taken a strong personal interest in the progress of the talks. The Cabinet-level Economic Policy Council recently reviewed and endorsed the SII and expressed high expectations for the talks. Congress, too, is closely monitoring our progress; one senator has called the SII "the most important trade negotiation we have ever engaged in."

Our more traditional trade negotiations complement the SII. With SII, we are working to redress structural flaws that inhibit the growth of consumption, investment, and imports and impede balance-of-payments adjustment. Our trade negotiations are aimed at reducing border restrictions and other measures that discriminate against imports, and are pursued through multilateral negotiations in the GATT Uruguay

Round and bilateral consultations between our two governments. Both the SII and trade negotiations should contribute to a more open Japanese economy and to balance-of-payments adjustment.

It is critical that the U.S. and Japanese governments, as well as the corporate sectors in both countries, work quickly and cooperatively to reduce the structural rigidities we have identified in the SII.

Our goal is to reduce large and unsustainable payments imbalances while encouraging open markets and free trade. If we succeed, the real winners will be the companies and citizens of both countries, who are bearing the burden of today's economic imbalances and inefficiencies.

I cannot overemphasize the importance that the United States places on working with Japan to resolve the investment and other structural issues I have raised this afternoon. And I shall be blunt as to what I think the political consequences could be if we fail to make perceptible progress in addressing these matters. The consequences may be to ignite protectionism to a level it has not attained in the recent past and with such force as to overcome the certain resistance that the Bush Administration -- which is committed to free and fair trade and investment policies and practices -- will make against such protectionist efforts.

The benefits that a free foreign investment policy has conferred on the United States are substantial. But they are diffuse and difficult for the individual worker or company to feel compared to the direct impact of a plant closing or loss of market share caused by foreign competition. It is small comfort to the farmer whose fields have been flooded that the rainstorm was good for agriculture generally.

So I am concerned about the consequences of failing to make progress in resolving these issues.

I am concerned because recent polls in the U.S. show that 84 percent of those surveyed believed that foreign direct investment hurts the U.S. economy.

I am concerned because Boone Pickens, who is probably not the most revered figure on the American corporate scene, is becoming a folk hero since he began his investment activities in Japan.

And I am concerned when I hear, as I recently did at a conference of leading businessmen and entrepreneurs, a chorus of harsh anti-Japan comments based on their frustration with

the barriers they believe exist to doing business in this country.

Our success in avoiding dangerous protectionism in the United States will depend very much on Japan's willingness to confront the problem of impediments to foreign trade and investment. We simply cannot allow the opportunity presented by the SII to constructively address these issues to elude us.

But I am equally confident that, if the U.S. and Japan accept this challenge, our two countries will lay the groundwork for continued economic growth and cooperation.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

REMARKS BY
DEPUTY SECRETARY OF THE TREASURY JOHN E. ROBSON
FOREIGN CORRESPONDENTS CLUB
TOKYO, JAPAN
OCTOBER 12, 1989

ROOM 5310

IT IS A PRIVILEGE TO ADDRESS THIS DISTINGUISHED AUDIENCE OF JOURNALISTS. I HAVE GREATLY ENJOYED MY RETURN TRIP TO JAPAN -- A COUNTRY I HAVE VISITED OFTEN BEFORE AS A BUSINESSMAN. IN FACT, MY FIRST VISIT TO JAPAN WAS NEARLY 20 YEARS AGO AS A LAWYER WORKING ON SOME PROBLEMS FOR SONY CHAIRMAN, AKIO MORITA.

MY DISCUSSIONS WITH GOVERNMENT AND BUSINESS LEADERS DURING THIS VISIT HAVE CONFIRMED MY BELIEF THAT JAPAN AND THE UNITED STATES ARE ON THE RIGHT TRACK IN OUR RELATIONSHIP; ALTHOUGH WE HAVE OUR HEALTHY DIFFERENCES ON SOME ISSUES, WE REMAIN CLOSE ALLIES AND FRIENDS AND WE ARE COMMITTED TO WORKING TOGETHER TO ELIMINATE OUR DISAGREEMENTS.

SOME HAVE WORRIED THAT OUR BILATERAL RELATIONSHIP HAS EXPERIENCED INCREASING FRICTIONS IN RECENT YEARS. ON SOME ISSUES THAT IS UNDENIABLY THE CASE. CERTAINLY THE LARGE BILATERAL TRADE IMBALANCE HAS HEIGHTENED TENSIONS AND CREATED DOMESTIC POLITICAL DIFFICULTIES FOR EACH COUNTRY.

MUCH OF THE DEBATE BETWEEN OUR TWO COUNTRIES HAS CENTERED AROUND ISSUES OF COMPETITIVENESS.

THE WORD "COMPETITIVENESS" HAS BEEN OVERUSED AND SOMETIMES MISUSED IN THE PAST FEW YEARS. HOWEVER, SINCE THE NOTION OF COMPETITIVENESS HAS ASSUMED SUCH POLITICAL IMPORTANCE, IT MAY BE WORTH TRYING TO DEFINE THE TERM AND TO CONSIDER SOME OF THE IMPLICATIONS OF THE DEFINITION.

FOR A BUSINESS TO BE "COMPETITIVE", IT MUST HAVE THE COMPETENCE TO DESIGN, PRODUCE AND MARKET GOODS OR SERVICES THAT CONSUMERS WILL BUY AND IT MUST HAVE THE OPPORTUNITY TO REACH POTENTIAL CONSUMERS ON ESSENTIALLY EQUAL FOOTING WITH ITS COMPETITORS. TAKE EITHER ELEMENT AWAY -- COMPETENCE OR OPPORTUNITY IN THE MARKETPLACE -- AND YOU WILL FIND A COMPANY THAT IS NOT COMPETITIVE.

FOR A COUNTRY TO BE "COMPETITIVE", IT MUST HAVE THE POPULATION, INFRASTRUCTURE AND ECONOMIC ENVIRONMENT TO CREATE CONSISTENT, SOUND ECONOMIC GROWTH AND TO FOSTER THE CONTINUING BIRTH AND RENEWAL OF BUSINESSES THAT ARE COMPETITIVE.

MOST OF US WOULD NOT DISPUTE THE NOTION THAT BUSINESS COMPETITIVENESS REQUIRES COMPETENCE AND FAIR ACCESS TO THE MARKETPLACE. AND MOST OF US WOULD AGREE WITH THE BASIC ELEMENTS I'VE MENTIONED THAT MAKE A NATION COMPETITIVE.

BUT WE HAVE DISCOVERED THAT DETERMINING WHETHER THESE CONDITIONS OF COMPETITIVENESS EXIST IN A PARTICULAR NATION OR BUSINESS MAY DEPEND A GREAT DEAL ON THE EYE OF THE BEHOLDER.

AND WHAT THE UNITED STATES AND JAPAN MUST DO IF WE EXPECT TO RESOLVE THE VARIOUS TRADE AND ECONOMIC ISSUES THAT HAVE BEEN THE SOURCE OF FRICTION, IS TO COME TO AGREEMENT ON THE BASIC DEFINITION OF COMPETITIVENESS AND THEN TO SQUARELY AND HONESTLY IDENTIFY THE COMPETITIVENESS PROBLEMS OF EACH PARTY AND TAKE THE ACTIONS NECESSARY TO CORRECT THEM.

THIS KIND OF FRANK DISCUSSION ON ISSUES OF COMPETITIVENESS IS UNDERWAY RIGHT NOW AS THE GOVERNMENTS OF THE UNITED STATES AND JAPAN PROCEED WITH THE IMMENSELY IMPORTANT STRUCTURAL IMPEDIMENTS INITIATIVE -- OR SII.

SOMETIMES WE ARE GUILTY OF LOOKING TOO MUCH AT THE TENSIONS AND NOT ENOUGH AT THE COOPERATIVE EFFORTS WE HAVE UNDERWAY TO REDUCE THOSE TENSIONS. CERTAINLY SII IS ONE OF THE BEST EXAMPLES.

SII GREW OUT OF A MUTUAL FRUSTRATION WITH THE PACE OF ADJUSTMENT IN THE U.S.-JAPAN EXTERNAL IMBALANCES THAT WE HAVE BEEN ABLE TO ACHIEVE, DESPITE DETERMINED EFFORTS BOTH IN MACROECONOMIC POLICY COORDINATION AND THE ELIMINATION OF SPECIFIC TRADE BARRIERS. ALTHOUGH THE EXCHANGE RATE HAS REALIGNED CONSIDERABLY, AND MANY TRADE BARRIERS HAVE BEEN ELIMINATED, WE HAVE NOT EXPERIENCED THE ADJUSTMENT THAT WE HAVE EXPECTED.

AS A RESULT, THE TWO GOVERNMENTS HAVE AGREED TO EXPLORE AREAS THAT ARE SELDOM ADDRESSED WITHIN THE CHANNELS NORMALLY USED TO ADDRESS MACROECONOMIC FISCAL AND MONETARY POLICIES, AND TRADE POLICIES. THESE ISSUES COMPRISE WHAT WE HAVE CALLED "STRUCTURAL IMPEDIMENTS". THE FIRST ROUND OF SII TALKS WAS HELD JUST LAST MONTH HERE IN TOKYO.

FOR OUR PART, WE HAVE ASKED THE GOVERNMENT OF JAPAN TO TAKE STEPS TO RAISE THE LEVEL OF PUBLIC INVESTMENT IN THE NATION'S SOCIAL INFRASTRUCTURE, TO ENCOURAGE SUPPRESSED CONSUMER DEMAND, TO FURTHER OPEN THE JAPANESE DISTRIBUTION SYSTEM TO FOREIGN PRODUCTS AND SERVICES, TO REFORM LAND USE POLICIES, AND TO END CERTAIN EXCLUSIONARY BUSINESS PRACTICES.

We believe these are reasonable requests. If accomplished, these changes would introduce new efficiencies into the Japanese economy, permit Japan's citizens to more fully reap the benefits of the spectacular industrialization that has occurred here over the past four decades, and benefit the U.S. economy, as well as helping to reduce current account imbalances.

At the same time, the United States SII representatives indicated their willingness to take seriously Japan's concerns about structural impediments in America.

The principal criticism levied against the United States on the competitiveness front is that American corporate management is "short-sighted" -- that we simply engage in "moving money around", to quote my friend, Akio Morita. For example, Japanese government officials point to the high level of mergers and acquisitions in the United States as evidence of a short-term perspective raising doubts about America's ability to compete. Concern with short-term profits and high shareholders payouts have also come under criticism.

Another issue raised is that a low U.S. national savings rate and high domestic consumer demands have contributed substantially to the current trade deficit.

Questions have also been raised regarding the commitment by the U.S. Government and business to long-term research and development and workforce education and training.

We recognize that some basis exists for these perceptions on the part of Japanese officials, but there are also some misconceptions. And I would like to address these points -- not just as a U.S. Government official, but as a former businessman.

As the former Chief Executive Officer of a Fortune 500 multinational pharmaceutical company, I will admit that we kept an eye on what our current performance would produce for our stockholders. American stockholders represent investors from all income levels. These investors have made a hopefully informed judgment in deciding to invest their savings in the stock of a particular company. As a corporate officer, I always believed in the company's responsibility to respect that judgment when it came to the continuing bottom line.

I WILL ALSO CONCEDE THAT THE PRACTICE IN MY COUNTRY OF PRECISELY MEASURING THE PERFORMANCE OF PUBLIC CORPORATIONS EVERY THREE MONTHS CAN SOMETIMES BE A DISTRACTION FROM LONGER-TERM CONSIDERATIONS.

AND YET, A PHARMACEUTICAL COMPANY MUST RELY FOR SUCCESS ON GROUND-BREAKING RESEARCH, EDUCATED PREDICTIONS OF FUTURE MEDICAL DEVELOPMENTS, AND A CONTINUING STREAM OF NEW PRODUCTS. A FOCUS ON SHORT-TERM PROFITS ALONE WOULD BE FATAL. AND SO EVERY YEAR WE HEAVILY REINVESTED OUR PROFITS IN HIGH-RISK RESEARCH AND DEVELOPMENT, MEASURABLY HURTING OUR SHORT-TERM RESULTS.

MOREOVER, MY COMPANY CONTINUOUSLY MADE LARGE CAPITAL OUTLAYS TO MODERNIZE OUR MANUFACTURING FACILITIES AND TO ESTABLISH A PRESENCE IN PROMISING FOREIGN PHARMACEUTICAL MARKETS WHERE THE PAYOFF WAS BOTH UNCERTAIN AND REMOTE IN TIME. CONSIDERABLE INVESTMENT WAS MADE HERE IN JAPAN.

I RELATE THESE PERSONAL EXPERIENCES AS AN AMERICAN CORPORATE EXECUTIVE TO ILLUSTRATE THE POINT THAT MANY U.S. FIRMS DO FOCUS ON AND INVEST FOR THE LONG TERM. CERTAINLY THAT IS TRUE OF THE PHARMACEUTICAL INDUSTRY, ONE OF THE FEW THAT ENJOYS A TRADE SURPLUS WITH JAPAN. AND I AM AWARE OF MANY FIRMS IN OTHER INDUSTRIES THAT DO LIKEWISE.

MERGERS AND ACQUISITIONS SEEM TO BE ON THE FRONT PAGES OF AMERICAN NEWSPAPERS EVERYDAY. THEY INCLUDE A NUMBER OF SIGNIFICANT ACQUISITIONS BY JAPANESE FIRMS. LEVERAGED BUYOUTS HAVE BEEN PARTICULARLY SINGLED OUT AS AN EXAMPLE OF THE SHORT-TERM BIAS OF AMERICAN CORPORATE MANAGEMENT AND THE U.S. FINANCIAL COMMUNITY.

IT IS TRUE THAT THE 1980'S SAW AN EXPLOSIVE GROWTH IN THE NUMBER OF ACQUISITIONS AND LEVERAGED BUYOUTS. BUT MANY OF THESE TRANSACTIONS HAVE RESULTED IN A NEW CORPORATE STRATEGIC FOCUS BENEFICIAL TO COMPETITIVENESS. IN THE 1960'S AND 70'S, MANY CONGLOMERATES WERE FORMED THROUGH ACQUISITIONS OF UNRELATED BUSINESSES. THESE TRANSACTIONS MAY HAVE SOMEWHAT HAMPERED THE ABILITY OF THOSE FIRMS TO COMPETE BECAUSE MANAGEMENTS WERE REQUIRED TO OPERATE UNDER DIVERSE AND SOMETIMES CONFLICTING STRATEGIES.

TODAY, DIVESTITURES OF UNRELATED BUSINESSES AND LEVERAGED BUYOUTS ARE BREAKING UP MANY OF THESE CORPORATE HODGEPODGES. HOSTILE TAKEOVERS, WHICH COMMAND SO MANY HEADLINES, ACTUALLY COMPRISE ONLY ONE PERCENT OF THE MERGERS AND ACQUISITIONS IN AMERICA DURING 1988 AND LEVERAGED TRANSACTIONS COMPRISE ONLY A SMALL SEGMENT OF ALL MERGERS AND ACQUISITIONS.

DURING MY TENURE AS A CORPORATE EXECUTIVE WE DECIDED TO SELL THE COMPANY TO A LARGER FIRM. I DID NOT VIEW THAT DECISION AS A SHORT-TERM PROFIT-MAKER, BUT RATHER AS A WAY TO ENSURE THE JOBS OF THE COMPANY'S WORKERS AND THE COMPANY'S CONTINUED GROWTH. THE LARGER COMPANY WAS BETTER CAPABLE OF INFUSING NEW CAPITAL AND WEATHERING THE DRY YEARS BETWEEN RESEARCH AND DEVELOPMENT AND ACTUALLY BRINGING NEW PRODUCTS ON LINE. AND TODAY, THE COMPANY IS MORE COMPETITIVE.

INADEQUATE EDUCATION AND TRAINING OF U.S. WORKERS IS ANOTHER IMPEDIMENT IDENTIFIED BY THE JAPANESE SIDE IN THE SII PROCESS. WE FIRMLY AGREE THAT EDUCATION AND TRAINING OF A NATION'S WORKFORCE IS A VITAL COMPONENT OF COMPETITIVENESS. WE RECOGNIZE THAT THE U.S. ELEMENTARY AND SECONDARY EDUCATION AND WORKER TRAINING SYSTEMS COULD BE IMPROVED AND WE ARE DOING SOMETHING ABOUT IT.

PRESIDENT BUSH HAS ALREADY SENT TO CONGRESS THE EDUCATIONAL EXCELLENCE ACT OF 1989 TO IMPROVE ELEMENTARY AND SECONDARY EDUCATION. AND ONLY TWO WEEKS AGO HE CONVENED THE GOVERNORS OF THE NATION'S 50 STATES AT A SUMMIT CONFERENCE TO ESTABLISH A COMMITMENT TO QUALITY IN EDUCATION AND AN ACTION PLAN TO ESTABLISH DEMANDING STANDARDS OF PERFORMANCE AND TANGIBLE RESULTS BY EDUCATIONAL PROVIDERS.

U.S. BUSINESSES ARE ALSO INCREASING THEIR SPENDING FOR ON-THE-JOB TRAINING AND RETRAINING AND WORKING WITH THE PUBLIC EDUCATIONAL SECTOR TO DEVELOP COOPERATIVE PROGRAMS TO IMPROVE THE QUALITY OF EDUCATION FOR OUR FUTURE WORKFORCE.

AS THE FORMER DEAN OF A PROMINENT U.S. BUSINESS SCHOOL, I MIGHT ALSO MENTION THAT SIMILAR IMPROVEMENT EFFORTS ARE GOING ON IN GRADUATE BUSINESS EDUCATION, PARTICULARLY IN A HOST OF NEW PROGRAMS TO SENSITIZE OUR FUTURE BUSINESS LEADERS TO THE CHALLENGES AND OPPORTUNITIES OF OPERATING IN THE GLOBAL MARKETPLACE.

AT THE SAME TIME THAT THE GOVERNMENTS OF JAPAN AND THE UNITED STATES ARE ADDRESSING STRUCTURAL IMPEDIMENTS, THE BUSH ADMINISTRATION, LED BY SECRETARY OF THE TREASURY NICHOLAS BRADY, IS ALREADY IN THE PROCESS OF DEFINING THE AGENDA FOR REVITALIZATION OF OUR TRADITIONAL STRENGTHS.

THE STOCK OF CAPITAL IS ONE OF OUR COUNTRY'S GREATEST RESOURCES. IT IS NOT A NATURAL RESOURCE, BUT A PRODUCT OF MANY GENERATIONS OF HARDWORK AND SAVING FOR THE FUTURE. BUT IF THE PRICE A COMPANY HAS TO PAY FOR CAPITAL IS MATERIALLY HIGHER IN ONE COUNTRY THAN ANOTHER, IT IS DIFFICULT TO BE PRICE COMPETITIVE IN THE MARKETPLACE.

THE REAL AFTER-TAX COST OF CAPITAL IN THE UNITED STATES IS ESTIMATED TO BE TWICE THAT OF JAPAN'S. SUCH HIGH CAPITAL COSTS MEAN THAT A NEW FACTORY OR A RESEARCH AND DEVELOPMENT PROJECT UNDERTAKEN BY A U.S. COMPANY MUST BE TWICE AS PROFITABLE -- OR LOOKING AT IT IN ANOTHER WAY -- THE PROJECTS MUST PAY OFF IN HALF THE TIME.

A NUMBER OF ACTIONS CAN AND ARE BEING TAKEN TO NARROW THE GAP IN THE COST OF CAPITAL.

THE FIRST STEP TO BRING DOWN THE COST OF CAPITAL IS TO REDUCE THE FEDERAL BUDGET DEFICIT. THE BUSH ADMINISTRATION IS COMMITTED TO REDUCING THE DEFICIT BY MEETING THE TARGETS ESTABLISHED BY THE GRAMM-RUDMAN-HOLLINGS DEFICIT REDUCTION LEGISLATION. AND WE ARE MAKING PROGRESS. SINCE FISCAL YEAR 1983 THE DEFICIT HAS BEEN SUBSTANTIALLY REDUCED IN SIZE AND AS PERCENT OF GNP FROM 6.3 TO 2.9 PERCENT. AS WE MEET THE GRAMM-RUDMAN-HOLLINGS TARGETS FOR FISCAL 1990 AND 1991, THE DEFICIT WILL FALL TO 1.1 PERCENT OF GNP.

A SECOND STEP IN LOWERING CAPITAL COSTS IS TO INCREASE THE RATE OF PERSONAL SAVINGS IN THE UNITED STATES. A LARGER SUPPLY OF DOMESTIC SAVINGS WOULD PROVIDE BUSINESSES WITH INVESTMENT FUNDS AT LOWER INTEREST RATES. LED BY THE TREASURY DEPARTMENT, THE BUSH ADMINISTRATION IS ACTIVELY EXAMING WAYS TO IMPROVE OUR SAVINGS RATE. I EXPECT SOME CONCRETE PROPOSALS TO RESULT FROM THIS EXAMINATION.

CAPITAL FORMATION CAN ALSO BE STIMULATED BY LOWERING THE CAPITAL GAINS TAX. A DIFFERENTIAL IN THE TAX OF LONG-TERM CAPITAL GAINS IS FOUND IN MOST OF OUR PRINCIPAL INDUSTRIAL COMPETITORS AND A LOWER TAX RATE FOR CAPITAL GAINS WILL PROMOTE LONG TERM INVESTMENT AND ENTREPRENEURSHIP.

As I'm speaking to you today, the Bush Administration is working to pass proposals in Congress to reduce the capital gains tax.

A further step to lower U.S. capital costs would be to eliminate the double tax on corporate earnings distributed to stockholders -- one tax paid by the corporation on its profits and a second by the stockholder when he receives dividends. So the corporation must earn more to provide investors with the same return that would result if profits were taxed only once. The cost of this double tax is reflected in both the stock price and the market price of the products and services of U.S. corporations. We are currently looking at ways to accomplish relief of double taxation consistent with our deficit reduction efforts.

I believe I have been candid in recognizing that, while there are a number of misconceptions, some of the U.S. structural impediments observed by the Japanese Government in the SII talks do exist. But I hope I have made equally clear that we are taking concrete actions to address these concerns.

SII is a two-way street. As the talks continue, we intend to maintain a constructive attitude toward issues the Japanese Government may raise. We would likewise expect the Japanese side to reflect thoughtfully and respond positively to the structural impediments perceived by the U.S. negotiators.

Our objective is to make significant progress in the SII discussions before next spring. We believe it will be important to see specific commitments and actions from Japan. And we believe that the risks in failing to make significant progress may be considerable. I am certain that the framework of the SII talks is one of the most constructive, durable, and effective ways to lower the recent frictions and to benefit the economies and people of both nations.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

OCT 16

FOR IMMEDIATE RELEASE
October 11, 1989

Contact: Cheryl Crispen
566-5252

CAROL BOYD HALLETT
Selected for Commissioner of Customs

Secretary Nicholas F. Brady, today announced his selection of Carol Boyd Hallett for the position of Commissioner of Customs.

Mrs. Hallett is currently a consultant with the Carmen Group. In 1986, she was appointed by President Reagan and confirmed by the United States Senate as the sixth Ambassador to the Commonwealth of The Bahamas. She held this position through May 1989.

From 1983-1986, Mrs. Hallett was the Western Regional Director, National Vice Chairman and National Field Director for Citizens for America. She served as an Assistant to the Secretary of Interior and was Director of the Western Regional Office responsible for the 17 western states from 1984-1985. In 1983 she was Director of Parks and Recreation for the State of California.

Mrs. Hallett served in the California State legislature as Assemblywoman from the 29th District from 1976-1982. She was elected Republican Leader of the State Assembly from 1979-1982.

A native Californian, Mrs. Hallett and her husband, Jim currently reside in Virginia. In her private life, she is a pilot with over 5,000 hours of pilot in command time; plays classical piano; and enjoys dry fly fishing.

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NB-505

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR IMMEDIATE RELEASE
October 11, 1989

CHARLES B. RESPASS

Charles B. Respass was born on November 9, 1938, in Newport News, Virginia. In 1955, he enlisted in the United States Naval Reserves for two years and then joined the United States Air Force, serving four years. After his military service, he attended the Community College of Delaware County, Media, Pennsylvania.

Mr. Respass has over 28 years experience in the field of Building Construction, Facilities Management and Administration. Mr. Respass performed as the Acting Deputy Assistant Secretary for Administration from May 18, 1988, until he was appointed to the position as the Deputy Assistant Secretary for Administration on March 29, 1989.

In 1985, Mr. Respass accepted a position at the Department of the Treasury, as the Director of Facilities Management. From 1971 to 1985, he served in various Administrative and Management positions at the General Services Administration, with the last position held for six years as the Buildings Manager of the White House Field Office. Prior to Federal Government service, Mr. Respass served at the Newport News Shipbuilding and Drydock Company from 1961 to 1968, completing his tenure as an Electrical Supervisor on Nuclear Submarines. He also held positions with Rogers Inc., and Impac Inc., mechanical construction contractors, as a planner and estimator.

In 1985, Mr. Respass received the Office of Administration's Distinguished Service Award, the highest award presented by the Executive Office of the President. In 1987, he also received the General Services Administration's Excellence in Administration Award and the Presidential Design Federal Achievement Award. Mr. Respass has been married for 28 years and resides with his wife in Woodbridge, Virginia.

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NB-506

PRESS RELEASE

OVERSIGHT BOARD

RESOLUTION FUNDING CORPORATION

FOR IMMEDIATE RELEASE
October 12, 1989

CONTACT: Art Siddon
387-7667

The Resolution Funding Corporation (REFCORP) announces that it will auction securities on Wednesday, October 25, 1989, for settlement Monday, October 30, 1989. The amounts and maturity of the first auction will be announced on Wednesday, October 18, 1989, and when-issued trading can begin at that time. Details of the securities are available in the attached summary.

SUMMARY OF
RESOLUTION FUNDING CORPORATION BONDS

The following summary is qualified in its entirety by detailed information appearing in the offering circular.

Obligor

The Resolution Funding Corporation (Refcorp), established under the authority of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 is the obligor. The sole purpose of Refcorp is to provide financing for the Resolution Trust Corporation (RTC). Net proceeds will be provided to RTC to fund thrift case resolutions; RTC is not responsible for payment of principal or interest on Refcorp bonds.

Issue

Refcorp may offer interest-bearing obligations from time to time in an aggregate amount not to exceed $30 billion. The obligations (the "Bonds") will be offered under terms, including series, amount and maturity, described in a supplement to the offering circular to be released at the time of each offering.

Sale Procedures

The Bonds will be sold from time to time in competitive auctions in which bids are to be submitted on a yield basis. When-issued trading can begin as soon as each offering of Bonds is announced.

General

The Bonds are not obligations of, or guaranteed as to principal by, the Home Loan Bank System, the Federal Home Loan Banks, the Resolution Trust Corporation or the United States of America.

Principal Payment

Prior to issuance of Refcorp obligations, Refcorp will purchase zero-coupon Treasury securities directly from the Treasury. The principal amount at the maturity of the zero-coupon Treasury securities will equal the principal amount of Refcorp obligations. The zero-coupon securities will be held in a segregated account at the Federal Reserve Bank of New York. The proceeds of the zero-coupon Treasury securities shall be used to pay the principal on Refcorp obligations.

Unless otherwise specified in a supplement to the offering circular relating to a particular series of Bonds, the Bonds will not be subject to redemption prior to maturity.

Interest Payment

Unless otherwise specified in a supplement to the offering circular, interest on the Bonds shall be payable semiannually, on January 15 and July 15 for Bonds with maturity dates on January 15 or July 15, or April 15 and October 15 for Bonds with maturity dates on April 15 or October 15, through the date the principal becomes payable.

The Secretary of the Treasury will pay all interest to the extent not paid by other sources. The other sources are payments by the Federal Home Loan Banks and various proceeds available from thrift resolutions.

Treasury has received appropriations for the amounts to be paid by the Treasury for fiscal year 1989 and each fiscal year thereafter. The Treasury payments are not subject to sequestration.

Currency of Payment

Principal and interest are payable in U.S. dollars.

Form of Bonds

The Bonds will be issued and maintained and may be transferred only on the book-entry system maintained by the Federal Reserve Banks.

Denomination of Bonds

The Bonds will be issued in minimum denominations of $1,000 and multiples of $1,000 thereafter.

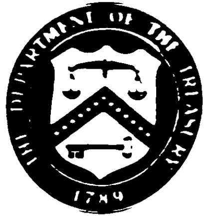
Strippable and Reconstitutable

The Bonds may be stripped into their separate interest and principal components in book-entry form and may be reconstituted into whole Bonds.

U.S. Taxation

The Bonds are subject to federal taxation in the United States, including income taxes. They are exempt as to principal and interest from State and local taxation (except surtaxes and estate, inheritance and gift taxes).

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

5310

FOR RELEASE AT 12:00 NOON
October 13, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $9,750 million of 364-day Treasury bills to be dated October 26, 1989, and to mature October 25, 1990 (CUSIP No. 912794 UR 3). This issue will provide about $175 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $9,575 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Thursday, October 19, 1989.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing October 26, 1989. In addition to the maturing 52-week bills, there are $14,060 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks currently hold $3,319 million as agents for foreign and international monetary authorities, and $5,303 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rate of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $553 million of the original 52-week issue. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-3.

NB-507

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

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DEPARTMENT OF THE TREASURY

FOR IMMEDIATE RELEASE October 13, 1989

STATEMENT BY
SECRETARY OF THE TREASURY
NICHOLAS F. BRADY

Today's decline of 190 points on the Dow Jones Industrial Average should be viewed in the context of a 591-point rise since January 1, 1989. It's important to recognize that today's stock market decline doesn't signal any fundamental change in the condition of the economy. The economy remains well balanced and the outlook is for continued moderate growth.

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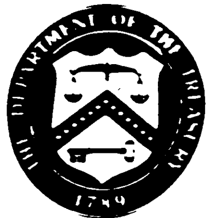
NB-508

TREASURY NEWS



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CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
October 16, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,600 million of 13-week bills and for $7,623 million of 26-week bills, both to be issued on October 19, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing January 18, 1990			26-week bills maturing April 19, 1990		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	7.28% a/	7.52%	98.160	7.42% b/	7.82%	96.249
High	7.40%	7.65%	98.129	7.43%	7.83%	96.244
Average	7.37%	7.61%	98.137	7.42%	7.82%	96.249

a/ Excepting 1 tender of $4,120,000.
b/ Excepting 1 tender of $900,000.
Tenders at the high discount rate for the 13-week bills were allotted 25%.
Tenders at the high discount rate for the 26-week bills were allotted 89%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 34,430	$ 34,430	$ 29,745	$ 29,745
New York	19,771,140	6,146,390	20,572,405	6,773,155
Philadelphia	18,250	18,250	20,205	20,095
Cleveland	32,650	32,650	21,530	21,530
Richmond	38,055	38,055	33,900	33,900
Atlanta	28,685	28,675	25,720	25,720
Chicago	1,346,515	71,515	1,129,370	57,170
St. Louis	19,585	19,585	18,205	18,205
Minneapolis	16,020	16,020	4,925	4,925
Kansas City	42,930	42,930	33,250	33,250
Dallas	18,295	18,295	11,600	11,600
San Francisco	1,066,150	701,650	1,053,115	45,115
Treasury	431,700	431,700	548,845	548,845
TOTALS	$22,864,405	$7,600,145	$23,502,815	$7,623,255
Type				
Competitive	$19,746,045	$4,681,785	$20,291,770	$4,612,210
Noncompetitive	1,107,760	1,107,760	1,006,645	1,006,645
Subtotal, Public	$20,853,805	$5,789,545	$21,298,415	$5,618,855
Federal Reserve	1,783,400	1,583,400	1,600,000	1,400,000
Foreign Official Institutions	227,200	227,200	604,400	604,400
TOTALS	$22,864,405	$7,600,145	$23,502,815	$7,623,255

1/ Equivalent coupon-issue yield.

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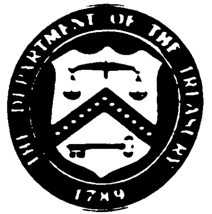
TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 11:00 a.m.
October 17, 1989

STATEMENT OF
KENNETH W. GIDEON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present to you the Treasury Department's views regarding the provisions of the Administration's enterprise zone proposal, as well as the provisions of H.R. 6 (the "Enterprise Zone Improvements Act of 1989"). The President already indicated in his July 25th letter to you, Mr. Chairman, that the establishment of tax-based incentives for economically distressed urban and rural areas is a high priority of this Administration.

The objective of Federal enterprise zone tax legislation is to encourage private investment and job creation within designated areas otherwise unable to participate fully in our Nation's prosperity and growth. The Administration believes that the economic problems faced by these urban and rural areas require specifically targeted tax incentives.

THE ADMINISTRATION PROPOSAL

The Administration believes that the proposal we are presenting today focuses upon those benefits likely to

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effectively stimulate economic activity within Federally designated zones, while establishing appropriate safeguards to preclude the availability of benefits to taxpayers adding little or no value within zones.

Under the Administration's proposal, up to fifty zones may be designated between 1990 and 1993 by the Secretary of Housing and Urban Development as eligible for targeted Federal tax incentives during a term of up to 24 years. Specifically, the proposal authorizes up to 15 zones in 1990, 15 zones in 1991, 15 zones in 1992, and 5 zones in 1993. Areas would be eligible for designation based upon their relative degree of poverty and population size. State and local governments would have to compete for designation through their own commitment of support in the form of tax relief, improved services, deregulation, etc. This competitive selection process will encourage a range of State and local incentive programs complementing the Federal initiative.

Immediately upon a zone's designation, two Federal tax incentives would be available to encourage zone capital formation, and one Federal tax incentive would be aimed at stimulating zone employment.

The focus of the capital formation incentives is upon offering investors in enterprise zone businesses lower effective Federal tax rates with respect to their income from zone investment. Under the first incentive, taxes would be eliminated for long-term capital gains arising with respect to tangible property used in enterprise zone businesses and located within enterprise zones for at least two years. In order to constitute an "enterprise zone business," more than 80 percent of gross income must be attributable to active zone business sources, substantially all assets and employees must be located within zones, and the business may not be controlled by non-zone businesses. These restrictions are designed to focus the incentive upon the assets of independent activities actually conducted within zones and likely to create significant zone value and employment opportunities. Gains qualifying for elimination must accrue while the assets are used in the enterprise zone business and during the period of a zone's designation.

Under the second capital formation incentive, individuals would be permitted to fully deduct in the first year their contributions to the capital of Subchapter C corporations engaged solely in the conduct of enterprise zone businesses. Recipient corporations must have less than $5 million of total assets, and

must use the contributions to acquire tangible assets to be located within the zone for use in enterprise zone businesses. Expensing is restricted to up to $50,000 annually per investor with a $250,000 lifetime limit per investor, and is not permitted for purposes of taxpayer computations of the alternative minimum tax. These restrictions are designed to limit the potential for tax shelters and target the relief to the small entrepreneurial businesses which the Administration believes are most likely to stimulate the economic rejuvenation of zones. Nevertheless, the profile of a qualifying corporation conforms to the needs of most small businesses likely to engage in zone business activities, and associates tax benefits with tangible assets located in zones and used in "enterprise zone businesses."

The focus of the employment incentive is upon reducing employee costs associated with zone employment. A 5 percent refundable tax credit for the first $10,500 of wages (that is, up to $525 per worker), would be provided to qualified enterprise zone employees for wages earned in an enterprise zone business. To qualify for the credit, substantially all the zone services of the "enterprise zone employee" must be performed in the zone for a non-governmental "enterprise zone business." The Administration believes that the credit will provide an additional incentive to work in private businesses within Federal enterprise zones. The credit phases out for each employee between $20,000 and $25,000 of total wages, and must be reduced by the employee's alternative minimum tax (if any) for such year.

To protect against unintended enrichment, the Administration proposal authorizes Treasury regulations to coordinate Internal Revenue Code provisions that otherwise might result in more than a 100% Federal subsidy to enterprise zone activities. For example, taking into account the proposals in H.R. 3299 to modify and extend the low-income housing credit beyond 1989, it is possible that certain low-income residential rental projects located within zones would qualify for as much a 91% credit with respect to eligible costs. Because of HUD or FmHA rental subsidies, cost recovery deductions, and other tax benefits also associated with such an investment, it may be necessary to reduce or eliminate the special enterprise zone tax benefits in order to prevent a combined Federal subsidy of more than 100% for the activity.

The Administration believes that the foregoing incentives are essential to the economic revitalization of Federal enterprise zones. Economic problems faced by these areas require specifically targeted tax incentives because activity within the designated areas cannot otherwise be adequately stimulated by

such generally available tax incentives as tax-exempt qualified mortgage bonds for single-family housing development in distressed areas, tax-exempt private activity and exempt facility bonds for certain business ventures and low-income residential rental projects, targeted jobs tax credits for employment of disadvantaged persons, tax credits for acquisition or production of housing for low-income persons, and tax credits for rehabilitation of historic and non-residential older buildings.

The likely proximity of designated Federal enterprise zones to more established business areas (particularly in the case of urban zones) does raise the possibility for taxpayers to geographically rearrange economic activities in order to claim tax benefits while adding little or no value within the zones. Because of the difficulties targeting incentives to taxpayers potentially adding significant value, and the budgetary concerns presented by Gramm-Rudman limitations, the Administration believes that the incentives must be carefully circumscribed and limited at this time to incentives essential to effectively stimulate economic activity within Federal enterprise zones.

The Treasury Department estimates that the Administration's Federal enterprise zone tax proposal will reduce Federal revenues by approximately $50 million in 1990, $160 million in 1991, $310 million in 1992, and $520 million in 1993. These figures are consistent with the President's budget commitment and are summarized in more detail in the attached chart.

H.R. 6 ("THE ENTERPRISE ZONE IMPROVEMENTS ACT OF 1989")

Congressman Rangel and others are to be commended for recognizing the plight of economically distressed areas and introducing bills such as H.R. 6. In contrast to the Administration's proposal, H.R. 6 would designate zones in accordance with the Housing and Community Development Act of 1987 and would offer these designated areas the following array of tax incentives:

(i) an employer credit in an amount equal to 10 percent of the qualified increase in zone wages over the predesignation zone payroll, but not to exceed 2.5 times the FUTA wage base for each zone employee (currently a product equal to $17,500);

(ii) an employer credit in an amount equal to 50 percent of wages paid to certified economically disadvantaged zone employees during the first three years of employment, phasing down to 10 percent during the 7th through 20th

year of employment and zero thereafter;

(iii) a credit for non-government zone employees in an amount equal to 5 percent of wages qualified received, but not to exceed 1.5 times the FUTA wage base (currently a product equal to $10,500);

(iv) an investment tax credit (with full basis reduction) in an amount equal to 10 percent of qualifying acquisition, construction, reconstruction and rehabilitation costs with respect to real property located in enterprise zones;

(v) deferred recognition of any capital gain from the sale of property where the sale proceeds are "rolled over" into enterprise zone property or an interest in an enterprise zone business;

(vi) a deduction of up to $100,000 annually for the purchase of newly issued stock from an qualified, active enterprise zone Subchapter C corporation having net worth under $2 million;

(vii) the general limitation upon accelerated cost recovery deductions with respect to tax-exempt financed property is inapplicable to certain zone property, and the December 31, 1989 sunset date for "small issue" industrial development bonds would be revoke where proceeds are used to finance zone facilities;

(viii) any loss on worthless securities of an enterprise zone business is treated as ordinary rather than capital;

(ix) the research credit is increased from 20% to 37.5% for research conducted in zones; and

(x) preferential treatment of zone applications to be foreign-trade zones.

While H.R. 6 would designate zones based upon relative rankings of distress criteria, the Administration's proposal would take rankings of distress criteria into account but would also give preference to areas offering the strongest and highest quality of State and local incentives. The Administration believes that the commitment of State and local governments to distressed areas is important to the success of the Federal enterprise zone program, and that recognition and special attention to the State and local anti-poverty strategy will

encourage the necessary State and local support. Accordingly, designations may be targeted to those areas most likely to succeed with a Federal enterprise zone program.

The incentives under H.R. 6 are more far-reaching than those of the Administration's proposal. However, the Treasury Department estimates that, assuming 50 zones are phased-in as described under the Administration's proposal, H.R. 6 would reduce Federal revenues during fiscal years 1990 through 1993 by more than 3.5 times the revenue loss associated with the incentives under the Administration's proposal. Gramm-Rudman constraints require careful weighing of competing needs in light of the current budget deficit, and only the most essential aspects of a Federal enterprise zone tax incentive program can be enacted at the present time. The Administration believes its proposal is consistent with the objectives of H.R. 6, utilizes the most effective of the incentives common to both proposals, and clearly would be more affordable.

With regard to capital formation incentives, the Administration's proposal agrees with H.R. 6 to the extent that capital gains and newly issued zone corporate stock should be the focus of tax incentives. While the balance of the H.R. 6 capital formation incentives might stimulate economic activity, the Administration believes that its targeted capital incentives are more efficient than those in H.R. 6, will not encourage non-economic activity, and are substantially more affordable than the additional H.R. 6 proposals.

The Administration's capital gain incentive is an exclusion of capital gains arising within zones rather than the tax-free "roll over" under H.R. 6 of non-zone capital gains into zones. The Administration believes that its exclusion targeted to zone gains will be a more powerful inducement for productive zone activity than the H.R. 6 deferral which would attract new zone capital but disregard the productivity of zone investments. The Administration proposal ensures that value is added within zones by limiting the exclusion to gain arising with respect to tangible zone property used for at least two years in zone businesses. The Administration believes that this restriction will avoid the difficulties associated with providing incentives for intangible assets, which assets only increase the cost of the incentive without creating enduring value.

The Administration's proposal for expensing of newly issued stock of small zone Subchapter C corporations is very similar to the comparable provision in H.R. 6. Expensing of stock upon acquisition is economically equivalent to excluding the future

earnings of that stock from taxation, and the Administration believes that its proposal offers investors an incentive equivalent to capital gain exclusion while allowing taxpayers to chose the incentive best suited to their own needs. Unlike H.R. 6, however, the Administration's proposal eliminates the possibility that investors would have a negative effective tax rate on income from zone investments by treating all gain (if any) from expensed stock as ordinary income rather than capital gain. Under H.R. 6, gain would be treated as ordinary only to the extent of the previously expensed amount. The potential budget impact of the Administration's proposal is limited by restricting expensing to individual investors, and the limitations imposed are $50,000 annually (rather than $100,000 under H.R. 6) and $250,000 lifetime (rather than no such limitation under H.R. 6). To ensure that value is added within zones, the Administration proposal requires the issuer to purchase tangible zone assets within 12 months of the purchase, and no issuer may issue more than $5 million of expensed stock.

With regard to employment incentives, the Administration has omitted employer credits in favor of an employee credit similar to that suggested in H.R. 6. Unlike H.R. 6, the Administration's credit would be refundable in order to ensure that employees benefit regardless of tax liability, and the credit would phase out where wages exceed $20,000. In addition, H.R. 6 would allow the credit with respect to any wages attributable to services performed for a zone employer, but the Administration's proposal requires that substantially all of the employee's creditable services be directly related to the conduct of enterprise zone businesses and performed within a zone.

SUMMARY

The Administration strongly supports enactment of Federal enterprise zone tax legislation. Due to concerns associated with the Federal budget deficit, as well as potential abuse of the geographically targeted benefits, the appropriate incentives must be carefully structured to achieve economic recovery for Federal enterprise zones within affordable budget parameters. The Administration believes that its proposal strikes an appropriate balance between effectiveness and cost and should be enacted.

Mr. Chairman, that concludes my formal statement. I am happy to answer any questions that you or the Members of the Committee may wish to ask.

REVENUE EFFECT OF PRESIDENT'S
ENTERPRISE ZONE PROPOSAL
50 ZONES 1/

	Fiscal Year					
	1990	1991	1992	1993	1994	1990 - 94
	($'s in millions)					
Wage Credit for EZ Employees 2/	-20	-60	-100	-120	-130	-430
EZ Corporate Stock Expensing 3/	-30	-100	-200	-270	-310	-910
Capital Gains Elimination on Certain EZ Assets 4/	0	0	-10	-130	-310	-450
Total Enterprise Zone Proposal	-50	-160	-310	-520	-750	-1790

Department of the Treasury
Office of Tax Analysis

1/ 50 zones phased-in: 15 in 1990, 15 in 1991, 15 in 1992 and 5 in 1993.

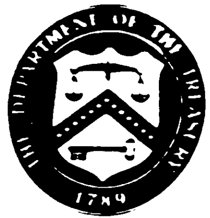
2/ Refundable wage credit for zone employees equal to 5% of FUTA wages up to 1.5 times the FUTA cap ($10,500).

3/ Proposal would permit expensing of investment in newly issued corporate stock of EZ subchapter C corporations.
Expensing limited to $50,000 per year with a lifetime cap of $250,000 per individual.
Limited to investments in corporations with total assets of $5 million or less and limited to corporate stock representing increases in tangible assets of the corporation held in the zone.
Limited to investments by individuals.
Gain on expensed stock will be subject to ordinary tax irrespective of other tax law provisions.

4/ Exemption from tax on gain accrued during zone designation on enterprise zone tangible business assets.
Assets in the zone prior to the date of zone designation must be appraised as of such date to receive tax benefits, although tax is deferred until realization. Only gain accruing after the date of designation qualifies for tax exemption.
Asset must relate to an enterprise zone business which has operated in the zone for at least two years prior to gain realization.
Estimate assumes no capital gains tax rate reduction in effect.

NOTE: Estimates assume 50 zones phased-in in accordance with the pattern described in 1/ above. Estimates also assume the characteristics of zones will be consistent with the distress requirements contained in Title VII of the Housing and Community Development Act of 1987. Any deviation from these assumptions may materially impact the revenue estimates.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.

October 17, 1989

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $15,600 million, to be issued October 26, 1989. This offering will provide about $1,550 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $14,060 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, October 23, 1989. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,800 million, representing an additional amount of bills dated July 27, 1989, and to mature January 25, 1990 (CUSIP No. 912794 TN 4), currently outstanding in the amount of $6,631 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,800 million, to be dated October 26, 1989, and to mature April 26, 1990 (CUSIP No. 912794 UB 8).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing October 26, 1989. In addition to the maturing 13-week and 26-week bills, there are $9,575 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $2,751 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $3,304 million as agents for foreign and international monetary authorities, and $5,298 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

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Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

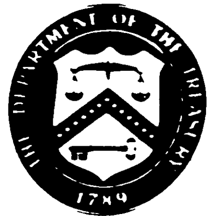
Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

8/89

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at: 10:00 a.m.
October 19, 1989

STATEMENT OF
KENNETH W. GIDEON
ASSISTANT SECRETARY FOR TAX POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON HOUSE WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the Treasury Department's Final Report to the Congress on Life Insurance Company Taxation (the "final report"). The final report responds to the congressional directive to the Treasury Department, contained in the Deficit Reduction Act of 1984, to conduct a study of the tax treatment of life insurance companies and their products.

At the outset, I should note that we have no illusions that our work product will resolve the seemingly endless battle between the stock and mutual segments of the life insurance industry. We have, however, attempted to approach the problem with a view toward fashioning a system which addresses both appropriate taxation of life insurance companies when compared with other financial intermediaries -- and elimination of the advantage mutual companies enjoy over stock companies because policyholder dividends are received virtually tax free while stockholder dividends are taxable at the shareholder level.

The final report principally addresses section 809, a provision that imputes equity income to mutual life insurance companies. In addition, we believe that consideration of the appropriateness of section 809 offers an opportunity to improve the taxation of income flowing through life insurance companies.

NB-512

Section 809 was intended to equalize the tax treatment of mutual (policyholder-owned) and stock (shareholder-owned) life insurance companies and generally to ensure that mutual companies are taxed on a base that is neither greater nor less than their economic income. As a result of serious practical and conceptual shortcomings, however, section 809 has not succeeded in equalizing the tax treatment of mutual and stock companies.

In our opinion, current law generally does not tax the equity income of participating policyholders at the individual level although it taxes the equity income of stock company shareholders twice. A participating policy is one through which the policyholder purchases an equity-like interest in the insurance company -- along with some amount of term insurance and a savings certificate. Both stock and mutual companies now issue participating policies. While there are legal distinctions between the participation rights of such policyholders under participating policies issued by mutual and stock companies, we believe that these products are essentially equivalent economically and that they should be analyzed similarly for purposes of Federal income taxation. Participating policies issued by both types of companies provide, as one component of the participating dividend (or other return), an equity return for participation in the enterprise risks. Indeed, given the heavy reliance of stocks as well as mutuals on retained earnings as a primary source of equity, the distinctions between stocks and mutuals from this standpoint have been growing less distinct over time.

Moreover, current law allows a significant portion of investment income flowing through life insurance companies to escape both corporate and individual Federal income tax, which is inconsistent with the tax treatment of such income flowing through other financial institutions.

We believe that a shareholder dividends-paid credit and an investment earnings tax on all life insurance companies, in combination with repeal of section 809, would represent a significant improvement in the taxation of income flowing through life insurance companies. The tax rules governing mutual and stock companies would be the same, and equity income of shareholders and participating policyholders would be taxed only once.

We recognize, however, the complexity of the issues addressed in our final report. In view of that complexity, our final report presents for congressional consideration additional options for improving life insurance company taxation. The Treasury Department is prepared to work with Congress in addressing the issues outlined above and in our final report, as well as our common concern that any changes made to current law not result in a loss of revenue.

My testimony today will be divided into four parts. First, I will briefly describe the current provisions taxing life insurance companies that relate to the differential taxation of the participating policies of stock and mutual life insurance

companies, and the basic policies on which they are based. Second, I will discuss the findings of the final report on the amount of taxes paid by life insurance companies for 1984 through 1986 and the relative tax burdens of the mutual and stock segments of the life insurance industry. Third, I will present our analysis of the differential taxation of stock and mutual life insurance companies and their policyholders and shareholders. Finally, I will outline our recommendation and additional options for improving life insurance company taxation.

I. CURRENT LAW TREATMENT OF PARTICIPATING POLICIES

The rules for taxing life insurance companies were substantially revised in 1984 in response to concerns that the "three-phase" system enacted in the Life Insurance Company Tax Act of 1959 (the "1959 Act") was unduly complex and did not result in an appropriate measure of life insurance company income in an environment of high interest rates and new insurance products. Under the Deficit Reduction Act of 1984 (the "1984 Act"), life insurance companies are taxed on a single income tax base corresponding generally to the tax base applicable to other corporations. Many of the special deductions and accounting rules that had applied under the 1959 Act were repealed. Even with these changes, however, the tax base of life insurance companies differs from that of other corporations in certain significant respects. Among these is the imputation of equity income to mutual life insurance companies under section 809.

Under section 809 of the Code, an amount of income, called the "differential earnings amount," generally is added to a mutual company's taxable income. The differential earnings amount is equal to the product of the mutual company's average equity base and the "differential earnings rate." The differential earnings rate, in turn, is equal to the excess of the "imputed earnings rate" (90.55 percent of a three-year average of the earnings rates of the 50 largest stock life insurance company groups) over the average earnings rate of all mutual life insurance companies for the second calendar year preceding the taxable year. The differential earnings amount for a taxable year is "recomputed" in the subsequent taxable year. The recomputed amount reflects the average mutual earnings rate for the calendar year in which the taxable year begins (rather than the second preceding calendar year). The difference between the differential earnings amount and the recomputed differential earnings amount (the so-called "true-up") is included in (or deducted from) income in the subsequent year.

Section 809 was enacted primarily to assure that mutual companies are taxed on a base that is neither greater nor less than their economic income. Congress believed that a portion of the policyholder dividends paid by mutual companies is a distribution of corporate earnings to the policyholders as owners. Because stock life insurance companies cannot deduct amounts paid to their

shareholders as dividends, Congress thought it appropriate to impute equity income to mutual companies. The imputation of equity income was described as a limitation on policyholder dividend deductions, but in fact it is an income imputation. If the imputed income exceeds current policyholder dividends, the current reserve deduction is reduced by the excess.

To determine the additional amount of mutual company equity income, an imputation mechanism was chosen because there was no means available to segregate and measure directly the ownership return of "participating" policies. Congress believed that profit-oriented enterprises generally distribute earnings to their owners in amounts that are proportional to the owners' equity in the business and, thus, determined that the equity earnings can be measured as a percentage of mutual company equity. Congress also believed that mutual and stock companies in the same industry will earn comparable rates of return on equity over a period of several years. It observed, however, that the average post-dividend, pre-tax return on equity of mutual companies was lower than that for a comparable group of stock companies. This difference, Congress concluded, was attributable to the distribution by mutual companies of earnings to their policyholders.

At the individual level, distributions with respect to life insurance contracts, including policyholder dividends, generally are included in the policyholder's income only to the extent that the distributions exceed the premiums paid by the policyholder. As a result, the policyholder is permitted to recover the full amount of his premium payments before any income is taxed. Moreover, the cash value of a life insurance contract is reduced by the mortality charges under the contract. Thus, such mortality charges are, in effect, deducted against investment income. This treatment is much more generous than the treatment of a separate purchase of insurance protection since the cost of insurance protection is a personal expense that is not deductible.[1] These rules generally

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1/ These favorable rules generally apply only to contracts that meet the definition of a life insurance contract contained in section 7702 of the Code and that are not "modified endowment contracts," as defined in section 7702A. Sections 7702 and 7702A were adopted in the 1984 Act and the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"), respectively, to prevent contracts that provide for much larger investments or buildups of cash value than traditional products from qualifying for the favorable life insurance tax rules. The policyholder of a modified endowment contract (that meets the definition of a life insurance contract under section 7702) is not permitted to recover his full investment before being taxed on distributions. Rather, the investment is recovered only after investment income (reduced by mortality charges) has been taxed. For contracts that do not meet the definition of a life insurance contract, investment income (unreduced by mortality charges) is taxed currently.

result in exempting from tax at the individual level virtually all policyholder dividends.[2]

Congress determined that the appropriate percentage of mutual company equity was generally equal to the difference between the average earnings rate of all mutual companies and the average of the earnings rates of the 50 largest stock companies. Congress believed, however, that the stock earnings rate should be adjusted so that the mutual segment of the industry would bear 55 percent of the aggregate industry tax burden for 1984. This allocation was thought appropriate in light of the historic allocation of the industry's tax burden between the mutual and stock segments, the relative percentages of assets held by the stock and mutual segments of the industry, and the difference in tax treatment at the individual level of mutual company policyholders and stock company shareholders. Historical data on these relationships were presented in the Interim Report to the Congress on Life Insurance Company Taxation (the "1988 report").

Neither section 809 nor any other provision of current law imputes equity income to stock life insurance companies that sell participating policies, even though the concerns expressed by Congress in 1984 with respect to the distribution of corporate earnings to policyholders apply to participating policies sold by stock life insurance companies, as will be explained in part three of our testimony. Further, no amount of equity income is imputed to life insurance subsidiaries of non-life mutual companies.

The decision of Congress in 1984 to impute equity income to mutual life insurance companies was an attempt to treat mutual life insurance companies like stock companies for tax purposes.[3] With an unintegrated tax system, that decision appeared to produce the need to distinguish between the debt and equity returns in mutual

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2/ For example, if a 35-year-old male purchased a standard, level premium ($850) whole life policy with a face value of $100,000 and no loading charges, and surrendered the policy after 10 years, the surrender value (at 7 percent interest) would be slightly less than his investment in the contract. As a result, he would pay no tax upon surrender, even though approximately $2,800 of investment earnings had been credited to the policy. If surrendered after 20 years, 75 percent of the policy investment earnings of over $12,000 would be exempt from tax. At no time would surrender of the policy produce taxation of more than 31 percent of the policy's investment earnings. Further, if the policy were not surrendered, but held until death, all investment earnings would be exempt from individual level tax.

3/ *See* S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess. 522 (1984); H.R. Rep. No. 432, Part 2, 98th Cong. 2d Sess. 1398 (1984).

company policyholder dividends so as to tax the equity returns in policyholder dividends at the corporate level. As we will explain more fully in parts three and four of our testimony, we do not think that it is conceptually necessary to make such distinctions to tax stock and mutual companies equally at the corporate level on equity-like returns. Under a stock company model, we think it is necessary, but not practically possible, to make such distinctions to tax stock company and mutual company investors equally at the individual level. As a result, we believe that we should attempt to treat stock life insurance companies like mutual companies in order to accomplish the equal tax treatment of stock and mutual companies and their investors.

II. REVENUE EFFECTS OF CURRENT LAW

During consideration of the life insurance provisions of the 1984 Act, Congress expressed concern about: (1) the amount of taxes paid by the life insurance industry, and (2) the relative tax burden of mutual and stock life insurance companies. As a result, the 1984 Act required the Treasury Department to report to the Congress on the revenue effects of the life insurance company tax changes of the 1984 Act.

In the 1988 report, we reported to Congress that the 1984 Act changes increased revenues in 1984 and 1985 by a smaller amount than predicted. We also reported that the relative shares paid by the mutual and stock segments in 1984 and 1985 did not meet congressional expectations. The 1988 report attributed these shortfalls to the difficulty in estimating receipts from the life insurance company tax rules, including the complexity of the tax law changes, the difficulty in predicting accurately taxpayers' responses to those changes, and the changing nature of the life insurance industry's products and practices.

