U.S. Treasury Department

PRESS RELEASES

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

EMBARGOED FOR RELEASE AT 1:00 PM
April 1, 1991

CONTACT: Barbara Clay
202-566-5252

TREASURY NAMES IRAQ'S AGENTS

The Treasury Department today identified 52 businesses and 37 individuals worldwide as front companies and agents of Iraq. The action is part of an ongoing investigation by Treasury of Iraq's worldwide arms and financial complex.

In announcing the action, Treasury Deputy Secretary Robson said, "Exposing these companies and individuals strikes a blow at Iraq's subterranean network in the world of arms trading and clandestine financial operations."

As a result of today's action by the Treasury's Office of Foreign Assets Control (OFAC), the companies and individuals are now considered "Specially Designated Nationals", or agents of the Government of Iraq, bringing them under the existing embargo and asset freeze put in place by President Bush against Iraq. All transactions with them under U.S. jurisdiction are prohibited unless licensed by the Treasury Department.

In addition, Treasury today named 160 Iraqi-owned or controlled merchant ships. These ships are now subject to embargo provisions that prohibit their use by U.S. businesses and individuals.

Doing business with an Iraqi specially designated national is equivalent to doing business with the Government of Iraq, which carries criminal penalties of up to $1 million per violation for both corporations and individuals, as well as prison sentences of up to 12 years for individuals. Civil penalties of up to $250,000 may be imposed administratively.

OFAC has established a special Iraqi assets telephone hotline through which anyone with information on companies or individuals holding Iraqi assets or acting on behalf of Iraq may report that information to OFAC. All calls will be kept confidential. The number is 202-566-6045.

NB-1204

oOo

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
April 1, 1991

Contact: Barbara Clay
202-566-5252

OPENING STATEMENT
JOHN E. ROBSON
DEPUTY SECRETARY OF THE TREASURY
APRIL 1, 1991

Today the Treasury Department is revealing the names of 89 businesses and individuals determined to be agents and front companies in Iraq's arms procurement and financial network.

While this action may lack the spectacular drama of Operation Desert Storm, it represents an important companion effort by the United States to bring stability to the region. It will disrupt the ability of Saddam Hussein or a successor to employ this network to rebuild Iraq's military capacity or to divert funds that rightfully belong to the Iraqi people for other nefarious purposes or personal gain.

The events that culminated in Iraq's invasion of Kuwait last August 2nd began long before.

For over the last decade, Saddam strengthened the sinews of his war machine through a sophisticated network of front companies and agents. Through it he got weapons, spare parts, machine tools, and raw materials necessary to sustain his militarized state. And through it he may have hidden away ill-gotten fruits of embezzlements from the Iraqi people. We want the network exposed. And we want it neutralized.

By declaring these front companies and agents to be Specially Designated Nationals of Iraq, we are putting the world on notice that when you deal with them, you're dealing with Saddam. And exposure of the network may also assist the allied nations in discovering hidden wealth that could be used to pay part of Iraq's war reparations.

I should point out, however, that despite considerable speculation, neither we nor anyone else knows the specific dollar amount of hidden assets. As the investigation of this network's operations goes forward we hope to learn more. But at this point it is inappropriate for us to speculate about the amount of assets that may have been diverted.

Treasury's action today places these companies and individuals under the trade embargo and asset freeze that President Bush imposed following the invasion of Kuwait. This means that they are cut off from their financial assets and business relations within our jurisdiction and that their ability to serve Saddam is disrupted.

Months of hard investigative work under the leadership of Treasury's Office of Foreign Assets Control went into producing this information. But the job is not finished. And I want to emphasize that the fact that a name or a company isn't on this list does not imply the U.S. Government's seal of approval. We have many more cases under investigation.

Throughout the embargo we've worked closely with our allies. We are asking them to join us in this effort by taking similar steps to expose and neutralize Saddam's known agents and front companies in their jurisdictions. Worldwide cooperation will help eliminate this network.

Thank you.

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 1, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $7,638 million of 13-week bills to be issued on April 4, 1991 and mature on July 5, 1991 were accepted today (CUSIP: 912794WR1).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.78%	5.96%	98.523
High	5.80%	5.98%	98.518
Average	5.80%	5.98%	98.518

Tenders at the high discount rate were allotted 53%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	36,440	36,440
New York	21,508,575	6,285,390
Philadelphia	23,175	23,175
Cleveland	42,665	42,055
Richmond	55,230	51,760
Atlanta	39,610	39,140
Chicago	1,761,260	116,300
St. Louis	56,730	22,030
Minneapolis	7,320	7,320
Kansas City	41,020	41,020
Dallas	31,800	31,800
San Francisco	870,450	104,000
Treasury	837,225	837,225
TOTALS	$25,311,500	$7,637,655
Type		
Competitive	$20,858,635	$3,184,790
Noncompetitive	1,679,215	1,679,215
Subtotal, Public	$22,537,850	$4,864,005
Federal Reserve	2,486,935	2,486,935
Foreign Official Institutions	286,715	286,715
TOTALS	$25,311,500	$7,637,655

An additional $138,685 thousand of bills will be issued to foreign official institutions for new cash.

NB-1206

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 1, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $7,612 million of 26-week bills to be issued on April 4, 1991 and mature on October 3, 1991 were accepted today (CUSIP: 912794XH2).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.77%	6.04%	97.083
High	5.79%	6.06%	97.073
Average	5.79%	6.06%	97.073

Tenders at the high discount rate were allotted 70%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	27,975	27,975
New York	20,482,810	6,523,385
Philadelphia	13,805	13,805
Cleveland	31,895	31,895
Richmond	38,390	37,190
Atlanta	29,465	29,165
Chicago	1,479,765	51,465
St. Louis	36,570	20,070
Minneapolis	5,370	5,370
Kansas City	47,415	46,970
Dallas	17,835	17,835
San Francisco	566,500	59,000
Treasury	747,970	747,970
TOTALS	$23,525,765	$7,612,095
Type		
Competitive	$19,782,815	$3,869,145
Noncompetitive	1,280,365	1,280,365
Subtotal, Public	$21,063,180	$5,149,510
Federal Reserve	2,050,000	2,050,000
Foreign Official Institutions	412,585	412,585
TOTALS	$23,525,765	$7,612,095

An additional $191,215 thousand of bills will be issued to foreign official institutions for new cash.

NB-1207

12139
RTR-
a0514BC-TEXT-TREASURY/IRAQ-MULTITAKES
THE REUTER TRANSCRIPT REPORT

TREASURY DEPUTY SECRETARY JOHN ROBSON NEWS CONFERENCE
Date: April 1, 1991
Topic: The release of a list of front companies and agents of the Iraqi government
Location: Treasury Department, 15th St. and Penn. Ave. NW
Time: 1 p.m.
*****

The editor of the report is Steve Ginsburg. Tim Ahmann, Eric Beech, Eugenio Ramos, Peter Ramjug and Paul Schomer also are available to help you. If you have questions, please call 202-898-8345. For service problems inside the District of Columbia, call 202-898-8355; outside D.C., call 1-800-537-9755.
*****
*****

This transcript is provided by News Transcripts, Inc. If questions of content arise, call 682-9050
*****

JOHN E. ROBSON (Deputy Secretary of the Treasury): Good afternoon. Today the Treasury Department is revealing the names of 89 businesses and individuals determined to be agents and front companies in Iraq's arms procurement and financial network.

While this action may lack the spectacular drama of Operation Desert Storm, it represents an important companion effort by the United States to bring stability to the region. It will disrupt the ability of Saddam Hussein or his successor to employ this network to rebuild Iraq's military capacity, or to divert funds that rightfully belong to the Iraqi people for other nefarious purposes or personal gain.

The events that culminated in Iraq's invasion of Kuwait last August 2nd began long before.

For over the last decade, Saddam strengthened the sinews of his war machine through a sophisticated network of front companies and agents. Through it he got weapons, spare parts, machine tools, and raw materials necessary to sustain his militarized state. And through it he may have hidden away ill-gotten fruits of embezzlements from the Iraqi people. We want the network exposed and we want it neutralized.

By declaring the front companies and agents to be Specially Designated Nationals of Iraq, we are putting the world on notice that when you deal with them, you are dealing with Saddam. And exposure of the network may also assist the allied nations in discovering hidden wealth that could be used to pay part of Iraq's war reparations.

I should point out, however, that despite considerable speculation, neither we nor anyone else knows the specific dollar amount of hidden assets. As the investigation of this network's operation goes forward, we hope to learn more. But at this point, it is inappropriate for us to speculate about the amount of assets that may have been diverted.

Treasury's action today places these companies and individuals under the trade cmbargo and asset freeze that President Bush imposed following the invasion of Kuwait. This means that they are cut off from their financial assets and business relations within our jurisdiction, and that their ability to serve Saddam is disrupted.

Months of hard, investigative work under the leadership of Treasury's Office of Foreign Assets Control went into producing this information. But the job is not finished. And I want to emphasize that the fact that a name or a company isn't on this list does not imply the U.S. government's seal of approval. We have many more cases that are under investigation.

Finally, throughout the embargo we've worked closely with our allies. And we are asking them to join us in this effort by taking similar steps to expose and neutralize Saddam's known agents and front companies in their jurisdictions. Worldwide cooperation will help eliminate this network.

Thank you. Rick Newcomb and I will be pleased to answer your questions.

Q: Why did you wait so long?

ROBSON: The process of examining--first, I don't think we waited too long; and second, that this is a complicated set of facts that bore careful investigation. We have been in that investigation. That investigation continues, and we want to be sure as we go forward with it that when we make these disclosures, they're based on the best evidence we can get.

Q: The two American firms listed--Bay Industries and Matrix (phonetic)--can you tell us with some specificity what they did or were engaged in, and what their assets are?

R. RICHARD NEWCOMB (Director, Office of Foreign Assets Control): I think you're referring to--

Q: Microphone, please.

NEWCOMB: --you're referring to two companies where we took individual blocking actions; these are companies we determined to be under, controlled by Iraq in the United States. We base it on information which we gathered over the period of time we were looking into this. That's not information that we've here to date made public, nor are we opening our investigative files on those.

Q: When did you take the blocking action against those two companies?

NEWCOMB: We took the blocking action on the Soen (phonetic) Ohio company, Matrix Churchill in September. We took the blocking action on the company in southern California last week.

Q: Mr. Robson, I'm trying to understand exactly what you hope to gain by releasing this list. Do you hope that no

12139
one doing business--anyone doing business doesn't do business with these firms, or knows that if they do do business with any of these firms or individuals, that they're then subject to these series of penalties?

ROBSON: Well, it's a combination of things. Certainly one of our primary goals is to illuminate the people who are players in this network and were instrumentalities or agents of Iraq. That hopefully in one case will make people very wary of doing business; in other cases it will bring in-- trigger the operation of sanction laws in this country and others that preclude them doing business; and, third, it will perhaps stem or spark other investigations that will lead to the uncovering of further members of the network and/or assets.

Q: Can you give us some kind of idea for the involvement of some of these companies--what type of involvement you're talking about? For instance, Iraqi Airways--are you talking about just their normal transportation functions? What are you talking about?

ROBSON: Well, the qualifications for becoming listed here are that you are an agent or instrumentality of the government of Iraq.

Q: So they could be on that list simply because they're the government-owned airline.

ROBSON: It does not mean that you have in every case performed activities that are unlawful.

Q: Does it mean it's illegal to fly Iraqi Air for an American citizen? What do you do if someone--

ROBSON: It has been illegal since the embargo was imposed.

Q: Are there any companies in here that were particularly involved in arms trading more so than any other? And could you perhaps describe a typical transaction? Is there anything particularly clandestine about it, or did they just purMon Apr 1, 1991 14:41

12141
RTR-hase something and ship it to Iraq?

ROBSON: Rick, do you want to answer that.

NEWCOMB: Perhaps half of these companies, give or take a small percentage, are involved in arms purchases or equipment that can be used to build arms or whole machines that are involved, precision instruments, possible dual-use items and so forth.

Q: Does that include this sewing machine company that's on the list?

ROBSON: The companies on there are--insofar as individually identifying what each of them has done is not a matter that we will be getting into.

Q: What kind of cooperation are you getting internationally?

ROBSON: Good.

Q: Can you be more specific. Can you state that other governments will freeze any assets of these companies, such as the government of (inaudible)?

ROBSON: Well, bear in mind that most of the allies who were part of the coalition have followed the U.N. sanctions with some kind of internal sanctions of their own. This would expose those companies or people to those sanctions, and would certainly make it easier for their law enforcement agencies to examine the question of whether they have violated the sanctions.

Q: Do you anticipate any of those companies' assets being frozen in the UK, for instance?

ROBSON: I don't want to speak for the United Kingdom on that.

Q: Have any of the other foreign companies had their assets frozen--any on the list at this point?

ROBSON: Have any of the other foreign companies--

Q: Have any of the foreign companies on the list.

NEWCOMB: Without going into specifics about any companies on the list, I can say that other governments have taken actions within their jurisdiction to prohibit them from conducting transactions.

Q: Can you quantify in any way what this designation of these additional business and individuals does to Saddam Hussein economically?

12141

ROBSON: I think that would be very difficult to do. I think what we have tried to do is, as I said earlier, illuminate the presence of this group of companies and individuals, make it very clear that they are agents and instrumentalities of Iraq, and by virtue of that hopefully put a quarantine sign on them that will discourage others from doing business and lead to law enforcement activity where it's appropriate.

Q: You mention that the California firm--I think the (inaudible) Michigan firm--was last fall; I would say it's probably safe to assume, from what you said, that the Iraqi Airlines, it's been illegal to fly them probably since the sanctions first began last summer. What on this list is really new?

ROBSON: In respect of not having been publicly identified?

Q: Well, yes, what exactly is new here?

ROBSON: Well, a good deal of it is. Rick?

NEWCOMB: I think this is an important first step in a series of steps, as Mr. Robson has pointed out in his remarks, that the Treasury Department will take to identify the full breadth and extent of this network worldwide.

Q: Can you describe the number of agents you had working on this, what they were doing? Were you information-sharing with other countries, et cetera?

NEWCOMB: Yes, we have information shared with other countries; we've worked with a number of informants; people have come forward with information for us. The government of Kuwait has been of great assistance in this to us. We have a variety of sources. We've utilized the entire federal law enforcement community to aid us in our effort, and we'll continue to do so.

Q: Bay Industries is on the list, of course--it's one of the two companies. Now, Mr. Wylie is supposed to control that, yet he is not one of the individuals listed. Can you explain that, please?

NEWCOMB: Mr. Wylie's assets were blocked, as were Bay Industries. But we felt that the blocking action, the individual notification that we gave to him, and the financial institutions that we suspected had his accounts were sufficient notice. The company itself is indeed on the list, however.

*****

*****

The Reuter Transcript Report
John Robson/News conference
April 1, 1991
MORE

Mon Apr 1, 1991 14:42

12168
RTR-
a0525BC-TEXT-TREASURY/IRAQ-1STADD
THE REUTER TRANSCRIPT REPORT

TREASURY DEPUTY SECRETARY JOHN ROBSON NEWS CONFERENCE
Date: April 1, 1991
(First Add)
*****

x x x list, however.

Q: A follow-up. Can you identify his whereabouts or his status (inaudible)?

NEWCOMB: As far as we know, he's still in California.

Q: I notice that on your list there are no companies or people in any of the financial centers, let's say--the Virgin Islands, the Cayman Islands, Lichtenstein, Switzerland, the Antilles, places like that. (Inaudible).

ROBSON: As I said earlier, our investigation is a continuing one, and we expect it to be going on for some while.

Q: Are you getting cooperation from the countries he referred to or from our agents (inaudible)?

ROBSON: I'll just echo what Mr. Newcomb said, which is just that we are getting good cooperation from countries around the world.

Q: (Inaudible).

ROBSON: I don't want to identify any particular countries with which we are cooperating. We're cooperating with as many as we can.

Q: One follow-up, then. Are there any countries which are not cooperating with you which you would like to get more cooperation out of?

ROBSON: I'm not aware of any.

Q: Sir, March 15th was the deadline for U.S. companies to state their claims to you of damages. Can you give a rough ballpark estimate at this time about what the damages incurred by U.S. companies is?

ROBSON: We don't have them finalized yet.

Q: Has nobody at State Department or some place asked you (inaudible) U.N. cease-fire resolution, some ballpark figure?

NEWCOMB: Yes, we have worked closely with the State

Department in the issue of the U.N. resolution; we've worked as far as the figures that we have; we're going through the figures to attempt to verify their validity. I believe any attempt at this point to speculate on the amount that might be involved wouldn't accurately reflect exactly what's at stake and what the issues are. I will, however, say that as far as blocked Iraqi assets we've recorded somewhere in the neighborhood of one billion dollars blocked domestically.

Q: But, sir, are you saying that you've given--you've given a ballpark figure to State, but you don't want to make it public? Is that correct?

NEWCOMB: Oftentimes these figures can be double counted because of the nature of people that are making the claims, and we need to go through a verification process to verify their validity. This was an exercise that we went through in the Iran process in the 1979-1980 Iran hostage crisis. It's a similar process.

Q: I must admit to some curiosity about why you won't reveal what some of these companies may or may not have done. What reasons would there be for not saying that this company was involved in some sort of arms procurement, or, is there a logistical reason, an investigatory reason, a legal reason why--

ROBSON: Well, there are investigatory reasons that the particular activities of one or another of the companies or individuals on the list are not being divulged.

Q: You have a lot of Jordanians on this list. How much cooperation--could you characterize the cooperation of the Jordanian government, and do you expect assets within Jordan and under Jordanian nationals' control to be frozen in that country?

NEWCOMB: We have met on many occasions with the Jordanian people, or with the Jordanian ambassador to the United States. We are receiving cooperation from them; however, you are correct--there are some Jordanian companies on this list. We're continuing to look in that area.

Q: Can you define just what you mean by a ''front company.'' Does it have to be Iraqi owned, Iraqi government owned?

ROBSON: No, it has to be either an Iraqi owned or controlled entity, or one that has demonstrated a pattern of dealing as agent for the Iraqi government.

Q: And is this, these activities all since August 2nd, or are you talking about things these companies might have done before the invasion?

ROBSON: Both sides of the August 2nd date.

Q: So if a company--I mean there is nothing illegal,

12168
there are no sanctions involved with--before August 2nd, why would you include a company cn your list?

ROBSON: There are two reasons. One is there may be--there may in some cases be violation of export control laws with respect to certain kinds of technology, and second, even in those cases where the particular transaction may not have been a violation of the particular country's export control laws, they were nonetheless part of the Iraqi network that has led to the arms buildup and we believe that as agents, and instrumentalities of the government, they ought to be identified.

Q: So in fact there are probably some companies on this list who've really done nothing wrong under the law, is that correct?

ROBSON: Who have done nothing that is illegal; that's possible.

Q: In your investigation, were you able to ascertain if any of the money from any of these companies was being skimmed off by Saddam Hussein, by members of his family? Did you get to that level at all?

ROBSON: I think we've spoken about as much ont he money skimming and hidden asset issue as we're going to at this point.

Q: Isn't it illegal for a company or an individual to act as an agent of the government and not declare itself (inaudible)?

ROBSON: Well, it depends what you're up to, and in this case these particular entities were acting as agents or instrumentalities of the government of Iraq, and we believe that it is in the interest of the world to make that fact known. So--

Q: Given the size of this network--you said you've got (inaudible) businesses and individuals, but there's--you're continuing your investigation. How much more is out there, either fractionally, proportionally or rhetorically?

ROBSON: Well, I think that's going to be revealed as this investigation goes forward, but we have at the moment a number of other leads that we are following.

Q: But what percentage of the network have you identified, designated?

ROBSON: Well, it's sort of like an iceberg. You don't know how big it is till you've tracked it to its end. We think we're off to a good start, but there are many more cases that are under investigation.

Q: How big is the iceberg so far in terms of--

12168
(Laughter) --in terms of the arms, illegal arms trading that you have found so far, are we talking about a few million dollars, a few hundred million dollars, perhaps a billion dollars? How much of the arms trade--how large is it that you've found so far?

ROBSON: Well, as I say the iceberg we found is 89
indMon Apr 1, 1991 15:01

12169
RTR-viduals and entities high, and we are still investigating the rest of it. In terms of the dollar aspects of it, I think I've indicated that we're simply not going to speculate on that at the moment.

Q: Well, even with an iceberg, you know, that two-thirds of it is below water--

Q: (Inaudible) in addition, you know, in addition (inaudible) identifying these companies, what additional enforcement steps are you taking today that you have not previously (inaudible)? (Inaudible) that you have not done differently?

ROBSON: Well, for one thing these entities and individuals are now identified around the world as subject to the sanctions. Second, there are now clear opportunities for further investigation to determine whether there was sanction busting, and third, the investigations of them and companies that were their colleagues are now going forward.

Q: Are any of these companies having their assets today frozen for the first time (inaudible) identification process? And how many of them are?

ROBSON: Mr. Newcomb says none here in the United States, although there may be ones that are taking place abroad.

Q: Would you be able to give us a list of when enforcement action actually has been taken on a case-by-case basis? In other words, one company, last September, there was an enforcement action; another one last week. Would you be able to provide a list to us of when you actually took enforcement action?

ROBSON: When we have taken--when we have taken enforcement actions?

Q: When you already have taken--when Treasury's actually taken an action such as closing down a particularly entity, could you give us a list of the dates of when you've done that and what kind of action you may have taken against these identified individuals or organizations.

ROBSON: We generally make those public as they happen, and would continue to do that. Yes, ma'am?

Q: Why is Hachette not on the list, some French company that supposedly publishes some American magazines, and there was some talk that they were kind of (inaudible)?

ROBSON: First, let me say that, as I said in my remarks, the fact that a company isn't on the list is not necessarily a determination as to its status as an instrumentality or agent of Iraq. Second, just let me say that my understanding of the Hachette situation is that there's an

12169
allegation that they have a minority ownership in them, as Iraq-either -sponsored or -controlled. And I'll leave it at that.

*****

*****

The Reuter Transcript Report
John Robson/News conference (first add)
April 1, 1991
MORE
Mon Apr 1, 1991 15:01

Removal Notice

FRASER

The item identified below has been removed in accordance with FRASER's policy on handling sensitive information in digitization projects due to

Citation Information

Document Type:

Number of Pages Removed:

Author(s):

Title:

Date:

Journal:

Volume:

Page(s):

URL:

Removal Notice

The item identified below has been removed in accordance with FRASER's policy on handling sensitive information in digitization projects due to

Citation Information

Document Type:

Number of Pages Removed:

Author(s):

Title:

Date:

Journal:

Volume:

Page(s):

URL:

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
April 2, 1991

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 $ 14,400 million, to be issued April 11, 1991. This offering will result in a paydown for the Treasury of about $ 5,250 million, as the maturing bills are outstanding in the amount of $ 19,651 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, April 8, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Daylight Saving time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated January 10, 1991, and to mature July 11, 1991 (CUSIP No. 912794 WY 6), currently outstanding in the amount of $ 10,498 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated April 11, 1991, and to mature October 10, 1991 (CUSIP No. 912794 XJ 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 April 11, 1991. In addition to the maturing 13-week and 26-week bills, there are $9,807 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 $ 735 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $ 895 million as agents for foreign and international monetary authorities, and $ 7,078 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).

NB-1208

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 competitive 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 AT 4:00 P.M.
April 3, 1991

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $8,500 MILLION OF 7-YEAR NOTES

The Department of the Treasury will auction $8,500 million of 7-year notes to refund $5,162 million of 7-year notes maturing April 15, 1991, and to raise about $3,350 million of new cash. The public holds $5,162 million of the maturing 7-year notes, including $116 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $8,500 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 $216 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-1209

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 7-YEAR NOTES
TO BE ISSUED APRIL 15, 1991

April 3, 1991

Amount Offered:
To the public .... $8,500 million

Description of Security:
Term and type of security .... 7-year notes
Series and CUSIP designation F-1998
(CUSIP No. 912827 A4 4)
Maturity date .... April 15, 1998
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 .... October 15 and April 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, April 10, 1991
a) noncompetitive .... prior to 12:00 noon, EDST
b) competitive .... prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):
a) funds immediately available to the Treasury .. Monday, April 15, 1991
b) readily-collectible check .. Thursday, April 11, 1991

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 4, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 52-WEEK BILLS

Tenders for $10,811 million of 52-week bills to be issued on April 11, 1991 and mature on April 9, 1992 were accepted today (CUSIP: 912794YH1).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.87%	6.25%	94.065
High	5.88%	6.26%	94.055
Average	5.88%	6.26%	94.055

Tenders at the high discount rate were allotted 80%. The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	28,085	28,085
New York	29,432,605	9,545,830
Philadelphia	18,600	18,600
Cleveland	31,495	31,495
Richmond	53,115	47,905
Atlanta	22,745	21,145
Chicago	1,733,320	472,010
St. Louis	23,395	16,995
Minneapolis	7,220	7,220
Kansas City	36,330	36,330
Dallas	8,425	8,395
San Francisco	878,440	172,440
Treasury	404,940	404,940
TOTALS	$32,678,715	$10,811,390
Type		
Competitive	$28,781,775	$6,914,450
Noncompetitive	886,940	886,940
Subtotal, Public	$29,668,715	$7,801,390
Federal Reserve	2,850,000	2,850,000
Foreign Official Institutions	160,000	160,000
TOTALS	$32,678,715	$10,811,390

An additional $185,000 thousand of bills will be issued to foreign official institutions for new cash.

NB-1210

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR RELEASE AT 3:OO PM
April 4, 1991

Contact: Peter Hollenbach
(202) 376-4302

PUBLIC DEBT ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR MARCH 1991

Treasury's Bureau of the Public Debt announced activity figures for the month of March 1991, of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS).

Dollar Amounts in Thousands

Principal Outstanding (Eligible Securities)	$495,965,790
Held in Unstripped Form	$372,581,055
Held in Stripped Form	$123,384,735
Reconstituted in March	$4,447,260

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.

oOo

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

April 7, 1991

ADDRESS BY DR. DAVID C. MULFORD, GOVERNOR FOR THE UNITED STATES, AT THE THIRTY-SECOND PLENARY SESSION

I want to take this opportunity to thank the Government of Japan and the people of Nagoya for the warm welcome we have received. I also want to congratulate Governor Hashimoto on his election as Chairman of the Board of Governors of the Bank, and President Iglesias and the management of the Bank for the excellent preparations they have made for this Thirty-second Annual Meeting of the Inter-American Development Bank.

This is the first international financial meeting since the end of the Persian Gulf war. Throughout the period of the war, financial markets performed exceptionally well. Presently, the global economic situation is mixed. Some countries are doing well and ought to continue along this path. In the U.S. we expect we will shortly be coming out of our recession. We have a better pattern of external balances among the major industrial countries, but there are challenges we will need to face in the coming months. These include many complex economic and financial problems in the Middle East following the Gulf War; the restructuring of the Eastern European economies and related adjustment problems in Europe; and, of course, the challenges we here face in the already established democracies and market-based economies of Latin America and the Caribbean. We will need the resources and the expertise of the multilateral institutions to overcome these challenges.

At past meetings of the IDB, we have spoken of new opportunities which were expected to unfold for the hemisphere. Today, rather than looking forward to events to come, we find ourselves in the midst of a period of major change. The process of building more vibrant economies in the hemisphere is now underway. Leaders in the region are putting in place economic policies which demonstrate their determination to increase growth, improve performance and lift the prosperity of their people. Likewise, the IDB now has a role to play that is central to the transformation of the hemisphere. It also has the resources to carry out its mission.

Forward-looking steps by new leaders in Latin America and the Caribbean hold the prospect for a bright future for the region. Impressed by the efforts of these leaders, President Bush launched the new Enterprise for the Americas Initiative last June as a means of promoting prosperity for the hemisphere.

The President proposed specific actions in all the major policy areas of greatest importance to Latin America and the Caribbean. He issued a challenge to all of us and committed the U.S. to seek more open trading arrangements among our countries, to increase investment throughout the region, to reduce official debt burdens and to stimulate national environmental programs. The President knows that he has touched sensitive chords of hope in Latin America and the Caribbean and that the Enterprise Initiative could be the most productive hemispheric initiative ever. Successful efforts in all these major policy areas by national governments and by the IDB can lay the basis for lasting growth and a better life for all our peoples.

The IDB: Charting a Course for Prosperity in Latin America and the Caribbean

At the time of its last replenishment, the Inter-American Development Bank sought to assume a more central role in the region. I would underscore on a personal note that many issues which were raised in the replenishment process were successfully resolved through negotiation and accommodation on all sides. A new vision was set forth for the Bank, giving it the mandate to move beyond its traditional role to become a key player in the major economic and financial issues facing our hemisphere as this century comes to a close.