Our final report generally confirms the findings in the 1988 report that the 1984 Act changes increased revenues by a smaller amount than predicted. The findings in the 1988 report and the final report are based upon an analysis of life insurance company tax returns. The results of that analysis for 1984, 1985, and 1986 are summarized in Table 1. Although receipts from the life insurance industry were estimated at the time of the 1984 Act to be $9.5 billion for 1984 through 1986, actual payments were $7.2 billion (including tax liabilities attributable to the mutual sector's "true-up", _i.e._, an adjustment to income made in a subsequent year). Receipts were estimated to be $5.2 billion (55 percent of the total) for mutual life insurance companies and $4.3 billion (45 percent of the total) for stock life insurance

Table 1

Comparison of Estimated and Actual Tax Payments of the Life Insurance Industry: 1984-1986 ($ billions)

	1984	1985	1986	Total 1984-86
Life Insurance Industry				
1984 estimate	3.0	3.1	3.4	9.5
Actual payments	2.4	2.9	3.3	8.5
Actual payments including true-up	2.7	2.2	2.3	7.2
Mutual Life Insurance Companies 1/				
1984 estimate	1.6	1.7	1.9	5.2
Actual payments	1.0	1.3	1.9[2]	4.1
Actual payments including true-up	1.3	0.6	0.9[2]	2.8
Stock Life Insurance Companies				
1984 estimate	1.4	1.4	1.5	4.3
Actual payments	1.4	1.6	1.4	4.4

Department of the Treasury
Office of Tax Analysis

July 1989

NOTE: Details may not add to totals because of rounding.

SOURCES: Actual payments for 1984 and 1985 and estimates for 1984-1986, Department of the Treasury, Interim Report to the Congress on Life Insurance Company Taxation (June 1988). Actual payments for 1986, sample of 1986 life insurance company tax returns.

1/ Includes stock life company subsidiaries of mutual life companies.

2/ On July 19, 1989, the mutual sector provided additional data not previously available to the Office of Tax Analysis (OTA) in making this estimate. Based on the data provided by the mutual sector, OTA estimates that actual payments for the mutual sector in 1986 may be $2.2 billion or $1.2 billion including the "true-up".

companies. Actual collections were $2.8 billion from mutual life insurance companies (including the "true-up") and $4.4 billion from stock life insurance companies.[4]

The Treasury Department hopes that the revenue data contained in this testimony and the final report will be useful in evaluating the success of current law in raising the amount of revenue expected under the 1984 Act. We believe, however, that a more appropriate standard for evaluating the success of the 1984 Act is whether it measures accurately the economic income of life insurance companies and taxes equally returns to mutual and stock company investors. This is the standard the Treasury Department applied in evaluating section 809 and possible improvements in life insurance company taxation.

III. ANALYSIS OF THE DIFFERENTIAL TAXATION OF STOCK AND MUTUAL LIFE INSURANCE COMPANIES

A. Background and General Observations

Measuring the economic incomes of life insurance companies and their policyholders has been difficult and controversial for many years. Because we have an unintegrated individual and corporate income tax system, we must consider to what extent mutual company policyholders should be treated like partners in an unincorporated business, or like corporate owners of their businesses. A closely related issue is whether payments to "participating" policyholders of income produced at the corporate level should be treated as payments with respect to debt, and thus as deductible interest at the corporate level, or as payments to owners, and thus as nondeductible dividends.

A major difficulty in taxing the income of life insurance companies, both stock and mutual, is that the total income of companies selling participating policies cannot be identified dirctly. In participating policies, the policyholder may provide, through premiums, funds necessary for company surplus. Surplus is used to cover contingencies and for other capital requirements, such as buildings and equipment. Such equity-like contributions

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4/ After the final report was issued, mutual companies supplied data not previously available to the Office of Tax Analysis in making the preceding estimates. Based on that data, it appears that actual payments for the mutual sector in 1986 were $2.2 billion (or $1.2 billion including the true-up). As a result, mutual sector payments and life insurance industry payments over the period 1984-86 appear to have been $0.3 billion higher than previously reported. Nevertheless, there remains a significant shortfall in collections from the life insurance industry compared to the 1984 Act estimate.

are known as "redundant" premiums. Participating policies, however, do not require redundant premiums if future investment earnings of the policyholder are subject to fluctuation.

The return that a participating policyholder may receive on his equity interest is difficult to identify or measure because the return can be received in many forms, including increased policyholder dividends, reduced premiums, or increased cash values. As a result, the payment of classic policyholder dividends is not a sufficient means of identifying a participating policy.

Furthermore, to impose a tax on life insurance company corporate profits, a determination must be made of what portion of policyholder dividends should be taxable and what portion should not. This determination is complicated by the fact that policyholder dividends may blend together several components, including premium reductions, interest payments, and equity-like returns. Unfortunately, there has never been a practical or accurate means of determining what portion of policyholder dividends falls in each category.

Mutual companies have contended that policyholders' rights do not include ownership rights, and thus no equity return is present. While the limitations on policyholders' contractual rights generally do distinguish them from conventional equity owners,[5] it is also clear that the return received through policyholder dividends does not represent classic debt.[6] Furthermore, the argument that policyholder dividends are entirely customer rebates ignores the fact that such rebates may be received many years after the purchase. Any premium overcharge will earn either an interest or an equity-like return during the time that it is held by the company. As a result, the policyholder dividend must include either an interest or equity-like return.

The difficulty created by the sale of participating life insurance has generally been viewed as a problem of devising a satisfactory measure of mutual life insurance company profits. This view is based on the assumption that mutual companies sell only participating policies and stock companies sell only nonparticipating policies. Increasingly, however, stock companies are also issuing participating policies. For example, stock companies sell universal life policies, which are policies that credit interest at rates that may not be fixed in the contract. The dollar amount of universal life insurance in force in the

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5/ See, e.g., Paulsen v. Commissioner, 469 U.S. 131 (1987).

6/ See, e.g., Texas Farm Bureau v. United States, 725 F.2d 307 (5th Cir. 1984); W.T. Plumb., Jr., "The Federal Income Tax Significance of Corporate Debt," 26 Tax Law Rev. 369 (1971).

United States increased sevenfold between 1983 and 1987.[7] As Congress recognized in the 1984 Act in defining policyholder dividends, when any amount paid or credited to a policyholder is not fixed in the contract, but depends on the experience of the company or the discretion of management, the amount paid should be considered a policyholder dividend for tax purposes.[8]

Thus, we believe that the identification and appropriate taxation of any equity-like returns to participating (or similar) policyholders is an issue that is also involved in the taxation of stock life insurers. The identification and measurement of equity-like returns to participating policyholders, however, is even more difficult in the case of stock companies because stock company participating policyholders share the equity risk on their policies with stock company shareholders.

A person who buys a participating life insurance policy from a mutual or stock company acquires a life insurance policy _and_ a right to share in the surplus or profits of the company. Both types of companies sell a large amount of cash value insurance policies, which comprise both a savings fund and pure insurance protection. By issuing cash value policies, life insurers act as financial intermediaries -- borrowing money from their policyholders and lending these funds to other borrowers -- and as poolers of their policyholders' mortality. Although stock and mutual companies have substantially different forms of legal ownership, they are in direct competition with each other. Moreover, life insurance companies increasingly operate in competition with other financial intermediaries. We believe that the tax system should not place any of these competitors at a disadvantage.

We also believe that, in general, different tax rules, such as section 809, should apply to different forms of business organizations only to the extent necessary to measure accurately and tax equally their net income. Correct measurement and equal taxation of net income is important so that the tax system does not favor one form of business over another, but instead provides a level playing field for all forms of business. For the reasons that follow, we do not believe that section 809, which applies only to mutual companies, is a necessary or appropriate means of equalizing the corporate tax treatment of stock and mutual companies.

7/ _See_ American Council of Life Insurance, _Life Insurance Fact Book_ (1988).

8/ _See_ Staff of the Joint Committee on Taxation, 98th Congress, 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 611 (1984).

B. Conceptual Shortcomings of Section 809: The "Prepayment" Analysis

Stock companies are not required to include in income capital contributions of their shareholders. Pointing to this fact, mutual companies have argued that section 809 is unnecessary to provide a level playing field in the insurance industry because any deduction of corporate earnings through mutual company policyholder dividends is exactly offset by the additional tax due from mutuals when they raise capital through premiums by selling participating insurance policies. According to the "prepayment" analysis, the tax mutual companies pay on their paid-in capital (premiums) combined with the full deductibility of the return to their contributors (policyholder dividends) provides the same after-tax returns at the company level as the exclusion from tax of stock company paid-in capital combined with no deduction for the dividends stock companies pay to their shareholders.[9]

Stock life insurance companies and certain commentators have raised various questions or criticisms concerning the prepayment analysis. Our final report addresses each of these questions in detail. In this testimony, we will present for the Subcommittee a summary of our findings with respect to the most significant criticisms.

1. Individual-Level Tax Advantages to Policyholders

The most serious problem raised with respect to the prepayment analysis is that the analysis demonstrates the equal treatment of shareholder equity and policyholder equity at the company level only. Policyholders, however, enjoy a tax advantage at the individual level because shareholder dividends and interest payments to bondholders are fully taxed when received (and stock appreciation is taxed when the stock is sold). In contrast, policyholder dividends are not taxed until the full amount of premiums has been recovered. Further, the amount of premiums that may be recovered is overstated by the cost of comparable renewable term insurance. That is, by allowing recovery of total premiums paid as the policyholder's investment in the contract, the cost of personal insurance protection is effectively deducted from investment returns. This treatment of policyholder dividends generally results in effectively exempting any income included in policyholder dividends from taxation at the individual level.

We believe that the disparity between the treatment of policyholders and shareholders at the individual level could

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9/ The prepayment analysis was first described fully in 1986 by Michael J. Graetz of Yale Law School in "Life Insurance Company Taxation: An Overview of the Mutual-Stock Differential," _Life Insurance Company Taxation: The Mutual vs. Stock Differential_ (M. Graetz ed. 1986).

justify a corporate-level tax on the equity return and interest element of policyholder dividends as a proxy for the absent investor-level tax. The approach of section 809 is not, however, appropriate for such a proxy. For example, section 809 uses corporate tax rates, not the individual income tax rates appropriate to address the tax exemption at the individual level. Furthermore, section 809 does not take account of the returns to stock company participating policyholders, who also enjoy a similar individual-level tax advantage. However, identifying that portion of returns to stock company participating policyholders that is an equity-like return is particularly difficult because of the need to determine the relative amount of equity risk borne by stock company participating policyholders and shareholders. As a result, we do not believe that a proxy tax designed to tax only equity returns to participating policyholders is the best approach to solving the problem of the individual-level tax on participating policyholders. Our preferred approach is described later in this testimony.

2. Initial Taxation of Any Redundant Premium

Stock companies and several commentators have also objected that the redundant premiums of mutual life companies were not initially taxable in the past, or that mutual companies do not collect redundant premiums currently, but grow through retained earnings only. Because currently retained earnings are taxed in the same fashion for both types of insurers, this objection questions whether mutual companies enjoy a current tax advantage because pre-1984 redundant premiums escaped taxation. Mutual companies have attempted to determine whether any equity accumulated by mutual companies from redundant premiums escaped taxation prior to 1984. This empirical question cannot be answered conclusively because of the limitations in the data available with respect to years prior to 1958.

Regardless of the empirical conclusions with respect to the pre-1984 equity, we believe that the competitive balance between mutual and stock companies is unlikely to be affected adversely even if untaxed equity exists. If, as is likely, the prior tax savings benefited mutual company participating policyholders in the past, an adjustment in the future for those prior tax savings would be likely to penalize current and future mutual company policyholders through the pricing of mutual company policies. Untaxed equity would provide a windfall to current and future mutual company policyholders through the pricing of their policies only if mutual companies transfer income to new policyholders from existing and prior policyholders. It cannot be determined from existing data whether this inter-generational transfer occurs, but we do not believe that the tax system should attempt to correct for this non-tax business differential if it does exist. Furthermore, section 809 was not justified, nor is it well designed, to account for any prior untaxed equity which Congress might conclude exists.

C. Practical Shortcomings of Section 809

Even if the focus of concern is limited solely to the equity returns at the corporate-level of mutual policyholders (as opposed to the total returns earned by all participating policyholders), there are nevertheless numerous shortcomings in section 809's attempt to implement an addition to mutual company income. Our final report explains these problems in detail. We will summarize the more important ones for the Subcommittee today.

1. Imputing Income on the Basis of Earnings Differences Between Industry Segments

First, section 809 links the taxes owed by mutual companies to the actions and economic performance of stock companies. Mutual companies owe more taxes when the stock segment performs relatively better than the mutual segment. As a result, stock company earnings will increase (or decrease) taxes paid by their mutual competitors. Under this system, mutual company tax payments are disconnected from the earnings experience of the mutual segment, generally, and from the earnings of individual mutual companies, in particular.

2. Socialization in the Measurement of the Mutual Segment Earnings Rate

Second, under section 809, mutual companies are treated as if they earn one pre-tax return on equity. As a result, a decrease in one mutual company's earnings produces an offsetting increase in tax for the mutual segment. Thus each mutual company's performance affects the tax of all other mutual companies. Furthermore, the business or tax planning of one mutual company will shift part of the mutual segment tax burden to other mutual companies. This socialization in the measurement of the mutual sector's average earnings rate causes the taxes attributable to section 809 for small companies to depend largely on the economic performance of large mutual companies. However, analysis of earnings rates based on 1986 tax return data shows that small companies benefited from socialization in 1986.

3. Imputing Income on the Basis of Annual or Short-term Differences in Earnings

Third, while the mechanism under section 809 for imputing an addition to mutual company income is based on the theory that both segments of the life insurance industry will earn comparable rates of return over the long term, section 809 generally measures the annual difference between stock and mutual company earnings rates. Numerous factors may in the short term lead to significant variations in the rates of return of the two segments. If, for example, one segment first introduces a new product, its rate of return may change substantially for a temporary period, increasing

(or decreasing) significantly the additional income imputed to mutual companies in comparison to the income that would be imputed if earnings rate differences were accounted for over a longer period.

The yearly measurement of the differential earnings rate under section 809 also means that the rate of tax applicable to mutual companies is not known in advance of business decisions that it will affect. Furthermore, since the business and tax planning of other companies in the industry affects the differential earnings rate, mutual companies may be subject to wide and capricious yearly variations in their rate of tax.

Section 809 makes some compensation for swings in the stock segment earnings rate by computing the current stock earnings rate on the basis of a three-year average. No comparable averaging mechanism applies to the determination of the mutual company earnings rate. Thus, the earnings rate of the mutual segment and, hence, the imputation rate, may change dramatically because of one year's swing in the earnings rate of large mutual companies.

4. Mismatching of Earnings Rate Years

Fourth, section 809 determines the differential earnings rate by comparing the average of the stock earnings rates for the three years preceding the taxable year with the mutual earnings rate for the current taxable year (after the recomputation under section 809(f)). This mismatching of years increases the likelihood that the differential earnings rate under section 809 will be inappropriate.

5. Recomputation of the Differential Earnings Rate in Later Tax Years.

Fifth, the differential earnings rate under section 809 for the current tax year is recomputed in the subsequent tax year to take account of the actual mutual company earnings rate in the current tax year. This recomputation adds a layer of complexity to the computation of the addition to mutual company income, and exacerbates the problem that mutual companies cannot predict the applicable rate of tax in advance of the current tax year. Moreover, a recomputation appears unnecessary because the actual mutual company earnings rate for a given tax year is given effect under section 809 in the second year following the current tax year. The current recomputation provision merely changes the year in which mutual company earnings are taken into account. Absent systematic changes in the equity base, this should not alter the mutual segment's tax liability viewed over a period of years.

D. Conclusions

We have concluded from the preceding analysis that section 809 is ineffectual and arbitrary in its attempt to identify and measure equity returns to mutual policyholders and it ignores entirely the fact that equity-like returns are also paid to stock company participating policyholders. Moreover, the prepayment analysis calls into serious question the reasons offered in 1984 for imposing on mutual companies an imputed amount of taxable income. While there remains some uncertainty regarding certain assumptions of the prepayment analysis, this analysis generally demonstrates that equity returns to participating policyholders bear an appropriate tax at the corporate level.

The prepayment analysis does not, however, address the problem that income of participating policyholders, both stock and mutual, enjoys an individual-level tax advantage when compared to income of shareholders and bondholders. Unless some adjustment is made for the fact that shareholders of stock life insurance companies are subject to both corporate and individual-level tax on equity returns, whereas equity returns to all mutual company owners are taxed only once at the corporate level, stock life insurance companies could be placed at a competitive disadvantage. Finally, when comparing the tax exemption of participating life insurance policyholders' income and the taxation of stock life insurance companies' shareholder dividends at the individual level, we believe that the relative tax treatment of total income flowing through life insurance companies and competing financial institutions should be considered.

IV. RECOMMENDATIONS AND OPTIONS FOR IMPROVING LIFE INSURANCE COMPANY TAXATION

As a result of the conceptual and practical flaws in section 809, we recommend its repeal and propose an alternative that would address the three issues described below.

First, equity returns to participating policyholders of both mutual and stock companies are not appropriately taxed at the individual level. A larger fraction of equity returns are attributable to the policyholders of mutual companies than to policyholders of stock companies, and, consequently, this advantage accrues more to mutual companies than to stock companies. It is, however, available to both segments of the industry. In contrast, returns to stock company shareholders are subject to double taxation because the returns are taxed at both the corporate and individual levels.

The tax treatment of equity returns to investors in mutual and stock life insurance companies could be made equal either by imposing an individual-level tax on the returns to participating policyholders or by removing the double taxation of shareholder dividends and thereby imposing tax at one level only. An additional tax on returns to participating policyholders could be imposed at the corporate level which would serve as a proxy tax that accounts for the absence of taxation of returns to participating policyholders at the individual level. Alternatively, the corporate and individual-level taxes could be integrated by providing to stock life insurance companies a shareholder dividends-paid credit at the corporate level that accounts for the individual-level tax on shareholder dividends.

We believe that the dividends-paid credit is preferable to a proxy tax imposed at the corporate level because it reduces double taxation by providing partial integration of corporate and individual-level taxes and because of the difficulty in identifying and measuring returns to participating policyholders. Designing a proxy for a tax on the individual-level equity returns to participating policyholders, as proposed in a draft report of the General Accounting Office, would involve the same difficulties involved in designing a corporate-level tax on such returns. There is no easy means of identifying at the individual level that portion of returns to participating policyholders that represents a return on equity, rather than a return on debt or a customer rebate. Moreover, identifying the equity portion of returns is particularly difficult with respect to stock company participating policyholders because it is reasonable to assume that stock participating policyholders share the equity risk and return on their policies with the stock company's shareholders. That is, all equity in a stock company is not contributed by the stock participating policyholders, and the equity-like return on stock participating policies will inure in part to the company's shareholders. There is no data available, however, to estimate the relative share of risk and return to stock company shareholders and participating policyholders.

A second concern is that income flowing through other financial intermediaries generally bears at least one level of tax, while billions of dollars of income flowing through life insurance companies is subject to little or no Federal tax liability at either the corporate or individual level. Of concern with life insurance companies is their investment earnings. A significant portion of these earnings are deductible at the corporate level. Other financial intermediaries also may deduct a substantial portion of investment earnings. The investment earnings of other financial intermediaries, however, are generally subject to tax at the individual level. In contrast, the investment earnings of life insurance contracts are preferentially taxed at the individual level through deferral, exemption or both. In 1986, for example,

the amount of life insurance company investment earnings that was subject to little or no Federal income tax was approximately $24 billion dollars. A tax based on net investment earnings imposed at the corporate level would ensure the collection of some amount of tax on income flowing through life insurance companies.

Third, any solution chosen should not result in loss of revenue. The Treasury Department is prepared to work with Congress in addressing these issues.

The final report presents for congressional consideration blueprints of several options for improving the taxation of life insurance companies. We believe that the first option, a shareholder dividends-paid credit with an investment earnings tax, in combination with the repeal of section 809, is preferable because it integrates the corporate and individual taxation of returns to equity owners and avoids the problem of identifying equity-like returns to participating policyholders, both stock and mutual.

A. Recommendation

Under our recommended approach, section 809 would be repealed. It would be replaced with a shareholder dividends-paid credit and a tax based on net investment income that applies to all life insurance companies (including life insurance company subsidiaries of non-life insurance corporations). Under this proposal, stock life insurance companies would be allowed a dividends-paid credit for shareholder dividends paid which are attributable to life insurance companies. This credit would be limited to the company's net investment income tax. The credit would be equal to 15 percent of shareholder dividends paid to account for lower effective tax rates of shareholders. We believe this rate of credit should offset the shareholder taxes paid on stock dividends, although we would be pleased to consider any new data which becomes available as a result of Congress' consideration of this issue.

In addition, life insurance companies would pay a tax equal to 1 percent of net investment income of life insurance contracts. This rate (combined with the shareholder dividends-paid credit) would raise approximately the same revenue from life insurance companies for the period FY 1990-91 as is expected to be raised under section 809. The rate would have to be increased to slightly more than 2 percent in later years to maintain revenue neutrality. It would be payable in addition to and separately from the tax payable on gain from operations after policyholder dividends. This tax would not be subject to reduction by net operating losses or tax credits (other than the shareholder dividends-paid credit). These rates have been set to offset the anticipated revenue loss from repeal of section 809. Higher rates would, of course, raise more revenue.

Investment income would be broadly defined to include all interest, dividends, and net capital gains from all life insurance subgroup assets. So as to apply the tax only on investment income of life insurance contracts, however, we anticipate that investment income would be reduced by prorating investment income according to the ratio of reserves under life insurance contracts to total reserves. Net investment income would be a statutorily set percentage of investment income. Furthermore, a deduction against investment income for dividends received from affiliated companies would be allowed.

A shareholder dividends-paid credit with an investment earnings tax on all life insurance companies would have several advantages over the current system of life insurance company taxation. First, the taxation of total returns on participating policies would apply equally to mutual and stock companies, and section 809 would be repealed. Second, the double taxation of equity returns of stock company shareholders would be eliminated with the dividends-paid credit to put them on a par with the current individual tax treatment of participating policyholders. Third, the tax treatment of financial products across different financial institutions would be made more consistent by ensuring that investment income flowing through life insurance companies is taxed at least once at either the corporate or individual level.

Since the final report was issued, numerous questions have been raised regarding our recommendation for a shareholder dividends-paid credit, an investment earnings tax, and repeal of section 809. Should Congress decide to enact our proposal, or a similar proposal, we would anticipate working with Congress and the industry to address the technical issues raised. In this testimony, we will respond to two significant questions that have arisen. We will also be happy to answer any other questions from the Subcommittee.

First, stock companies have questioned whether mutual companies will "dividend out" and pay virtually no tax absent section 809 or a similar provision that limits the deductibility of mutual company policyholder dividends. We do not believe that it is reasonable to assume that mutual companies would pay out all earnings through dividends principally because mutual companies, like stock

companies, need to retain earnings to grow. Indeed, there is evidence that life insurance companies, both stocks and mutuals, have been growing mainly through retained earnings.[10] Retained earnings bear a corporate level tax without section 809.[11]

Second, some have characterized the investment earnings tax as a tax on the so-called "inside build-up" in life insurance contracts. Inside build-up is a term applied to the investment earnings within qualified life insurance contracts that escapes

---

10/ See Task Force on Mutual Life Insurance Company Conversion, Report of the Task Force on Mutual Life Insurance Company Conversion, XXXIX Transaction of the Society of Actuaries (1987).

11/ Under the 1959 Act, insurance companies were able to reduce their taxes through the use of so-called "modified coinsurance," which had the effect of changing the character of income from investment income into more favorably taxed underwriting income. In contrast to an increase in the level of actual payments of policyholder dividends, a modified coinsurance transaction had no actual effect on funds available to the insurance company even though it affected the character of the company's income for tax purposes. We do not believe that the allowance of a deduction for dividends is comparable to the tax treatment formerly available for modified coinsurance.

In 1980 and 1981, companies reduced the level of unused dividend deductions through modified coinsurance transactions, but there is no evidence that companies generally, or mutual companies in particular, paid more dividends than they would otherwise have paid. Policyholder dividend payments of both stocks and mutuals increased in 1980 and 1981. However, the percentage increase between 1979 and 1981 was 19.4 for both mutuals and stocks. Moreover, it is reasonable to assume that increased dividends were paid because of the high interest rates offered by competitive investment firms, and not for tax purposes. Tax revenues from the life insurance industry declined in 1980 and 1981, and taxes of mutuals declined marginally more than taxes of stocks. However, numerous non-economic deductions generally available under prior law, but which are not currently available, contributed to the low tax payments. See, generally, The 1988 Interim Report, Table 13.1, at p. 53; Brannon, Gerard M., Report on Life Insurance Segment Balance, final report under Treasury Order No. OS-86552, Req. No. 19956, pp. 3.1-3.9 (September 1986).

current taxation at the individual level while it is also deductible at the corporate level.[12]

Although the proposed investment earnings tax applies to investment income credited to life insurance contracts, it is not comparable to the taxation of inside build-up, such as was proposed by the Treasury Department in 1984. The Treasury's 1984 proposal to tax inside build-up would have included the inside build-up annually in an individual's taxable income, regardless of whether amounts were actually received by the policyholder. In contrast, the investment earnings tax would be paid at the corporate level (by both mutual and stock corporations), not at the individual level. Further, the investment earnings tax would be at a low rate, far below policyholders' marginal tax rates. In fact, under the Treasury's investment earnings proposal the tax-preferred status of qualified life insurance contracts at the individual level would remain unchanged.

B. Options

Since Congress may wish to consider several options, alternative means of improving life insurance company taxation are described in our final report. These include: (1) the repeal of section 809; (2) an alternative add-on tax on life insurance companies issuing participating policies that is based on the rate of stock company shareholder dividend payments; and (3) modification of section 809 to tax more accurately equity returns to mutual companies and simplify the operation of this provision. In addition to any of these three corporate tax options, a tax could be imposed at the corporate level as a proxy for the tax exemption at the individual level of returns to participating policyholders.

C. Revenue Estimates

Preliminary revenue estimates of the change in Federal income tax revenue as a result of enactment of each of the options discussed in the final report are presented in Chapter 5. These estimates compare the revenue expected under current law with the revenue expected if each option were enacted.

12/ Under current law, some inside build-up is taxed when a withdrawal from, or surrender of, a policy occurs, but such investment earnings are generally taxed at a low effective tax rate and only after some years of deferral. *See* note 2, *supra*.

Table 2 shows that repeal of section 809 would reduce receipts by $2.1 billion for FY 1990-94. The proposed replacement of section 809 with the shareholder dividends-paid credit and investment earnings tax is estimated to be approximately revenue neutral with respect to current law if the investment earnings tax rate were 1 percent in 1990 and 1991 and slightly more than 2 percent thereafter. For mutual life insurance companies, the reduction in receipts from repeal of section 809 would be largely offset by the increase in receipts from the investment earnings tax. The increase in receipts from stock companies would be less than $50 million because the investment earnings tax would be largely offset by the dividends-paid credit.

V. CONCLUSION

In summary, we believe that a shareholder dividends-paid credit and an investment earnings tax on all life insurance companies, combined with repeal of section 809, would improve significantly the taxation of income flowing through life insurance companies. As a result of these changes, the tax rules that apply to mutual and stock companies would be the same, and the equity income of shareholders and participating policyholders would be taxed only once.

Mr. Chairman, that concludes my formal statement. I would be happy at this time to answer questions from you or any other members of the Subcommittee.

Table 2

Revenue Effects of Selected Options to Reform
Life Insurance Company Taxation:
All Life Insurance Companies
($ billions)

	FY90	FY91	FY92	FY93	FY94	Total FY90-94
Repeal Section 809:	0	-0.4	-0.6	-0.5	-0.6	-2.1
with investment earnings tax and shareholder dividends paid credit	0.1	-0.1	-0.1	*	0.1	*
with proxy tax	0.2	-0.1	-0.3	-0.3	-0.3	-0.7
with add-on tax based on shareholder dividends	0.4	0.2	*	0.1	0.1	0.8
Modify Section 809:	0.3	0.2	0.1	0.2	0.2	1.0
with proxy tax	0.5	0.5	0.4	0.5	0.5	2.3

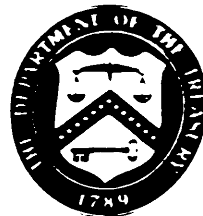
Department of the Treasury
Office of Tax Analysis

July 1989

Note: Details may not add to totals because of rounding.

* Less than $50 million.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
October 18, 1989

CONTACT: Office of Financing
202/376-4350

ROOM 5310

TREASURY TO AUCTION $10,000 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $10,000 million of 2-year notes to refund $9,288 million of 2-year notes maturing October 31, 1989, and to raise about $700 million new cash. The public holds $9,288 million of the maturing 2-year notes, including $235 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $10,000 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks, for their own accounts, hold $1,586 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

oOo

Attachment

NB-513

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 2-YEAR NOTES
TO BE ISSUED OCTOBER 31, 1989

October 18, 1989

Amount Offered:
To the public .... $10,000 million

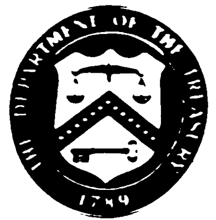
Description of Security:
Term and type of security .... 2-year notes
Series and CUSIP designation AF-1991
(CUSIP No. 912827 YC 0)
Maturity date .... October 31, 1991
Interest rate .... To be determined based on the average of accepted bids
Investment yield .... To be determined at auction
Premium or discount .... To be determined after auction
Interest payment dates .... April 30 and October 31
Minimum denomination available .. $5,000

Terms of Sale:
Method of sale .... Yield auction
Competitive tenders .... Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders .... Accepted in full at the average price up to $1,000,000
Accrued interest
payable by investor .... None

Payment Terms:
Payment by non-
institutional investors .... Full payment to be submitted with tender
Deposit guarantee by
designated institutions .... Acceptable

Key Dates:
Receipt of tenders .... Tuesday, October 24, 1989, prior to 1:00 p.m., EDST
Settlement (final payment
due from institutions):
a) funds immediately
available to the Treasury .. Tuesday, October 31, 1989
b) readily-collectible check .. Friday, October 27, 1989

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
October 18, 1989

Contact: Peter Hollenbach
(202) 376-4302

TREASURY AIDS SAVINGS BONDS OWNERS AFFECTED BY CALIFORNIA EARTHQUAKE

The Treasury's Bureau of the Public Debt took swift action to assist victims of the earthquake that hit northern California last night by expediting the replacement or payment of United States Savings Bonds for owners in the affected areas. The emergency procedures are effective immediately and will remain in effect through November 30, 1989.

The Bureau's action waives the normal six-month minimum holding period for Series EE savings bonds presented for payment by residents of the affected area. Savings bonds paying agents, which includes most financial institutions, are to certify the request for payment on savings bonds for owners and forward the bonds to the Federal Reserve Bank of San Francisco for expedited redemption.

The replacement of bonds lost or destroyed will also be expedited by Public Debt. Bond owners should complete form PD-1048, available at most financial institutions or the Federal Reserve Bank. Bond owners should include as much information as possible about the lost bonds on the form such as inscriptions (including Social Security Numbers), approximate dates of issue, denominations and serial numbers if available. The completed form must be certified by their financial institution, which will forward it to Public Debt's Savings Bonds Operations Office in Parkersburg, West Virginia.

These emergency procedures apply to bond owners in the city and county of San Francisco and those in the following northern California counties: Alameda, Monterey, San Benito, San Mateo, Santa Clara and Santa Cruz.

The Bureau of the Public Debt is the Treasury agency charged with financing and accounting for the nation's public debt.

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NB-514

PRESS RELEASE

OVERSIGHT BOARD

RESOLUTION FUNDING CORPORATION

FOR RELEASE AT 4:15 P.M.
Oct. 18, 1989

CONTACT: Art Siddon
202-387-7667

REFCORP ANNOUNCES AUCTION OF $4.5 BILLION OF 30-YEAR BONDS

The Resolution Funding Corporation will auction $4.5 billion of 30-year bonds to provide funding to the Resolution Trust Corporation.

The bonds will be offered to the public through a yield auction conducted by the Federal Reserve Banks as fiscal agents to REFCORP. The bonds will be available in book-entry form only and in minimum denominations of $1,000. Noncompetitive tenders must be submitted through a primary dealer or a depository institution with a book-entry account at a Federal Reserve Bank. Only commercial banks and primary dealers may submit tenders for the accounts of customers. Noncompetitive tenders will be accepted at the average price of accepted competitive tenders.

The bonds may be stripped into their separate principal and interest components in book-entry form and may be reconstituted into whole bonds on the book-entry system maintained by the Federal Reserve.

The details on the new securities are contained in the attached highlights of the offering and in the Resolution Funding Corporation offering circular dated October 13, 1989, and offering circular supplement dated October 18, 1989.

oOo

Attachment

HIGHLIGHTS OF REFCORP
OFFERING TO THE PUBLIC
OF 30-YEAR BONDS
TO BE ISSUED AS OF OCTOBER 15, 1989

October 18, 1989

Amount Offered:

To the public	$4,500 million

Description of Security:

Term and type of security	30-year bonds
Series and CUSIP designation	Series A-2019 (CUSIP No. 761157AA4)
Settlement date	October 30, 1989
Maturity date	October 15, 2019
Interest rate	To be determined based on average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	April 15 and October 15
Minimum denomination available	$1,000

Terms of Sale:

Method of sale	Yield auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, i.e., 7.10%
Noncompetitive tenders	Accepted in full at average price up to $1,000,000
Accrued interest payable by investor	Interest accrues from October 15, 1989. Amount to be determined at auction

Payment Terms:

Payment by non-institutional investors	Full payment to be submitted with tender
Deposit guarantee by designated institutions	Acceptable

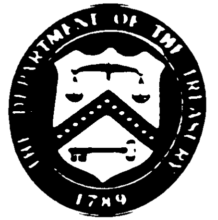
Key Dates:

Receipt of tenders	Wednesday, October 25, 1989 prior to 1:00 p.m., EDST

Settlement:

Immediately available funds	Monday, October 30, 1989

// TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

ROOM 5310

OCT 23 9 11 AM

DEPARTMENT

FOR IMMEDIATE RELEASE October 19. 1989

John M. Niehuss
Appointed Senior Deputy Assistant Secretary
for International Economic Policy

Secretary of the Treasury Nicholas F. Brady today announced the appointment of John M. Niehuss to serve as Senior Deputy Assistant Secretary for International Economic Policy. Mr. Niehuss will serve as an advisor to the Assistant Secretary for International Affairs on a range of issues, including international debt policy, the multilateral development banks and international investment and financial services. He will also represent the Assistant Secretary at various inter-agency and international meetings and assist in the administration and management of the Treasury Department's international operations.

Prior to joining Treasury, Mr. Niehuss was, from 1977-1989, a Vice President in the international investment banking group at Merrill Lynch Capital Markets. He served in the U.S. Government from 1973-1977 as an Assistant Director of the Council on International Economic Policy in the White House and as a Deputy Assistant Secretary in the Treasury Department. Previously, Mr. Niehuss had practiced law in Cleveland and New York and worked in the field of development finance in Zambia and at the World Bank.

He graduated from Amherst College in 1958 and from the University of Michigan Law School in 1962. He also studied at the London School of Economics in 1962-1963.

Mr. Niehuss is a native of Ann Arbor, Michigan and now resides in Washington, D.C.

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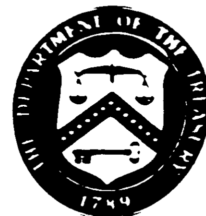
NB-515

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
October 19, 1989

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,751 million of 52-week bills to be issued October 26, 1989, and to mature October 25, 1990, were accepted today. The details are as follows:

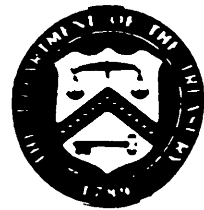
RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.33% a/	7.87%	92.589
High -	7.37%	7.92%	92.548
Average -	7.35%	7.90%	92.568

a/ Excepting 2 tenders totaling $2,095,000.
Tenders at the high discount rate were allotted 73%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 13,485	$ 13,485
New York	19,976,245	8,879,445
Philadelphia	4,820	4,820
Cleveland	16,035	16,035
Richmond	14,900	14,900
Atlanta	9,970	9,970
Chicago	1,379,570	547,820
St. Louis	12,765	10,495
Minneapolis	4,325	4,325
Kansas City	21,320	21,320
Dallas	7,670	7,670
San Francisco	295,470	18,470
Treasury	202,500	202,500
TOTALS	$21,959,075	$9,751,255
Type		
Competitive	$19,454,095	$7,246,275
Noncompetitive	424,980	424,980
Subtotal, Public	$19,879,075	$7,671,255
Federal Reserve	1,900,000	1,900,000
Foreign Official Institutions	180,000	180,000
TOTALS	$21,959,075	$9,751,255

TREASURY NEWS


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LIBRARY, ROOM 5310

OCT 23 9 11 AM '89

DEPARTMENT ...

FOR IMMEDIATE RELEASE
October 12, 1989

CONTACTS: Cheryl Crispen
566-5252
Kathy Wagner
566-8191

TREASURY BUILDING TOUR PROGRAM

Washington's oldest office building is offering tours for the public. Guided tours of the Treasury building are available on alternate Saturday mornings by advance reservation. The tour program is part of the Treasury Department's celebration of its 200th anniversary as an Executive Branch agency.

The Treasury building is the third oldest building in the Capital City, but it is the oldest built to accommodate members of the federal workforce. Its original T-shaped section dates from 1836 and was designed by American architect Robert Mills who also designed the Washington Monument.

The one-hour tour features opportunities to view the building's distinctive architectural and decorative features, its large art collection and its historic nineteenth century furnishings, and to learn about the Department's influential role in domestic and international economic affairs. Tours begin at 10 o'clock, 10:20, and 10:40, accommodate 20 visitors, and are led by Treasury employees trained as docents.

Advance reservations are required. Visitors will be asked to provide their name, birthdate, and social security number when phoning to reserve space. The Treasury building is located at 15th Street and Pennsylvania Avenue, NW. For reservations, call 343-9136.

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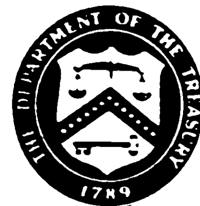
NB-517

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR IMMEDIATE RELEASE October 19, 1989

Statement by
Secretary of the Treasury
Nicholas F. Brady

We support the capital gains and IRA proposal introduced today by Senator Packwood and Senator Roth. We continue to believe that a permanent lower capital gains rate -- one that rewards long-term holdings -- will lower the cost of capital, increase savings and create new jobs. We urge the Senate to take action on this important proposal.

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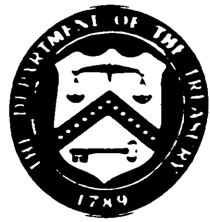
NB-518

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
October 20, 1989

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of September 1989.

As indicated in this table, U.S. reserve assets amounted to $68,418 million at the end of September, up from $62,364 million in August.

U.S. Reserve Assets
(in millions of dollars)

End of Month	Total Reserve Assets	Gold Stock 1/	Special Drawing Rights 2/3/	Foreign Currencies 4/	Reserve Position in IMF 2/
1989					
August	62,364	11,066	9,240	33,413	8,644
Sept	68,418	11,065	9,487	39,080	8,786

1/ Valued at $42.2222 per fine troy ounce.

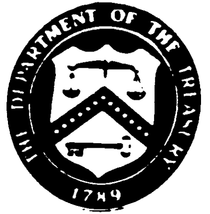
2/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of selected member countries. The U.S. SDR holdings and reserve position in the IMF also are valued on this basis beginning July 1974.

3/ Includes allocations of SDRs by the IMF plus transactions in SDRs.

4/ Valued at current market exchange rates.

NB-519

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
OCTOBER 20, 1989

CONTACT: BOB LEVINE
566-2041

GEORGE A. FOLSOM
Deputy Assistant Secretary
For Developing Nations

Secretary of the Treasury Nicholas F. Brady today announced the appointment of George A. Folsom as Deputy Assistant Secretary of the Treasury for Developing Nations. He serves as the principle advisor to the Assistant Secretary for International Affairs on the formulation and execution of Treasury Department policy with developing nations. He also coordinates U.S. policy and participation in the multilateral development lending programs of the World Bank and the regional development banks.

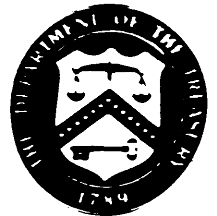
Mr. Folsom was most recently employed by the law firm of Berry, Dunbar, Daniel, O' Connor, Jordan and Eslinger in Columbia, South Carolina where his practice was concentrated in the fields of international trade regulation, and trans-national commercial and corporate transactions.

From 1983 to 1986, Mr. Folsom served in the Office of the Secretary of Defense as the Special Assistant for International Technology Transfer Policy. He developed and managed export trade control policy in the context of national security, current intelligence and legal issues. In this capacity, Mr. Folsom represented the Defense Department in diplomatic, interagency, Congressional and public deliberations involving allied and neutral governments.

Mr. Folsom received his M.A. in International Studies (December 1982) and his J.D. from the University of South Carolina (May 1982). He earned his B.A. in International Relations from the School of International Service of the American University (May 1977) in Washington, D.C. He is licensed to practice law in the State of South Carolina and in the District of Columbia as well as before the U.S. Court of International Trade. Mr. Folsom was born on January 2, 1955 in Greenville, South Carolina and more recently resided in Columbia, South Carolina.

NB-520

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

ROOM 5310

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
October 23, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,806 million of 13-week bills and for $7,813 million of 26-week bills, both to be issued on October 26, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing January 25, 1990			:	26-week bills maturing April 26, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.47% a/	7.72%	98.112	:	7.48% b/	7.88%	96.218
High	7.54%	7.79%	98.094	:	7.50%	7.90%	96.208
Average	7.52%	7.77%	98.099	:	7.50%	7.90%	96.208

a/ Excepting 1 tender of $140,000.
b/ Excepting 1 tender of $5,580,000.
Tenders at the high discount rate for the 13-week bills were allotted 44%.
Tenders at the high discount rate for the 26-week bills were allotted 92%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 32,060	$ 32,060	:	$ 28,180	$ 28,180
New York	20,549,660	6,385,260	:	18,927,445	6,767,445
Philadelphia	26,015	26,015	:	17,615	16,615
Cleveland	31,785	31,785	:	30,205	30,205
Richmond	38,200	38,200	:	36,105	35,105
Atlanta	27,825	27,825	:	21,070	21,070
Chicago	1,643,700	243,700	:	1,669,010	240,410
St. Louis	24,485	24,485	:	22,600	22,600
Minneapolis	8,035	8,035	:	5,975	5,975
Kansas City	42,300	42,300	:	39,620	39,620
Dallas	36,385	26,385	:	35,460	25,460
San Francisco	1,055,495	302,495	:	917,820	38,820
Treasury	617,460	617,460	:	541,940	541,940
TOTALS	$24,133,405	$7,806,005	:	$22,293,045	$7,813,445
Type					
Competitive	$21,084,615	$4,757,215	:	$18,267,250	$3,787,650
Noncompetitive	1,279,530	1,279,530	:	1,097,195	1,097,195
Subtotal, Public	$22,364,145	$6,036,745	:	$19,364,445	$4,884,845
Federal Reserve	1,747,560	1,747,560	:	1,650,000	1,650,000
Foreign Official Institutions	21,700	21,700	:	1,278,600	1,278,600
TOTALS	$24,133,405	$7,806,005	:	$22,293,045	$7,813,445

1/ Equivalent coupon-issue yield.

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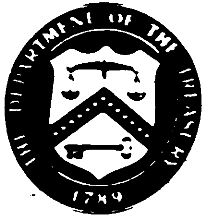
TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

STATEMENT OF FRANK VUKMANIC
DIRECTOR, OFFICE OF MULTILATERAL DEVELOPMENT BANKS
DEPARTMENT OF TREASURY
BEFORE THE SUBCOMMITTEE ON
NATURAL RESOURCES, AGRICULTURAL RESEARCH AND ENVIRONMENT
OF THE COMMITTEE ON SCIENCE, SPACE AND TECHNOLOGY
U.S. HOUSE OF REPRESENTATIVES
OCTOBER 24, 1989

I am pleased to have the opportunity to present Treasury's views regarding World Bank financing of the Sardar Sarovar Dam Project in India and, more generally, environmental issues in the multilateral development banks.

The U.S. Government has been a very strong advocate for environmental reforms in the World Bank and the regional multilateral development banks (MDBs) for a number of years. During that period, there has been substantial progress made by the MDBs: environmental expertise has increased dramatically, almost all operations staff now receive environmental training, environmental issues are now explicitly considered in project preparation, and mitigation measures or environmentally beneficial components are now included where appropriate in projects. The U.S. has also pressed the Banks to open up more, to provide more information on the environmental aspects of projects, and to communicate with and consult NGOs and representatives of affected community groups. We have pushed the Banks in this direction not because of political demands from the groups

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but because we genuinely believe that participation can produce a better project, and can help avoid costly delays or mistakes.

While the Banks have made progress in a large number of areas, they have not always moved as rapidly as we would like, particularly in areas such as information access. I would emphasize, however, that we will continue to press the banks and I am sure that there will be positive changes in the MDBs' environmental policies and practices. It is very clear that while the MDBs have made mistakes they have also learned much from their mistakes. I think it would be fair to say that the Banks would not handle many projects today the way they did in the past.

Recent Initiatives

I would like to turn to an important, recent development in the World Bank for a moment. Last spring, Secretary Brady called on President Conable and members of the Bank's Development Committee to develop procedures for assuring that environmental impact assessments are completed for projects that have a significant effect on the environment. The World Bank formally adopted environmental assessment procedures last week and is preparing to implement them over the next several months. In addition, the Bank has announced its intention to review the experience in the implementation of these procedures in one year's time.

We believe that establishment of these procedures is an important step forward. At our urging, the Bank will provide an opportunity for comment by interested outside parties. I am hopeful that NGOs from many member countries will do so. The key, however, will be how these are implemented. Here again, NGOs can assist the Bank by their participation, with their comments and suggestions.

IDA Negotiations

We are also making the environment a central issue in the on-going negotiations for the replenishment of the International Development Association. We have made it clear that our participation in the ninth replenishment of IDA is contingent upon further progress in environmental reform. Four items are at the top of the list: 1) thoroughgoing implementation of the environmental impact assessment procedures; 2) an increase in public access to environmental information; 3) greater emphasis on energy efficiency and conservation; and 4) closer collaboration and cooperation with local community groups and NGOs in borrowing countries. We are making progress in most of these areas.

Multilateral Contacts

The MDBs are multilateral institutions and operate on majority rule. Unilateral actors do not promote effective and lasting changes. Therefore, while we have had success in pressing for reforms, further progress will require more international cooperation. Other countries have not placed

as high a priority on the environment as we have. We are working in a variety of international arenas to increase their awareness of and commitment to dealing with environmental issues in the MDBs. We have frequently raised the issues at international meetings--most recently, at the Paris Summit--and asked other member countries to join us in working with the Banks. Most importantly, we believe that the borrowing countries must increase their awareness of and their capacity to deal with environmental problems. The Banks' policy dialogue and institutional strengthening functions can help make improvements in that regard.

<u>Sardar Sarovar Dam</u>

Let me now turn to the Sardar Sarovar Dam. The two World Bank loans associated with this project came to the Board of Executive Directors in 1985. The United States supported those loans because we believed the project was economically and financially viable and would promote development. We were acutely aware of the need to resettle people who would eventually be displaced by the flooding of the reservoir. We believed the state governments involved, with the assistance of the Bank, would be able to implement an adequate resettlement plan.

Since 1985, we have followed the implementation of this project closely, particularly with regard to resettlement issues. The U.S. Executive Director at the World Bank has met several times with senior Bank staff to discuss the

progress being made to resolve pressing problems associated with this project. In 1987, the USAID specialist on environment and MDB projects went to India to discuss the Narmada valley projects with Bank staff, government officials and members of the Indian NGO community. We at Treasury have met on a number of occasions with the Environmental Defense Fund which has helped keep us apprised of events in the Narmada Valley and we have received copies of correspondance from local NGOs reporting on the situation. We have also made clear to the Bank on several occasions our strong concern that the problems of this project be resolved in a timely manner.

This project provides important benefits to the farmers of the drought prone state of Gujarat. We agree, however, with the Indian NGO representatives, that these benefits cannot come at the expense of people who might be displaced without adequate compensation. The Narmada Water Disputes Tribunal handed down an important decision with respect to compensation for the displaced. The Bank project took into consideration that decision and the need for careful implementation. We supported the project on that basis and are committed to helping ensure that the human welfare objectives of the project are met.

In addition to resettlement issues, this project has raised questions about environment problems in the Narmada Valley. All the environmental studies associated with this

project are now underway or completed. The most serious concern appears to be that of losing forest through flooding of the reservoir and the relocation of people into forest preserves. While this is a serious issue, it must be seen in the context of the present ecological state of the valley. Many of the forest areas shown on maps of the valley are actually denuded or substantially deforested. This project will not contribute substantially to the problem of deforestation. Deforestation is a valley-wide phenonmenon that must be dealt with even without the dam project.

Everyone acknowledges that the environmental and human welfare issues associated with this project have turned out to be more complex than anyone had expected and that progress on resolving problems has been slow. Since the beginning of the implementation period the Bank has undertaken intensive supervision of this project. Senior Bank staff, including Senior Vice President Qureshi, have met with representatives of the people who will be displaced. This attention reflects not only Bank management's concern for proper handling of the problems but also concerns expressed by the Bank's board of directors.

The problems are not inherently unsolvable. What is needed is an intensified effort on the part of the three state governments, working with representatives of the affected communities to develop solutions that meet the needs of the affected communities. In this connection, the

Bank has played a useful role and can continue to be helpful in the process of finding solutions. I am aware that the Bank has been asked to take more dramatic steps vis-a-vis the state governments, for example, halting disbursements. There is a real question as to whether a continuing dialogue and joint efforts would not be more helpful than a disruption of relations. The Bank may be the only point of leverage to achieve needed environmental reforms. If the Bank backs away from this project, there is the possibility that private sources of funding may be available with no real prospect of resolving the problem.

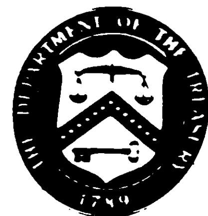
The Bank has been responsive to the concerns raised by NGOs and member countries. Since the initiation of this project in 1985, the Bank has adopted new operational guidelines for dam projects. The Bank has decided to put another Narmada River dam project (Narmada Sagar Dam) on hold, pending resolution of the problems encountered in the implementation of Sardar Sarovar Dam. The key is to find ways in which development needs can be met without compromising the welfare of individuals and the health of the environment.

Conclusion

I mentioned that we have followed the implementation of this project closely. In doing so, we have cooperated with other member countries of the Bank who have been concerned with the same issues. As in the case of pushing for general

environmental reforms in the MDBs, we think a multilateral approach would be more effective. We will continue to monitor this project and to press alone and in conjunction with other members of the Bank for appropriate actions to speed resolution of problems.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

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For Release Upon Delivery
Expected at 9:30 a.m.
October 24, 1989

STATEMENT OF
JOHN G. WILKINS
SENIOR ADVISOR (ECONOMICS)
OFFICE OF TAX POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Treasury Department on the tax policy aspects of mergers, acquisitions, and leveraged buyout transactions (collectively, LBOs) in the airline industry. I will focus my remarks on the tax treatment of airlines and these transactions.

I. INTRODUCTION

Airlines are subject to the same tax rules as generally apply to all U.S. corporations. Other than certain special excise taxes, there are no significant special tax rules for airlines. However, as discussed below, certain tax rules concerning depreciation, investment tax credit carryforwards, leasing, and the alternative minimum tax (AMT) are relatively more important to capital intensive businesses such as airlines than to other, less capital-intensive businesses.

The tax policy aspects of airline LBOs are best addressed in the general context of LBOs because the relevant issues are not unique to the airline industry. In the past year, the Treasury Department has, on three occasions, testified before the Ways and Means Committee regarding LBOs. On January 31, 1989, Secretary Brady testified generally on LBOs. On April 27, 1989, Tax Legislative Counsel Dana Trier testified on the role of pension plans in LBOs. And on May 16, 1989, in my former capacity as Acting Assistant Secretary for Tax Policy, I testified on a number of specific proposals. In addition, on January 24, 1989, Secretary

Brady testified generally on LBOs before the Senate Finance Committee. I will not repeat the prior testimony, but instead will summarize certain relevant points made therein.

The budget reconciliation bills, H.R. 3299 and S. 1750, currently under consideration, include several provisions modifying tax rules relevant to LBOs. For example, the bills contain provisions modifying the tax treatment of employee stock ownership plans (ESOPs) and certain high-yield original issue discount (OID) debt obligations, and limiting the carryback of the net operating losses (NOLs) of corporations undergoing certain reorganizations. These provisions (as well as certain additional provisions contained in the bills) are described below.

In addition, the House budget reconciliation bill calls for a Treasury Department study of debt/equity and corporate tax integration issues. The Office of Tax Policy has already initiated a study of corporate tax integration that is planned for completion in 1990.

II. FEDERAL INCOME TAXATION OF THE AIRLINE INDUSTRY

The airline industry is very capital intensive. Most airlines operate a fleet of aircraft, maintain an inventory of spare parts, including engines and flight equipment, maintain substantial computer systems, and own repair and maintenance facilities, and other depreciable property.

The following discussion is a summary of certain of the tax rules that are important to companies in capital-intensive industries generally, and the airline industry specifically.

Depreciation of Airline Assets

The tax laws relating to the depreciation of airline industry assets are essentially the same as those that apply to other depreciable assets. For a taxpayer subject to the regular tax, under the present depreciation system (called the Modified Accelerated Cost Recovery System or MACRS), a depreciation period and method is assigned to each asset based on its "class life." For this purpose, the "class life" of an asset is its Asset Depreciation Range (ADR) guideline life as currently published in Revenue Procedure 87-56 (as modified). Several alternative elections are available and numerous transition and other special rules apply. In general, for property placed in service after 1981 and before 1986, a different depreciation system (called the Accelerated Cost Recovery System or ACRS) applied.

Under MACRS, assets that have a class life of 10 or more years but less than 16 years, may be depreciated using the 200 percent declining balance method (switching to the straight-line method at the appropriate time to maximize depreciation deductions) over 7 years. Aircraft and certain other assets used in the airline industry are in Asset Class 45.0, which has a class

life of 12 years and thus an MACRS depreciation period of 7 years. Computers are in Asset Class 00.12, which has a class life of 6 years, and under MACRS may be depreciated using the 200 percent declining balance method (switching to the straight-line method at the appropriate time to maximize depreciation deductions) over 5 years.

The Tax Reform Act of 1986 linked the specific depreciation period that may be used for various types of assets to their class life, which was intended to reflect the economic lives of such assets. Recognizing that the ADR guideline lives (some of which were set as early as 1962) may no longer reflect the economic lives of the assets, and that some assets do not have ADR guideline lives, Congress has required the Treasury Department to study the actual depreciation of all depreciable assets, and to report the results of its studies. Pursuant to this mandate, the Treasury Department is studying the depreciation of a number of assets, including assets used in the airline industry. We intend to submit to the Congress a preliminary report on our study of the depreciation of commercial aircraft early next year, and a complete report on our study of depreciation of assets used in the airline industry later in 1990.

Investment Tax Credit Carryforwards

Certain tangible personal property (*i.e.*, machinery and equipment) placed in service before 1986 was eligible for the investment tax credit (ITC). Except with respect to certain types of property not important to the airline industry, the ITC was repealed by the Tax Reform Act of 1986, subject to numerous transition rules. Aircraft and computer equipment generally were eligible for a 10 percent ITC.

With certain limitations, the ITC reduces a corporation's tax liability, and, in addition, may offset up to 25 percent of the AMT. Any ITC not used for a particular taxable year can be carried back 3 taxable years and carried forward 15 taxable years. However, the amount of ITC carried forward to a taxpayer's first taxable year beginning after June 30, 1987, is reduced by 35 percent.

Because of the ability to carry ITC forward, certain capital intensive companies, such as airlines, may have substantial excess ITC which may be used to reduce tax liability (and AMT) incurred in future years.

Leasing

Leasing is a common way for a business to finance its acquisition of equipment and facilities. In a typical case, a business determines whether to lease property (or whether to sell it and lease it back) as an alternative to more traditional methods of raising capital, such as borrowing money or issuing stock. In recent years, businesses, including airlines, have increasingly relied on leasing transactions as an efficient method of either financing acquisitions of equipment and facilities or raising capital.

The tax consequences to a corporation of leasing assets are very different from those of owning assets. An owner of an asset, such as an aircraft or a computer, recovers its costs through depreciation deductions. If the owner borrowed to purchase the asset, interest payments are also generally deductible. A lessee is not entitled to depreciation deductions, but instead may generally deduct rent payments. Depending on the tax situation of the lessor and lessee, leasing may be more advantageous to both parties than loan financing on an after-tax basis, even though the amount and timing of cash payments in the two transactions may be similar. Leasing may also take the form of a sale-leaseback where the owner of the asset sells it outright to an independent party and simultaneously leases it back.

The airline industry is cyclical in nature. It is not unusual for an airline to have both profit and loss years. Because airlines--particularly during loss years--are likely to generate excess depreciation deductions and, for years prior to 1986, ITC, airlines engage in leasing transactions or sale-leasebacks in order to improve their cash flow by shifting such tax benefits to parties either in a higher tax bracket or able to use such tax benefits on a more consistent basis.

Although the Tax Reform Act of 1986 removed the ITC as a factor in the decision whether to own rather than lease airline assets, the corporate AMT introduced by that Act may have provided an additional reason for capital-intensive industries such as airlines to lease rather than own depreciable property. The corporate AMT is a parallel tax system, and in principle all corporations must determine both their regular and AMT liability. In any year in which the AMT liability exceeds the regular tax liability, the corporation is subject to the AMT. However, a credit for the excess of the AMT over the regular tax may generally be claimed in any future year in which the regular tax exceeds the AMT. In short, corporations subject to the AMT may be viewed as prepaying their future regular tax, although the frequency with which such AMT credit will be used in the future will differ from corporation to corporation.

The AMT rate is only 20 percent; however, the base of the AMT is much broader than the base of the regular corporate tax. In particular, for AMT purposes, depreciation allowances for equipment are calculated using the 150 percent declining balance method over the class life of the asset. Thus, for a corporation subject to the AMT, airline industry assets (e.g., aircraft) must be depreciated using the 150 percent declining balance method over 12 years (in contrast to the 200 percent declining balance method over 7 years available under the regular tax).

In addition, for the 1987-89 tax years, the AMT base includes 50 percent of the difference between the income reported for financial accounting purposes (book income) and the corporate AMT income calculated without this additional item. This book income adjustment is to be replaced in 1990 and later tax years by an

adjustment equal to 75 percent of the difference between "adjusted current earnings" (which is a concept based on elements of current earnings and profits) and the AMT income excluding this item.

Airlines typically depreciate owned aircraft for financial accounting purposes using the straight-line method (with some allowance for salvage value) over 20 years (in contrast to the 5-year depreciation period under ACRS and the 7-year depreciation period under MACRS). Because financial accounting depreciation is an element of both the book income and adjusted current earnings adjustments, airlines owning relatively new aircraft may be subject to the AMT. However, because the deduction for rent is the same for regular tax and AMT calculations, such airlines may reduce their AMT by either leasing aircraft or engaging in sale-leasebacks of aircraft.

III. SUMMARY OF TREASURY POSITION AND PRIOR TESTIMONY ON LBOs

We believe there is nothing unique about the tax policy aspects of LBOs involving the airline industry. Although tax considerations will have an influence on the structure of an LBO, other nontax factors will likely have a significantly greater impact on the determination of whether the LBO transaction will occur. At present, the nontax considerations motivating LBOs may be especially strong in the airline industry.

We oppose any legislative attempt to single out and address concerns regarding LBOs in a specific industry. An industry-by-industry approach to tax policy concerns will not achieve tax neutrality with respect to investment decisions and can only produce dislocations between industries.

As we have previously stated, however, we are concerned about the impact of the tax treatment of corporate debt and equity on the competitiveness of U.S. businesses in world markets. LBOs are merely one symptom of a fundamental bias against equity of the U.S. corporate income tax system and, thus, represent only a part of this concern. We believe that the best approach is to focus on the overtaxation of corporate equity. Eliminating the double taxation of dividends would reduce the reliance on leverage in the capital structure of U.S. companies without increasing the cost of capital and undermining our international competitiveness.

Review of LBOs

In May 1989 the Treasury Department established an office of Corporate Finance, which focuses on corporate financial issues including leveraged buyouts, junk bonds, capital markets, etc. This group and others within Treasury have been gathering data and reviewing academic studies that have been carried out. The Treasury Department continues to assess the impact of leveraged buyouts, including more recent trends and their future ramifications.

Modifying the Treatment of Dividends

The disparate treatment of corporate debt and equity distorts decisions regarding a corporation's capitalization, and its policies with regard to investment and distribution of earnings, in ways that impair the efficiency of the economy. The double taxation of income from equity capital also discourages the use of the corporate form even in circumstances where nontax considerations (such as limited liability and free transferability of interests) make it desirable. Moreover, this double taxation scheme may disadvantage U.S. businesses vis-a-vis foreign businesses, because most other major industrialized countries provide some relief from the double taxation of dividends.

We are carefully examining methods to reduce the existing bias against corporate equity. These include a dividends paid deduction for corporations and a dividends received exclusion or credit for shareholders.

We recognize that revenue considerations may limit the ability to provide this relief in the near future. We also realize that these dividend relief proposals raise difficult issues, such as whether relief should apply to dividends paid out of tax-free or preferentially taxed corporate income, to foreign shareholders, or to tax-exempt shareholders. We are studying several alternative methods of integrating the corporate and individual tax systems and the extent to which each can be designed to deal with these problems within the context of budget considerations.

Distinguishing "Good" Debt or LBOs From "Bad"

Others have suggested approaches that would target "bad" debt or "bad" LBOs. We believe it is both difficult and dangerous to attempt to place value judgments on a single corporation's capital structure or on an individual transaction using a tax policy standard. Clear-cut policy reasons do not support distinctions based, for example, on whether an LBO is hostile or friendly, whether the debt consists of so-called junk bonds, or whether the corporation's debt-to-equity ratio increases as a result of the acquisition. The tax code is generally too blunt an instrument to draw distinctions between "good" and "bad" debt or between "good" LBOs and "bad" LBOs and there is a real danger that any cure would be worse than the perceived problem. The markets are the appropriate judges of a corporation's capital structure or of a transaction.

Limits on Interest Deductions

Others have also suggested limits on the deductibility of interest. We continue to believe that limitations on the deductibility of interest would increase the cost of capital, hindering the ability of U.S. businesses to compete in the global economy, and would adversely affect the domestic economy. In addition, such a limitation could favor a foreign acquirer that

was allowed an interest deduction in its home country. Limitations on interest deductions could also adversely affect other sectors of the economy--especially high-technology, high-growth, and start-up companies--which can only borrow funds at high interest rates.

Limitations on the deductibility of interest would have uneven effects. Limitations may severely affect highly-leveraged industries, such as the airline industry, and may disadvantage those members of the airline industry which are more highly leveraged than the industry average. Such limitations would not only affect interest on debt attributable to LBOs but would also penalize airlines that have higher debt-to-equity ratios resulting from continued financial difficulties.

Treatment of Foreign Persons and Foreign Investment

Suggestions have also been made regarding the treatment of foreign persons and foreign investment. Some of these proposals have assumed that foreign persons have an unfair advantage over U.S. taxpayers. Any determination of whether foreign persons have an unfair advantage must be made on the basis of numerous factors and not on the basis of a single criterion, such as the deductibility of interest. Moreover, many proposals relating to the treatment of foreign persons and foreign investment would override tax treaties. The Treasury Department wishes to reiterate its objection to such overrides. Such overrides violate our international commitments and are inconsistent with our long-term economic and political interests. Overrides threaten to upset the careful balance of interests represented by treaties and to jeopardize the substantial benefits treaties confer on U.S. companies operating and investing overseas. Finally, we must be careful not to erect new and unnecessary barriers against U.S. companies' access to international capital markets.

IV. LEGISLATIVE ACTIVITY SINCE TREASURY TESTIMONY ON LBOs

Since the Treasury Department's earlier testimony on the tax policy implications of LBOs, a number of legislative proposals have been included in the budget reconciliation bills that would modify tax rules relevant to LBOs. These provisions would generally remove or reduce tax benefits that may be available in certain LBOs. As noted below, the Treasury Department supported legislative efforts to curb tax abuses in the LBO area.

High-Yield Original Issue Discount Obligations

OID is the excess of the stated redemption at maturity of a debt instrument over its issue price. Under present law, the issuer of a debt instrument with OID deducts the OID, as interest, over the life of the obligation even if interest is not paid until the debt matures. The holder of such an obligation also generally includes the OID in income, as interest, over the life of the obligation.

The House bill would treat certain debt instruments having significant OID as preferred stock for tax purposes. As a consequence, payments on such obligations would generally be treated as dividends and would not be deductible by the issuer. The Senate bill would continue to treat such obligations as debt for tax purposes but defer the issuer's deduction for the OID until the interest is actually paid. We initiated and we support the proposed changes in this area.

Transfers to Controlled Corporations

Under current law, no gain or loss is recognized if property is transferred to a corporation solely in exchange for stock and securities in such a corporation if the transferors are in control of the corporation immediately after the transfer. This current provision may be used in an LBO to obtain more favorable tax treatment than a traditional acquisition. In such a transaction, the parties form a new corporation having the "purchaser" contributing cash and receiving substantially all of the stock of the new corporation and the "seller" contributing the wanted assets and receiving almost exclusively securities.

Both the House and Senate bills would restrict the use of this current provision with respect to LBOs by generally requiring a transferor to recognize gain with respect to the contribution of appreciated assets to the extent it received securities in the new corporation. We initiated and we support the proposed changes in this area.

Limitations on Tax Attribute Carryovers

Under current law, certain changes in the ownership of a corporation trigger a limitation on the ability of the corporation to use carryovers of tax attributes such as NOLs and net unrealized built-in gain or loss. In general, if a corporation undergoes a more than 50 percent change in ownership, the use of its tax attribute carryovers for each year after the change in ownership is limited to an amount equal to the value of the corporation before the change in ownership multiplied by a rate of return known as the "long-term tax-exempt rate" in effect at the time of the change in ownership. The limitations on the use of net unrealized built-in gain or loss only apply if the amount of such built-in gains or losses exceed 25 percent of the fair market value of the assets of the corporation (determined immediately before the change in ownership).

Both the House and Senate bills would reduce this 25 percent threshold so that the limitation would apply if the net unrealized built-in gain or loss exceeded the lesser of 15 percent of the value of the assets or a minimum dollar amount. This change, which would reduce the ability of an acquirer to use the acquired corporation's built-in gain or loss, may have an effect on future airline LBOs as some airlines may have large built-in gains or losses that may not have exceeded the existing threshold.

NOLs in Corporate Equity Reducing Transactions

Under present law, a corporation is allowed to carry back an NOL to the three preceding taxable years, even if the NOL results from interest expenses attributable to a debt-financed equity-reducing transaction, such as a debt-financed stock acquisition, stock repurchase, or dividend.

Both the House and Senate bills would limit the ability of a corporation to carry back an NOL attributable to certain interest deductions to a taxable year preceding certain corporate equity-reducing transactions.

Interest Exclusion for Loans to ESOPs

Under current law, certain entities regularly engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a loan used by an ESOP to acquire employer securities.

The House and Senate bills both provide that the partial interest exclusion generally would be available only if the ESOP owns at least 30 percent of the stock of the employer.

Provisions Relating to Treatment of Stock and Debt

Both the House and Senate bills would provide the Treasury Department authority to characterize a single instrument as part debt and part equity, and to require reporting when control of a corporation is acquired or a recapitalization or other significant change in the capital structure of a corporation (including a transaction in which equity is replaced with debt) occurs.

In addition, the House bill would require the Treasury Department to study whether the present law distinctions between debt and equity are meaningful and whether there are cases in which it is appropriate to limit interest deductions, and to study the policy and revenue implications of integration and corporate interest and dividend distributions to tax-exempt entities and foreign persons.

V. CONCLUSION

We do not favor special income tax rules for airlines or for any other specific industry. The tax system should not contain special, industry-specific tax rules for LBOs. We firmly believe that any future changes in this area must be carefully crafted to maintain or increase the competitiveness of U.S. companies in the global economy. An important objective of such future changes in the tax system would be to achieve neutrality between debt and equity financing.

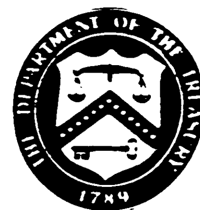
We believe the forthcoming Treasury Department studies on corporate integration and the depreciation of airline industry

assets will provide useful information and will help Congress evaluate these issues in the context of the airline industry in further depth.

The Treasury Department is interested in continuing to work with the Committee to analyze and develop appropriate tax policy with respect to these important economic and tax policy issues.

This concludes my prepared remarks. I would be pleased to respond to any questions.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
October 24, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $10,039 million of $24,175 million of tenders received from the public for the 2-year notes, Series AF-1991, auctioned today. The notes will be issued October 31, 1989, and mature October 31, 1991.

The interest rate on the notes will be 7-5/8%. The range of accepted competitive bids, and the corresponding prices at the 7-5/8% rate are as follows:

	Yield	Price
Low	7.72%	99.827
High	7.75%	99.772
Average	7.74%	99.791

Tenders at the high yield were allotted 49%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

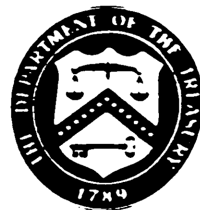
Location	Received	Accepted
Boston	$ 30,535	$ 30,535
New York	21,345,050	8,626,990
Philadelphia	17,920	17,920
Cleveland	30,725	30,725
Richmond	119,040	106,290
Atlanta	17,910	17,880
Chicago	1,294,910	450,760
St. Louis	49,460	37,460
Minneapolis	19,000	18,490
Kansas City	52,430	52,430
Dallas	13,485	10,935
San Francisco	944,710	398,960
Treasury	239,505	239,505
Totals	$24,174,680	$10,038,880

The $10,039 million of accepted tenders includes $819 million of noncompetitive tenders and $9,220 million of competitive tenders from the public.

In addition to the $10,039 million of tenders accepted in the auction process, $720 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,586 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-524

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
October 24, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $15,600 million, to be issued November 2, 1989. This offering will provide about $1,800 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,811 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, prior to 1:00 p.m., Eastern Standard time, Monday, October 30, 1989. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,800 million, representing an additional amount of bills dated August 3, 1989, and to mature February 1, 1990 (CUSIP No. 912794 TP 9), currently outstanding in the amount of $6,421 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,800 million, to be dated November 2, 1989, and to mature May 3, 1990 (CUSIP No. 912794 UC 6).

The Treasury will alter the auctions unless it has assurance of enactment of legislation to raise the statutory debt limit before the scheduled auction date of October 30, 1989.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing November 2, 1989. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $2,054 million as agents for foreign and international monetary authorities, and $3,530 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

NB-525

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

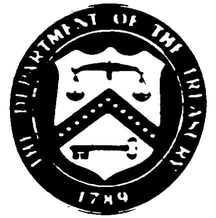
Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

8/89

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

TESTIMONY OF THE HONORABLE

NICHOLAS F. BRADY

SECRETARY OF THE TREASURY

BEFORE THE SENATE COMMITTEE ON BANKING,

HOUSING, AND URBAN AFFAIRS

OCTOBER 26, 1989

Chairman Riegle, Senator Garn, and Members of the Committee, thank you for inviting me to discuss the current state of the securities markets, their trend towards globalization, and continuing efforts by Congress and the Executive branch to address financial market issues.

The Committee certainly picked an appropriate time for this hearing: the market's fall and rise on October 13 and 16 underscored the continuing potential for volatility. It also showed us the real progress that has been made in several areas and highlighted some steps that we should take to reduce the chances of major market disruptions.

One important step is the enactment of the four proposals contained in S.648, "The Market Reform Act of 1989," which

several members of this Committee have co-sponsored. Another is the continuing effort of the Working Group on Financial Markets which addresses such key issues as circuit breakers, margin requirements, and clearance and settlement.

While my testimony today will address each of these steps, the time has also come to acknowledge that global securities markets are linked. In exploring international and intermarket linkages, I believe the United States should lead the way, and the Working Group decided just this week to begin the initial efforts to do so. A description of these efforts is set forth later in the testimony.

Let me now begin my remarks with a brief description of the market's sharp swing two weeks ago and the general condition of the markets since October of 1987.

October 13 through 16

The tailspin of the equity and derivative markets on Friday, October 13, raised fears of an eerie repeat of the Friday before the Monday collapse in October 1987. The Dow Jones Industrial Average lost 190 points, the second largest point drop ever and the 12th largest in percentage terms. Obvious imbalances existed between markets in New York and Chicago, as in 1987. Yet as we know, despite a two-day layover and the fourth highest trading

volume in history, on Monday the equities market recovered 50 percent of its losses without incident.

We will know much more about the events of two weeks ago -- and how they compared with October of 1987 -- when studies now underway by the regulatory agencies have been completed. Yet preliminary observations can be made.

First, as I said on October 13, it's important to recognize that the Friday decline does not signal any fundamental change in the condition of the economy. We continue to believe that the economy is well-balanced, with prospects for continued moderate growth.

Second, in many ways I think we can be reassured by how well the system functioned. Few, if any, of the operational problems that we witnessed in 1987 occurred, and although investor concerns were understandable, there was obviously a greater sense of confidence by all market participants. Contributing to this sense of confidence was the general recognition that markets in New York and Chicago really act as one market.

Furthermore, the systems that were put in place over the last two years to address market gyrations appeared to work

twice (the 250 point circuit breaker in the equities markets was never reached). These seemed to perform as designed and appeared to relieve some of the pressure on the stock market, but their performance needs to be analyzed carefully in order to draw any final conclusions.

Another positive development was the computer capacity added by the securities exchanges, which seemed more than adequate to handle the exceedingly high volume on October 16. As you know, the exchanges and the over-the-counter market soon will have the capacity to handle one billion share days, which will further improve market operations.

Over the weekend following October 13, the members of the Working Group were in constant communication with each other, the self-regulatory organizations, and the domestic and international markets. Together we collected information about risk to the system and major participants, and what reaction we could expect -- at both the retail and institutional levels -- on Monday.

Our most pressing concern was market overhang, the unfinished business that we hoped would not flood the market with sell orders on Monday. The futures market on Friday closed at a discount to the stock market, which was equivalent to 50 points on the Dow Jones average. This was a significant discount and an obvious cause for some concern.

Over the weekend, we canvassed retail firms, major investment banks, institutional investors, mergers and acquisition arbitrageurs, and mutual funds to assess conditions in the market. While we learned much that was helpful, other information that would have made our task easier -- such as large trader data in the equities market -- was simply unavailable. I believe that during our next period of market turbulence it would be extremely useful to have that data before us.

The Current Status of the Markets

Apart from the events of October 13, there is both good news and bad news about the current condition of the securities markets. The good news is that:

- Distortions from portfolio insurance have more or less disappeared, largely due to the dramatic reduction of that program trading strategy resulting from the general recognition that it simply does not work, rather than from any regulatory actions taken in the wake of October 1987;

- Prices seem more in line with fundamentals (S&P 500 price/earnings ratios have dropped from 21 to about 14,

- The economy continues to expand and the stock market has recovered; and

- The Administration's Working Group, in partnership with the regulators, self-regulatory organizations and member firms, has helped to substantially lessen possible systemic dangers to the U.S. financial system.

There is also some bad news:

- Participants, both institutions and individuals, have left the market in large numbers;

- The amount of new equity issued in the markets is off substantially, even in the face of an expansion -- for the first half of 1989, initial public offering volume was down 60 percent from the first half of 1987; and

- Extreme cases of market volatility continue to occur, with the Dow Jones down 141 points on January 8, 1988; down 101 on April 14, 1988; up 75 on May 31, 1988; and, of course, down 190 on October 13, 1989, and up 88 on the following Monday -- all of which underscore the need for market mechanisms capable of accommodating major moves.

In short, some of the specific weaknesses in market mechanisms are still with us and must be addressed. That is the reason that I believe the legislation before this Committee represents important steps in the right direction.

The Market Reform Act of 1989

As you know, we recently sent the Committee a letter expressing Administration support for "The Market Reform Act of 1989," a copy of which is attached. The bill's four important proposals, which respond to issues raised by the 1987 market break, would:

- Authorize the Securities and Exchange Commission (SEC) to take certain actions in a market emergency;

- Authorize the SEC to require large trader reporting of program or block trades;

- Direct the SEC and the Commodity Futures Trading Commission (CFTC), in consultation with the Federal Reserve, to facilitate linked or coordinated clearance and settlement of intermarket transactions, and grant the SEC authority, in

- Authorize the SEC to require reports from broker-dealers concerning the financial or operational health of their affiliates.

The Administration believes that all four proposals, with some modifications, will better prepare us for future market volatility. Since our attached letter details our reasons why, I will not repeat them here. I will only say that we stand ready to provide any technical assistance that the Committee may require.

The Progress and Agenda of the Working Group

We are generally pleased with the progress of the Working Group on Financial Markets, consisting of the Treasury Department, the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. Indeed, through the constructive actions of market participants, regulators and self-regulatory organizations, the Working Group has accomplished much of what was advocated by the commission I chaired in 1987 and 1988, the Task Force on Market Mechanisms. The Working Group focused on the significant suggestions of the Task Force and others that could be accomplished immediately to substantially lessen possible systemic dangers to the U.S.

financial system if we were again to encounter a severe stock market decline.

Most importantly, the Task Force's fundamental premise -- that the equity, futures and options markets are linked as one market -- has been widely accepted. This recognition of one market is the basis for the important private sector initiative embodying the Task Force's recommendation of coordinated circuit breaker mechanisms: the joint plan of the securities and futures exchanges to establish coordinated trading halts in their markets. We applaud the decision in October to extend the NYSE-CME circuit breaker.

In addition, the Working Group has formed a staff subgroup on circuit breakers which currently is reviewing the timing of release of important government economic data on days when contracts for equities, options, and futures expire -- the so-called triple- and double-witching days. The subgroup will also analyze the regulators' review of the performance of circuit breakers on October 13, and will specifically consider whether they need to be simplified and whether triggers should be adjusted and better coordinated.

In short, the Working Group has created a process for

of the year, and in the short time since Chairman Breeden's recent appointment to the SEC, we have held two meetings of Working Group principals. I believe that three of our most important agenda items are globalization of the securities markets, harmonization of margin requirements, and clearance and settlement issues, which I would now like to discuss.

Global Securities Markets

The Task Force I headed two years ago to study the 1987 market break concluded that our domestic securities and derivative markets are so closely linked as to constitute one market requiring coordinated policies and procedures. Although the world's securities and derivative markets are unified in only some respects, the evidence of their close linkages and interdependence has continued to grow:

- International transactions in securities have soared from levels earlier in this decade, particularly foreign purchases and sales of U.S. Treasury notes and bonds, which surpassed $3 trillion on a gross basis last year;

- Total foreign portfolio investment (corporate debt and equity) in the U.S. has increased from $74 billion in 1980 to an estimated $394 billion in 1988;

- U.S. portfolio investment in foreign countries in turn has risen over the comparable period from $63 billion to $157 billion;

- The growth of international indices and global funds feeds back into the demand for many U.S. securities, making them subject to conditions in world markets;

- The objective of developing within the European Community a single internal market for services and capital by 1992 is evidence of the changes taking place in world financial markets;

- Vastly improved technology has created instantaneous world-wide trading and information sharing;

- Deregulation of entry barriers to domestic markets, such as London's Big Bang, has also contributed to the integration of world markets; and

- Despite the growth of international securities transactions, clearance and settlement systems differ dramatically on a market-by-market and country-by-country basis.

global scale. The Working Group will identify particular issues where an international and intermarket approach would be useful. We will certainly keep Congress fully informed and consult with other countries as we proceed with efforts in this area.

Margin Requirements

As you know, the Task Force that I chaired on the 1987 market break recommended that margin requirements be harmonized between the equity and derivative markets. Thereafter, in 1988 the Working Group concluded that the then-current minimum margin requirements were sufficient for prudential purposes, and consistent between the two markets.

However, the futures markets subsequently reduced their minimum margin requirements to levels even lower than before the 1987 collapse. This raises questions whether futures and equity margin requirements are consistent at these levels and whether futures margins are adequate.

I am very concerned about these issues, because I believe there is a public interest involved beyond the private interest of the exchanges. I therefore intend to ask the Working Group to reconsider issues related to margin requirements.

Clearance and Settlement

Finally, let me mention one other item on the Working Group's agenda that is critically important: the intermarket clearance and settlement system. Sufficient progress in this area has not been achieved, although the Working Group has made a number of constructive proposals. Since clearance and settlement is the weakest link in the whole system, improving it would help ensure that a securities market failure does not become a credit market failure. It also would facilitate cross-margining in a safer, more straightforward way, with possible implications for margin levels.

The Working Group has reviewed existing clearing, payment and settlement systems to identify and set priorities for measures to reduce uncertainty, increase coordination, assure confidence in the integrity of such systems, and facilitate their smooth operation in volatile markets. It has proposed an agenda of specific actions in the following areas:

- Facilitation of timely payments. Several features of existing clearance and settlement systems relevant to payment capacity can be enhanced to facilitate the timely satisfaction of payment obligations, including increased Fedwire availability in highly volatile markets, coordinated

intermarket settlement processes, and increased availability of timely information concerning payment obligations and cash flows.

- <u>Exploration of methods to simplify settlement systems</u>. This would include a cross-margining pilot program for non-customer accounts in options and futures, and consideration of specific initiatives to reduce cash transfers, simplify settlements systems, and unify clearing.

- <u>Refinement of relevant legal frameworks</u>. It is important to harmonize transfer, delivery and pledge requirements for options and uncertificated securities at the federal level and to better coordinate bankruptcy protection for securities and commodity brokers.

In addition to these recommendations, a number of system refinements already are under way, such as the NYSE-NASD commitment to implement next-day comparisons. Useful studies have been completed or are in process, notably the Group of Thirty report in the international area and the American Bar Association task force on state laws.

Clearly, more needs to be done, both domestically and internationally, and the sooner the better. The proposal in S.648 to facilitate linked or coordinated clearance and

settlement systems would be a useful way to facilitate this process. Additional prompt and effective action on clearance and settlement is essential if we are serious about strengthening the weakest link in the system.

Conclusion

There is a continuing need to modernize our domestic markets to make them operate more effectively, while at the same time identifying those areas in which an international as well as an intermarket approach would be useful. This does not require burdensome new regulation. Furthermore, we cannot and should not attempt to eliminate major market moves, whether by legislation or regulation. But we do need to ensure that our markets are configured in the best manner possible to withstand the increasing demands that are placed on them.

We should concentrate on ensuring the preeminent position of the United States' markets in an increasingly global marketplace. This is no longer a parochial tug-of-war between markets in New York and Chicago. Unless we manage and configure our markets correctly, we will not maintain our leadership in the global marketplace -- and this is one industry where once we fall behind, it will be very, very, difficult to catch up.

* * * * *

Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the Committee may have.

THE SECRETARY OF THE TREASURY
WASHINGTON

October 24, 1989

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

In response to your request, this letter provides the Administration's views on S. 648, "The Market Reform Act of 1989."

"The Market Reform Act" contains four proposals that the Securities and Exchange Commission (SEC) submitted to Congress last year to address issues raised by the market break. The SEC subsequently proposed a revised version of two of its provisions. The key provisions of the bill would:

(1) authorize the SEC to take certain actions in a market emergency;

(2) authorize the SEC to require large trader reporting of program or block trades;

(3) direct the SEC and Commodity Futures Trading Commission (CFTC) to facilitate linked or coordinated clearance and settlement of intermarket transactions; and

(4) authorize the SEC to require reports from broker-dealers concerning the financial or operational health of their affiliates.

We believe all four of these proposals are constructive and, with minor modifications, the Administration supports each of them. The stock market's 190 point decline on October 13, 1989, only serves to reaffirm their importance, especially the ones dealing with large trader reporting and risk assessment.

Volatility in the financial markets is likely to continue, and we must take steps to ensure that the markets can sustain themselves in turbulent conditions. The four proposals in S. 648 are timely and important -- the sooner they are enacted the better prepared we will be for future market volatility.

1. Emergency Powers

We support in concept giving the SEC emergency powers similar to those of the CFTC. In doing so we are aware that the SEC remains concerned that the provision could diminish Executive Branch control over the financial markets during emergencies. We disagree for several reasons.

First, this provision is necessary to enable the SEC to take emergency action without procedural delay in response to a major securities market disturbance. It is appropriate for the initial response to market emergencies to come from a regulator with expertise and proximity to the markets.

Second, the legislation already provides for some Executive oversight by allowing the President to terminate SEC emergency actions and requiring his approval of any trading halt longer than 24 hours (the maximum duration would be three days).

Finally, we also believe that language should be added to the bill requiring the SEC to consult with the President, the Federal Reserve Board, and the securities self-regulatory organizations (SRO) prior to taking any emergency action. This close coordination should help to ensure that emergency actions are not taken precipitously.

2. Large Trader Reporting

We are strongly in favor of large trader reporting to facilitate SEC surveillance and enforcement, including curbing intermarket front-running and market manipulation. Increasing the SEC's authority in this area also would make it more comparable to the CFTC's.

The October 13 decline underscores the importance of this provision as well. While the CFTC was able to reconstruct large futures trading almost immediately, the SEC was forced to collect data from member firms -- a cumbersome process that impedes the agency's ability to do its job effectively.

The Task Force on Market Mechanisms recommended establishment of a large trader reporting system for the securities markets similar to the one used in the futures markets. Although the Working Group on Financial Markets did not have a specific recommendation on this issue, Treasury did testify that strong agency and SRO action was needed to curb intermarket front-running and market manipulation.

Although we strongly favor enhanced SEC information in this area, we are concerned about the cost burden of collecting and reporting this information as well as its confidentiality. We suggest a provision be added to the effect that the Commission, in promulgating any rule, regulation or order, shall pay due regard to existing reporting systems, the costs and benefits of the additional information to be required, etc. Additionally, to enhance coordination the provision should require consultation with the CFTC as to any SEC rulemaking and permit disclosure of the reports to other agencies.

On May 17, 1989 the SEC transmitted to Congress a revised large trader reporting provision and section-by-section analysis. The revised section-by-section states that the SEC would:

- take into account relevant differences among reporting entities in establishing reporting requirements;

- take into account the adequacy of SRO large trader reporting requirements;

- make every effort to minimize the economic burdens and utilize existing data streams;

- carefully consider the costs and benefits of beneficial ownership reporting and not require broker-dealers to report such information if it is not recorded in the normal course of business; and

- carefully consider the impact on capital formation and the relationship between U.S. and international securities markets.

Although this is an improvement over the original section-by-section, we suggest that language be added to the legislation itself requiring the SEC to pay due regard to these factors, as well as to the need for confidentiality.

The SEC's revised version of the large trader reporting provision deletes futures reporting, and the section-by-section deletes a reference to CFTC consultation. We believe the legislation should require consultation with the CFTC as to any SEC rulemaking, even if futures reporting is deleted.

To the extent the large trader reporting provision would require reporting on government securities transactions, Treasury should have the rulemaking authority, consistent with Treasury's existing authority under the Government Securities Act.

We support the new language in the SEC revision authorizing the SEC to share large trader information with other federal agencies and extending confidential treatment of such information under the Freedom of Information Act (FOIA) to information received by those agencies.

3. <u>Risk Assessment for Holding Company Systems</u>

The risk assessment reporting provision contains the SEC's proposal enhancing the Commission's ability to assess the activities of firms associated with broker-dealers which may materially affect the broker-dealer's operational or financial condition.

The October 13 experience again points out the need for this authority, particularly during turbulent market conditions. We and the financial regulators spent much of the weekend after October 13 trying to find information on bridge loans and other indicia of systemic risk. This information should have been made available to regulators <u>before</u> it was needed.

We do have some concerns, however, about extraterritorial application of the reporting requirement and both its possible chilling effect on foreign investment in the U.S. and its implications for foreign regulation of U.S. firms. We would urge that the exclusions be codified to the extent possible (rather than leaving them to the SEC's discretion). This would include, for example: (1) the provision allowing the Commission to exclude from the reporting requirement any information regarding diversified holding companies and international financial organizations that do not devote a significant portion of their consolidated assets to activities in the U.S. financial markets; and (2) the provision allowing the Commission to consider the primary business of any associated person and the nature and extent of domestic or foreign regulation of the associated person's activities (perhaps excluding small broker-dealers, or not requiring information from primarily non-financial holding companies or major foreign banks).

Treasury should be given the rulemaking authority with respect to government securities brokers and dealers, consistent with Treasury's existing authority under the Government Securities Act.

We support the new language in the SEC's May 17 revision allowing the SEC to share such information with other federal agencies, notwithstanding FOIA, and extending confidential treatment of such information under FOIA to information received by those agencies.

4. Coordinated Clearing and Settlement

The bill would require the SEC and CFTC, in consultation with the Federal Reserve Board, to facilitate the establishment of linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities and related options, and securities derivative instruments. In addition, it would grant the SEC authority, in consultation with Treasury, to prescribe uniform rules concerning the transfer of certificated or uncertificated securities.

The Working Group on Financial Markets endorsed the view that the proper functioning of clearance and settlement systems is integral to the proper functioning of the financial markets as a whole. It concluded, however, that private market solutions, where feasible, are preferable to legislation in this area. The Working Group recommended a number of incremental actions which generally could be taken by federal regulators within the scope of existing authority, to increase security and clarity of clearance and settlement arrangements, enhance public confidence, and increase coordination. It identified initiatives that could be taken by the securities futures and banking industries to ease potential cash flow strains in volatile markets by reducing the size of payment obligations. It also recommended studies of more fundamental modifications.

Notwithstanding the Working Group's views (and subsequent Treasury statements in accord with them), we now believe that legislation is needed to speed up the process of refining and coordinating intermarket clearance and settlement.

Clearance and settlement is one of the most critical issues remaining on the Working Group's agenda from the 1987 market break, and it remains the weakest link in the system. Although the Working Group developed a very constructive set of recommendations, there has been enough progress in this area so far, which is especially important in the international arena. Improving clearance and settlement would reduce the risk that a securities market failure could become a credit market failure. It also would facilitate cross-margining in a more straightforward way.

A number of system refinements already are under way, for example the New York Stock Exchange/National Association of Securities Dealers commitment to implement next day comparisons and the Options Clearing Corporation/Chicago Mercantile Exchange joint cross-margining program. Useful studies have been completed or are in process, notably the American Bar Association task force on state laws and the Group of Thirty report in the international area. But more needs to be done, and without undue

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at: 10:00 a.m.
Date: October 26, 1989

STATEMENT OF
KENNETH W. GIDEON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Administration on a number of miscellaneous revenue measures referred to the Select Revenue Measures Subcommittee. Accompanying my statement is a letter from Acting Tax Legislative Counsel Robert Wootton that addresses an issue related to the definition of tar sands.

A. ENERGY RELATED PROPOSALS

Current Law

Current law provides incentives for domestic oil and gas exploration and production by allowing the expensing of intangible drilling costs (IDCs) and the use of percentage depletion. These two incentives are subject to certain limitations and their benefits are included as preferences in the alternative minimum tax (AMT).

The search for new oil and gas reserves typically begins with certain preliminary tests (e.g., geological and geophysical tests) designed to determine the likelihood of discovering commercial quantities of hydrocarbons. If such tests suggest that oil and gas may be present, further tests may be conducted. New oil and gas reserves, however, are typically identified only by exploratory

amount by which the depletion deduction claimed for regular tax purposes exceeds the taxpayer's basis in the property at the end of the taxable year (disregarding the depletion deduction for the year). Treating such amounts as a preference item in computing AMTI may reduce or eliminate the benefit of permitting percentage depletion for certain taxpayers. The IDC tax preference is the amount by which a taxpayer's "excess IDCs" claimed with respect to successful wells exceed 65 percent of his net income from oil, gas, or geothermal properties. The "excess IDCs" are the amount by which the IDC deductions claimed for the year exceed the deductions that would have been claimed had the IDCs been capitalized and either amortized over 120 months or recovered through cost depletion. Thus, for AMT purposes, the IDC deduction for incremental IDC expenditures in excess of the net income limit is reduced to zero.

Proposals

1. Alternative Minimum Tax Relief

This proposal would eliminate 80 percent of current AMT preference items generated by exploratory IDCs incurred by independent producers effective January 1, 1990. Thus, independent producers would be allowed to deduct 80 percent (rather than zero, as under current law) of exploratory excess IDCs in excess of the net income limit for purposes of the AMT.

Administration Position

The Administration supports this proposal, which was among the proposals included in the President's budget.

Current law limits the incentive effects of IDC expensing and percentage depletion, particularly for independent producers, which have historically drilled a majority of our exploratory wells. Increasing levels of oil imports may raise both energy security and national security concerns. The Administration supports an energy policy that is designed to address these concerns by improving our long-term energy security and promoting a strong, competitive domestic oil industry.

An increase in domestic oil and gas reserves would improve our energy security. The level of proven domestic reserves is closely related to the level of domestic exploratory drilling. The level of domestic exploratory drilling, however, has fallen by 70 percent from recent levels, largely due to uncertainty concerning low world oil prices. In addition, over the same time period, development drilling has increased 20 percent, resulting in a substantial decline in domestic oil and gas reserves. Special tax incentives are appropriate to encourage higher levels of exploratory drilling which may lead to increased domestic reserves.

of the net income from the property. We continue to believe that this approach would provide a more effective incentive than increasing the taxable income limitation. Under current law, any depletion in excess of the 50 percent net income limitation is not carried over. Thus, this approach would increase aggregate deductions from affected properties. Furthermore, at current oil and gas prices the 50 percent net income limitation may significantly reduce the benefits of percentage depletion for production from properties generating a small amount of net income. Raising the net income limitation to 100 percent would allow some oil producers to claim greater depletion deductions, thus encouraging them to operate marginal properties. In combination with repeal of the transfer rule, increasing the 50 percent net income limit to 100 percent should preserve substantial marginal production. Moreover, raising the limit might also encourage added investment in exploratory drilling projects.

4. Definition of Independent Producer for Purposes of Section 613A(d)

The proposal would provide that for purposes of section 613A(d), an interest owned by an irrevocable section 501(c)(3) trust would not be treated as a significant ownership interest for purposes of defining an independent producer.

Administration Position

The Administration opposes this proposal. As a general matter, we do not believe that charitable organizations should be exempted from related party rules. In the absence of a compelling reason to provide a special rule for independent producers, we cannot support such an exemption under section 613A.

5. Investment Tax Credit for Alternative Fuels Vehicles

Current Law

Subject to certain restrictions and special rules, taxpayers are allowed to reduce the amount of income tax due for a taxable year by the amount of the general business credit. The general business credit is the sum of: (1) the investment tax credit; (2) the targeted jobs credit; (3) the alcohols fuels credit; (4) the research credit; and (5) the low-income housing credit.

The investment tax credit is based on the amount of eligible property placed in service during the taxable year. The credit is equal to the sum of: (1) the regular percentage of the taxpayer's qualified investment in section 38 property; (2) the energy percentage of the taxpayer's investment in energy property; and (3) the rehabilitation percentage of the taxpayer's qualified rehabilitation expenditures. Section 38 property generally

by such fuel (including storage tanks for such fuel at the point where such fuel is so delivered).

Clean-burning fuels would be defined as: (1) natural gas; (2) liquefied petroleum gas; and (3) any fuel at least 85 percent of which is methanol, ethanol, any other alcohol, ether, or any combination thereof.

The basis of property would not be reduced by the amount of the credit.

A State or any of its political subdivisions would be eligible to file a claim in an amount determined by treating all qualified clean-burning motor vehicle fuel property held by it as used in a trade or business, and by treating such State or political subdivision as subject to the federal income tax. Such claim would be paid by the Treasury Department.

Administration Position

The Administration opposes this proposal as we believe that it would create an inefficient subsidy. In particular, we oppose the portion of the proposal that would allow States and their political subdivisions to apply to the Treasury Department for a payment of an amount calculated as if such entity was a taxpaying business. The effect of this provision would be to create a program where funds are transferred from the federal government to State and local governments through the tax system. We believe that such transfers of funds should be made through a grant program pursuant to the appropriations process.

B. HIGH-TECHNOLOGY SMALL BUSINESSES

Introduction

The Administration has taken a leading role in encouraging businesses to conduct research and experimentation (R&E). After working closely with all interested sectors, the Administration proposed a permanent, restructured R&E credit. We support the permanent R&E credit contained in the Omnibus Budget Reconciliation Act of 1989 (H.R. 3299), which, while taking a different approach than the Administration proposal, similarly provides a sound tax incentive for the undertaking of R&E. Included in this restructuring is a specific set of rules designed to ensure that start-up businesses will share in the benefits of the R&E tax credit.

Our lack of support for some of the narrow, ad hoc proposals being considered today that relate to small business high-technology issues must be placed in this larger context. If the Congress desires to provide an R&E tax incentive to start-up companies and small businesses, it can do no better good than to

2. Treatment of Research and Experimental Expenditures Start-up Costs for the Alternative Minimum Tax Book Income Adjustment

Current Law

Taxpayers are allowed to currently expense R&E expenditures incurred in connection with the taxpayer's trade or business. Alternatively, taxpayers may elect to capitalize R&E expenditures and to amortize such capitalized costs over a 60-month or longer period. Unlike R&E expenditures, taxpayers are required to capitalize start-up costs. A taxpayer may elect, however, to amortize such costs over a 60-month or longer period.

The 1986 Act subjected corporations to the AMT system. Under this system, tax liability is equal to the greater of the taxpayer's regular tax liability and the "tentative minimum tax" (TMT). The TMT is equal to 20 percent (in the case of a corporation) of the taxpayer's AMTI, reduced by an exemption.

AMTI is equal to taxable income, computed with certain adjustments, and with the addition of certain items of preference. For corporations in taxable years beginning in 1987, 1988, or 1989, AMTI is adjusted to include 50 percent of the amount by which the corporation's income for financial statement purposes (book income) exceeds the corporation's AMTI determined without regard to this adjustment and the AMT net operating loss deduction (unadjusted AMTI). The regular tax deductions allowed for R&E expenditures and start-up costs are taken into account in determining unadjusted AMTI.

Proposal

Under the proposal, deductions for R&E expenditures and start-up expenses would be treated in the same manner as AMT net operating loss deductions. As a result, unadjusted AMTI would not be reduced by such deductions, and the corporation's adjustment for book income would be reduced. The deductions would continue to be allowed as a reduction of AMTI, however.

Administration Position

The Administration opposes creating retroactive exceptions to the book income adjustment. The adjustment was designed to ensure that profitable corporations pay an acceptable level of tax. This proposal, however, would enable certain corporations with sufficient R&E expenditures and/or start-up costs to reduce their tax liability to as low as one percent of book income. Accordingly, we believe such a retroactive change is inappropriate.

before the ownership change other than those attributable to R&E expense would remain subject to limitation under section 382.

Administration Position

We oppose these proposals. The proposal permitting a retroactive revocation of the election to deduct currently R&E expenses is administratively undesirable. In addition, treating unamortized research and experimental expenditures as not constituting built-in losses is inconsistent with the policy underlying the section 382.

In its current form, the proposal permitting an election to treat convertible preferred stock as having a value equal to the value of the common stock into which it could be converted for the purpose of testing for an ownership change solely with respect to pre-change losses attributable to R&E expenses would add substantial complexity to the application of section 382. In effect, the proposal would require application of two ownership change analyses with respect to a single corporation. In addition to this complexity, a very carefully drafted set of rules would be required to avoid the use of convertible stock to circumvent the purposes of section 382.

4. Personal Holding Company Income

Current Law

The personal holding company (PHC) provisions were enacted to prevent taxpayers from using the corporate form to avoid or defer the individual income tax. In the absence of these provisions, an individual, subject to an effective tax rate of 28 percent, could incorporate his stock portfolio in order to obtain a reduced tax rate of 10.2 percent on the income earned from such investments (34 percent maximum corporate tax rate after taking into account the 70 percent dividends received deduction). The PHC provisions prevent such avoidance by requiring a corporation to either distribute dividends to shareholders or incur a penalty tax.

Section 541 imposes a 28 percent penalty tax in addition to the regular corporate income tax on a PHC with respect to its undistributed (PHCI). In general, a corporation is considered a PHC if at least 60 percent of its adjusted ordinary gross income for the taxable year is comprised of PHCI and more than 50 percent of the value of its outstanding stock is owned by five or fewer individuals at any time during the last half of the taxable year. PHCI is generally comprised of certain personal service income and passive investment income such as dividends, rents, royalties, and interest. In computing its undistributed PHCI a PHC is allowed a deduction from its taxable income for the amount of certain dividends paid (or deemed paid) to its shareholders.

tax benefit.

The 1986 Act repealed the add-on minimum tax, and replaced it with the AMT system. Congress recognized in 1986 that the repeal of the old add-on minimum tax, and its replacement with a new system, created a transition issue with respect to minimum tax that had arisen in earlier years but was deferred under section 56(b). Accordingly, the 1986 Act provided that if the minimum tax of a corporation was deferred under section 56(b), and such minimum tax had not been paid for any taxable year beginning before 1987, net operating loss carryovers to tax years beginning after 1986 are reduced by the amount of the tax preferences the tax on which was deferred. This reduction applies only for purposes of the AMT system, and not for purposes of the regular tax. Thus, the provision increases a personal holding company's AMTI in a post-1986 tax year by the amount of preferences for R&E expenses arising in a pre-1987 tax year, if those preferences had not yet been subject to add-on minimum tax.

The inclusion of pre-1987 R&E preferences in post-1987 AMTI will, in many cases, produce a result that is more favorable to taxpayers than the result under prior law would have been. Although such preferences would potentially be subject to AMT at a rate of 20 percent (rather than 15 percent, as under prior law), such preferences will escape AMT entirely if the increase in AMTI that they produce is not sufficient to require payment of additional AMT. Even if the increase is sufficient to trigger imposition of additional AMT, the taxpayer will be permitted under section 53 to credit such tax against its regular tax, unless the taxpayer's preferences and adjustments are so great that the taxpayer is permanently subject to the AMT.

Proposal

The proposal would amend the 1986 Act transitional provision to forgive any deferred minimum tax which resulted from past R&E expensing.

Administration Position

The Administration opposes this proposal. This proposal is, in effect, a retroactive change in the law to forgive minimum tax imposed on past R&E preferences. The R&E expenses giving rise to these preferences have already been incurred. Thus, enactment of the proposal would not encourage new research.

use of the corporation's losses by virtue of the shareholder's continuing legal ownership of the corporation.

Proposals

In certain cases in which a loss corporation emerges from a title 11 proceeding or similar case and qualifies for the special treatment provided by section 382(l)(5), the proposal would permit redetermination of whether any ownership change occurred as the result of a worthless stock deduction taken by a 50-percent shareholder during the pendency of the proceeding. The proposal, in effect, would permit the loss corporation to test whether the deemed acquisition of the worthless stock would have caused an ownership change by treating such stock as representing a percentage ownership interest in the loss corporation equal to the relative percentage of the post-bankruptcy reorganization equity that is received in the reorganization with respect to such stock.

For example, if the sole shareholder of a loss corporation during the pendency of a bankruptcy proceeding deducts as worthless all of its stock in the corporation and the shareholder later acquires four percent of the stock of the reorganized corporation as the result of continuing to own such stock, the worthless stock deduction would be treated as resulting in an increase in the ownership of the loss corporation of only four percentage points (not 100 percentage points). Accordingly, the deemed acquisition of such stock would not alone cause an ownership change for the loss corporation. In such a case, the proposal would permit the corporation to amend its return for prior years in which losses were limited under section 382 (without regard to the otherwise applicable statute of limitations).

In addition, the proposal would require that a 50-percent shareholder must recapture any worthless stock deduction if the shareholder receives any stock in the post-bankruptcy corporation as the result of continuing to own the stock previously treated as worthless.

An alternative proposal would permit the loss corporation to redetermine whether an ownership change occurs only in cases in which a 50-percent shareholder owns no stock in the reorganized corporation after it emerges from bankruptcy. Under such an approach, there would be no recapture of a 50-percent shareholder's worthless stock deduction.

With respect to the determination of whether a corporation has experienced an ownership change, both proposals would be effective as if included in the 1987 Act. The requirement for the recapture of the worthless stock deduction under the first alternative proposal would be effective only with respect to worthless stock deductions claimed in taxable years ending after the date of committee action.

Administration Position

We generally defer to the judgment of Congress in setting the appropriate carryover period for capital losses. However, we do not support this proposal on the grounds that it could lose a significant amount of revenue outside the budget period.

4. Subchapter S Shareholder Limitation

Current Law

An S corporation can have no more than 35 shareholders. For purposes of the 35 shareholder limitation, a husband and wife (and their estates) are treated as one shareholder.

Proposal

For purposes of the 35 shareholder limitation, brothers and sisters (and their estates) would be treated as one person so long as all the stock of the corporation is owned by members of the same family.

Administration Position

Treasury does not support this proposal. Although husband and wife are frequently treated as one unit under the Internal Revenue Code, the community of interest of brothers and sisters is presumably less substantial than that of marriage. The proposed sibling unity rule would minimize, if not effectively eliminate, the impact of the shareholder limitation on family-owned S corporations.

D. RICS, REITS AND REMICS

1. Hedging Activities of Real Estate Investment Trusts

Current Law

To qualify as a real estate investment trust (REIT), an entity must satisfy several gross income tests. First, at least 75 percent of its gross income must be derived from real estate sources, including rents from real property and gain from the sale or other disposition of real property. Second, at least 95 percent of its gross income must be derived from passive sources, including sources satisfying the 75 percent test, dividends, interest, gain from the sale or other disposition of stock or securities. Finally, less than 30 percent of its gross income may be derived from the sale or other disposition of stock or securities held for less than one year, property in a prohibited transaction, or, with certain exceptions, real property held for less than four years.

2. Treatment of Interests in Regulated Investment Companies

Current Law

Under section 582(c), the sale or exchange of a bond, debenture, note or certificate or other evidence of indebtedness by a bank (as defined) is not treated as the sale or exchange of a capital asset, and so generates ordinary, as opposed to capital, gain or loss. This rule reflects the notion that all of a bank's transactions in debt instruments are conducted in the ordinary course of its business of loaning money. Generally, the tax treatment of a taxpayer's interest in a regulated investment company (RIC) is not determined by "looking-through" to the character of the RICs assets. Thus, absent a specific reference to RICs in section 582(c), the sale or exchange of an interest in a RIC would generate capital gain or loss, without regard to the type of assets held by the RIC. Section 582(c) specifically treats a regular or residual interest in a REMIC as an evidence of indebtedness for this purpose.

Under section 7701(a)(19), the term "domestic building and loan association" is defined by reference to a number of tests, one of which requires that at least 60 percent of a qualifying institution's assets consist of various qualified assets. For this purpose, qualified assets include real estate loans and similar obligations, specifically including regular or residual interests in a REMIC. Qualified assets do not include interests in RICs, whether or not the assets of the RIC would be qualified assets if owned directly by the financial institution.

Proposal

The proposal would amend section 582(c) to provide that the sale or exchange of shares in a RIC will not be treated as the sale or exchange of a capital asset if 95 percent or more of the mutual fund's assets consist of bonds, notes, or other evidences of indebtedness. Also, section 7701(a)(19) would be amended to provide that shares in a RIC would constitute a qualified asset for purposes of the 60 percent asset test for thrifts to the extent that the assets of the RIC consist of qualified assets. If 95 percent or more of the assets of the RIC are qualified assets, the entire interest in the RIC would be a qualified asset.

Administration Position

We do not oppose the proposal to amend section 582(c). Although the proposal is arguably inconsistent with the general tax theory of RICs in that it requires "looking-through" the RIC to determine the character of the holding, it would be consistent with the policy of the Office of the Comptroller of the Currency which permits national banks to purchase RIC shares where the underlying assets of the RIC consist solely of obligations eligible for direct

Proposal

Under the proposal, a mutual savings bank that fails the 60 percent test (or otherwise changes to the specific charge-off method) may elect to recapture the experience portion (i.e., the amount the reserve would have been had the institution used the bank experience method rather than the generally more favorable percentage of taxable income method) using the 4-year recapture method. Any actual losses with respect to pre-change loans would be charged to the reserve (rather than deducted) to the extent the cumulative amount of such losses exceeds the cumulative amount of reserves to be recaptured as of the end of the taxable year. Any remaining reserves would be recaptured only to the extent required under section 593(e) in the event of a taxable liquidation or distribution in excess of post-1951 earnings.

Administration Position

The Administration opposes this proposal. The treatment of large institutions that fail the 60 percent test was adequately resolved by the 1986 Act. Such institutions may choose between recapturing their entire reserve over 4 years or retaining the reserve method for pre-disqualification loans (i.e., the cut-off method). Under the cut-off method, the entire reserve would be "recaptured" either through charge-offs of pre-disqualification loan losses to the reserve, or through income inclusion to the extent that the reserve balance exceeds the remaining balance of pre-disqualification loans. The proposal allows thrifts to recapture less than the full amount of the reserve.

F. TAX EXEMPT BONDS

1. Hospital bonds

Current Law

Bonds that finance activities of nongovernmental persons are private activity bonds. Certain private activity bonds, including qualified 501(c)(3) bonds, may be tax exempt, subject to the sate volume limit and other requirements. A 501(c)(3) organization generally may not have more than $150 million in outstanding tax-exempt bonds. This limitation does not apply to hospitals. There is no requirement that institutions that utilize qualified 501(c)(3) bonds provide any indigent care.

Proposal

The proposal would subject hospital bonds to the generally applicable $150 million volume limitation unless the hospital provides a minimum level of care to indigents. The minimum level of indigent care would be computed over a three year average based

A second exception to the general rule for private activity bonds permits tax-exempt financing for certain activities of section 501(c)(3) organizations. Section 145 provides that qualified 501(c)(3) bonds may be issued to finance residential rental housing when such housing is an exempt purpose of the issuing non-profit organization owning and operating the housing. The low-income tenant minimum set aside requirements generally applicable to private, for-profit qualified residential rental projects only apply to qualified 501(c)(3) bonds when the proceeds are used to finance the acquisition of existing property.

Proposal

Qualified 501(c)(3) Bonds. -- H.R. 151 generally would require that bonds issued by section 501(c)(3) organizations to finance residential rental property, whether new or existing, satisfy the low-income tenant minimum set aside requirements under section 142(d). Consistent with these requirements, the residential units must be available to qualifying members of the general public, and the bill would clarify that qualified continuing care facilities are subject to the requirements. Bonds failing the requirements would not be qualified 501(c)(3) bonds treated as tax-exempt financing, however, an exception would be provided for new residential rental property financed with the proceeds of bonds issued by a general purpose governmental unit and primarily secured by the full faith and credit of such unit.

Governmental Bonds. -- H.R. 151 generally would expand the class of governmental bonds subject to arbitrage rules, by treating as investment property any residential rental property for family units located within the issuer's jurisdiction unless either: (1) the property satisfied the low-income tenant minimum set aside requirements under Code section 142(d); or (2) the bonds are issued by a general purpose governmental unit and primarily secured by the full faith and credit of such unit. Rental property acquired to implement a court ordered or approved housing desegregation plan would remain exempt from these requirements.

H.R. 151 generally would be applicable to bonds issued after January 3, 1989. Exceptions would be provided for construction in progress or subject to binding agreement. Additional exceptions would be provided for certain refunding bonds.

Administration Position

The Administration does not oppose the substance of this proposal as it relates to qualified 501(c)(3) bonds, but we object to the retroactive effective date suggested. We do not support the proposal to modify the arbitrage rules in order to restrict governmental investment in real estate activities. We believe that the arbitrage rules are an inappropriate means to accomplish the

be secured by the full faith and credit of the issuer and (2) loans made with the proceeds of the bond issue for housing must charge an interest rate no greater than one half of the rate the issuer is paying on the bonds.

The initial occupants of such housing would be required to satisfy certain income targeting requirements. In addition, any loans made under the proposal would have to provide restrictions, enforceable against the property so financed, that would encourage continued low- and moderate-income use.

Income Targeting Requirements. -- The tenants or owners of the housing financed using these bonds would be required to satisfy income targeting requirements. In the case of owner-occupied housing the purchaser would be required to meet present law requirements for qualified mortgage bonds. Tenants of new or substantially rehabilitated rental housing would be required to have family incomes at or below area median income adjusted for family size. Any occupied existing housing using the proceeds of an issue under the proposed exception would be required to be located in a census tract in which the median income is no greater than 80 percent of the area median income.

Provisions to Provide for Long-Term Housing. -- In the case of an owner-occupied residence which was purchased with loans made from qualifying bond proceeds, the proposal would require that any subsequent sale satisfy one of two alternatives: (1) any subsequent owner during the 10-year period following the initial purchase must satisfy the income tests applicable to qualified mortgage bonds; or (2) on any sale which is made during the 15-year period following the initial purchase, the interest rate subsidy would be recaptured upon disposition to the extent there is any gain on the sale of the property.

In the case of rental housing, rent on all assisted units would be restricted to a level set by the issuer at time of initial occupancy. Any increases in rent in subsequent years would be determined by the issuer, based upon increases in operating and maintenance costs in the jurisdiction. Subsequent vacant units could be rented only to tenants with incomes no more than four times the rent. For new or substantially rehabilitated rental housing, cooperative or condominium conversion would be barred for a least 15 years. For existing housing, cooperative or condominium conversion would be barred for the term of loan, unless the loan is repaid earlier.

The proposal would be effective for bonds issued after December 31, 1989.

Administration Position

The Administration does not support this proposal because we believe that the exceptions and structure established for private

G. EXCISE TAXES

1. Structure of Alcohol Occupational Taxes

Current Law

Occupational taxes are imposed on numerous business activities involving the production, marketing, and use of alcohol products. These include the following annual taxes: a tax of $250 per place of business in the case of retail dealers in alcoholic beverages; a tax of $500 per place of business in the case of wholesale dealers in alcoholic beverages, persons receiving drawbacks (refunds) of the excise taxes paid on distilled spirits used for nonbeverage purposes, and producers of alcoholic beverages having gross receipts of less than $500,000 for the preceding taxable year; and a tax of $1,000 per place of business in the case of producers having gross receipts of $500,000 or more for the preceding taxable year.