The IDB should be recognized and congratulated for moving forward to define and begin implementing its mission. In the three years of his Presidency, Enrique Iglesias has made one giant step in each year. First he concluded the largest replenishment in the history of the Bank. Then he implemented a major reform of the structure and organization of the Bank. Now he is articulating the broader mission of the Bank and setting in place a program to realize this mission. Much of his success to date results from the fact that Enrique Iglesias is a political as well as a financial leader. He has promoted greater interaction between all parties who have a stake in the institution: borrowing and non-borrowing members; the public sector and private sector; governments and NGOs; and management, staff and the Board of Directors.

By asking the IDB to assume the lead in important elements of the Enterprise for the Americas Initiative, President Bush has expressed U.S. support and confidence in the IDB's new stature. The Inter-American Development Bank will be an important force for action in issues of vital importance to Latin America and the Caribbean -- particularly, though not exclusively on those issues highlighted in the EAI. The Bank is now well-placed to help implement our shared vision. Our task as Governors, Executive Directors, and professional Bank staff is to help get the job done.

Attracting Investment to Latin America and the Caribbean

A number of countries in Latin America and the Caribbean have made substantial progress in implementing macroeconomic and structural reforms. These are fundamental steps toward stronger and more vibrant economies. However, without the needed capital to finance growth, Latin American and Caribbean countries will not experience the full benefits of broad economic policy reforms.

The need to attract capital in order to build upon reforms already underway is at the heart of every country's development challenge. Resources in today's world are limited. We all know this, yet our policy actions often fail to recognize this reality. For example, commercial banks are no longer extending loans that provide broad support for economic growth. But, more debt is not the answer anyway; we all learned that lesson in the 1980s. Nor can creditor governments avoid present constraints on their ability to provide economic assistance. Eastern Europe and the Middle East have added heavily to demands for creditor government resources.

Creating a climate attractive to private investment is therefore being given a new priority as a source of capital for development and growth. Latin American and Caribbean countries must compete more aggressively to draw the interest of investors and to recover the savings of their own people. This is where the IDB must step forward to support the reforms in Latin America and the Caribbean -- first to liberalize and open national economies and then to help countries become competitive in the global capital sweepstakes.

The IDB is already moving forward on a new investment sector lending program to advance additional reforms needed to help countries open and improve their investment regimes. Loans under this program will make a critical difference in the competition for capital. We urge the Bank and eligible countries to proceed aggressively now to implement this new ground-breaking program and to bring the first loans to the Board as quickly as possible.

The United States will provide important support and incentives for countries which move in this direction through the Enterprise for the Americas Initiative. We already have authority to reduce concessional food assistance debt (PL-480) and are ready to begin negotiations as soon as countries qualify. We are nearly ready to enter into negotiation of the associated Environmental Framework Agreements which will establish the mechanisms for channelling local currency interest payments to support local environmental programs. We are also seeking additional authority from our Congress to reduce U.S. AID, Eximbank and CCC debt and to facilitate debt-for-nature swaps. We hope to obtain passage of the necessary authorizing legislation in this session of Congress and would welcome your support.

As part of discussions with our Congress, we are also seeking authority for contributions to a new Multilateral Investment Fund to provide further direct support for the liberalization of investment regimes. This Fund would target resources to support specific aspects of investment reform and to help ease some of the burden of investment liberalization.

The Investment Fund will channel resources through three facilities: the Technical Assistance Facility; the Human Resources Facility; and the Enterprise Development Facility. A large portion of available resources will fund grant assistance to mitigate the social costs of investment reform. These resources can help speed implementation of needed reforms and moderate social dislocations. With such support, governments can pursue reforms aggressively during a window of opportunity while minimizing the potential for social unrest and political pressures in emerging democracies. In addition, the Investment Fund will channel market-priced resources to and through NGOs and financial institutions to stimulate creation or expansion of small businesses.

We are proposing that the Investment Fund be created with a one-time capitalization of $1.5 billion to be paid over a 5 year period. The United States is prepared to provide one third of the contributions. We have invited Japan to share the leadership of this effort with the United States. Japan's increasing involvement in Latin America has been one of the more hopeful developments for the region in recent years. We propose that the balance be funded by other non-borrowing members of the IDB, many of whom have strong traditional ties with the region. Under our proposal, voting rights would be proportional to the contributions that are made.

Why did the U.S. propose a new investment fund, when other programs and organizations already exist?

The answer is that these are extraordinary times. Existing institutions are not equipped to respond quickly and flexibly to meet the challenge of simultaneous and fast-paced reform on a variety of fronts. High quality technical assistance must be in place prior to major decisions on privatization and on investment policy reform in such areas as the regulatory environment, the tax system, and the financial sector. Resources for retraining and human resource development must equally be assured to workers fearful of change. And smaller businesses must see that they can participate in the new opportunities created by freer markets.

Additional policy-based lending by the MDBs may overburden countries already under fiscal constraints and external indebtedness. Furthermore, the private sector arms of the IFC and IIC generally cannot fund otherwise profitable projects that have high initial development costs.

There is no question that the IDB and the IIC will continue to be important to the overall adjustment efforts of the Latin American and Caribbean countries. They will make crucial contributions to private investment in many countries. However, these institutions alone cannot provide the timely concentration of financial resources needed by countries that are poised to make a major commitment to radically overhauling and opening their investment regimes. For these reasons, we urge your immediate and full support for the Multilateral Investment Fund.

Building Economic Confidence: The Need to Reduce Debt Burdens

I have already mentioned the U.S. intention to reduce bilateral official debt under the Enterprise for the Americas Initiative. Reducing debt is essential for some countries as an integral part of economic reform.

The international community has been pursuing a strategy to help countries to reduce their debt to commercial banks. We are pleased to note that the Board of Directors has approved a new policy to enable the IDB to join the IMF and World Bank in providing support for commercial bank debt and debt service reduction. In two years, many countries in our hemisphere have taken advantage of the strengthened international debt strategy. Some are benefitting already from the renewed confidence of investors and nationals who are bringing their capital home.

I want to reiterate that the United States stands ready to begin reducing PL-480 debt and to expand this activity as we secure additional authority from our Congress. President Bush transmitted legislation to our Congress in February that would provide the necessary authority to complete the Enterprise Initiative. I would remind you that despite the demands of the Gulf Crisis, full implementation of the Enterprise Initiative remains among President Bush's highest priorities.

We are also committed to renewal of the fast track authority for negotiation of free trade agreements. This process is now underway and will be completed by June 1st. Approval of this authority by Congress will permit the United States Administration to move forward quickly on FTA negotiations with Mexico and with other qualifying Latin American and Caribbean nations.

The Diverse Role of the IDB

In addition to its prominent new role in advancing policy reform and economic growth, the IDB has also initiated new programs in the areas of environmental protection, the role of women in development, poverty alleviation and social sector development.

The management has brought forward a new private sector strategy paper which the Committee of the Board of Governors discussed yesterday (April 6th), that will enable the IDB to provide greater support to private sector development in borrowing member countries. This program will complement activities already underway in the Bank, including the new investment sector loan program, and will make an important contribution to building viable economies throughout the region. Support from the Multilateral Investment Fund will contribute importantly to the success of the private sector development strategy.

We particularly wish to congratulate Bank management for its achievements on the environment. Important progress has been made in:

-- developing new procedures to assess the impact of project loans for the environment; and
-- updating the Bank's approach to forest issues through promotion of new projects to protect tropical forests and measures to guard against environmentally unsound projects.

The Bank has devoted a great deal of effort to environmental issues, but more work is needed. Effective implementation of the new environmental impact assessment procedure is critical. Additional measures are needed to manage activities in related sectors that have a major impact on forests. Finally, we believe that the Bank must also assign higher priority to demand-side energy efficiency and to promotion of renewable energy options. Both project loans and policy-based lending in the energy sector would be useful. Greater attention to integrated least-cost investment plans in the energy sector and enhancement of the Bank's capability to exploit alternative energy investment opportunities would also help address our concerns.

<u>Conclusion</u>:

Strong, vibrant Latin American and Caribbean economies will benefit not only our hemisphere but the world as a whole.

The United States has made a new commitment through the Enterprise for the Americas Initiative to advance sustained growth and enhanced prosperity throughout the hemisphere. We ask non-regional members of the IDB to join us in investing in the region's future by providing their support for the Multilateral Investment Fund.

We also look to borrowing countries to rise to the challenge presented by the Enterprise for the Americas Initiative. Each country must sustain and extend its reform efforts in order to realize the goals of economic growth and improved well-being for its citizens.

As we dedicate ourselves to this important endeavor, we all rely upon the Inter-American Development Bank, which brings us together today, not only to respond to our efforts but to continue asserting its leadership in the important task of transforming the future of Latin America and the Caribbean.

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 8, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $7,230 million of 13-week bills to be issued on April 11, 1991 and mature on July 11, 1991 were accepted today (CUSIP: 912794WY6).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.58%	5.75%	98.590
High	5.61%	5.79%	98.582
Average	5.60%	5.78%	98.584

Tenders at the high discount rate were allotted 35%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	42,665	42,665
New York	23,174,560	5,699,295
Philadelphia	51,400	51,400
Cleveland	61,075	61,075
Richmond	56,405	55,105
Atlanta	39,305	38,255
Chicago	1,669,955	78,705
St. Louis	60,230	20,230
Minneapolis	6,720	6,720
Kansas City	47,775	47,775
Dallas	27,780	27,780
San Francisco	812,320	78,320
Treasury	1,022,995	1,022,970
TOTALS	$27,073,185	$7,230,295
Type		
Competitive	$22,533,105	$2,690,215
Noncompetitive	1,930,150	1,930,150
Subtotal, Public	$24,463,255	$4,620,365
Federal Reserve	2,377,830	2,377,830
Foreign Official Institutions	232,100	232,100
TOTALS	$27,073,185	$7,230,295

NB-1212

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 8, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $7,212 million of 26-week bills to be issued on April 11, 1991 and mature on October 10, 1991 were accepted today (CUSIP: 912794XJ8).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.67%	5.93%	97.134
High	5.69%	5.96%	97.123
Average	5.68%	5.95%	97.128

Tenders at the high discount rate were allotted 35%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	34,125	34,125
New York	21,134,610	5,872,110
Philadelphia	15,185	15,185
Cleveland	38,335	38,335
Richmond	50,200	50,200
Atlanta	30,085	30,085
Chicago	1,488,180	249,055
St. Louis	39,775	21,525
Minneapolis	6,285	6,285
Kansas City	47,720	46,720
Dallas	21,410	21,410
San Francisco	609,820	91,570
Treasury	734,935	734,935
TOTALS	$24,250,665	$7,211,540
Type		
Competitive	$20,723,745	$3,684,620
Noncompetitive	1,361,520	1,361,520
Subtotal, Public	$22,085,265	$5,046,140
Federal Reserve	1,900,000	1,900,000
Foreign Official Institutions	265,400	265,400
TOTALS	$24,250,665	$7,211,540

NB-1213

TREASURY NEWS

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

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m. D.S.T.

PREPARED STATEMENT OF R. RICHARD NEWCOMB
DIRECTOR, OFFICE OF FOREIGN ASSETS CONTROL
DEPARTMENT OF THE TREASURY

before the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

April 9, 1991

Economic Sanctions Against Iraq and Kuwait

Chairman Gonzalez and members of the committee:

My name is R. Richard Newcomb and I am the Director of the Office of Foreign Assets Control at the United States Department of the Treasury. I am here today to appear before the committee to discuss the Treasury Department's role in formulating, administering, and enforcing the sanctions against Iraq and Kuwait.

The Office of Foreign Assets Control ("FAC") has primary responsibility within the Executive branch for implementing the financial and trade sanctions against Iraq and measures to protect the assets of the legitimate Government of Kuwait. In addition to these programs, FAC also administers economic sanctions programs against Libya, Iran, South Africa, Cuba, Vietnam, Cambodia, and North Korea and administers certain residual World War II asset controls affecting the Baltic Republics. The Office was also responsible for administering the recently-concluded economic sanctions programs against the Sandinista regime in Nicaragua and the Noriega regime in Panama.

This morning I will address the topics and concerns in which you have expressed an interest, which relate principally to the blocking of Iraqi and Kuwaiti assets in the United States. I will also comment on your offer to suggest measures which would increase FAC's effectiveness in formulating, administering, and enforcing administrative sanctions.

Identification and Blocking of Iraqi and Kuwaiti Assets

Following the Iraqi invasion of Kuwait on August 2, the President, acting under authority of the International Emergency Economic Powers Act ("IEEPA"), declared a national emergency and issued Executive Orders No. 12722 and No. 12723 ("the August 2 Executive Orders"), which froze all Iraqi and Kuwaiti government-owned assets within the jurisdiction of the United States or under the control of U.S. persons and imposed an immediate and comprehensive trade embargo against Iraq.

On August 6, the United Nations Security Council, to bring the invasion and occupation of Kuwait to an end and to restore the sovereignty, independence, and territorial integrity of Kuwait, decided that all U.N. member states should impose sweeping economic sanctions against Iraq and occupied Kuwait. On August 9, the President issued Executive Orders No. 12724 and No. 12725, this time acting under authority of IEEPA and the United Nations Participation Act, broadening the U.S. sanctions with respect to both Iraq and Kuwait to include a complete prohibition on trade and trade-related activities with any person located within the territories of Iraq or Kuwait, in addition to continuing the freeze of Iraqi and Kuwaiti government-owned assets imposed seven days earlier. The Executive orders of August 2 and 9 were developed by Treasury with the assistance of the Departments of State and Justice, the White House staff and National Security Council. The sanctions programs presented by the orders are similar, in whole or in part, to sanctions programs previously implemented with respect to other countries, most notably Libya in 1986.

The August 9 Executive order with respect to Iraq:

-- prohibits exports and imports of goods, technology, and services between the United States and Iraq, and any activity that promotes or is intended to promote such exportation and importation;

-- prohibits any dealing by a U.S. person in connection with property of Iraqi origin exported from Iraq after August 6, 1990;

-- prohibits transactions related to travel;

-- prohibits transactions related to transportation to or from Iraq, or the use of vessels or aircraft registered in Iraq by U.S. persons;

-- prohibits the performance by any U.S. person of any contract in support of projects in Iraq;

-- prohibits the commitment or transfer of funds or other financial or economic resources by any U.S. person to the Government of Iraq, or any other person in Iraq; and

-- blocks all property of the Government of Iraq located in the United States or in the possession or control of U.S. persons, including their foreign branches on or after August 2, 1990.

The August 9 Executive order with respect to Kuwait imposed essentially the same regimen of economic sanctions on Kuwait, then under occupation and control by Iraq. Since the liberation of Kuwait, the prohibitions on most trade and financial transactions with Kuwait have been removed through the issuance of a general license authorizing such transactions. Similarly, except for seven Kuwaiti banks, the U.S. property of the Government of Kuwait has been effectively unblocked by general license. The seven banks, while remaining blocked, are licensed to utilize their assets to settle pre-August 2 obligations.

The objectives of the Executive orders were to deprive Iraq of any economic or financial benefits that might result from its illegal invasion and occupation of Kuwait and to preserve and protect the assets of the Government of Kuwait for the benefit of their rightful owner. Iraqi assets blocked in the United States and in all U.N. member states may be used as a source of funds to pay claimants and creditors of Iraq if such a course of action is determined appropriate and enabling legislation is enacted.

The August 2 Executive orders immediately froze, by operation of law, all property and interests in property, of the Governments of Iraq and Kuwait that were in, or thereafter came within, the jurisdiction of the United States or under control of U.S. persons. Any unauthorized transfers of property or interests in property subject to the blocking orders occurring after the effective date are deemed to be null and void. This means that a U.S. financial institution, for example, which transfers blocked funds after the effective date without authorization from FAC can be penalized for violating the sanctions.

On the morning of August 2, immediately after the President signed the blocking orders, FAC began contacting major U.S. money center banks and requested that the Federal Reserve Bank of New York ("the FRBNY") notify Federal Reserve member banks of the blocking. We also began a series of what have since become regular consultations with the FRBNY, and various U.S. Government agencies, including the Departments of State, Commerce, and Defense, the Customs Service, the FBI, the NSC, and members of the intelligence and law enforcement communities. Since the morning of August 2, we have travelled abroad several times for coordination meetings with our allies. We have also met with hundreds of U.S. and foreign businesses, official agencies, and individuals affected by the sanctions, in addition to responding to several thousand telephone inquiries and pieces of correspondence. Additionally, we have an ongoing program in place with foreign governments and their embassies which enables us to act in concert with all governments worldwide to ensure the uniform application of all U.N. resolutions.

On August 3, we issued a press release announcing the first of a series of general licenses designed to address many of the most immediate and pressing problems relating to the freeze. Most of these licenses addressed the need to safeguard and preserve the value of the frozen assets and investments without causing unnecessary and irreparable harm to the interests of innocent third parties, including those of many U.S. businesses and individuals and of the legitimate Government of Kuwait.

The need to quickly address these complicated and fact-intensive problems proved especially critical with respect to the Kuwaiti assets since the freeze was intended primarily as a protective measure, and complete immobilization of the Kuwait governmental assets in the United States for a prolonged period would have diminished their value and disrupted a number of markets.

These initial licenses addressed problems such as: what to do about Iraqi and Kuwaiti oil already en route to the United States on the effective date; how to complete or unwind variously affected financial or securities transactions entered into prior to the effective date; what types of transactions or investments by blocked companies or investment portfolios owned or controlled by the Government of Kuwait to allow to continue unimpeded; and what to do about payments due under letters of credit involving U.S. banks for goods or services exported to Iraq or Kuwait prior to the effective date. These general licenses, as well as the specific licenses we have issued on a case-by-case basis, have been carefully crafted to ensure that transactions permitted thereunder are consistent with the objectives of the sanctions and do not confer any realizable benefit on the Government of Iraq. These licenses have been fully incorporated into a comprehensive body of implementing regulations published on November 30, 1990, for Kuwait and on January 18, 1991, for Iraq.

Very early in the program we began meeting regularly with Kuwaiti Embassy officials to begin the process of identifying and clarifying the status of Kuwaiti-owned entities around the world, licensing limited operation of Kuwait entities within U.S. jurisdiction under the effective control of legitimate governmental authorities, and generally coordinating the efforts of our respective governments concerning the sanctions. We received excellent cooperation from the Kuwaiti authorities. This proved to be an understandably painstaking and tedious process inasmuch as the legal, financial, and commercial information required to make these determinations must be precise and accurate. Moreover, this information must be obtained from various locations worldwide and some of the records were destroyed or were under the control of Iraqi authorities.

In the first few weeks, our efforts regarding Kuwait focused heavily on identifying and clarifying the status of Kuwaiti-owned banks and financial institutions and communicating this information through the Federal Reserve System. By October 4, we were able to issue a general notice clarifying the status of 94 major banking and non-banking entities or corporate groups operating in the United States.

Obviously, no such assistance was forthcoming from the Government of Iraq. In identifying and blocking Iraqi assets, both in the U.S. and worldwide, FAC has relied upon the cooperation of allied governments, other Federal agencies, the business community, and the investigative efforts of its own staff.

The Nature of the Property Blocked

The Kuwaiti and Iraqi government-owned assets frozen by the August 2 Executive orders were substantial. The frozen Kuwaiti investments totalled in the billions of dollars and consisted primarily of bank deposits, debt and equity securities (involving both direct investment and portfolio holdings), and real estate. Most of these assets were owned or controlled by licensed Kuwaiti governmental entities such as the Kuwait Investment Office and the Kuwait Investment Authority. The blocked Iraqi assets in Government of Iraq designated accounts will total more than a billion dollars. They are primarily bank deposits and blocked oil payments. On February 11, 1991, we initiated a formal census or inventory of these blocked assets as well as U.S. financial claims against Iraq by publishing in the Federal Register regulations requiring the filing of reports by all U.S. holders of Iraqi property and U.S. claimants against Iraq as to the full extent of such assets and claims. The inventory of blocked Iraqi assets has not yet been completed; thus a total value is not yet available.

In addition to the publication of the list of Specially Designated Nationals, which I will describe momentarily, six individual blocking actions have been taken to identify property not clearly known to the public as property of the Government of Iraq.

Iraqi-Owned or -Controlled Companies

Through information obtained by FAC from readily available public sources, as well as from the domestic and international intelligence communities, we have undertaken a major initiative to identify front companies and agents used to acquire technology, equipment, and other resources for Iraq. This is called the Specially Designated Nationals or "SDN" program. As in the case of current sanctions against Cambodia, Cuba, Libya, North Korea, and Vietnam, FAC has the authority to "specially designate"--i.e., to identify publicly and to block--any person, whether an individual or a business, directly or indirectly owned or controlled by the Government of Iraq, or who acts or purports to act for or on its behalf.

The term "specially designated national" is not used in the Iraqi Sanctions Regulations (31 C.F.R. Part 575, 56 Fed. Reg. 2112 (January 18, 1991) ("ISR"). Such designation relies rather on the definition of the Government of Iraq provided by Section 575.306 of the ISR:

> The term "Government of Iraq" includes:
>
> (a) The state and the Government of Iraq, as well as any political subdivision, agency, or instrumentality thereof, including the Central Bank of Iraq;
>
> (b) Any partnership, association, corporation, or other organization substantially owned or controlled by the foregoing;
>
> (c) Any person to the extent that such person is, or has been, or to the extent that there is reasonable cause to believe that such is, or has been since the effective date [August 2, 1990], acting or purporting to act directly or indirectly on behalf of any of the foregoing; and
>
> (d) Any other person or organization determined by the Director of the Office of Foreign Assets Control to be included in this section.

In practice, a Specially Designated National of the Government of Iraq ("Iraqi SDN") is an Iraqi government body, representative, agent, intermediary, or front (whether overt or covert) that is located outside Iraq and functions as an extension of the Government of Iraq. It may be a firm created by the Iraqi government, or it may be a third-country company that otherwise becomes owned or controlled by the Iraqi government, or that operates for or on behalf of the Government of Iraq.

The effect of being listed as an Iraqi SDN is four-fold: (1) the SDN is exposed internationally as an Iraqi government front; (2) U.S. persons will be prohibited from any trade or transactions with the SDN; (3) the SDN's property, including financial assets, within U.S. jurisdiction (which includes U.S. banks' corporate branches overseas) will be blocked; and (4) other governments will be urged to take similar steps or other appropriate actions against the SDNs subject to their jurisdiction. As a matter of U.S. law, persons holding the property of any Iraqi SDN or other property in which there is a Government of Iraq interest must report that information to FAC.

A U.S. company or individual could be designated as an Iraqi SDN and, as such, would have its assets blocked by FAC and, in effect, would be put out of business. Note that, because of the definition of "Government of Iraq" in the ISR, a U.S. firm that had not been designated an SDN, but in which the Government of Iraq holds a controlling interest, is already subject to blocking. For example, in September 1990 FAC served a blocking notice covering all bank accounts and tangible property of the Matrix-Churchill Corporation of Solon, Ohio. Public sources of information demonstrated that the company was owned by Iraqi-controlled companies in England. Last month, the property and accounts of a Santa Monica, California, based company as well as that of its owner and his wife, were blocked. All were identified as participants in Saddam Hussein's arms network.

On April 1, Treasury formally identified these and other businesses and individuals worldwide as front companies and agents of Iraq. The full list of these companies and individuals, which are now considered SDNs, accompanies my testimony as an attachment. The Iraqi SDN list is not a static document, but will be continuously augmented as additional front companies and agents are identified.

For U.S. persons, dealing with an Iraqi SDN is equivalent to doing business with the Government of Iraq--an activity that is prohibited by Executive Orders No. 12722 and No. 12724, and the ISR. Such violations are subject to severe penalties. Pursuant to the Iraq Sanctions Act (Pub.L. 101-513, Sec. 586E), civil penalties of up to $250,000 may be imposed administratively. Criminal fines of up to $1,000,000 per violation may be imposed on both individuals and corporate entities, and prison sentences of up to 12 years are authorized for individuals, including officers, directors, and agents of a corporation, who are knowingly involved in a corporate criminal violation.

Problems in Blocking Assets

I have already alluded to the frenzy of activity into which the staff of FAC was plunged beginning on the morning of

August 2, and which continued in the weeks and months to follow. The incredible demands placed on the Office by the Iraqi emergency occupied every member of my staff and resulted, unfortunately but necessarily, in a temporary suspension of much of our important work in the various other sanctions programs currently in effect. The American people have every reason to be proud, as I am, of this loyal and dedicated cadre of individuals who worked literally around-the-clock, putting aside their personal lives to perform countless hours of uncompensated service, under very difficult conditions, to put the new sanctions program in effect and make them work as intended. The workload demands of the Iraqi and Kuwaiti programs more than equalled that of all other sanctions programs combined, but international crises are seldom predictable, nor is the workload they create. Ultimately, we were fortunate to be able to get personnel detailed to us from other agencies and got the job done.

Monitoring of Government-Controlled Banks

Under the Executive orders, as well as the Kuwaiti Assets Control Regulations and the Iraqi Sanctions Regulations, the definitions of Government of Kuwait and Government of Iraq include the central bank of each country. For this reason all assets of the Central Bank of Kuwait and the Central Bank of Iraq that were in the control of a U.S. person were blocked from August 2, 1990. Secondly, any transaction between these entities and any U.S. person required the authorization of FAC. Where transactions affecting the assets of the Central Bank of Kuwait or the Central Bank of Iraq occurred pursuant to FAC authorization, reports were required to ensure that the transactions were carried out in a manner consistent with the authorization. The Government of Kuwait complied fully with the requirements to report regularly on the assets of the Central Bank of Kuwait which were subject to U.S. jurisdiction.

It is a pleasure to appear before this committee again. I will be pleased to respond to any questions.

#####

Attachment

Office of Foreign Assets Control

31 CFR Part 575

Iraqi Sanctions Regulations

AGENCY: Office of Foreign Assets Control, Department of the Treasury.

ACTION: Final rule; List of specially designated nationals of the Government of Iraq; List of vessels registered, owned or controlled by the Government of Iraq.

SUMMARY: The Iraqi Sanctions Regulations (the "Regulations") are being amended to add a new appendix A and a new appendix B to the end thereof. Appendix A contains the list of Individuals and Organizations Determined to be Within the Term "Government of Iraq" (Specially Designated Nationals of Iraq). The list at Appendix A contains the names of companies and individuals which the Director of the Office of Foreign Assets Control has determined are acting or purporting to act directly or indirectly on behalf of the Government of Iraq. Appendix B contains the names of merchant vessels registered, owned, or controlled by the Government of Iraq. These lists may be expanded or amended at any time.

EFFECTIVE DATE: April 3, 1991.

ADDRESSES: Copies of these lists are available upon request at the following location: Office of Foreign Assets Control, U.S. Department of the Treasury, Annex, 1500 Pennsylvania Avenue NW., Washington, DC 20220.

FOR FURTHER INFORMATION CONTACT: Richard J. Hollas, Chief, Enforcement Section, Office of Foreign Assets Control, Tel.: (202) 566–5021.

SUPPLEMENTARY INFORMATION: The Iraqi Sanctions Regulations, 31 CFR part 575 (56 FR 2112, Jan. 18, 1991, the "Regulations") were issued by the Treasury Department to implement Executive Orders No. 12722 and 12724 of August 2 and August 9, 1990, in which the President declared a national emergency with respect to Iraq, invoking the authority, *inter alia*, of the International Emergency Economic Powers Act (50 U.S.C. 1701 *et seq.*) and the United Nations Participation Act (22 U.S.C. 287c), and ordered specific measures against the Government of Iraq.

Section 575.306 of the Regulations defines the term "Government of Iraq" to include:

(a) The state and the Government of Iraq, as well as any political subdivision, agency, or instrumentality thereof, including the Central Bank of Iraq;

(b) Any partnership, association, corporation, or other organization substantially owned or controlled by the foregoing;

(c) Any person to the extent that such person is, or has been, or to the extent that there is reasonable cause to believe that such person is, or has been, since the effective date, acting or purporting to act directly or indirectly on behalf of any of the foregoing; and

(d) Any other person or organization determined by the Director of the Office of Foreign Assets Control to be included within this section.

Determinations that persons fall within this definition are effective upon the date of determination by the Director, Office of Foreign Assets Control ("FAC"). Public notice is effective upon the date of publication or upon actual notice, whichever is sooner.

This rule adds appendix A to part 575 to provide public notice of a list of persons, known as "specially designated nationals" of the Government of Iraq. The list consists of companies and individuals whom the Director of the Office of Foreign Assets Control has determined to be owned or controlled by or to be acting or purporting to act directly or indirectly on behalf of the Government of Iraq, and thus fall within the definition of the "Government of Iraq" contained in § 575.306 of the Regulations. The persons included in appendix A are subject to all prohibitions applicable to other components of the Government of Iraq. All unlicensed transactions with such persons, or in property in which they have an interest, are prohibited.