Proposal

The proposal would redistribute the burden of the occupational taxes. The annual tax would be reduced from $250 to $165 per place of business in the case of retail dealers in alcoholic beverages, and from $500 to $250 in the case of persons receiving drawbacks with respect to less than 250 proof gallons of distilled spirits. The annual tax would be increased from $500 to $5,000 per place of business in the case of persons receiving drawbacks with respect to 250 or more proof gallons of distilled spirits, and from $500 to $2,000 per place of business in the case of wholesale dealers in alcoholic beverages. The annual tax imposed on producers of alcoholic beverages other than wine would be increased from $1,000 to $5,000 per place of business in the case of producers having gross receipts of $500,000 or more for the preceding taxable year, and from $500 to $2,500 in the case of producers having gross receipts of less than $500,000 for the preceding taxable year. In the case of wineries, the annual tax imposed on the producer would be increased from $1,000 to $5,000 per place of business if the producer had gross receipts of $750,000 or more for the preceding taxable year, and would either be reduced from $1,000 to $500 or remain at $500 if the producer had gross receipts of less than $750,000 for the preceding taxable year.

Administration Position

The Administration does not oppose this proposal, based on our understanding that it will have little if any revenue impact.

that compliance levels have increased from 40 percent before 1987 to 80 percent at present despite a 500 percent increase in the tax rate suggests that lack of knowledge was the primary cause of noncompliance in years before 1987. In these circumstances, the Committee might reasonably conclude that the original proposal achieves an equitable result.

The exemption from taxes provided under the modified proposal is more troublesome than the waiver of interest and penalties. We would be particularly concerned if the exemption resulted in the forgiveness of significant amounts of tax.

H. INDIVIDUALS

Alternative Minimum Tax Deduction for Investment Expenses

Current Law

Expenses paid or incurred by an individual (1) for the production or collection of income, (2) for the management, conservation, or maintenance of property held for the production of income, or (3) in connection with the determination, collection, or refund of any tax are deductible for purposes of the regular tax, but only to the extent that such expenses, when aggregated with other miscellaneous itemized deductions, exceed two percent of the individual's adjusted gross income. These expenses, however, are not deductible for purposes of the AMT applicable to individuals.

Proposal

The proposal would allow individuals an AMT deduction for expenses paid or incurred (1) for the production or collection of income or (2) for the management, conservation, or maintenance of property held for the production of income, to the extent such expenses are deductible for regular tax (*i.e.*, the amount by which such expenses, when aggregated with other miscellaneous itemized deductions, exceed two percent of the individual's adjusted gross income). The AMT deduction for such expenses would be further limited to the individual's net investment income for the taxable year.

Administration Position

The Administration does not oppose this proposal, provided that it would have a minimal revenue impact, or would be appropriately offset. It is appropriate, in the context of the AMT, to allow deductions for investment

DEPARTMENT OF THE TREASURY

WASHINGTON

October 26, 1989

Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman and Members of the Subcommittee:

This letter is attached to the testimony of Kenneth W. Gideon, Assistant Secretary (Tax Policy) of the Department of the Treasury, given to the Subcommittee today at its hearing on miscellaneous revenue measures. It addresses a proposal concerning the definition of "tar sands" for purposes of section 29 of the Internal Revenue Code.

As you know, section 29 provides a credit for the production of fuels from a variety of nonconventional sources, including tar sands. The statute does not define the term "tar sands".

The Internal Revenue Service recently issued a technical advice memorandum*/ that sets forth an interpretation of the definition of tar sands (the "process-based definition"). This interpretation follows a ruling issued in 1976 by the Federal Energy Administration, FEA Ruling 1976-4, 41 Fed. Reg. 25,886 (1976), and defines tar sands for purposes of the section 29 credit as follows:

> The several rock types that contain an extremely viscous hydrocarbon which is not recoverable in its natural state by conventional oil well production methods including currently used enhanced recovery techniques. The hydrocarbon-bearing rocks are variously known as bitumen-rocks, oil impregnated rocks, oil sands, and rock asphalt.

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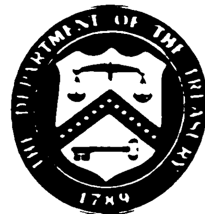
* A technical advice memorandum is furnished by the National Office of the Internal Revenue Service upon the request of a district office for guidance as to the interpretation and proper application of the internal revenue laws in connection with the examination of a particular taxpayer's return or claim for refund. It cannot be used or cited as precedent by other taxpayers.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 9:30 a.m.
October 26, 1989

STATEMENT OF
HARVEY ROSEN
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON INVESTIGATIONS AND OVERSIGHT
COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to respond to several questions that you have raised concerning the possibility of imposing the Federal gasoline excise tax at the point at which gasoline is first removed from the refinery. Your October 12 letter to Secretary Brady pointed out that the Treasury Department's December 1987 "Report to Congress on Evasion of Federal Gasoline Excise Tax" indicated that the only practical solution to evasion is to impose the tax at the point at which gasoline is first removed from the refinery. Your letter asked the following questions about such a change:

(1) What advantage would there be to moving the collection point to the "refinery gate"?

(2) How could problems related to tax exempt sales and the blending of petroleum products be overcome?

(3) Would there be a competitive advantage for markets close to regional refineries?

Your letter raised a fourth question regarding coordination between the Internal Revenue Service and the Customs Service, which has already been addressed by the IRS.

Before responding to the specific questions that your letter raised, I want to point out that, in testimony given subsequent to the 1987 report, the Treasury Department stated that it did not support movement of the collection point to the "refinery gate". In testimony on March 16, 1988, before the Subcommittee on Energy and Agricultural Taxation of the Senate Finance Committee, former Deputy Assistant Secretary Dennis E. Ross stated that:

petroleum products, such as butane, that can be used either for blending with gasoline as octane enhancers, or to produce plastics. Naphtha is the principal component of gasoline, but may also be used as a petro-chemical feed stock or as a solvent. To the extent that petroleum products are not used to produce gasoline, they should not be subject to the gasoline excise tax; however, if they are used for blending with or into gasoline, they should be taxed. The problem is that the refinery may not know to which of these uses the product will be put. This problem does not exist under current law, because blending of additives generally takes place prior to the point of taxation. Our preliminary estimate is that approximately 8 percent (9 billion gallons annually) of petroleum product that could become gasoline is not gasoline when it leaves the refinery system.

There are two general directions to take in responding to these problems. First, Congress might require refiners to pay tax on all of their products that can be used for blending with or into gasoline, and then require industrial users (or persons selling to such users) to apply for refunds or credits. Alternatively, Congress might exempt completely from tax any product that can be used for purposes other than producing gasoline, and then assess the tax on such products at the time they actually become gasoline.

Both approaches have obvious weaknesses. The first approach would, in effect, require loans to the Federal Government, which we believe would impose a burden on affected businesses. This approach might also create a massive administrative burden both for the IRS (which would be required to process refund or credit claims) and for industrial users (which would be required to prepare such claims). It is unlikely that the IRS could audit all claims before allowing them, leading to opportunities for false claims, and revenue loss.

The second approach would turn all blenders into taxpayers, thereby increasing the number of taxpayers and negating in part the benefits expected from moving the collection point.

Sales between refineries pose an even more difficult problem. Inter-refinery sales would either require an elaborate credit system or a system of refunds.

Another problem involves gasohol. Because gasohol blenders generally purchase gasoline for blending at the terminal, all gasoline sold to blenders would be fully tax-paid at the time of sale. Thus, either persons selling gasoline to blenders, or blenders themselves, would be required to claim credits or refunds of the difference between the full rate of tax already imposed upon such gasoline (9.1 cents per gallon) and the reduced rate imposed on gasoline used to make gasohol (3.44 cents per gallon). It would not be possible, as it is under the current system, to impose tax at the reduced rate on sales to gasohol blenders. (Under current law, tax is imposed at the reduced rate

on a sale to a gasohol blender if the blender blends within 24 hours.)

An additional problem involves persons other than refiners that produce products for blending with gasoline. One example is MTBE (methyl tertiary butyl ether), an octane enhancer generally produced by chemical companies. Such products are customarily added to gasoline before it leaves the terminal and thus, under current law, are subject to tax as part of the gasoline. If the collection point were moved to the refinery, such products could escape taxation unless Congress required tax to be paid either by the manufacturer, or by the blender. In either case, the number of taxpayers would be increased beyond the number of refineries, thereby negating in part the benefit of moving the collection point.

We do not expect that moving the collection point to the refinery would create additional problems for exempt users of gasoline such as State and local governments and farmers. Because these users generally purchase gasoline at a point in the distribution chain below the collection point under current law, it is not possible currently to exempt sales to these users from tax. Under current law, farmers are required to buy gasoline for farm use tax-paid and then claim a credit or refund. State and local governments may purchase gasoline tax-paid and apply for a refund, or, alternatively, such governments may purchase gasoline at a price that does not include the tax, even though tax has already been imposed on such gasoline, with the seller claiming a refund or credit for such tax. Movement of the collection point to the refinery would not require changes in these procedures.

III. Competitive Disadvantage

Movement of the collection point to the refinery would put refiners that are a long distance from their customers at a disadvantage compared to refiners that are located close to their customers. In effect, refiners located at a long distance from their customers (or customers of those refiners) would be required to finance the amount of the tax for a longer period of time than refiners located near to their customers.

That concludes my prepared remarks.

PRESS RELEASE

O V E R S I G H T B O A R D

RESOLUTION FUNDING CORPORATION

FOR IMMEDIATE RELEASE
October 25, 1989

CONTACT: Art Siddon
202-387-7667

REFCORP ANNOUNCES RESULTS OF AUCTION OF 30-YEAR BONDS

The Resolution Funding Corporation has accepted $4,522 million of $12,974 million of tenders received from the public for the 30-year bonds, Series A-2019, auctioned today.1/ The bonds will be issued October 30, 1989, and mature October 15, 2019.

The interest rate on the bonds will be 8 1/8%. The range of accepted competitive bids, and the corresponding prices at the 8 1/8% interest rate are as follows:

	Yield	Price2/
Low	8.14%	99.821
High	8.15%	99.709
Average	8.15%	99.709

Tenders at the high yield were allotted 90%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

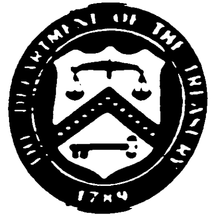
Location	Received	Accepted
Boston	$ 10	$ 10
New York	12,220,820	4,434,120
Philadelphia	--	--
Cleveland	--	--
Richmond	4,018	1,018
Atlanta	3,020	3,020
Chicago	398,000	63,900
St. Louis	2,000	2,000
Minneapolis	1,000	1,000
Kansas City	1,000	1,000
Dallas	2,000	--
San Francisco	342,100	16,000
Totals	$12,973,968	$4,522,068

The $4,522 million of accepted tenders includes $131 million of noncompetitive tenders.

1/ The minimum par amount required to strip the REFCORP bonds is $320,000. Larger amounts must be in multiples of that amount.

2/ In addition to the auction price, accrued interest of $3.34821 per $1,000 for October 15, 1989, to October 30, 1989, must be paid.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

Contact: Cheryl Crispen (202) 566-5252
Barbara Clay (202) 395-3080

FOR IMMEDIATE RELEASE
October 27, 1989

JOINT STATEMENT OF
NICHOLAS F. BRADY,
SECRETARY OF THE TREASURY,
AND
RICHARD G. DARMAN,
DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET,
ON
BUDGET RESULTS FOR FISCAL YEAR 1989

SUMMARY

The Treasury Department is today releasing the September Monthly Treasury Statement of Receipts and Outlays of the United States Government. The statement shows the actual budget totals for the fiscal year that ended on September 30, 1989, as follows:

-- total receipts of $990.8 billion;

-- total outlays of $1,142.9 billion; and

-- a deficit of $152.1 billion.

NB-529

Table 1. TOTAL RECEIPTS, OUTLAYS, AND DEFICITS
(in billions of dollars)

	Receipts	Outlays	Deficits (-)
1988 Actual	908.2	1,063.3	-155.2
1989:			
February Budget Estimate.....	978.9	1,143.0	-164.1
July Mid-Session Review Estimate (with REFCORP entirely off-budget)........	995.7	1,144.0	-148.3
Mid-Session Review Estimate (with on-budget FIRREA financing).................	996.0	1,163.1	-167.2
Actual.......................	990.8	1,142.9	-152.1

Note: 1988 actuals and February and Mid-Session Review estimates have been adjusted to conform to current accounting practices for customs fees.

DEFICIT

The deficit for 1989 was $152.1 billion, $3.1 billion lower than the 1988 deficit. The actual 1989 deficit was only $3.8 billion higher than the July Mid-Session Review (MSR) estimate, which assumed REFCORP financing off-budget, but $15.1 billion lower than the MSR estimate after it had been adjusted for enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which provided on-budget financing in 1989.

RECEIPTS

Receipts were estimated in the February budget at $978.9 billion, and were revised upward to $995.7 billion in the July MSR. Actual receipts for 1989 were $990.8 billion, $11.9 billion higher than the February budget estimate, but $4.9 billion lower than the July MSR estimate. Relative to the MSR estimates, most of the difference is attributable to lower-than-anticipated estimated payments of liabilities by both corporations and individuals.

Changes in Receipts According to Source

-- Individual Income Taxes were $445.7 billion, $0.4 billion higher than the $445.3 billion estimated in MSR. Withheld taxes were somewhat higher than previously estimated, and previously credited collections from unemployment insurance taxes and employment taxes and contributions were reallocated to individual income taxes. These reallocations were based on more recent data provided by employers. Non-withheld payments were below the MSR estimate.

-- Corporation Income Taxes were $103.3 billion, $2.5 billion lower than the $105.8 billion estimated in MSR, in large part due to lower-than-anticipated estimated payments of 1989 liability.

-- Employment Taxes and Contributions were $332.9 billion, $1.2 billion lower than the $334.1 billion estimated in MSR due to the larger-than-expected reallocation of collections between employment taxes and contributions and income taxes, discussed above.

-- Unemployment Insurance Receipts were $22.0 billion, $0.7 billion lower than the MSR estimate due to the reallocation of collections between unemployment insurance receipts and individual income taxes, discussed above.

-- Customs Duties were $16.3 billion, $0.7 billion lower than the MSR estimate, in part due to a lower-than-anticipated effective tax rate on the level of merchandise imports.

OUTLAYS

Total outlays in the February budget were estimated at $1,143.0 billion. This estimate was increased by $1.0 billion to $1,144.0 billion in the MSR, reflecting the net impact of technical re-estimates, policy changes, and a revised economic forecast. Actual 1989 outlays were $1,142.9 billion, $1.1 billion below the MSR estimate.

The $1.1 billion decrease from the MSR estimate is the net result of numerous increases and decreases. Outlays of the newly created Resolution Trust Corporation (RTC) were assumed in the MSR to be financed by the off-budget Resolution Funding Corporation, and budgetary outlays by the RTC were assumed to net to zero. Because of the on-budget financing for 1989, actual RTC outlays were $9.1 billion. Outlays were also higher than anticipated for the Department of Defense - Military ($2.1 billion above the MSR estimate). These and other increases were more than offset by

lower than anticipated outlays for the Federal Deposit Insurance Corporation ($3.3 billion below the MSR estimate), the Department of Agriculture ($2.9 billion below the MSR estimate), the Department of Health and Human Services -- except Social Security ($1.7 billion below the MSR estimate), Funds Appropriated to the President ($1.2 billion below the MSR estimate), the Office of Personnel Management ($1.1 billion below the MSR estimate), and other agencies.

Outlay Changes by Agency and Program

The major outlay changes since the July MSR are described below. Table 2, which follows this discussion, displays the estimates for the February Budget and the July MSR and the actual levels by agency and major program.

Funds Appropriated to the President. Outlays of Funds Appropriated to the President were $4.3 billion, $1.2 billion lower than the $5.5 billion estimated in MSR. The difference was largely due to changes in the Foreign Military Sales Financing (FMSF) program, where collections exceeded outlays by $2.2 billion, $1.3 billion more than in MSR, when it was estimated that collections would exceed outlays by $0.9 billion. This difference was in part due to unanticipated prepayments of $1.0 billion in FMSF loans and $0.4 billion in outlays of various country programs that did not occur.

Department of Agriculture. Outlays of the Department of Agriculture were $48.4 billion, $2.9 billion lower than the $51.4 billion estimated in MSR. In large part, this was due to lower outlays by the Commodity Credit Corporation (CCC). CCC outlays were $10.7 billion, $3.0 billion lower than estimated in MSR due in part to bad weather in 1989. Higher world prices for cotton, rice, and corn resulted in fewer new loans and more repayments of existing loans.

Department of Defense-Military. Outlays of the Department of Defense-Military were $294.9 billion, $2.1 billion higher than the $292.7 billion estimated in MSR, due primarily to higher-than-projected fuel prices, a decline in the value of the U.S. dollar, and faster-than-estimated spending in various accounts.

Department of Health and Human Services -- except Social Security. Outlays were $172.3 billion, $1.7 billion below the $174.0 billion estimated in MSR, largely due to medicare. Medicare outlays were $96.5 billion, $1.3 billion lower than the $97.8 billion estimated in MSR. Medicare MSR estimates reflected significant adjustments to the February estimates. These adjustments were based on highly preliminary trends in then-year-to-date spending. In the case of Supplemental Medical Insurance benefits, the downward trend appears to have accelerated, resulting in actual outlays of $0.5 billion lower than the MSR estimate. In the case of Hospital Insurance benefits, the upward trend appears to have moderated, resulting in

actual outlays of $0.6 billion lower than the MSR estimate.

Office of Personnel Management. Outlays of the Office of Personnel Management were $29.1 billion, $1.1 billion lower than the MSR estimate of $30.2 billion due primarily to fewer retirees than assumed in MSR, and because lower than anticipated payments were made to retirees who chose to withdraw their benefits in a lump-sum.

Federal Deposit Insurance Corporation. Outlays were $11.5 billion, $3.3 billion lower than the MSR estimate of $14.8 billion.

-- Bank Insurance Fund. Outlays were $2.8 billion, $1.5 billion lower than the MSR estimate. The decrease in net outlays reflects delays in payment of costs associated with resolution of two failed banks. In addition, proceeds from the sale of FDIC's interest in Continental Illinois National Bank and the sale of NCNB stock reduced net outlays. These decreases were partially offset by an increase in disbursements for other failed banks.

-- FSLIC Resolution Fund. Outlays were $8.8 billion, $1.7 billion below the MSR estimate due to fewer than expected notes issued and cash payments made on pre-1989 FSLIC case resolutions.

Resolution Trust Corporation (RTC) -- Outlays were $9.1 billion for 1989. The MSR assumed that $50 billion would be raised for the RTC over three years through the off-budget Resolution Funding Corporation (REFCORP). Under the assumed financing arrangement, the receipt and expenditure by RTC of the REFCORP proceeds would not have added to net budgetary outlays. Thus the MSR estimate for RTC was zero.

FIRREA, as finally enacted in August, 1989, authorized that $18.8 billion of the $50 billion for RTC be provided directly out of Treasury funds in 1989. The actual outlays of $9.1 billion fell short of the revised August estimate of $18.8 billion because the process of resolution of a number of savings and loan cases was not completed by September 30.

Table 2.—1988 and 1989 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

Receipts by Source	1988 Actual a/	1989 Estimate February a/	1989 Estimate July a/	1989 Actual
Individual income taxes	401,181	427,121	445,329	445,690
Corporation income taxes	94,195	107,422	105,772	103,291
Social insurance taxes and contributions:				
Employment taxes and contributions	305,093	336,837	334,062	332,859
On-budget	(63,602)	(69,325)	(69,318)	(69,193)
Off-budget	(241,491)	(267,512)	(264,744)	(263,666)
Unemployment insurance	24,584	23,097	22,687	22,011
Other retirement contributions	4,658	4,737	4,737	4,546
Subtotal, Social insurance taxes and contributions	334,335	364,671	361,487	359,416
Excise taxes	35,540	33,977	34,104	34,386
Estate and gift taxes	7,594	7,850	8,516	8,745
Customs duties	15,411	16,141	17,064	16,334
Miscellaneous receipts	19,909	21,755	22,749	22,927
Proposed legislation	---	---	697	---
Total, Receipts	908,166	978,937	995,718	990,789
On-budget	(666,675)	(711,425)	(730,974)	(727,123)
Off-budget	(241,491)	(267,512)	(264,744)	(263,666)

a/ FY 1988 actuals and February and July estimates for FY 1989 have been adjusted to conform to current accounting practices for customs fees.

Table 2.—1988 and 1989 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

	1988	1989		
		Estimate		
	Actual a/	February a/	July a/	Actual
Outlays by Major Agency				
Legislative branch and the Judiciary	3,189	3,721	3,740	3,587
Executive Office of the President	121	126	127	124
Funds Appropriated to the President:				
International Security Assistance:				
Foreign Military Sales Financing	-75	-923	-923	-2,241
Economic Support Fund	3,184	3,360	3,381	3,573
Other	1,164	-62	-165	-321
International development assistance	2,980	3,031	3,031	2,790
International monetary programs	-136	---	---	68
Military sales programs	106	97	97	392
Other	29	74	99	41
Subtotal, Funds Appropriated to the President	7,252	5,576	5,520	4,302
Agriculture:				
Commodity Credit Corporation	12,224	14,072	13,714	10,743
Foreign assistance – P.L. 480	1,060	1,098	1,098	1,098
Federal Crop Insurance Corporation	411	1,244	828	1,103
Rural Electrification Administration	-1,825	193	316	502
Farmers Home Administration	7,277	7,975	7,670	7,608
Food and Nutrition Service	19,581	20,764	21,055	20,613
Other	5,276	6,716	6,678	6,746
Subtotal, Agriculture	44,003	52,063	51,359	48,414
Commerce	2,279	2,793	2,810	2,571

Table 2.—1988 and 1989 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

	1988	1989		
		Estimate		
	Actual a/	February a/	July a/	Actual
Defense–Military:				
Military personnel	76,337	78,229	81,175	80,676
Operation and maintenance	84,475	85,394	85,394	87,001
Procurement	77,166	80,617	80,651	81,620
Research, development, test, and evaluation	34,792	37,021	37,023	37,002
Other	9,166	8,503	8,503	8,578
Subtotal, Defense–Military	281,935	289,764	292,746	294,876
Defense–Civil	22,047	23,329	23,353	23,427
Education	18,246	21,239	21,338	21,608
Energy	11,166	11,379	11,372	11,387
Health and Human Services — except Social Security:				
Medicare	87,676	98,305	97,760	96,452
Medicaid	30,462	34,301	34,709	34,604
Public Health Service	11,408	12,623	12,658	12,250
Other	29,445	29,361	28,876	28,995
Subtotal, Health and Human Services — except Social Security	158,991	174,589	174,003	172,301

Table 2.—1988 and 1989 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

	1988	1989		
		Estimate		
	Actual a/	February a/	July a/	Actual
Health and Human Services — Social Security	214,178	226,894	227,128	227,473
Housing and Urban Development:				
Housing payments	11,108	12,565	12,453	12,335
Federal Housing Administration fund	1,134	1,447	1,277	976
Government National Mortgage Association	208	-213	99	50
Community development grants	3,044	3,020	3,021	2,913
Other	3,461	3,562	3,354	3,497
Subtotal, Housing and Urban Development	18,956	20,381	20,204	19,772
Interior	5,147	5,529	5,478	5,308
Justice	5,426	6,042	6,099	6,232
Labor:				
Training and employment services	3,701	3,836	3,826	3,758
Advances to the unemployment trust fund and other funds	95	124	52	56
Unemployment trust fund	18,598	17,777	18,600	18,730
Other	2,005	2,418	2,379	2,354
Intrabudgetary transactions	-2,528	-1,362	-2,301	-2,240
Subtotal, Labor	21,870	22,792	22,555	22,657
State	3,421	3,791	3,666	3,722
Transportation:				
Federal Highway Administration	14,002	13,585	13,602	13,485
Urban Mass Transportation Administration	3,266	3,470	3,499	3,541
Federal Aviation Administration	5,192	5,769	5,738	5,822
Other	3,944	4,210	4,196	3,841
Subtotal, Transportation	26,404	27,034	27,036	26,689

Table 2.—1988 and 1989 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

	1988	1989		
		Estimate		
	Actual a/	February a/	July a/	Actual
Treasury:				
Exchange Stabilization Fund	-1,498	-100	-820	-1,119
Interest on the public debt	214,145	238,672	239,315	240,863
Offsetting receipts	-24,599	-22,706	-23,504	-24,267
Other	13,596	15,130	15,332	15,096
Subtotal, Treasury	201,644	230,996	230,323	230,573
Department of Veterans Affairs	29,249	29,302	30,277	30,041
Environmental Protection Agency	4,872	5,142	5,167	4,906
General Services Administration	-281	57	-280	-462
National Aeronautics and Space Administration	9,092	10,596	10,610	11,036
Office of Personnel Management	29,191	30,790	30,175	29,073
Small Business Administration	-54	151	70	83
Other independent agencies:				
District of Columbia	520	504	511	504
Export-Import Bank	-894	-337	-337	47
Federal Deposit Insurance Corporation:				
Bank insurance fund	2,146	3,807	4,307	2,784
FSLIC resolution fund b/	8,077	10,650	10,498	8,800
Other FDIC	---	---	---	-100
Federal Emergency Management Agency	551	738	597	531
Postal Service	2,229	574	770	127
Railroad Retirement Board	4,147	4,326	4,344	4,315
Resolution Trust Corporation	---	---	---	9,108
Tennessee Valley Authority	1,089	644	625	348
Other (net)	5,582	5,973	6,058	5,858
Subtotal, other independent agencies	23,446	26,878	27,374	32,323

Table 2.—1988 and 1989 BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY AGENCY
(fiscal years; in millions of dollars)

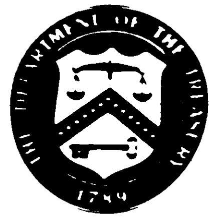
	1988	1989		
		Estimate		
	Actual a/	February a/	July a/	Actual
Undistributed offsetting receipts:				
Other interest	-1	---	---	-1
Employer share, employee retirement (on-budget)	-28,957	-29,427	-29,425	-29,425
Employer share, employee retirement (off-budget)	-4,071	-4,849	-4,857	-4,858
Interest received by on-budget trust funds	-34,481	-39,775	-39,792	-40,547
Interest received by off-budget trust funds	-7,416	-11,210	-11,318	-11,395
Rents and royalties on the Outer Continental Shelf lands	-3,548	-2,655	-2,863	-2,929
Sale of major assets	---	---	---	---
Subtotal, undistributed offsetting receipts	-78,473	-87,916	-88,254	-89,155
Total Outlays	1,063,318	1,143,039	1,143,995	1,142,869
On-budget	(860,626)	(932,204)	(933,041)	(931,648)
Off-budget	(202,691)	(210,836)	(210,953)	(211,221)
Deficit (-)	-155,151	-164,102	-148,277	-152,080
On-budget	(-193,951)	(-220,779)	(-202,067)	(-204,525)
Off-budget	(+38,800)	(+56,676)	(+53,791)	(+52,445)

NOTE: Detail may not add to totals due to rounding.

a/ FY 1988 actuals and February and July estimates for FY 1989 have been adjusted to conform to current accounting practices for customs fees.

b/ The Federal Savings and Loan Insurance Corporation (FSLIC) Fund was replaced by the FSLIC resolution fund as a result of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Outlays from the FSLIC Fund are reflected within the FSLIC resolution fund amounts.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

5310

FOR IMMEDIATE RELEASE October 27, 1989

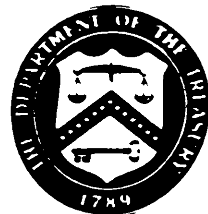
Statement by
Secretary of the Treasury
Nicholas F. Brady

Treasury Secretary Nicholas F. Brady today welcomed the announcement by President Arias of Costa Rica that agreement in principle had been reached by Costa Rica and representatives of its Bank Advisory Committee on a package which would reduce the country's debt and debt service obligations:

"This agreement will, when implemented, provide significant reduction in the level of debt and debt service owed by Costa Rica and provide important support for Costa Rica's economic reform program. It also represents an important step forward in the strengthened debt strategy. Implementation of the agreement will be facilitated by funds provided by the International Monetary Fund, the World Bank, and several donor governments, including the United States."

NB-530

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 1:00 P.M.
October 27, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY OFFERS $2,000 MILLION OF 51-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $2,000 million of 51-day Treasury bills to be issued October 31, 1989, representing an additional amount of bills dated December 22, 1988, maturing December 21, 1989 (CUSIP No. 912794 SP 0).

Competitive tenders will be received at all Federal Reserve Banks and Branches prior to 12:00 noon, Eastern Standard time, Monday, October 30, 1989. Each tender for the issue must be for a minimum amount of $1,000,000. Tenders over $1,000,000 must be in multiples of $1,000,000. Tenders must show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions must not be used.

Noncompetitive tenders will not be accepted. Tenders will not be received at the Department of the Treasury, Washington.

The bills will be issued on a discount basis under competitive bidding, and at maturity their par amount will be payable without interest. The bills will be issued entirely in book-entry form in a minimum denomination of $10,000 and in any higher $5,000 multiple, on the records of the Federal Reserve Banks and Branches. Additional amounts of the bills will not be issued to Federal Reserve Banks as agents for foreign and international monetary authorities.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 11:30 a.m., Eastern time, on the day of the auction. Such positions would include bills acquired through "when issued" trading, futures,

and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

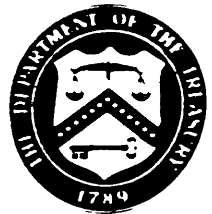
No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Those submitting tenders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch in cash or other immediately-available funds on Tuesday, October 31, 1989.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars may be obtained from any Federal Reserve Bank or Branch.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 1:00 P.M.
October 27, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY ALTERS WEEKLY BILL AUCTIONS AND SCHEDULES QUARTERLY REFUNDING ANNOUNCEMENT

The Department of the Treasury hereby amends its offering announcement for weekly Treasury bills made on October 24, 1989, to change the issue date and term to maturity of the bills. Both series of bills will be issued on Tuesday, October 31, 1989, rather than Thursday, November 2, 1989, as originally announced. The 93-day bills (CUSIP No. 912794 TP 9), maturing February 1, 1990, and the 184-day bills (CUSIP No. 912794 UC 6), maturing May 3, 1990, will each be issued in the amount of approximately $7,800 million. Tenders for both auctions will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, prior to 1:00 p.m., Eastern Standard time, Monday, October 30, 1989.

The announcement of October 24 is further amended as follows:

(1) Tenders will not be accepted from Federal Reserve Banks for their own accounts. Tenders will be accepted from Federal Reserve Banks as agents for foreign and international monetary authorities. Foreign and international monetary institutions may only make new cash purchases. Their holdings of weekly bills maturing on November 2, 1989, may not be used to purchase bills issued on October 31, 1989.

(2) Noncompetitive tenders for both auctions will be considered timely if postmarked no later than Sunday, October 29, 1989, and received no later than Tuesday, October 31, 1989.

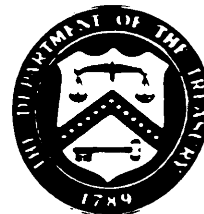
All other terms and conditions in the announcement of October 24 remain the same. These actions are being taken in the absence of Congressional action on legislation to raise the public debt limit.

The Treasury plans to announce tentative quarterly refunding plans on November 1, 1989.

oOo

NB-532

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
October 27, 1989

CONTACT: Office of Financing
202/376-4350

REINVESTMENT OF TREASURY BILLS MATURING NOVEMBER 2, 1989

The Department of the Treasury announced today that it will not be able to honor reinvestment requests from holders of bills maturing November 2, 1989, held in the Treasury's book-entry system (TREASURY DIRECT). The Department will make payment for bills maturing on November 2, 1989, to all investors who have requested reinvestment of their bills on that date, as well as to all accountholders who have previously requested payment.

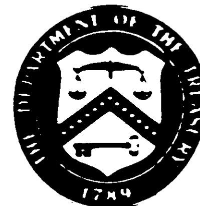
These actions will be required because the temporary debt limit, which provides the authority for the Treasury to borrow money, will expire at midnight on October 31 and would not allow for any reinvestments to be made on November 2.

However, in the event Congress raises the debt limit by October 31, Treasury will reinvest those accounts into the weekly bills to be issued November 9, 1989. In that case, investors who do not wish to be reinvested on that date could request payment of their bills, and the Treasury will take steps to accommodate their requests as quickly as possible. The Department will be making further announcements, depending upon Congressional action on legislation to raise the debt limit.

Investors are advised to look for notice of future auctions in their local newspapers or the financial press, or to contact their local Federal Reserve Bank for such information.

oOo

NB-533

TREASURY NEWS 

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
October 27, 1989

CONTACT: LARRY BATDORF
Phone: (202) 566-2041

TREASURY ANNOUNCES DESIGNATION OF PANAMANIAN DICTATOR MANUEL NORIEGA AS AN AGENT OF CUBA

The Department of the Treasury today added the names of Panamanian dictator Manuel Antonio Noriega, his wife and 32 companies to the existing list of 134 firms and individuals in Panama who act for or on behalf of Cuba and, as such, are Specially Designated Nationals of Cuba. Fourteen names, including Noriega associate Carlos Duque, were added to the list on September 20.

The listing of Manuel Noriega and the others as Specially Designated Nationals of Cuba in Panama has the effect of applying the full force of the U.S. trade and financial embargo against Cuba to these designated persons and firms operating in Panama. Additional names of those acting for or on behalf of Cuba in Panama and elsewhere in the world, wherever Cuba conducts business relations, will continue to be added to the list and published in the Federal Register as they are identified.

This action is another step in the United States' efforts to halt the channeling of funds to the illegal regime of General Noriega and to neutralize Cuban commercial activities in Panama that serve to circumvent the U.S. trade embargo against Cuba. This action serves to underscore the Administration's resolve to undermine the extensive network of commercial and financial collusion between the Noriega and Castro regimes.

Any person subject to the jurisdiction of the United States is prohibited from engaging, directly or indirectly, in any transactions whatsoever, anywhere in the world, involving any of the Specially Designated Nationals of Cuba, or in any transaction involving any property in which there exists an interest of Cuba.

Violations are punishable under the Trading with the Enemy Act by corporate criminal fines of up to $500,000 per count, individual criminal fines of up to $250,000 per count, and imprisonment of willful individual violators for up to 12 years.

A copy of the new names listed in the Federal Register is attached.

NB- 534

IN ADVANCE OF PRINTED COPY

4810-25-M

DEPARTMENT OF THE TREASURY

Office of Foreign Assets Control

31 CFR Part 515

Supplemental List of Specially Designated Nationals (Cuba) in Panama

AGENCY: Office of Foreign Assets Control, Department of the Treasury.

ACTION: Notice of Additions to the List of Specially Designated Nationals of Cuba.

SUMMARY: This notice provides the names of individuals and firms operating in Panama that have been added to the list of Specially Designated Nationals under the Treasury Department's Cuban Assets Control Regulations (31 CFR Part 515). Also provided is a complete current listing of known Specially Designated Nationals of Cuba in Panama.

EFFECTIVE DATE: [Date of publication]

FOR FURTHER INFORMATION CONTACT: Richard J. Hollas, Chief, Enforcement Division, Office of Foreign Assets Control, Tel: (202) 376-0400. Copies of the list of Specially Designated Nationals are available upon request at the following location: Office of Foreign Assets Control, Department of the Treasury, 1331 G Street, N.W., Room 300, Washington, D.C. 20220.

10/27/89

SUPPLEMENTARY INFORMATION:

Under the Cuban Assets Control Regulations, persons subject to the jurisdiction of the United States are prohibited from engaging, directly or indirectly, in transactions with any nationals or specially designated nationals of Cuba, or involving any property in which there exists an interest of any national or specially designated national of Cuba, except as authorized by law or by the Treasury Department's Office of Foreign Assets Control by means of a general or specific license.

Section 515.302 of Part 515 defines the term "national," in part, as (a) a subject or citizen domiciled in a particular country, or (b) any partnership, association, corporation, or other organization owned or controlled by nationals of that country, or that is organized under the laws of, or that has had its principal place of business in that foreign country since the effective date (for Cuba, 12:01 a.m., e.s.t., July 8, 1963), or (c) any person that has directly or indirectly acted for the benefit or on behalf of any designated foreign country. Section 515.305 defines the term "designated national" as Cuba or any national thereof, including any person who is a specially designated national. Section 515.306 defines "specially designated national" as any person who has been designated as such by the Secretary of the Treasury; any person who, on or since the effective date, has either acted for or on behalf of the government of, or authorities exercising control over, any designated foreign country; or any partnership, association,

corporation or other organization that, on or since the applicable effective date, has been owned or controlled directly or indirectly by such government or authorities, or by any specially designated national.

Section 515.201 prohibits any transaction, except as provided in Section 515.201 or as authorized by law or by the Secretary of the Treasury, involving property in which there exists an interest of any national or specially designated national of Cuba. The list of Specially Designated Cuban Nationals is a partial one, since the Department of the Treasury may not be aware of all the persons located outside Cuba that might be acting as agents or front organizations for Cuba, thus qualifying as specially designated nationals of Cuba. Also, names may have been omitted because it seemed unlikely that those persons would engage in transactions with persons subject to the jurisdiction of the United States. Therefore, persons engaging in transactions with foreign nationals may not rely on the fact that any particular foreign national is not on the list as evidence that it is not a specially designated national.

The Treasury Department regards it as incumbent upon all U.S. persons engaging in transactions with foreign nationals to take reasonable steps to ascertain for themselves whether such foreign nationals are specially designated nationals of Cuba, or other designated countries (at present, Cambodia, North Korea, and Vietnam). The list of Specially Designated Nationals was last published on December 10, 1986, in the Federal Register (51 FR 44459), and was amended on November 3, 1988 (53 FR 44397),

January 24, 1989 (54 FR 3446), April 10, 1989 (54 FR 14215) and August 4, 1989 (54 FR 32064), and September 20, 1989 (54 FR 38811)

Please take notice that section 16 of the Trading with the Enemy Act as amended (the "Act"), 50 U.S.C. App. 16, provides in part that whoever willfully violates any provision of the Act or any license, rule or regulation issued thereunder:

"Shall, upon conviction, be fined not more than $50,000, or, if a natural person, imprisoned for not more than ten years, or both; and the officer, director, or agent of any corporation who knowingly participates in such violation shall be punished by a like fine, imprisonment, or both; and any property, funds, securities, papers, or other articles or documents, or any vessel, together with her tackle, apparel, furniture, and equipment, concerned in such violation shall be forfeited to the United States."

In addition, persons convicted of an offense under the Act may be fined a greater amount than set forth in the Act, as provided in 18 U.S.C. 3571 and 3581.

Authority: 50 U.S.C. App. 5(b) and 18 U.S.C. 3571 and 3581.

Specially Designated Nationals of Cuba in Panama (New Additions at this Publication)

Noriega, Manuel Antonio

Panama

Sieiro de Noriega, Felicidad

Panama

Atlantic Pacific, S.A. (APSA)

Panama

Calpar de Panama, S.A. (a.k.a. Zebetex International, S.A.)

Panama

Carbonica, S.A.

Panama

Casas de Cambio

Panama

Cia. Istmena de Aviacion

Panama

Club Villa Fenix

Panama

Duty Free Shop

Balboa Pier

Panama

Duty Free Shop

Cristobal Pier

Panama

Duty Free Shop

Paitilla Airport

Panama

Duty Free Shop

Torrijos Airport

Panama

Duty Free Shop

Port of Vacamonte

Panama

Econollantas

Panama

El Deposito

Panama

El Millon

Panama

Hotel Granada

Panama

Hotel Nacional

Panama

Hotel Riande Aeropuerto

Panama

Hotel Riande Continental

Panama

Hotel Suites Alvear

Panama

Joyeria y Boutique Pretelt

Panama

Marinexam

Panama

Melo y Cia.

Panama

Pan Canal Shipping Company

Panama

Piex

Panama

Procesos Metalicos, S.A.

Panama

Radio Verbo

Panama

Setraca, S.A.

Panama

Shahani Auto Supplier

Panama

Superseguros

Panama

Televisora Nacional Canal 2

Panama

Teneria Tauro, S.A.

Panama

Zebetex International, S.A. (a.k.a. Calpar de Panama, S.A.)

Panama

Complete Current List of Specially Designated Nationals of Cuba in Panama

Abastecadora Naval Y Industrial, S.A. (a.k.a. Anainsa)

Panama

Abdelnur, Nury De Jesus

Panama

Agencia de Viajes Guama (a.k.a. Viajes Guama Tours, Guamatur, S.A. and Guama Tour)

Bal Harbour Shopping Center, Via Italia,

Panama City, Panama

Alfonso, Carlos, (a.k.a. Carlos Alfonso Gonzalez)

Panama

Alvarez, Manuel (Aguirre)

Panama

Anainsa (a.k.a. Abastecadora Naval y Industrial, S.A)

Panama

Angelini, Alejandro Abood

Panama

Atlantic Pacific, S.A. (APSA)

Panama

Avalon, S.A.

Colon Free Zone, Panama

Azrak, S.A.

Panama

Azrak, Victor

Panama

Batista, Miguel

Panama

Bewell Corporation, Inc.

Panama

Boutique La Maison

42 Via Brasil

Panama City, Panama

Bradfield Maritime Corp., Inc.

Panama

Calpar de Panama, S.A. (a.k.a. Zebetex International, S.A.)

Panama

Caballero, Roger Montanes (a.k.a. Roger Montanes and Roger Edward Dooley)

Panama

Canapel, S.A.

Panama

Carbonica, S.A.

Panama

Caribbean Happy Lines (a.k.a. Caribbean Happy Lines Co.)

Panama

Caribsugar, S.A.

Panama

Carisub, S.A.

Panama

Casa de Cambio

Panama

Casa del Respuesto

Panama

Castell, Osvaldo Antonio (Valdez)

Panama

Cecoex, S.A.

Panama City, Panama

Chamet Import, S.A.

Panama

Cia. Istmena de Aviacion

Panama

Cimex, S.A.

Panama

Club Villa Fenix

Panama

Duty Free Shop

Balboa Pier

Panama

Duty Free Shop

Cristobal Pier

Panama

Duty Free Shop

Paitilla Airport

Panama

Duty Free Shop

Torrijos Airport

Panama

Duty Free Shop

Port of Vacamonte

Panama

Coll, Gabriel (Prado)

Panama

Colon, Eduardo (Betancourt)

Panama

Colony Trading, S.A.

Panama

Comercial Cimex, S.A.

Panama

Comercial Muralla, S.A. (a.k.a. Muralla, S.A.)

Panama City, Panama

Compania Pesquera Internacional, S.A.

Panama

Contex, S.A.

Panama

Corporacion Cimex, S.A.

Panama

Cubana Airlines (a.k.a. Empresa Cubana de Aviacion)

Calle 29 y Avda Justo Arosemena

Panama City, Panama

Cuenca, Ramon Cesar

Panama

Delgado, Antonio (Arsenio)

Panama

Deprosa, S.A. (a.k.a. Desarrollo De Proyectos, S.A.)

Panama City, Panama

Desarrollo De Proyectos, S.A. (a.k.a. Deprosa, S.A.)

Panama City, Panama

Dooley, Michael P.

Panama

Dooley, Roger Edward (a.k.a. Roger Montanes Caballero and Roger Montanes)

Panama

Duque, Carlos

Panama

Echeverri, German

Panama

Econollantas

Panama

Edyju, S.A.

Panama

El Deposito

Panama

El Millon

Panama

Empresa Cubána de Aviacion (see Cubana Airlines)

Panama

Fabro Investment, Inc.

Panama

Facobata

Panama

Famesa International, S.A.

Panama

Fruni Trading, S.A.

Panama City, Panama

Gallo Import

Panama

Garcia Santamaria de la Torre, Alfredo Rafael (see also "Santamarina")

Panama

Global Marine Overseas, Inc.

Panama

Golden Comet Navigation Co., Ltd.

Panama

Gonzalez, Carlos Alfonso (a.k.a. Carlos Alfonso)

Panama

Grete Shipping Co., S.A.

Panama

Guaco Export

Panama

Guama Tour (a.k.a. Agencia de Viajes Guama, Viajes Guama Tours and Guamatur, S.A.)

Bal Harbour Shopping Center, Via Italia

Panama City, Panama

Guamar Shipping Co., S.A.

Panama

Guamatur, S.A. (a.k.a. Agencia de Viajes Guama, Viajes Guama Tours and Guama Tour)

Bal Harbour Shopping Center, Via Italia

Panama City, Panama

Havanatur, S.A.

Panama City, Panama

Havinpex, S.A. (a.k.a. Transover, S.A.)

Panama City, Panama

Haya, Francisco

Panama

Hermann Shipping Corp., Inc.

Panama

Heywood Navigation Corp.

Panama

Hotel Granada

Panama

Hotel Nacional

Panama

Hotel Riande Aeropuerto

Panama

Hotel Riande Continental

Panama

Hotel Suites Alvear

Panama

Imprisa, S.A.

Panama

Interconsult

Panama

International Petroleum, S.A.

Colon Free Zone, Panama

International Transport Corporation

Colon Free Zone, Panama

Inversiones Lupamar, S.A. (a.k.a. The Lupamar Investment Company)

Panama

IPESCO (a.k.a. International Petroleum S.A.)

Colon Free Zone, Panama

Jiminez, Gillermo (Soler)

Panama

Joyeria y Boutique Pretelt

Panama

Kaspar Shipping, S.A.

Panama

Kave, S.A.

Panama

Lakshmi

Panama

Leybda Corporation, S.A.

Panama

Louth Holdings, S.A.

Panama

Manzper Corp.

Panama

Marine Registration Company

Panama

Marinexam

Panama

Marisco (or Mariscos) de Farallon, S.A.

Panama

Marketing Associates Corporation

Calle 52 E, Campo Alegre

Panama City, Panama

Maryol Enterprises, Inc.

Panama

Medina, Anita (a.k.a. Ana Maria Medina)

Panama

Melo y Cia.

Panama

Mercurius Import/Export Company, Panama, S.A.

Calle C, Edificio 18

Box 4048, Colon Free zone, Panama

Monet Trading Company

Panama

Montanes, Roger (a.k.a. Roger Montanes Caballero and Roger Edward Dooley)

Panama

Montanez, Michael

Panama

Moonex International, S.A.

Panama

Muralla, S.A. (a.k.a. Comercial Muralla, S.A.)

Panama City, Panama

Navigable Water Corp., Ltd.

Panama

Noriega, Manuel Antonio

Panama

Ortega, Dario (Pina)

Edificio Saldivar

Panama City, Panama

Panamerican Import and Export Commercial Corp.

Panama

Panoamericana

Panama

Pan Canal Shipping Company

Panama

Pena, Jose (Torres)

Panama

Pena, Victor

Panama

Perez, Alfonso

Panama

Perez, Manuel Martin

Panama

Perez, Osvaldo (Cruz)

Panama

Pescados Y Mariscos de Panama (a.k.a. Pesmar or Pezmar) S.A.

Panama City, Panama

Pesmar (or Pezmar), S.A. (a.k.a. Pescados y Mariscos de Panama)

Panama City, Panama

Piex

Panama

Piramide Internacional

Panama

Pons, Alberto

Executive Representative

Banco Nacional de Cuba

Federico Boyd Ave. & 51 St.

Panama City, Panama

Prado, Julio (a.k.a. Julio Lobato)

Panama

Presa, S.A.

Panama

Processos Metalicos, S.A.

Panama

Radio Service, S.A.

Panama

Radio Verbo

Panama

Reciclaje Industrial, S.A.

Panama

Rent-A-Car, S.A.

Panama

Reyes, Guillermo (Vergara)

Panama City, Panama

Rocha, Antonio

Panama City, Panama

Rodriquez, Jesus (Borges or Borjes)

Panama

Romeo, Charles (a.k.a. Charles Henri Robert Romeo)

Panama

Roque, Roberto (Perez)

Panama

Ruiz, Ramon Miguel (Poo)

Panama

Santamarina, de la Torre Rafael Garcia (see also "Garcia")

Panama

Servimpex, S.A.

Panama

Servinaves, S.A.

Panama

Setraca, S.A.

Panama

Shahani Auto Supplier

Panama

Shipley Shipping Corp.

Panama

Siboney Internacional, S.A.

Edificio Balmoral, 82 Via Argentina

Panama City, Panama

Sieiro de Noriega, Felicidad

Panama

Superseguros

Panama

Suplidora Latino Americana, S.A. (a.k.a. Suplilat, S.A.)

Panama City, Panama

Suplilat, S.A., (a.k.a. Suplidora Latino Americana, S.A.)

Panama City, Panama

Taller De Reparaciones Navales, S.A. (a.k.a. Tarena)

Panama City, Panama

Tarena, S.A. (a.k.a. Taller De Reparaciones Navales S.A.)

Panama

Technic Digemex Corp.

Calle 34 No. 4-50, Office 301

Panama City, Panama

Technic Holding Inc.

Calle 34 No. 4-50, Office 301

Panama City, Panama

Televisora Nacional Canal 2

Panama

Temis Shipping Co.

Panama

Teneria Tauro, S.A.

Panama

Tosco, Arnaldo (Garcia)

Panama

Tramp Pioneer Shipping Co.

Panama

Transit, S.A.

Panama

Transover, S.A. (a.k.a. Havinpex, S.A.)

Panama City, Panama

Treviso Trading Corporation

Edificio Banco de Boston

Panama City, Panama

Trober, S.A. (a.k.a. Trover, S.A.)

Edificio Saldivar

Panama City, Panama

Trust Import-Export, S.A.

Panama

Valletta Shipping Corp.

Panama

Vasquez, Oscar D. (a.k.a. Vazques, Oscar D.)

Panama

Viacon International, Inc.

Apartment 7B Torre Mar Building

Punta Paitilla Area, Panama City, Panama

France Field, Colon Free Zone, Panama

Viajes Guama Tours (a.k.a. Guamatur, S.A., Guama Tour and Agencia de Viajes Guama)

Bal Harbour Shopping Center, Via Italia

Panama City, Panama

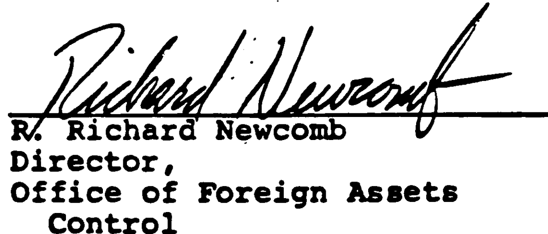
Wittgreen, Carlos (a.k.a. Carlos Wittgreen Antinori, Carlos Wittgreen A., and Carlos Antonio Wittgreen)

Panama

Zebetex International, S.A. (a.k.a. Calpar de Panama S.A.)

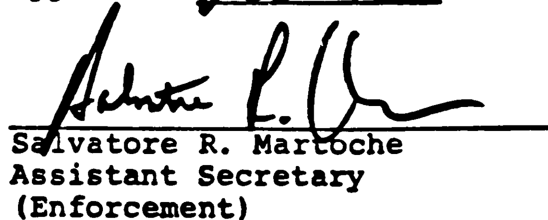
Panama

Date: October 13, 1989



R. Richard Newcomb
Director,
Office of Foreign Assets Control

Approved: Oct. 17, 1989



Salvatore R. Martoche
Assistant Secretary
(Enforcement)

Filed: October 27, 1989
Publication date: October 31, 1989

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press 566-2041
FFB 566-2468

FOR IMMEDIATE RELEASE

Ocotber 27, 1989

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of September 1989.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $136.1 billion on September 30, 1989, posting a decrease of $1.6 billion from the level on August 31, 1989. This net change was the result of an increase in holdings of agency debt of $85.6 million, and decreases in holdings of agency assets of $1,193.6 million, and in agency-guaranteed debt of $489.7 million. FFB made 39 disbursements during September.

During fiscal year 1989, FFB holdings of obligations issued, sold or guaranteed by other Federal agencies posted a net decrease of $10,058.6 million from the level on September 30, 1988. This change was the result of decreases in agency assets of $5,158.4 million and in agency guaranteed debt of $5,858.3 million. Holdings of agency debt increased by $958.1 million.

The Continuing Appropriations Resolution for 1988 allowed FFB borrowers under foreign military sales (FMS) guarantees to prepay at par their debt with interest rates of 10 percent or higher. Pursuant to this Resolution, FFB received FMS prepayments of $4,767.0 million in FY 1989. FFB suffered an associated loss of $695 million.

Attached to this release are tables presenting FFB September loan activity and FFB holdings as of September 30, 1989.

NB-535

FEDERAL FINANCING BANK

SEPTEMBER 1989 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
EXPORT-IMPORT BANK					
Note #79	9/1	$ 238,000,000.00	3/1/90	8.334%	
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #502	9/5	7,090,000.00	12/4/89	8.251%	
+Note #503	9/26	45,000,000.00	10/26/89	8.205%	
TENNESSEE VALLEY AUTHORITY					
Advance #1079	9/5	289,000,000.00	9/11/89	8.247%	
Advance #1080	9/8	10,000,000.00	9/13/89	8.191%	
Advance #1081	9/8	301,000,000.00	9/15/89	8.191%	
Advance #1082	9/11	291,000,000.00	9/19/89	8.164%	
Advance #1083	9/15	32,000,000.00	9/20/89	7.959%	
Advance #1084	9/15	10,000,000.00	9/21/89	7.959%	
Advance #1085	9/15	213,000,000.00	9/22/89	7.959%	
Advance #1086	9/19	286,000,000.00	9/26/89	7.984%	
Advance #1087	9/22	205,000,000.00	9/26/89	8.222%	
Advance #1088	9/26	314,000,000.00	10/1/89	8.205%	
Advance #1089	9/26	178,000,000.00	10/2/89	8.205%	
Advance #1090	9/29	29,000,000.00	10/3/89	8.264%	
Advance #1091	9/29	26,000,000.00	10/6/89	8.264%	
Advance #1092	9/30	135,000,000.00	10/6/89	8.301%	
Advance #1093	9/30	60,000,000.00	10/9/89	8.301%	
AGENCY ASSETS					
FARMERS HOME ADMINISTRATION					
RHIF - CBO # 57529	9/1	700,000,000.00	9/1/04	8.366%	8.541% ann.
RURAL ELECTRIFICATION ADMINISTRATION - Certificates of Beneficial Ownership					
Certificate #30	9/30	111,500,000.00	12/29/89	8.303%	

+rollover

FEDERAL FINANCING BANK

SEPTEMBER 1989 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Greece 17	9/14	$ 2,393,459.85	8/25/14	8.282%	
Greece 17	9/28	1,151,653.79	8/25/14	8.380%	
Morocco 9	9/28	632,345.39	3/31/94	8.462%	
Morocco 13	9/28	65,907.28	5/31/95	8.448%	
Turkey 18	9/28	131,228.80	3/12/14	8.381%	
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
*Brownsville, TX	9/1	769,850.25	9/2/92	8.500%	8.681% ann.
*Detroit, MI	9/1	36,000,000.00	9/3/96	8.426%	8.603% ann.
Anderson, SC	9/12	86,356.50	10/2/89	8.068%	
*Binghamton, NY	9/15	7,300,000.00	9/15/95	8.212%	8.381% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
M & A Electric Power #337	9/14	977,000.00	1/3/23	8.282%	8.198% qtr.
Oglethorpe Power #320	9/14	555,000.00	9/30/91	8.320%	8.235% qtr.
*Wabash Valley Power #206	9/14	6,605,000.00	1/2/18	8.287%	8.203% qtr.
Old Dominion Electric #267	9/15	1,204,000.00	12/31/13	8.244%	8.161% qtr.
*Oglethorpe Power #246A	9/21	54,745,000.00	9/30/91	8.390%	8.304% qtr.
*Oglethorpe Power #246A	9/21	57,524,000.00	1/3/17	8.278%	8.194% qtr.
Plains Electric #300	9/22	1,364,000.00	1/3/17	8.322%	8.237% qtr.
South Texas Electric #322	9/27	527,000.00	12/31/19	8.388%	8.302% qtr.
New Hampshire Electric #270	9/28	327,000.00	1/2/18	8.394%	8.308% qtr.
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-89-12	9/29	892,151,798.02	12/29/89	8.227%	

*maturity extension

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	September 30, 1989	August 31, 1989	Net Change 9/1/89-9/30/89	FY '89 Net Change 10/1/88-9/30/89
Agency Debt:				
Export-Import Bank	$ 10,983.6	$ 11,007.6	$ -24.0	$ 26.0
NCUA-Central Liquidity Facility	111.4	116.8	-5.4	-6.7
Tennessee Valley Authority	17,467.0	17,352.0	115.0	336.0
U.S. Postal Service	6,195.0	6,195.0	-0-	602.8
sub-total*	34,757.0	34,671.4	85.6	958.1
Agency Assets:				
Farmers Home Administration	53,311.0	54,611.0	-1,300.0	-5,185.0
DHHS-Health Maintenance Org.	74.7	74.7	-0-	-4.8
DHHS-Medical Facilities	88.1	88.1	-0-	-8.3
Rural Electrification Admin.-CBO	4,182.7	4,076.0	106.7	43.5
Small Business Administration	11.6	11.9	-0.3	-3.8
sub-total*	57,668.1	58,861.7	-1,193.6	-5,158.4
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	10,188.5	10,684.9	-496.4	-5,823.2
DEd.-Student Loan Marketing Assn.	4,910.0	4,910.0	-0-	-0-
DOE-Geothermal Loan Guarantees	-0-	-0-	-0-	-50.0
DHUD-Community Dev. Block Grant	283.4	297.8	-14.4	-34.7
DHUD-Public Housing Notes +	1,995.3	1,995.3	-0-	-41.7
General Services Administration +	378.1	378.1	-0-	-9.4
DOI-Guam Power Authority	31.0	31.5	-0.6	-1.2
DOI-Virgin Islands	25.9	25.9	-0-	-0.6
NASA-Space Communications Co. +	995.2	995.2	-0-	96.4
DON-Ship Lease Financing	1,720.5	1,720.5	-0-	-38.3
Rural Electrification Administration	19,275.0	19,270.0	5.0	69.6
SBA-Small Business Investment Cos.	555.3	556.0	-0.8	-77.4
SBA-State/Local Development Cos.	799.4	802.2	-2.8	-71.5
TVA-Seven States Energy Corp.	2,294.9	2,274.5	20.3	132.5
DOT-Section 511	37.2	37.3	-0.1	-9.0
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	43,666.7	44,156.4	-489.7	-5,858.3
grand total*	$ 136,091.9	$ 137,689.5	$ -1,597.6	$ -10,058.6

*figures may not total due to rounding
+does not include capitalized interest

DEPARTMENT OF THE TREASURY

Report to the Congress

on

International Economic and Exchange Rate Policy

October 1989

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PART I: INTRODUCTION

Section 3005 of the Omnibus Trade and Competitiveness Act of 1988 (Pub. L. 100-418) requires the Secretary of the Treasury to submit to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives an annual report each October 15 on international economic policy, including exchange rate policy. The first annual report was submitted in October 1988. In April 1989, a written update of developments was submitted to Congress, 6 months after the initial report, pursuant to this Section.

Part II of this report reviews recent developments in the world economy, including efforts by the major industrial countries to coordinate economic policies. Part III analyzes recent exchange market developments, including the dollar's movement in terms of the currencies of major U.S. trading partners, and U.S. foreign exchange market intervention. Part IV reviews the U.S. economic and balance of payments situation, and contains a discussion of the prospects for the U.S. current account, issues regarding the sustainability of the external imbalance, and the U.S. net investment position. Part V provides a status report on negotiations with Korea and Taiwan, economies which were considered in the October 1988 and April 1989 reports to be "manipulating" their exchange rates, within the meaning of the trade legislation. The final part provides conclusions on the principal issues discussed in the report.

PART II: ECONOMIC SITUATION IN THE INDUSTRIAL COUNTRIES AND ECONOMIC POLICY COORDINATION

The Economic Situation in the Industrial Countries

o Overview

The economic expansion in the major countries has slowed over the past year, but GNP growth continues at a satisfactory and sustained pace and should average about 3.5 percent this year.

With more balanced industrial country growth and a substantial increase in world trade, progress was made last year in reducing some of the largest external account imbalances. The trade and current account imbalances of the United States and Japan continued to decline during the first half of 1989, and moderate reductions are expected for this year as a whole. The combined current account surplus of the European Community member countries was reduced by half in 1988 and should decline further this year.

Nevertheless, external adjustment has slowed in 1989, raising uncertainties as to the prospects for further adjustment in 1990. While U.S. export growth remains strong, it has slowed; meanwhile, export growth in the major surplus countries has revived and, with domestic demand generally slowing, their import growth over the 1989-90 period is unlikely to match last year's unusually high levels. In addition, fundamental shifts that are underway in the international investment income flows of the three largest economies, the result of persistent large current account imbalances, will tend to offset adjustment in the trade account.

Due mainly to higher commodity prices and some one-time factors, inflation rates in the major countries are, on average, about 1-1/2 percentage points over last year's levels, although inflation in a number of countries has grown by less. However, the impact of some these temporary factors is already subsiding and inflationary pressures have moderated. Moreover, with monetary and fiscal policies remaining cautious, inflation should continue to ease. (See Table 1.)

o Economic Growth

With real GNP growth strengthening in each of the Group of Seven economies (except the United Kingdom) in 1988, average G-7 growth increased by about a full percentage point to 4.5 percent. Substantially higher investment expenditures, buoyed by improved profits and business sentiment, contributed importantly. Within the G-7, Japan recorded the highest growth rate (5.7 percent), followed by Canada (5.0 percent) and the United States (4.4 percent). GNP growth in the four largest European economies was tightly clustered around an average of 3.6 percent.

The composition of growth within the G-7 economies in 1988 provided important support for the current account adjustment process. In the United States, domestic demand growth lagged GNP growth, with a major portion of overall growth (about 25 percent, or one percentage point) being supplied by the improvement in net exports. The reverse was true in Japan, where domestic demand growth substantially exceeded that of GNP, boosting imports and contributing to a significant decline in net exports. In Germany, domestic demand growth exceeded that of GNP by only a small margin so net exports declined only slightly.

For the United States and Japan, the composition of growth in 1989 is expected to be qualitatively similar to 1988, and again to support external adjustment. That is, domestic demand growth is projected to remain in excess of GNP in Japan, with the reverse pattern in the United States. In Germany, however, GNP growth is generally forecast to exceed domestic demand growth this year, its counterpart being rising net exports. Elsewhere in the G-7, demand trends should provide support for additional U.S. external adjustment, though not necessarily for their own. Specifically, domestic demand growth in the United Kingdom, Italy, and Canada (all with current account deficits) should continue to exceed that of GNP, which implies higher net imports and external deficits.

o <u>Trade and Current Account Developments</u>

With industrial country growth both more vigorous and better balanced in 1988, world trade flows increased substantially, facilitating substantial current account adjustment. World trade volume rose 9 percent, the strongest annual growth of the decade and well in excess of its 20-year average. Moreover, this strong advance was broadly shared by both the industrial and the developing economies.

According to the latest data (revised since the semiannual update of this report completed in April) the U.S. current account deficit declined $17 billion, to $126.5 billion (2.6 percent of GNP) in 1988. Japan's current account surplus dropped by about $7.5 billion (to 2.8 percent of GNP). The aggregate current account surplus of the European Community was reduced by $22 billion, though developments in the different member economies diverged sharply. In particular, the U.K.'s deficit alone rose by nearly $22 billion (to 3.3 percent of GNP), by far the largest individual country shift last year. Germany's current account surplus, in contrast, rose by about $3 billion though it remained unchanged at 4 percent of GNP. (German exports, which are heavily oriented toward capital goods, have been strongly supported by surging investment in other European countries.)

These current account developments reflect substantial shifts in trade flows. U.S. exports increased 27-1/2 percent in value terms while import growth slowed to 9 percent. Japanese imports rose 10 percent (in yen terms) while exports rose less than 2 percent. (The changes were much larger in dollar terms, given exchange rate movements between 1987 and 1988.) German exports and imports both expanded by about 7.5 percent in Deutschemark terms last year.

The available data for 1989 indicate that these basic trends have continued. The U.S. trade deficit during the first half of 1989 was about $9 billion below the previous year's first half level (equivalent to an annual decline of about $18 billion) while the first half current account deficit was down about $4 billion ($8 billion at an annual rate). The Japanese trade surplus declined about $1 billion, and the current account surplus about $5.5 billion, over the same period. Germany's overall trade surplus rose by $2 billion and its current account surplus by $5 billion. Given these results for the first half, reductions of the U.S. and Japanese trade and current account imbalances are in prospect for 1989 as a whole, though increases are likely for the German surpluses. (Despite the availability of additional monthly trade data for these countries, first half, 1989, data have been used to allow comparability using the same methodology.)

Several general points about the current situation and the near-term prospects are worth noting. First, U.S. export growth continues substantially to exceed import growth, and slowing domestic demand growth should support this trend. Second, the lack of external adjustment in Germany is due in part to its particular export mix, coupled with the unusual strength of investment goods demand in its principal trading partners. Third, international direct investment flows can have important trade-substituting effects; in the case of the United States, these investments will tend to displace some imports over time. Fourth, stronger net investment income earnings by Japan and Germany on their cumulative foreign assets are offsetting adjustment in the trade account, while the opposite is tending to accentuate the U.S. adjustment problem.

o <u>Inflation</u>

Boosted by the late 1988 run-up in commodity prices and a variety of one-time developments earlier this year, consumer price inflation in the G-7 countries is likely to be almost 1-1/2 percentage points higher in 1989 than in 1988. Japan, Germany and France should remain at the low end of the Summit 7 economies (2-1/4 to 3-1/2 percent), the United Kingdom and Italy at the upper end, and the United States and Canada in the middle.

However, the commodity price pressures in late 1988 and early 1989 appear to have peaked. In addition, other factors such as slowing growth, continued cautious monetary and fiscal policies, and recent capacity expansion suggest that some of the recent inflation increase is likely to unwind over the next 12 months. Thus the overall inflation situation tracks well with the assessment presented in the April 1989 report: the situation bears close watching in some countries, but pressures are easing and the prospects are good for a return to lower average rates during the course of 1990.

Economic Policy Coordination

The major industrial countries have continued their efforts to promote sustained growth with low inflation and reduced external imbalances. In the increasingly integrated world economy in which we live -- characterized by 24-hour financial markets, international production facilities, and greater balance in size among the major countries -- such coordination is essential if the major countries are to put in place the consistent and compatible policies necessary to achieve these shared objectives.

The evolving G-7 economic policy coordination process represents an important step forward in this regard. (The history of this process is covered at length in the October 1988 report.) It has become an accepted feature of the international economic landscape and provides an established framework in which policymakers can review their economic policies and prospects and the possible need for remedial actions. It has promoted greater understanding among policymakers for the international ramifications of domestic policies.

This process also represents the most effective and realistic means of reforming the international monetary system. Past blueprints for reform have focussed almost exclusively on exchange rate arrangements and international reserves. The test of an international monetary system, however, is to promote an open and growing world economy. The coordination process, through the use of indicators, allows policymakers to focus on the broad range of fundamentals that influence economic performance and policies.

Furthermore, it is symmetrical in its treatment of surplus and deficit nations. Past international monetary arrangements have tended to focus the burden of adjustment on deficit countries. The coordination process, however, recognizes that sustained growth and external adjustment are the shared responsibilities of surplus and deficit countries alike.

Most importantly, this process has contributed significantly to the improved global economic performance we have experienced this decade. As discussed in the previous section on the economic situation in the industrial countries, the G-7 nations are well into the seventh consecutive year of expansion. Further solid growth is expected this year and the expansion should be sustained next year. Inflationary pressures have been contained and external imbalances have been substantially reduced.

The coordination process is not without problems, however, and there is no room for complacency. External imbalances remain large and the adjustment process has slowed. Continued vigilance is required in containing inflation.

The recent meetings of the G-7 in April and September have focussed on the policies the major countries must implement to continue to produce the 7 years of sustained growth with relatively low inflation. They have recognized that this will require efforts by all of the G-7 countries. In particular:

- The United States must continue its ongoing efforts to reduce the Federal budget deficit by implementing measures to achieve the Gramm-Rudman-Hollings targets. It should be noted that the United States has already registered significant progress, reducing the Federal deficit from over 6 percent of GNP in FY 1983 to an expected 2 percent in FY 1990. Adding in the financial positions of state and local governments, our general government deficit is projected to be roughly 1 percent of GNP in FY 1990, well below the OECD average.

- Germany and Japan, the major surplus countries, must continue to put in place policies aimed at promoting noninflationary growth with a sufficient margin in the medium term between domestic demand and output growth to reduce substantially their large external imbalances.

- All countries must implement structural reforms to promote economic efficiency and openness of their economies, reduce subsidies and regulations, and to foster savings, as appropriate.

Exchange rate policies are one aspect of the broader economic policy coordination process. They are discussed in the following part of the report.

PART III: FOREIGN EXCHANGE MARKET DEVELOPMENTS

Overview

Over the past year, demand for dollars has generally been strong and the dollar has appreciated on the exchange markets. The dollar's appreciation has been influenced by a number of factors, including: better than expected trade data in the United States; favorable market reactions to the moderation of growth in the United States and the containment of price pressures; economic policies here and abroad; and political uncertainties overseas.

Since the October 1988 report, the dollar has appreciated by over 13 percent against the Japanese yen and about 4-1/2 percent against the German mark. The dollar's movement against the continental European currencies generally paralleled its trend against the German mark, but the dollar rose by 12 percent against the British pound. Meanwhile, against the Canadian dollar, the currency of our largest trading partner, the U.S. dollar depreciated by over 2-1/2 percent.

Furthermore, since the April 1989 report, the dollar has appreciated by almost 9 percent against the Japanese yen and the British pound. Against the continental European currencies, its appreciation has generally been between 1 and 1-1/2 percentage points. (See Table 2.)

The Finance Ministers and Central Bank Governors of the G-7 countries have kept their economic policies and prospects under continuous review, including the performance of exchange markets, as part of their multilateral surveillance activities. In their September 23, 1989, statement, they noted the further solid growth their economies were experiencing this year and the containment of price pressures. They also noted the further progress being made in reducing large external imbalances, but that the adjustment of external imbalances had slowed. Against this background, they stated: "... the rise in recent months of the dollar [is] inconsistent with longer run economic fundamentals. They agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy. In this context, they agreed to cooperate closely in exchange markets."

Exchange rate cooperation is an important element of broader economic policy coordination. G-7 cooperation on exchange rates, no matter how often reiterated, has frequently come into question in the market during short periods of strong one-way exchange rate movements. It sometimes appears that doubts in the market surface about G-7 cooperation during periods between G-7

meetings. Such doubts appear to minimize the cumulative impact of G-7 operations -- both policy actions and exchange market intervention -- which have been influential in maintaining a sense of two-way risk in the market, the intensified cooperation among the G-7 and their commitment to continue their close cooperation between G-7 meetings.

Exchange market developments between October 1988 and mid-April of this year were covered in the April report. On balance, this period was characterized by an easing of the dollar in October through mid-December and a subsequent rebound. Since then, trends in the exchange markets can be subdivided into three periods: from April through mid-June, when dollar demand surged; from mid-June through August, when the dollar dipped briefly and then rebounded strongly; and since August, when the dollar rose followed by a decline in the aftermath of the G-7 statement and subsequent intervention.

In market intervention, U.S. monetary authorities made record sales of dollars in the April-June period. Total sales of dollars against purchases of Japanese yen exceeded $7 billion; total dollar sales against German marks were nearly $5 billion. Intervention tapered off in the first half of July, which marks the last month for which intervention data are publicly available. U.S. monetary authorities have subsequently continued to monitor exchange rate developments closely and have conducted operations as appropriate in close cooperation with foreign monetary authorities.

<u>April through mid-June 1989</u>: <u>Surge of Demand for Dollars</u>

In April, the G-7 stated "that a rise of the dollar which undermined adjustment efforts or an excessive decline would be counterproductive." The G-7's commitment to this view was immediately illustrated by the Bank of Japan, which entered the market to sell dollars for the first time since late 1985. The dollar declined moderately but soon began to rise when an interest rate hike by the Bundesbank on April 20 had little impact on the DM/$ exchange rate.

In May, the dollar began a strong upward move. Very active buying by investment managers and corporations pushed the dollar steadily higher for much of the month. Reportedly, investment managers shifted to a heavier dollar weighting in their portfolios and foreign institutional investors bought dollars to unwind "short hedges." And, as the dollar was nearing, then passing, 1988 highs, U.S. corporations were buying dollars for balance sheet hedging purposes.

Underlying such buying was the view that the threat of significant further dollar depreciation had passed. Also, market participants increasingly believed that the U.S. economy was headed for a "soft landing" and, therefore, that downside risk to investors was limited. This view gained credence from further indications of moderation of U.S. domestic demand and, subsequently, of inflationary pressures. Further stimulating dollar demand were political uncertainties overseas during June. The crackdown in China prompted substantial "safe haven" flows into dollars. Also, developments in Japan, Germany and elsewhere reportedly added to the demand for dollars.

This surge of dollar buying climaxed at mid-June, when the dollar reached 2 to 2-1/2 year highs. But a sense of downside risk to dollar positioning reemerged immediately afterward, when market participants found that they could not bid the dollar any higher following the release of April U.S. trade figures showing a further narrowing of the deficit. They therefore began to try the downside. Also, intervention had gradually helped balance the market's sense of risk, particularly since market participants perceived that intervention tactics had become less predictable. The possibility of further heavy intervention was raised when Administration officials expressed concern about the rise of the dollar.

Mid-June through August 1989:

May economic data reinforced expectations of slowing U.S. economic activity, and some talk of a U.S. recession emerged by early July. The June employment release (July 7) was seen as adding to expectations of lower U.S. interest rates. Meanwhile, demand strength and capacity constraints in Europe had raised inflation risks and prospects for monetary tightening there.

Around mid-July, the dollar declined on worse than expected May trade data. Subsequently, Chairman Greenspan's July 20 Humphrey-Hawkins testimony suggested that a shift in the balance of economic risks had oriented U.S. monetary policy more toward avoiding recession than countering inflation. At end-July, U.S. banks lowered their prime rates, and on August 1, the Purchasing Managers' Index suggested an unexpectedly sharp slowing of the economy in July.

But market sentiment reversed dramatically within days, and the dollar returned to its upward trend. Most important, the July employment release showed the first of several big upward revisions of major U.S. economic indicators. Stronger than expected U.S. economic performance was confirmed by a large upward revision of second-quarter GNP growth and a big gain in employment in August. Political factors also influenced the market. The Liberal Democratic Party's July 23 election loss in Japan weighed on the yen. Political developments in Eastern Europe might have dampened demand for DM.

Since August 1989:

At mid-September, the upward trend faltered when the dollar did not sustain levels reached following U.S. trade release showing an unexpected narrowing of deficit in July. A decline in imports shown in this release, together with an earlier report of lower than expected August retail sales, were seen in the market as suggesting some possibility for the Federal Reserve to consider monetary easing. But underlying bullishness toward the dollar was not seriously shaken. Many market participants suspected this pause to be merely a consolidation before a further rise of the dollar. Rather, with a G-7 meeting coming later in the month, the market paused to assess the G-7's commitment to currency stability and wait for a statement regarding G-7 cooperation on exchange rates.

As noted, the G-7 Finance Ministers and Central Bank Governors, in their statement of September 23, reaffirmed their support for the economic policy coordination process, and agreed that surplus and deficit countries must continue to implement economic policies to sustain growth with low inflation and to reduce external imbalances. In this context, they considered that the recent rise of the dollar is inconsistent with longer run fundamentals, agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy, and reiterated their commitment to cooperate closly in exchange markets.

Immediately after the G-7 Statement, the dollar retreated by some 6 yen and 8 pfennigs. Intervention was conducted on a worldwide basis, with several G-7 monetary authorities operating at times outside their own financial centers.

With their bullishness on the dollar partly dispelled, market participants waited to see whether there would be changes in interest rates to forestall a renewed dollar uptrend. On October 5, the Bundesbank led a round of coordinated interest rate hikes in Europe, and the dollar initially retreated, before demand resurfaced. On October 9, the Bank of Japan followed with a smaller interest rate hike of its own. The dollar remained in good demand, however, and rose moderately in the aftermath of these actions. Following the abrupt decline in share prices on October 13, the dollar declined against the German mark to levels not seen since around the time of the April report. It eased back less against the Japanese yen.

PART IV: U.S. BALANCE OF PAYMENTS SITUATION

U.S. Balance of Payments Developments and Trends

o Developments in 1988

The U.S. trade deficit, after peaking in value terms in 1987 at $160 billion, declined markedly in 1988 by $32 billion to $127 billion.

The decline in the deficit was characterized by double-digit export growth (27-1/2 percent in value, 23-1/2 percent in volume), and exports totalled $319 billion. These strong export gains were primarily influenced by the lagged effects of the dollar's depreciation since early 1985, and strong domestic demand growth in Europe, and especially in Japan.

At the same time, import growth moderated somewhat and merchandise imports were nearly flat at roughly the fourth quarter level of 1987 during the first three quarters of 1988. For 1988 as a whole, imports grew 9 percent in value (6-1/2 percent in volume) to $446 billion. The moderate import growth was also influenced by the lagged effects of the dollar's depreciation. Both export strength and import moderation were broadly based across product groups and geographic areas.

The pace of adjustment in the trade balance slowed over the course of 1988, however. For example, in the first half of 1988, the trade balance declined by $16 billion (20 percent) in comparison with the second half of 1987. In the second half of 1988, however, the trade deficit declined by $2-1/2 billion (less than 4 percent) in comparison with the first half.

o Developments in 1989

Exports have continued to grow strongly in 1989. For the first 6 months of 1989, merchandise exports on a balance of payments basis were up 15-1/2 percent in value, and 11 percent in volume, over the like period of 1988 and totalled $179 billion ($358 billion at an annualized rate). As was the case in 1988, export increases so far in 1989 have been broadly-based in terms of both products and geographic areas.

-- Growth rates in value terms by end-use category over first-half 1988 were:

Consumer goods	37%
Foods, feeds & beverages	22%
Capital goods	16%
Automotive vehicles, parts & engines	9%

-- Corresponding growth rates by country groups were:

Major industrial countries	14%
Asian NIEs	10%
OPEC members	1-1/2%
Other countries	24%

This strong export performance, which has continued despite the strengthening of the dollar, is consistent with evidence of U.S. competitiveness gains in recent years shown by such measures as unit labor costs or export market shares.

At the same time, merchandise import growth appears to have remained moderate after a bulge in the fourth quarter of 1988. Indeed, the increase between first and second quarter 1989 was due entirely to oil imports, which posted increases in both price and volume. Non-oil imports actually declined slightly in the second quarter, despite continued strength in capital goods imports. For the first half of 1989, balance of payments imports were up about 7 percent in value and 4-1/2 percent in volume from the first half of 1988, totalling $235 billion ($470 billion at an annualized rate). The main factors in the continued import moderation appear to have been improved U.S. competitiveness, and a slowing of U.S. demand growth.

The trade deficit through the first half of this year was $56 billion, an improvement of not quite $9 billion over the first half of 1988. (The data above for the first half of 1989 are on a Balance of Payments basis, as published by the Commerce Department.)

Monthly trade data, which are available through August on a Census basis, showed a higher deficit, on average, in July and August than in the preceding months. On balance, however, further progress is expected in reducing the trade deficit this year, though not as great as in 1988. For 1989 as a whole, the deficit might be reduced on the order of $10 to $15 billion from 1988.

The U.S. current account deficit also declined by $17 billion to $126-1/2 billion in 1988. This improvement was, however, less than that in the trade deficit because of reduced net receipts on invisibles (services and unilateral transfers). (See Table 3.)

The difference between the trade balance and the current account balance largely reflects U.S. performance on services. (Recent improvements in methodology and coverage of service transactions have resulted in substantial revisions of the data especially on exports of services, reducing the previously-published current account deficit for 1988 by $7 billion.) In recent years, the balance on services transactions has been

strongly influenced by capital gains and losses resulting from accounting effects of exchange rate changes on conversion into dollars of foreign earnings as reported by U.S. direct investors.

In 1987, because of dollar depreciation, direct investment income was increased by capital gains amounting to $16.2 billion from exchange conversion. But in 1988 U.S. direct investors reported very small conversion losses (amounting to $0.1 billion), thus exaggerating the underlying trend deterioration in the balance on services transactions.

Abstracting from these factors, however, the basic trend underlying the decline in the services balance has been a gradual and persistent increase in investment-income payments (interest and dividends), reflecting steady erosion of the U.S. international investment position.

Thus, the surplus on service transactions, which had peaked at $43.8 billion in the early 1980s, was $30.0 billion in 1987 and $15.3 billion in 1988. In the first half of 1989, the balance on invisibles was in deficit by $5.3 billion (including $8 billion of exchange-related capital losses on U.S. direct investment abroad) -- the first such deficit in three decades.

With regard to capital flows, the recorded net inflow (seasonally unadjusted) in the first half of 1989 was $30.2 billion. Unrecorded transactions (statistical discrepancy) provided net inflows of $26.5 billion. Major contributors to recorded gross inflows in first half 1989 were inward direct investment ($31.5 billion) and foreign private purchases of U.S. securities ($27.2 billion). By contrast, the increase in foreign official assets in the United States was modest, with a shift from inflows to outflows between first and second quarters, reflecting exchange market intervention to stem dollar appreciation. U.S. banking liabilities to foreigners declined, in contrast to the 1988 pattern. (See Table 4.)

On the outflows side, there was a substantial ($16 billion) increase in U.S. official reserve assets (balance of payments outflow), primarily reflecting intervention activity to counter the rising dollar. Direct investment outflows continued at levels similar to 1988, while purchases of foreign securities roughly doubled. As with inflows, outflows through banks turned negative in the first half, in contrast to full-year 1988.

Issues and Discussion of U.S. Economic and Balance of Payments Situation

As has been discussed, the U.S. trade deficit has continued to decline in 1989, following a significant fall in the deficit in 1988 from its 1987 peak. However, the pace of external adjustment has slowed this year and there is substantial uncertainty as to the prospects for further reduction in the large external imbalances in 1990. For example, the OECD in its June Outlook projected modest further reduction in the U.S. current account deficit in 1990 of around $7 billion. In contrast, the IMF recently projected a deterioration in the U.S. deficit by some $14 billion to $139 billion.

The outlook for 1990 will be affected by a wide range of developments, including growth and inflation rates in the United States and abroad, and exchange rate developments. These developments are standard inputs into conventional trade forecasting models. Economic policies in the major countries will also play a major role.

The conventional models highlight several important considerations. First, U.S. imports exceed exports by roughly 40 percent. If imports and exports grew at equal rates, the differential between the two in nominal terms would necessarily widen. Second, the responsiveness of import demand to income growth in the United States is greater in some models than the elasticity of foreign demand for U.S. exports. For both these reasons, all other things being equal, higher rates of growth abroad than in the United States are needed to narrow the differential between imports and exports. Third, the cost of servicing the U.S. external position will mount in the coming years (see below).

On balance, it would appear that further improvement in the U.S. current account position in 1990, if any is to occur at all, is likely at best to be very modest. Furthermore, the possibility of deterioration in the current account next year cannot be excluded.

The continued current account deficits of the United States have resulted in the steady erosion of the U.S. international investment position. For example, since its peak in 1981, the U.S. net asset position has deteriorated by some $673 billion from a surplus of $141 billion to a deficit of $533 billion at the end of 1988.

To be sure, the published data on the U.S. international investment position are estimates -- they provide a rough indicator, and not a precise measure of the actual position. Nevertheless, the deteriorating trend in the U.S. net investment

position during the 1980s is clear. There are a range of potentially important and negative implications associated with this development, including the fact that the growing cost of servicing U.S. obligations could reduce resources available to meet domestic objectives and have implications for future standards of living.

Against this background, the International Monetary Fund (IMF) recently reviewed U.S. economic policies and prospects as part of its annual Article IV surveillance exercise. The IMF reaffirmed its support for the economic policy coordination process among the major industrial countries, observing that sustained growth with low inflation and the reduction of global imbalances will require continued efforts by surplus and deficit countries alike. In this context, the IMF was of the view that the United States must demonstrate convincing action in reducing the fiscal defict as well as make efforts to raise private savings. The Fund further emphasized that inflationary pressures should be contained and that the United States must remain vigilant in this regard. Also, the Fund stressed that protectionist pressures must be resisted in order to maintain an open and growing world economy.

The developments discussed above have contributed to concerns in the international financial community about worsening payments deficits in the United States and globally, and about the "sustainability" of the U.S. current account position. There are a number of important considerations, however, which suggest that medium-term prospects for the current account may be more positive than projected by most forecasters, using conventional models, and that concerns about "sustainability" may be overstated.

-- The G-7 process is dynamic, in contrast with the conventional models which assume no policy changes. The G-7 countries have kept the policies and performance of their economies under continuous review, and as demonstrated most recently at their September meeting, they are committed to putting into place the policies necessary to sustain growth with low inflation and reduce external imbalances.

-- The size, strength, and soundness of the U.S. economy will continue to make this country an extremely attractive locus for investment for the foreseeable future. The United States has produced seven consecutive years of sustained expansion. Our economy and capital markets are the largest, most open and resilient in the world. This consideration is all the more important at this time of rapid build-up in foreign portfolios. The political stability of the United States has traditionally attracted "safe haven" flows into the dollar.

-- A number of factors may be producing longer term and continuing adjustments in the current account. Exchange-rate adjusted unit labor costs in the United States have declined substantially in recent years vis-a-vis those of our main competitors abroad, and could produce ongoing, longer-term supply-side adjustments in the current account. Also, many U.S. industries importantly streamlined production operations in the earlier part of the decade in response to competitive realities and are continuing to reap the benefits in terms of improved efficiency.

There is no accepted method for quantifying the "sustainability" of the U.S. current account deficit. Ultimately, whether the U.S. external imbalance is sustainable and can be reduced in an orderly fashion for any level of interest and/or exchange rates will depend on the judgments of market participants. These judgments will respond to perceptions regarding the broad range of fundamental policies that affect economic policies and performance in the major countries. In this context, the efforts of the G-7 to sustain global growth with low inflation, reduce external imbalances, and maintain an open global trade and financial system will play a critical role.

PART V: ASIAN NEWLY INDUSTRIALIZED ECONOMIES (NIEs)

Overview

Since the release of the April report, Taiwan's exchange rate has appreciated against the dollar, while Korea's has depreciated slightly. The New Taiwan (NT) dollar rose more than five percent immediately following the April report and in conjunction with the implementation of a new exchange rate system. The Korean won, on the other hand, has depreciated in nominal terms by about 3/4 of 1 percentage point against the dollar. Viewed in a longer term context, the NT dollar has strengthened by 57.5 percent and the Korean won by 33 percent, compared to 70.5 percent for the yen and 54 percent for the German mark, since the Plaza Agreement in September, 1985.

The decline in the U.S. merchandise trade deficit with the Asian NIEs as a group -- Korea, Taiwan, Hong Kong, and Singapore -- in 1988 continued through the first 8 months of 1989. In 1988, the trade deficit with the Asian NIEs was $29.2 billion, down $5.6 billion or 16 percent from 1987. Through August of 1989, this deficit (on a customs value basis) was $15.7 billion, 10 percent below the comparable period last year. As a proportion of the overall U.S. trade deficit, the deficit with the NIEs has remained constant at close to 22 percent.

The decline in the deficit with the NIEs in 1988 was boosted by $2.5 billion in gold purchases by Taiwan's Central Bank from the United States. Gold purchases were subsequently halted last year, distorting comparisons of the deficit with the NIEs collectively, and with Taiwan in particular. The cessation of gold exports to Taiwan, for instance, obscures more rapid declines in the U.S. bilateral deficits with the other NIEs in 1989. Through August of this year, the U.S. bilateral deficits have fallen by 40 percent with Singapore, 30 percent with Hong Kong, and 25 percent with Korea.

Under Section 3004 of the 1988 Trade Act, the Secretary of the Treasury is required to "consider whether countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." It was concluded in the October 1988 report that Taiwan and Korea "manipulated" their exchange rates, within the meaning of the legislation.

Pursuant to Section 3004, the Treasury was required to initiate bilateral negotiations with Taiwan and Korea for the purpose of ensuring that these two economies regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustment and to eliminate the unfair advantage. In April 1989, the Treasury again concluded that these economies were "manipulating" their currencies within the meaning of the legislation, and bilateral negotiations were continued.

Following is a summary of the economic and exchange rate developments in Taiwan and Korea and the negotiations which have taken place with Taiwan and Korea since October 1988. (See Table 5 on U.S. trade with Asian NIEs and currency changes.)

Taiwan

The appreciation of the NT dollar since 1985 has been an integral factor -- along with the more recent reductions in trade barriers and rising wages -- in the reduction of Taiwan's external surpluses. It is anticipated that these factors will continue at least through next year, and lead to additional significant reductions in Taiwan's current account and bilateral trade surplus with the United States.

o Exchange Rate Developments

Following significant appreciation in 1986 and 1987, the NT dollar depreciated in 1988 through October. Since the October 1988 report, however, Taiwan's exchange rate has appreciated by 12 percent against the U.S. dollar, more than that of any other major trading partner. Significantly, more than 5 percentage points of this movement has been since the release of Treasury's April report. Since May, the NT dollar has been relatively stable, fluctuating within a 2.4 percent range.

Following the sharp appreciation of the NT dollar immediately after the April report, along with the institution of a new exchange rate system and reduction in external surpluses, Treasury concluded during congressional testimony in early May that there might not be a need for further appreciation at that time.

o Trade and Economic Developments

Taiwan's global current account surplus decreased by 43 percent in 1988 to $10.1 billion, or by 27 percent to $13 billion excluding gold. As a proportion of GNP, this translated into a sizeable decline to 8.5 percent from 18.1 percent in 1987. While this was proportionately the equal of Korea's ratio, it was significantly higher than Japan's 2.8 percent ratio. Taiwan's overall trade surplus (balance of payments basis) fell 32 percent in 1988 to $13.8 billion.

The $2.5 billion in official gold purchases from the United States last year made gold the largest U.S. export to Taiwan and contributed to over half of the decline in our bilateral trade imbalance in 1988. For example, including gold, the U.S. trade deficit with Taiwan (customs value) declined by 27 percent to $12.6 billion. Excluding gold, the deficit fell by less (15 percent) to $15.1 billion.

Currency appreciation has had an advantageous impact on the restructuring of Taiwan's economy. Appreciation has encouraged the production of higher value-added goods and the movement of lower value-added production offshore. In addition, domestic demand has replaced exports as the main source of growth for the economy, as Taiwanese consumers begin to benefit from years of high savings. At the same time, unemployment, which is less than 2 percent, remains low.

Real GNP growth in 1988 fell from 12 percent in 1987, but remained strong at a more sustainable 7.8 percent. Inflation, at 1.3 percent, was more than double the rate in 1987. Foreign exchange reserves fell slightly to $74 billion, which is still the world's second largest stock and equal to an extraordinary 19 months of merchandise imports.

In 1989, excess liquidity pressures, largely due to the buildup of the sizable external surpluses, began to present more serious problems for the economy. In response, Taiwan introduced stringent credit tightening measures in the spring. This should keep inflation below 5 percent, but still well above the 0.5 percent average over the last 5 years.

As a result of a continuing fall in the current account surplus and a rise in the net capital outflow, Taiwan posted its first overall balance of payments deficit since 1980 in the second quarter of this year. It is expected that the continuation of these factors will turn last year's overall balance of payments surplus into a deficit for 1989 as a whole and further reduce foreign exchange reserves.

In the first 9 months of this year, Taiwan reported a $10.4 billion surplus (cif basis) in overall trade. This is 37 percent greater than the similar period in 1988, but virtually unchanged if the gold shipments from the United States last year are discounted.

In absolute terms, our trade deficit with Taiwan so far this year is larger than last year. This is primarily the result of the enhancement of U.S. exports last year due to the unsustainable gold purchases and, to a lesser degree, a shift in export orders from Korea owing to labor strife. Including 1988 gold acquisitions, our bilateral trade imbalance through August of this year is up by 13 percent. Excluding gold, however, the deficit is down by 14.5 percent.

o <u>Exchange Rate System</u>

Following U.S. negotiations early in the year (under the auspices of the American Institute in Taiwan and Coordination Council for North American Affairs) regarding exchange rate policy, Taiwan implemented a new exchange rate system in early April. Since that time, Taiwan has also taken a number of significant steps to further liberalize the system and reduce the capital controls that have facilitated the authorities' ability to manipulate the rate. These liberalizations are a necessary step toward the establishment of a more market-based system and the internationalization of the financial sector.

The new exchange rate system allowed all NT dollar-U.S. dollar transactions above $30,000 to be freely determined. This minimum was further lowered to $10,000 in July. Under the previous system, the NT dollar's value against the U.S. dollar was determined by the "middle rate" of interbank transaction rates on the prior business day, with a limit on fluctuation.

There was also substantial, direct intervention by the Central Bank under the old system to prevent currency appreciation. Currently, however, there is no evidence that the Central Bank has been substantially intervening in the market. We remain concerned, however, about the Central Bank's potential to control the market through the large government-controlled banks.

An additional liberalization has been the raising of the limit on foreign liabilities of foreign exchange banks by 30 percent beginning in early August. This should permit banks to increase correspondingly their foreign exchange activities. The base period for determining the increase, however, was also moved to a later period when there was relatively less market activity. The two changes, hence, offset each other. Some banks have actually had their foreign liability limits reduced. At least one foreign bank which was adversely affected was given a waiver by the Central Bank.

Taiwan also instituted a U.S. dollar call market to reduce the cost of short-term foreign exchange funds to local domestic and foreign banks by using Central Bank foreign exchange reserves as a pool of loanable funds. The Central Bank initially supplied $3 billion for the market, which was raised to $4 billion in September. The Central Bank has indicated that it will provide more funds if market conditions warrant.

In another positive step, the limits on annual foreign exchange inflows have been raised twice since June to $500,000 per entity. We welcome indications from Taiwan that this limit will again soon be raised, as such controls serve as a barrier to currency appreciation. Given that there has been no surge in capital inflow after the recent increases in the limit and the NT dollar is stable, there is little justification for not raising the limit to at least the level of that for outflows, $5 million annually. We hope that the authorities will take this action shortly.

A prevailing problem of the new system is the ceilings on "long" and "short" foreign exchange positions, which effectively prevent a forward foreign exchange market from operating. The ceilings also discriminate against foreign banks since they are based on local assets. These assets are relatively small since Taiwan has restrictions on foreign banks' branches. The Central Bank is working on a plan to reopen the forward foreign exchange market.

At this time, it is our assessment that the introduction of the new exchange rate system serves as a basis to support adjustment of Taiwan's external imbalances. The new system is also consistent with the move toward a market-based determination for the NT dollar's value.

On balance, we are encouraged by the improvement in the trade balance over the past 18 months. Moreover, the liberalization of the exchange rate system and the authorities' willingness to allow the rate to appreciate are positive. At this time, there are no clear indications that the exchange rate is currently being manipulated by Taiwan for competitive advantage. The pace of improvement in Taiwan's external imbalances has, however, slowed in 1989. As such, it is necessary for the authorities to recognize the continued importance of the exchange rate in furthering the adjustment process. We will continue to monitor carefully the situation.

Korea

The Korean won's 33 percent nominal appreciation since the time of the Plaza Agreement in September, 1985, has also helped encourage a decline in Korea's external surpluses. Significant currency adjustment began early in 1988, later than it did for Taiwan, and has, thus, resulted in a later reduction in Korea's external surpluses. The domestic economic developments that have reinforced this reduction have been more pronounced recently than those in Taiwan. It remains to be seen, however, whether the welcome correction in Korea's external accounts so far in 1989 will continue, as is necessary.

o <u>Exchange Rate Developments</u>

The won has appreciated by 33 percent since the Plaza Accord. Almost half of this movement, or 15.7 percent, occurred in 1988. Given the strengthening of the U.S. dollar against other major currencies in 1988, the won's own appreciation against the U.S. dollar in 1988 resulted in an even greater strengthening of the won against the major non-dollar currencies. Thus, for the first time, the won began in 1988 to lose some of the competitiveness that it had gained earlier in the decade and especially since 1985.

In 1989, the won appreciated an additional 2.74 percent through April 24, when it reached won 665.85/US$1. Of this appreciation, 1.1 percent occurred in the period from late March, when the U.S.-Korean exchange rate negotiations intensified as the deadline approached for the April report to the Congress.

Since April 24, however, the won has depreciated in nominal terms against the U.S. dollar. On October 13, the exchange rate stood at won 671.4/US$1. As of that date, therefore, cumulative nominal won appreciation against the dollar so far this year totalled only 2 percent. Given the dollar's own strengthening against most of the other major currencies this year, the won's appreciation against most non-dollar major currencies has continued this year, particularly with regard to the yen. This has not been the case, however, as regards the NT dollar, against which the won has depreciated by 7 percent so far this year.

o <u>Trade and Economic Developments in 1988</u>

Korea's current account surplus grew 43 percent to $14.2 billion, or 8.4 percent of GNP in 1988. This was the result of increases in the trade surplus, Olympics-related tourism revenues, and private transfers, as well as the decline in interest payments on a smaller foreign debt.

Korea's global trade surplus increased 50 percent to $11.4 billion on a balance of payments basis in 1988. Export volume continued to boom, albeit at a slower pace than the previous year, and import volume also decreased. Despite Korean concerns at the time about maintaining competitiveness in the face of earlier won appreciation and rising wages, all major exports, including labor-intensive products other than toys, experienced growth in 1988 in value terms.

In 1988, the growth of U.S. exports to Korea accelerated to 39 percent from 27 percent in 1987, while the growth of U.S. imports from Korea slowed to 19 percent from 33 percent in 1987. As a result, the U.S. bilateral trade deficit (customs value) with Korea increased by a modest 1 percent last year.

Given these results, Korea was able to reduce its external debt and build its foreign reserves by substantial amounts in 1988. Gross external debt fell by $4.4 billion to $31.2 billion (only 18 percent of GNP). Foreign reserves, excluding gold, rose by nearly $9 billion to $12.3 billion, equal to about 3 months' imports.

Korea's domestic economy also continued to excel in 1988, as real GNP growth exceeded 12 percent for the third consecutive year. Domestic demand made a greater contribution to growth -- reflecting wage increases, lower tariffs, and cuts in excise taxes. Foreign demand, however, still accounted for nearly 50 percent of real GNP growth. Cumulative wage gains of about 33 percent in 1987-88 outstripped both consumer price increases (10 percent cumulative) and, by a small margin, productivity growth (30 percent). Unemployment, at 2.5 percent in 1988, reached its lowest level in the last three decades.

- Trade and Economic Developments in 1989

In the first 8 months of this year, Korea's current account surplus stood at $2.7 billion, a sharp drop of 66 percent from the same period in 1988. In the last month for which data are available (August), the current account registered a small deficit. Korea's global trade surplus (balance of payments basis) similarly declined by 63 percent to $2.3 billion through August, relative to the comparable period a year earlier. For 1989 as a whole, a current account surplus on the order of $5-6 billion appears likely.

The U.S. bilateral trade deficit with Korea declined $4.2 billion in the first 8 months of 1989, a 25 percent drop compared with the same period in 1988. On a quarterly basis, the U.S. bilateral deficit has been declining fairly steadily since the first quarter of 1988, the sole exception being the last quarter of 1988, when it grew 5 percent. Growth of U.S. exports to Korea through August 1989 slowed to 22 percent compared with 39 percent in 1988 as a whole. The rate of growth of U.S. imports from Korea, however, slowed even more to only 1 percent, compared with 19 percent in all of 1988.

A number of causes appear to have contributed to the sharp drop in Korea's trade and current account surpluses so far this year:

- Labor-management disputes are believed to have cut exports by over $1 billion in the first half of the year.

- Korean exporters accelerated shipments in the fourth quarter of 1988 in the belief that the won would continue to strengthen, while importers delayed clearing goods through customs until the new year in anticipation of the January 1, 1989, tariff cuts.

- Cumulative wage increases in manufacturing exceeded growth of productivity in 1987-88 by a small margin, thus beginning to reduce Korea's labor cost competitiveness.

- Growing domestic demand is absorbing tradable goods and stimulating investment and production patterns that are cutting into export capacity.

- Cumulative appreciation of the won in 1988 in both nominal and real effective terms has also reduced competitiveness.

Reflecting the sharp drop in Korea's external surpluses, the rate of real GNP growth has slowed and is expected to be on the order of 6 percent. Sizable wage increases, estimated at an average of 20 percent in the first half of the year, are contributing to strong expansion of domestic demand, which is expected to grow by about 11 percent in real terms. Nonetheless, inflation should moderate somewhat to 6 percent this year, as the smaller external surpluses are easing liquidity.

Due to seasonal factors and the labor-management disputes, unemployment rose to an average of 3.3 percent in the first quarter of 1989, compared with an average of 2.5 percent in 1988 as a whole. In the second quarter, however, unemployment fell again to an average of 2.4 percent.

The growth of labor productivity in the first half of the year averaged 11 percent (annualized rate). This represented a drop from 15 percent in 1988 as a whole and was due in large part to the effects of widespread labor-management disputes. In the second quarter, however, productivity growth reached 12 percent on an annual basis, compared with 10 percent in the first quarter, and should continue to improve in the second half of 1989. Nonetheless, unit labor costs are likely to rise for the year as a whole and, coupled with the 4.4 percent increase in 1988, may offset the 8.7 percent decline in unit labor costs in 1986-87.

- <u>Assessment</u>

Some of the factors producing the decline in Korea's external surpluses may allow for some further adjustment, particularly the strengthening of Korean domestic demand coupled with Korea's ongoing trade liberalization efforts. At the same time, the effects of other factors, such as the exporter/importer expectations in late 1988, are not lasting. In addition, labor-management disputes and wage increases may have a less disruptive effect on exports in the future as the Korean government has shown signs of exerting renewed controls in these areas.

Therefore, it has yet to be demonstrated clearly that a lasting, structural decline in Korea's external surpluses is underway. Caution should be exercised against imposing trends on data for recent months. Although uncertainties exist on both sides, renewed growth of Korea's external surpluses could emerge, absent some further strengthening of the won to reinforce positive trends.

In this regard, we are concerned about the modest depreciation of the won since late April. While we understand the authorities' reluctance to encourage further appreciation at this time in view of the decline in Korea's surpluses so far this year, the recent depreciation -- however modest -- could be interpreted as a signal of the authorities' desire for larger external surpluses. This would impede the necessary continued adjustment of global imbalances and could exacerbate trade tensions. In addition, depreciation, if continued, is likely to have adverse effects on Korea's domestic economy by generating inflationary pressures, encouraging demands for higher wages, and retarding the trend toward more balanced growth. These developments would delay the very structural changes that the authorities have indicated they wish to promote in the Korean economy.

In addition, further appreciation may prove necessary if the reduction of Korea's imbalances does not continue next year. At 2-3 percent of GNP, Korea's current account surplus is still large. Quite apart from the need for continued adjustment of global imbalances, accumulation of external surpluses of this magnitude may not be the best use for Korean savings, given Korea's still moderate level of incomes and standards of living, its requirement for substantial infrastructure development, and the presumably high returns on capital.

The absence of a role for market forces in exchange rate determination remains a fundamental problem in Korea and adds to our concern about the won's movements over the past six months. Government controls over interest rates and capital flows, while eased somewhat in the past year, remain tight and enable the government to "manipulate" the exchange rate.

In this regard, we welcome the agreement of the Ministry of Finance for Korea, which plays the central role in exchange rate determination, to initiate talks with the Treasury Department on financial policies and markets.

The significant decline in Korea's external surpluses so far this year is a positive and encouraging development. The 25 percent reduction in our bilateral imbalance is also very welcome, particularly as it reflects the expansion of U.S. exports to Korea. Nonetheless, continued reductions of Korea's surpluses are necessary.

Despite these welcome developments, however, we believe that there have continued to be indications of exchange rate "manipulation" during the six months since the April report. This judgment is based on a variety of factors: exchange rate developments over the past six months; questions as to whether this year's welcome reduction in Korea's surpluses will continue; the lack of a significant role for market forces in Korea's exchange rate determination system; and the widespread capital and interest rate controls that contribute to the government's ability to directly "manipulate" the exchange rate.

In our exchange rate negotiations with Korea in the coming months, we will continue to press for exchange rate policy to support further external adjustment. Over the medium-term, in our talks on financial policies and markets, we will encourage the liberalization of Korea's exchange rate system and of the capital and interest rate controls that impede the full operation of market forces.

PART VI: CONCLUSION

The major industrial countries bear a special responsibility for the effective functioning of the world economy and the international monetary system. In the increasingly integrated world economy in which we live, the major countries must pursue consistent and compatible policies to achieve sustained growth with low inflation and reduced external imbalances.

The economic coordination policy process has contributed significantly to improved global economic performance. The industrial countries are well into the seventh year of sustained growth, the longest expansion since World War II, and further moderate growth is anticipated next year. The determination of monetary authorities to resist inflationary pressures has been evident throughout this upswing and concerns earlier this year about an intensification of price pressures have receded in view of the implementation of appropriate policies. External imbalances, which in the mid-1980s were projected to grow to unsustainable dimensions on the basis of then prevailing policies and prospects, have been substantially reduced.

Despite the progress, there is no room for complacency. All countries must remain vigilant in containing inflation, particularly in those countries where pressures persist. The adjustment process has slowed and imbalances remain too large. Indeed, the prospects for further current account adjustment next year are uncertain. Any improvement in the U.S. current account position is likely at best to be very modest, given current policies and prospects. Furthermore, the possibility of deterioration in the current account next year cannot be excluded.

The major countries must continue to implement the policies which have sustained the expansion. This will require action by surplus and deficit countries alike.

- The United States must continue its ongoing efforts to reduce the Federal budget deficit by implementing measures to achieve the Gramm-Rudman-Hollings targets.

- Germany and Japan, the major surplus countries, must continue to put in place policies aimed at promoting noninflationary growth with a sufficient margin in the medium term between domestic demand and output growth to reduce substantially their large external imbalances.

- All countries must implement structural reforms.

Exchange rates are but one of the many fundamental factors that affect economic performance, and exchange markets are kept under close and continuous review by the major countries within the broader context of the economic policy coordination process. The dollar has risen substantially this year and the Ministers and Central Bank Governors of the G-7 countries recently considered "the rise ... inconsistent with longer run fundamentals. They agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy. In this context, they agreed to cooperate closely in exchange markets."

Effective global adjustment, however, is not only the responsibility of the G-7 countries. Other economies have a clear and complementary role to play. In the report on International Economic and Exchange Rate Policy submitted to Congress last October, it was determined that Taiwan and Korea, within the meaning of Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, were "manipulating" their exchange rates against the U.S. dollar to prevent effective balance of payments adjustment or gain unfair competitive advantage in international trade. This determination was reiterated in the April 1989 report. In accordance with Section 3004, the Treasury initiated and has been conducting bilateral negotiations with Taiwan and Korea for the purpose of ensuring that they regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustment and eliminate the unfair trade advantage.

Significant developments have occurred, particularly since April.

Taiwan's global current account surplus has been declining this year. The NT dollar has appreciated by 12 percent against the U.S. dollar since last October's report, of which more than 5 percentage points has occurred since the release of the April report. Taiwan also implemented a new exchange rate system in early April, and since then has taken a number of significant steps to further liberalize the system and reduce the capital controls that have facilitated the authorities' ability to manipulate the NT dollar. The liberalization is a necessary step towards creation of a more market-based system and the internationalization of the financial sector.

We expect Taiwan's trade and current account surpluses to continue to fall, influenced by the currency appreciation that has occurred since Plaza and over the past year, and recent reductions in trade barriers and rising wages. We are encouraged by the significant steps Taiwan has taken to liberalize its foreign exchange system and allow its currency to more accurately reflect market forces. At this time, there are no clear indications that Taiwan is "manipulating" its currency for competitive advantage. Nonetheless, since there has been a slowdown in the pace of improvement in Taiwan's trade surpluses so far in 1989, the authorities should recognize the importance of the exchange rate in furthering the adjustment process. We will continue, therefore, to monitor the situation carefully.

Korea's global current account surplus rose sharply in 1988, along with a modest increase in its bilateral surplus with the United States. This occurred during a period of strong economic performance, rapid buildup in its reserves and repayment of external debt.

This year, Korea's global trade and current account surpluses and its bilateral surplus with the United States have both declined dramatically. This development reflects a number of factors. In addition to exchange rate appreciation largely in 1988, these factors include the effects of labor-management disputes in slowing exports in the first half of the year, accelerated shipments of exports in the fourth quarter of 1988, cumulative wage increases in excess of productivity growth in 1987 and 1988, and strong domestic demand.

Some of these factors may faciliate further adjustment, but others are not lasting. Therefore, it has not yet been demonstrated that a structural and lasting decline in Korea's surplus is underway.

Since April, the won has depreciated by roughly 3/4 of 1 percentage point against the dollar. We are quite concerned that Korea avoid any depreciation of the won against the U.S. dollar. Given the strong overall performance of the economy and some of the special circumstances leading to this year's reduction of the external surpluses, there is no basis for won depreciation, however slight.

Recently, the Treasury Department and the Korean Ministry of Finance have agreed to initiate talks on financial policies, including the exchange rate system and capital market issues. We hope to encourage a more market-oriented exchange rate system in Korea within the framework of these talks.

The won's appreciation against the dollar in 1988, this year's declines in Korea's external imbalances, and the agreement to enter into talks on financial policies, are all significant and positive developments. Yet, on balance, exchange rate developments over the past six months and the absence of a role for market forces in exchange rate determination are indications that exchange rate "manipulation" continued in the six months since the April report. In our exchange rate negotiations with Korea in the coming months, we will continue to press for exchange rate policy to support the necessary further adjustment of Korea's external imbalances. Over the medium term, in our talks on financial policies and markets, we will encourage the liberalization of Korea's exchange rate systems and of the capital and interest rate controls that impede the full operation of market forces.

APPENDIX

TABLES

1. Economic Performance of Key Industrial Countries
2. Measurements of Dollar Movements Versus G-7 Currencies
3. Summary of U.S. Trade and Current Account
4. Summary of U.S. Capital Account
5. U.S. Trade with Asian NIEs and Currency Changes

Table 1

Economic Performance of Key Industrial Countries 1/

	GNP 2/			Domestic Demand 2/		
	1987	1988	1989	1987	1988	1989
U.S.	3.7	4.4	2.9	3.2	3.3	2.4
Japan	4.5	5.7	4.9	5.2	7.7	5.2
Germany	1.8	3.4	3.3	3.1	3.5	2.2
France	1.9	3.5	3.4	3.0	3.6	3.6
U.K.	4.5	4.2	3.0	5.2	6.2	3.6
Italy	3.0	3.9	3.2	4.6	4.3	3.7
Canada	4.5	5.0	3.1	4.9	5.8	5.2
Total G-7 3/	3.6	4.5	3.4	3.8	4.6	3.3

	Inflation 4/			Current Account 5/		
	1987	1988	1989	1987	1988	1989
U.S.	3.6	4.1	5.0	-3.2	-2.6	-2.4
Japan	0.1	0.7	2.2	3.6	2.8	2.5
Germany	0.2	1.2	3.2	4.0	4.0	4.5
France	3.3	2.7	3.5	-0.5	-0.4	-0.6
U.K.	4.1	4.9	7.9	-0.7	-3.2	-3.7
Italy	4.7	5.0	6.6	-0.2	-0.6	-1.0
Canada	4.4	4.0	5.1	-1.7	-1.7	-2.3
Total G-7 3/	2.8	3.1	4.4	-0.3	-0.4	-0.5

1/ All data are latest IMF figures, except for U.S.

2/ Real growth rates, annual average.

3/ Average of individual country rates weighted by GNP in dollar terms; annual averages.

4/ Consumer prices; annual averages.

5/ Calculated as percent of GNP; negative indicates deficit.

Table 2

Measurements of Dollar Movements (for key dates)
Versus G-7 Currencies
Percent dollar appreciation (+) or depreciation (-)

As of October 13, 1989

Value of the Dollar in Terms of:	Since Dollar Peak 26-Feb-85 to date	Since Plaza Accord 20-Sep-85 to date	Dollar Lows 31-Dec-87 to date	Over Last Year 14-Oct-88 to date	Since Previous Report 14-Apr-89 to date
Japanese yen	-44.9	-40.5	+18.6	+13.2	+8.7
German mark	-45.3	-34.1	+20.4	+4.4	+1.3
British sterling	-33.1	-13.2	+20.0	+12.0	+8.7
French franc	-39.2	-26.7	+17.0	+3.8	+1.5
Italian lira	-35.7	-28.2	+19.4	+2.8	+1.2
Canadian dollar	-16.3	-14.8	-9.7	-2.7	-1.1

Source: London midday rates.