The list of specially designated nationals is a partial one, since FAC may not be aware of all the persons located outside Iraq that might be owned or controlled by the Government of Iraq or acting as agents or front organizations for Iraq, and which thus qualify as specially designated nationals of the Government of Iraq. Therefore, persons engaging in transactions may not rely on the fact that any particular person is not on the specially designated nationals list as evidence that it is not owned or controlled by, or acting or purporting to act directly or indirectly on behalf of, the Government of Iraq. The Treasury Department regards it as incumbent upon all U.S. persons to take reasonable steps to ascertain for themselves whether persons they enter into transactions with are owned or controlled by the Government of Iraq or are acting or purporting to act on its behalf, or on behalf of other countries subject to blocking (at present, Cambodia, Cuba, Libya, North Korea, and Vietnam).

This rule also adds appendix B to part 575 to provide public notice of a list of merchant vessels which the Director of the Office of Foreign Assets Control has determined to be registered, owned, or controlled by the Government of Iraq or by persons acting or purporting to act directly or indirectly on behalf of the Government of Iraq, pursuant to § 575.306 of the Regulations. The merchant vessels included in appendix B constitute blocked property in which the Government of Iraq has an interest, and are subject to all the prohibitions applicable to the Government of Iraq. No U.S. person may engage in any unlicensed transaction involving these vessels.

The list of Government of Iraq-flagged, owned, or controlled vessels is a partial one, since FAC may not be aware of all merchant ships registered, owned, or controlled by the Government of Iraq or by persons located outside Iraq that may be acting as agents or front organizations for Iraq who fall within the definition of "Government of Iraq." Therefore, persons engaging in transactions may not rely on the fact that any particular vessel is not on the list as evidence that it is not owned or controlled by the Government of Iraq. The Treasury Department regards it as incumbent upon all U.S. persons to take reasonable steps to ascertain for themselves whether such vessels are registered, owned, or controlled by Iraq or by other countries subject to blocking or transportation-related restrictions (at present, Cambodia, Cuba, Libya, North Korea, and Vietnam).

Section 586E of the Iraq Sanctions Act of 1990, contained in the Foreign Operations Authorization and Appropriations Act of 1990, dated November 5, 1990, 104 Stat. 1979, provides for civil penalties not to exceed $250,000 for violations of the Regulations and fines of up to $1,000,000 and imprisonment for up to 12 years for willful violations of the Regulations. In addition, section 5(b) of the United Nations Participation Act of 1945 (22 U.S.C. 287c(b)) provides for the forfeiture of any property involved in a violation of the Regulations.

List of Subjects in 31 CFR Part 575

Banks, Banking, Exports, Imports, Iraq, Kuwait, Loans, Penalties, Reporting and recordkeeping requirements.

1. The authority citation for part 575 continues to read as follows:

Authority: 50 U.S.C. 1701 *et seq.*; 50 U.S.C. 1601 *et seq.*; 22 U.S.C. 287c; Public Law 101–513, 104 Stat. 2047–55 (Nov. 5, 1990); 3 U.S.C. 301; E.O. 12722, 55 FR 31803 (Aug. 3, 1990); E.O. 12724, 55 FR 33089 (Aug. 13, 1990).

2. Appendices A and B to part 575 are added to read as follows:

Appendix A—Individuals and Organizations Determined To Be Specially Designated Nationals of the Government of Iraq

Please note that addresses of companies and persons may change. The addresses listed below are the last ones known to the Office of Foreign Assets Control. Where an address is not listed or someone wishes to check for latest address information, the Office of Foreign Assets Control will assist with any updated information in its possession.

Companies

1. Admincheck Limited, 1 Old Burlington Street, London, England, United Kingdom
2. Advanced Electronics Development Ltd., 3 Mandeville Place, London, England, United Kingdom
3. Al-Arabi Trading Company Limited, Lane 11, Hai Babil, Baghdad District 929, Iraq
4. Al-Rafidain Shipping Company, Bombay, India
5. The Arab Petroleum Engineering Company Ltd., Amman, Jordan
6. Arab Projects Company S.A. Ltd., P.O. Box 1318, Amman, Jordan

P.O. Box 7939, Beirut, Lebanon

P.O. Box 1972, Riyadh, Saudi Arabia

7. Arab Trans Trade Co. S.A.E., 36, Kaft Abdou Street, Rouchdy, Alexandria 481 638, Egypt
8. Archi Centre I.C.E. Limited, 3 Mandeville Place, London, England, United Kingdom
9. Archiconsult Limited, 128 Buckingham Place, London 5, England, United Kingdom

10. Associated Engineers, England, United Kingdom
11. A.T.E. International Ltd., f/k/a RWR International Commodities, 3 Mandeville Place, London, England, United Kingdom
12. Atlas Air Conditioning Company Limited, 55 Roebuck House, Palace Street, London, England, United Kingdom
13. Atlas Equipment Company Limited, 55 Roebuck House, Palace Street, London, England, United Kingdom
14. A.W.A. Engineering Limited, 3 Mandeville Place, London, England, United Kingdom
15. Banco Brasileiro-Iraquiano S.A., Praca Pio X, 54-10o Andar, CEP 20091, Rio de Janeiro, Brazil (Head office and city branch)
16. Bay Industries, Inc., 10100 Santa Monica Boulevard, Santa Monica, California, United States
17. Dominion International, England, United Kingdom
18. Endshire Export Marketing, England, United Kingdom
19. Euromac, Ltd., 4 Bishops Avenue, Northwood, Middlesex, England, United Kingdom
20. Euromac European Manufacturer Center SRL Via Ampere 5, 20052 Monza, Italy
21. Euromac Transporti International SRL, Via Ampere 5, 20052 Monza, Italy
22. Falcon Systems, England, United Kingdom
23. Geodesigns, England, United Kingdom
24. Investacast Precision Castings, Ltd., 112 City Road, London, England, United Kingdom
25. I.P.C. International Limited, England, United Kingdom
26. I.P.C. Marketing Limited, England, United Kingdom
27. Iraqi Airways, Saddam International Airport, Baghdad, Iraq
Opernring 6, 1010 Wien, Vienna, Austria
General Service Agent, Bangladeshi-owned Travel Agency, Dhaka, Bangladesh
Rio de Janeiro, Brazil
Jianguomenwai Diplomatic Housing Compound, Building 7-1, 5th Floor, Apartment 4, Beijing, People's Republic of China
Prague Airport, Prague, Czechoslovakia
Nekazanka 3, Prague 1, Czechoslovakia
Copenhagen, Denmark
Main Eisenhuttenplatz 26, Frankfurt 6, Germany
Rome, Italy
Tokyo, Japan
Casablanca, Morocco
The Netherlands
27, Ulica Grojecka, Central Warsaw, Poland
Tunis, Tunisia
Ankara, Turkey
Moscow, U.S.S.R.
Abu Dhabi, United Arab Emirates
4 Lower Regent Street, London SW1Y 4P, United Kingdom
5825 W. Sunset Blvd. #218, Los Angeles, California 90028, United States
25040 Southfield Road, Southfield, Michigan 48075, United States
Building 68, J.F.K. International Airport, Jamaica, New York 11430, United States
1211 Avenue of the Americas, New York, New York 10036, United States
Sanaa, Yemen
Belgrade, Yugoslavia
28. Iraqi Allied Services Limited, England, United Kingdom
29. Iraqi Freight Services Limited, England, United Kingdom
30. Iraqi Reinsurance Company, 31-35 Fenchurch Street, London EC3M 3D, United Kingdom
31. Iraqi State Enterprise for Foodstuffs Trading, P.O. Box 1308, Colombo 3, Sri Lanka
P.O. Box 2839, Calcutta 700.001, India
32. Iraqi State Enterprise for Maritime Transport, Bremen, Germany
Amman, Jordan
33. Iraqi Trade Center, Dubai, United Arab Emirates
34. Keencloud Limited, 11 Catherine Place, Westminister, London, England, United Kingdom
35. Matrix Churchill Corporation, 5903 Harper Road, Cleveland, Ohio 44139, United States
36. Meed International Limited, 3 Mandeville Place, London, England, United Kingdom
37. Pandora Shipping Co., S.A., Honduras
38. Petra Navigation & International Trading Co. Ltd., White Star Building., P.O. Box 8362, Amman, Jordan
Armoush Bldg., P.O. Box 485, Aqaba, Jordan
18 Huda Sharawi Street, Cairo, Egypt
Hai Al Wahda Mahalat 906, 905 Zulak 50, House 14, Baghdad, Iraq
39. PMK/QUDOS (Liverpool Polytechnic), England, United Kingdom
40. Rafidain Bank, New Banks' Street, P.O. Box 11360, Massarif, Baghdad, Iraq (227 branches in Iraq)
P.O. Box 607, Manama, Bahrain (2 branches in Bahrain)
114 Tahreer Str. Eldukki, P.O. Box 239, Omran Giza, Cairo, Egypt
P.O. Box 1194, Cinema al-Hussein Street, Amman, Jordan
P.O. Box 685, Aqaba, Jordan
P.O. Box 815401, Jabal Amman, Jordan
Mafraq, Jordan
2nd Floor Sadat Tower, P.O. Box 1891, Beirut, Lebanon (2 branches in Lebanon)
Sheikh Khalifa Street, P.O. Box 2727, Abu Dhabi, United Arab Emirates
Rafidain Bank Building, 7-10 Leadenhall Street, London EC3V 1NL, United Kingdom
P.O. Box 10023, Sanaa, Yemen Arab Republic
41. Rajbrook Limited, England, United Kingdom
42. Reynolds and Wilson, England, United Kingdom
43. S.M.I. Sewing Machines Italy S.P.A., Italy
44. Sollatek, England, United Kindgom
45. Technology and Development Group Ltd., Centric House 390/391, Strand, London, England, United Kingdom
46. T.E.G. Limited, 3 Mandeville Place, London, England, United Kingdom
47. T.M.G. Engineering Limited, Castle Row, Horticultural Place, Chiswick, London, England, United Kingdom
48. T N K Fabrics Limited, England, United Kingdom
49. Trading & Maritime Investments, San Lorenzo, Honduras
50. U.I. International, England, United Kingdom
51. UNIMAS Shipping, 138 El Geish Road, P.O. Box 44, Alexandria, Egypt
52. Whale Shipping Ltd., c/o Government of Iraq, State Organization of Ports, Maqal, Basrah, Iraq

Individuals

1. Abbas, Abdul Hussein, Italy
2. Abbas, Kassim, Italy
3. Abraham, Trevor, England, United Kingdom
4. Ahmad, Rasem, P.O. Box 1318, Amman, Jordan
5. Ahmad, Wallid Issa, Iraq
6. Al-Amiri, Adnan Talib Hassim, 43 Palace Mansions, Hammersmith, London, England, United Kingdom
7. Al-Azawi, Dafir, Iraq
8. Al-Dajani, Leila N.S., P.O. Box 1318, Amman, Jordan
9. Al-Dajani, Nadim S., P.O. Box 1318, Amman, Jordan
10. Al-Dajani, Sa'ad, P.O. Box 1318, Amman, Jordan
11. Al-Habobi, Dr. Safa Haji J., Flat 4D Thorney Court, Palace Gate, Kensington, England, United Kingdom
12. Ali, Abdul Mutalib, Germany
13. Allen, Peter Francis, "Greys", 36 Stoughton Lane, Stoughton, Leicestershire, England, United Kingdom
14. Al-Ogaily, Akram H., Flat 2, St. Ronons Court, 63 Putney Hill, London, England, United Kingdom
15. Amaro, Joaquim Ferreira, Praca Pio X, 54-10° Andar, CEP 20091, Rio de Janeiro, Brazil
16. Armoush, Ahmad, White Star Bldg., P.O. Box 8362, Amman, Jordan
17. Armoush, Ali, White Star Bldg., P.O. Box 8362, Amman, Jordan
18. Aziz, Fouad Hamza, Pracia Pio X, 54-10° Andar, CEP 20091, Rio de Janeiro, Brazil
19. Daghir, Ali Ashour, 2 Western Road, Western Green, Thames Ditton, Surrey, England, United Kingdom
20. Fattah, Jum'a Abdul, P.O. Box 1318, Amman, Jordan
21. Hand, Michael Brian, England, United Kingdom
22. Henderson, Paul, 4 Copt Oak Close, Tile Mill, Coventry, Warwickshire, England, United Kingdom
23. Jon, Hana Paul, 19 Tudor House, Windsor Way, Brock Green, London, England, United Kingdom
24. Jume'an, George, P.O. Box 1318, Amman, Jordan
25. Kadhum, Dr. Fadel Jawad, c/o Alvaney Court, 250 Finchley Road, London, England, United Kingdom
26. Khoshaba, Robert Kambar, 15 Harefield Road, Maidenhead, Berkshire, England, United Kingdom
27. Mohamed, Abdul Kader Ibrahim, Jianguomenwai Diplomatic Housing Compound, Building 7-1, 5th Floor, Apartment 4, Beijing, People's Republic of China
28. Omran, Karim Dhaidas, Iraq
29. Raouf, Khalid Mohammed, Praca Pio X, 54-10° Andar, CEP 20091, Rio de Janeiro, Brazil
30. Ricks, Roy, 87 St. Mary's Frice, Benfiect,

Essex, England, United Kingdom

31. Schmitt, Rogerio Eduardo, Praca Pio X, 54–10° Andar, CEP 20091, Rio de Janeiro, Brazil

32. Sim, Gilberto F., Praca Pio X, 54–10° Andar, CEP 20091, Rio de Janeiro, Brazil

33. Souza, Francisco Antonio, Praca Pio X, 54–10° Andar, CEP 20091, Rio de Janeiro, Brazil

34. Speckman, Jeanine, England, United Kingdom

35. Tall, Aktham, P.O. Box 1318, Amman, Jordan

36. Taveira, A. Arnaldo G., Praca Pio X, 54–10° Andar, CEP 20091, Rio de Janeiro, Brazil

37. Zahran, Yousuf, P.O. Box 1318, Amman, Jordan

APPENDIX B—Merchant Vessels Registered, Owned, Or Controlled by the Government of Iraq or by Persons Acting Directly or Indirectly on Behalf of the Government of Iraq

- All ships listed or Iraqi-flagged unless otherwise indicated.
- "N/A" is listed where information is not available.

Vessel name	Ship type	DWT	Call sign	Owner
1. Ain Zalah	Tkr	36,330	HNAZ	Iraqi Oil Tankers Company, Basrah, Iraq.
2. Al Anbar	Tug	N/A	YIAV	Government of the Republic of Iraq. Managed by the State Organization of Iraqi Ports, Basrah, Iraq.
3. Al Fao	Res	80	YIAN	State Org. of Iraqi Ports.
4. Al Karamah	Tkr	12,882	HNKM	Iraqi Oil Tankers Company.
5. Al Khalida	Tkr	7,155	HNKD	Iraqi Oil Tankers Company.
6. Al Mansur	Ycht	1,223	HNMR	Iraqi State Enterprise for Water Transport.
7. Al Merbid	Svc	4,649	YIMD	State Org. of Iraqi Ports.
8. Al Mosul	Svc	1,219	YIAS	State Org. of Iraqi Ports.
9. Al Najaf	Svc	4,740	YINF	State Org. of Iraqi Ports.
10. Al Nasr	Svc	2,444	DDRH	State Org. of Iraqi Ports.
11. Al Nasr	Tkr	1,502	HNNR	Iraqi Oil Tanker Company
12. Al Omarah	Tug	320	YIAW	State Org. of Iraqi Ports.
13. Al Ramadi	Tug	320	YIAI	State Org. of Iraqi Ports.
14. Al Rasheed	Svc	304	YIBE	State Org. of Iraqi Ports.
15. Al Ratba	Tkr	544	YIBA	State Org. of Iraqi Ports.
16. Al Shumookh	Tug	375	N/A	State Org. of Iraqi Ports.
17. Al Waleed	Res	N/A	YIEF	State Org. of Iraqi Ports.
18. Al Zab	Tug	N/A	YISH	State Org. of Iraqi Ports.
19. Al Zawraa	Cgo	3,549	HNZW	Iraqi State Enterprise for Water Transport, Baghdad.
20. Al-Alyaa	Tug	375	N/A	State Org. of Iraqi Ports.
21. Al-Amin	Tug	368	YIAM	State Org. of Iraqi Ports.
22. Al-Baath	Tkr	9,928	HNST	Iraqi Oil Tankers Company.
23. Al-Bakr	Res	390	YIBR	State Org. of Iraqi Ports.
24. Al-Bayaa	Brg	1,662	HNHB	Iraqi State Enterprise for Water Transport. Formerly the Hiboob.
25. Al-Entisar	Tug	375	N/A	State Org. of Iraqi Ports.
26. Al-Hather	Tug	368	YIHR	State Org. of Iraqi Ports.
27. Al-Karrkh	Tug	368	YIKH	State Org. of Iraqi Ports.
28. Al-Khalij Al-Arabi	Svc	4,740	YIKA	State Org. of Iraqi Ports.
29. Al-Nohoodh	Tug	375	YINU	State Org. of Iraqi Ports.
30. Al-Qadisiya	Ycht	100	HNKS	Iraqi State Enterprise for Water Transport.
31. Al-Ressafa	Tug	368	YIRF	State Org. of Iraqi Ports.
32. Al-Sahil Al-Arabi	Svc	6,396	NHSA	Iraqi State Enterprise for Sea Fisheries, Basrah, Iraq.
33. Al-Thirthar	Tkr	524	YITH	State Org. of Iraqi Ports.
34. Al-Wandah	Tug	149	YIWH	State Org. of Iraqi Ports.
35. Alabid	Brg	1,662	HNDB	Iraqi State Enterprise for Water Transport. Formerly the Sanabul.
36. Aledreesi	Cgo	3,550	HNID	Iraqi State Enterprise for Water Transport.
37. Altarabi	Cgo	8,342	HNFB	Iraqi State Enterprise for Water Transport.
38. Altarahidi	Tkr	149,441	HNFR	Iraqi Oil Tankers Company.
39. Alfidaa	Brg	1,662	HNFD	Iraqi State Enterprise for Water Transport. Formerly the Silowat.
40. Alkhansaa	Cgo	3,525	HNKN	Iraqi State Enterprise for Water Transport.
41. Alkindi	Cgo	8,342	HNKI	Iraqi State Enterprise for Water Transport.
42. Almustansiriyah	Tkr	155,210	HNMS	Iraqi Oil Tankers Company.
43. Almutanabbi	Tkr	130,241	HNMB	Iraqi Oil Tankers Company.
44. Alnajaf	Svc	4,740	YINF	State Org. of Iraqi Ports.
45. Alqadisiyah	Tkr	155,210	HNQS	Iraqi Oil Tankers Company.
46. Alsumood	Svc	6,977	YISD	State Org. of Iraqi Ports.
47. Alttaawin Alarabi	Cgo	13,634	HNAI	Iraqi State Enterprise for Water Transport.
48. Alwahda	Brg	1,662	HNAD	Iraqi State Enterprise for Water Transport.
49. Alwasitt	Cgo	8,343	HNWS	Iraqi State Enterprise for Water Transport.
50. Alyarmuk	Tkr	149,371	HNYK	Iraqi Oil Tankers Company.
51. Alzubair	Svc	4,640	YIZR	State Org. of Iraqi Ports.
52. Amuriyah	Tkr	155,210	HNAM	Iraqi Oil Tankers Company.
53. Antara	Svc	508	YIBD	State Org. of Iraqi Ports.
54. Arbeel	Tug	320	YIBB	State Org. of Iraqi Ports.
55. Baba Gurgur	Tkr	36,397	HNGR	Iraqi Oil Tankers Company.
56. Babylon	Cgo	13,656	HNSB	Iraqi State Enterprise for Water Transport.
57. Badr 7	Svc	647	N/A	Government of the Republic of Iraq. Ministry of Oil, State Company for Oil Projects, Baghdad, Iraq. (flag: Saudi Arabia).
58. Baghdad	Svc	2,900	YIAD	State Org. of Iraqi Ports.
59. Baghdad	Cgo	13,656	HNBD	Iraqi State Enterprise for Water Transport.
60. Baloees	RO/RO	3,985	HNBL	State Organization of Iraqi Government.
61. Basra	Svc	2,906	YIAB	State Org. of Iraqi Ports.
62. Basrah	Cgo	13,656	HNBS	Iraqi State Enterprise for Water Transport.
63. Buzurgan	Tkr	36,400	HNBR	Iraqi Oil Tankers Company.
64. Damascus	Tug	149	YIDS	State Org. of Iraqi Ports.
65. Damen Gorinchem 5716	Svc	N/A	N/A	State Org. of Iraqi Ports.
66. Damen Gorinchem 5717	Svc	N/A	N/A	State Org. of Iraqi Ports.
67. Damen Gorinchem 5718	Svc	N/A	N/A	State Org. of Iraqi Ports.

Vessel name	Ship type	DWT	Call sign	Owner
68. Deyala	Tug	350	YIBJ	State Org. of Iraqi Ports.
69. Dijlah	Tug	356	HNDJ	State Org. of Iraqi Ports.
70. Diving Launch 1	Svc	N/A	N/A	State Org. of Iraqi Ports.
71. Diwaniya	Tug	350	YIBK	State Org. of Iraqi Ports.
72. Dockan	Tkr	528	YIDN	State Org. of Iraqi Ports.
73. Dump Barge I	Svc	1,330	J8IY	Whale Shipping Ltd., c/o State Org. of Iraqi Ports (flag: Gibralter).
74. Dump Barge II	Svc	1,330	J8IZ	Whale Shipping Ltd., c/o State Org. of Iraqi Ports (flag: Gibralter).
75. Dump Barge III	Svc	1,330	J8JA	Whale Shipping Ltd., c/o State Org. of Iraqi Ports (flag: Gibralter).
76. Fire Boat No. 705	Svc	N/A	N/A	State Org. of Iraqi Ports.
77. Fire Boat No. 706	Svc	N/A	N/A	State Org. of Iraqi Ports.
78. Forel	Fsh	1,163	HNFL	Rafidain Fisheries Co. Ltd., Basrah, Iraq.
79. Furat	Tug	350	HNFT	State Org. of Iraqi Ports.
80. Gaza	Svc	2,422	YIGZ	State Org. of Iraqi Ports.
81. Hamdan	Tug	387	YIHM	State Org. of Iraqi Ports.
82. Heet	Tug	89	N/A	State Org. of Iraqi Ports.
83. Hillah	Svc	6,709	YIAR	State Org. of Iraqi Ports.
84. Himreen	Tug	508	YIHN	State Org. of Iraqi Ports.
85. Hittin	Tkr	155,210	HNHT	Iraqi Oil Tankers Company.
86. Ibn Khaldoon	Svc	12,670	HNIN	State Org. of Iraqi Ports.
87. Ibn Majid 6	Svc	N/A	N/A	Iraqi State Company for Oil Projects (flag: Saudi Arabia).
88. Imhejran	Tug	386	YIMH	State Org. of Iraqi Ports.
89. Jabha	Tug	244	YIJA	State Org. of Iraqi Ports.
90. Jambur	Tkr	35,338	HNJM	Iraqi Oil Tankers Company.
91. Jamhona	Tug	368	YIJR	State Org. of Iraqi Ports.
92. Ketal	Fsh	1,170	HNKL	Rafidain Fisheries Co. Ltd.
93. Kerbala	Svc	N/A	N/A	State Org. of Iraqi Ports.
94. Khalid Ibin Al Waleed	Svc	2,235	YIBM	State Org. of Iraqi Ports.
95. Khanaqin	Tkr	35,338	HNKQ	Iraqi Oil Tankers Company.
96. Khawla Bint Al Zawra	RO/RO	3,985	HNKN	Iraqi State Enterprise for Water Transport.
97. Kirkuk	Tkr	35,338	HNKK	Iraqi Oil Tankers Company.
98. Mandali	Svc	6,977	YIQS	State Org. of Iraqi Ports. Formerly the Alkadisiyah.
99. Maysaloon	Tug	368	YIMY	State Org. of Iraqi Ports.
100. Measan	Tug	310	YIMN	State Org. of Iraqi Ports.
101. Methaq	Tug	248	YIMQ	State Org. of Iraqi Ports.
102. Moon Lady	RO/RO	3,985	HNNZ	Pandora Shipping Co., S.A., Honduras. Managed by Petra Navigation & International Trading Co. Ltd., Amman, Jordan. Formerly the Iraqi-owned AL-ZAHRAA. (flag: Honduras).
103. Nagroor	Fsh	140	N/A	Government of the Republic of Iraq, Ministry of Agriculture & Agrarian Reform, State Fisheries Company, Baghdad, Iraq.
104. Nainawa	Tug	310	YINW	State Org. of Iraqi Ports.
105. Nisr	Svc	744	YISR	State Org. of Iraqi Ports.
106. No. 1	SVc	30	N/A	State Org. of Iraqi Ports.
107. No. 2	Svc	30	N/A	State Org. of Iraqi Ports.
108. Nuwaibi	Fsh	140	N/A	Iraqi State Fisheries Co.
109. Ohod 5	Svc	N/A	N/A	Iraqi State Company for Oil Projects (flag: Saudi Arabia).
110. Ohod 6	Svc	N/A	N/A	Iraqi State Company for Oil Projects (flag: Saudi Arabia).
111. Ohod 7	Svc	N/A	N/A	Iraqi State Company for Oil Projects (flag: Saudi Arabia).
112. Orooba	Tug	368	YIOB	State Org. of Iraqi Ports.
113. Otori Maru No. 2	Svc	N/A	N/A	State Org. of Iraqi Ports.
114. Palestine	Svc	4,649	YIFN	State Org. of Iraqi Ports.
115. Pilot 393	Svc	N/A	N/A	State Org. of Iraqi Ports.
116. Pilot 394	Svc	N/A	N/A	State Org. of Iraqi Ports.
117. Police 1	Ptrl	N/A	N/A	State Org. of Iraqi Ports.
118. Police 2	Ptrl	N/A	N/A	State Org. of Iraqi Ports.
119. Police 3	Ptrl	N/A	N/A	State Org. of Iraqi Ports.
120. Radhwa 18	Tug	N/A	N/A	Iraqi State Company for Oil Projects.
121. Radhwa 19	Tug	N/A	N/A	Iraqi State Company for Oil Projects.
122. Radhwa 20	Tug	N/A	N/A	Iraqi State Company for Oil Projects.
123. Robian	Fsh	129	N/A	Iraqi State Fisheries Company.
124. Rumaila	Tkr	36,330	HNRM	Iraqi Oil Tankers Company.
125. Saif Saad	Svc	742	N/A	State Org. of Iraqi Ports.
126. Samarra	Fer	N/A	YIBC	State Org. of Iraqi Ports.
127. Senam	Svc	508	YISM	State Org. of Iraqi Ports.
128. Sboor	Fsh	129	HRN2	Iraqi State Fisheries Company.
129. Seabank	Fsh/Cgo	8,953	HOHR4	Trading & Maritime Investments, Honduras. Managed by Arab Trans Trade Co. S.A.E., Alexandria Egypt. Formerly the Iraqi-owned AL-BAHAR AL-ARABI (flag: Honduras).
130. Seamusic II	Cgo	26,732	9HYH2	Seamusic Shipping co. Ltd., c/o Theniemans Ships Management Inc., Athens, Greece. Vessel Seized by Government of Iraq. (flag: Malta).
131. Seoaa Nissan	Tug	368	YISN	State Org. of Iraqi Ports.
132. Shaboot	Fsh	1,163	HNLK	Rafidain Fisheries Co., Ltd.
133. Shatt al Basrah	Fsh	404	HNSR	Iraqi State Fisheries Company.
134. Shorook	Svc	403	YISH	State Org. of Iraqi Ports.
135. SHU' Aiah	Tug	N/A	N/A	State Org. of Iraqi Ports.
136. Sihan	Tug	387	YISI	State Org. of Iraqi Ports.
137. Sinai	Svc	1,296	N/A	State Org. of Iraqi Ports.
138. Sinjar	Svc	N/A	YIAY	State Org. of Iraqi Ports.
139. Sky Sea	Cgo	8,334	HNRZ	Pandora Shipping Co. S.A., Honduras. Managed by Petra Navigation & International Trading Co. Ltd., Amman, Jordan. Formerly the Iraqi-owned ALRAZI. (flag: Honduras).
140. Solnechnik	Fsh	404	UOJE	Iraqi State Fisheries Company.
141. Sulaimaniyan	Svc	N/A	YIAG	State Org. of Iraqi Ports.