Table 3

SUMMARY OF U.S. TRADE AND CURRENT ACCOUNT DEVELOPMENTS
($ billion, seasonally adjusted)

	YEARS		1988				1989	
	1987	1988	Q1	Q2	Q3	Q4	Q1	Q2
Exports	250.266	319.251	76.447	78.471	80.604	83.729	87.919	90.866
Agricultural	29.547	38.142	9.021	9.405	9.927	9.789	10.763	10.732
NonAgricultural	220.719	281.109	67.426	69.066	70.677	73.940	77.156	80.134
Imports	-409.766	-446.466	-109.893	-109.882	-110.943	-115.748	-116.297	-118.584
Petrol & Prods	-42.944	-39.309	-10.068	-10.248	-9.775	-9.218	-10.850	-13.427
NonPetroleum	-366.822	-407.157	-99.825	-99.634	-101.168	-106.530	-105.447	-105.157
TRADE BALANCE	-159.500	-127.215	-33.446	-31.411	-30.339	-32.019	-28.378	-27.718
Net Investment Income	22.283	2.228	2.795	-2.465	-2.590	4.489	-2.416	-5.015
Direct Investment	45.254	31.516	8.490	4.927	5.567	12.533	5.966	3.853
(of which Capital Gains/Losses on U.S. Investments Abroad)	16.174	-0.144	0.858	-2.487	-2.585	4.069	-3.512	-4.437
Portfolio Investment	-22.971	-29.288	-5.695	-7.392	-8.157	-8.044	-8.382	-8.868
Net Other Services	7.728	13.096	1.969	3.290	3.965	3.871	3.960	4.839
Military	-2.857	-4.606	-0.964	-1.033	-1.006	-1.604	-1.498	-1.630
Travel & Fares	-6.251	-1.922	-1.496	-0.493	-0.039	0.105	-0.240	0.339
Other Transport	-1.073	-0.711	-0.358	-0.226	-0.116	-0.011	-0.057	0.173
Fees, Royals & Misc	17.909	20.335	4.787	5.042	5.126	5.381	5.755	5.957
Unilat Transfers	-14.212	-14.656	-3.364	-2.899	-3.376	-5.018	-3.526	-3.094
Remits & Pensions	-4.063	-4.279	-1.131	-0.971	-1.088	-1.090	-1.186	-0.952
Government Grants	-10.149	-10.377	-2.233	-1.928	-2.288	-3.928	-2.340	-2.142
NET INVISIBLES	15.799	0.668	1.400	-2.074	-2.001	3.342	-1.982	-3.270
CURRENT ACCOUNT BALANCE	-143.700	-126.548	-32.046	-33.485	-32.340	-28.677	-30.390	-30.988

Source: SURVEY OF CURRENT BUSINESS, September 1989

Table 4

SUMMARY OF U.S. CAPITAL FLOWS

Inflows(+) Outflows(-); $ Billion

	YEARS		1988				1989	
	1987	1988	Q1	Q2	Q3	Q4	Q1	Q2
U.S. Reserve Assets (Incr(-) Decr(+))	9.149	-3.566	1.503	0.039	-7.380	2.272	-4.000	-12.095
Other US-Govt Assets	0.997	2.999	-1.673	-0.829	2.001	3.499	0.869	-0.318
Foreign Official Assets:	45.193	38.882	24.631	5.895	-2.234	10.589	7.478	-4.948
Industrial	49.337	30.215	20.689	7.238	-3.106	5.393	1.371	-6.900
OPEC	-9.955	-3.109	-1.547	-1.776	-0.459	0.672	7.143	0.281
Other	5.811	11.776	5.489	0.433	1.331	4.524	-1.036	1.671
Banks, net:	46.907	14.351	-1.871	17.853	-2.938	1.307	-8.871	5.705
Claims	-42.119	-54.481	15.266	-12.602	-26.229	-30.916	-22.132	28.527
Liabilities	89.026	68.832	-17.137	30.455	23.291	32.223	13.261	-22.822
Securities, net	25.427	33.706	2.687	14.817	9.263	6.940	14.016	4.701
Foreign Securities	-5.251	-7.846	-4.539	1.333	-1.592	-3.047	-2.568	-5.908
U.S.Treas Securities	-7.643	20.144	5.928	5.458	3.422	5.336	8.590	2.722
Other U.S. Securities #	38.321	21.408	1.298	8.026	7.433	4.651	7.994	7.887
U.S. Direct Invest. Abroad	-40.395	-12.493	-5.474	0.732	-4.891	-2.860	-4.921	-3.567
Reinvested Earnings	-34.264	-15.170	-3.901	-2.721	-4.489	-4.058	-3.856	-3.411
Equity & Inter-Co Debt #	-6.130	2.678	-1.573	3.453	-0.401	1.198	-1.065	-0.156
For. Direct Invest. in U.S.	46.894	58.436	9.616	13.885	11.896	23.038	19.161	12.331
Reinvested Earnings	1.481	6.560	1.774	1.357	2.083	1.347	0.208	1.174
Equity & Inter-Co Debt	45.413	51.875	7.842	12.528	9.814	21.692	18.953	11.157
Other U.S.-Corp., net	7.651	4.874	1.500	-6.502	2.605	7.271	4.687	0.000
Claims	5.201	-1.684	-0.065	-6.443	0.255	4.569	1.835	n.a.
Liabilities	2.450	6.558	1.565	-0.059	2.350	2.702	2.852	n.a.
NET CAPITAL FLOWS	141.821	137.189	30.919	45.891	8.324	52.056	28.419	1.809
Statistical Discrepancy	1.878	-10.641	-3.364	-12.015	28.603	-23.865	-2.425	28.969
TOTAL *	143.700	126.548	27.556	33.875	36.926	28.191	25.994	30.778

Source: Sept 1989 SURVEY OF CURRENT BUSINESS

Adjusted to treat Inter-Company borrowing by U.S. corporations from Netherlands Antilles financing subsidiaries as US-Securities, rather than Direct-Investment, transactions.

* Equals seasonally-unadjusted Current Account Balance, with reversed sign.

Table 5

U.S. TRADE WITH ASIAN NIES AND CURRENCY CHANGES

Cumulative Change against US$ as of October 13, 1989

from:	7/22/80	2/26/85	9/20/85	end-86	end-87	10/14/88	Rate on 10/13
HK$	-37.11%	-0.38%	0.06%	-0.26%	-0.65%	0.04%	HK$ 7.81
Won	-12.39%	24.20%	33.23%	28.28%	18.01%	5.79%	W 671.40
Singapore$	7.35%	14.24%	11.78%	10.18%	1.27%	2.63%	S$ 1.97
NT$	39.97%	52.41%	57.54%	38.02%	11.00%	12.36%	NT$ 25.72
Yen	55.07%	84.09%	70.47%	12.35%	-12.99%	-11.00%	Y 142.05
DM	-7.16%	85.67%	54.28%	3.66%	-14.65%	-3.54%	DM 1.87

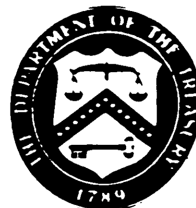
* [-] signifies depreciation against the U.S. dollar.

U.S. Trade Deficit with Asian NIEs [1]
(U.S. $ Billions)

	1980 [2]	1987 [2]	1988 [2]	%Change [3]	1-8/88 [4]	1-8/89 [4]	%Change
Hong Kong	-2.1	-5.8	-4.6	121%	-2.7	-1.9	-30%
Korea	0.2	-9.4	-9.5	n.a.	-5.6	-4.2	-25%
Singapore	1.1	-2.1	-2.2	n.a.	-1.4	-0.8	-40%
Taiwan	-2.8	-17.5	-13.0	369%	-7.7	-8.7	13%
TOTAL NIEs	-3.6	-34.8	-29.2	722%	-17.5	-15.7	-10%
Total U.S.	-25.5	-160.3	-126.5	397%	-77.8	-72.2	-7%
% Total U.S.	14%	22%	23%		22%	22%	

[1] Totals may not equal sum of components due to rounding.
[2] U.S. balance of payments adjusted data.
[3] From 1980 to 1988.
[4] U.S. customs value data, not seasonally adjusted.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
October 30, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S AUCTION
OF 51-DAY CASH MANAGEMENT BILLS

Tenders for $2,005 million of 51-day Treasury bills to be issued on October 31, 1989, and to mature December 21, 1989, were accepted at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low	7.85%	8.05%	98.888
High	7.90%	8.10%	98.881
Average	7.87%	8.07%	98.885

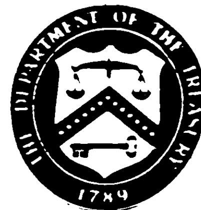
Tenders at the high discount rate were allotted 2%.

TOTAL TENDERS RECEIVED AND ACCEPTED
BY FEDERAL RESERVE DISTRICTS
(In Thousands)

Location	Received	Accepted
Boston	$ --	$ --
New York	15,725,000	1,880,400
Philadelphia	--	--
Cleveland	--	--
Richmond	--	--
Atlanta	77,000	77,000
Chicago	1,470,000	45,000
St. Louis	2,000	2,000
Minneapolis	--	--
Kansas City	--	--
Dallas	--	--
San Francisco	400,000	1,000
TOTALS	$17,674,000	$2,005,400

NB-536

TREASURY NEWS



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CONTACT: Office of Financing
202/376-4350

5310

FOR IMMEDIATE RELEASE
October 30, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,802 million of 13-week bills and for $7,822 million of 26-week bills, both to be issued on October 31, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing February 1, 1990			:	26-week bills maturing May 3, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.78% a/	8.05%	97.990	:	7.58%	7.99%	96.126
High	7.78%	8.05%	97.990	:	7.62%	8.04%	96.105
Average	7.78%	8.05%	97.990	:	7.62%	8.04%	96.105

a/ Excepting 2 tenders totaling $3,845,000.

Tenders at the high discount rate for the 13-week bills were allotted 57%.
Tenders at the high discount rate for the 26-week bills were allotted 96%.

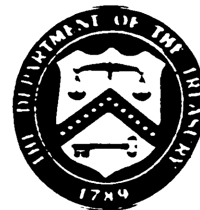
TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 21,085	$ 21,085	:	$ 19,730	$ 19,730
New York	33,678,355	7,574,910	:	23,224,690	7,306,730
Philadelphia	10,245	10,245	:	11,440	11,440
Cleveland	27,515	24,245	:	15,535	15,535
Richmond	23,920	18,920	:	27,610	27,610
Atlanta	20,285	16,285	:	22,425	22,425
Chicago	2,552,075	26,960	:	1,903,080	321,080
St. Louis	57,180	13,180	:	23,530	17,450
Minneapolis	19,100	9,100	:	15,450	5,450
Kansas City	24,250	24,250	:	21,820	21,820
Dallas	20,900	10,900	:	21,970	11,970
San Francisco	876,995	48,995	:	566,405	38,405
Treasury	2,470	2,470	:	2,455	2,455
TOTALS	$37,334,375	$7,801,545	:	$25,876,140	$7,822,100
Type					
Competitive	$36,856,050	$7,323,220	:	$24,818,325	$6,764,285
Noncompetitive	460,825	460,825	:	348,215	348,215
Subtotal, Public	$37,316,875	$7,784,045	:	$25,166,540	$7,112,500
Federal Reserve	-0-	-0-	:	-0-	-0-
Foreign Official Institutions	17,500 2/	17,500 2/	:	709,600 2/	709,600 2/
TOTALS	$37,334,375	$7,801,545	:	$25,876,140	$7,822,100

1/ Equivalent coupon-issue yield.

2/ This represents cash purchases. Foreign official institutions were not permitted to tender their holdings of Treasury bills maturing November 2, 1989, to purchase bills issued October 31, 1989.

NB-537

TREASURY NEWS 

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 A.M.
October 31, 1989

TESTIMONY OF THE HONORABLE
DAVID W. MULLINS, JR.
ASSISTANT SECRETARY FOR DOMESTIC FINANCE
FOR THE DEPARTMENT OF THE TREASURY
BEFORE
THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON
WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

OCTOBER 31, 1989

Chairman Pickle and Members of the Subcommittee, thank you for inviting the Treasury Department today to provide our views on working capital for the Resolution Trust Corporation (RTC), and on H.R. 3469, the "Federal Agency Debt Management Act."

The Need for Working Capital

I understand that the other witnesses today, representatives of the Resolution Trust Corporation and the Oversight Board, will provide detailed reasons for the critical need for sufficient RTC working capital. This is appropriate, since they are responsible for establishing the general policies and specific mechanisms in accordance with FIRREA. Accordingly, while Treasury strongly agrees that there is a critical need for working capital for the RTC, I will not repeat the detailed reasons here except to reiterate a few key points.

First, there has been some confusion between working capital funding and the $50 billion that REFCORP and the Federal government are providing to pay for the thrift clean-up. Working capital is temporary bridge financing that will be repaid by the sale of RTC assets; the $50 billion is money spent to fund thrift losses, and this money will never be repaid. Working capital borrowing authority does not increase the $50 billion in

resources available to the RTC to pay for the ultimate cost of the thrift clean-up.

Second, working capital is crucial to the RTC's ability to choose the least cost method of resolving institutions, rather than resorting to a least cash alternative that could cost the taxpayers more money -- which is exactly what FSLIC was forced to do in 1988 when it had no cash. In essence, the ability to raise working capital permits the RTC to strip problem assets out of a failed institution, repackage them, and carry them until later sale if that would be cheaper than selling the institution in one piece.

By separating problem assets from the thrift franchise itself, the RTC can often increase the pool of bidders for both, which can save substantial amounts of taxpayer funds. Financial institution bidders are interested in acquiring core deposits and quality assets, a "clean" bank, but may have little interest in dealing with problem assets. Other bidders, asset workout specialists for example, may be interested in acquiring problem assets, but have little interest in core deposits and the thrift franchise. Splitting apart problem assets from core deposits will allow the RTC to sell them separately and appeal to specialized bidders to produce a higher sales price than would be possible if problem assets were sold as part of thrift institutions in "whole" bank deals. Working capital financing is necessary to achieve these higher resolution values and to save taxpayers money.

On the other hand, if working capital financing is not provided, the RTC may have to slow case resolutions or dump acquired assets through fire sales in order to unlock cash for resolutions -- obviously, neither result is desirable. Thus, to provide the RTC with the maximum flexibility to choose the least cost case resolution method, it must have adequate working capital.

Third, as you know, Treasury played a key role in designing the thrift legislation and formulating Administration positions. We were concerned from the outset that the RTC have at least as much flexibility as the FDIC has always had in financing working capital. This included the ability to issue notes, guarantees, and other obligations, as well as the ability to carry assets in bridge banks, federal savings associations, conservatorships or similar structures using brokered deposits and other forms of financing until purchasers could be found.

The authority to issue notes, guarantees and other obligations was given to the RTC in the Administration's original bill. But it soon became the subject of debate, both for the RTC and the FDIC, because of the experience with FSLIC in 1988 where

billions of dollars of notes were issued to fund permanent thrift losses rather than temporary working capital.

This Committee and others made it perfectly clear that Congress should not permit the FSLIC experience to be repeated. The Administration agreed, and I personally responded to questions by the full Ways and Means Committee during its mark-up of the thrift legislation last May that indicated our support for a borrowing cap. The Committee subsequently sent a letter to Banking Committee Chairman Gonzalez expressing its concerns, and he successfully offered a floor amendment that appeared to tie borrowing authority to REFCORP financing rather than to working capital needs.

The Administration strongly objected to this particular borrowing cap because it was much too stringent. Instead, we argued that a cap should be imposed that would have the effect of limiting RTC working capital financing to the fair market value of RTC assets. This would protect the taxpayer by ensuring that notes would be backed by tangible assets that would be sufficient to pay off all obligations.

This approach was adopted in Conference with an added protection: RTC borrowing would be limited to 85 percent of the fair market value of RTC assets (plus RTC cash held and future REFCORP proceeds), and FDIC borrowing would be limited to 90 percent of the fair market value of FDIC assets. In the case of the RTC, the 15 percent "haircut" provided an additional layer of protection between the taxpayer and losses.

In short, rather than imposing a specific amount as the borrowing cap, Congress instead adopted a cap tied to 85 percent of the tangible, fair market value of RTC assets. As a result, the taxpayer is not at risk because working capital financing must be temporary and self-liquidating through subsequent asset sales --notes cannot be used to fund permanent thrift losses as FSLIC did in 1988. This meets the dual concerns of maximum flexibility to the RTC to choose the least cost resolution method, and maximum protection of the taxpayer through over-collateralized borrowing.

We believe this makes sense.

Specific Working Capital Mechanisms

FIRREA did not specify a particular working capital mechanism among the range of options available to the RTC. Again, we believe this is appropriate since the RTC should have the maximum number of options available to it in order to choose least cost resolution methods.

We understand that the process for choosing the best working capital mechanisms is now going forward. As you know, now that the legislation has passed, Treasury is no longer playing a direct role. Instead, the RTC must design specific working capital mechanisms consistent with the general policy to be established by the RTC Oversight Board. Treasury's formal role in designing working capital mechanisms is now limited to advising Secretary Brady in his role as Chairman of the Oversight Board.

Although we have had several discussions with the RTC and the Oversight Board regarding preliminary ideas of various working capital options, we understand that no final working capital proposal has been presented by the RTC to the Oversight Board. However, we do know that the people who have the most knowledge about the issue are working carefully to design the best approach to working capital financing, which is no easy task because of the advantages and disadvantages associated with each available option.

General Observations On Working Capital Plans

Obviously, in the absence of a specific proposal, it is difficult to provide definitive answers to some of the questions raised in the Subcommittee's letter of invitation, such as the specific entity that will be used to raise working capital, its budget treatment, the interest cost, and the issue of whether the full faith and credit of the United States stands behind working capital obligations. Nevertheless, we do have some comments about the general objectives of any working capital plan that address some of these questions.

First, any working capital mechanism must achieve one fundamental objective: to minimize the overall resolution cost to the taxpayer taking into account all direct and indirect costs. There are really two components to this general objective.

The first and most important is that the working capital mechanism must facilitate the best and cheapest methods for case resolution and asset disposition. If that requires resolutions that are cash intensive in the early phases, then enough cash must be provided; otherwise, the RTC could begin to resort to least cash options like FSLIC did last year -- such as long-term asset guarantees and yield maintenance -- which would drive up the cost to the taxpayer.

The second component is the cost of carrying assets -- any working capital proposal should attempt to do this cheaply without creating other costs in the process.

In the context of this overall objective, the RTC has a number of available options, each of which has advantages and disadvantages. These include, but are not limited to, the following:

1. Using a conservatorship or related structure to finance working capital with federally insured, brokered deposits that are backed by the full faith and credit of the United States (brokered deposits are very expensive);

2. Providing asset guarantees and yield maintenance agreements, as FSLIC did in 1988 (also expensive);

3. Issuing RTC-guaranteed obligations to acquiring institutions (also expensive) or public markets -- the obligations could be issued by a thrift resolution entity (conservatorship, bridge bank, federal savings association, or similar structure);

4. Issuing direct RTC obligations to acquiring institutions (also expensive) or public markets; and

5. Borrowing directly from the Treasury through the $5 billion emergency line of credit specifically authorized by FIRREA (although this will be clearly inadequate to finance working capital and the funds may be needed for other emergency purposes).

Budgetary Treatment

Once a specific proposal is announced, the determination of any budget treatment will be made by the Administration after careful analysis. Nevertheless, we do have some general observations about budget treatment and the consequences of requiring working capital to flow through the federal budget.

First, Treasury believes that, regardless of the specific option chosen, the budget scoring of working capital should reflect the actual cost to the taxpayer. As described above, the borrowing cap imposed by FIRREA directly limits the taxpayer's exposure by requiring all borrowing to be backed by tangible assets at market value. The taxpayer is exposed only in the event asset values fall dramatically. This exposure is more in the nature of a guarantee rather than in the full amount of the working capital obligation.

By tying working capital financing to asset values, the borrowing cap ensures that notes cannot be used to pay for permanent thrift losses. In addition, this temporary interim

financing will be self-liquidating with the obligations paid off as assets are sold.

In these circumstances, does it make sense to distort the budget by ballooning budget expenditures in early years with amounts that will be fully repaid with budget receipts in later years? Since this is merely a cash-flow timing question, there will be no ultimate effect on the budget over time. Temporary increases and decreases to the budget deficit would therefore be misleading.

Second, the magnitude of the yo-yo effect on the budget, which would appear to have no apparent purpose, is likely to be dramatic. Budget deficits in early years, particularly in FY 1990, could skyrocket by tens of billions of dollars. These same deficits would dramatically fall in later years by similar amounts when asset sales become substantial. This massive upswing and downturn reflect neither economic reality nor exposure to the taxpayer. But it has the potential of making a mockery of the budget process.

Third, working capital flowing through the budget is likely to have perverse results under Gramm-Rudman-Hollings. Cash intensive resolutions this year, in FY 1990, will require working capital borrowing that would raise the budget deficit dramatically but have no effect whatsoever on GRH sequestration. This is because GRH applies only to prospective fiscal years and has no effect on supplementary spending in current fiscal years.

As the same time, however, substantial budget receipts from the sale of working capital assets are likely to begin in FY 1991 and later years. The result would be that GRH targets would be easier to satisfy, relieving a critical discipline on federal spending. This perverse result does not reflect any real or net taxpayer spending.

Fourth, once the federal budget process applies to working capital borrowing and receipts, it has the potential to affect the RTC case resolution and asset disposition process. If working capital is scored on-budget, the RTC's operations could be the single largest determinant of budget results, a position that could expose the RTC to political pressure. Least-cost resolutions should be the ultimate goal, and that can best be achieved by the RTC if it is not drawn into the budgetary political arena. Both the Administration and Congress should think long and hard before allowing the budget process to drive the case resolution and asset disposition process.

Fifth, financial institution resolution entities have typically not been scored on the federal budget despite the fact that they often issue full faith and credit obligations.

Insolvent banks and thrifts run by government conservators or receivers as well as bridge banks have financed working capital by issuing federally-insured, full faith and credit deposits. This is clearly an expensive means to raise working capital, yet it is just as clear that the borrowing has been off-budget. Obviously, it would be preferable for thrift resolution entities to raise funds more cheaply than through the use of brokered deposits.

Moreover, it is not immediately apparent that on-budget financing mechanisms are always less costly than off-budget mechanisms, even without taking into account indirect costs. For example, issuing on-budget RTC notes to acquiring thrift institutions could well be more expensive than issuing RTC-guaranteed securities directly to public markets.

In sum, we would raise the question of whether it makes sense to distort the federal budget with working capital financing that is fully collateralized, exposes the taxpayer to little risk, is self-liquidating and ultimately has no net effect on the budget looking over a number of years.

However, these observations should not be viewed as a rigorous analysis of the budgetary treatment of working capital financing -- they are only general comments about the scoring treatment of any working capital plan. No final conclusions can be made until a specific working capital proposal is put forward. Again, we feel that minimizing the cost of resolutions, rather than budgetary treatment, should determine the decision on working capital financing.

H.R. 3469, the "Federal Agency Debt Management Act"

Let me now provide specific comments on H.R. 3469, the "Federal Agency Debt Management Act," both with respect to its specific impact on the RTC and its general impact on future agency borrowing.

Because of its effect on the RTC, we would strongly oppose H.R. 3469. First, the bill would have consequences that would raise the cost of resolutions and possibly stop them altogether. The RTC mentions several of these in its testimony, including the prohibition of routine RTC assurances and indemnities for thrift acquirers; the prohibition of routine asset "putback" provisions that facilitate acquisitions and actually decrease the need for working capital; and the prohibition of guarantees related to such items as the severance contracts for managers of thrift institutions. These consequences make H.R. 3469 unworkable.

Second, H.R. 3469 would limit RTC working capital funding to amounts borrowed from Treasury, yet the bill provides no specific authorization for Treasury borrowing. That would appear to limit RTC to the emergency $5 billion line of credit from Treasury that was specifically authorized by FIRREA. That amount appears to be completely insufficient for working capital needs, and it would also prevent the RTC from having a ready source of funds for unrelated emergencies. The effect would be to prevent the RTC from raising any meaningful amounts of working capital, which would slow down resolutions and immediately raise the cost of the clean-up well beyond $50 billion.

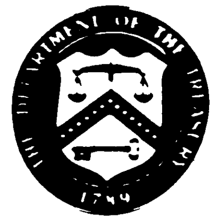
For all of these specific consequences to the RTC, we cannot support H.R. 3469.

There are, however, broader questions raised by H.R. 3469 concerning its effect on future government agencies and government sponsored enterprises (GSEs). For example, the legislation could preclude the use of federal loan guarantees or insurance arrangements where they might be desirable substitutes for direct federal lending. Furthermore, as you know, Treasury must conduct two studies of GSEs that were suggested by this Committee and mandated by FIRREA, and we recently testified before this Subcommittee on this subject. These studies will certainly address the issue, directly raised in H.R. 3469, of whether government agencies or GSEs should only be permitted to borrow from Treasury. It would be premature for us to take a position at this point, and we urge the Committee not to adopt such a proposal until we have had time to complete our overall GSE studies.

This concludes my testimony. I would be happy to answer any questions the Committee may have.

# # # # #

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
October 31, 1989

STATEMENT OF THE HONORABLE
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
FOR FINANCE
BEFORE THE SENATE BANKING COMMITTEE

Mr. Chairman and Members of the Committee:

I am happy to be here today to participate in this hearing on Government-sponsored enterprises and to discuss the GSE studies which Treasury will perform, as required under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

At the outset, let me say that we share your interest in GSEs, particularly with regard to the risk of taxpayer loss which they pose, their financial condition, and the adequacy of their current capital positions. As you may recall, Assistant Secretary Mullins in his April 18 testimony before the House Ways and Means Committee recommended that a Federal entity be asked to study the relationship between risks and GSE capital and to consider whether capital standards should be established for the GSEs. Thus, we are pleased that GAO will be conducting studies on capital requirements for GSEs, and we welcome the opportunity to perform Treasury studies to assess the financial safety and soundness of GSEs and the impact of their operations on Federal borrowing.

Over the years Treasury has been involved in a number of policy initiatives designed to control the growth and cost of Federal and federally-assisted credit. The Federal Government is the largest financial intermediary in the United States. At the end of FY 1988, the Government held $222 billion of outstanding direct loans (including $124 billion financed by the Federal Financing Bank) and had another $550 billion in outstanding guaranteed loans (including $451 billion of FHA and VA mortgages and $48 billion of guaranteed student loans). Government-sponsored enterprises, such as Fannie Mae and the Farm Credit Banks, had an additional $666 billion of outstanding loans at the end of the year (approximately $615 billion in the housing area and $51 billion in the agricultural sector). Thus, directly or indirectly, the Government had influenced the allocation of $1.4 trillion of outstanding credit to farmers, homeowners, small businesses, exporters, utilities, shipbuilders, and State, local and foreign governments.

NB-539

While much public attention is focused on direct Treasury borrowing to finance budget deficits, much less attention has been focused on federally-assisted borrowing in the form of off-budget guaranteed loans and borrowing by off-budget Government-sponsored enterprises. Yet, of the estimated $209 billion of net Federal and federally-assisted borrowing in FY 1990 (including the $4.5 billion of REFCORP bonds auctioned on October 25, but excluding prospective REFCORP borrowing), 49 percent is for financing the budget deficit, 15 percent for financing off-budget Federal loan guarantee programs, and 36 percent for financing off-budget GSEs. Taken together, it is clear that off-budget credit assistance from the Federal Government will be the largest component of total borrowing under Federal auspices in FY 1990.

FIRREA requires the Secretary of the Treasury to conduct two annual studies of the following eight GSEs:

- o Federal National Mortgage Association (Fannie Mae), created in 1938 as a Government-owned corporation to provide a secondary market for federally guaranteed home mortgages. Fannie Mae became private in 1968, and since 1970 has become a major purchaser of conventional mortgages.

- o Federal Home Loan Mortgage Corporation (Freddie Mac), created in 1970 to provide a secondary market for conventional mortgages.

- o Federal Home Loan Bank System, created in 1932 to provide liquidity for the thrift industry.

- o Farm Credit Banks, created in 1987 when the Federal Intermediate Credit Banks and the Federal Land Banks were merged. The Banks provide credit assistance for agricultural purposes.

- o Banks for Cooperatives, created in 1933 to finance the operations of farmers' cooperatives. All but two of these banks were merged in 1988 into a single National Bank for Cooperatives.

- o Federal Agricultural Mortgage Corporation (Farmer Mac), created in 1987 to shift the financing of farm loans from the bank loan market to the securities market.

- o Student Loan Marketing Association (Sallie Mae), created in 1972 to provide liquidity to lenders involved in the guaranteed student loan program.

- o College Construction Loan Insurance Association (Connie Lee), created in 1986 to guarantee and insure bonds and loans issued and made for the construction and renovation of college and university facilities.

The attached table provides aggregate data on the borrowing activities of the GSEs. Under FIRREA, the Secretary may also designate other GSEs to be included in the studies. However, given the limited resources which we have to devote to these studies, we may well limit them to the eight GSEs listed above.

With the exception of Connie Lee, the GSEs are privately owned entities, but are distinguished from fully private financial intermediaries by their close, favored relationship with the Federal Government. For example, GSEs generally have special tax exemptions; their obligations are eligible for open market purchase by the Federal Reserve; and, with the exception of securities issued or guaranteed by Farmer Mac, and securities guaranteed by Connie Lee, they are exempt from SEC registration. GSEs typically have authority to borrow limited amounts from the U.S. Treasury which helps to reinforce the market's perception of an implicit Federal guarantee of their outstanding debt, allowing them to borrow at interest rates lower than those available to fully private firms.

The value to the GSE of the Government's implicit guarantee depends largely on the operating policies adopted by the individual GSE. For a fully private firm, its borrowing costs are positively related to the market's perception of the risks that the firm undertakes and its activities. The implicit Government guarantee of agency debt, however, weakens the relationship between a GSE's cost of funds and the risks it assumes. The larger the gap between a GSE's actual cost of money and the cost it would have to pay if the Government were not seen as absorbing the risk of default, the greater the value of the implicit guarantee. Thus, GSEs have an incentive to take more risks, which could increase the taxpayer's exposure to potential loss.

Our two studies of GSE activities will, where possible, quantify the risks associated with each of the eight GSEs to be studied. In quantifying such risks, we will, as required under FIRREA, determine:

- o the volume and type of securities outstanding which are issued or guaranteed by each GSE;
- o the capitalization of each GSE; and
- o the degree of risk involved in the operation of each GSE due to such factors as credit risk, interest rate risk, management and operation risk, and business risk.

In addition, we will report on the quality and timeliness of information currently available to the public and the Government concerning the extent and nature of GSE activities and the financial risks associated with such activities. We will also

examine the growth and nature of GSE borrowing in the market and assess its impact on Federal and federally-assisted borrowing.

Although we are in the early, formative stages of the initial study, we have made considerable progress in establishing a broad set of issues for the study. As described above, FIRREA has clearly defined the parameters of the studies. Since the nature of a GSE's business and the operating policies of its management determine the risk exposure to the taxpayer, it is necessary to analyze each GSE separately. We have, therefore, decided to adopt a case study approach under which direct and indirect costs posed by the activities of each individual GSE will be studied in-depth. The case study approach will allow us to apply a common framework of analysis to each GSE, while recognizing that each GSE operates in a unique manner and environment.

The studies will require the cooperation of various Federal agencies and all the GSEs. We have already held several meetings with GAO staff which will be involved in conducting their study. While the focus of the GAO study is different from the focus of ours, we have agreed to coordinate our data collection efforts. Over the past three months, we have collected various data which will be needed for the studies. We have also met with several GSEs. The GSEs which we have contacted to date have been very cooperative. In addition, we have talked to private sector firms which may be of some help to us in analyzing the business and management risks posed by various GSE activities.

As you can see, our work on the studies has begun. Given our recent experience with the savings and loan crisis and the magnitude of GSE financial activities, we believe that the proposed studies of GSE activities are both timely and extremely important. By clearly identifying the risks of GSE activities to the taxpayer and assessing the impact of such activities on Federal and federally-assisted borrowing, we will be in a much better position to anticipate any potential problems in the GSE area.

We look forward to working with the GSEs and other entities involved in conducting the studies and to your continued interest in our efforts on the studies during the coming months.

This concludes my prepared statement. I will be happy to answer any questions that you may have.

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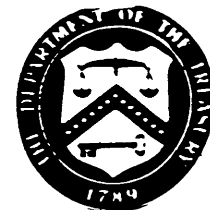
OUTSTANDING DEBT OF GSEs
($ in billions, end of fiscal year 1988)

Federal National Mortgage Association	$273.2
Federal Home Loan Mortgage Corporation	241.3
Federal Home Loan Bank System	
Federal Home Loan Banks	126.7
The Financing Corporation	3.7
Farm Credit System	
FCS Financial Assistance Corporation	.4
Banks for Cooperatives	11.2
Farm Credit Banks	43.4
Student Loan Marketing Association	25.0
Total (gross)	$724.9
Less:	
Borrowing from other GSEs	$ .9
Borrowing from Federal sources	5.0
Investment in Federal securities	5.2
Borrowing for guaranteed loans held as direct loans	50.2
Borrowing with a Federal guarantee	.4
Subtotal for deduction to avoid double counting	$ 61.7
Total net borrowing	$663.2

Source: Table F-20, in "Special Analysis F", from Special Analyses, Budget of the United States Government, Fiscal Year 1990.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT, FINANCE, TRADE AND MONETARY POLICY
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
OCTOBER 31, 1989

Mr. Chairman and members of the Committee:

It is a great pleasure to be here today and to have this opportunity to discuss with you the Department of the Treasury's report on international economic and exchange rate policy. This report and the consultations with Congress on U.S. international economic policy have in a very short time proven to be a highly effective and important element in broadening understanding of the relationship of U.S. domestic and external policies and advancing U.S. international economic objectives. We look forward to continuing and broadening this dialogue.

I would like to focus my remarks on two aspects of U.S. international economic policy. First, the economic policy coordination process and our efforts to promote sustained growth with low inflation and reduce external imbalances. Second, our negotiations to achieve exchange rate appreciation and market-oriented policies in Korea and Taiwan, consistent with their sizable external surpluses and growing international responsibilities in the world economy.

Economic Policy Coordination

The economic policy coordination process has contributed importantly to the record of success achieved by the major countries in recent years. This process has provided a framework in which the Finance Ministers and Central Bank Governors of the G-7 countries can collectively review their economic policies and prospects, establish objectives, and assess the need for changes in policies.

The major countries have achieved 7 consecutive years of sustained expansion. At the same time, inflation and interest rates have been substantially reduced. World trade growth has been strong, facilitating external adjustment. The major countries have put into place policies to rein in public spending, reform tax systems, liberalize financial markets and dismantle excessive regulations and red-tape.

The efforts undertaken in 1987 resulted in a solid performance for the world economy last year, despite the fears arising from the stock market decline in October 1987. The G-7 countries experienced vibrant growth well in excess of expectations. The U.S. trade deficit was reduced by a substantial $32 billion. The success of 1988 is being carried forward this year.

In 1989, further adjustment of external imbalances is taking place, although at a reduced pace. Strong export growth is continuing in the United States this year, and developments to date point to further reduction of our trade deficit on the order of $10 to 15 billion to the $110 to 115 billion range. We expect solid, moderate economic growth in the range of 3-1/2 percent in the G-7 countries and the current expansion should continue next year. Inflation is likely to be about 1-1/2 percentage points higher on average this year, largely due to the run-up in commodity prices in late 1988 and early 1989. Significantly, however, concerns earlier this year about an intensification of price pressures have receded as the G-7 have responded with the implementation of appropriate policies.

Despite this progress, we have not become complacent. We remain vigilant in containing inflation. We are concerned about the slowing of the external adjustment process. Sustaining the expansion <u>and</u> reducing external imbalances will continue to be our priorities. This will require further efforts by deficit and surplus countries.

For the United States, this means continuing our efforts to reduce the Federal budget deficit by implementing measures to achieve the Gramm-Rudman-Hollings targets. Progress has been made in deficit reduction. From a peak of over 6 percent as a share of GNP in FY 1983, the deficit has been brought down to an anticipated 2 percent of GNP in FY 1990. Combining Federal, state, and local governments, our deficit is projected to be 1 percent of GNP in FY 1990. Now we are at the hardest part in deficit reduction, where difficult choices must be made. The success of this effort is crucial to improving national savings and our external deficit. We must also take other measures to strengthen private savings and reduce reliance on foreign funds to finance domestic investment.

The efforts of the G-7 to maintain global growth and adjust external imbalances is a shared responsibility. Japan and Germany must put in place policies to reduce substantially their large external surpluses by achieving a level of domestic demand growth

over the medium term which exceeds by a sufficient margin output growth. Japan has experienced the strongest growth of the G-7 countries in recent years and its current account surplus as a share of GNP has declined to the 2-1/2 percent range. Germany has also experienced strong growth but its composition has not been consistent with external adjustment requirements. Thus, imports have not increased sufficiently to offset export growth, and the trade surplus has grown substantially. As a result, the current account surplus remains at a record high, equivalent to over 4 percent of GNP.

The exchange rate adjustments and changes in relative growth rates are necessary but not sufficient conditions for achieving adequate external adjustment. All countries must also implement structural reforms to promote greater economic efficiency, such as opening their economies to foreign goods and services, curbing subsidies and burdensome regulations, and fostering savings where they are inadequate. Such reforms are difficult to negotiate, involving complex domestic political issues and longstanding practices that have become ingrained in our societies. Nevertheless, they must be addressed.

Exchange rates are one of the many factors that affect economic performance and prospects and are thus reviewed within the broader framework of the economic policy coordination process. At their recent meeting, the G-7 Finance Ministers and Central Bank Governors stated that the rise of the dollar in recent months was inconsistent with longer run fundamentals. They agreed that a rise of the dollar above levels prevailing at the time or an excessive decline could adversely affect prospects for the world economy. The G-7 have been cooperating on an intensified basis and progress has been made in exchange markets and in related economic policies. We will continue to work closely in this effort.

Asian Newly Industrialized Economies

Responsibility for the adjustment of global external imbalances does not lie only with the largest countries. The newly industrialized economies of Asia are playing an increasingly important role in the world economy in recent years as their own economies grow and their share of world trade expands. The interest that they share in preserving the world trading system and the sizable external surpluses that some of these economies are enjoying confer an obligation on them to assume a greater responsibility for contributing to the reduction of the world's external imbalances and promoting a sound and growing world economy.

The Omnibus Trade and Competitiveness Act of 1988 recognized that undervalued currencies can be unfairly exploited to build up sizable external surpluses. The Treasury Department concluded in its October 1988 report on International Economic and Exchange Rate Policy that Korea and Taiwan "manipulated" their exchange

rates within the meaning of the legislation. Pursuant to these findings, we initiated bilateral negotiations, on an expedited basis, with these two economies in late 1988. We reaffirmed our assessment in our April 1989 report and have continued our negotiations since then.

We have achieved progress in these negotiations. The Korean and Taiwanese currencies have both appreciated since the October 1988 report. Reflecting this appreciation and certain other factors, the external surpluses of both economies have declined. We still have concerns, however, which I will discuss in the remainder of my testimony.

Since the October 1988 report, the New Taiwan dollar has strengthened by over 12 percent against the U.S. dollar. More than 5 percentage points of this movement came shortly after the release of the April report. In the last 5 months, the New Taiwan dollar has been fairly stable.

The cumulative appreciation of the New Taiwan dollar has contributed to a decline in Taiwan's external surpluses. Taiwan's global current account surplus fell by 43 percent last year to $10.1 billion. The U.S trade deficit with Taiwan decreased by 27 percent in 1988 to $12.6 billion. Half of this reduction, however, was due to extraordinary purchases of $2.5 billion of gold from the United States by Taiwan's Central Bank.

Taiwan's current account deficit is expected to fall further in 1989, although by a modest amount. Because Taiwan's one-time gold purchases have been completed, our trade statistics show an increase in our trade deficit with Taiwan of 13 percent in the first 8 months of 1989. If we exclude the effect of Taiwan's 1988 gold purchases and compare 1988 and 1989 trade on a non-gold basis, we see continued modest improvement. Our non-gold trade deficit with Taiwan in the first 8 months of this year is 14.5 percent lower than in the same period last year.

Following our bilateral negotiations early this year, Taiwan instituted a new and liberalized exchange rate system in April. As Secretary Brady and I mentioned in testimony before Congressional Committees last May, we viewed this step as a constructive move toward a more market-oriented system. We noted several operational problems, however, that caused us to question how effective the new system would be in reducing "manipulation."

Since our testimony last May, the Taiwanese authorities have taken a number of steps to allow greater play for market forces in the new exchange rate determination system and also to reduce capital controls. Most importantly, there is no evidence that the Central Bank continues to intervene substantially in the market, as it has in the past.

In view of these developments, I am pleased to be able to report to you that there are no clear indications that Taiwan is still "manipulating" the exchange rate for competitive advantage. Given the slowdown in the pace of improvement in Taiwan's external surpluses, however, the authorities need to recognize the continued importance of the exchange rate in furthering the adjustment process. We will continue to monitor the situation closely.

Exchange rate appreciation has been consistently more difficult to achieve in Korea. Significant improvement was not forthcoming until 1988. Thus, the correction of Korea's external surpluses was also delayed and did not begin until this year.

Between the beginning of 1988 and the release of the October 1988 report, the Korean won appreciated by almost 12 percent against the U.S. dollar. In the remainder of 1988, the won strengthened by another 4 percent. Because the U.S. dollar itself strengthened against other major currencies in 1988, the won appreciated by even more against non-dollar currencies such as the yen. This is a significant development, because it meant that for the first time, Korea began to lose some of the competiveness that it had established earlier.

In 1989, the won has appreciated by less than 2 percent against the U.S. dollar, but again because the dollar has strengthened against other major currencies in 1989, the won has appreciated more relative to the non-dollar currencies. Since the end of April, however, the authorities have depreciated the won slightly due to their concern about Korea's declining surpluses.

Korea has made considerable progress so far this year in reducing its external surpluses. In the first 8 months of 1989, Korea's current account surplus fell to $2.7 billion. This is a 66 percent drop, compared to the same period last year. Also, our trade imbalance with Korea declined by 25 percent through August to $4.2 billion. On a quarterly basis, our bilateral trade deficit with Korea has been declining fairly steadily since the beginning of 1988.

These welcome declines reflect a number of factors. The won's past currency appreciation, including against the non-dollar currencies, is a principal cause. The sizable increase in imports due to large wage increases and Korea's on-going trade liberalization program is of major significance. Severe labor-management disputes also played an important role in restraining Korea's export growth this year.

It is not clear, however, that these factors will contribute to continued declines in Korea's external surpluses, which still remain large as a percentage of Korea's GNP. Indeed, the recent depreciation of the won and press reports that export promotion programs will be reinstated could be interpreted as a desire on the part of the Korean authorities for larger external surpluses. Further appreciation may be required to ensure that the decline in the external surpluses continues next year.

In addition, unlike Taiwan, Korea has not made progress on the fundamental task of reforming its exchange rate determination system. This system continues to be characterized by comprehensive controls, a lack of a role for market forces, and thus, remains "manipulative" by its very nature. In this regard, I would like to note that Korea's Ministry of Finance has recently agreed to commence talks with Treasury on financial policies and markets. We hope to make progress in those talks on the fundamental issue of Korea's exchange rate determination system.

In sum, Korea presents a mixed picture. We welcome the significant decline that has occurred in Korea's external surpluses so far this year. Yet, exchange rate developments in the past 6 months have not been fully satisfactory in view of questions as to whether Korea's surpluses will continue to decline next year. Moreover, market forces still do not have a role in exchange rate determination. Thus, on balance, our judgment is that there have continued to be indications of exchange rate "manipulation" during the 6 months since the April report.

In our negotiations with Korea in the period ahead, as well as within the framework of our new dialogue on financial policy issues, we will continue to press for exchange rate policy to support further, lasting external adjustment and urge liberalization of the exchange rate system.

Conclusion

The United States is committed to cooperating with its major trading partners to promote the sound world economy and stable financial system on which all countries' prosperity rests. The success of this effort will also require that the Executive Branch and the Congress work closely to deal with difficult domestic issues. The dialogue we have begun on the international aspects of U.S. economic and exchange rate policies is an important element in this effort. The Treasury Department looks forward to extending and broadening this dialogue in the weeks and months ahead.

Thank you, Mr. Chairman.

PRESS RELEASE

O V E R S I G H T B O A R D
Resolution Trust Corporation
1825 CONNECTICUT AVENUE N.W. WASHINGTON, D.C. 20232

FOR IMMEDIATE RELEASE
October 31, 1989

Contact:
(202) 376-5477

OVERSIGHT BOARD SEEKS PUBLIC COMMENT ON STRATEGY FOR INSOLVENT THRIFTS

Methods for resolving failed thrift institutions and for selling property in distressed real estate markets are among the issues presented for public comment in a long-range strategic plan released today by the Oversight Board of the Resolution Trust Corporation.

The plan is designed as a broad framework to guide the operations of the Resolution Trust Corporation (RTC) in five areas: resolution of insolvent thrifts; disposition of the institutions' assets; conflict-of-interest and ethics standards; external relations; and administration. The RTC must meet a series of deadlines, from November 1989 through June 1990, for designing procedures to implement the plan.

The Oversight Board decided unanimously at a public meeting September 21 to submit the plan to the Federal Register for a 30-day period of public comment. That decision was made to provide for the broadest possible participation in plans to resolve troubled thrifts. The document was delivered to the Federal Register today.

Comments will be considered in drafting the final plan, which must be approved by the Board and submitted to Congress by Dec. 31, 1989. The Oversight Board and the RTC board of directors strongly encourage comment from individuals and organizations.

"This plan was developed by the Oversight Board staff in consultation with the staff of the RTC as a cooperative effort,"

- more -

said Daniel P. Kearney, president and chief executive officer of the Oversight Board.

Kearney praised the plan as an "impressive, significant work" by interim Board staff members who hold key positions in other agencies, including the Department of Housing and Urban Development (HUD), the Federal Reserve and the Office of Thrift Supervision.

The plan stresses the need to offer failed thrifts and assets to the widest possible market for the least possible cost to taxpayers. The document specifically invites public suggestions on ways to achieve affordable-housing objectives required by federal law, and on how extensively private contractors should be used to dispose of failed thrifts' assets.

The strategic plan is based primarily on requirements set by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The legislation requires that RTC resolve failed thrifts and dispose of assets for maximum return and minimum loss to taxpayers; minimum impact on local real estate and financial markets; and maximum availability and affordability of housing for low- and moderate-income buyers.

The plan directs RTC to set priorities by Nov. 30, 1989 for resolving failed thrifts, depending on the condition of the institutions and the risk to RTC involved in keeping failed thrifts open. The plan recommends that RTC base its resolution priorities on broad groups of institutions, rather than on a rigid scale.

The document also calls for detailed cost analyses of thrift resolutions, and sets 14 directives for RTC regarding affordable housing, including financing methods and the designation of unmarketable properties for public use.

The RTC must tailor its asset sales so as not to disrupt local real estate markets by selling property at below-market prices, the plan said, while avoiding market speculation by holding properties too long.

The RTC should keep the market informed of its plans, avoid political favoritism, and explore creative, low-cost methods of providing affordable housing, such as selling eligible properties in bulk to nonprofit organizations and to state and local housing finance agencies, the plan said.

- more -

The RTC is responsible for managing and resolving thrift institutions that will have failed between Jan. 1, 1989 and Aug. 9, 1992. As of Sept. 30, 1989 there were 256 institutions holding $101 billion in assets under RTC's jurisdiction.

The RTC was established by FIRREA to resolve failed thrift institutions and to manage and dispose of the institutions' assets. The Oversight Board was created by FIRREA to set policy and approve funding for the RTC.

The Board is composed of Secretary of the Treasury Nicholas F. Brady, who serves as chairman; Alan Greenspan, chairman of the Board of Governors of the Federal Reserve; HUD Secretary Jack Kemp; and two members to be appointed by President Bush.

Comments on the plan can be mailed to the Policy and Financial Analysis Unit, Oversight Board, room 906, 1825 Connecticut Ave. NW, Washington, D. C., 20232.

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Attachment

OB - 8

STRATEGIC PLAN HIGHLIGHTS

The Resolution Trust Corporation (RTC) must meet a number of objectives in resolving failed thrifts and disposing of the institutions' assets, according to a strategic plan released today by the Oversight Board of the RTC. The plan directs the RTC to:

* draft standards by Dec. 15, 1989 for determining which thrifts should be resolved first, depending on risk and financial condition, thereby reducing resolution costs;

* establish and publicize bidder qualification standards by Nov. 15, 1989;

* develop cost guidelines by Jan. 31, 1990 on the use of cash, notes, warrants, yield maintenance and other types of financial assistance to acquirers of failed thrifts;

* develop procedures by March 30, 1990 to address bidders' complaints of discrimination or unfair treatment;

* establish guidelines by Dec. 29, 1989 for asset sale and management by private contractors;

* set procedures by Dec. 29, 1989 to assure compliance by contractors with ethics and conflict-of-interest standards;

* establish by March 30, 1990 the standards for determining market value and sale prices of assets in both distressed and healthy markets, standards for deviating from those values, and guidelines for determining which nonprofit groups have the capacity and expertise to act as clearinghouses for information regarding low- and moderate-income housing.

* adopt ethics and conflict-of-interest rules for RTC employees within 180 days of enactment of FIRREA, which was passed by Congress Aug. 9, 1989.

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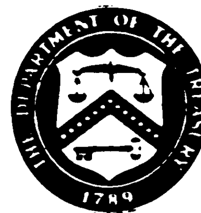
TREASURY NEWS



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FOR IMMEDIATE RELEASE
OCTOBER 31, 1989

CONTACT: LARRY BATDORF
566-2041

TREASURY ANNOUNCES REGULATORY PROPOSALS TO ADDRESS THE PROBLEM OF MONEY LAUNDERING THROUGH INTERNATIONAL WIRE TRANSFERS OF FUNDS

The Department of Treasury today published an Advance Notice of Proposed Rulemaking in the Federal Register inviting comments from financial institutions and other interested parties on regulatory proposals dealing with money laundering through international payments by wire transfers and other means.

For the next sixty days, Treasury welcomes the comments of financial institutions and any other interested parties. After the sixty day comment period, Treasury expects to make a specific regulatory proposal through a Notice of Proposed Rulemaking, followed by a second comment period.

The Advance Notice which is attached contains a list of some of the regulatory proposals under consideration. These proposals are not meant to be considered as mutually exclusive alternatives. Other suggestions from financial institutions or other interested parties concerning alternative regulatory measures are welcomed.

In general, Treasury is considering requiring more complete recordkeeping with respect to international payments and reporting of large transfers of credit between domestic and foreign financial institutions.

For example, Treasury is considering requiring financial institutions to follow model "know your customer" procedures to guard against dealing with money launderers, and to develop profiles of suspicious transactions indicative of money laundering.

Law enforcement authorities dealing with money laundering are discovering that illegal funds are being transferred through creative and intricate money laundering schemes, some of which are being facilitated through the use of international transfers of funds by wire. Recent money laundering investigations conducted by Treasury and other federal law enforcement agencies, such as Operations C-Chase and Polar Cap, show striking examples of this phenomenon.

In announcing this regulatory initiative, a Treasury spokesman stated: "Treasury is committed to the development of a regulatory solution to the problem of money laundering through international payments that balances the needs of law enforcement, the benefits of the free flow of capital in the global financial network, and the concerns of financial institutions. To meet this challenge, we are counting on the active participation by banks and other financial institutions in this regulatory process."

A copy of the Federal Register notice is attached.

[Billing Code: 4810-25]

DEPARTMENT OF THE TREASURY

31 CFR PART 103

Bank Secrecy Act Regulatory Applications to the Problem of Money Laundering through International Payments

AGENCY: Departmental Offices, Treasury

ACTION: Advance Notice of Proposed Rulemaking.

SUMMARY: Treasury expects to issue a Notice of Proposed Rulemaking under the Bank Secrecy Act to address the problem of money laundering through international payments, especially wire transfers of funds. This Advance Notice of Proposed Rulemaking requests comments on a number of regulatory options.

DATES: **Comments must be received no later than [60 days from date of publication].**

ADDRESS: Comments should be sent to: Amy G. Rudnick, Director, Office of Financial Enforcement, Department of the Treasury, Room 4320, 1500 Pennsylvania Avenue, N.W., Washington, D.C. 20220.

prescribed under section 5314 or any other provision in 31 U.S.C. 5311-5326. Treasury will be exercising its authority under these provisions to address the problem of "laundering" drug and other illegal proceeds through the international payments system, particularly through international wire transfers of funds. International wire transfers of funds include transactions where either (1) a foreign office of a financial institution instructs a U.S. office of a financial institution to effect a payment in the U.S., directly or indirectly, or (2) where a U.S. office of a financial institution instructs a foreign office of a financial institution to effect a payment abroad, directly or indirectly. (The term does not include check or ACH payments.)

World-wide gross drug revenues are estimated to be $300 billion. Illegal drug revenues in the United States are estimated to total $110 billion. Estimates are that only 20% of the money generated from narcotics trafficking goes to the cost of goods sold, with 80% available for profits. These profits are used to finance other narcotics and criminal activities, purchase luxury items, make investments in real estate and acquire legitimate businesses.

Money laundering is a vital component of drug trafficking and other criminal activity throughout the world. Criminals must "wash" their "dirty" money to make it appear "clean." As President Bush recently stated,

> Drug money undermines honest businesses, corrupts political institutions, and even threatens the security of nations. To conceal their obscene profits, drug barons must wash their money by cycling it through financial institutions and illegitimate shell corporations.

Currently, illegal funds are being transferred from or to the United States and "cycled" through intricate money laundering schemes involving international payments, particularly wire transfers. Several recent money laundering operations, which have been discovered by Treasury and other federal law enforcement agencies, such as Operations C-Chase and Polar Cap, are testaments to this phenomenon. In an April 28, 1989, submission to the Director, Office of National Drug Control Policy, reprinted in the Congressional Record of May 18, 1989, the American Bankers Association stated that, "Wire transfers, which are essentially unregulated, have emerged as the primary method by which high volume launderers ply their trade." 135 Cong. Rec. S5555 (May 18, 1989).

To date Treasury has used its Bank Secrecy Act authority to require financial institutions to keep records of all requests, advices and instructions relating to international transfers of more than $10,000 to or from any person or account outside the

United States. 31 C.F.R. 103.33(b). Under this provision, a financial institution must keep a record of each international transaction over $10,000, including all international wire transfers of funds and book transfers of credit. Currently, Treasury does not specify what type of information must be contained in the record. Thus, financial institutions are not required to obtain or record information from or about the identity of an originator or beneficiary of a payment, about the parties on whose behalf the originator or beneficiary may be acting, or other information beyond what is in their records or necessary to make the transfer.

In addition to the current recordkeeping requirements for wire transfers, Treasury is authorized to require financial institutions to report transactions, including international wire transfers of funds, with foreign financial institutions in a designated location for a limited period of time pursuant to 31 C.F.R. 103.25. This authority is limited by the fact that financial institutions involved in international wire transfers of funds frequently do not have complete information about the originator or beneficiary of payments.

Treasury is reviewing a number of regulatory options under the authority of 31 U.S.C. 5314 and 5318 to deal with these deficiencies and the severe money laundering problem. In our regulatory review, we will give careful consideration to the

question of reaching an appropriate balance between law enforcement needs, the importance of free capital flow in global commerce and an efficient international financial network, and the potential burden on financial institutions. This is difficult given the severity of the money laundering problem and the enormous daily volume of international payments, the overwhelming majority of which represent normal commercial transactions. Therefore, Treasury is soliciting views of financial institutions, law enforcement officials, regulatory agencies, and other interested parties on these or other regulatory options. After Treasury analyzes the comments received in response to the Advance Notice, it expects to issue a Notice of Proposed Rulemaking with specific regulatory proposals for comment.

The following list illustrates some of the regulatory options under consideration. Treasury seeks views on each of these proposals. However, these proposals are not meant to be considered as mutually exclusive alternatives; they may be later proposed in combination with one another. With respect to any possible reporting requirement, Treasury would propose that reporting could be made by electronic data transmission.

1. Require a record or report by the financial institution originating or receiving an international wire transfer of funds for a customer which includes identifying and account

information about the originator, beneficiary and the person on whose behalf the payment is being made or received and whether the sender or receiver is aware of any separate payment instructions regarding the payment unknown to the financial institution. This requirement might be coupled with some type of an exemption system designed to cover the majority of normal business transactions.

2. Require that all international wire transfer messages contain all known third party identifying information, e.g., account numbers, addresses, and names of the originator and beneficiary of the payment.

3. Require that, prior to originating international payments on a customer's behalf, either through book entry transfers of credit or through international wire transfers of funds, financial institutions apply model "know your customer" procedures to verify the legitimate nature of the customer's business and that the transfers are commensurate with legitimate business activities.

4. Require special identification procedures and recordkeeping or reporting of international payments sent or received by persons without established account relationships at financial institutions.

5. Require that financial institutions develop a suspicious international wire transfer profile and report suspicious payments to Treasury. The profile might include certain criteria suggested by Treasury, for example, the presence of large currency deposits prior to an outgoing transfer or the existence of an incoming transfer followed by issuance of a cashier's check.

6. Require that (A) when an institution, typically a bank, receives a targeting order under 31 C.F.R. 103.25 relating to international wire transfers of funds, it must obtain, to the extent possible, information from other domestic banks involved in the transfer regarding the identity of the originator or beneficiary of the transfer, and (B) that those other domestic banks cooperate in providing this information on a timely basis to the targeted institution.

7. Provide that an additional category of information may be requested through a regulation issued under 31 C.F.R. 103.25, relating to international book transfers of credit not involving wire transfers, e.g., transfers of credit between U.S. and foreign offices of a financial institution.

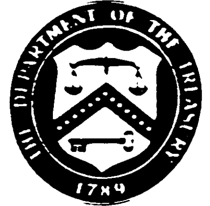
This list is not meant to be exhaustive of the ways in which Treasury's regulatory authority might be used to address the problem. Treasury is open to other suggestions from financial

institutions or other interested parties regarding additional or alternative regulatory measures or voluntary programs.

Treasury requests that financial institutions that have dealt with the issue of money laundering through international payments share their experiences with Treasury, for instance, on efforts to isolate suspicious wire transfers or to impose "know your customer" procedures. We would like financial institutions to advise of their policies and procedures for "pay on proper ID" payments or other arrangements whereby noncustomers can receive (or send) international payments. Treasury also is interested in comments on any practical problems presented by these options and on the estimated costs of compliance. We welcome recommendations on how best to fashion an appropriate exemption system if routine recordkeeping or reporting requirements are adopted. Finally, we welcome comments relating to specific problems which might arise with foreign jurisdictions, such as foreign constraints on U.S. jurisdiction and enforcement abilities.

Treasury is committed to the effective and judicious use of its Bank Secrecy Act authority and wishes to work with the affected financial institutions and law enforcement community to fashion a responsible regulatory solution to the problem at hand. We

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
October 31, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $16,000 million, to be issued November 9, 1989. This offering will provide about $2,300 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,712 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, prior to 1:00 p.m., Eastern Standard time, Monday, November 6, 1989. The two series offered are as follows:

91-day bills (to maturity date) for approximately $8,000 million, representing an additional amount of bills dated August 10, 1989, and to mature February 8, 1990 (CUSIP No. 912794 TQ 7), currently outstanding in the amount of $6,616 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $8,000 million, representing an additional amount of bills dated May 11, 1989, and to mature May 10, 1990 (CUSIP No.912794 UD 4), currently outstanding in the amount of $9,057 million, the additional and original bills to be freely interchangeable.

The Treasury will postpone the auctions unless it has assurance of enactment of legislation to raise the statutory debt limit before the scheduled auction date of November 6, 1989.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing November 9, 1989. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,891 million as agents for foreign and international monetary authorities, and $3,673 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

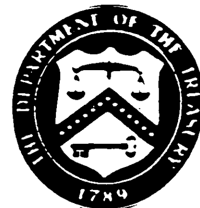
Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

8/89

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
November 1, 1989

CONTACT: Office of Financing
202/376-4350

REINVESTMENT OF TREASURY BILLS MATURING NOVEMBER 2, 1989

The Department of the Treasury announced today that it will make payment for bills maturing on November 2, 1989, to all holders of these securities in the Treasury's book-entry system (TREASURY DIRECT). This action is necessary because of the expiration of the temporary debt limit at midnight on October 31, which does not allow the Treasury to make any new issues or to reinvest maturing issues.

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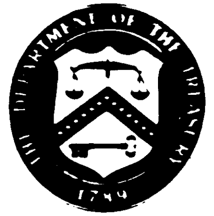
NB-543

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
November 1, 1989

CONTACT: Pete Hollenbach
202/376-4302

TREASURY TO SUSPEND SALES OF SAVINGS BONDS AND STATE AND LOCAL GOVERNMENT SERIES SECURITIES

Because legislation to raise the statutory public debt limit has not been enacted, the Department of the Treasury announced that the sale of U. S. Savings Bonds and State and Local Government Series securities would be suspended effective today, Wednesday, November 1, 1989, until further notice. Without new legislation to increase the debt limit, the Government lacks authority to issue any new debt obligations.

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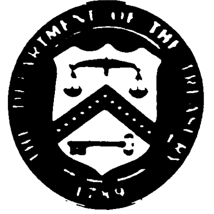
NB-544

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
November 1, 1989

CONTACT: CHERYL CRISPIN
(202) 566-5252

Senate Confirms Dr. Sidney L. Jones Assistant Secretary for Economic Policy

Dr. Sidney L. Jones was sworn in October 31 as Assistant Secretary for Economic Policy in the Treasury Department. His nomination was confirmed by the U.S. Senate last Friday.

Dr. Jones will advise Treasury Secretary Nicholas Brady on economic issues and play an important role in the preparation of the Bush Administration's annual economic forecasts. He served previously as Treasury's Assistant Secretary for Economic Policy and Counselor to the Secretary from 1974-77.

The senior Treasury official brings nearly two decades of experience in senior government positions to his new assignment. Most recently, Jones served from 1983-85 as Under Secretary for Economic Affairs in the Commerce Department. He was also Assistant to the Federal Reserve System's Board of Governors in 1978, and Deputy Assistant to the President and Deputy to the Counselor for Economic Policy in 1974.

In addition, Dr. Jones served as Minister-Counselor for Economic Affairs, U.S. Mission to NATO, 1972-73. He began his government career in 1969 as a Senior Economist and Special Assistant to the Chairman of the Council of Economic Advisors.

Dr. Jones has broad academic experience as well. He has taught economics and finance at the University of Michigan, Northwestern University, Dartmouth College, Rice University, and Georgetown University.

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In recent years, he has been an associate faculty member at the Brookings Institution, a research scholar at the American Enterprise Institute, and a visiting scholar at the Woodrow Wilson International Center for Scholars at the Smithsonian Institution. Dr. Jones has authored over 70 published books and articles on economic and financial matters.

Dr. Jones received a B.S. from Utah State University in 1954. After serving as a U.S. Army officer, he resumed his graduate studies and earned a Ph.D. degree from Stanford University in 1960. He and his wife, Marlene, have five children and reside in Potomac, Maryland.

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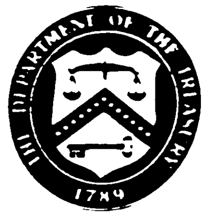
TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
November 1, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY OFFERS $10,000 MILLION OF 36-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $10,000 million of 36-day Treasury bills to be issued November 15, 1989, representing an additional amount of bills dated December 22, 1988, maturing December 21, 1989 (CUSIP No. 912794 SP 0).

Competitive tenders will be received at all Federal Reserve Banks and Branches prior to 12:00 noon, Eastern Standard time, Thursday, November 9, 1989. Each tender for the issue must be for a minimum amount of $1,000,000. Tenders over $1,000,000 must be in multiples of $1,000,000. Tenders must show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions must not be used.

Noncompetitive tenders will <u>not</u> be accepted. Tenders will not be received at the Department of the Treasury, Washington.

<u>The Treasury will postpone this auction unless it has assurance of enactment of legislation to raise the statutory debt limit before the scheduled auction date of November 9, 1989.</u>

The bills will be issued on a discount basis under competitive bidding, and at maturity their par amount will be payable without interest. The bills will be issued entirely in book-entry form in a minimum denomination of $10,000 and in any higher $5,000 multiple, on the records of the Federal Reserve Banks and Branches.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 11:30 a.m., Eastern time, on the day of the auction. Such positions would include bills acquired through "when issued" trading, futures,

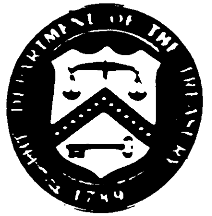
and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Those submitting tenders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch in cash or other immediately-available funds on Wednesday, November 15, 1989.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars may be obtained from any Federal Reserve Bank or Branch.

TREASURY NEWS 

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
November 1, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY NOVEMBER QUARTERLY FINANCING

The Treasury will raise about $10,000 million of new cash and refund $20,010 million of securities maturing November 15, 1989, by issuing $10,000 million of 3-year notes, $10,000 million of 10-year notes, and $10,000 million of 29-3/4-year bonds. The $20,010 million of maturing securities are those held by the public, including $1,836 million held, as of today, by Federal Reserve Banks as agents for foreign and international monetary authorities.

The three issues totaling $30,000 million are being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average prices of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks hold $4,230 million of the maturing securities for their own accounts, which may be refunded by issuing additional amounts of the new securities at the average prices of accepted competitive tenders.

<u>The Treasury will postpone these auctions unless it has assurance of enactment of legislation to raise the statutory debt limit by November 7, 1989.</u>

The 10-year note and 29-3/4-year bond being offered today will be eligible for the STRIPS program.

Details about each of the new securities are given in the attached highlights of the offering and in the official offering circulars.

oOo

Attachment

NB-547

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
NOVEMBER 1989 QUARTERLY FINANCING

November 1, 1989

Amount Offered to the Public	$10,000 million	$10,000 million	$10,000 million
Description of Security:			
Term and type of security	3-year notes	10-year notes	29-3/4-year bonds (reopening)
Series and CUSIP designation	Series U-1992 (CUSIP No. 912827 YD 8)	Series D-1999 (CUSIP No. 912827 YE 6)	Bonds of 2019 (CUSIP No. 912810 ED 6)
CUSIP Nos. for STRIPS Components .	Not applicable	Listed in Attachment A of offering circular	Listed in Attachment A of offering circular
Issue date	November 15, 1989	November 15, 1989	November 15, 1989
Maturity date	November 15, 1992	November 15, 1999	August 15, 2019
Interest rate	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids	8-1/8%
Investment yield	To be determined at auction	To be determined at auction	To be determined at auction
Premium or discount	To be determined after auction	To be determined after auction	To be determined after auction
Interest payment dates	May 15 and November 15	May 15 and November 15	February 15 and August 15 (first payment on February 15, 1990)
Minimum denomination available ...	$5,000	$1,000	$1,000
Amount required for STRIPS	Not applicable	To be determined after auction	$320,000
Terms of Sale:			
Method of sale	Yield auction	Yield auction	Yield auction
Competitive tenders	Must be expressed as an annual yield with two decimals, e.g., 7.10%	Must be expressed as an annual yield with two decimals, e.g., 7.10%	Must be expressed as an annual yield with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000	Accepted in full at the average price up to $1,000,000	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None	None	$20.31250 per $1,000 (from August 15, 1989, to November 15, 1989)
Payment Terms:			
Payment by non-institutional investors	Full payment to be submitted with tender	Full payment to be submitted with tender	Full payment, including accrued interest, to be submitted with tender
Deposit guarantee by designated institutions	Acceptable	Acceptable	Acceptable
Key Dates:			
Receipt of tenders	Tuesday, November 7, 1989, prior to 1:00 p.m., EST	Wednesday, November 8, 1989, prior to 1:00 p.m., EST	Thursday, November 9, 1989, prior to 1:00 p.m., EST
Settlement (final payment due from institutions):			
a) funds immediately available to the Treasury	Wednesday, November 15, 1989	Wednesday, November 15, 1989	Wednesday, November 15, 1989
b) readily-collectible check	Monday, November 13, 1989	Monday, November 13, 1989	Monday, November 13, 1989

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

<u>TEXT AS PREPARED</u>
<u>FOR DELIVERY</u>
Expected at 6:30 p.m., E.S.T.
November 1, 1989

Remarks By
Secretary of the Treasury
Nicholas F. Brady
Before the
Bank Maryland Corporation
Townson, Maryland

It is a pleasure to be here this evening. I commend the Bank Maryland Corporation for sponsoring a forum which brings together representatives of government and the Maryland business and academic communities to discuss the economic and financial issues that confront our nation.

Tonight I would like to address an issue of great importance to the future vitality and strength of the American economy--the low savings rate in the United States. We in the Bush Administration are very concerned about our country's low rate of savings. We are currently studying saving in America in the Economic Policy Council which I chair. I would like to discuss with you tonight several of the options for improving savings that we are investigating.

I believe now is the right time to pursue solutions to our low savings rate because I see in Washington the beginning of a new era of thinking about the relationship of government and politics to the economy. Attitudes about economic growth and economic equity in society are changing. Many who used to see achieving "fairness" as the goal of government economic policy now recognize that stimulating economic growth is inextricably linked to this goal.

NB-548

To see this, you need only look to the House of Representatives, where 64 Democrats joined the Republicans in voting to support a cut in the capital gains tax. They did so because they recognized that a lower capital gains tax will encourage saving and investment and that saving and investment are the foundations upon which growth is built. They recognized that growth is essential to an economically strong and just society. And lastly, they acknowledged that the debate about capital gains should be about the benefits of growth for all Americans and not about the politics of division and economic confrontation. I'll have more to say about capital gains later in my remarks, but it is important to recognize here what a significant change in perspective the current Congressional debate represents.

As we look at saving and investment as an essential foundation and engine for growth in our economy, we can do so with the knowledge that there is a burgeoning understanding in the policy realm: just as there is a direct relationship between investment and growth, there is an equally direct correlation between growth and economic well-being throughout our society.

Our impressive economic performance in recent years allows us a positive launching point for analyzing the issue of saving. We're about to enter our eighth consecutive year of economic growth. Americans enjoy a high standard of living and relatively low rates of inflation and unemployment. However, we must not let our pride in these accomplishments distract us from focusing on whether the United States is adequately preparing to compete over the long-term in an integrated world economy.

We must honestly acknowledge that, in some respects, we are <u>not</u> adequately preparing for the future. By any measure, our national saving rate has been declining since the late 1970s. This decline inevitably raises questions about our ability to fund investment and therefore to sustain economic growth in the face of ever-increasing competition from abroad. Historically, investment capital in the United States has come from foreign capital as well as domestic saving. This combination of sources has served us well. However, our ability to attract foreign capital must not lead us to neglect to foster domestic sources of capital. It would be extremely unwise for us to lose sight of the difference between benefitting from foreign investment capital and being dependent upon it.

Those of us in government, business and academia must join the effort to make Americans aware that our nation's stock of capital is one of our greatest resources. But because we are not saving at a sufficient rate, the cost of capital in the United States is consistently higher than for our major trading partners. In some cases, our companies face capital costs fully twice as high as their competitors pay. The consequence is

clear. If one of the essential inputs of production is so much more expensive in the United States, we're at a disadvantage in world trade. You simply can't pay more than your competitors for a basic component of production and hope to come out ahead. So ultimately, the higher cost of capital endangers the competitive position of American companies. And if our capital costs are consistently higher than those of our competitors over a long period of time, our leadership in the international economy, and even our standard of living, will be placed in jeopardy.

This is the problem we face. The solutions lie in changing the practices and attitudes of government, of business and of individual Americans. These categories are not independent of one another, nor are the solutions. Tonight I'd like to focus my remarks on the particular steps the government can take and on how these steps will assist and encourage private sector efforts to increase domestic saving and investment.

It's a fundamental fact that the most important step the government can take to increase national saving is to decrease the greatest source of national dissaving--the federal budget deficit. Let me say frankly that until we have the budget deficit under control, it will necessarily shape our thinking and dominate our actions across the spectrum of policy issues. Several of the proposals to increase saving that I'll discuss tonight would be constrained by the demands of reducing the deficit. For that reason, some might say we shouldn't discuss them at all because we can't move forward this year. I agree that there is an inevitable tension between prescriptions for increasing saving and investment and the need to maintain the current revenue base. But I don't believe that just because we are grappling with one great problem, we have the luxury of dismissing other great challenges as insolvable. We can't afford to stop planning and working toward worthwhile long-term goals solely because we have to address the budget deficit first. At Treasury, our goal is to deal with the current problems, but at the same time, to plan for the country's future.

We have made progress on the deficit. We've reduced its size as a percent of GNP from 6.3 percent in 1983 to 3.0 percent of GNP in fiscal 1989. If we can meet this year's Gramm-Rudman-Hollings target of a $100 billion deficit, that percentage will decline to 1.8 percent. If we meet the 1991 target of $64 billion, the deficit will be 1.1 percent of GNP. We've achieved this decrease primarily by reducing the rate of increase of federal spending from double-digit levels to single digits, while increasing federal revenues through economic growth.

It hasn't proved to be easy to reach the $100 billion mark this year, even with a bipartisan commitment to do so. Next fiscal year will be even tougher, but the Bush Administration remains committed to meeting the deficit reduction targets set in law.

A word about the debt limit. The debt limit is a ceiling which Congress imposes on the Treasury's borrowing authority. Due to Congress' failure to pass timely debt limit legislation, today the debt limit reverted to its permanent level of $2,800 billion.

If Congress fails to act by November 7th, the Government will run out of cash and default on November 9. Each day that Congress fails to act, however, will cause additional disruption in our borrowing schedule, possibly resulting in higher interest costs to the taxpayer. To avoid these potential costs and the prospect of default, immediate Congressional action is imperative.

As I mentioned earlier, as part of the debate over the fiscal year 1990 budget, the Congress and the Bush Administration are engaged in a great debate over another means of lowering capital costs and promoting capital formation: the reduction of the capital gains tax. For 65 years, from 1922 to 1986, this country gave long-term capital gains a preferential tax rate. The logic was simple and compelling. A permanently lower rate of taxation for capital gains promotes long-term investment and economic growth.

President Bush proposed a restoration of a permanent reduction in the capital gains tax rate in his budget presentation to Congress last February. The House of Representatives has taken a step in the right direction by approving a temporary reduction. We should build upon their efforts and we encourage the Senate to finish the job by putting in place permanently a capital gains tax which reduces the rate according to the length of the holding period.

The debate in Congress and the support of many Democrats for the reduction in the capital gains rate has made clear in Washington what the majority of Americans already know: that the benefits of a preferential capital gains rate reach across American society. Capital gains are at one time or another received by individuals of all income brackets. For example, in 1987, 70 percent of the taxpayers reporting long-term capital gains had income other than capital gains of less than $50,000. So it can no longer be argued that capital gains are only for the wealthy.

But it definitely can be argued that by not lowering the capital gains tax we are reducing our international competitiveness. We have higher taxes on capital gains than most of our trading partners. Belgium, Italy, and the Netherlands

have no tax on capital gains. Nor do Hong Kong, Singapore or South Korea. West Germany doesn't tax the gain on assets held more than six months. And France and Japan provide apreferential rate for long-term capital gains that is considerably below ours. We can't expect to remain competitive when our tax structure provides so little incentive for new investment.

Our trading partners also have the advantage when it comes to the tax treatment of corporate earnings. Almost all, to some extent, integrate individual and corporate taxes to prevent fully taxing the same income twice. In the United States, as you are all aware, corporate earnings are taxed twice: once when the company pays taxes on its profits and again when the shareholders pay tax on their dividends.

Elimination of the double taxation of dividends obviously would involve a loss of revenue to the Treasury, so our options in this area will be limited by the reality of the budget deficit. However, whenever it could be done, such a change would lower the cost of capital and help corporations of every size. A lower cost of capital means a corporation can invest in projects with lower returns or longer term payoffs, and still provide the same or better return to its shareholders. Every corporation would benefit, even those that pay no dividends or raise no new equity. Without this extra layer of tax, which reduces returns to shareholders, the stock prices of every corporation would be higher.

Changing the policy of double taxation would provide an incentive for long-term growth by lowering the overall cost of capital. And it would do more. It would end the bias of the tax system toward debt financing and thereby return Americans to active participation in our equity markets. It would also substantially reduce the incentives for leveraged buyouts.

There has been a great deal of concern expressed about the leveraging of America in recent years. Congress has correctly traced much of this increased leverage to the unequal tax treatment of debt and equity. The answer put forth by some in Congress is to simply limit the deductibility of interest on corporate debt. But this would further increase the cost of capital to American business, which clearly isn't in our national interest. Removing the double taxation of dividends would eliminate the bias toward debt without raising the cost of capital.

Just as there is an important role for the government to play in assisting business, there is also a role for government in encouraging individual Americans to increase their private saving. We at Treasury, along with others in the Administration, are examining ways to improve Americans' private saving rate. Among the ideas we are examining is the possibility of expanding the Individual Retirement Account (IRA).

We are exploring a range of options for IRAs:

- increasing the liquidity of IRAs by permitting early withdrawals without penalty for specific purposes;

- and delaying the budget impact of IRAs by permitting no tax deduction for contributions, but still allowing the accumulation of interest and the final withdrawal of funds to be tax free.

While we pursue these proposals, we must recognize that there will always be limits to what can be accomplished by government action alone, especially in the realm of individual saving. Thus I believe that government also has a valuable role to play in educating the American public about the importance of saving and capital formation to our long-term economic well-being. But of course, the government can't do this alone. It must be a truly collaborative effort.

We here tonight have an important role to play in creating a consensus that saving and investment are the foundations upon which economic growth rests, and that economic growth holds the key to a prosperous future for us all.

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CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE REPUBLIC OF FINLAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL

The Government of the United States of America and the Government of the Republic of Finland, desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital, have agreed as follows:

ARTICLE 1

Personal Scope

1. This Convention shall apply to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.

2. The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded

a) by the laws of either Contracting State; or

b) by any other agreement between the Contracting States.

3. Notwithstanding any provision of the Convention except paragraph 4, a Contracting State may tax a person who is treated as a resident under its taxation laws (except where such person is determined to be a resident of the other Contracting State under the provisions of paragraph 2 or 3 of Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if the Convention had not come into effect. For this purpose, the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of 10 years following such loss.

4. The provisions of paragraph 3 shall not affect

a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), under subparagraph b) of paragraph 1 and paragraph 4 of Article 18 (Pensions, Annuities, Alimony, and Child Support), and under

Articles 23 (Elimination of Double Taxation), 24 (Non-Discrimination), and 25 (Mutual Agreement Procedure); and

b) the benefits conferred by a Contracting State under Articles 19 (Government Service), 20 (Students and Trainees), and 27 (Members of Diplomatic Missions and Consular Posts), upon individuals who are neither citizens of, nor lawful permanent residents in, that State.

ARTICLE 2

Taxes Covered

1. The existing taxes to which this Convention shall apply are:

a) in Finland:

(i) the state income and capital tax;

(ii) the communal tax;

(iii) the church tax; and

(iv) the tax withheld at source from non-residents' income;

(hereinafter referred to as "Finnish tax");

b) in the United States: the Federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax, the personal holding company tax,

and social security taxes), and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations (hereinafter referred to as "United States tax"). The Convention shall, however, apply to the excise taxes imposed on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to the benefits of this or any other convention which provides exemption from such taxes.

2. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws and of any significant official published material concerning the application of the Convention, including explanations, regulations, rulings, or judicial decisions.

ARTICLE 3

General Definitions

1. For the purposes of this Convention, unless the context otherwise requires:

a) the term "Finland" means the Republic of Finland and, when used in a geographical sense, means the territory within which Finnish tax law is in force;

b) the term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession or territory;

c) the term "person" includes an individual, an estate, a trust, a partnership, a company, and any other body of persons;

d) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;

e) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

f) the term "national" means:

(i) in respect of Finland, any individual possessing the nationality of Finland, and any legal person, partnership and association deriving its status as such from the laws in force in Finland;

(ii) in respect of the United States, any individual possessing the citizenship of the United States of America, and any legal person, partnership and association deriving its status as such from the laws in force in the United States;

g) the term "international traffic" means any transport by a ship or aircraft, except when such transport is solely between places within a Contracting State;

h) the term "competent authority" means:

(i) in Finland, the Ministry of Finance or its authorized representative;

(ii) in the United States, the Secretary of the Treasury or his delegate.

2. As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 25 (Mutual Agreement Procedure), have the meaning which it has under the laws of that State concerning the taxes to which the Convention applies.

ARTICLE 4

Residence

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. A United States citizen or

an alien lawfully admitted for permanent residence (a "green card" holder) is a resident of the United States only if such person has a substantial presence, permanent home, or habitual abode in the United States. However,

a) the term "resident of a Contracting State" does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein; and

b) in the case of a partnership, an estate, or a trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.

2. Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);

b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall settle the question by mutual agreement and determine the mode of application of the Convention to such person.

ARTICLE 5

Permanent Establishment

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop; and

f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. The use of an installation or drilling rig or ship in a Contracting State to explore for or exploit natural resources constitutes a permanent establishment only if such use is for more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e).

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

ARTICLE 6

Income from Immovable (Real) Property

1. Income derived by a resident of a Contracting State from immovable (real) property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. For the purposes of this Article

a) The term "immovable property" shall, subject to the provisions of subparagraphs b) and c), have the meaning which it has under the law of the Contracting State in which the property in question is situated.

b) The term "immovable property" shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources.

c) Ships and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. Where the ownership of shares or other corporate rights in a company entitles the owner of such shares or corporate rights to the enjoyment of immovable property held by the company, the income from the direct use, letting, or use in any other form of such right to enjoyment may be taxed in the Contracting State in which the immovable property is situated.

5. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

ARTICLE 7

Business Profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries or carried on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries or carried on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries or carried on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be

attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of this Convention, the profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other Articles of the Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

7. For the purposes of the Convention, the term "profits" means income derived from any trade or business, including the

rental of tangible personal property, but not including the rental or licensing of cinematographic films and films or tapes used for radio or television broadcasting.

ARTICLE 8

Shipping and Air Transport

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

2. For the purposes of this Article, profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft if such rental profits are incidental to the profits dealt with in paragraph 1.

3. Profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used for the transport of goods or merchandise shall be taxable only in that State, except where such containers are used for the transport of goods or merchandise solely between places within the other Contracting State.

4. The provisions of paragraphs 1 and 3 shall also apply to profits from participation in a pool, a joint business, or an international operating agency.

ARTICLE 9

Associated Enterprises

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State; or

b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and that other State agrees that the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made

between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be paid to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

3. The provisions of paragraph 1 shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons, whether or not residents of a Contracting State, owned or controlled directly or indirectly by the same interests when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

ARTICLE 10

Dividends

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a

resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 5 percent of the gross amount of the dividends if the beneficial owner is a company which owns at least 10 percent of the voting stock of the company paying the dividends;

b) 15 percent of the gross amount of the dividends in all other cases.

Subparagraph b) and not subparagraph a) shall apply in the case of dividends paid by a person which is a resident of the United States and which is a Regulated Investment Company. Subparagraph a) shall not apply to dividends paid by a person which is a resident of the United States and which is a Real Estate Investment Trust, and subparagraph b) shall only apply if the dividend is benefically owned by an individual holding an interest of less than 10 percent in the Real Estate Investment Trust.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term "dividends" as used in this Article means:

a) income from shares or other rights, not being debt-claims, participating in profits;

b) income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident; and

c) income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the law of the Contracting State in which the income arises.

4. The provisions of paragraph 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries or carried on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs or performed in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. A Contracting State may not impose any tax on dividends paid by a company which is not a resident of that State, except insofar as

a) the dividends are paid to a resident of that State; or

b) the dividends are attributable to a permanent establishment or a fixed base of the beneficial owner of the dividends situated in that State.

6. A company which is a resident of a Contracting State and which has a permanent establishment in the other Contracting State or which is subject to tax on a net basis in that other State on items of income that may be taxed in that other State

under Article 6 (Income from Immovable (Real) Property) or under paragraph 1 of Article 13 (Gains), may be subject in that other State to a tax in addition to the tax allowable under the other provisions of this Convention. Such tax, however, may be imposed only on:

a) in the case of the United States,

(i) the portion of the business profits of the company attributable to the permanent establishment, and

(ii) the portion of the income referred to in the preceding sentence which is subject to tax under Article 6 or 13,

which represent the "dividend equivalent amount" as that term is defined under the laws of the United States as it may be amended from time to time without changing the general principle thereof, and

b) in the case of Finland,

(i) the portion of the business profits of the company attributable to the permanent establishment, and

(ii) the portion of the income referred to in the first sentence of this paragraph which may be taxed in Finland under Article 6 or under paragraph 1 of Article 13,

which in both cases represent an amount, as defined under the laws of Finland, that if the operation was carried on by a subsidiary incorporated in Finland would be distributed as a dividend.

7. The tax referred to in paragraph 6 shall not be imposed at a rate exceeding the rate specified in subparagraph a) of paragraph 2.

ARTICLE 11

Interest

1. Interest derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.

2. The term "interest" as used in this Convention means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds, or debentures, as well as all other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises. Penalty charges for late payment shall not be regarded as interest for the purposes of the Convention. However, the term "interest" does not include income dealt with in Article 10 (Dividends).

3. The excess of the amount deductible by a permanent establishment in the United States of a company which is a resident of Finland over the interest actually paid by such

permanent establishment, as those amounts are determined pursuant to the laws of the United States, shall be treated as interest derived and benefically owned by a resident of Finland.

4. The provisions of paragraph 1 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries or carried on business in the other Contracting State through a permanent establishment situated therein, or performs or performed in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

ARTICLE 12

Royalties

1. Royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.

2. However, notwithstanding the provisions of paragraph 1, royalties of the kind referred to in subparagraphs b) and c) of paragraph 3 may be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other State the tax so charged shall not exceed 5 percent of the gross amount of the royalties.

3. The term "royalties" as used in this Convention means payments of any kind received as a consideration

a) for the use of, or the right to use, any copyright of literary, artistic, or scientific work including cinematographic films and films or tapes for radio or television broadcasting;

b) for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property;

c) for information concerning industrial, commercial, or scientific experience.

The term "royalties" also includes gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries or carried on business in the other Contracting State through a permanent establishment situated therein, or performs or performed in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. Royalties shall be deemed to arise in a Contracting State when the payer is that State itself or a political subdivision, statutory body, local authority, or resident of that State. Where, however, the right or property for which the royalties are paid is used within a Contracting State, then such royalties shall be deemed to arise in the State in which the right or property is used.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

ARTICLE 13

Gains

1. Gains derived by a resident of a Contracting State from the alienation or disposition of immovable (real) property situated in the other Contracting State may be taxed in that other State.

2. For the purposes of this Article, the term "immovable (real) property situated in the other Contracting State", when the United States is that other Contracting State, includes a United States real property interest and immovable (real) property referred to in Article 6 (Income from Immovable (Real) Property) which is situated in the United States. The term "immovable (real) property situated in the other Contracting State", when Finland is that other State, shall have the meaning which it has under paragraph 2 of Article 6 (Income from Immovable (Real) Property), and includes shares or other corporate rights referred to in paragraph 4 of that Article.

3. Gains from the alienation of movable (personal) property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has or had in the other Contracting State or of movable (personal) property pertaining to a fixed base which is or was available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services,

including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

4. Gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft, or containers operated in international traffic shall be taxable only in that State.

5. Gains described in Article 12 (Royalties) shall be taxable only in accordance with the provisions of Article 12.

6. Gains from the alienation of any property other than that referred to in the preceding paragraphs of this Article, shall be taxable only in the Contracting State of which the alienator is a resident.

ARTICLE 14

Independent Personal Services

Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State. However, such income may also be taxed in the other Contracting State to the extent that such services are or were performed in that other State and the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his activities.

ARTICLE 16

Limitation on Benefits

1. A person that is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other State only if such person is:

a) an individual;

b) a Contracting State or a political subdivision or local authority thereof;

c) engaged in an active conduct of a trade or business in the first-mentioned Contracting State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business;

d) a person

(i) more than 50 percent of the beneficial interest in such person (or in the case of a company, more than 50 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by persons entitled to benefits of this Convention under subparagraphs (a), (b), (e) or (f) of this paragraph or who are citizens of the United States; and

(ii) not more than 50 percent of the gross income of such person is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons

who are not entitled to benefits of this Convention under subparagraph (a), (b), (e) or (f) of this paragraph and are not citizens of the United States;

e) a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange; or

f) an entity which is a not-for-profit organization (including pension funds and private foundations), and which, by virtue of that status, is generally exempt from income taxation in the Contracting State of which it is a resident, provided that more than half of the beneficiaries, members or participants, if any, in such organization are persons that are entitled, under this Article, to the benefits of the Convention.

2. A person that is not entitled to the benefits of the Convention pursuant to the provisions of paragraph 1 may, nevertheless, be granted the benefits of the Convention if the competent authority of the Contracting State in which the income in question arises so determines.

3. For the purposes of subparagraph e) of paragraph 1, the term "a recognized stock exchange" means:

a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934;

b) the Helsinki Stock Exchange; and

c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

ARTICLE 17

Artistes and Sportsmen

1. Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the amount of the gross receipts derived by such entertainer or sportsman, including expenses reimbursed to him or borne on his behalf, from such activities does not exceed twenty thousand United States dollars ($20,000) or its equivalent in Finnish currency for the calendar year concerned.

2. Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself, but to another person, that income of that other person may, notwithstanding the provisions of Articles 7 (Business Profits) and 14 (Independent

Personal Services), be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised, unless it is established that neither the entertainer or sportsman nor persons related thereto participate directly or indirectly in the profits of that other person in any manner, including the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income, or income or other distributions.

ARTICLE 18

Pensions, Annuities, Alimony, and Child Support

1. Subject to the provisions of paragraph 2 of Article 19 (Government Service)

a) pensions and other similar remuneration derived and beneficially owned by a resident of a Contracting State in consideration of past employment shall be taxable only in that State; and

b) pensions and other payments under the social security legislation of a Contracting State and, where that Contracting State is the United States, other public

pensions, paid to a resident of the other Contracting State or a citizen of the United States shall be taxable only in the first-mentioned State.

2. Annuities derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State. The term "annuities" as used in this paragraph means stated sums paid periodically at stated times during life or a specified or ascertainable number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered or to be rendered).

3. Alimony paid to a resident of a Contracting State shall be taxable only in that State. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident.

4. Periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, paid by a resident of a Contracting State to a resident of the other Contracting State, shall be taxable only in the first-mentioned State.

ARTICLE 19

Government Service

1. a) Remuneration, other than a pension, paid by a Contracting State or a political subdivision, statutory body or local authority thereof to an individual in respect of services rendered to that State, subdivision, body or authority shall be taxable only in that State.

b) However, such remuneration shall be taxable only in the Contracting State of which the individual is a resident if the services are rendered in that State and the individual:

(i) is a national of that State; or

(ii) did not become a resident of that State solely for the purpose of rendering the services.

2. a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision, statutory body or local authority thereof to an individual in respect of services rendered to that State, subdivision, body or authority shall be taxable only in that State.

b) However, such pension shall be taxable only in the Contracting State of which the individual is a resident if he is a national of that State.

3. The provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services) and 18 (Pensions, Annuities, Alimony, and Child Support) shall apply to

remuneration and pensions in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision, statutory body or local authority thereof.

ARTICLE 20

Students and Trainees

Payments received for the purpose of maintenance, education, or training by a student, apprentice, or business trainee who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State for the purpose of his full-time education or training shall not be taxed in that State, provided that such payments arise outside that State.

ARTICLE 21

Other Income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

ARTICLE 21

Other Income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable (real) property as defined in paragraph 2 of Article 6 (Income from Immovable (Real) Property), if the beneficial owner of such income, being a resident of a Contracting State, carries or carried on business in the other Contracting State through a permanent establishment situated therein, or performs or performed in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

ARTICLE 22

Capital

1. Capital represented by immovable (real) property referred to in paragraph 2 of Article 6 (Income from Immovable (Real)

Property), owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.

2. Capital represented by shares or other corporate rights referred to in paragraph 4 of Article 6 (Income from Immovable (Real) Property) and owned by a resident of a Contracting State may be taxed in the Contracting State in which the immovable (real) property held by the company is situated.

3. Subject to the provisions of paragraph 4, capital represented by assets, other than property referred to in paragraphs 1 and 2, which are effectively connected with a permanent establishment or fixed base of a resident of a Contracting State may be taxed in the State in which the permanent establishment or fixed base is situated.

4. Ships and aircraft of a resident of a Contracting State, and assets, other than property referred to in paragraphs 1 and 2, pertaining to the operation of such ships or aircraft shall be exempt from tax on capital by the other Contracting State.

5. All other elements of capital of a resident of

a) Finland not dealt with in this Article shall be exempt from tax on capital by the United States;

b) the United States not dealt with in this Article shall be exempt from tax on capital by Finland.

ARTICLE 23

Elimination of Double Taxation

1. In Finland double taxation shall be eliminated as follows:

a) Where a resident of Finland derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the United States (other than solely by virtue of citizenship), Finland shall, subject to the provisions of sub-paragraph b), allow:

(i) as a deduction from the tax on income of that person, an amount equal to the tax on income paid in the United States;

(ii) as a deduction from the tax on capital of that person, an amount equal to the tax on capital paid in the United States.

Such deduction in either case shall not, however, exceed that part of the tax on income or on capital, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in the United States.

b) Dividends paid by a company which is a resident of the United States to a company which is a resident of Finland and owns directly at least 10 percent of the voting stock of the company paying the dividends shall be exempt from Finnish tax.

c) Notwithstanding any other provision of the Convention, an individual who is a resident of the United States and

under Finnish taxation law with respect to the Finnish taxes referred to in Article 2 (Taxes Covered) also is regarded as resident in Finland may be taxed in Finland. However, Finland shall allow any United States tax paid on the income or on the capital as a deduction from Finnish tax in accordance with the provisions of sub-paragraph a). The provisions of this subparagraph shall apply only to nationals of Finland.

d) Where in accordance with any provisions of the Convention, income derived or capital owned by a resident of Finland is exempt from tax in Finland, Finland may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

2. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income

a) the income tax paid to Finland by or on behalf of such resident or citizen; and

b) in the case of a United States company owning at least 10 percent of the voting stock of a company which is a resident of Finland and from which the United States company receives dividends, the income tax paid to Finland by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

For the purposes of this paragraph, the taxes referred to in subparagraph a) of paragraph 1 and paragraph 2 of Article 2 (Taxes Covered) shall be considered income taxes.

3. For the purposes of computing United States tax, where a citizen of the United States is a resident of Finland, the United States shall allow as a credit against United States tax the income tax paid to Finland after the credit referred to in paragraph 1. The credit so allowed against United States tax shall not reduce that portion of the United States tax that is creditable against Finnish tax in accordance with paragraph 1. For the purposes of this paragraph, income beneficially owned by a resident of Finland who is a citizen of the United States shall be deemed to arise in Finland to the extent necessary to give effect to the provisions of this paragraph.

4. For the purposes of allowing relief from double taxation pursuant to this Article and subject to such source rules in the domestic laws of the Contracting States as apply for the purpose of limiting the foreign tax credit, income shall, except as otherwise provided in paragraph 3, be deemed to arise exclusively as follows:

a) income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with the Convention (other than solely by reason of citizenship in accordance with paragraph 3 of Article 1 (Personal Scope)) shall be deemed to arise in that other State;

b) income derived by a resident of a Contracting State which may not be taxed in the other Contracting State in

accordance with the Convention shall be deemed to arise in the first-mentioned State.

ARTICLE 24

Non-discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall also apply to persons who are not residents of one or both of the Contracting States. However, for the purposes of United States tax, an individual who is a United States national and who is not a resident of the United States and an individual who is a national of Finland and who is not a resident of the United States are not in the same circumstances.

2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family

responsibilities which it grants to its own residents. Nothing in this Article shall be construed as obliging a Contracting State to grant to a resident of the other Contracting State the right to deduct from the profits attributable to a permanent establishment of that resident situated in the first-mentioned State any portion of the amount of any dividends paid by that resident.

3. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 6 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

5. Nothing in this Article shall be construed as preventing either Contracting State from imposing the tax described in paragraph 6 of Article 10 (Dividends).

6. The provisions of this Article shall, notwithstanding the provisions of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision, statutory body, or local authority thereof.

ARTICLE 25

Mutual Agreement Procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or national.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached in

accordance with the preceding paragraph shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States, provided that the competent authority of the Contracting State requested to provide a refund has received notification that such a case exists within six years from the end of the taxable year to which the case relates.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular, the competent authorities of the Contracting States may agree

a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;

b) to the same allocation of income, deductions, credits, or allowances between persons;

c) to the same characterization of particular items of income;

d) to the same application of source rules with respect to particular items of income;

e) to a common meaning of a term;

f) to increases in any specific amounts referred to in the Convention to reflect economic or monetary developments; and

g) to the application of the provisions of domestic law regarding interest on deficiencies and refunds and non-

criminal penalties and fines, in a manner consistent with the purposes of the Convention.

They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

ARTICLE 26

Exchange of Information

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1 (Personal Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities

shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.

3. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and

writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

4. Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by that other State does not inure to the benefit of persons not entitled thereto.

5. Paragraph 4 shall not impose upon either of the Contracting States the obligation to carry out administrative measures which are of a different nature from those used in the collection of its own taxes, or which would be contrary to its sovereignty, security, or public policy.

6. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article 2 (Taxes Covered), to taxes of every kind imposed by a Contracting State.

ARTICLE 27

Members of Diplomatic Missions and Consular Posts

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

ARTICLE 28

Entry Into Force

1. This Convention shall be subject to ratification, acceptance, or approval in accordance with the applicable procedures of each Contracting State. The Governments of the Contracting States shall notify each other as soon as possible that those procedures have been complied with.

2. The Convention shall enter into force thirty days after the date of the later of the notifications referred to in paragraph 1, and its provisions shall have effect:

a) in Finland:

(i) in respect of taxes withheld at source, on income derived on or after 1 January in the calendar year next following the year in which the Convention enters into force;

(ii) in respect of other taxes on income and taxes on capital, for taxes chargeable for any taxable year beginning on or after 1 January in the calendar year next following the year in which the Convention enters into force;

b) in the United States:

(i) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of the second month next following the date on which the Convention enters into force;

(ii) in respect of other taxes, for taxable years beginning on or after the first day of January next following the date on which the Convention enters into force.

3. The Convention between the Republic of Finland and the United States of America with respect to taxes on income and property, signed at Washington on 6 March 1970, (hereinafter referred to as "the 1970 Convention"), shall cease to have effect with respect to taxes to which the Convention applies in accordance with the provisions of paragraph 2. The 1970 Convention shall terminate on the last date on which it has effect in accordance with the foregoing provision of this paragraph.

ARTICLE 29

Termination

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year following after the period of five years from the date on which the Convention enters into force. In such event, the Convention shall cease to have effect:

a) in Finland:

(i) in respect of taxes withheld at source, on income derived on or after 1 January in the calendar year next following the year in which the notice is given;

(ii) in respect of other taxes on income and taxes on

capital, for taxes chargeable for any taxable year beginning on or after 1 January in the calendar year next following the year in which the notice is given;

b) in the United States:

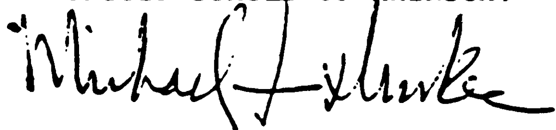
(i) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of January next following the expiration of the 6 months period;

(ii) in respect of other taxes, for taxable years beginning on or after the first day of January next following the expiration of the 6 months period.

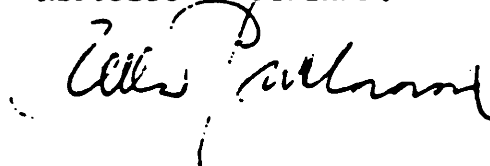
IN WITNESS WHEREOF, the undersigned, being duly authorized thereto, have signed this Convention.

DONE in Helsinki, in duplicate in the English and Finnish languages, both texts being equally authentic, this 21st day of September 1989.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:



FOR THE GOVERNMENT OF THE REPUBLIC OF FINLAND:



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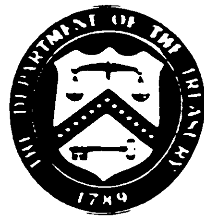

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
Nov. 2, 1989

Contact: Bob Levine
(202) 566-2041

U.S.-JAPAN WORKING GROUP TO MEET

The Department of the Treasury announced today the U.S.-Japan Working Group on Financial Markets will meet in Washington, DC on Nov. 8. The U. S. delegation will be led by Under Secretary of the Treasury for International Affairs David C. Mulford and the Japanese delegation by Vice Minister of Finance Makoto Utsumi.

Originally called the Yen-Dollar talks, the Working Group will address the full range of traditional issues pertaining to Japanese financial markets and those relating to U.S. financial markets, as well as issues of mutual interest.

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NB-549

Billing Code: 4810-25

OVERSIGHT BOARD

Strategic Plan for the Resolution Trust Corporation

AGENCY: Oversight Board

ACTION: Proposed Strategic Plan

SUMMARY: The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, requires the Oversight Board to develop a strategic plan for the Resolution Trust Corporation's functions and activities. The Oversight Board is seeking public comment on the proposed strategic plan for the Resolution Trust Corporation. The strategic plan establishes overall goals and objectives for the RTC in six areas: case resolution, asset disposition, affordable housing, conflicts of interest and ethical standards, external relations, and administration.

DATES: Comments must be submitted on or before (Insert date 30 days after date of publication in the FEDERAL REGISTER.) The strategic plan must be submitted to Congress by December 31, 1989.

ADDRESS: Comments may be mailed to the Policy and Financial Analysis Unit, Oversight Board, Room 906, 1825 Connecticut Avenue, N.W., Washington, DC 20232.

FOR FURTHER INFORMATION CONTACT: The Policy and Financial Analysis Unit, Oversight Board, 202-376-5464.

SUPPLEMENTARY INFORMATION:

Background and Statutory Requirements

The Resolution Trust Corporation (RTC) and the Oversight Board of the Resolution Trust Corporation (Oversight Board) were established as instrumentalities of the United States on August 9, 1989, by the enactment of Section 21A of the Federal Home Loan Bank Act (12 U.S.C. 1441a) as added thereto by Section 501(a) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Pub. L. No. 101-73, Section 501(a), 103 Stat. 183, 363-93). Throughout this document, all references to Section 21A are to Section 21A of the Federal Home Loan Bank Act as amended by Section 501(a) of FIRREA.

FIRREA requires the Oversight Board, in consultation with the RTC, to develop a strategic plan for the RTC's functions and activities, and to submit the plan to Congress no later than December 31, 1989. FIRREA establishes the minimum contents required for the strategic plan, which are listed in the Appendix to this Preamble. FIRREA further requires the Oversight Board to appear with the RTC, by January 31, 1990, before the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate to describe the strategic plan established for the RTC.

At its public meeting on September 21, 1989, the Oversight Board determined that it would be beneficial at an early stage in the development of the strategic plan to make a draft available for public comment. Accordingly, this preliminary, draft strategic plan is being published for comment. The Oversight Board wishes to emphasize that this is an early draft that will be revised in response to comments received and in the course of the Board's own further review and deliberation. The Board recognizes that certain aspects of this preliminary draft might be regarded

by some as controversial or that others might recommend the inclusion of matters that are omitted. That is, of course, the purpose of soliciting comment on this proposed strategic plan. The Board will consider all comments received as it shapes the final plan for submission to Congress.

Duties of Resolution Trust Corporation and Oversight Board

The mission of the RTC is to carry out a program, under the general oversight of the Oversight Board, to manage and resolve institutions that come under its jurisdiction and to dispose of any residual assets in a manner that:

- maximizes return and minimizes loss;
- minimizes the impact on local real estate and financial markets; and
- maximizes the preservation of the availability and affordability of residential property for low- and moderate-income individuals.

The duties of the Oversight Board are to oversee and be accountable for the RTC. The Oversight Board is required, in consultation with the RTC, to develop and establish overall strategies, policies, and goals for the RTC's activities, including the RTC's overall financial goals, plans and budgets. The Oversight Board is also required to review the overall performance of the RTC on a periodic basis, including its work, management activities, and internal controls and the performance of the RTC relative to approved budget plans pursuant to the terms of FIRREA.

Purpose and Contents of the Strategic Plan

The purpose of the strategic plan is to set forth the RTC's goals and objectives in support of its mission. The RTC will develop specific procedures for implementing the general guidance provided by the strategic plan. Until such specific procedures are developed by the RTC, the Oversight Board has directed the RTC to operate in accordance with existing FDIC procedures.

The strategic plan elaborates on the mission of the RTC through goals, objectives, and implementation procedures. The strategic plan's goals establish broad, general direction for the RTC in six areas: case resolution, asset disposition, conflicts of interest and ethical standards, external relations, and administration.

The strategic plan's objectives provide more specific statements with respect to the goals set forth. Subject to the review of the Oversight Board, the RTC is responsible for adopting the rules, regulations, standards, policies, procedures, guidelines, and statements necessary to implement the strategic plan established by the Oversight Board.

The strategic plan will be refined and strengthened through experience and ongoing review. Additionally, the National and Regional Advisory Boards will provide input to the policies and procedures developed by the Oversight Board and RTC for the sale or disposition of real property assets.

<u>Strategic Plan Development</u>

The strategic plan was developed by Oversight Board staff in consultation with the staff of the RTC. At its first meeting, on August 9, 1989, the Oversight Board established a Joint Policy Development Task Force with staff from both

the Oversight Board and the RTC to make recommendations to the Oversight Board on overall strategies, policies and goals for the RTC and the strategic plan.

In addition, the strategic plan reflects input from staff of the Treasury Department, the Department of Housing and Urban Development, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Furthermore, the strategic plan incorporates individual policies that have been adopted by the Oversight Board during the period between the Oversight Board and the RTC's creation on August 9, 1989, and publication of this proposed strategic plan.

Request for Comment

At its September 21, 1989 Board meeting, the members of the Oversight Board decided unanimously to invite public participation in the development of the strategic plan before submitting it to Congress. The Oversight Board is seeking comments on all aspects of the strategic plan, and particularly on the questions posed by the Oversight Board. Public comment should contribute to a more effective strategic plan. It is hoped that publication of an early and preliminary draft of the strategic plan will promote participation in formulating the RTC's goals, objectives and implementation procedures.

In addition, the Board wants the strategic plan to reflect expertise available in the private as well as the public sector. The private sector has extensive expertise in matters of loan workouts, asset management and disposition, which would be invaluable to the Oversight Board in

formulating the strategic plan. Furthermore, FIRREA requires the RTC to utilize the private sector in carrying out its duties, including real estate and loan portfolio asset management, property management, auction marketing, and brokerage services, to the extent that those services are available and their utilization by the RTC would be practicable and efficient. Because it is expected that the RTC will utilize the private sector in carrying out its mission, the Oversight Board believes it is important to receive comment from that sector in developing the strategic plan.

Appendix to the Preamble

FIRREA-MANDATED CONTENTS OF THE STRATEGIC PLAN

Section 21A (a)(14)(B) requires the strategic plan and implementing policies and procedures to contain, at a minimum, the following:

1. Factors for determining the order of resolutions.
2. Standards to select the type of resolution.
3. Factors to consider in deciding treatment of nonperforming assets in assisted acquisitions.
4. Plan for the disposition of assets.
5. Management objectives for measuring progress.
6. Plan for organizational structure, staffing, and use of third-party contracts.
7. Consideration of incentives to promote efficient asset management.
8. Standards for competition among and fair treatment of offerors.
9. Standards to prohibit discrimination in solicitation and consideration of offers.
10. Procedures for active solicitation of offers from minorities and women.
11. Procedures for notification of rejected offers.
12. Procedures for establishing the market value of assets.
13. Procedures requiring timely evaluation of purchase offers.
14. Procedures for bulk sales and auction marketing of assets.
15. Guidelines for determining which assets have no reasonable recovery value and may, therefore, be considered for public purposes.

16. Guidelines for conveyance of assets to state and local government agencies for use in HUD urban homesteading programs.
17. Policies and procedures for avoiding political favoritism and undue influence in contracts and decisions made by the Oversight Board and RTC.

PROPOSED STRATEGIC PLAN FOR THE RESOLUTION TRUST CORPORATION

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PROPOSED STRATEGIC PLAN FOR THE RESOLUTION TRUST CORPORATION

I. MISSION STATEMENT

The Resolution Trust Corporation should carry out a program, under the general oversight of the Oversight Board, to manage and resolve institutions that come under the jurisdiction of the RTC and to dispose of any residual assets in a manner that:

- o maximizes return and minimizes loss;
- o minimizes the impact on local real estate and financial markets; and
- o maximizes the preservation of the availability and affordability of residential property for low- and moderate-income individuals.

II. BACKGROUND

A. CASE RESOLUTION

FIRREA gives the Resolution Trust Corporation (RTC or the Corporation) the responsibility for managing and resolving all cases involving depository institutions previously insured by the Federal Savings and Loan Insurance Corporation (FSLIC) for which a conservator or receiver is appointed from January 1, 1989 through August 8, 1992. As of September 30, 1989 there were 256 institutions holding $101 billion in assets under RTC jurisdiction. Additional insolvent institutions are expected to be transferred to the RTC over the next three years.

Resolution Schedule

Given the expected costs associated with resolving the institutions under RTC jurisdiction, the large backlog of insolvent institutions and the potential disruption these resolutions could impose on the financial and real estate markets, it is important to carefully consider the process by which these institutions are resolved. Furthermore, given that institutional, financial, and human resource constraints preclude simultaneous resolution of insolvent institutions presently under RTC jurisdiction, it is important to establish a prioritization schedule for case resolutions. FIRREA stipulates that the strategic plan for the RTC will include the "factors the Corporation shall consider in deciding the order in which failed institutions or categories of failed institutions will be resolved."

There are numerous factors to consider in deciding which institutions to resolve first. For example, of primary importance is the deterioration at an institution, a measure of the cost savings the RTC could achieve by resolving an

institution immediately. As such, institutions with the highest operating losses (both in absolute terms and relative to the expected cost of resolution) should be given first priority in order to save the RTC these additional losses.

Additionally, the estimated loss in franchise value due to eroding customer bases and the loss of key personnel and systems is important in determining deterioration and therefore, should also be evaluated in deciding the priority of resolutions. Likewise, the ongoing risk exposure to the RTC should be considered. Institutions posing the greatest risk to the RTC should be given priority. Also, the order of resolutions should reflect the most efficient use of RTC resources and staff. The strategic plan requires the RTC to evaluate all of these factors in establishing a case resolution schedule.

Many of the factors that need to be considered in establishing a priority schedule are not easily quantified. It would not be cost effective, however, to devote inordinate time and resources to developing a precise priority schedule if such an effort delays the resolution process. Therefore, in evaluating the various factors, the RTC may consider establishing priority deciles or quartiles rather than attempting to establish the order of resolution for each institution.

Method of Resolution

In addition to establishing resolution priorities, the RTC will need to select a method of resolution for each institution. Resolutions generally take the form of either liquidations accompanied by the payment of insured deposits, or assisted acquisitions. In paying insured deposits, the

FDIC has generally paid cash to depositors, either directly, or indirectly through a "paying agent." An insured depositor may choose to take the cash or use it to open a deposit account with the paying agent. The RTC may use the same techniques. Use of a paying agent is often referred to as an insured deposit transfer.

In an assisted acquisition, the acquiring entity assumes some portion of the assets and liabilities of the failed institution. The RTC provides sufficient cash to the acquiring institution to offset the difference between the amount of liabilities assumed and the market value of assets acquired from the failed institution -- net of any premium paid by the acquiring institution. To the extent the acquiring institution acquires substantially all of the assets of the failed institution, the transaction is termed a "whole thrift" purchase and assumption. If the acquiring institution acquires only the "good" assets (e.g., cash, securities, and performing loans), the transaction is termed a "clean thrift" purchase and assumption.

There is no precise line of demarcation between a whole-thrift transaction and a clean-thrift transaction. Rather, they run on a continuum. In fact, the results of a deposit transfer can be similar to a purchase and assumption transaction. For example, if in its role as the paying agent, an institution is able to attract and retain the deposits from the failed institution and uses the deposits to purchase the good assets of the failed institution, the net result resembles a clean-thrift purchase and assumption. If the paying agent further purchases the problem assets, the net result resembles a whole-thrift purchase and assumption.

In selecting a method of resolution, FIRREA, by cross referencing the Federal Deposit Insurance Act, prohibits the RTC from providing assistance in an amount in excess of that required to liquidate an institution, unless the RTC determines that the continued operation of the institution is essential to provide adequate banking services in its community. FIRREA also stipulates that the RTC conduct its operations in a manner which "maximizes the net present value return from the sale or other disposition of institutions," and "minimizes the amount of any loss realized in the resolution of cases." Finally, FIRREA stipulates that the RTC's strategic plan and its implementing policies and procedures must include "standards the Corporation shall use to select the appropriate resolution action for a failed institution," and "factors the Corporation shall consider in deciding whether non-performing assets of the failed institution will be transferred to the acquiring institution rather than retained by the Corporation for management and disposal." This latter requirement regarding the treatment of non-performing assets draws attention to the whole-thrift versus clean-thrift decision. The strategic plan requires the RTC to consider each of these statutorily imposed criteria in selecting the preferred method of resolution.

One policy issue that arises in the selection of a resolution method is whether the RTC should sell an individual institution as a whole or in parts. For example, some have suggested that the RTC could obtain a higher price if it were to sell individual branches to separate acquirers rather than attempting to sell all the branches to one acquirer. It has been further argued that selling smaller pieces, such as individual branches, might also increase the pool of eligible bidders, thereby, increasing the

competitiveness of the bidding. A counter to these arguments is the amount of time and administrative costs associated with attempting to evaluate and compare multiple combinations of offers. Also, in deciding whether to pursue the sale of individual branches, consideration must be given to the effect of this policy on cash outlays, the expected volume of assets to be liquidated and the disruption payoffs of insolvent branches could cause.

Financial Assistance

Another area of policy debate is the type of assistance that the RTC may provide in order to facilitate an assisted acquisition. In the past, various forms of assistance have been used including, but not limited to, cash, notes, yield-maintenance agreements, capital-loss coverage, asset puts, and regulatory forbearances.

Yield maintenance was sometimes given to an acquirer that accepted problem assets (or assets with below market contract rates due to interest rate changes) in lieu of immediately paying the institution for the capital losses on the assets. The guaranteed yield for these assets was generally based on a cost-of-funds index, plus a spread to cover operating expenses associated with managing the asset and, in some cases, a profit margin. Capital-loss coverage effectively guarantees that the acquiring institution will not sustain any further capital losses on specified or "covered" assets after the sale of these assets to the institution. When capital loss coverage is offered in conjunction with yield maintenance, the provider (e.g., the RTC) effectively retains all the risks associated with problem assets and the acquiring institution may have disincentives to minimize the losses in the assets.

Asset-puts as a form of assistance can be used when the acquirer has not had sufficient time to evaluate the condition of all the assets in the portfolio or mark them to market. If an asset that has been sold to an institution becomes "bad" or non-performing, does not have clear title, or there is some litigation liability, the association may sell or "put" the asset back to the RTC in exchange for cash or other assets. An "asset-put" provision reduces the discount a purchaser would otherwise require on accepting assets of unknown quality and allows for more expedient disposition of institutions with problem assets. Asset-puts can be thought of as a form of capital loss coverage and, like the capital loss coverage and yield maintenance, creates a financial contingent liability for the RTC and reduces the incentive for acquiring institutions to maximize recoveries.

Ownership interests in resolved institutions allow the RTC to protect its interests when at the time of resolution there is continued uncertainty regarding the value of the resolved institution and, therefore, the appropriate amount of assistance. This uncertainty creates the potential for large upside gains for the acquirer. Equity participations, such as common stock, give the RTC a direct ownership position in a thrift and allow the RTC to share in upside gains. Equity participations, however, may create a conflict if the RTC assumes a controlling position and thereby becomes a competitor with other financial institutions. Warrants are passive equity instruments that allow the RTC to share in the profits of a resolved institution, but if structured properly, can avoid the control issue.

Regulatory forbearances occur when a merging institution is granted non-cash assistance by having the regulator abstain from enforcing certain regulatory requirements. In the past, regulators have granted forbearances from complying with capital requirements, liquidity requirements, and asset restrictions. In most, but not all, situations, forbearances do not reduce the requirement but merely preclude the regulator from taking action as a result of noncompliance. Forbearances were usually granted only for a limited period of time. Granting forbearances may reduce the resolution cost to the RTC and unlike other forms of assistance, often do not involve a direct financial outlay or immediate risk to the RTC. They may, however, transfer risk to the insurance funds and are inherently difficult to value.