Vessel name	Ship type	DWT	Call sign	Owner
142. Survey Launch No. 1	Res	N/A	N/A	State Org. of Iraqi Ports.
143. Survey Launch No. 2	Res	N/A	N/A	State Org. of Iraqi Ports.
144. Survey Launch No. 3	Res	N/A	N/A	State Org. of Iraqi Ports.
145. Tadmur	Tkr	3,627	HNTD	Iraqi Oil Tankers Company.
146. Tahreer	Svc	4,649	YITR	State Org. of Iraqi Ports.
147. Tarik Ibn Ziyad	Tkr	118,139	HNTZ	Iraqi Oil Tankers Company.
148. Theeqar	Tug	220	YIAC	State Org. of Iraqi Ports.
149. Ur	Tug	368	YIUR	State Org. of Iraqi Ports.
150. Work Boat No. 6	Brg	N/A	N/A	State Org. of Iraqi Ports.
151. Workship 3	Svc	N/A	N/A	State Org. of Iraqi Ports.
152. Yanbu 31	Svc	N/A	N/A	Iraqi State Company for Oil Projects (flag: Saudi Arabia).
153. Yousifan	Tug	386	YIYN	State Org. of Iraqi Ports.
154. Zain Al Qaws	Cgo	9,247	HNZQ	Iraqi State Enterprise for Water Transport.
155. Zamzam	Tkr	544	YIAZ	State Org. of Iraqi Ports.
156. Zanoobia	Cgo	3,549	HNZN	Iraqi State Enterprise for Water Transport.
157. Zubaidy	Fsh	N/A	YIBO	State Org. of Iraqi Ports.
158. 1 Athar	Tkr	1,502	HNAR	Iraqi Oil Tankers Company.
159. 1 Hunzan	Tkr	1,502	HNHN	Iraqi Oil Tankers Company.
160. 7 Nissan	Tkr	1,502	HNHN	Iraqi Oil Tankers Company.

Dated: March 13, 1991.

R. Richard Newcomb,

Director, Office of Foreign Assets Control.

Approved: March 15, 1991.

John P. Simpson,

Acting Assistant Secretary, (Enforcement).

[FR Doc. 91-7795 Filed 4-1-91; 8:45 am]

BILLING CODE 4810-25-M

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
April 9, 1991

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 $14,400 million, to be issued April 18, 1991. This offering will result in a paydown for the Treasury of about $19,150 million, as the maturing bills total $33,555 million (including the 15-day cash management bills issued April 3, 1991, in the amount of $13,505 million). Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, April 15, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Daylight Saving time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated January 17, 1991, and to mature July 18, 1991 (CUSIP No. 912794 WZ 3), currently outstanding in the amount of $10,063 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated April 18, 1991, and to mature October 17, 1991 (CUSIP No. 912794 XK 5).

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 April 18, 1991. 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 $2,685 million as agents for foreign and international monetary authorities, and $4,719 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).

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 competitive 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

EMBARGOED UNTIL GIVEN
EXPECTED AT 11:00 A.M.
WEDNESDAY, APRIL 10, 1991

**TESTIMONY OF
THE HONORABLE JEROME H. POWELL
ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBCOMMITTEE ON CONSUMER AFFAIRS AND COINAGE**

Chairman Torres, Congressman McCandless, and members of the Subcommittee, thank you for the opportunity to address the implications for the consumer of H.R. 1505, the Financial Institutions Safety and Consumer Choice Act of 1991, which is the Administration's comprehensive proposal to modernize our outdated banking laws. We believe that our proposal holds the promise of multiple benefits to the consumer, including:

-- First, a safer, better capitalized, better regulated banking system, which would leave taxpaying consumers less exposed to losses through the deposit insurance system;

-- Second, a broader choice of financial products for consumers when they go to the bank, accompanied by strengthened disclosure requirements;

-- Third, greater convenience, and lower interest rates and transaction costs; and

-- Fourth, enhanced availability of credit and other financial products to local communities.

In short, we believe that H.R. 1505 represents a profoundly pro-consumer approach to banking reform -- and that's why we named it the Financial Institutions Safety and Consumer Choice Act.

NB-1216

Time to Fix the System

Before addressing the particulars of the bill, I would like to explain why we have placed such a comprehensive reform proposal before the Congress.

Mr. Chairman, the problems that the banking system faces today are fundamental, and not superficial. These problems demand a comprehensive solution, and will defeat a narrow, piecemeal approach.

The evidence of fundamental problems is overwhelming. The Bank Insurance Fund, after increasing steadily for over 50 years, has now dropped to its lowest level in history as a percentage of insured deposits. In the thirty-eight year period between 1942 and 1980, we had a total of 198 bank failures, or about 5 per year. And yet in 1989 alone, we had 206 failures. In 1990, another 161 banks failed, and 131 of them were small banks with under $100 million in assets. The system is not working well for our banking institutions, large or small.

Why are all these failures occurring? One reason is that, over the years, banks have become less competitive as traditional banking business has migrated to new products in other parts of the financial services industry -- products that are off limits for banks due to outdated laws. This trend has left the banks to do too much risky lending to LBOs, Third World countries and other less attractive borrowers. Another reason is that, while we now allow interstate <u>banking</u> throughout almost the entire nation, we impose enormous unnecessary costs on banks by preventing them from <u>branching</u> across state lines. A third reason is that our overextended deposit insurance safety net has eliminated most of the incentive for sophisticated, large depositors to monitor the activities of banks and check excessive risk taking.

In part due to our failure to modernize, our international competitive position has declined to the point where we have no banks among the top 25 in the world. And as the economy has slowed, some regions have experienced "credit crunches". Weak banks have not been able to lend even to good customers, which has exacerbated the recession and hampered a speedy recovery.

Fundamental Reforms

We believe that comprehensive reform is needed to accomplish three fundamental objectives. First, we must make deposit insurance safe for taxpayers and depositors. That means stronger supervision, better capitalized banks, and the return of deposit insurance to its original purpose of protecting average depositors in this country. It also means a well capitalized Bank Insurance Fund.

Second, it is time to modernize archaic laws to let banks catch up with their customers and deliver products more efficiently to consumers across the country -- which translates into greater convenience, lower interest rates and transaction fees for consumers, and more bank capital.

Third, we need to restore the preeminent international position of our banking industry. Our economy is twice the size of our nearest competitor's, and a world class economy demands a world class banking system.

We believe that our legislation will help accomplish each of these objectives.

The full scope of the Administration's proposal has been covered in prior testimony before the full Committee and before the Subcommittee on Financial Institutions. As you requested in your letter of invitation, I will focus today on aspects of the legislation that bear most directly on consumers. But before doing so I would like to stress that comprehensive reform -- and not piecemeal reform -- is what is needed. If we only tinker with the problem -- for example, by simply recapitalizing the Bank Insurance Fund -- then we will not have addressed the underlying causes that have brought the Fund to its present state. The chances are good that if we take that course, we will be back again, sooner rather than later, recapitalizing the Fund again, the next time perhaps with the taxpayer's money. That is a prospect that no one could relish. To put it another way, with over $2 trillion in insured deposits, there is no fund large enough to protect the taxpayer if we allow the banking system to remain weak, inefficient and unable to compete.

Mr. Chairman, the most important thing our legislation can do for the consumer is to enhance the safety and soundness of our banking institutions, making deposit insurance safe for depositors and taxpayers alike. To do that, we need to improve the supervision of our depository institutions; to limit the extension of deposit insurance to those who are in need of protection; and to modernize the archaic laws that keep our banks from competing efficiently in today's world.

<u>Prompt Corrective Action</u>

Like Mr. Gonzalez' bill -- H.R. 6 -- the Administration's proposal recognizes that our regulatory system must be better designed to catch problems early, before they mushroom into costly failures. Our legislation's proposed system of Prompt Corrective Action will do just that. The combination of rules and flexibility will help foster two desirable results: regulators will be able to take action more swiftly as capital declines, and there will be more pressure to take such swift action because of the presumptions built into the statute. More important, banks will be more likely to maintain strong levels of capital if they face the certainty of decisive regulatory action as their capital declines.

Not everyone will like this system, because it will be argued that statutory presumptions will reduce regulatory "flexibility." But that is in part its purpose. Open-ended flexibility can be the enemy of decisive corrective action.

Critics will also claim that capital is not a good leading indicator of problems, and that prompt corrective action relies exclusively on capital. Both allegations are false. Numerous studies have shown that capital is an excellent leading indicator of problems in banks, and a simple one to measure. But it is not a perfect early warning system, and our legislation specifically recognizes its limits. Even a well-capitalized bank will trigger prompt corrective actions under the new system if it is in an unsafe and unsound condition due to loan concentrations or other supervisory problems. Prompt corrective action does <u>not</u> rely exclusively on capital.

<u>Reduction of Overextended Deposit Insurance</u>

In common with H.R. 6 and Mr. Wylie's H.R. 15, the legislation recognizes the importance of rolling back the creeping expansion of deposit insurance coverage to large, sophisticated depositors. We have proposed eliminating insurance coverage for brokered deposits and have carefully tried to eliminate so-called "pass through" coverage for depositors that are least in need of protection. Defined benefit pension plans with professional management, employer liability, and guarantees from the Pension Benefit Guaranty Corporation are not in need of deposit insurance protection as well. At the same time, however, the legislation would preserve pass-through protection for self-directed defined contribution plans, where individuals choose their own investments and bear the risk of any loss.

Likewise, the use of multiple insured accounts has gotten out of hand. It is time to impose limits, and ours is $100,000 per depositor per bank for most accounts, with a separate $100,000 in coverage for retirement savings. While this limit is important, it is obviously not radical. A couple can still get up to $400,000 in insurance coverage in each bank, which is hardly a small sum. Only about 3% of American households have over $100,000 in any one institution. Since households typically have several members, it is a reasonable conclusion that our proposal would affect substantially less than 3% of households. And insurance for business accounts would not change.

Those who suggest that such clearly reasonable limits would destroy the banking system or deprive the elderly of safe places to invest are just plain wrong -- and worse, are irresponsibly and needlessly stirring up depositor fears.

Finally, the FDIC's current "too big to fail" policy must be changed. The legislation would therefore essentially eliminate the FDIC's discretion to protect uninsured depositors in bank failures. But it would also preserve the government's ability to protect the financial system when necessary, even if that requires the rare protection of uninsured depositors.

We believe that this balance struck between direct taxpayer exposure and the stability of the financial system is the correct one. Nevertheless, some argue that we have not gone far enough -- that the government should never protect uninsured depositors. In our view, it would be foolhardy for the government to give up its ability to protect uninsured depositors when the entire financial system is at stake. No other government has embraced that restriction, and we shouldn't be the first to run the experiment.

Others argue that we should simply expand the safety net to cover <u>all</u> deposits in all banks in order to create "fairness" for uninsured depositors. That would be equally foolhardy -- what about fairness to the taxpayer? Why should the taxpayer have to pick up the tab to protect an uninsured depositor who knows his or her deposits are uninsured?

The best way to address this problem is to stop banks from failing so frequently, which is exactly what this legislation would do.

<u>Restored Competitiveness</u>

Another important aspect of enhancing safety and soundness is restoring the competitiveness of our banking system. Our banking laws served us well for many years, but they are now archaic. They impose substantial and unnecessary costs, and prevent banks from competing in the modern economy. The system needs an overhaul, which the proposed legislation would accomplish.

<u>Nationwide banking and branching</u>. Interstate branching is a perfect example. Now that 48 of the 50 states allow some form of interstate banking, it is fair to say that the philosophical debate over interstate banking is over. Yet interstate branching is still virtually prohibited, imposing unnecessary costs on banks.

Like H.R. 15, introduced by Mr. Wylie -- as well as Mr. Schumer's H.R. 624 and Mr. Neal's H.R. 1480 -- our legislation would move to end these artificial barriers. It would do so in a way that recognizes the legitimate interests of state governments. A state would still be able to restrict <u>intra</u>state branching of all state and national banks operating within its borders. It would also have the ability to establish activities restrictions for all of its own state banks and all in-state branches of banks chartered in another state. The Community Reinvestment Act would continue to apply, and states could continue to apply state consumer protection laws to branches of all out-of-state banks. Finally, states could tax branches of all banks, state or national, to avoid any adverse revenue impact resulting from changes in the law.

Nationwide interstate banking and branching would provide tremendous benefits to consumers. Experience shows that greater ease of entry would mean greater competition, which in turn would lead to increased availability of credit and other financial products, and to lower prices. The many consumers who live in multistate areas -- such as those in the Washington, D.C. metropolitan area -- would have easier everyday access to branches of their banks. And more regionally diverse banking organizations would be less vulnerable to regional economic woes, and therefore less likely to fail.

Critics argue that these interstate activities provisions would reduce the need for small banks, draw funds out of local communities and deprive rural areas of much needed sources of credit. There is no credible evidence to support these hypothetical fears. Today, we have interstate banking in 48 states. Yet there is no evidence that out-of-state institutions are overrunning the community banks. In fact, the evidence is to the contrary. Studies show that community banks not only survive entry by out-of-state rivals, they also tend to outperform them.

In states like New York, larger banks have actually decreased the number of their branches in recent years in the face of stiff competition from community banks. In California as well, community banks continue to thrive and to compete quite effectively with larger rivals, both in-state and out-of-state. Smaller banks that serve local communities appear to have a competitive advantage that their larger and more diversified rivals cannot match -- they know their customers and their communities. We fully expect that to continue to be the case.

I stated earlier that the Community Reinvestment Act would continue to apply when banking organizations expand across state lines. I would like to address directly two instances in which the application of CRA would change under our proposal. First, we have provided for expedited 45-day review of applications for mergers and acquisitions by Zone 1 banks -- banks that have substantially more than the minimum capital levels. The concern may be raised that the 45-day period may be inadequate for CRA concerns to be fully addressed. In response, I would point out that our proposal would explicitly require the regulators to deny the application if it is determined that the transaction is inconsistent with the convenience and needs of the community. And we would expect that the regulators would develop procedures to accommodate CRA concerns within the 45-day review period.

Second, Zone 1 banks with Satisfactory or Outstanding CRA ratings will be able to branch within a state -- after opening their first branch in that state -- by subsequent notice and without going through an application process. Here, the concern may arise that full CRA review will be frustrated. We have addressed that concern by limiting the provision to banks that are very highly capitalized and that have good records under CRA. The provision is meant as an additional "carrot" to encourage banks to hold high levels of capital. This is a fundamental goal of our legislation, and one that would greatly benefit consumers and taxpayers who will be better served by a stronger, better capitalize banking system.

Financial Services Holding Companies. Like Mr. Barnard's bill -- H.R. 192 -- our legislation would also permit banking organizations to engage in a broader range of financial activities. In some ways, the proposed changes reflect the reality of the way that banking organizations already do business. Banks are already in many aspects of the securities and insurance businesses through a patchwork system created by changes to state laws, exceptions in federal laws, and legitimate regulatory interpretations. But this hodgepodge system is costly and burdensome, with numerous restrictions that keep our financial companies from competing fairly and effectively.

Under our proposal, bank holding companies would become financial services holding companies. These financial services holding companies could engage in all of the currently authorized financial services activities, and those who maintained highly capitalized banks could engage in a broad range of new financial activities through affiliates -- securities activities, insurance activities, and any new activities that are determined to be "of a financial nature" over time.

But important safeguards would be in place to protect banks from risks associated with new activities and to prevent unfair competition. Any new activities would be carried out in separately capitalized affiliates whose capital could not be double counted as capital of the bank. Only companies with well-capitalized banks could take advantage of these new activities, and only if their banks were not in an unsafe or unsound condition and were not engaging in unsafe or unsound practices. If the bank's capital level should decline or if it otherwise falls into an unsafe or unsound condition, the holding company would have to fix the problem or face the prospect of strong remedial action. This could include divestiture of either the new financial activities or the bank itself, or, if that did not occur, holding company capital requirements, dividend restrictions, and much closer supervision.

In addition, a number of strict firewalls would exist between the bank and its new affiliates. A strengthened version of Section 23A of the Federal Reserve Act expands the type of transactions subject to its provisions. In addition, banks would have to give prior notice to the regulator of any loan exceeding 5 percent of capital. At the same time, under revised Section 23B of the Federal Reserve Act, bank loans to <u>customers</u> of affiliates would also have to be conducted on an arms length basis.

Strict disclosure rules would apply to sales of non-deposit products not only by banks, but by affiliates of banks. Customers would have to sign plainly worded forms acknowledging that such products were <u>not</u> covered by federal deposit insurance. We have also included a provision barring the sale of securities of bank affiliates on the bank's premises where deposits are accepted. In addition, regulators would have the explicit authority to limit the disclosure by banks to their affiliates of nonpublic customer information. And most important, they would have broad regulatory authority to impose limits on transactions between banks and affiliates to prevent conflicts of interest, unfair competition, and unsafe and unsound banking practices.

Once again, the consumer would be a direct beneficiary of these reforms. Consumers would choose from a much broader array of financial products at the bank, with strengthened disclosure requirements. And the increased competition provided by banks would lead to lower transaction costs and lower interest rates. Finally, broader financial activities would lead to better capitalized, more competitive, and safer and sounder banks.

<u>Diversified Holding Companies</u>. The bill would also allow diversified holding companies to own financial services holding companies. These diversified holding companies would have no limits on the types of activities in which they could engage. They would provide a critical new source of capital for banks, since 80 percent of the capital in this country is in commercial companies. But these companies must be prepared to put up this capital if they want to own banks -- again, their ownership of banks would be contingent on maintaining high bank capital levels, and they would be subject to similar prompt corrective action penalties if bank capital should ever drop and the holding company was unwilling to restore capital.

All of the firewalls that apply to bank transactions within the financial services holding company would apply to bank transactions with affiliates in the diversified holding company -

- with one crucial difference. No bank, and no bank affiliate within a financial services holding company, could provide loans of any kind to the diversified holding company or its subsidiaries. The bank simply could not become a commercial company's "piggy bank" for private sources of credit. We believe that this prohibition along with the other safeguards described above will be more than adequate to protect against abusive lending practices.

Conclusion

Mr. Chairman, I would like to close by reemphasizing the four broad benefits provided to consumers by our legislation.

-- First, a safer, better capitalized, better regulated banking system, which would leave taxpaying consumers less exposed to losses through the deposit insurance system;

-- Second, a broader choice of financial products for consumers when they go to the bank, accompanied by strengthened disclosure requirements;

-- Third, greater convenience, and lower interest rates and transaction costs; and

-- Fourth, enhanced availability of credit and other financial products to local communities.

The time has come to address the urgent problems facing the banking industry. We strongly urge Congress to adopt the "Financial Institutions Safety and Consumer Choice Act of 1991."

###

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 10, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 7-YEAR NOTES

Tenders for $8,534 million of 7-year notes, Series F-1998, to be issued on April 15, 1991 and mature on April 15, 1998 were accepted today (CUSIP: 912827A44).

The interest rate on the notes will be 7 7/8%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	7.92%	99.762
High	7.94%	99.656
Average	7.93%	99.709

$20,000 was accepted at lower yields.
Tenders at the high yield were allotted 96%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	10,931	10,921
New York	15,893,839	8,124,119
Philadelphia	5,862	5,862
Cleveland	10,871	10,871
Richmond	45,138	44,258
Atlanta	13,299	13,259
Chicago	996,327	266,887
St. Louis	6,702	6,702
Minneapolis	2,958	2,957
Kansas City	13,517	13,514
Dallas	4,185	4,185
San Francisco	223,267	27,717
Treasury	3,019	3,019
TOTALS	$17,229,915	$8,534,271

The $8,534 million of accepted tenders includes $291 million of noncompetitive tenders and $8,243 million of competitive tenders from the public.

In addition, $25 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $216 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1217

TREASURY NEWS

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

As Prepared for Delivery
Embargoed until 11:30am EST (4:30pm London)
April 15, 1991

CONTACT: CHERYL CRISPEN
202/566-2041

REMARKS BY THE HONORABLE
NICHOLAS F. BRADY
U.S. SECRETARY OF THE TREASURY
AT
THE SPECIAL SESSION ON THE FUTURE OF EUROPE
London, England

Thank you. It is indeed an honor to address such a distinguished group.

The sweeping developments in Europe over the past few years provide the backdrop for our discussions here today. The political and economic reforms underway throughout Eastern Europe, the reunification of Germany, and the accelerated pace of integration in the European Community, have brought with them distinct challenges as well as great opportunities for Europe and the world community.

Our belief is that we can overcome these challenges and take advantage of the opportunities if we build on a few guiding principles.

First, the rise of democracy reflects the power and enduring appeal of freedom, self-determination, economic openness, and free enterprise.

Second, we live in a highly integrated global system in which economic power is shared among us. Increasingly, national policies have international implications, and international developments impact our policies at home. We should question whether the old distinctions between internal and external policies have become outdated and counterproductive.

A decade of prosperity based on economic growth has brought with it expanding responsibilities for us all. A world of twenty-four hour global communications, instantaneous funds transfer and interdependent economies is necessarily a world of increased responsibility sharing.

NB-1218

The unique success of the international response to Iraqi aggression demonstrates how a common cause widely agreed to can advance our shared interests. We need to extend this spirit to the economic challenges before us.

As we face the challenges ahead we recognize the need for funds for Eastern Europe, German reunification, Latin America, and for the rebuilding of the Middle East. To do all these things we need a positive, operational framework. This framework can only be based on sustained, low inflationary growth.

First and foremost, each of us needs to pursue fiscal and monetary policies that support low-inflationary growth and strike an appropriate balance between domestic objectives and international obligations.

In reaching that balance, we should act on the risks as they are today, not as they were in times past. Today, there are indications of slowing growth in a number of countries. Although there are signs the U.S. economy is emerging from its slowdown, the pace of expansion in numerous West European economies is decelerating. In these circumstances, we must continue to be vigilant against inflation but recognize that the greatest need we face today is for strong, low-inflationary growth in the industrial world. The policy coordination process remains a most effective tool to meet this challenge.

In addition, we must accept the challenge of strengthening the global trading system and make a success of the Uruguay Round. It is too important for all of us not to receive the political support it deserves.

Of course, the final measure of our success will not be embracing these objectives in the abstract, but implementing them in practice. Solid economic growth in the major European economies is a necessary precondition for solid growth elsewhere in the world. The EBRD will have an integral part to play in this process. As Europe increasingly speaks with one voice, we look forward to continuing and strengthening our partnership. However, the transition within Europe contains a special problem from our perspective. We should not be asked to accept the lowest common denominator that emerges from EC debate as the basis for international negotiation. And we cannot be asked to negotiate the same issue twice -- once with the EC as a whole and then again with the individual member states.

The challenges are large. But the potential rewards are greater. We must succeed.

Thank you.

###

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

FOR IMMEDIATE RELEASE
APRIL 15, 1991

CONTACT: Bob Levine
(202) 566-2041

UNITED STATES AND THE REPUBLIC OF THE MARSHALL ISLANDS SIGN AGREEMENT TO EXCHANGE TAX INFORMATION

The Treasury Department announced today that the United States and the Republic of the Marshall Islands have signed an agreement to exchange tax information (the "Agreement") that satisfies the criteria set forth in the Compact of Free Association Act of 1985 (the "Act"). Pub. L. No. 99-239, § 404 (1986). The Agreement was signed in Majuro, Republic of the Marshall Islands, on March 14, 1991 by Minister of Foreign Affairs Tom D. Kijiner, on behalf of the Republic of the Marshall Islands, and Ambassador William Bodde, Jr., on behalf of the United States. The Agreement entered into force upon signature.

Under the Act, the Republic of the Marshall Islands qualifies as a jurisdiction eligible for the benefits of Internal Revenue Code Section 936. As a result, electing U.S. corporations that conduct certain business and investment activities in the Marshall Islands will be allowed a credit against the U.S. income tax that would otherwise be imposed on such activities. The Agreement is intended to meet the Act's requirement that these income tax benefits are available only so long as the Marshall Islands has in effect a tax information exchange agreement with the United States.

A limited number of copies of the Agreement are available from the Treasury Public Affairs Office, Treasury Department, Room 2315, Washington, D.C. 20220.

oOo

NB-1219

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 15, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $7,213 million of 13-week bills to be issued on April 18, 1991 and mature on July 18, 1991 were accepted today (CUSIP: 912794WZ3).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.55%	5.72%	98.597
High	5.57%	5.74%	98.592
Average	5.57%	5.74%	98.592

$935,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 100%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	45,665	45,665
New York	21,110,490	5,918,740
Philadelphia	28,235	28,235
Cleveland	52,675	52,675
Richmond	56,465	56,465
Atlanta	37,340	34,340
Chicago	1,395,800	93,800
St. Louis	57,135	17,135
Minneapolis	9,220	9,220
Kansas City	36,605	36,605
Dallas	21,515	21,515
San Francisco	703,195	102,195
Treasury	796,600	796,600
TOTALS	$24,350,940	$7,213,190
Type		
Competitive	$19,368,255	$2,230,505
Noncompetitive	1,864,465	1,864,465
Subtotal, Public	$21,232,720	$4,094,970
Federal Reserve	2,569,020	2,569,020
Foreign Official Institutions	549,200	549,200
TOTALS	$24,350,940	$7,213,190

NB-1220

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 15, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $7,202 million of 26-week bills to be issued on April 18, 1991 and mature on October 17, 1991 were accepted today (CUSIP: 912794XK5).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.66%	5.92%	97.139
High	5.68%	5.95%	97.128
Average	5.67%	5.93%	97.134

Tenders at the high discount rate were allotted 14%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	27,905	27,905
New York	21,417,825	5,981,820
Philadelphia	17,500	17,500
Cleveland	33,155	33,155
Richmond	35,275	35,250
Atlanta	34,905	34,045
Chicago	1,291,005	80,005
St. Louis	35,370	15,370
Minneapolis	6,880	6,880
Kansas City	48,335	44,035
Dallas	16,400	16,400
San Francisco	805,405	261,905
Treasury	647,635	647,635
TOTALS	$24,417,595	$7,201,905
Type		
Competitive	$20,171,090	$2,955,400
Noncompetitive	1,260,305	1,260,305
Subtotal, Public	$21,431,395	$4,215,705
Federal Reserve	2,150,000	2,150,000
Foreign Official Institutions	836,200	836,200
TOTALS	$24,417,595	$7,201,905

NB-1221

TREASURY NEWS

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

EMBARGOED UNTIL GIVEN
EXPECTED AT 9:30 A.M.

TESTIMONY OF
THE HONORABLE ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
April 16, 1991

Chairman Riegle, Senator Garn, members of the Committee:

I appreciate this opportunity to present the Administration's views on Title III of S. 207, the "Futures Trading Practices Act of 1991."

As you know, early last month the Senate Agriculture Committee was poised to mark-up a bill to reauthorize the Commodity Futures Trading Commission (CFTC). For nearly a year the Administration has taken the position that such legislation should not be enacted without addressing the crucial, systemwide intermarket issues that were identified in the wake of the market decline in 1987 -- particularly the lack of harmonized federal oversight of margins in the "one market" of stocks, stock options, and stock index futures. Unfortunately, opponents of these far-reaching changes had managed to block its consideration in the last Congress, and the stalemate appeared likely to continue in the Agriculture Committee mark-up.

At this point the Administration decided that we could no

NB-1222

longer afford stalemate, especially given the crucial need for harmonized federal oversight of margins to avoid financial market disruptions. Accordingly, we agreed to a compromise that would resolve the margin issue and at least make some progress on other intermarket issues involving competition between markets.

We believed that such a compromise was the wisest course of action under the circumstances, and the spirit of this compromise was adopted by the Agriculture Committee in Title III of S.207. While the actual language reported by the Committee raised a number of important but unintended technical issues, during the last several weeks we have worked hard to resolve these issues. I would like to thank the staffs of the Securities and Exchange Commission, the CFTC, and the Federal Reserve for their technical help, especially since they did not always agree with the substance of the provisions. We expect a revised version of Title III addressing these technical issues to be offered as a managers' amendment to S.207 when it is taken up on the floor of the Senate.

It is Secretary Brady's view that this new Title III addresses many of the competing interests in the debate over CFTC jurisdiction without compromising fundamental public benefits embodied in previous proposals. Most importantly, with the new ability to harmonize margins on the basis of systemic risk, an end to the stalemate will substantially reduce ongoing risk to our financial markets. In addition, improvements to the jurisdictional issue involving hybrid instruments are at least a modest step forward. In that spirit, the Administration generally supports new Title III.

To understand this compromise, let me provide you with some additional background information. As you will recall, the Administration in 1990 submitted a proposal that in some respects went considerably farther than the current proposal. Among other things, the 1990 bill would have unified regulation of stock and stock derivative products; authorized harmonized federal oversight of margins on such products to take into account systemic risk; and permitted hybrid instruments to trade on both stock and futures exchanges. The 1990 proposal, like the proposed version of Title III, included key recommendations developed by the 1987 Presidential Task Force on Market Mechanisms chaired by Secretary Brady.

Members of this Committee and members of the Senate Agriculture Committee subsequently developed a substitute version that deleted our proposal for unified regulation of equity-related markets but preserved other important elements of the bill in modified form (the so-called "Leahy-Lugar compromise"). We appreciate the considerable efforts that were made to reach this compromise last fall. As you know, however, it was not passed in the closing days of the last Congress, and the

Agriculture Committee was not prepared to report it out of Committee last month.

Under the new Title III that was passed by the Agriculture Committee (and as expected to be amended), the Federal Reserve would be given authority to prescribe margin levels for stock index futures, which it could delegate to the CFTC. The CFTC would be authorized to exempt certain products in the public interest, and it would be directed to exempt certain swaps and deposit hybrids if not contrary to the public interest. Unlike our original 1990 proposal and the Leahy-Lugar compromise, however, jurisdiction over hybrid commodities would depend on a preponderance-of-value test, rather than allowing hybrid securities to trade anywhere as we had originally proposed.

Importance of this Bill

While new Title III does not go as far as our original proposal, particularly in the area of hybrid instruments, it is timely, constructive, and deserves to be enacted. Four years have passed since the October 1987 market break. While several important steps have been taken to prepare for major market disruptions -- including intermarket circuit breakers, large trader reporting, and improved clearance and settlement procedures between markets -- critical legislation has yet to be enacted, particularly in the crucial area of intermarket margins. Meanwhile, we have experienced repeated episodes of violent drops in the stock market in the absence of any significant news events. These major market disruptions have severely damaged the confidence of individual investors.

We continue to believe the single most important step Congress can take to address the likelihood and consequences of major market disruptions is to unify regulation of the "one market" of stocks, stock options, and stock index futures. Short of jurisdictional reform, however, we believe the provision in new Title III assigning broad authority for setting margin levels for stock index futures to the Federal Reserve Board represents a critical step toward promoting intermarket stability. We strongly support this margin provision as amended.

Regulatory fragmentation over hybrid commodity instruments also is creating a serious impediment to innovation, as amply demonstrated in the Seventh Circuit's decision concerning Index Participations in Chicago Mercantile Exchange v. Securities and Exchange Commission, 883 F.2d 537 (1989). The 50 percent test under new Title III, together with new authority to exempt futures contracts and mandatory exemptions for certain swaps and deposit products, represent modest improvements and clarification over the current situation. Although the new provisions on hybrids do not authorize the broader competition in financial instruments that the Administration initially proposed, we generally support them in the context of new Title III.

Let me now explain our views in more detail on the two basic issues embodied in new Title III -- margins and exclusivity.

Margins

To enhance the safety and soundness of the financial system, the bill gives the Federal Reserve authority to request any contract market to set the margin for any stock index futures contract (or option thereon) at such levels as the Board in its judgment determines are appropriate to preserve the financial integrity of the contract market or to prevent systemic risk. If the contract market fails to do so, the Board can direct the contract market to adopt such margin levels. This would preserve the ability of the futures exchanges to manage margin requirements on a day-to-day basis, and the statute would not require minimum margin levels, which would be left to regulatory discretion.

The result would be that, for the first time since stock index futures began trading in 1982, the federal government would have oversight authority over margins on all stock and stock derivative products -- and not just for the narrow "prudential" concerns of participants in a single market, but also for the broader concern of systemic risk. This systemic risk standard is absolutely crucial to the protection of the integrity of the nation's financial system. Moreover, the Federal Reserve would have the authority to harmonize margins across markets because it already has ultimate margin authority over stocks and stock options.

We have repeatedly emphasized the problems that are inherent in the current scheme of margin regulation. Currently the futures exchanges and their clearinghouses set margins on stock index futures themselves. The result is a tremendous disparity in margin levels on stock and stock index futures, even though they are part of one market where margin levels on one type of instrument can have a direct impact on the trading and price of other types of instruments. The result has been that futures margins, which have no federal oversight, have often dipped to dangerously low levels.

Those who try to dismiss the need for harmonized margins by claiming that they are unrelated to volatility are simply missing the point. We have never said that average volatility has increased. Our concern is major market disruptions and how to slow them down when the tidal wave starts to form -- not volatility.

There is a broad consensus about the need for federal oversight of margins on stock index futures to limit systemic risk. Indeed, no credible argument has been advanced against federal oversight -- we must have such oversight where the actions of private market participants in a narrow segment of the market create risks for the financial system as a whole. It is a dangerous practice that is not in the public interest. We need to address this unjustified anomaly, and new Title III does so effectively.

Exclusivity

New Title III also contains five provisions relating to the exclusivity clause in the Commodity Exchange Act -- mandatory exemptive authority for institutional swaps, a 50 percent value test to determine jurisdiction over hybrid commodity instruments, general exemptive authority over futures contracts entered into by institutional participants, mandatory exemptive authority for certain deposits, and the exclusion of exchange-traded index participations that the SEC had approved or for which approval was pending on or before December 31, 1990.

We are well aware of the concerns others have expressed about these provisions. We would underscore, however, that a reasonable compromise that could break the legislative stalemate serves the overall interests of the public and the financial markets. Moreover, instruments that trade today off of futures exchanges would not be affected by the new Title III, and some new hybrid products that might be subject to the exclusivity provision today would not be subject to it under the new legislative language. In short, as described below, each of these five provisions represents at least a modest improvement over current law.

Swaps. The treatment of swaps under new Title III would improve the current state of the law, which consists of a CFTC policy statement under which traditional swaps are not subject to regulation under the Commodity Exchange Act.

Under the proposed amendment, the CFTC would be required to exempt all swaps that meet certain conditions:

- the CFTC determines that the exemption is consistent with the public interest;
- each party to the swap is an "institutional participant" as defined in the proposed amendment;
- the creditworthiness of the parties is a material consideration in entering into or determining the terms of the swap; and
- the swap is not standardized and "fungible" and it not traded in an exchange setting.

Unlike the policy statement under existing law, the proposed swap provision in new Title III does not preclude, among other things, the netting of payments among parties to swap agreements, which may help to decrease systemic risk. Moreover, eligible swap agreements would be exempted effective as of October 23, 1974, the date of enactment of the Commodity Futures Trading Commission Act, to ensure that the exemption is available for all eligible swaps, regardless of when they were entered into. We believe the required exercise of exemptive authority for swaps will remove a great deal of uncertainty that has surrounded the swaps market. Indeed, we understand that the International Swap Dealers Association and the Securities Industry Association consider this provision in new Title III to be an improvement over current law.

Hybrid Commodity Instruments. Current CFTC statutory interpretation and regulations, as upheld by the courts, provide the CFTC with broad discretion to assert exclusive jurisdiction over hybrid commodity instruments. This could be upheld even where an instrument resembles a security much more than a futures contract. The 50 percent test of new Title III would exclude from CFTC jurisdiction certain instruments that would otherwise be covered under this broad CFTC authority, such as certain bonds whose return is tied to the price of oil. Moreover, the new test would allow financial instruments to be structured to take advantage of the broader rules.

Exemptive Authority. For the first time, the CFTC would have exemptive authority with respect to futures contracts entered into by institutional participants. While this exemptive authority is not as broad as the CFTC's authority with respect to commodity options, it is a step in the right direction. As the Agriculture Committee report noted, this new exemptive authority can and should be used to provide greater regulatory flexibility with respect to transactions in existing markets, as well as for new transactions or markets. An example is the Brent crude oil market. The CFTC's statutory interpretation, which concludes that the market is not covered by the Commodity Exchange Act, has been questioned by some, including a dissenting commissioner of the CFTC. In the absence of exemptive authority, the CFTC's interpretation may not remove all doubt concerning the legal status of Brent market transactions, which at least one court has held to be futures contracts. Exempting transactions in the Brent markets would alleviate this uncertainty and free U.S. participants from the competitive disadvantage of off-exchange trading restrictions under the Commodity Exchange Act.

Deposits. The bill also improves current law by mandating the exemption of deposits with futures or options attributes that do not meet the 50 percent test if the deposit or account is subject to comprehensive banking regulation and the exemption would not be contrary to the public interest. This is similar to the provision that was included in the Leahy-Lugar compromise that was agreed to by a number of Senators in the latter part of the last Congressional session. This provision is an improvement over current law, because it clarifies that the CFTC has clear authority to exempt certain deposits from the Act, and indeed, is required to exercise that authority if the new statutory standards are satisfied. Moreover, it must be emphasized that this provision gives no new jurisdiction to the CFTC over deposit instruments, and certainly does not extend to bank products that have no futures or options attributes.

Index Participations. Regarding index participations, at least five of the eight IPs products that have been approved by the SEC or pending approval will be allowed to trade on securities exchanges. The other three could trade if a licensing agreement between the Chicago Mercantile Exchange and Standard & Poor's Corporation is amended.

While all of these improvements to the exclusivity clause fall short of the Administration's original proposal, the margin provision represents a substantial improvement over current law. At the same time, the exclusivity provisions represent at least a modest improvement over existing law.

The Bond-Wirth Proposal

Let me turn now to the language proposed by Senators Bond and Wirth as an alternative to the exclusivity provisions of new Title III (the margin language would not be affected). This alternative includes broader general exemptive authority for the CFTC; broader exclusions from CFTC jurisdiction for swaps and deposit products; a broader exclusion provision for Index Participations; and the ability of some hybrid instruments to trade either on futures or securities exchanges if approved by the appropriate agency. This language is obviously closer in nature to provisions the Administration included in its original proposal in 1990. However, the controversy surrounding this type of proposal has failed to result in legislation, delaying passage of crucial safety and soundness measures such as federal oversight of margins on stock index futures based on systemic risk. As a result, we believe it is wise at this time to support the compromise embodied in new Title III, which addresses the key margin issue and makes modest improvements in the areas addressed more sweepingly by the Bond-Wirth proposal.

Conclusion

As you well recall, Mr. Chairman, on Black Monday four years ago, we had a crisis on our hands. Despite the progress that has been made to improve market stability, the many studies that have been conducted, and the thorough debate that has taken place, there is much unfinished business -- business that is crucial. We cannot continue to keep our financial markets at risk, which they are without federal oversight of stock index margins.

We believe Congress now has an opportunity to make a significant contribution to the stability and competitiveness of U.S. financial markets. This is the time to move forward, to take the next constructive step, which new Title III represents. Let's not make the best legislation the enemy of good legislation. If we wait for a perfect bill, we may be waiting a long time. Meanwhile, our regulatory system will not be adequately prepared in the event of another market break.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions the Committee may have.

TREASURY NEWS

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

As Prepared for Delivery
Immediate Release
April 16, 1991

STATEMENT BY THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
GOVERNOR OF THE UNITED STATES
BEFORE THE
INAUGURAL MEETING OF THE
EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

Mr. President, fellow Governors, delegates, and distinguished guests. It is a privilege to take part today in this inaugural meeting of the European Bank for Reconstruction and Development, whose purpose is to help transform the nations of Central and Eastern Europe into growing democratic market economies.

The challenge to these nations is great. Entire political and economic systems must be transformed. The United States stands ready to help in this process. Our participation in the creation of this Bank is a reflection of the importance which we attach to this task.

Today we celebrate the historic change that [illegible] in Central and Eastern Europe over the past two years. The political and economic objectives have been clear. Politically, citizens of Central and Eastern Europe choose freedom. Economically, they choose a system that promotes economic growth and rewards private initiative. They strive to replace state-run economies with the efficiency of the free market. Our task is to support these aspirations.

The EBRD has a central role to play in turning these aspirations into reality. Free market and democratic principles are enshrined in its Articles. Its structure is a combination of a merchant bank and a development bank, which gives it the flexibility to build the private sector with the support of government. It also will have the ability to work directly with foreign investors. In addition, the Bank will have the capacity to promote regional projects in market areas such as the environment, telecommunications and transport.

NB-1223(*)

The founding members' emphasis on free market forces is enshrined in its Articles of Agreement, which reserve the bulk of the Bank's activities for direct support of the private sector and for privatization activities. This private sector emphasis, which is also a legal requirement, was a critical element of U.S. support for the Bank.

The next step is to turn the Articles of Agreement into an operational program for the Bank, a process that is already underway. Of course, the Bank will need to keep in mind the ongoing activities of other multilateral and bilateral donors to the region, in order to avoid duplication and conflicting operations. Building on its unique structure, however, the EBRD has a special role to play.

We believe strongly that the EBRD's focus should be private sector development and the financing of infrastructure which directly supports private sector activity. In particular, the Bank should emphasize the privatization of existing state enterprises, the provision of venture capital, the creation of new, private, financial institutions and the development of capital markets.

The EBRD has been given a special mandate in the environment. Its involvement in this area is vital and will be assisted through the environmental impact assessment process and meaningful public participation. In view of the critical need for environmental recovery in the region, this process is a pre-requisite for sound and sustainable development.

We, the shareholders, have a responsibility to provide the Bank, through our Directors, with clear policy guidance. The Directors -- as personal representatives of the Governors -- must play a key role in developing the focus of the EBRD. The Board of Directors, therefore, should be fully involved and informed. The Board should conduct its role of guiding policy and approving operations with the knowledge that management is to carry out day-to-day operations. We do not view the activity of the Board as an advisory one, but, instead, as a critical element of the Bank's operations.

In conclusion, I would like to state the United States' strong support for this institution and its goals. As an international institution with a membership that spans many continents, the Bank can play a pivotal role in assisting the countries of East and Central Europe through the transition process.

I would like to congratulate Jacques Attali and his staff for the progress they have made in the organization of the Bank. We stand ready to work with you, Mr. President, on the important task that lies ahead.

I would also like to thank Her Majesty's Government for the extraordinary support it has shown this new organization.

Finally, I would like to reiterate the United States' strong commitment to the nations of Central and Eastern Europe as they seek an historic transformation of their economic and political life. They have earned our admiration and merit our support.

Thank you.

###

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
April 16, 1991

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 $15,200 million, to be issued April 25, 1991. This offering will result in a paydown for the Treasury of about $15,575 million, as the maturing bills total $30,774 million (including the 161-day cash management bills issued November 15, 1990, in the amount of $12,032 million). Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, April 22, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Daylight Saving time, for competitive tenders. 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 24, 1991, and to mature July 25, 1991 (CUSIP No. 912794 XA 7), currently outstanding in the amount of $10,369 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 October 26, 1990, and to mature October 24, 1991 (CUSIP No. 912794 WV 2), currently outstanding in the amount of $10,132 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 April 25, 1991. 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 $2,132 million as agents for foreign and international monetary authorities, and $5,597 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).

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 competitive 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 AT 4:00 P.M.
April 17, 1991

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR NOTES
TOTALING $21,000 MILLION

The Treasury will auction $12,000 million of 2-year notes and $9,000 million of 5-year notes to refund $10,573 million of securities maturing April 30, 1991, and to raise about $10,425 million new cash. The $10,573 million of maturing securities are those held by the public, including $951 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $21,000 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 prices of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks, for their own accounts, hold $777 million of the maturing securities that may be refunded by issuing additional amounts of the new securities at the average prices of accepted competitive tenders.

Details about each of the new securities are given in the attached highlights of the offerings and in the official offering circulars.

oOo

Attachment

NB-1224

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 5-YEAR NOTES TO BE ISSUED APRIL 30, 1991

April 17, 1991

<u>Amount Offered to the Public</u> ...	$12,000 million	$9,000 million
<u>Description of Security</u>:		
Term and type of security	2-year notes	5-year notes
Series and CUSIP designation ...	Series Z-1993 (CUSIP No. 912827 A5 1)	Series N-1996 (CUSIP No. 912827 A6 9)
Maturity date	April 30, 1993	April 30, 1996
Interest Rate	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
Investment yield	To be determined at auction	To be determined at auction
Premium or discount	To be determined after auction	To be determined after auction
Interest payment dates	October 31 and April 30	October 31 and April 30
Minimum denomination available .	$5,000	$1,000
<u>Terms of Sale</u>:		
Method of sale	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%
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
Accrued interest payable by investor	None	None
<u>Payment Terms</u>:		
Payment by non-institutional investors	Full payment to be submitted with tender	Full payment to be submitted with tender
Deposit guarantee by designated institutions	Acceptable	Acceptable
<u>Key Dates</u>:		
Receipt of tenders	Wednesday, April 24, 1991	Thursday, April 25, 1991
a) noncompetitive	prior to 12:00 noon, EDST	prior to 12:00 noon, EDST
b) competitive	prior to 1:00 p.m., EDST	prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Tuesday, April 30, 1991	Tuesday, April 30, 1991
b) readily-collectible check ...	Friday, April 26, 1991	Friday, April 26, 1991

TREASURY NEWS

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

For Immediate Release — April 19, 1991

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of March 1991.

As indicated in this table, U.S. reserve assets amounted to $78,002 million at the end of March 1991, down from $82,797 million in February 1991.

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/
1991					
February	82,797	11,058	10,958	51,225	9,556
March	78,002	11,058	10,368	47,666	8,910

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-1225

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 22, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $7,615 million of 13-week bills to be issued on April 25, 1991 and mature on July 25, 1991 were accepted today (CUSIP: 912794XA7).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.67%	5.85%	98.567
High	5.70%	5.88%	98.559
Average	5.69%	5.87%	98.562

$100,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 29%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	32,310	32,310
New York	24,503,885	6,192,370
Philadelphia	28,350	28,350
Cleveland	36,485	36,485
Richmond	49,580	49,580
Atlanta	21,060	20,350
Chicago	1,128,740	164,990
St. Louis	17,205	17,205
Minneapolis	7,755	7,755
Kansas City	31,970	31,970
Dallas	20,510	20,510
San Francisco	517,345	96,345
Treasury	916,460	916,460
TOTALS	$27,311,655	$7,614,680
Type		
Competitive	$22,845,635	$3,148,660
Noncompetitive	1,686,460	1,686,460
Subtotal, Public	$24,532,095	$4,835,120
Federal Reserve	2,546,860	2,546,860
Foreign Official Institutions	232,700	232,700
TOTALS	$27,311,655	$7,614,680

NB-1226

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 22, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $7,619 million of 26-week bills to be issued on April 25, 1991 and mature on October 24, 1991 were accepted today (CUSIP: 912794WV2).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.79%	6.06%	97.073
High	5.79%	6.06%	97.073
Average	5.79%	6.06%	97.073

$1,500,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 98%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	24,080	24,080
New York	22,536,705	6,736,045
Philadelphia	12,555	12,555
Cleveland	25,385	25,385
Richmond	40,930	40,930
Atlanta	19,540	18,540
Chicago	1,678,525	28,525
St. Louis	15,345	15,345
Minneapolis	3,510	3,510
Kansas City	30,540	27,540
Dallas	15,870	15,870
San Francisco	529,705	53,525
Treasury	616,800	616,800
TOTALS	$25,549,490	$7,618,650
Type		
Competitive	$20,766,915	$2,836,075
Noncompetitive	1,098,475	1,098,475
Subtotal, Public	$21,865,390	$3,934,550
Federal Reserve	3,050,000	3,050,000
Foreign Official Institutions	634,100	634,100
TOTALS	$25,549,490	$7,618,650

NB-1227

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 ECONOMIC POLICY,
TRADE, OCEANS AND ENVIRONMENT
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE
APRIL 23, 1991

Introduction

Mr. Chairman and Members of the Committee, it is a great pleasure to testify before you today on the critical role of the international financial institutions (IFIs) as instruments to achieve U.S. economic policy objectives in the world economy, and international and bilateral efforts underway to support economic reform. More specifically, I will be presenting the Administration's request for Congressional approval for U.S. participation in an increase of resources for the International Monetary Fund (IMF), a Special Capital Increase (SCI) for the Asian Development Bank (ADB), and the sixth replenishment of resources of the African Development Fund (AfDF).

I will also give you an update on the international debt strategy and the contribution of the IFIs to the strategy, discuss President Bush's Enterprise for the Americas Initiative (EAI), and review the role of the IFIs in protecting the global environment.

The International Monetary Fund (IMF)

The resource needs of the IMF are reviewed periodically to ensure that the Fund has adequate resources to fulfill its global responsibilities. Negotiations on the current increase began in 1987 and were scheduled to be concluded in 1988. The United States delayed conclusion of the negotiations by some two years, however, until there was a clear and compelling case for the increase and we were certain that an increased contribution would be wisely spent. Last year, the IMF concluded negotiations on a 50 percent increase in its resources from $130 to $195 billion.

The U.S. share of the increase is some $12 billion at current exchange rates, for which we will be seeking Congressional authorization and appropriations. This is the first quota increase since 1983.

NB-1228

Passage of this legislation is essential. The increase in IMF resources is vital if the Fund is to provide assistance throughout the world and to secure U.S. objectives in the new world order of multilateral cooperation. Following the onset of the Gulf crisis, the Fund adapted its procedures to help countries throughout the world address the economic costs of the crisis, including higher oil imports.

In Eastern Europe, the IMF is backing sweeping reforms aimed at restructuring economic life away from central planning and establishing the foundation for the transition to market economies. Especially in Poland, Hungary, and Czechoslovakia, IMF policy advice and financial support is opening up free markets and unlocking substantial additional resource flows. The Fund is also supporting debt and debt service reduction, particularly in Latin America, under the U.S.-led international debt strategy. In addition it is promoting comprehensive reforms for increased growth and the alleviation of poverty on concessional terms in Africa. Through its essential support for the international monetary system, the IMF is promoting a stronger world economy in which U.S. jobs and exports can thrive.

Overall Fund lending is expected to more than double in 1991 to $16 billion in disbursements and remain high in subsequent years. In addition to bolstering Fund liquidity to meet these near-term financing demands, the quota increase will provide for adequate Fund resources over the medium term.

The quota increase will also help the Fund to keep pace with the growth in the world economy. Over time, the size of the Fund's quotas has fallen significantly to roughly 4 percent of world imports. IMF quotas were at the 10 percent level during the 1960s. If the Fund is to be effective in its mission, it must be perceived as being of a meaningful size relative to the problems at hand in the world economy. This is necessary for countries to adopt appropriate adjustment measures and for the Fund to catalyze resources from other lenders.

Furthermore, the United States, as the leading and largest member of the IMF, has a special responsibility to do its part in the organization. Failure of the United States to support the quota legislation would seriously erode the effectiveness and credibility of the IMF.

In this context, the United States, with some 19 percent of the IMF's voting power, has effective veto over key IMF decisions, such as quota increases and amendments to the IMF's Articles, both of which require an 85 percent majority. This veto power has often proven essential to ensure that the Fund operated in a manner consistent with overall U.S. interests.

The IMF is also extremely cost-effective in supporting U.S. interests. First, the transfer of dollars to the IMF is like putting money into a checking account which is interest-bearing and can be drawn automatically. In recognition of this unique monetary character of the IMF, the U.S. quota involves no net budgetary outlays. Under the recent budget summit agreement, a specific provision was made to account for the unique budgetary treatment of the quota increase. While use by the IMF of the U.S. quota will increase Treasury's borrowing requirements, the interest earned on the U.S. position in the Fund offsets this cost. Furthermore, the IMF leverages our scarce resources, which is particularly important at this time of budget restraint. For every dollar we put in, others put in four.

During the quota negotiations, a number of steps were taken to ensure that U.S. resources would be used far more effectively by the IMF. Thus, at U.S. insistence, as an integral part of the quota negotiations, the United States gained agreement on a strengthened strategy to tackle the large and growing problems of arrears in payments to the Fund. In recent years, arrears to the Fund have grown to some $5 billion.

The strengthened arrears strategy is designed to protect the Fund's financial position. This strategy is well balanced, combining incentives for countries to clear their overdue obligations with disincentives to deter new arrears cases.

Mr. Chairman and Members of the Committee, the IMF is serving vital U.S. interests throughout the world. It is an extremely cost-effective organization. To ensure continued strong U.S. leadership in this critical global organization, I urge you to support the proposed increase in the U.S. quota share in the IMF.

The Multilateral Development Banks (MDBs)

U.S. participation in the World Bank Group and the regional MDB groupings is based on the same premise as our participation in the IMF -- to promote a sound world economy and increased prosperity for all countries. In an interdependent world this means furthering an international economic framework that is open and market-oriented to promote the efficiencies in production that trade fosters. These gains from trade make for a world-wide improvement in living standards.

MDB lending supports this general objective by mobilizing private sector and government resources to finance the basic infrastructure and service projects that improve productivity and living standards in developing countries. Loans from the World Bank and the regional MDBs have financed rural electricity, basic health care, agricultural extension, education, water and sewerage, environmental and resource management, telecommunications, private sector investment, and public sector reform projects.

Project viability, however, is determined not only by the rate of return on a specific project, but also is dependent upon the policy environment in which a particular project exists. Therefore, the MDBs also engage in adjustment lending to support sectoral and macroeconomic reforms to improve the domestic policy and institutional environment with the goal of moving a national economy toward self-sustaining economic growth. World Bank adjustment lending, in particular, provides an essential structural counterpart to the macroeconomic stabilizations provided by the IMF.

Stronger, more stable, growing developing country economies directly help the U.S. economy: they contribute to an expansion of employment in the United States through increased exports. In addition,the business contracts resulting from MDB projects are a direct and tangible benefit of U.S. participation in the MDBs.

These contracts are composed of three related elements. First, there is the procurement stemming directly from MDB-provided finance. U.S. businesses secured roughly $2.0 billion in contracts from the MDBs last year. This compares with U.S. budget expenditures for the MDBs averaging about $1.6 billion annually. Secondly, since the MDBs only provide a portion of the finance needed for a project, there are other procurement possibilities generated by non-MDB finance for a project. Finally, the business contacts established through U.S. business participation in bidding on MDB projects lead to follow-on business. In sum, MDB projects are an important nexus for the development of U.S. exports and jobs in the export sector, the value of which far exceeds our financial support for these institutions.

Financing the operations of these institutions is shared by all member countries. Consequently, U.S. interests in developing countries can be pursued through these institutions without the United States bearing the full burden. This is particularly important during periods of severe budgetary constraint.

For their market-related lending operations the MDBs leverage the callable capital guarantees of member countries to borrow funds on private capital markets. Hence, the majority of MDB loans are financed with relatively small cash outlays from MDB members, and are cost effective when compared with U.S. bilateral economic assistance.

Periodically we need to increase the capital base of the market-related "hard-loan windows" and replenish the resources of the concessional "soft-loan windows" of these institutions. This year we will be seeking Congressional approval for U.S. participation in a Special Capital Increase (SCI) of the Asian Development Bank

(ADB) and in the sixth replenishment of resources for the African Development Fund (AFDF). There have also been discussions between the management and executive directors of the International Finance Corporation (IFC) regarding justifications for an IFC capital increase.

When the ADB was established in 1966, the United States and Japan, as the two pre-eminent economic powers in the region, each subscribed to the same number of shares in the Bank's capital stock. The presumption was that equal ownership would be reflected in equal influence in the policies and operations of the Bank.

Although the situation has changed since then -- most notably with Japan's rapid growth and the expansion of its influence in Asia -- the United States' involvement and stake in the economic and political development of the Asian countries have remained strong. Also, the Asian Development Bank has evolved as a significant factor in the economic development of the poorer countries in the region. During this time we have adhered to the principle that the United States should keep its relative share in the ownership of the Bank's capital in order to maintain our influence in the ADB.

In 1988 Japan sought a Special Capital increase to make up for the decrease in its percentage ownership that had resulted from the entry of China in the Bank and a previous SCI for several European countries. The United States, in accordance with our long-time objective of maintaining parity with Japan, also joined, as did Sweden.

The SCI was approved by the ADB's Board of Governors in 1988. An agreement was reached, however, that the participating countries' contributions would not have to be made until later --during our fiscal years 1992 and 1993. The Administration is asking for $425 million to be authorized to be appropriated for purchasing U.S. shares in the SCI. The Administration will seek an appropriation of $51 million for paid-in shares, and program limitations in the amount of $374 million for callable shares.

In meeting our obligation under the SCI we will maintain the basis for our influence in the ADB and thus avoid ceding a measure of our influence in Asia in general, the world's most rapidly growing economic region. This is why we have agreed to participate in the SCI and seek the funds to meet our obligations under it.

In late February, the U.S. met all of its major policy objectives for the sixth replenishment of the African Development Fund (AfDF), and as a result, agreed to support a $3.4 billion increase in the resources of this institution over a three year period. As in the fifth replenishment, the U.S. would contribute 11.8 percent of the total, which is $405 million, or $135 million annually.

Full implementation of the agreement will result in a fundamental improvement in the quality of this institution's operations and will signal a new commitment by the donor community and management to make the AfDF a more effective and productive development institution.

The bulk of the Fund's resources will now be allocated to countries that are providing the economic environment conducive to development and growth. Countries not pursuing sound economic policies will be restricted to a defined program focussing on a limited number of projects that can be implemented successfully even in the face of adverse economic circumstances and policies. To improve loan quality, donors agreed on new Board procedures allowing executive directors with economic or technical concerns on a loan to return it to the Loan Committee so that these concerns may be addressed. We also reached agreement to strengthen the Fund's environmental staff, and increase emphasis on protection of forests and promotion of energy efficiency and conservation.

The IFC serves U.S. policy goals in promoting the emergence of a competitive private sector in developing countries. Nevertheless, the IFC could be more effective in both promoting needed developing country policy changes, and in encouraging the rest of the World Bank group to give higher priority to the private sector. The United States is, therefore, reviewing the proposal of IFC management to increase IFC's capital in the broader context of the need for the entire World Bank group to give significantly greater priority to private sector developments in the 1990s. The World Bank's private sector activities should be strengthened and enhanced, and there should be better coordination between the World Bank and the IFC on key policy issues regarding private sector development and privatization. We are encouraging both the IFC and World Bank to increase their support for privatization of government entities. We also want the IFC to be more selective in the countries and sectors in which it operates.