Each of these forms of assistance entails different costs and levels of ongoing risk exposure for the RTC. The Oversight Board has already adopted policies that: (1) limit the period of assistance involving a financial contingency (e.g., asset-puts, asset guarantees, capital loss coverage, yield maintenance guarantees) for the RTC to the lesser of 6 months or the time necessary to complete due diligence; and (2) limit the RTC from taking an active equity positions in resolved institutions. The strategic plan requires the RTC to develop written guidelines for the use of various forms of financial assistance.

Bidding Procedures

A significant way to reduce the cost of resolutions is to encourage active participation in the resolution process by all qualified bidders. Also, FIRREA explicitly requires the RTC to develop standards for fair, non-discriminatory treatment and competition among prospective bidders and

requires the RTC to encourage the active participation of women and minorities.

These requirements can best be fulfilled by having an open and widely publicized bidding procedure and a broad dissemination of information regarding institutions being marketed and the terms of previous transactions. This need for openness has been highlighted by the public reaction to the transactions completed by the Federal Home Loan Bank Board in December 1988. In addition, providing sufficient time to disseminate the pertinent information to a wide range of bidders and allowing adequate time for carefully constructing competitive bids, should assure that the RTC receives the best offer. Finally, the fair and consistent evaluation of all bids and the timely notification of rejected bids should encourage continued participation in future marketing efforts by prospective purchasers. The strategic plan identifies each of these items as an area for the RTC to develop implementation procedures.

Use of Private Sector

FIRREA requires the RTC to use the services of private persons if such services are available and the RTC determines that the utilization of such services are practicable and efficient. While the statute appears to presume that this will occur primarily in the asset disposition process, the RTC might use the services of private sector entities in activities related to the resolution of institutions. These services could include managing institutions or performing due diligence for the RTC. The strategic plan directs the RTC to identify areas where private sector services could be used in resolving institutions.

B. ASSET DISPOSITION

Assets not sold as a part of a thrift institution resolution will have to be disposed of separately by the RTC. The volume of assets the RTC will dispose of is uncertain and will depend in part on the method chosen by the RTC to resolve thrift institutions.

Whatever the eventual volume, most of the assets under RTC jurisdiction will fall into one of three categories: (1) cash and readily marketable loans, servicing rights, and securities; (2) high risk or otherwise undesirable, but performing, loans; or (3) real estate owned and non-performing loans, including loans in foreclosure. Most of the policy issues relate to the disposition of the second and third groups; accordingly, these assets are the focus of this section.

The task facing the RTC for asset disposition is unprecedented in magnitude and complexity. The RTC will need to try alternative approaches, learning from experience what works and what does not work. Nothing in this plan is intended to preclude that flexibility.

Use of the Private Sector to Maximize Net Present Value

The sheer number of assets to be worked out will require that the RTC rely heavily on private sector contractors for the management and disposition of these assets, subject to general oversight and audit by the RTC. In addition, the private sector's expertise and the opportunity for the RTC to utilize incentive-based contracts argue for the RTC to use private contractors whenever practicable and efficient, as called for in FIRREA.

The RTC should develop and employ incentive structures tailored to maximizing the net present value of the assets to the RTC. While the RTC staff will be monitoring its contractors, it will be the contractors who, in most instances, manage the assets and negotiate their disposition, subject to appropriate RTC approval. The RTC should, therefore, rely on incentive schemes for contractors as a means of assuring that the government receives the maximum net present value return on its assets. No incentive structure, however, can eliminate the need for managerial oversight by RTC staff.

Neither the eventual proceeds from asset disposition nor the interim operating returns will be known to the RTC or the contractor at the time the assets are placed under private control. Therefore, when practical, the RTC should enter into contracts that have the RTC and the contractor sharing in better-than-expected returns, as well as sharing the risk that net proceeds will fall short of expectations (i.e., yielding the contractor less than a market rate of return).

Competitive Procurement

Depending on the structure of the contract, a variety of procurement designs may be appropriate for promoting competition consistent with the objective of maximizing net present value. In all instances, the RTC must make available, in writing and to all requesting parties, its procurement policies and procedures.

Sales Methods

As a general rule, bulk contracts for management and disposition of a large block of assets should be used if the RTC deems that this is the strategy that will maximize the net present value of the proceeds. Furthermore, the

administrative constraints on the number of separate transactions that can be directly executed by the RTC suggests that bulk transactions may be an efficient method for disposing of assets. The RTC should experiment with alternative methods of structuring bulk transactions. In bulk sales, modest discounting in price may be appropriate because of the reduction in the RTC's sales costs per unit.

The RTC can delegate many of the decisions regarding choice of disposition methods to private contractors, subject to guidelines established by the RTC. However, there may be instances in which the RTC should override the recommendation of its contractors. For example, using large-volume auctions to dispose of single-family homes or raw land in distressed areas may maximize near-term returns to the RTC but could have adverse market effects that could be avoided through an alternative sales method.

Continuing RTC Involvement with Assets

As with resolutions of insolvent thrifts, the RTC should avoid retaining long-term equity interests in assets under its jurisdiction. These assets should be sold expeditiously following orderly and thorough marketing. The RTC should explore ways, however, in which it can participate in any extraordinary gains realized at the time of disposition.

The RTC will have to develop criteria that must be met for the RTC to undertake major capital improvements (i.e., buildouts of incomplete properties and major rehabilitation of completed structures) prior to marketing. There may be some special cases in which the net present value of properties to the RTC will be enhanced by capital improvements prior to sale, but in most instances properties should be sold in "as is" condition (exclusive of minor

cosmetic repairs).

Financing of Asset Sales

If the RTC were to provide financing of asset sales, it should do so only when necessary to complete transactions that maximize the present value return to the RTC, net of the value of any concessions provided in the financing. Unless directed otherwise by the Oversight Board, the RTC should, in general, offer financing only as a marketing tool. If private sector lenders are unwilling to finance a proposed purchase on terms as favorable to the buyer as those offered by the RTC, then the RTC is providing a subsidy that should be recouped through a higher purchase price.

Data Base Development

To assure the RTC's capability to respond to future data requests, the database system developed to inventory RTC assets should be flexible and contain as many descriptors of assets as is practicable. As required by FIRREA, the data base should identify those properties with natural, cultural, recreational, or scientific values of special significance. Compliance with this requirement will be difficult, but the RTC should develop procedures and guidelines for determining these designations as quickly as practicable.

Ethics and Conflicts of Interest

Ongoing enforcement of ethics and conflicts of interest requirements will complement the incentive schemes and regular audits as methods of assuring that contractors promote the objectives of the RTC. The interim statement of Principles of Ethical Conduct for Independent Contractors to the RTC, on which public comment has been solicited, will be

succeeded by regulations on this subject.

The ethics standards should not preclude asset managers from acting in more than one capacity for the RTC, if the RTC determines that no conflicts or potential conflicts of interest exist with respect to the services performed for the RTC by RTC contractors. For example, if appropriate, asset managers should be allowed to sell RTC properties in one region of the country and buy properties in another.

Asset Disposition in Distressed Areas

RTC will be a significant holder of real estate in some local real estate markets already beset by economic problems and experiencing declining real estate values. FIRREA notes this fact and calls for special asset disposition procedures to protect against the dumping of assets while not restricting the flexibility RTC needs to make sound business decisions. The RTC will consider providing seller financing in distressed areas.

FIRREA specifies that in distressed areas the RTC should not sell at less than a specified minimum disposition price. The legislation sets this price at 95 percent of market value and gives the RTC Board of Directors the authority to change this percentage if a change is deemed consistent with the overall objectives of the RTC. Outside of distressed areas, the RTC should strive as well to sell only at prices at or near market value, unless otherwise directed by the Oversight Board. The term "market value" is defined in FIRREA to mean "the most probable price which a property should bring in a competitive and open market if: (1) all conditions requisite to a fair sale are present, (2) the buyer and seller are acting prudently and are knowledgeable, and (3) the price is not affected by any undue stimulus."

Thorough marketing of properties will be particularly important in distressed areas for the RTC to secure offers near market value. But even with careful and comprehensive marketing, market value and, therefore, the disposition price of RTC properties in distressed areas may often be a small fraction of book value.

The RTC should avoid deferring the marketing of properties, subject to the right of first refusal marketing provisions in FIRREA. Holding properties off the market for an extended period of time will generally not serve the interests of either the local community or the taxpayer. The uncertainty caused by an overhang of properties held off the market may depress local property values more than would their sale. Furthermore, holding rental housing off the market increases rents and, therefore, may place renters at a disadvantage. Properties held off the market -- especially vacant properties -- can deteriorate and lose value, raising the cost to the RTC and ultimately to the taxpayer. Even properties that do not deteriorate impose carrying costs on the RTC. The RTC should not attempt to "outguess the market" by speculating on future developments not reflected in the current market values of properties.

The ongoing resolution of insolvent thrift institutions during the next several years, together with delays in securing clear title to properties that come under the RTC's control, will result in the disposition of RTC's assets over a multi-year period, even if individual properties are marketed expeditiously. If the RTC were to delay disposition of currently marketable properties, it would only concentrate the peak load problem, and place pressure on local markets in years to come.

While the RTC should dispose of properties expeditiously following thorough marketing, in some instances certain marketing methods may have adverse consequences for local property values that could be avoided. For example, in areas where the RTC is a large holder of similar properties, including raw land, disposition according to a pre-advertised multi-month marketing schedule may be preferable to disposing of a large number of properties by auction on a single day.

Keep the Market Informed

The RTC should keep market participants and other interested parties fully informed, to the extent practical, on RTC's plans for asset sales. Uncertainty increases the risk of investing in real estate and thereby depresses real estate values. The "overhang" of RTC properties in local real estate markets increases uncertainty and depresses real estate values for two reasons: (1) market participants do not know the RTC's plans for these properties, and (2) even if RTC's plans were known, the resulting market effects are uncertain. RTC can eliminate at least part of this uncertainty by providing as much information as practical about its inventory and general policies and strategies for asset disposition to all interested parties in the local market areas where RTC has properties.

C. AFFORDABLE HOUSING PROVISIONS

FIRREA mandates maximizing the preservation of the availability and affordability of residential real property for low and moderate-income individuals. One mechanism that FIRREA provides for meeting this mandate is to require a specified right of first refusal period for qualified purchasers of certain eligible single and multi-family properties.

The RTC's implementing procedures for housing disposition should be designed to maximize the effectiveness of this initial marketing or right of first refusal period. Eligible properties are to be offered to qualifying households, public agencies, or nonprofit organizations so that the properties may be available for purchase or occupancy by lower-income families. To assure that its disposition strategies for low and moderate income housing are effectively implemented, the RTC should consult on an ongoing basis with local and state housing finance agencies, other governmental agencies, and local and national nonprofit organizations with specialized knowledge of low-income housing.

No later than March 30, 1990, the RTC will submit to the Oversight Board comprehensive guidelines and procedures to implement the low- and moderate-income housing provisions of FIRREA. (The specific coverage of these guidelines and procedures is detailed in a subsequent section of this strategic plan.) To avoid keeping needed housing off the market and to avoid any further deterioration of the eligible properties involved while comprehensive guidelines are developed by the RTC and reviewed by the Oversight Board, the RTC may sell eligible properties in accordance with the housing provisions of FIRREA prior to the delivery

to the Oversight Board of these comprehensive guidelines. Prior to commencing such disposition, however, the RTC will prepare interim guidelines for disposition that are in accordance with the lower- and moderate-income housing provisions of FIRREA. The RTC will provide its interim guidelines to the Oversight Board and will keep the Board apprised of its disposition procedures. (Public comment is specifically invited on whether the RTC should begin disposing of eligible properties prior to development of comprehensive housing program guidelines.)

In order to facilitate the Oversight Board's review of the low- and moderate-income housing program as it evolves and to assist in identifying any areas needing special attention, the RTC will keep records on eligible properties and their disposition. As the RTC begins marketing eligible properties, it will compile data on the number of eligible properties offered for sale, the number of these properties that are purchased for low- and moderate income housing, and any other pertinent data related to the effectiveness of the initial marketing period in meeting the FIRREA's housing goals. The RTC will report regularly to the Oversight Board on its experience in meeting its low- and moderate-income housing objectives under FIRREA, including providing any relevant data.

Marketing

Marketing eligible residential properties may require special techniques that differ from the RTC's normal marketing methods. The RTC should develop marketing strategies in consultation with state housing finance agencies, other government agencies, and non-profit organizations for implementation, either directly or through contractors (including government agencies and non-profit

organizations). The RTC should also consider assigning low-income housing specialists to its field offices.

Clearinghouses

FIRREA requires that the RTC shall provide information on eligible properties to clearinghouses to make such information available to public agencies, non-profit organizations, and qualifying households. FIRREA authorizes state housing finance agencies and the Federal Housing Finance Board to act as clearinghouses. The RTC can also authorize national non-profit organizations as clearinghouses. The RTC shall develop guidelines for entering into contracts or other arrangements with clearinghouses to carry out their responsibilities.

To assure a maximum level of operating efficiency by all clearinghouses, RTC personnel should work with organizations, including the FHFB, to develop general strategies, including agreement on both the form and content of the information the RTC will provide regarding eligible properties. The information provided should be in a form suitable for immediate dissemination by the clearinghouses to eligible purchasers and include as much information as necessary to assure the most informed possible basis for judgement by the eligible purchasers.

The RTC should also investigate the extent to which information about eligible properties may be provided to clearinghouses before the RTC has clear title to the properties.

Disposition of Eligible Properties

FIRREA directs the RTC to determine a market value for each eligible residential property and sell eligible properties

at the net realizable market value. The net realizable market value is the price below the market value that takes into account any reduction in certain holding and transactions costs resulting from expedited and direct sale of a property. Consequently, the price reduction represents an economic discount, not a price subsidy.

The costs that can be avoided through an expedited sale include, but are not limited to, foregone real estate taxes, insurance, maintenance expenses, security costs and the loss of use of its funds as well as the avoidance, if applicable, of fees paid to real estate brokers, auctioneers, or other individuals usually involved in the sale of property.

The RTC should consider selling eligible properties in bulk to capable non-profit organizations and state and local housing finance agencies. The reduction in transaction costs to the RTC resulting from a bulk sale may permit the RTC to sell properties at a below-market price and still maximize net present value.

Subsidies

FIRREA authorizes the RTC to provide subsidies such as concessionary financing and price discounts in the furtherance of FIRREA's housing objectives. If subsidies are deemed necessary to meet the housing objectives, the appropriate form of the subsidies, as well as the total amount of subsidy provided for this program, will be determined by the Oversight Board. Under section G of this strategic plan, Specific Questions for Public Comment, the staff of the Oversight Board specifically seek comment on subsidies and other issues related to the affordable housing provisions in FIRREA.

Qualifying Purchasers

The legislation specifies which households and organizations are eligible to bid on properties during the right of first refusal period. The RTC should investigate the feasibility of contracting for the service of qualifying households and institutions, in light of the relevant experience outside the RTC that could be drawn upon from such agencies and organizations as state housing finance agencies, other government agencies, and non-profit organizations.

Competing Bids

When selling single family properties, the RTC may have to choose between substantially similar competing offers from low- and moderate-income households. In the case of multi-family housing, the conference report directs the RTC to give preference to offers that propose to house more lower income families for longer periods of time and the RTC will establish guidelines to implement this directive. Given the RTC's mandate to maximize the affordability and availability of low-income housing, the RTC will establish guidelines that among substantially similar offers for single family properites give preference to bids from lower-income families.

Consultation with Other Agencies

FIRREA directs the Secretary of Housing and Urban Development and the Secretary of Agriculture to expedite the processing of applications for assistance under a number of specified programs, including FHA mortgage insurance. To the extent practical, the RTC should consult with those parties, as well as with other organizations that can financially assist qualified households and organizations in purchasing and renting housing. These organizations include the federally sponsored housing credit agencies and

corporations, and state and local housing finance agencies.

The legislation requires the Federal Housing Finance Board (FHFB) to establish an Affordable Housing Program to subsidize interest rates on advances to member savings institutions for lending for low- and moderate-income owner occupied and rental housing. The RTC should work with the FHFB as the FHFB designs its Affordable Housing Program to maximize the mutual effectiveness of the RTC's and FHFB's respective programs.

Use of Secondary Market Agencies

As required in FIRREA, the RTC shall, in consultation with the Secretary of HUD, explore opportunities to work with secondary market entities to provide housing for lower- and moderate-income households. The Secretary of HUD is authorized to work with the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and other secondary market entities to develop risk-sharing structures, mortgage insurance, and other credit enhancements to assist in the provision of property ownership, rental, and cooperative housing opportunities for lower- and moderate-income families.

Enforcement of Low-Income Residency Requirements

FIRREA requires purchasers of qualifying multi-family property to make available a certain number of units for low- and very low-income residents during the remaining useful life of the property. (The requirements may be reduced for a temporary period if HUD or the applicable state housing finance agency determines that compliance is no longer financially feasible.) The residency requirements must be recorded in a deed or other legal instrument.

FIRREA provides that the lower-income occupancy requirements shall be judicially enforceable against the purchasers of property by affected very low- and lower-income families.

Regional Advisory Boards

FIRREA directs the Oversight Board to select members of the regional advisory boards who will represent the views of low- and moderate-income consumers and small businesses, or who have knowledge and experience regarding business, financial, and real estate matters. These groups can advise the RTC about implementation strategies in specific regions.

D. CONFLICTS OF INTEREST AND ETHICAL STANDARDS

Conflicts of Interest

Within 180 days from the date of enactment, FIRREA requires the RTC to promulgate rules and regulations applicable to independent contractors governing conflicts of interest, ethical responsibilities and use of confidential information. The RTC has adopted an interim statement of principles establishing minimum standards of ethical conduct applicable to independent contractors retained by the RTC. The RTC has also been charged with the obligation to utilize the private sector to the maximum extent possible. The RTC is facing a monumental task and will have to rely heavily on third party contractors to successfully accomplish that task. Accordingly, it is important that any conflicts of interest standards will not preclude participation by a significant proportion of the private sector.

If the standards established are too restrictive, the RTC will have difficulty hiring sufficient contractors to accomplish its mission. On the other hand, if the standards are too liberal or lax, they may not provide sufficient protection against unethical conduct by the RTC employees, contractors, and agents.

Proposed regulations concerning the conduct of the RTC's independent contractors are expected to be published for public comment in the near future. The proposed regulations are intended to require the RTC to preserve the integrity of the system while allowing it the flexibility needed to meet its statutory mandate.

Political Favoritism

FIRREA also requires that measures be taken to avoid political favoritism and undue influence with respect to the

activities of the RTC. Until specific policies and procedures are developed, the RTC will draw upon current FDIC policies. The FDIC has attempted to guard against undue political pressure by having policies that allow them to investigate and provide information to those in political office in response to an inquiry, complaint or concern. The policies do not permit FDIC personnel to discuss the substance of pending decisions with respect to specific actions. In addition, the policies do not allow the FDIC personnel to alter or change an FDIC decision, policy or procedure at the request of any outside party.

However, the RTC will be operating in a more diverse and complex environment than the FDIC. Due to the greater number of special interest groups involved and the greater range of activities the RTC will be undertaking, the RTC may be subject to more political pressure. The policies the FDIC has in place may not be adequate to address the complexity of the RTC's mission.

Staff of the Oversight Board invites comments on how to most effectively implement the mandates of FIRREA regarding avoiding political favoritism in contracts and decisions made by the RTC.

E. EXTERNAL RELATIONS

As a new instrumentality of the U.S., it is critical for the RTC to establish and maintain good relationships and open communications with other entities. The RTC must be responsive to Congressional inquiries and cooperate with other government offices. The nature of the mission of the RTC also makes imperative a positive relationship with the public. The External Relations section of the strategic plan provides guidance on RTC activities designed to establish and enhance the RTC's reputation as an efficient and capable agency in achieving its mission.

Communications with the Public

The National and Regional Advisory Boards, which will be established by the Oversight Board, will play an important role in maintaining open communications with the public regarding the RTC's policies and procedures for the sale or disposition of real property assets. The National and Regional Advisory Boards will bring local expertise and concerns to the attention of the RTC and the Oversight Board and will provide a means for the RTC and Oversight Board to improve public understanding of the RTC's activities.

Questions or concerns may also be raised by the public through mechanisms that will be developed by the RTC for accepting general complaints and complaints of discrimination on the basis of race, sex or ethnic group in the solicitation and consideration of offers. FIRREA requires that the strategic plan and its implementing policies and procedures include standards that prohibit discrimination. The complaint mechanism established by the RTC will provide a means for the public to provide input on the RTC's performance in this area.

Congressional Reports

FIRREA imposes two reporting periods on the RTC: 1) semiannual reports covering the October 1 - March 31 and April 1 - September 30 periods; and 2) an annual report covering the January 1 - December 31 period. In addition, FIRREA requires semiannual appearances by the Oversight Board before the House and Senate Banking Committees to report on RTC progress in certain areas. The specific information requested by Congress is somewhat different for the semiannual reports, the annual report, and the semiannual Congressional appearances by the Oversight Board. These reporting requirements as well as other reporting and disclosure obligations concerning the RTC's operations, which are required by Title V of FIRREA, are listed in the Appendix to this strategic plan.

F. ADMINISTRATION

The Oversight Board oversees and is accountable for the RTC. In its oversight capacity, the Board must periodically review the overall performance of the RTC including its work, management activities, internal controls, and performance relative to its approved budget plans. The Administration section of the strategic plan sets forth objectives and strategies to assure that the RTC has sufficient and effectively managed resources to achieve its mission.

Planning and Budgeting

The Administration section contains guidelines for the RTC's budgeting, planning, and staffing activities. FIRREA requires the strategic plan and implementing policies and procedures to contain management objectives and a plan for the organizational structure and staffing of the RTC. The section also includes guidelines to ensure fiscal responsibility. FIRREA requires the RTC to provide the Oversight Board with periodic financing requests for Oversight Board approval.

At the Oversight Board's first meeting, it adopted a policy regarding procedures and documentation for approving RTC financing requests. These procedures require the RTC, in advance, to support the need for authorization of disbursements of funds by the Oversight Board for case resolutions, working capital requests, high cost funds replacement, liquidity advances, and operating expenditures. This has evolved into a two-step process.

The first step is the RTC's submission to the Oversight Board of a general business plan that describes its projected use of funds over succeeding weeks and requests a

general authorization to spend the projected amount. After Board staff review, its recommendation and the RTC's request are submitted to the Oversight Board for a general authorization to spend all or part of the requested funds.

The Oversight Board's general authorization does not release the funds, however. That comes during the second step of the process, when the RTC submits a written request for funds needed for specific transactions that are consistent with the general authorization. The request is reviewed to determine if it includes all the required information, is signed by the Certifying Officer, and conforms with the uses of funds permitted by FIRREA and Oversight Board policies. If the Oversight Board has authorized sufficient funds to meet the request, a staff memorandum including recommended action is prepared and sent to the Oversight Board CEO. Only upon his approval are funds actually transferred to the RTC account.

Working Capital

In order for the RTC to effectively accomplish its goal of resolving institutions in an expeditious manner, it is important to develop a mechanism through which the RTC can raise working capital. The need for working capital arises from timing differences that occur in the case resolution process. For example, when the RTC liquidates an institution, the RTC must make up-front payments to depositors. This cash advance, however, does not represent the actual cost of resolution. The RTC will ultimately sell the assets of the failed institution and recover the fair market value of the assets. Since the sale of these assets takes time, but depositors must be paid up front, the resources provided by FIRREA could quickly be tied up in the illiquid assets acquired for resolved institutions. Working

capital allows the RTC to proceed with case resolutions while continuing the orderly disposition of these assets. The strategic plan requires the RTC to establish the necessary systems and procedures for implementing a working capital program.

Reporting Requirements

FIRREA authorizes the Oversight Board to require from the RTC any reports, documents, and records it deems necessary to carry out its oversight responsibilities. Furthermore, FIRREA imposes reporting requirements on the RTC, including reports to Congress. The RTC, in consultation with the Oversight Board and Congress, will streamline the process for responding to the various reporting requirements imposed on the RTC by Congress, the Oversight Board, and others, to the extent possible.

Independent Audits and Other Appraisals of Operations

FIRREA established an Inspector General (IG) for the RTC. The Inspector General Act of 1978, as amended, requires the IG/RTC to prepare, by April 30 and October 31 of each year, semiannual reports containing certain information for the six-month periods ending on March 31 and September 30, respectively, for submission to Congress. FIRREA also requires the Comptroller General to annually audit the financial statements of the RTC unless the Comptroller General notifies the Oversight Board not later than 180 days before the close of a fiscal year that it will not perform an audit for that fiscal year. In that event, the Oversight Board must contract with an independent certified public accountant to perform the annual audit. (GAO, however, has indicated that agency will conduct an annual report of RTC's financial statement.)

The strategic plan requires the RTC to appraise its operations, including cooperating fully in audits such as those performed by the Inspector General, Comptroller General, and Oversight Board to assist its Board of Directors and management in ensuring an efficient, economical, and effective application of its resources.

G. SPECIFIC QUESTIONS FOR PUBLIC COMMENT

While the Oversight Board invites comments on all aspects of the proposed strategic plan, comment on the following key issues is especially requested.

1. The strategic plan identifies four factors that the RTC should consider in establishing its schedule for case resolutions: (1) deterioration, (2) risk, (3) recovery of franchise value, and (4) efficient use of staff. How should each of these factors be measured? For example, should deterioration be measured as an absolute level (e.g., total operating losses) or on a relative basis (e.g., operating losses relative to expected cost of resolution or relative to total assets)? Are there other factors that should also be considered? What is the relative importance of each factor?

2. As noted in the background section, there are a number of policy questions regarding the method by which institutions are resolved. What factors should the RTC consider in selecting a particular method of resolution? For example, should the RTC attempt to sell individual branches? What are the advantages and disadvantages of selling the individual components of a thrift association versus selling the thrift as a total unit. Do the costs of administering a piecemeal liquidation approach outweigh the potential benefits of attracting a wider group of interested bidders?

3. There are a variety of forms of financial assistance available for the resolution of insolvent thrift institutions. The Oversight Board has adopted a policy limiting the maturity on assistance creating a financial contingency for the RTC to no greater than six months. Will

limiting the terms of such assistance significantly discourage potential acquirers? What types of factors should the Oversight Board and the RTC consider is establishing policies and procedures regarding the use of financial assistance?

4. What methods are available to ensure that all interested bidders are fully informed regarding the bidding procedure and the institutions being marketed?

5. Asset management and disposition involve a number of services, including: property management, loan servicing and workout, accounting and legal services, capital improvements to completed or partially built structures, marketing of loans and properties, and negotiating the terms of sale of these assets. A distinction can be made between asset managers and property managers. Asset managers in the private sector have responsibility for overseeing all of these services on behalf of the owners of portfolios of loans and properties. FIRREA directs the RTC to utilize the private sector for such services -- both the overall asset management function and its component services, including property management -- if such services are available in the private sector and the RTC determines utilization of such services to be practicable and efficient. The Oversight Board staff requests public comment on the extent to which it is practicable and efficient for the RTC to utilize the private sector for the overall asset management function, rather than for RTC staff to serve as asset managers and contract directly with providers of the component services.

6. FIRREA calls for the RTC to utilize "clearinghouses" to serve as sources of information on eligible residential

properties (i.e., properties held by the RTC that are subject to the special marketing provisions specified in the statute). FIRREA permits the following organizations to serve as clearinghouses: state housing finance agencies, the Office of Community Investment (or other comparable division) within the Federal Housing Finance Board, and any national nonprofit organizations that the RTC determines to have the capacity to act as a clearinghouse for information. The Oversight Board staff requests public comment on other functions, in addition to information dissemination, that might be performed for the RTC by these organizations (e.g., qualifying the bidders for eligible residential properties) and the advantages these organizations have in providing these services.

7. FIRREA contains several provisions relating to the objective of maximizing the preservation of the availability and affordability of residential real property for low- and moderate-income individuals. For example, provisions in FIRREA require a right of first refusal for qualified purchasers of eligible properties. FIRREA authorizes the RTC to provide subsidies to qualified purchasers of eligible residential properties to the extent necessary to facilitate purchases of properties by lower income families and to help public agencies and non-profit organizations to meet lower income occupancy requirements for properties which these entities wish to purchase.

The Oversight Board staff specifically requests public comment on strategies for and approaches to implementing the low and moderate income housing provisions of FIRREA. Comments are requested on (1) methods for implementing the FIRREA's right of first refusal provisions, (2) alternative approaches to providing subsidies to enable eligible

individuals and public agencies to purchase properties for lower-income housing while at the same time providing maximum return to the Government, (3) the extent and nature of the subsidies that would be most useful, singularly or in combination, under particular circumstances, including but not limited to price discounts or concessionary financing, as well as alternative program designs, (4) the proposed role of government and nongovernment entities, including but not limited to national and regional nonprofit organizations, clearinghouses and other entities in carrying out FIRREA's housing objectives, and (5) the nature of Government assistance to best facilitate the program, e.g., assistance to aid capacity building for nongovernment entities.

III. GOALS, OBJECTIVES, AND IMPLEMENTATION PROCEDURES

A. CASE RESOLUTION

GOAL: Resolve institutions under RTC jurisdiction in a timely and cost effective manner, while minimizing the negative effects on local financial and real estate markets.

OBJECTIVE 1. Reduce resolution costs by establishing a resolution schedule for institutions under RTC jurisdiction that to the extent practicable:

- o gives priority to institutions with relatively high rates of deterioration;
- o minimizes the ongoing risk exposure to the RTC;
- o maximizes the recovery of franchise value; and,
- o makes the most efficient use of RTC resources and staff.

IMPLEMENTATION PROCEDURES:

A. By November 30, 1989, develop written guidelines and procedures for evaluating each institution under RTC jurisdiction.

B. By December 15, 1989, develop prioritization schedules for institutions to be resolved after January 1, 1990, and update thereafter at least 30 days before the end of each calendar quarter.

OBJECTIVE 2. Establish procedures for the selection of the preferred method of resolution that is consistent with:

- the requirements in FIRREA that the RTC conduct its operations in a manner that maximizes the net present value of return from the sale or other disposition of institutions and minimizes the amount of any loss realized in the resolution of cases;

- Section 13 (c) (4) of the Federal Deposit Insurance Act that prohibits providing assistance in an amount in excess of that required to liquidate an institution unless the RTC determines that the continued operation of the institution is essential to provide adequate banking services in its community;

- minimizing the ongoing risk exposure to the RTC;

- o minimizing the effects on local real estate and financial markets; and,

- o the provisions in FIRREA regarding the continuation of minority-owned institutions.

IMPLEMENTATION PROCEDURES:

A. By November 30, 1989, develop written guidelines for the "cost test" calculation required by Section 13 (c) (4) of the FDI Act and the loss minimization criteria in FIRREA.

B. By December 15, 1989, identify the factors the RTC will consider in deciding whether non-performing assets of a failed institution will be transferred to the acquiring institution rather than retained by the RTC;

C. By December 15, 1989, develop written policies and procedures consistent with the provisions of FIRREA regarding the continuation of minority-owned institutions.

D. By January 31, 1990, establish written guidelines on the use of various forms of financial assistance available from the RTC.

OBJECTIVE 3. Develop and implement bidding procedures for selling institutions under RTC jurisdiction that:

- o encourage active participation by all qualified bidders, including minorities and women;

- o provide sufficient time for bidders to file necessary applications and for the chartering, regulatory and insurance agencies to process and evaluate the applications;

- o provide for fair, non-discriminatory treatment and competition among prospective bidders; and,

- o enable the RTC to notify bidders of a rejected bid within 30 days.

IMPLEMENTATION PROCEDURES:

A. As soon as possible, but not later than November 15, 1989, establish and publicize the criteria and procedures for qualifying bidders.

B. By December 29, 1989, develop written plans for soliciting bids from all interested qualified buyers without preference to type of organization, including

procedures for encouraging the active participation in the bidding process by women and minorities.

C. By December 29, 1989, develop written procedures for:

- o making available to all interested qualified bidders, to the extent practical, full and consistent information on institutions under RTC jurisdiction and the terms of previous transactions;

- o the timely and nondiscriminatory evaluation and selection of offers; and,

- o notifying rejected bidders within 30 days.

D. By March 30, 1990, establish written procedures for accepting and investigating complaints of discrimination or unfair treatment in the consideration of offers.

OBJECTIVE 4. Establish computer systems and record keeping and reporting procedures necessary to keep the Oversight Board, the President, Congress and the general public informed of the case resolution process.

IMPLEMENTATION PROCEDURES:

A. By December 29, 1989, in consultation with the Oversight Board and the Congress, determine the extent of information required to be reported under the provisions of FIRREA and for full and complete disclosure of the case resolution process.

B. By March 30, 1990, develop and implement, to the extent possible, quarterly and other periodic reports that present all required information in clear and consistent formats.

OBJECTIVE 5. To the extent practicable and efficient, use private sector entities for the management and disposition of institution under RTC jurisdiction.

IMPLEMENTATION PROCEDURES:

A. By December 29, 1989, identify areas where private sector entities could be used to facilitate the management and disposition of institutions.

B. ASSET DISPOSITION

GOAL: To dispose of real estate and other assets in such a way as to maximize the net present value to the RTC while also minimizing the effect of these transactions on local real estate and financial markets.

OBJECTIVE 1. Maximize the net present value recovery to RTC by establishing appropriate policies, procedures and/or guidelines concerning:

- appropriate methods of disposition;
- asset marketing of pools of assets;
- preserving and enhancing values during the asset management process;
- distressed area designations;
- establishing and defining market values;
- keeping market participants and other interested parties fully informed, to the extent practical, on RTC's inventory and plans for asset sales;
- the active solicitation of offers from minorities and women; and

- o the prohibition of discrimination on the basis of race, sex, or ethnic group in the solicitation and consideration of offers.

IMPLEMENTATION PROCEDURES:

A. By March 30, 1990, establish comprehensive performance standards and written guidelines on overall asset disposition strategies.

B. By December 29, 1989, provide the Oversight Board with issues and alternatives for providing financing for assets sold.

C. Consult with the Oversight Board and the National and Regional Advisory Boards and revise written guidelines on an ongoing basis as necessary.

D. By December 29, 1989, develop record keeping requirements to facilitate the orderly disposition of assets and to comply with the required semi-annual reporting of RTC's national inventory of real property assets.

E. By December 29, 1989, develop policies and procedures for notifying rejected bidders within

30 days.

F. By December 29, 1989, develop policies and procedures for actively soliciting offers for assets from minorities and women.

G. By December 29, 1989, develop policies and procedures prohibiting discrimination on the basis of race, sex or ethnic group in the solicitation and consideration of offers.

H. By March 30, 1990, establish written procedures for accepting and investigating complaints of discrimination or unfair treatment in the consideration of offers of services to the RTC.

OBJECTIVE 2. To the extent practicable and efficient, place assets under private control for management and disposition under a program that:

- o Employs incentive schemes tailored to maximizing the net present value of the assets to the RTC;

- o Assures compliance by contractors with the ethics and conflicts of interest provisions of FIRREA; and

- Assures open and fair competition for asset management and disposition contracts.

IMPLEMENTATION PROCEDURES:

A. By December 29, 1989, establish guidelines concerning contracting with public and private entities for performance of asset management and disposition functions.

B. By December 29, 1989, establish guidelines concerning incentive schemes in asset management and disposition contracts.

C. By December 29, 1989, establish procedures to assure compliance by contractors with the ethics and conflicts of interest provisions of FIRREA.

D. By December 29, 1989, establish guidelines to assure open and fair competition for asset management and disposition contracts.

E. By March 30, 1990, establish performance standards for asset management and disposition contracts.

F. By December 29, 1989, provide the Oversight Board with issues and

alternatives for implementing the statutory mandates for minority contractors.

OBJECTIVE 3. Minimize the impact of RTC transactions on local real estate and financial markets.

IMPLEMENTATION PROCEDURES:

A. By March 30, 1989, establish written guidelines for determining market values of assets based upon market analysis valuation techniques and sound asset appraisal practices.

B. By March 30, 1990, establish written general guidelines for acceptable disposition prices in non-distressed areas.

C. By March 30, 1990, develop guidelines for designating distressed areas and modifying the "95%-of-market value" rule for minimum disposition prices in distressed areas.

D. Establish an informal working group to consult with other federal agencies that are selling assets in the same geographical markets, as directed by Oversight Board Policy 11, "Interagency Consultation on Asset Sales".

OBJECTIVE 4. Fully document asset management and disposition activities to ensure compliance with all relevant statutory requirements.

IMPLEMENTATION PROCEDURES:

A. By December 29, 1989, in consultation with the Oversight Board and the Congress, determine the extent of information required to be reported under the provisions of FIRREA and for full and complete disclosure of the asset disposition process.

B. By March 30, 1990, develop and implement, to the extent possible, semiannual and other periodic reports that present information in clear and consistent formats.

C. AFFORDABLE HOUSING PROVISIONS

GOAL: To dispose of qualifying single and multi-family residential properties in such a way as to maximize the availability and affordability of residential real property for low- and moderate-income households.

OBJECTIVE 1. Implement the housing and public use provisions of FIRREA in order to maximize the preservation and affordability of housing for low- and moderate-income individuals.

IMPLEMENTATION PROCEDURES:

A. By March 30, 1990, establish guidelines for determining which national non-profit organizations have the capacity to act as clearinghouses; develop strategies to ensure the effective and efficient dispersal of information by the clearinghouses, including guidelines for contracting with clearinghouses.

B. By March 30, 1990, develop written guidelines to assure that adequate information, and access to properties, is made available to clearinghouses and eligible buyers on a timely basis.

C. By March 30, 1990, develop a strategy for actively marketing

eligible properties for sale to qualifying individuals and organizations.

D. By March 30, 1990, develop and implement procedures for qualifying low and moderate-income households, non-profit organizations, and for-profit entities for eligibility as preferred bidders on low-income properties.

E. By March 30, 1990, develop guidelines for determining the net realizable market value of eligible properties.

F. By March 30, 1990, develop and implement guidelines for choosing among substantially similar competing bids for single-family properties, consistent with the objectives of the low-income housing provisions and with the statutory directive that the RTC should choose among substantially similar bids for multifamily properties those offers that propose to house more lower income families for longer periods of time.

G. By March 30, 1990, develop procedures for coordinating RTC

disposition of eligible residential properties with programs at HUD (including FHA and GNMA), the Farmers Home Administration, and other government agencies and organizations.

H. By June 29, 1990, in consultation with HUD, develop written guidelines for conveyance of assets to state and local government agencies and other agencies and organizations participating in HUD's urban homesteading programs.

I. By June 29, 1990, in consultation with HUD and state housing finance agencies, establish procedures to assure compliance of multi-family residential property owners with the low-income occupancy requirements.

J. By March 30, 1990, provide the Oversight Board with issues and alternatives regarding financing the purchase of low and moderate-income housing.

K. Consult with the national and regional advisory boards about strategies for meeting the low-income housing goal.

L. Consult with the Federal Housing Finance Board about methods for coordinating, to the extent practical, the affordable housing program and the Community Reinvestment Program.

M. By March 30, 1990, establish guidelines for determining whether eligible properties should be sold individually or in bulk, including an evaluation of savings on disposition costs that may justify price discounts on bulk sales.

N. By March 30, 1990 establish written guidelines for determining if the value of an asset is so low that no reasonable recovery is anticipated. In such cases, the RTC may consider potential public uses, such as housing for lower-income families (including the homeless), urban open space, day care centers for the children of low- and moderate-income families, and other public purposes designated by the Secretary of Housing and Urban Development.

OBJECTIVE 2. Fully document affordable housing activities to ensure compliance with all relevant statutory requirements.

IMPLEMENTATION PROCEDURES:

A. By December 29, 1989, in consultation with the Oversight Board and the Congress, determine the extent of information required to be reported under the provisions of FIRREA and for full and complete disclosure of affordable housing activities.

B. By March 30, 1990, develop and implement, to the extent possible, semiannual and other periodic reports that present information in clear and consistent formats.

D. CONFLICTS OF INTEREST AND ETHICAL STANDARDS

GOAL: Adopt conflicts of interest and ethical standards for RTC employees, officers, advisory board members, contractors, and agents.

OBJECTIVE 1. Develop regulations and procedures that:

- o Govern conflicts of interest, ethical responsibilities, post-employment restrictions and use of confidential information for RTC employees, officers, advisory board members, contractors, and agents and

- o Ensure that RTC employees, officers, advisory board members, contractors, and agents meet appropriate competence, experience, integrity, and fitness standards.

IMPLEMENTATION PROCEDURE: Final regulations should be promulgated within 180 days of enactment of FIRREA.

OBJECTIVE 2. Develop policies and procedures for avoiding political favoritism and undue influence in RTC activities and decisions.

IMPLEMENTATION PROCEDURE: By March 30, 1990, the RTC will develop specific written policies and procedures that draw upon current FDIC policies and that delineate internal operating procedures and

methods for responding to inquiries from those who are or have been in political office.

E. EXTERNAL RELATIONS

GOAL: Establish and maintain open communications with the Congress, other government offices, and the public to increase understanding of RTC policies and actions.

OBJECTIVE 1: Promote public understanding of the RTC's policies and actions.

IMPLEMENTATION PROCEDURES:

A. As soon as possible, but no later than March 30, 1990, develop written policies and procedures concerning:

- o providing timely responses to public inquiries;
- o the RTC's working relationship with the National and Regional Advisory Boards;
- o mechanisms for accepting general complaints and mechanisms for accepting complaints of discrimination on the basis of race, sex or ethnic group in the solicitation and consideration of offers, as required by FIRREA.

B. Report to Congress on the operations of the RTC as required. The Congressionally-mandated reporting requirements included in

Title V of FIRREA are listed in the Appendix to this plan.

C. Prepare other reports requested by the Congress on a timely basis.

OBJECTIVE 2: As necessary, consult with other government offices in developing policies and procedures.

IMPLEMENTATION PROCEDURES: As needed, create or participate on interagency working groups to resolve interagency issues.

F. ADMINISTRATION

GOAL: Assure that the RTC has sufficient and effectively managed human and financial resources to achieve the mission and the goals of the agency.

OBJECTIVE 1: Assure that the RTC's resources are effectively managed to respond properly and promptly to the agency's needs and priorities.

IMPLEMENTATION PROCEDURES:

A. Annually, develop and present to the Oversight Board an operating plan and budget, including a staffing plan, for the upcoming calendar year.

The operating plan and budget for 1990 must be submitted to the Oversight Board 60 calendar days from the issuance date of this strategic plan. Subsequent annual budgets shall be presented to the Oversight Board by November 30.

B. Quarterly, the RTC will reassess the allocation of resources and make adjustments.

OBJECTIVE 2: Ensure fiscal responsibility for operations.

IMPLEMENTATION PROCEDURES:

A. As required by FIRREA, provide the Oversight Board with periodic financing

requests for prior approval that detail: a) anticipated funding requirements for operations including, case resolutions, high cost funds replacement, liquidity advances, administrative expenses and asset disposition; b) anticipated payments on previously issued notes, guarantees, other obligations, and related activities; and c) any proposed use of notes, guarantees or other obligations. Such financing requests shall be submitted on a quarterly basis or such other period as the Oversight Board determines necessary.

B. Manage assets under RTC jurisdiction and working capital in order to allow case resolutions to proceed at a rate that minimizes the net present value cost to the RTC and the American taxpayer.

C. As soon as practicable, after approval by the Oversight Board, establish the systems and procedures to implement the working capital program.

OBJECTIVE 3: Respond to required reports in a timely and efficient manner.

IMPLEMENTATION PROCEDURES:

A. By December 29, 1989, in consultation with the Oversight Board and Congress, streamline the process for responding to

the various reporting requirements imposed on the RTC by Congress, the Oversight Board, and others, to the extent possible.

B. As required by FIRREA, respond to requests from the Oversight Board for any reports, documents, and records that it deems necessary to carry out its oversight responsibilities.

Objective 4: Appraise operations within the RTC, including cooperating fully in independent audits, to assist the Board of Directors and management in ensuring an efficient, economical, and effective application of resources.

IMPLEMENTATION PROCEDURES:

A. By March 30, 1990, the RTC Board of Directors and senior management should develop management processes designed to ensure compliance with policies, laws, rules and regulations. At a minimum, these processes should address planning, policy making, personnel, administration, and management information systems.

B. Cooperate fully in the audits performed by the Inspector General.

C. Cooperate fully in the annual audit performed by the Comptroller General, or other independent certified public

accountant selected by the Oversight Board, as required by FIRREA.

D. Cooperate fully in periodic reviews and audits of RTC activities performed by the Oversight Board in fulfilling its responsibility for reviewing the overall performance of the RTC, including its work, management activities, and internal controls, and the performance of the RTC relative to approved budget plans as required by FIRREA.

E. Within 60 days of receiving any audit or review, develop follow-up procedures to ensure that deficiencies and recommendations cited in audits and reviews by the Inspector General, Comptroller General, Oversight Board, public accounting firms or others, receive appropriate corrective action.

APPENDIX to the Strategic Plan
FIRREA, Title V
Reporting and Disclosure Obligations for the Resolution Trust Corporation

The following reporting requirements are from Title V of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Pub. L. No. 101-73, Section 501, 103 Stat. 183, 363-94) ("FIRREA"). All references to Section 21A, are to Section 21A of the Federal Home Loan Bank Act (12 U.S.C. 1441a), as added by Section 501(a) of FIRREA.

1. The RTC shall make available to the public:

   o any agreement by the RTC relating to a transaction that provides assistance pursuant to section 13(c) of the Federal Deposit Insurance Act ("section 13(c)"), not later than 30 days after the first meeting of the Oversight Board after such agreement is entered into; and

   o all agreements relating to the RTC's review of prior cases pursuant to subsection (b)(11)(B) of 21A.

   "Agreement" includes: a) all documents that effectuate the terms and conditions of the assisted transaction; b) a comparison by the RTC of the estimated cost of the transaction with the estimated cost of liquidating the insured institution, and c) a description of any economic or statistical assumptions on which such estimates are based.

The Oversight Board may withhold public disclosure if it determines by a unanimous vote that disclosure would be contrary to the public interest. A written report containing a full explanation of the reasons for such a determination must be published in the Federal Register and transmitted to the House and Senate Banking Committees.

Section 21A (k)(2)(A),(B), and (C)

2. The RTC shall make available to the House and Senate Banking Committees any agreement by the RTC relating to a transaction for which the RTC provides section 13(c) assistance not later than 25 days after the first meeting of the Oversight Board after such agreement is entered into. This requirement is in addition to the RTC's obligation to make such agreements publicly available.

Section 21A (k)(3)(A)

3. The RTC shall submit a report to the Oversight Board and the Congress containing the results and conclusions of the review of 1988 and 1989 FSLIC transactions (pursuant to subsection (b)(11)(B) of 21A) and recommendations for legislative action that the RTC may determine to be appropriate.

Section 21A (k)(3)(B)

4. The RTC's Real Estate Asset Division shall publish before January 1, 1990 an inventory of real property assets of institutions subject to the jurisdiction of the RTC. The inventory must be updated semiannually

and must identify properties with natural, cultural, recreational, or scientific values of special significance.

Section 21A (b)(12)(F)

5. Annually, the Comptroller General shall audit the financial statements of the RTC unless the Comptroller General notifies the Oversight Board not later than 180 days before the close of a fiscal year that it will not perform an audit for that fiscal year. In that event, the Oversight Board must contract with an independent certified public accountant to perform the annual audit. All books, records, accounts, reports, files, and property belonging to or used by the RTC, or the Oversight Board, or by an independent certified public accountant retained to audit the RTC's financial statement, shall be made available to the Comptroller General.

Sections 21A (k)(1)(A) and (B)

6. The Inspector General of the RTC shall comply with the reporting requirements imposed on the Inspector General pursuant to the Inspector General Act of 1978, as amended.

Section 501 (b) of FIRREA

7. The RTC shall: i) document decisions made in the solicitation and selection process and the reasons for the decisions; and ii) maintain such documentation in the offices of the RTC, as well as any other documentation relating to the solicitation and

selection process.

Section 21A (b)(12)(C)

8. The Oversight Board and the RTC shall annually submit a full report of their respective operations, activities, budgets, receipts, and expenditures for the preceding 12-month period. The RTC shall submit the annual report to Congress and the President as soon as practicable after the end of the calendar year for which the report is made, but not later than June 30 of the year following that calendar year. The report shall include:

   - audited statements and such information as is necessary to make known the financial condition and operations of the RTC in accordance with generally accepted accounting principles;

   - the RTC's financial operating plans and forecasts (including budgets, estimates of actual and future spending and cash obligations) taking into account the Corporation's financial commitments, guarantees, and other contingent liabilities;

   - the number of minority and women investors participating in the bidding process for assisted acquisitions and the disposition of assets and the number of successful bids by such investors; and

- o a list of the properties sold to State housing finance authorities (as such term is defined in section 1301 of FIRREA), the individual purchase prices of such properties, and an estimate of the premium paid by such authorities for such properties.

Sections 21A (k)(4)(A),(B), and (C)

9. The Oversight Board and the RTC shall submit to Congress not later than April 30 and October 31 of each calendar year, a semiannual report on the activities and efforts of the RTC, the FDIC, and the Oversight Board for the 6-month period ending on the last day of the month prior to the month in which such report is required to be submitted. The report shall include the following information with respect to the RTC's assets and liabilities and to the assets and liabilities of institutions for which the RTC is or has been the conservator or receiver:

   - o the total book value of all assets held or managed by the RTC at the beginning and end of the reporting period;

   - o the total book value of assets that are under contract to be managed by private persons and entities at the beginning and end of the reporting period;

   - o the number of employees of the Corporation, the Federal Deposit Insurance Corporation, and the Oversight Board at the beginning and end of the reporting period;

- the total amounts expended on employee wages, salaries, and overhead, during such period that are attributable to: (a) contracting with, supervising, or reviewing the performance of private contractors, or (b) managing or disposing of such assets;

- the total amount expended on private contractors for the management of such assets;

- the efforts of the RTC to maximize the efficient utilization of the resources of the private sector during the reporting period and in future reporting periods and a description of the policies and procedures adopted to ensure adequate competition and fair and consistent treatment of qualified third parties seeking to provide services to the RTC or the Federal Deposit Insurance Corporation;

- the total book value and total proceeds from such assets disposed of during the reporting period;

- summary data on discounts from book value at which such assets were sold or otherwise disposed of during the reporting period.

- a list of all of the areas that carried a distressed area designation during the reporting period (including a justification

for removal of areas from or addition of areas to the list of distressed areas);

- an evaluation of market conditions in distressed areas and a description of any changes in conditions during the reporting period;

- any change adopted by the Oversight Board in the minimum disposition price and the reasons for such change; and,

- the valuation method or methods adopted by the Oversight Board or the RTC to value assets and the reasons for selecting such methods.

Sections 21A (k)(5)(A) and (B)

10. Before January 31, 1990, the Oversight Board and the RTC shall appear before the House and Senate Banking Committees to:

    - describe the strategic plan established for the operations of the RTC;

    - describe the policies and procedures established or proposed to be established for the RTC, including specific measures taken to avoid political favoritism or undue influence with respect to the activities of the RTC;

- o provide any regulation proposed to be prescribed by the RTC; and
- o provide the proposed case resolution schedule.

Sections 21A (k)(7)(A) and (B)

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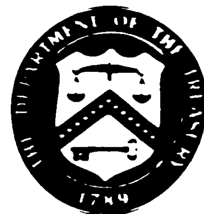
Daniel P. Kearney
President and Chief Executive Officer

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
November 6, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY POSTPONES AUCTION OF WEEKLY BILLS

The Treasury announced today that it is postponing the auctions of 13-week and 26-week bills originally scheduled for today. This postponement is necessary because Congress has not completed action on legislation to increase the statutory debt limit to permit issuance of the bills on November 9, 1989.

Investors are advised to look for notice of rescheduling of these auctions in the financial press or to contact their local Federal Reserve Bank or Branch for such information.

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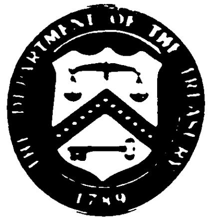
NB-550

TREASURY NEWS



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FOR RELEASE AT 3:00 PM
November 6, 1989

Contact: Peter Hollenbach
(202) 376-4302

TREASURY ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR OCTOBER 1989

The Department of the Treasury announced activity figures for the month of October 1989, of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS).

	Dollar Amounts in Thousands
Principal Outstanding (Eligible Securities)	$366,929,254
Held in Unstripped Form	$285,341,204
Held in Stripped Form	$81,588,050
Reconstituted in October	$2,497,600

The accompanying table gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision. These monthly figures are included in Table VI of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form." These can also be obtained through a recorded message on (202) 447-9873.

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NB-551

TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, OCTOBER 31, 1989
(In thousands)

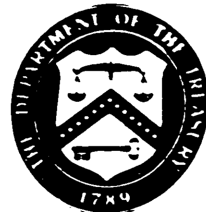
Loan Description	Maturity Date	Principal Amount Outstanding			Reconstituted This Month[1]
		Total	Portion Held in Unstripped Form	Portion Held in Stripped Form	
11-5/8% Note C-1994	11/15/94	$6,658,554	$5,269,754	$1,388,800	-0-
11-1/4% Note A-1995	2/15/95	6,933,861	6,220,101	713,760	$12,000
11-1/4% Note B-1995	5/15/95	7,127,086	5,383,726	1,743,360	-0-
10-1/2% Note C-1995	8/15/95	7,955,901	7,143,501	812,400	-0-
9-1/2% Note D-1995	11/15/95	7,318,550	6,477,750	840,800	-0-
8-7/8% Note A-1996	2/15/96	8,575,199	8,288,799	286,400	-0-
7-3/8% Note C-1996	5/15/96	20,085,643	19,863,243	222,400	14,400
7-1/4% Note D-1996	11/15/96	20,258,810	19,958,810	300,000	-0-
8-1/2% Note A-1997	5/15/97	9,921,237	9,852,037	69,200	-0-
8-5/8% Note B-1997	8/15/97	9,362,836	9,362,836	-0-	-0-
8-7/8% Note C-1997	11/15/97	9,808,329	9,793,929	14,400	-0-
8-1/8% Note A-1998	2/15/98	9,159,068	9,158,428	640	-0-
9% Note B-1998	5/15/98	9,165,387	9,135,387	30,000	-0-
9-1/4% Note C-1998	8/16/98	11,342,646	11,221,046	121,600	-0-
8-7/8% Note D-1998	11/15/98	9,902,875	9,899,675	3,200	-0-
8-7/8% Note A-1999	2/15/99	9,719,628	9,719,628	-0-	-0-
9-1/8% Note B-1999	5/15/99	10,047,103	9,538,303	508,800	-0-
8% Note C-1999	8/15/99	10,163,644	10,113,644	50,000	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	3,631,406	4,670,400	43,200
12% Bond 2005	5/15/05	4,260,758	1,957,708	2,303,050	-0-
10-3/4% Bond 2005	8/15/05	9,269,713	7,658,513	1,611,200	561,600
9-3/8% Bond 2006	2/15/06	4,755,916	4,755,916	-0-	-0-
11-3/4% Bond 2009-14	11/15/14	6,005,584	2,373,584	3,632,000	243,200
11-1/4% Bond 2015	2/15/15	12,667,799	2,746,839	9,920,960	-0-
10-5/8% Bond 2015	8/15/15	7,149,916	1,970,396	5,179,520	-0-
9-7/8% Bond 2015	11/15/15	6,899,859	2,351,059	4,548,800	24,000
9-1/4% Bond 2016	2/15/16	7,266,854	5,649,254	1,617,600	200,000
7-1/4% Bond 2016	5/15/16	18,823,551	16,692,351	2,131,200	127,200
7-1/2% Bond 2016	11/15/16	18,864,448	11,123,088	7,741,360	220,000
8-3/4% Bond 2017	5/15/17	18,194,169	7,666,169	10,528,000	292,000
8-7/8% Bond 2017	8/15/17	14,016,858	9,994,458	4,022,400	313,600
9-1/8% Bond 2018	5/15/18	8,708,639	4,871,839	3,836,800	217,600
9% Bond 2018	11/15/18	9,032,870	3,071,470	5,961,400	124,800
8-7/8% Bond 2019	2/15/19	19,250,793	12,481,193	6,769,600	104,000
8-1/8% Bond 2019	8/15/19	9,953,364	9,945,364	8,000	-0-
Total		366,929,254	285,341,204	81,588,050	2,497,600

[1] Effective May 1, 1987, securities held in stripped form were eligible for reconstitution to their unstripped form.

Note: On the 4th workday of each month a recording of Table VI will be available after 3:00 pm. The telephone number is (202) 447-9873.
The balances in this table are subject to audit and subsequent adjustments.

GPO 942-638

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
November 7, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY POSTPONES AUCTIONS OF QUARTERLY FINANCING ISSUES

The Treasury announced today that it is postponing the auction of 3-year notes originally scheduled for today; the auction of 10-year notes scheduled for Wednesday, November 8, 1989; and the auction of 29-3/4-year bonds and 36-day cash management bills scheduled for Thursday, November 9, 1989. The postponement of these auctions is necessary because Congress has not completed action on legislation to increase the statutory debt limit to permit issuance of the securities on November 15, 1989.

Investors are advised to look for notice of rescheduling of these auctions in the financial press or to contact their local Federal Reserve Bank or Branch for such information.

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TREASURY DEPARTMENT LIBRARY

INFORMATION
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