<u>The International Debt Strategy</u>

The international community has called on the IMF and World Bank to assume pivotal roles in addressing external debt problems of developing countries.

The international debt strategy, which has been shaped in large part through U.S. leadership, has proven effective. Under the debt strategy, we have seen real progress in reducing the debt burdens of countries with strong economic reform programs. Eight countries with substantial commercial bank debt -- including two of the largest debtor countries, Mexico and Venezuela -- have reached agreements with their commercial banks on packages that include debt and/or debt service reduction. These countries account for almost half of the total commercial bank debt of the major debtor countries. The benefits are substantial. For example:

* The Mexican agreement reduced annual interest payments by 33 percent ($1.5 billion); commercial bank debt was reduced by 38 percent; and the burden of $42 billion in principal payments was removed.

* The Costa Rican agreement reduced that country's commercial bank debt by 62 percent and cut annual debt service payments by 74 percent.

Chile, Venezuela, Morocco, the Philippines and Uruguay have also reached agreements involving significant reductions in debt burdens. Nigeria has recently reached an agreement in principle with its banks on a debt reduction package. Several other countries are continuing discussions with their banks including Argentina, Bolivia, Brazil, Ecuador and Poland.

These debt reduction agreements enable debtor countries and commercial banks to address their disparate needs. Furthermore, these agreements are producing results for debtor economies by helping restore investor confidence and stimulate new investment flows.

The support of the IMF and World Bank is vital to achieving these agreements. The economic reform programs countries undertake with these institutions enable countries to gain credibility with their creditors and to proceed with negotiations. The IMF has committed $2.8 billion and the World Bank $2.7 billion to support specific debt and debt service reduction instruments in countries that have reached agreements with their commercial banks under the strengthened debt strategy. As proposed in the President's Enterprise for the Americas Initiative, the Inter-American Development Bank is joining the IMF and World Bank in providing support for these commercial bank packages.

The ongoing support from these institutions will help debtor countries achieve real gains through economic reform and commercial bank debt reduction.

The Paris Club of creditor governments has reached an historic agreement to reduce Polish official bilateral debt by 50 percent in real terms. The restructuring will occur in two stages, including reduction of interest payments by 80 percent for the first three years. This agreement reflects the culmination of vigorous U.S. efforts to achieve multilateral agreement on substantial debt and debt service reduction for Poland. In addition, President Bush has announced that the United States is prepared to increase U.S. debt relief for Poland beyond the Paris Club consensus. A portion of the additional relief will help Poland fund a new foundation for the environment.

This agreement provides a strong signal of creditor support for Polish economic and democratic reforms. Together with the conclusion of a new IMF program, it should help provide a sound basis for sustained economic growth in Poland. Both measures should also provide strong encouragement for new investment and capital flows to Poland.

Enterprise for the Americas Initiative

In a further effort to strengthen the economies of our neighbors in Latin America and the Caribbean and to improve trade opportunities in the hemisphere, President Bush announced last June the new Enterprise for the Americas Initiative (EAI).

This region is of vital interest to the United States. Ten years of slow growth and debt overhang have plagued the economies of Latin America and the Caribbean and thwarted opportunities for the hemisphere as a whole.

The Enterprise for the Americas Initiative aims to address these problems through action in three areas -- trade, investment, and debt. It thereby joins in a single endeavor the three economic issues of greatest importance to the region. It also seizes, in terms of timing and concept, on important developments already underway in the region -- including the spread of democracy and a clear commitment on the part of many leaders in the region to pursue reforms that will improve their economic prospects and make them more competitive in attracting capital.

We are making real progress in implementing the vision laid out in the Initiative. To increase trade and move toward the goal of a hemispheric free trade system, we are pursuing a Free Trade Agreement (FTA) with Mexico and Canada. The goal of this agreement is to foster sustained economic growth for all three countries, which together compose a market of over 360 million people and $6 trillion in output. This FTA should expand and lock in recent trade and investment liberalization achieved by the Salinas Administration. As you know, the President has sent a formal request to Congress seeking extension of fast track authority, which will enable us to negotiate effectively such an FTA agreement.

The debt reduction proposed under the Initiative will be an important incentive for countries to carry out investment reforms. We gained authority from Congress to undertake reduction of concessional PL-480 debt for countries pursuing strong economic reform programs, including liberalization of their investment regimes. We will be discussing such debt reduction with individual countries as they become eligible.

The Initiative will also provide significant benefits for the environment within the hemisphere pursuant to EAI Environmental

Framework Agreements negotiated with each eligible country. Interest payments made in local currency on the reduced PL-480 and, eventually, AID debts will remain in the country to support a broad range of environmental projects. We expect local non-governmental organizations with expertise in the environment and conservation to play a strong role in determining the use of these environmental funds.

The President transmitted to the Congress on February 26, legislation seeking authority from Congress to implement fully the investment and debt elements of the Initiative. The Administration is also requesting funding for implementation of debt reductions and the creation of a multilateral investment fund to support policy reform.

We are also seeking authorization of $500 million over five years for a U.S. contribution to the Multilateral Investment Fund (MIF) which the President proposed be established in the Inter-America Development Bank (IDB). This Fund would target resources to support specific aspects of investment reform and to help ease some of the burden of investment liberalization.

The Investment Fund will channel resources through three facilities: the Technical Assistance Facility; the Human Resources Facility; and the Enterprise Development Facility. A large portion of available resources will fund grant assistance for development of human resources and business infrastructure, thus making countries more attractive to potential investors and help to mitigate the social costs of investment reform. These resources can help speed implementation of needed reforms and moderate social dislocations. With such support, governments can pursue reforms aggressively during a window of opportunity while minimizing the potential for social unrest and political pressures in emerging democracies. In addition, the Investment Fund will channel market-priced resources to and through non-governmental organizations (NGOs) and financial institutions to stimulate creation or expansion of small businesses.

We are proposing that the Investment Fund be created with a one-time capitalization of $1.5 billion to be paid over a 5-year period, with the U.S. providing one-third of the contributions. We have invited Japan to share the leadership of this effort with the United States. Indeed, I am pleased to inform you that at the annual meeting of the IDB in Nagoya, Japan, earlier this month, the Government of Japan announced its support for the Multilateral Investment Fund and encouraged other countries to follow the U.S. and Japanese lead. We propose that the balance be funded by other non-borrowing members of the IDB, many of whom have strong traditional ties with the region.

The need to attract capital in order to build upon reforms already underway is at the heart of every country's development challenge.

While other programs and organizations already exist which attempt to address these needs, the proposed new Investment Fund will direct capital to areas which until now have not received adequate attention.

Existing institutions are not equipped to respond quickly and flexibly to meet the challenge of simultaneous and fast-paced reform on a variety of fronts. High quality technical assistance must be in place prior to major decisions on privatization and on investment policy reform is such areas as the regulatory environment, the tax system, and the financial sector. Technical assistance must also be available to help countries improve vital business infrastructure such as telecommunications, without which no amount of policy reform will enable a country to attract additional private investment. Resources for retraining and human resource development must equally be assured to workers fearful of change. And smaller businesses must see that they can participate in the new opportunities created by freer markets.

This type of assistance requires costly, one-time grant financing which is not supplied on a large scale by existing multilateral development banks (MDBs). The MDBs cannot generate sufficient income surpluses through their operations to finance the level of technical assistance required. We and the other members of these institutions, plus bond rating agencies, insist that MDB operating expenses be fully covered in MDB loans. This rules out subsidizing loans to finance the technical assistance and detailed diagnostic studies envisioned; hence the need to establish a MIF to provide these resources.

We have been discussing this proposal in detail with the IDB and other donor governments. There is no question that the IDB and the IIC will continue to be important to the overall adjustment efforts of the Latin American and Caribbean countries. They will make crucial contributions to private investment in many countries. Implementing sweeping changes in investment climates requires broad policy control which we can only obtain through a multilateral approach in an institution that the region respects, namely, the IDB. To accomplish the goals of opening their investment regimes and attracting capital, countries rely on a range of programs, including IIC private sector equity and loans and the traditional sector and project financing of the IDB. However, while these programs provide critical support, they cannot substitute for the financial resources and additional expertise that the MIF can bring to bear. For these reasons, we urge your immediate and full support for the Multilateral Investment Fund.

<u>Environmental Considerations</u>

The environment has been an extremely important element in our overall approach to economic issues in recent years. Economic progress will be sustainable only in the context of sound environmental practices. Hence, environmental considerations must be integrated more effectively into the on-going operations of the international financial institutions.

This concern led us to negotiate an environmental framework for the IDA-9 Replenishment Agreement in 1990. It is the reason we took such a strong stance on these issues in negotiating replenishment of the African Development Fund and the establishment of the European Bank for Reconstruction and Development. It underlies the great weight we have given to three key issues: environmental impact assessment, protection of tropical forests, and promotion of energy efficiency and conservation measures.

We believe the World Bank and the IDB will be ready to implement new environmental impact assessment procedures in line with legislation passed in the last Congress. The World Bank is reassessing its forest policy and taking a new look at energy efficiency and conservation alternatives. It has created a special unit for energy efficiency and conservation for its operations in Eastern Europe and is restructuring its Energy Sector Management Assistance Program.

These reforms represent a significant commitment to strengthen environmental capability in the MDBs. However, additional effort is still needed to assure effective implementation. This year we will look for new opportunities to influence energy policy and promote more energy efficiency and conservation projects. We are seeking more rapid progress on environmental impact assessment in the Asian and African Development Banks. We will consider further improvements and refinements, if they are needed, in the procedures already being adopted by the World Bank and the Inter-American Development Bank. We will continue our efforts to secure greater protection for tropical forests, including reform of the Tropical Forestry Action Plan.

We also want to encourage innovative programs that can be a catalyst for more rapid environmental progress within developing countries. That is why we have encouraged debt-for-nature swaps and put so much emphasis on the environmental element of the Enterprise for the Americas Initiative, and will devote a portion of Poland's debt relief to help fund a Polish environmental foundation. In addition, we have offered to provide up to $150 million in parallel financing to the World Bank's Global Environmental Facility over its three life. Our objective in the facility is to foster greater interest in pilot projects that can become part of regular lending programs in future years. We also want to encourage a more open process that involves the scientific and NGO communities.

The United States is also at the forefront in encouraging the IMF to enhance its environmental focus. Widespread recognition has emerged that IMF macroeconomic policy advice and prescriptions can have at times an important, though indirect, impact on environmental protection. In particular, the IMF has decided to establish a group of economists that will serve as a liaison with other organizations on environmental research and advise the Fund on addressing environmental concerns. Also, most IMF country documents now discuss environmental concerns. The IMF has also strengthened its collaboration with the World Bank in taking account of structural measures for environmental protection in its work.

Conclusion

The United States relies heavily on the international financial institutions (IFIs) to promote a sound, environmentally safe, world economy and stable international monetary system. The successful operation of IFI activities makes one additional contribution: the promotion of peace and democracy among nations. These are important matters, as I am sure you will agree, Mr. Chairman. It is critical that the Executive and Legislative Branches of our government continue to coordinate their activities closely on these issues.

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M. April 23, 1991

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 May 2, 1991. This offering will result in a paydown for the Treasury of about $4,000 million, as the maturing bills are outstanding in the amount of $20,011 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, April 29, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Daylight Saving time, for competitive tenders. 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 2, 1990, and to mature August 1, 1991 (CUSIP No. 912794 WS 9), currently outstanding in the amount of $20,754 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $8,000 million, to be dated May 2, 1991, and to mature October 31, 1991 (CUSIP No. 912794 XL 3).

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 May 2, 1991. 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 $1,140 million as agents for foreign and international monetary authorities, and $4,702 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-1229

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 competitive 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

TEXT AS PREPARED
NOT FOR RELEASE UNTIL DELIVERY
Expected at 10:00 a.m.
Wednesday, April 24, 1991

TESTIMONY OF BARRY S. NEWMAN
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL MONETARY AFFAIRS
BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES
APRIL 24, 1991

Thank you, Mr. Chairman.

I am pleased to have this opportunity to present the Treasury Department's views on U.S. policy on trade in financial services and on the Fair Trade in Financial Services Act of 1991.

TRADITIONAL POLICY OF NATIONAL TREATMENT

At the outset, I would like to emphasize that the Treasury Department strongly believes that everyone benefits from open financial markets which are easily accessed by domestic and foreign participants. The benefits which accrue from competition in the financial services sector include increased liquidity, greater access to financing, lower cost of funds, and in general, a smoother functioning of financial markets. The strength, size and depth of U.S. financial markets certainly attest to such benefits.

The prevailing policy of the United States is to provide national treatment to foreign participants in the establishment and operation of financial institutions within the United States. For example, the International Banking Act of 1978 generally provides treatment for foreign banks that is no less favorable than that accorded U.S. banks in similar circumstances.

The results of this national treatment policy are clearly evidenced by the significant presence of foreign financial firms in the United States. As of June, 1990, 284 foreign banks had 721 offices, with assets totalling $734 billion, approximately 20

NB-1230

percent of total U.S. commercial bank assets. Foreign banks provide 17 percent of total lending in the U.S. and nearly 30 percent of total business loans. In some areas the role of foreign banks is much larger. For example, foreign banks provide 60 percent of the business loans in New York and about 50 percent in California.

Foreign banks, as illustrated by these numbers, have obviously benefitted from our open market policy. So has the entire U.S. economy. The Administration's legislative proposal for modernizing the U.S. financial system maintains the traditional policy of national treatment for foreign firms and will permit them to take advantage of the new opportunities on the same terms and conditions as U.S. financial service providers.

The United States has also persistently pressed for open financial markets and national treatment abroad in both bilateral and multilateral fora. For example, the Treasury Department has been engaged in bilateral talks with Japan since 1984 to open Japanese financial markets and improve foreign firms' access. These discussions have resulted in greater opportunities for U.S. and other countries' financial firms in the government securities markets, on the Tokyo Stock Exchange, and in various activities such as trust banking and foreign exchange trading.

Treasury has held similar talks with Korea and Taiwan where we have achieved some limited progress in opening those markets. Negotiations with the Canadians four years ago resulted in a U.S.-Canadian Free Trade Agreement which contained significant liberalization measures for financial services. We hope to be able to extend liberalization in a similar arrangement to Mexico, with which we have also been engaged in financial market talks. Discussions with the European Community have also been useful in clarifying the status of U.S. firms as the EC moves towards a single unified financial market in 1993.

In the OECD, Treasury has pressed for the principle of national treatment in various OECD agreements and has encouraged individual OECD member countries to adopt policies of open markets and national treatment.

In the Uruguay Round, the Treasury has been the U.S. Government agency responsible for negotiating a financial services agreement which would contain legally binding obligations calling for both market access and national treatment for financial institutions. We hope the Uruguay Round will improve financial services worldwide and lead to liberalization in a wide range of countries, particularly in the newly industrializing economies of Asia and Latin America.

1990 NATIONAL TREATMENT STUDY

While progress has been made over the years, the 1990 National Treatment Study demonstrated that U.S. firms continue to face difficulties in gaining access to many foreign markets. Significant progress was noted in Canada and in most European countries. However, the findings for other foreign financial markets were less satisfactory with regard to the ability of U.S. firms to participate fully and effectively.

Progress in Japan was found to be disappointingly slow and incomplete. For example, foreign banks' competitive opportunities have been effectively reduced by regulated interest rates, restrictive operating regulations, strong ties among related Japanese firms (keiretsu), excessive compartmentalization of financial markets and lack of transparency. Foreign securities firms cite difficulty in introducing new products and in underwriting and distributing domestic bond and equity issues.

In other Asian countries, such as Korea and Taiwan, progress was considered inadequate, with serious barriers to U.S. financial firms still existing. In Korea, U.S. and other foreign banks face discriminatory restrictions on their ability to establish and branch, and to obtain local currency funding. Until this year, foreign securities firms had not been permitted to establish branches.

In Taiwan, foreign banks face restrictions regarding their ability to fund themselves competitively in local currency. They also face restrictions on branching and are prohibited from establishing subsidiaries. In securities activities, with the exception of two recently approved foreign branches, foreign financial firms are only permitted limited ownership in securities operations.

Significant denials of national treatment were also noted in Latin America. Until recently, Mexico has been closed to foreign financial firms although current reform measures will permit foreign ownership of up to 30 percent of the banks being privatized. In Brazil, the establishment of new foreign bank branches, subsidiaries or securities firms are banned by the 1988 Constitution. Severe restraints also exist on the establishment of foreign bank branches and subsidiaries in Venezuela.

MOVEMENT TOWARD RECIPROCAL NATIONAL TREATMENT OVERSEAS

While the U.S. generally adheres to a policy of national treatment, many countries have moved toward a reciprocal national treatment policy whereby foreign firms are accorded national treatment only if the home country market of the foreign firm offers national treatment. In 1984, only 11 OECD members had reciprocity powers. By January 1993, at least 18 out of the 24

OECD members will have such powers available, including such major financial centers as Japan, the U.K. and Germany.

This trend is perhaps best illustrated by the European Community's legislation to establish an integrated market in banking and securities by the end of 1992. An early draft of the Second Banking Directive included a potential mirror image reciprocity provision. Such a provision would have limited the activities of U.S. firms in the EC to those activities which EC firms could undertake in the U.S. As a result, U.S. firms would have been treated less favorably than their competitors in the EC. Following discussions with the United States, this Directive was revised to provide for reciprocal national treatment.

FAIR TRADE IN FINANCIAL SERVICES ACT

The movement towards reciprocity or reciprocal national treatment in many other industrial countries and the slow progress in achieving national treatment and equality of competitive opportunity have raised the issue of whether the United States needs additional policy tools to attain U.S. objectives. Some have called for a change in our fundamental policy of national treatment, such as that contained in the Fair Trade in Financial Services Act.

The bill provides authority for the Secretary of the Treasury to publish in the Federal Register a determination that a particular country denies national treatment to U.S. financial firms. After publication of such a determination, U.S. financial regulators may deny applications for financial activities, after appropriate consultation with the Secretary. The bill also requires the Secretary of the Treasury to initiate negotiations with countries where there are significant denials of national treatment for U.S. firms.

The Treasury Department initially opposed proposals to adopt a reciprocal national treatment policy because of concern that even limited reciprocity would involve the risk that sanctions would be imposed and that retaliation would follow. Such action could have a potentially serious impact on global financial markets.

Treasury worked with the sponsors of the bill last year to modify those parts which we found most objectionable. Our primary objective was to obtain greater discretion and flexibility in the bill. As a result of these efforts, the provisions on financial services in the short-term extension of the Defense Production Act, S.468, were modified to respond to Treasury's concern. As a result, the Treasury has withdrawn its opposition to that bill.

TREASURY NEWS

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

TEXT AS PREPARED
FOR RELEASE UPON DELIVERY
EXPECTED AT 10 A.M.
APRIL 24, 1991

STATEMENT BY
THE HONORABLE DAVID C. MULFORD
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

It is a great pleasure to testify before you today on the subject of the Enterprise for the Americas Initiative. The Initiative has received broad support from Latin American and Caribbean leaders. It holds out the hope of a future of strong economic partnerships and sustained growth throughout the hemisphere. As we move forward to implement the Initiative, the Administration depends on the support of Congress to make the vision of the Initiative a reality.

Announced by President Bush last June, the Enterprise for the Americas Initiative (EAI) is designed to deepen and expand for our mutual benefit the wide array of trade and investment ties which link the United States with its neighbors in Latin America and the Caribbean. This is a region with which we share a common cultural heritage, and whose many new leaders have shown a strong commitment to democratic values and market-based economic reforms.

The President tailored his Initiative to the concerns of Latin American and Caribbean countries by proposing action in three areas of vital importance to them -- trade, investment, and debt. The Initiative rests on these three pillars, each of which represents a major priority for action.

<u>Advancing Free Trade</u>

As we work to expand trade through the Initiative, our long term goal is to establish a hemispheric free trade area. In announcing the Initiative, President Bush stated that the United States stands ready to enter into free trade agreements (FTAs) with Latin American and Caribbean countries, in particular with groups of countries that have associated for the purpose of trade liberalization. The first step in this process is the FTA we propose to negotiate with Mexico and Canada. We are also negotiating framework agreements with individual countries and groups of countries in the region to address technical issues and begin to reduce barriers to trade.

Ambassador Katz, in his testimony, will explore with you in greater detail our efforts in this area and, in particular, the importance of gaining fast-track negotiating authority. For my part, I want to emphasize the importance of the trade pillar to the success of the Enterprise for the Americas Initiative and, more fundamentally, to the future of relations between the United States and its neighbors.

The trade pillar of the Initiative cannot be considered in isolation. Rather, it should be viewed in terms of its contribution to the overall objective of the Initiative -- to create a partnership with Latin America that will lay the foundations for long-term growth. By itself, a free trade agreement would not necessarily succeed in bringing substantial economic benefits. But free trade is a cornerstone of a broader economic system based on market principles. It is that broader system that the Enterprise for the Americas Initiative seeks to foster jointly through its trade, investment, and debt pillars.

For the relatively small Latin American economies to open themselves to imports means to accept a set of relative prices determined by market forces and based on economic fundamentals. The discipline of market prices limits the latitude to use government intervention to distort resource allocation for the benefit of the few and the detriment of the overall economy. For example, opening borders to imports makes it increasingly difficult to subsidize loss-making government enterprises, protect industries through restricting new competition, and set prices by decree. Clearly, a commitment to free trade reflects a more fundamental commitment to a market-based economy.

For years we have been urging the countries of Latin America to eliminate barriers to trade and investment -- barriers that impede their own economic growth. Now, under the Initiative, we are offering them a tough but fair deal -- they commit themselves to effective market-oriented policies, and we undertake to negotiate reciprocal free trade relationships based on a balance of benefits and obligations.

The deal is tough because successful free trade agreements will require greater reform in Latin American countries than in the United States. The reason is simple: our barriers to trade and investment are far lower than theirs. For instance, our average tariff is less than half that of any country in Latin America; our investment climate is far more open; our trade in services is virtually free of restrictions; and we have a modern, effective system of intellectual property protection.

But why should Latin American countries accept agreements which will require them to shoulder the greater burden of policy reform? Ten, five, or even two years ago, the magnitude of the reforms required would have given them pause. Today, however, there is an emerging consensus in Latin America that the reforms implied by free trade agreements -- broader macroeconomic and structural reforms as well as elimination of barriers to trade and investment -- are prerequisites for renewed economic growth.

Those countries that have already embarked on reform are interested in seeking reciprocal elimination of trade barriers from their trading partners. In this sense, the timing of the EAI is crucial. It has met with such an enthusiastic response in Latin America because it harnesses an underlying momentum. But, while these countries are taking bold steps for their future, the temptation to slip back is ever-present. Our willingness to negotiate reciprocal free trade agreements would encourage ongoing reform and liberalization in the region. It offers a way to codify, make more permanent, and increase public support for these reforms.

Why is this a fair deal for the United States? What would we gain from free trade with Latin American countries under the EAI? First, in terms of U.S. trade policy interests, we benefit from elimination of barriers to our exports of goods and services. Because Latin America has higher barriers to trade and investment than we do, we stand to gain more in a direct way than the Latin American countries in a direct way from elimination of those barriers.

Second, we will gain from having more prosperous neighbors, and therefore more valuable trading partners, as reforms give rise to faster growth. The U.S. currently supplies about forty percent of Latin American and Caribbean imports -- as established trading partners, we are well positioned to benefit from increased capacity to trade on the part of Latin America and the Caribbean. Third, open, dynamic economies will be stronger partners in the world trading system. Their success will encourage other countries to adopt similar policies in international fora, like the GATT. Finally, we have an interest in the prosperity of Latin America that goes beyond immediate economic benefits -- an interest that rests on a shared heritage, ties of family and culture, and geographical proximity.

Our vision of a hemispheric free trade area is a realistic one. The first step towards this goal, discussing a free trade agreement with Mexico, has been made possible by the remarkable reforms that have transformed Mexico's economy in the last few years. These reforms are being mirrored in other countries in the hemisphere. Fast track authority is essential for us to seize this moment, to build upon and cement this momentum towards more open economies and faster growth throughout the hemisphere.

Without fast track we will miss this unique opportunity to form a new partnership in the Western Hemisphere.

Increasing Capital Flows to the Region

The investment pillar of the Initiative zeroes in on the importance of increasing capital flows to Latin America and the Caribbean.

A number of countries in the region have made substantial progress in implementing macroeconomic and structural reforms. These are fundamental steps toward stronger and more vibrant economies. Without the needed capital to finance growth, however, they will not experience the full benefits of market-oriented economic reform.

The need to attract capital in order to build upon reforms already underway is at the heart of every country's development challenge. Resources in today's world are limited. Commercial banks are no longer extending loans that provide broad support for economic growth. The lessons of the 1980s taught us that more debt is not the answer, yet countries now face the challenge of meeting their financing needs in the absence of significant commercial bank lending. Creditor governments also face constraints on their ability to provide economic assistance, while events in Eastern Europe and the Middle East have added heavily to demands for such assistance.

Private investment is therefore receiving new priority as a source of capital for development and growth. Latin American and Caribbean countries must compete more aggressively to draw the interest of investors and to recover the savings of their own people. To help countries undertake this challenge, we proposed that the Inter-American Development Bank (IDB) establish a new investment sector lending program. This program will provide guidance and financial support for specific measures to open investment regimes.

The IDB is already moving forward with this program. Negotiations of investment sector loans have begun with four countries, and we understand that the first loans are expected to be ready for consideration by the IDB Board of Directors in June. Two additional countries are planning to begin discussions with the IDB in the near future. A number of other countries have also expressed interest in pursuing IDB investment sector loans.

Loans extended under this program will make a critical difference in the competition for capital. Additional, more directly targeted support is also needed, however. For this reason, President Bush has proposed creation of a new Multilateral Investment Fund, administered by the IDB. This Fund would direct resources to support specific investment reform actions and would help ease some of the burden of undertaking these measures.

While existing institutions, including the IDB and the Inter-American Investment Corporation, continue to play a critical role in the overall adjustment and development efforts of Latin America and the Caribbean, we believe that a new Fund is required to provide the concentration of financial resources needed by countries poised to make a major commitment to radically overhauling and opening their investment regimes. We envision that this Fund would place special emphasis on smaller countries in the region, such as those in Central America and the Caribbean.

Resources will be channeled through three facilities in the Fund.

- ♦ The Technical Assistance Facility will help finance technical assistance to facilitate privatization and other investment-related policy reforms. It will also assist government efforts to improve vital business infrastructure, without which no amount of policy reform will enable a country to attract additional private investment.

- ♦ The Human Resources Facility will fund grant assistance to moderate social dislocations resulting from investment reforms. With this kind of support, governments can pursue reforms aggressively within a window of opportunity while minimizing the potential for social unrest and other pressures on emerging democracies.

- ♦ The Enterprise Development Facility will channel market-priced resources through non-governmental organizations and other financial institutions to stimulate creation or expansion of small and micro-sized enterprises. In this way, the Fund will help entrepreneurs access capital and make productive contributions to these economies.

Our goal is to establish a Fund of $1.5 billion over a five year period. We are seeking authority from Congress for a U.S. contribution of $500 million over five years. Based on extensive discussions with the IDB and other creditor governments at the recent IDB annual meeting, we are optimistic that other non-borrowing members of the IDB, many of whom have strong traditional ties with the region, will provide the remaining resources. Most notably, Japan has indicated that it will contribute an appropriate amount to the Fund. In the context of a shared commitment among donors to help countries take the steps to compete for capital, I hope we can count on your support for the U.S. contribution.

Building Economic Confidence: The Need to Address Debt Burdens

The overhang of external debt has constrained the resources available for growth and tested the resolve of nearly every government in Latin America and the Caribbean. By easing the burden of debt for countries committed to necessary economic reforms, we can help them attract new investment capital and reinforce the rewards of sound economic policies.

The debt pillar of the Enterprise for the Americas Initiative takes such a pragmatic approach. By proposing to reduce bilateral debt owed to the U.S. Government by eligible countries, the Initiative complements international efforts under the Brady Plan to address commercial bank debt problems. Reducing bilateral debt will be particularly important for the relatively small countries of the region that owe a substantial portion of their external debt to official creditors, rather than to commercial banks.

Last year's farm bill provided the authority to reduce PL-480 debt for countries pursuing strong economic and investment reform programs and to channel local currency interest payments to environmental projects in each country. We also have the approval of the appropriators to proceed. The President has signed an Executive Order providing for implementation of this authority.

Several countries -- including Chile, Jamaica, and Bolivia -- are well positioned to qualify for PL-480 debt reduction in the next few months. Other countries could also move to qualify in the near future. The potential for bilateral official debt reduction has been welcomed throughout the region. Countries are eager to benefit; we are working with them to establish eligibility and will begin discussing reduction of their PL-480 debt once they meet necessary conditions.

To offer the full potential benefits of the debt reduction proposed under the Initiative, however, we must gain authority from Congress to undertake reduction of AID debt. PL-480 debt constitutes only about one-fourth of the $7 billion in concessional debt owed to the U.S. by countries in the region. A far larger share of this debt (some $5 billion) is owed to AID. Substantial debt relief will therefore need to involve action on AID debt as well. We are also seeking authority to sell a portion of Eximbank loans and CCC assets in order to facilitate investments in equity, environmental, or development projects in eligible countries. These swaps will help reduce the stock of non-concessional, market-rate debt owed to the U.S. while promoting productive contributions to debtor economies.

I want to emphasize that by reducing bilateral official debt, we hope not only to ease countries' financial burdens and help restore the confidence of investors but also to provide significant support for the environment. Interest payments on reduced concessional debt obligations will be made in local currency into an Environmental Fund in the debtor country. The resources in each Fund will be programmed by a local administering body composed of representatives from the debtor country, the U.S. government, and local non-governmental organizations.

Similar government cooperation with non-governmental organizations will characterize the Washington oversight of this process. The Environment for the Americas Board will advise the U.S. Government on negotiation of environmental framework agreements, ensure that local administering bodies are appropriately constituted, and review annual programs and reports on operations prepared by each local body. We look forward to working with the environmental community, which has developed valuable expertise both on funding projects and on building community support for environmental protection and conservation.

By creating a dedicated stream of payments to support environmental projects, the Initiative can help assure ongoing support for sustained environmental progress. It will also make an important contribution to building institutional capacity in local organizations and, thereby, to generating long-term grass roots support for protection and preservation of the environment.

Realizing a New Vision for the Hemisphere

Strong, vibrant Latin American and Caribbean economies will benefit our hemisphere and the world as a whole. To respond to the efforts underway in Latin America and the Caribbean, we must be prepared to move forward on each element of the Initiative -- trade, investment and debt.

To work credibly with other countries toward a hemispheric free trade area, it is critical that we gain fast track negotiating authority. To proceed with support for the opening of investment regimes and the reduction of bilateral debt, we also need authority from Congress. The President transmitted on February 27 a legislative proposal that would provide the latter authorities; positive action on this legislation will send a strong signal to Latin America and the Caribbean about U.S. commitment to following through on the Initiative.

The United States shares with its neighbors in Latin America and the Caribbean high hopes for the future. As they turn toward stronger, market-oriented economies, leaders throughout the region are enthusiastically embracing our common objectives of enhanced growth and prosperity. The United States must also do its part. I hope we can count on your support.

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 24, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 2-YEAR NOTES

Tenders for $12,006 million of 2-year notes, Series Z-1993, to be issued on April 30, 1991 and mature on April 30, 1993 were accepted today (CUSIP: 912827A51).

The interest rate on the notes will be 7 %. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	6.99%	100.018
High	7.00%	100.000
Average	7.00%	100.000

Tenders at the high yield were allotted 96%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	53,190	53,185
New York	40,328,825	11,024,070
Philadelphia	34,805	34,795
Cleveland	48,895	48,895
Richmond	617,050	74,790
Atlanta	45,930	42,915
Chicago	1,659,020	64,020
St. Louis	88,875	76,875
Minneapolis	27,270	27,270
Kansas City	112,865	109,865
Dallas	21,910	21,910
San Francisco	729,395	78,335
Treasury	349,100	349,100
TOTALS	$44,117,130	$12,006,025

The $12,006 million of accepted tenders includes $1,317 million of noncompetitive tenders and $10,689 million of competitive tenders from the public.

In addition, $928 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $577 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1232

TREASURY NEWS

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

TEXT AS PREPARED
FOR RELEASE UPON DELIVERY
EXPECTED AT 2 P.M.
APRIL 25, 1991

STATEMENT BY
THE HONORABLE DAVID C. MULFORD
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON WESTERN HEMISPHERE AFFAIRS
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

I welcome this opportunity to discuss with you the Enterprise for the Americas Initiative.

Full implementation of the Initiative is a matter of high priority for the Administration. Advancing the goals of the Initiative is in the best interest of the United States. Our economy is linked to Latin American and Caribbean countries through a wide array of trade and investment ties, which the President's Initiative is uniquely positioned to deepen and expand for our mutual benefit. This is a region with which we share a common cultural heritage, and whose many new leaders have shown a strong commitment to democratic values and market-based economic reforms.

These leaders have welcomed the President's proposals under the Initiative, which holds out the hope of a future of strong economic partnerships and sustained growth throughout the hemisphere. We need to respond to their enthusiasm and the efforts they are making to reform their economies. In his trips to Mexico and South America late last year, President Bush was impressed with the commitment on the part of leaders in the region to pursue reforms that will improve their economic prospects and make them more competitive in attracting capital.

To move forward with these countries in advancing the aims of the Initiative, the Administration depends on the support of Congress. In particular, I seek your support for the legislative proposal transmitted by President Bush on February 26 which would provide authority to implement fully the investment and debt elements of the Initiative.

The President tailored the Initiative to the concerns of Latin American and Caribbean countries themselves by proposing action in three areas of vital importance to them -- trade, investment, and debt. The Initiative rests on these three pillars, each of which represents a major priority for action. I want to review with you briefly the progress made to date in each of these areas.

Advancing Free Trade

As we work to expand trade through the Initiative, our long term goal is to establish a hemispheric free trade area. In announcing the Initiative, President Bush stated that the United States stands ready to enter into free trade agreements (FTAs) with Latin American and Caribbean countries, in particular with groups of countries that have associated for the purpose of trade liberalization.

The first step in this process is the FTA we propose to negotiate with Mexico and Canada. Such an agreement would foster sustained economic growth for all three countries, which together compose a market of over 360 million people and $6 trillion in output. This step toward a hemispheric free trade area has been made possible by the remarkable reforms that have transformed Mexico's economy in the last few years. These reforms are being mirrored in other countries in the hemisphere. Fast track authority is essential for us to seize this moment, to build upon and cement this momentum towards more open economies and faster growth throughout the hemisphere. Without fast track we will miss a unique opportunity to form a new partnership in the Western Hemisphere.

Meanwhile, to advance our goal of hemispheric free trade, the Administration is negotiating framework agreements with individual countries and groups of countries in the region. Framework agreements establish fora for addressing and consulting on bilateral trade and investment issues. They contain immediate action agendas listing specific trade and investment issues of concern to both parties and areas in which liberalization is needed. Through these agreements, we can discuss the requirements for free trade agreements and facilitate negotiations when the appropriate time arrives.

Framework agreements have been signed since June with six countries -- Colombia, Ecuador, Chile, Honduras, Costa Rica, and Venezuela -- adding to those already in place with Mexico and Bolivia. Negotiations are also underway with a number of other countries.

I want to emphasize the importance of the trade pillar to the success of the Enterprise for the Americas Initiative and, in reality, to the future of relations between the United States and its neighbors. Free trade is a cornerstone of a broader economic system based on market principles. It is that broader system that the Enterprise for the Americas Initiative seeks to foster jointly through its trade, investment, and debt pillars.

For the relatively small Latin American economies to open themselves to imports means to accept a set of relative prices determined by market forces and based on economic fundamentals. The discipline of market prices limits the latitude to use government intervention to distort resource allocation for the benefit of the few and the detriment of the overall economy. For example, opening borders to imports makes it increasingly difficult to subsidize loss-making government-controlled enterprises, protect industries through restricting new competition, and set prices by decree. Clearly, a commitment to free trade reflects a more fundamental commitment to a market-based economy.

Why should Latin American countries accept agreements which will require them to shoulder the greater burden of policy reform? Ten, five, or even two years ago, the magnitude of the reforms required would have given them pause. Today, however, there is an emerging consensus in Latin America that the reforms implied by free trade agreements -- broader macroeconomic and structural reforms as well as elimination of barriers to trade and investment -- are prerequisites for renewed economic growth.

Those countries that have already embarked on reform are interested in seeking reciprocal elimination of trade barriers from their trading partners. In this sense, the timing of the Initiative is crucial. It has met with such an enthusiastic response in Latin America because it harnesses an underlying trend. But, while these countries are taking bold steps for their future, the temptation to slip back is ever-present. Our willingness to pursue FTAs would encourage Latin American countries to deepen and accelerate an ongoing movement toward open markets. It offers a way to make more permanent and increase public support for these reforms.

Why is this a fair deal for the United States? What would we gain from free trade with Latin American countries under the Initiative? The U.S. currently supplies about forty percent of Latin American and Caribbean imports -- as established trading partners, we are well positioned to benefit from increased capacity and openness to trade on the part of Latin America and the Caribbean. We will gain from having more prosperous neighbors, and therefore more valuable trading partners, as reforms give rise to faster growth. Furthermore, open, dynamic economies will be stronger partners in the world trading system. Their success will encourage other countries to adopt similar policies in international fora, like the GATT.

Increasing Capital Flows to the Region

The investment pillar of the Initiative zeroes in on the importance of increasing capital flows to Latin America and the Caribbean.

A number of countries in the region have made substantial progress in implementing macroeconomic and structural reforms. These are fundamental steps toward stronger and more vibrant economies. Without the needed capital to finance growth, however, they will not experience the full benefits of market-oriented economic reform.

The need to attract capital in order to build upon reforms already underway is at the heart of every country's development challenge. Resources in today's world are limited. Commercial banks are no longer extending loans that provide broad support for economic growth. The lessons of the 1980s taught us that more debt is not the answer, yet countries now face the challenge of meeting their financing needs in the absence of significant commercial bank lending. Creditor governments also face constraints on their ability to provide economic assistance, while events in Eastern Europe and the Middle East have added heavily to demands for such assistance.

Private investment is therefore receiving new priority as a source of capital for development and growth. Latin American and Caribbean countries must compete more aggressively to draw the interest of investors and to recover the savings of their own people. To help countries undertake this challenge, we proposed that the Inter-American Development Bank (IDB) establish a new investment sector lending program. This program will provide guidance and financial support for specific measures to open investment regimes.

The IDB is already moving forward with this program. Negotiations of investment sector loans have begun with four countries, and we understand that the first loans are expected to be ready for consideration by the IDB Board of Directors in June. Two additional countries are planning to begin discussions with the IDB in the near future. A number of other countries have also expressed interest in pursuing IDB investment sector loans.

<u>Reducing Debt Burdens and Providing Support for the Environment</u>

The overhang of external debt has constrained the resources available for growth and tested the resolve of nearly every government in Latin America and the Caribbean. By easing the burden of debt for countries committed to necessary economic reforms, we can help them attract new investment capital and reinforce the rewards of sound economic policies.

The debt pillar of the Enterprise for the Americas Initiative takes such a pragmatic approach. By proposing to reduce bilateral debt owed to the U.S. Government by eligible countries, the Initiative complements international efforts under the Brady Plan to address commercial bank debt problems. Reducing bilateral debt will be particularly important for the relatively small countries of the region that owe a substantial portion of their external debt to official creditors, rather than commercial banks.

In last year's farm bill, the Administration gained authority to reduce PL-480 debt for countries pursuing strong economic and investment reform programs and to channel local currency interest payments to environmental projects in each country. We have the approval of the appropriators to proceed, and the President has signed an Executive Order providing for implementation of this authority.

Several countries -- including Chile, Jamaica, and Bolivia -- are well positioned to qualify for PL-480 debt reduction in the next few months. Other countries could also move to qualify in the near future. The potential for bilateral official debt reduction has been welcomed throughout the region. Countries are eager to benefit; we are working with them to establish eligibility and will begin discussing reduction of their PL-480 debt once they meet necessary conditions.

I want to emphasize that by reducing bilateral official debt, we hope not only to ease countries' financial burdens but also to provide significant support for the environment. If the debtor country has entered into an environmental framework agreement, interest payments on reduced concessional debt obligations will be made in local currency into an Environmental Fund in the debtor country. The use of resources from each Fund will be determined by a local administering body composed of representatives from the debtor country, the U.S. government, and local non-governmental organizations.

This process for funding environmental projects with local currency interest payments on reduced debt is designed to nurture grass roots support for the environment in Latin America and the Caribbean. The wealth of natural resources in the region cannot be valued. While the amount of resources provided by local currency interest payments will be limited, we believe that this program can make a significant difference by targeting small projects and building local community infrastructure for addressing environmental issues. Furthermore, by bringing the government and non-governmental organizations in individual countries to serve together on local administering bodies, we can promote the kind of partnership that will help these countries devote greater attention to the protection and preservation of the environment in the region.

To make this process effective, the Administration intends to work closely with our own non-governmental environmental organizations. For this reason, the Environment for the Americas Board, which will oversee the environmental element of the Initiative, will have a strong non-governmental component. This Board will advise the U.S. Government on negotiation of environmental framework agreements, ensure that local administering bodies are appropriately constituted, and review annual programs and reports on operations prepared by each local body. We look forward to working with the environmental community, which has developed valuable expertise both on funding projects and on building community support for environmental protection and conservation.

The President's Legislative Proposal

Significant progress has indeed been made in advancing the goals of each pillar of the Initiative. To move ahead with full implementation of the Initiative, however, we must gain the authority from Congress contained in the legislative proposal transmitted by the President on February 26. These authorities affect both the investment and debt elements of the Initiative.

Loans extended under the IDB's new investment sector lending program will make a critical difference in the competition for capital. However, additional, more directly targeted support is also needed. For this reason, we have proposed creation of a new Multilateral Investment Fund, administered by the IDB. This Fund would direct resources to support specific investment reform actions and would help ease some of the burden of undertaking these measures.

Existing institutions, including the IDB and the Inter-American Investment Corporation, continue to play a critical role in the overall adjustment and development efforts of Latin America and the Caribbean. We believe that a new Fund is required to provide the concentration of financial resources needed by countries poised to make a major commitment to radically overhauling and opening their investment regimes. We envision that the Fund would place special emphasis on smaller countries in the region, such as those in Central America and the Caribbean.

Resources will be channeled through three facilities in the Fund.

- The Technical Assistance Facility will help finance technical assistance to facilitate privatization and other investment-related policy reforms. It will also assist government efforts to improve vital business infrastructure, without which no amount of policy reform will enable a country to attract private investment.

- The Human Resources Facility will fund grant assistance to moderate social dislocations resulting from investment reforms. With this kind of support, governments can pursue reforms aggressively within a window of opportunity while minimizing the potential for social unrest and other pressures on democracies.

- The Enterprise Development Facility will channel market-priced resources through non-governmental organizations and other financial institutions to stimulate creation or expansion of small and micro-sized enterprises. In this way, the Fund will help entrepreneurs access capital and make productive contributions to these economies.

Our goal is to establish a Fund of $1.5 billion over a five year period. We are seeking authority from Congress for a U.S. contribution of $500 million over five years. Based on extensive discussions with the IDB and other creditor governments at the recent IDB annual meeting, we are optimistic that other non-borrowing members of the IDB, many of whom have strong traditional ties with the region, will provide the remaining resources. Most notably, Japan has indicated that it will contribute an appropriate amount to the Fund. In the context of a shared commitment among donors to help countries take the steps to compete for capital, I hope we can count on your support for the U.S. contribution.

To offer the full potential benefits of the debt reduction proposed under the Initiative, however, we must gain authority from Congress to undertake reduction of AID debt. The authority we have already gained to reduce PL-480 debt allows us to act on only about one-fourth of the $7 billion in concessional debt owed to the U.S. by countries in the region. A far larger share of this debt (some $5 billion) is owed to AID. Substantial debt relief will therefore need to involve action on AID debt as well. We have also proposed to sell a portion of Eximbank loans and Commodity Credit Corporation (CCC) assets acquired through CCC's export credit guarantee programs in order to facilitate debt-for-equity, debt-for-nature, or debt-for-development swaps in eligible countries. These transactions will help reduce the stock of non-concessional, market-rate debt owed to the U.S. while promoting productive contributions to debtor economies.

Without additional authority from Congress, we would only be in a position to implement pieces of the Initiative as proposed by the President. As a result, our response to the concerted efforts of our neighbors to reform their economies and attain sustained growth would be partial at best. Positive action on this legislation, on the other hand, will send a strong signal to Latin America and the Caribbean about U.S. commitment to a new partnership to benefit the hemisphere as a whole.

Realizing a New Vision for the Hemisphere

Strong, vibrant Latin American and Caribbean economies will benefit our hemisphere and the world as a whole. To respond to the efforts underway in Latin America and the Caribbean, we must be prepared to move forward on each element of the Initiative -- trade, investment and debt.

The United States shares with its neighbors in Latin America and the Caribbean high hopes for the future. As they turn toward stronger, market-oriented economies, leaders throughout the region are enthusiastically embracing our common objectives of enhanced growth and prosperity. The United States must also do its part. I hope we can count on your support.

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 25, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 5-YEAR NOTES

Tenders for $9,057 million of 5-year notes, Series N-1996, to be issued on April 30, 1991 and mature on April 30, 1996 were accepted today (CUSIP: 912827A69).

The interest rate on the notes will be 7 5/8%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	7.69%	99.734
High	7.70%	99.694
Average	7.70%	99.694

$20,000 was accepted at lower yields.
Tenders at the high yield were allotted 84%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	25,869	25,869
New York	30,650,271	8,762,671
Philadelphia	16,136	16,136
Cleveland	33,041	33,029
Richmond	31,488	28,488
Atlanta	19,140	19,138
Chicago	919,291	35,281
St. Louis	26,673	22,673
Minneapolis	15,787	15,787
Kansas City	29,879	29,879
Dallas	4,856	4,856
San Francisco	688,930	28,830
Treasury	34,448	34,448
TOTALS	$32,495,809	$9,057,085

The $9,057 million of accepted tenders includes $550 million of noncompetitive tenders and $8,507 million of competitive tenders from the public.

In addition, $215 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $200 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1234

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

AS PREPARED FOR DELIVERY
EMBARGOED UNTIL 8:30 P.M.
(9:30 P.M. EDT)
April 25, 1991

Contact: Desiree Tucker-Sorini
(202) 566-8773

THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
REMARKS TO THE
INTERAGENCY SUPERVISION CONFERENCE
DALLAS, TEXAS
APRIL 25, 1991

Thank you, Tim [Ryan]. Chairman Seidman, Comptroller Clarke, and your colleagues here tonight representing the Federal Reserve, FDIC, OTS, OCC, and RTC -- I appreciate the invitation to speak to your conference and to discuss the U.S. economy and the Administration's banking reform proposal.

I have just returned from a trip to Europe and the Middle East, where I consulted with our G-7 partners, as well as other economic and business leaders in those regions. The purpose of my trip, undertaken at the request of the President, was to evaluate the financial and economic policies that will be needed to address the new challenges facing the world community.

We live in a highly integrated global system in which economic power is shared. A decade of prosperity based on economic growth has brought with it expanding responsibilities for all countries. A world of twenty-four hour global communications, instantaneous fund transfers and interdependent economies is necessarily a world of increased responsibility sharing. Obviously, each country will look to its own interests, but at the same time, as a community of nations, we must keep a strong weather eye on the fact that we are economically interdependent. The unique success of the international response to Iraqi aggression demonstrates how a common cause widely agreed to can advance our shared interests.

NB-1235

In the United States, we are meeting our international responsibility by reaffirming our commitment to low-inflationary economic growth. As the President said to a Joint Session of Congress earlier this year, "Our first priority is to get this economy rolling again." Most economists anticipate an end to the current recession by mid-year, and a resumption of moderate growth as the year progresses. The return to positive growth will be based on export opportunities, lower and more stable oil prices, increased credit availability, and lower interest rates.

I have no doubt we will see economic figures that send mixed signals before we see clearer signs of a turnaround. And that is why, in the long run, the most important domestic economic development is the President's budget agreement with Congress which has reformed Federal government spending and created the framework for future economic growth.

Think about it. The 1990 budget agreement mandates a $492 billion reduction in federal borrowing over the next five years and dictates that federal spending shall be governed by the principle of pay-as-you-go. Since these reforms, the Federal Funds rate has fallen from 8% in October 1990 to 6% today. This was not an accident. This was President Bush's plan. Remember, prior to the budget agreement, Chairman Greenspan said a "credible, enforceable reduction in the budget deficit" would result in lower interest rates. The President forged just such an enforceable reduction package and interest rates have dramatically declined.

Those who don't think this will help stimulate economic growth are dead wrong. Americans who have received downward adjustments in their variable rate mortgages and home equity credit lines certainly understand what it means. Those who can buy a car or a house with substantially lower monthly payments know what it means. Lower interest rates and monthly payments have always made a difference before and they will now.

Although these developments are encouraging, this does not mean we have rested on our oars. And, we are taking additional steps which will strengthen the economy both in the short-run and the long-term.

In the short-run, in order to encourage the economic turnaround, we have taken steps to address the credit crunch. On March 1, 1991, your agencies announced a series of guidelines and clarifications aimed at facilitating credit for sound borrowers. These steps were developed and agreed to by your leadership to assure that the supervisory process is not, in and of itself, contributing to a tightening of credit. As your announcement stated: "We do not want the availability of credit to sound borrowers to be adversely affected by supervisory policies or depository institutions' misunderstandings about them."

The guidelines and clarifications were issued to provide examiners with the confidence to use their own common sense and judgment. The new guidelines will also provide borrowers with hope that appropriate lines of credit will be renewed. Customers will believe that a worthy, new project has a chance for funding, even in sectors where an institution may have a concentration of loans it is trying to reduce.

You and the 7,000 supervision professionals who work with you have a critical role to play in this effort. Banks will lend when they have financial strength and confidence. Unfortunately, this is not always the case. Instead, we are told that a widespread anxiety is being expressed by banks that regulatory overkill is directly contributing to a lack of credit availability.

But this is not an academic lecture. We recognize you have a difficult job to do. Many of you may have vivid memories of Congressional hearings called to evaluate the actions and judgments of bank supervisors. Believe me, I know how you feel -- that your judgments are reviewed only when loans go bad and second-guessed with the 20-20 vision of hindsight. It is not often -- perhaps never -- that an examiner receives public praise for using balance and common sense, but that's exactly what your responsibilities and the welfare of the country require that you do.

We all realize that bank examination -- just like bank lending -- is an art, not a science. And the new guidelines are intended to complement the tools examiners employ as they do their job.

You are on the front line of economic vitality in this country. The financial industries you oversee perform an essential role in stimulating and sustaining economic growth. So you must be mindful that the way you do your job can have a profound effect on the willingness of banks to lend. The regulators' recent guidelines were not intended to be just a press release to be cast aside. They are meant to be an expression of the philosophy of common sense. But, the guidelines will remain only guidelines until you and your colleagues apply them in your examinations.

I should also make it clear that bankers have a responsibility to meet. As President Bush said in his State of the Union address, "Sound banks should be making sound loans, now." I have urged the banks not to overreact and to keep lending to their good customers. There are many ways to strengthen a balance sheet in addition to shedding loans.

Many have said to us that bankers hesitate because of fear of regulators, and that the regulators bear down too hard for fear of being second-guessed. This has led to fingerpointing between regulators and banks. Neither the banking industry, nor the regulatory community will be able to resume its constructive, time-honored roles if this state of mind continues. With your help, we can achieve a balanced regulatory environment which gives financial institutions the confidence to make sound loans, while at the same time protecting the depositor from speculative, risky investments.

We must address the current credit crunch, but we must also come to terms with longer range problems in the financial services industry. One of the Administration's top domestic priorities is to modernize our antiquated 40- and 50-year old banking laws. This is important not just for the financial services sector, but for the economy as a whole. Businesses must be able to count on our financial services firms, particularly banks, in bad times as well as good.

As we have seen in the current economic downturn, weak banks are forced to pull back just when their good customers need them most. When loans stop at the first sign of trouble, jobs are imperiled. If we expect to exert world economic leadership in the 21st century, we must have a modern, world-class financial services system in our country. Right here in the United States.

Consumers need a broader choice of financial products when they go to the bank. Businesses and workers need strong, well-capitalized banks that can keep lending in economic downturns. The nation needs a banking system that is strong enough to compete toe-to-toe with the best our international rivals have to offer. And most of all, the taxpayer needs to be spared the prospect of another costly and unnecessary cleanup.

Today, the United States does not have a single bank among the world's 25 largest. Twenty years ago we led the standings with the top three and had seven banks in the top 25. Of course, the question of pure size is not the whole story. But against the backdrop of an economy that is twice the size of our nearest competitor's, I wonder if anyone can explain the complete absence of U.S. banks from the list of world leaders.

Surely that statistic tells us something. To me, it is strong evidence that something is very wrong. Would we be comfortable with no aerospace companies in the world's top 25? No pharmaceutical companies? No computer manufacturers? Of course not.

This is not a size issue, but a competitiveness issue. Foreign banks are increasing lending in the United States as American banks lose market share here at home. While some bank stock prices are up, two of our largest banks have recently turned to foreign sources for a capital infusion.

The simple fact is, our banks -- large and small -- are being asked to compete in a highly competitive world financial services market with one hand tied behind their backs. For example, we have out-of-date laws on the books that prohibit banks from getting into new financial markets, and even keep them from branching across state lines. Banks in California, Michigan and Texas can open branches in Birmingham, England, but not in Birmingham, Alabama.

These laws are totally out of touch with reality. And they impose unnecessary expenses on banks and consumers that have been estimated to cost $10 billion annually, compared to total industry pre-tax profits of just $25 billion. Taking the simple step of permitting interstate branching would significantly improve the soundness of our banking system and could lead to lower interest rates for American borrowers and lower transaction costs for depositors.

Consumers have long since begun to ignore the artificial restrictions on banking practices, using credit cards, cash machines, and the 800 number to handle their financial affairs when and where they want. Customers have increasingly turned away from the banks, and now get auto loans from GMAC and Ford Motor Credit, checking services from Vanguard and Fidelity mutual funds, business loans through General Electric Credit Corporation and Goldman Sachs, and they save at Merrill Lynch and Sears Roebuck. Well-capitalized banks should be allowed to participate in the full range of services in their natural markets -- but to do so safely, outside the bank and outside the federal deposit insurance safety net.

We also have a deposit insurance system that has wandered away from its original purpose of protecting only the small depositor. This safety net now covers almost every depositor, large and small, sophisticated and trusting, insured and uninsured. The system has bailed out large, money-wise investors who don't need the protection, and exposed the taxpayer to potential losses.

What does this all add up to? Bank failures totalled 198 in the 38 years from 1942 to 1980, but reached 206 in 1989 alone. The Bank Insurance Fund (BIF) is at its lowest level in history as a percentage of insured deposits. The FDIC has projected that it will decline still further over the next two years. Without an infusion of funds, the FDIC could find itself with too little cash to pay for losses, resulting in possible exposure for the taxpayer. The Bank Insurance Fund must therefore be recapitalized with industry funds.

How do we reverse this trend? How do we help banks provide better and less expensive services to the consumer, attract capital, and lend when the economy is weak? The answer is plain: We need to overhaul our outdated laws which hinder the banks ability to provide consumers with better services, lower costs, and the funds necessary to stimulate economic growth. As we strengthen our banking system, we strengthen the ability of banks to raise capital and compete internationally.

Our banks hold $2.8 trillion in deposits. That means that, ultimately, there is simply no bank insurance fund large enough to protect the taxpayer, unless and until we address the underlying problems. We need to have deposit insurance reform, supervisory reform, and a recapitalized Bank Insurance Fund. But we also need interstate branching and broader financial activities so that our banks can finance economic growth.

Some have suggested that any financial services legislation passed this year should be restricted to just recapitalizing the Bank Insurance Fund. This is the height of folly. We should reform the industry and fix the problem, not just fund it.

The time has come to address these problems at their core; to deal with them decisively and comprehensively; and to put this country's financial services industry back where it belongs: number one in the world.

If we leave the job half done -- if we only tinker with the problem -- then we'll probably be back again, sooner rather than later, recapitalizing the Bank Insurance Fund again, perhaps the next time with taxpayer money. That's a prospect no one could relish.

By facing up to the reality of the marketplace today, we can help to ensure financial security for the future. Modernizing our financial services industry, encouraging sound lending practices, holding down the Federal Government's spending, pushing for lower U.S. interest rates and encouraging low-inflationary economic growth around the world will contribute to the strength of our own economy. With President Bush's leadership we can achieve these policy objectives and provide for a secure economic future, not only for all Americans, but for all nations. With your help, we'll get it done.

Thank you.

###

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
AS PREPARED FOR DELIVERY

CONTACT: Cheryl Crispen
(202) 566-2041
Charlotte Mehuron
(817) 847-3864

THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
DEDICATION CEREMONY FOR BEP WESTERN CURRENCY FACILITY
APRIL 26, 1991
FORT WORTH, TEXAS

Thank you, Cathi (Villalpando). It's a pleasure to be here with some great Texans -- including Senator Phil Gramm, Representative Pete Geren, and Mayor Bob Bolen. And I'm happy to extend greetings on behalf of another favorite son of Texas -- President George Bush.

I would also like to mention a great Texan whom we miss -- John Tower. John served this state and his country ably and with distinction for nearly 30 years. I was fortunate to serve with him in the Senate. His sudden loss is a tragic one for Texas and the nation, and I know his pride for the Lone Star State still lives on in many of you here for this celebration.

Today, we are making history. This is the first time the Treasury Department will be printing currency outside of Washington, D.C.

This is the result of five years of planning, hard work and cooperative spirit. It is a significant achievement that will buttress currency production in the United States, while spurring economic growth here in Texas.

The story of America's currency is a story of progress. When the first bills -- or greenbacks -- were issued in 1862 to help pay for the Civil War, it was a small operation. Only six employees were separating and sealing one- and two-dollar bills in the basement of the Treasury Building in Washington. And the operation has not stopped growing since.

By 1880, the operation was too big for the Main Treasury Building, so a new facility was built. And 34 years later -- 1914 -- the Bureau of Engraving and Printing expanded once again into an even larger building. Finally, a third annex building was ready for business in 1938 -- housing a total force of 3,000 employees and almost 25 acres of floor space.

For the next 50 years, the nation's demand for currency continued to increase -- by about five percent every year. America's population was expanding, and the demand for dependable U.S. dollars overseas has grown and grown. In fact, more than 60 percent of our circulating currency is now in foreign countries throughout the world.

Here at home, the demand is also great. The average one-dollar bill lasts only about 18 months. Five- and ten-dollar bills last only two or three years. In 1991 alone, the Federal Reserve System will need about eight billion new notes of all denominations.

The opening of the Western Currency Facility means we now have another state-of-the-art facility to help meet our increasing currency needs. By 1994, this facility will be capable of producing up to 40 percent of our nation's currency supply -- more than four billion notes every year.

I know we can count on the motivation and commitment of the people here in Fort Worth. Fort Worth has been a forward-looking city with a sound blueprint for growth. Business activity here is diversified. The workforce is educated and highly trained. This city is an ideal setting for any modern employer, and the Treasury is proud to be a part of it.

While we are employing about 300 workers on this site, city leaders believe every job here creates more jobs in the private sector.

The new Western Currency Facility is a real success story for Fort Worth and Texas. In 1985, the Bureau of Engraving and Printing started the selection process with 85 possible sites. In the end, Fort Worth was the choice. The community galvanized its skills and resources to provide overwhelming support for the project:

-- My friend, Senator Phil Gramm, has been a tireless and consistent advocate in Washington. He never lets up where Texas is concerned.

-- Mayor Bob Bolen also kept the enthusiasm alive by lending his leadership and support from start to finish.

-- The Fort Worth Chamber of Commerce played a key role in securing contributions equalling $15 million for the project. This includes a donation of 100 acres of land, along with a promise to provide the building's outer structure.

-- The U.S. Army Corps of Engineers and an architectural team joined the Bureau of Engraving and Printing in designing a facility to help meet the nation's needs well into the 21st century.

-- And, Pete Daly and his colleagues at the Bureau have also done a tremendous job of directing the project.

Today, the Western Currency Facility is ready for action with a full staff of trained professionals -- press operators, mechanical examiners, bookbinders, security experts and managers. They are the backbone of this operation, and they are making it work. Starting this fiscal year, the facility will produce about 800 million one-dollar notes. And, as Texans, I'm sure you will all recognize with pride the big "FW" printed on each bill.

The Western Currency Facility is now an important part of Fort Worth. And to commemorate this occasion, I'd like to ask Mayor Bolen to join me in unveiling the dedication plaque.

The plaque reads:

"The Western Currency Facility is a monument to the commitment of local community and business leaders and the United States Government. Their partnership has created the first currency production facility outside of Washington, D.C. May this facility stand as a cornerstone for the industrial and technological development of Fort Worth."

I am confident all Americans will benefit from this facility, and I look forward to watching it grow with the needs of our nation. As this operation expands, we will make more than money; we will make history.

Thank you all very much.

###

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

FOR IMMEDIATE RELEASE
April 25, 1991

Contact: Bob Levine
(202) 566-2041

ASSISTANT SECRETARY (MANAGEMENT) DR. LINDA M. COMBS RESIGNS

Dr. Linda M. Combs, Assistant Secretary (Management), has tendered her resignation to return to North Carolina to help care for her mother, who is suffering from Alzheimer's disease.

In accepting her resignation, Secretary Nicholas F. Brady said, "Linda has done an outstanding job as a member of the Treasury team and she will be missed."

Dr. Combs has been responsible for directing the Treasury Department's personnel and financial management, information systems and administrative operations.

She has also been the principal policy advisor to the Secretary and Deputy Secretary on the annual planning and budget process.

She was confirmed as Assistant Secretary on July 27, 1989.

Prior to coming to the Department of the Treasury Dr. Combs served in the Department of Veterans Affairs, the Department of Education and as an advisor to the governor of North Carolina.

NB-1237

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

FOR IMMEDIATE RELEASE
April 26, 1991

CONTACT: Charlotte Mehuron
(817)847-3864
(202)287-0140

U.S. Currency Being Produced Outside of Washington for First Time
-- Now Being Produced in Fort Worth, Texas

(Fort Worth, TX) -- Secretary of the Treasury Nicholas F. Brady today accepted one of the first dollar bills printed outside of Washington, D.C., at the dedication ceremony of the new Bureau of Engraving and Printing Western Currency Facility in Fort Worth, Texas.

In accepting the dollar bill, Secretary Brady said, "Today, we are making history. For the first time, the Treasury Department will print currency outside of Washington, D.C. Using state-of-the-art technology, this new facility will be able to meet the growing needs of currency production in the United States and throughout the world."

Currency production at the new facility began in January 1991 and the first notes are expected to be released into public circulation by the Federal Reserve System by July 1991. Approximately 800 million one dollar notes are scheduled for production this fiscal year. When fully equipped in 1994, this modern facility is expected to produce 4.5 billion notes per year or 40 percent of the Federal Reserve System's requirements. Production efficiencies will result from advanced, high-speed intaglio (engraved) printing presses, and a flexible, spacious production and processing layout.

Fort Worth was selected for the new facility from 83 other applicant cities. The winning proposal packaged nearly $15 million of local donations, including 100 acres of land, site improvements and a 280,000 square foot building shell. In addition to these private sector donations, the Federal Government has invested $110,000 million to complete and equip the facility.

Joining Secretary Brady at the Dedication Ceremony were United States Treasurer Catalina V. Villalpando, Senator Phil Gramm and Congressman Pete Geren. The Director of the Bureau of Engraving and Printing Peter H. Daly, the Mayor of Fort Worth Bob Bolen, and the Chairman of the Board of the Fort Worth Chamber of Commerce Gary Cumbie also participated in the ceremony.

The Western Currency Facility is located at 9000 Blue Mound Road, in Fort Worth, Texas.

oOo

NB-1238

Removal Notice

The item identified below has been removed in accordance with FRASER's policy on handling sensitive information in digitization projects due to

Citation Information

Document Type:

Number of Pages Removed:

Author(s):

Title:

Date:

Journal:

Volume:

Page(s):

URL:

federal financing bank NEWS
WASHINGTON, D.C. 20220

Press 566-2041
FFB 566-2468

FOR IMMEDIATE RELEASE April 25, 1991

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of March 1991.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $181.9 billion on March 31, 1991, posting an increase of $0.2 billion from the level on February 28, 1991. This net change was the result of a decrease in holdings of agency-guaranteed loans of $35.2 million, while holdings of agency debt increased by $46.3 million and holdings of agency assets increased by $181.5 million. FFB made 25 disbursements during March.

FFB holding on March 31, 1991, were the highest in the bank's history.

Attached to this release are tables presenting FFB March loan activity and FFB holdings as of March 31, 1991.

NB-1239

FEDERAL FINANCING BANK

MARCH 1991 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
EXPORT-IMPORT BANK					
Note #95	3/1	$ 102,000,000.00	12/1/98	7.601%	7.530% qtr.
Note #96	3/1	8,000,000.00	3/3/03	8.121%	8.286% ann.
Note #97	3/1	976,000,000.00	9/3/91	6.443%	
RESOLUTION TRUST CORPORATION					
Note No. 91-02					
Advance #6	3/4	700,000,000.00	4/1/91	6.392%	
Advance #7	3/7	400,000,000.00	4/1/91	6.403%	
TENNESSEE VALLEY AUTHORITY					
Short-term Bond #84	3/1	294,000,000.00	3/18/91	6.333%	
Short-term Bond #85	3/11	124,000,000.00	3/25/91	6.391%	
Short-term Bond #86	3/18	223,000,000.00	3/31/91	6.067%	
Short-term Bond #87	3/25	64,000,000.00	4/1/91	6.182%	
Short-term Bond #88	3/29	19,000,000.00	4/8/91	6.120%	
Short-term Bond #89	3/31	249,000,000.00	4/8/91	6.043%	
AGENCY ASSETS					
FARMER'S HOME ADMINISTRATION					
RHIF - CBO #57553	3/16	125,000,000.00	3/16/06	8.280%	8.451% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
Certificates of Beneficial Ownership					
CBO #33	3/31	56,700,000.00	3/31/01	8.173%	

FEDERAL FINANCING BANK

MARCH 1991 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					
Morocco 9	3/1	$ 15,322.00	3/31/94	7.411%	
GENERAL SERVICES ADMINISTRATION					
U.S. Trust Company of New York					
Advance #6	3/5	1,502,323.04	5/15/91	6.359%	
Advance #7	3/8	938,386.30	5/15/91	6.391%	
Advance #8	3/27	2,254,983.96	5/15/91	6.172%	
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
*Boston, MA	3/1	2,514,938.40	3/1/96	7.753%	7.903% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
M & A Electric Power Coop. #337	3/5	1,005,000.00	1/3/23	8.355%	8.270% qtr.
Brazos Electric #230A	3/8	2,667,000.00	1/3/22	8.291%	8.207% qtr.
Brazos Electric #332	3/8	20,000.00	12/31/19	8.276%	8.192% qtr.
Tri-State Electric #336	3/15	4,481,000.00	12/31/20	8.242%	8.159% qtr.
Western Illinois Power #294	3/18	1,192,000.00	1/2/18	8.309%	8.224% qtr.
Cornbelt Power #292	3/21	370,000.00	1/2/18	8.335%	8.250% qtr.
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-91-05	3/29	590,333,997.07	6/28/91	6.121%	

*maturity extension

FEDERAL FINANCING BANK
(in millions)

Program	March 31, 1991	February 28, 1991	Net Change 3/1/91-3/31/91	FY '91 Net Change 10/1/90-3/31/91
Agency Debt:				
Export-Import Bank	$ 11,180.5	$ 11,370.2	$ -189.7	$ -159.3
NCUA-Central Liquidity Fund	60.2	63.2	-3.0	3.6
Resolution Trust Corporation	56,990.7	55,890.7	1,100.0	15,509.0
Tennessee Valley Authority	13,258.0	14,119.0	-861.0	-1,124.0
U.S. Postal Service	6,697.8	6,697.8	-0-	-0-
sub-total*	88,187.1	88,140.9	46.3	14,229.2
Agency Assets:				
Farmers Home Administration	52,669.0	52,544.0	125.0	620.0
DHHS-Health Maintenance Org.	69.6	69.6	-0-	-0-
DHHS-Medical Facilities	82.7	82.7	-0-	-0-
Rural Electrification Admin.-CBO	4,463.9	4,407.2	56.7	56.7
Small Business Administration	7.3	7.5	-0.2	-1.1
sub-total*	57,292.5	57,111.0	181.5	675.6
Government-Guaranteed Loans:				
DOD-Foreign Military Sales	4,730.1	4,769.0	-39.0	-5,025.6
DEd.-Student Loan Marketing Assn.	4,850.0	4,850.0	-0-	-30.0
DHUD-Community Dev. Block Grant	222.1	224.7	-2.7	-21.9
DHUD-Public Housing Notes +	1,903.4	1,903.4	-0-	-47.4
General Services Administration +	483.3	478.6	4.7	115.9
DOI-Guam Power Authority	29.1	29.7	-0.7	-0.7
DOI-Virgin Islands	24.7	24.7	-0-	-0.5
NASA-Space Communications Co. +	32.7	32.7	-0-	-1,063.2
DON-Ship Lease Financing	1,624.4	1,624.4	-0-	-47.9
Rural Electrification Administration	18,903.5	18,906.4	-2.9	-138.8
SBA-Small Business Investment Cos.	309.9	313.4	-3.1	-72.6
SBA-State/Local Development Cos.	719.9	723.0	-3.1	-21.7
TVA-Seven States Energy Corp.	2,395.1	2,383.5	11.6	39.0
DOT-Section 511	22.4	22.5	-0.1	-0.9
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	36,427.4	36,462.6	-35.2	-6,316.3
grand total*	$ 181,907.0	$ 181,714.5	$ 192.6	$ 8,588.6

*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
April 26, 1991

Contact: Desiree Tucker-Sorini
202-566-8773

Statement by
Nicholas F. Brady
Secretary of the Treasury

A majority of the House Banking Committee including the Republican caucus, joined by a number of Democrat members, have voiced support for the need to do comprehensive bank reform as part of the recapitalization of the Bank Insurance Fund. In addition, all the banking regulators agree there is a need for comprehensive reform.

Chairman Gonzales and Subcommittee Chairman Annunzio have indicated they intend to push ahead with a bill which recapitalizes BIF and provides no structural reforms.

This narrow bill approach is the wrong way to go. We must reform the fundamental problems in the banking industry, not just fund them. We must fix the problem, not just feed it. If we fail to make comprehensive reforms now, we are likely to be back again in a few years recapitalizing BIF, this time perhaps with taxpayer money.

FDIC Chairman Seidman has said that the fund will not need more resources before October, and perhaps much later than that. Bank depositors are safe. There is ample time to do the job right. I call on the House Banking Committee to consider and adopt a comprehensive reform bill as part of the measures to recapitalize BIF. Let's do the job once and do it right.

###

NB-1240

TREASURY NEWS

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

FOR RELEASE AT 12:00 NOON
April 26, 1991

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 $ 11,750 million of 364-day Treasury bills to be dated May 9, 1991 and to mature May 7, 1992 (CUSIP No. 912794 YM 0). This issue will provide about $ 1,600 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $ 10,139 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Thursday, May 2, 1991 prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Daylight Saving time, for competitive tenders.

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 May 9, 1991. In addition to the maturing 52-week bills, there are $ 20,140 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 $ 1,679 million as agents for foreign and international monetary authorities, and $ 7,523 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 $ 200 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-1241

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 competitive 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

April 28, 1991

STATEMENT OF THE GROUP OF SEVEN

The Finance Ministers and Central Bank Governors of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States met on April 28, 1991, in Washington, D.C. for an exchange of views on current international economic and financial issues. The Managing Director of the International Monetary Fund (IMF) participated in the discussions of the economic situation and outlook in the world economy.

The Ministers and Governors underscored that their countries are part of a highly interdependent global economy in which economic power and responsibility is shared. Accordingly, they reiterated that the pursuit of international economic policy coordination is essential to achieving their common objective of sustained growth with price stability and reaffirmed their support for the policy coordination process.

With this in mind, the Ministers and Governors reviewed the global economic situation and prospects in the aftermath of the Gulf War. They noted the signs of prospective economic recovery and lower inflation in those countries which are in recession. They also noted the persistence of high real interest rates and the slowing of economic activity in those countries which until recently had been experiencing strong expansion.

Against this background, Ministers and Governors emphasized the importance of monetary and fiscal policies which provide the basis for lower real interest rates and a sustained global economic recovery with price stability. They believed that such a medium-term strategy was the best way of reducing potential risks and uncertainties in the current outlook. They reiterated the importance of policies aimed at increasing global savings. They agreed to monitor the situation closely and to take actions as needed within the coordination process with a view to achieving a sound recovery and a growing world economy.

Given the close linkage between trade and growth, the Ministers and Governors also emphasized the importance of bringing the Uruguay Round to a successful conclusion.

The Ministers and Governors also reviewed developments in international financial markets and reaffirmed their commitment to cooperate closely on exchange markets.

The Ministers and Governors welcomed the reform efforts underway in Central and Eastern Europe, and in Latin America, Africa, and Asia. They agreed that a strong global economic recovery and open markets in the major industrial countries will provide necessary support for these efforts. They noted the difficult economic situation in the Soviet Union and the need for sustained economic reforms.

The Ministers and Governors encouraged developing countries to continue the pursuit of market-oriented reforms, and underscored the importance of active IMF and World Bank support for this effort, both through conditionality and financing. In this connection, they reaffirmed their commitment to implement the increase in IMF quotas by the end of the year.

TREASURY NEWS

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

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.
April 29, 1991

Strengthening the International Economic Environment and Implications of the Middle East Crisis and its Aftermath

Developments in Eastern Europe and the Middle East are only the latest reminders that we live in a highly interdependent world, and not in isolation. These developments, coming on top of the globalization of financial markets and the growing interconnections among our economies, underscore an essential reality: while each country looks to its own interests, we must work collectively to achieve our common objectives of freedom and prosperity.

The dramatic developments in Eastern Europe, the Middle East and much of the developing world are an important backdrop to our work. Major changes are underway in the industrial world as well, including the reunification of Germany and the accelerated pace of integration in the European Community, bringing with them both challenges and opportunities.

The success of Desert Storm has shown what can happen when the international community focuses its energies on a singular objective. Now is the time to extend this spirit of international cooperation to meet the major challenges we face together on the economic front.

Circumstances are significantly changed from the recent past. The Gulf oil producers are no longer major suppliers of capital to the world -- indeed, over the foreseeable future these countries will have to direct their resources increasingly to internal needs. German current account surpluses are declining sharply, and funds once destined abroad are being used to build up the eastern part of the country. And, although the reduction in Japan's current account surplus is welcome, it also implies a reduction in the flow of funds from Japan to the rest of the world.

NB-1242

Fostering an open, growing world economy is the most effective tool we have to meet the new challenges of a changing world and to assure that strong support is provided to the reform efforts of Latin America, Eastern Europe and many other developing countries. Unfortunately, the world economy has slowed dramatically since our meeting last September.

There are hopeful signs of recovery in some quarters. In fact, here in the United States there have been some encouraging signs. But a recovery of world economic activity is by no means certain. Adjustment of structural fiscal deficits is underway in the United States and a number of other countries. This should strengthen public savings. But real interest rates remain high in many countries. This dampens investment and growth prospects.

In these circumstances, monetary and fiscal policies should be directed to providing the basis for lower real interest rates and a sustained global economic recovery with price stability. Such a strategy is the best way of reducing potential risks and uncertainties in the current outlook and providing a framework of confidence that will engender growth.

Strong world economic growth must also be accompanied by open markets. This is especially important for countries in Eastern Europe and the developing world striving to build growth on export markets. We should all carefully review our trade policies to consider whether we can open our markets more effectively to the reforming economies of Eastern Europe.

President Bush has, in fact, announced an initiative to expand Eastern European commercial opportunities with the United States. We call on other countries to do the same. Furthermore, at a time when the Soviet Union is experiencing economic difficulties, countries should avoid using export credits to displace Eastern European exports to that country.

Implications of the Middle East Crisis and Its Aftermath

As efforts proceed to build new arrangements for peace and security in the Middle East, we must also give our attention to the development and growth needs of the region. Multilateral cooperation must also be the cornerstone of efforts to promote market-oriented reform and economic development in the Middle East.

Obviously, the countries of the region will have to play a key role in charting a course for long-term development. We are therefore pleased to see that the members of the Gulf Cooperation Council (GCC) are establishing a new development program for countries in the region. We also welcome the importance that has been attached by the GCC to promoting economic reform and supporting the program activities of the IMF and World Bank. This will increase the effectiveness of development assistance and promote stronger, market-oriented economies, while at the same time catalyzing the support of other countries.

We believe that an effective approach supporting long term development in the Middle East would be one that is closely associated with the World Bank and the IMF. This could be through the establishment of a fund, facility, or subsidiary, within the World Bank, supported by or coordinated with the IMF. We look forward to working closely with countries in the Middle East and elsewhere during the months ahead in order to develop the precise elements of a global strategy to support long term development in the region.

Thank you, Mr. Chairman.

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 29, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $8,008 million of 13-week bills to be issued May 2, 1991 and to mature August 1, 1991 were accepted today (CUSIP: 912794WS9).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.57%	5.74%	98.592
High	5.61%	5.79%	98.582
Average	5.60%	5.78%	98.584

$13,400,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 23%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	35,890	35,890
New York	21,817,295	7,060,295
Philadelphia	23,920	23,920
Cleveland	48,645	48,645
Richmond	54,090	54,090
Atlanta	34,070	32,520
Chicago	1,326,410	80,160
St. Louis	61,315	31,315
Minneapolis	8,040	8,040
Kansas City	40,225	40,225
Dallas	28,945	28,945
San Francisco	483,870	133,870
Treasury	430,285	430,285
TOTALS	$24,393,000	$8,008,200
Type		
Competitive	$20,283,940	$3,899,140
Noncompetitive	1,257,160	1,257,160
Subtotal, Public	$21,541,100	$5,156,300
Federal Reserve	2,601,600	2,601,600
Foreign Official Institutions	250,300	250,300
TOTALS	$24,393,000	$8,008,200

NB-1243

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
April 29, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $8,008 million of 26-week bills to be issued May 2, 1991 and to mature October 31, 1991 were accepted today (CUSIP: 912794XL3).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.66%	5.92%	97.139
High	5.69%	5.96%	97.123
Average	5.68%	5.95%	97.128

$1,400,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 48%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	26,840	26,840
New York	19,016,415	7,246,730
Philadelphia	13,430	13,430
Cleveland	33,555	33,555
Richmond	36,815	36,815
Atlanta	25,935	25,935
Chicago	1,640,550	192,150
St. Louis	36,270	23,670
Minneapolis	6,720	6,720
Kansas City	41,315	39,815
Dallas	13,780	13,780
San Francisco	450,425	119,225
Treasury	228,955	228,955
TOTALS	$21,571,005	$8,007,620
Type		
Competitive	$18,027,745	$4,464,360
Noncompetitive	773,560	773,560
Subtotal, Public	$18,801,305	$5,237,920
Federal Reserve	2,100,000	2,100,000
Foreign Official Institutions	669,700	669,700
TOTALS	$21,571,005	$8,007,620

NB-1244

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

As Prepared for Delivery

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.
April 29, 1991

The International Debt Situation:
Progress and Perspective

As we discussed this morning, improved global growth is critical to our ability to meet the global challenges facing us in the period ahead, including the external debt problems of developing nations. Sustained low-inflation growth and more open markets for LDC exports are essential to maximize the benefits of macroeconomic and structural reforms in debtor nations.

Moreover, the need to attract capital is at the heart of every country's development challenge. Limited global capital resources, including a shift in the role of commercial banks in providing external finance and budgetary constraints on new foreign assistance within creditor governments, underscore the need for developing countries to encourage new private investment as a source of capital for development and growth. Such investment can only be attracted by more open investment regimes. Programs to encourage such reforms should receive a higher priority in all of the international financial institutions.

These themes should be central to our continued implementation of the debt strategy in the period ahead.

Recent Progress

As we begin our third year under the strengthened debt strategy, we can take hope from the progress made to date -- while recognizing the challenges that still lie ahead. In assessing progress within the strategy, we should consider first the sheer magnitude of debt covered through debt reduction agreements and the number of countries involved. Recent agreements with Venezuela, Uruguay and Nigeria bring the total to eight countries which have now reached new financing and debt reduction agreements with their commercial banks. These

NB-1245

countries account for some $125 billion in commercial bank debt, or nearly half of the commercial bank debt of all of the major debtor nations.

Niger is the first country to benefit from the IDA Debt Reduction Facility in securing a commercial bank agreement, while Jamaica and Senegal, have also reached multiyear rescheduling agreements which permit debt buybacks.

Nearly a dozen additional countries -- both middle and low income -- are at various stages of negotiations with their banks. The variety of packages which have been negotiated to date reflects positively on the flexibility of the debt strategy in accommodating the diverse interests and needs of both commercial banks and debtor nations. And the multiplicity of discussions underway offers broad testimony that our approach remains a sound one.

Perhaps more important, debtor countries are beginning to experience stronger growth, access to voluntary bond markets, new investment flows, and a repatriation of flight capital. Mexico -- which currently has a real GDP growth rate of 4% -- has recently received some $2-3 billion in foreign equity flows into its stock market, has successfully floated bonds on the Euromarket, and is now experiencing an over-financing of its Treasury offerings. One third of the commercial banks chose the new money option for Venezuela and capital is now being repatriated. And Chile's dramatic success in reducing debt through its debt/equity swap program has helped to pave the way for its recent $320 million Eurobond syndication with its commercial banks.

Underlying these success stories are strong reform efforts by each of these countries. All three have liberalized trade. Chile has one of the most open investment regimes in Latin America, and has inspired recent investment liberalization in both Mexico and Venezuela. Mexico has privatized its airline, copper, and trucking industries in the past year and a half, and has announced some $20-25 billion in future privatizations of government-owned enterprises in the banking, telecommunications, steel, fertilizer, and insurance sectors. Chile and Venezuela are also moving to privatize key public enterprises. Financial sector, tax, and price reforms are also helping to improve the market orientation of debtor economies. The market's response has been impressive.

Other debtor countries are also moving to implement similar reforms. Argentina, in particular, has already reduced its external debt by $7 billion through the privatization of major public enterprises, as an interim step toward a comprehensive agreement with its commercial banks.

Challenges clearly remain. Not least of these has been the continued growth in arrears to commercial banks by several countries. Serious efforts need to be made to regularize relations and address outstanding arrears as a prelude to comprehensive debt reduction negotiations. In this regard, following lengthy negotiations, Brazil recently reached an agreement involving a down payment and refinancing of some $8 billion in arrears. This agreement is a step forward, although further negotiations on a new financing package remain essential.

Those countries that have been experiencing significant arrears must also move on a comprehensive front to introduce sound macroeconomic and structural policies. Poor policy underpinnings and growing arrears frequently go hand in hand. Movement in these twin areas will help unleash new international resources to support growth and development, while also setting the stage for meaningful debt reduction.

Action by Bilateral Creditors

Official bilateral creditors are also doing their part. The international community is increasingly turning to a variety of mechanisms to provide financial support for heavily indebted countries which are undertaking economic reforms. New financial assistance -- particularly to low income countries -- is increasingly being provided on a grant basis. Maturities for lower middle income countries have been extended to permit deeper relief, and a portion of their debt to official creditors can be converted into equity, or used to support environmental or development programs.

In this context, we welcome the recent Paris Club action for Poland, which reflects its exceptional economic and political reform efforts, extreme dependence on bilateral creditors, and need for dramatic relief to assure a viable economy. We would also encourage other governments to "top up" this effort by making use of the debt swap option, as the United States will be doing to support vital environmental programs in Poland. Now that it has reached agreement with the IMF on an economic reform program, we believe that Egypt's exceptional circumstances warrant similar multilateral debt reduction by creditor governments.

For the poorest countries, the Paris Club is reviewing its current rescheduling options and considering proposals that would extend additional relief. Bilaterally, creditor governments have already forgiven some $6 billion in debt obligations for these countries. The United States has recently received Congressional authority to reduce food assistance debt, as well, for the least developed countries. The combination of these bilateral and multilateral efforts, together with new grant financing, should have a substantial impact on the debt profiles of individual countries over time.

Enterprise for the Americas

Finally, I would underscore our own commitment to the President's Enterprise for the Americas Initiative, which pledges debt reduction within the hemisphere for countries which are liberalizing their investment regimes, as a complement to sound IMF and World Bank programs.

Our initiative for Latin America and the Caribbean has struck a responsive chord within the hemisphere. Several countries are already pursuing negotiations on investment reforms with the Inter-American Development Bank, and several more have expressed an interest in its new investment sector lending program. I am confident that these efforts, together with the creation of a new Multilateral Investment Fund to target support for technical assistance, small businesses, and worker education and retraining, can make an immense difference in the climate for investment in the region, and to its future growth.

Conclusion

In short, we have experienced dramatic progress under the international debt strategy during the past two years. The sheer volume of debt covered by debt reduction agreements and the broad range of reforms underway offers brighter prospects for many debtor nations in the period ahead. We should take heart from their success and, from their example, renewed commitment to market-oriented reform. Concerted efforts to improve global growth and assure a successful Uruguay Round are also essential. Through continued mutual effort, I am confident that we can ease further debt problems and help provide an international environment conducive to greater prosperity in the developing world.

TREASURY NEWS

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

AS PREPARED FOR DELIVERY
FOR RELEASE AT 11:45 a.m.
April 30, 1991

Contact: Barbara Clay
202-566-5252

THE HONORABLE JOHN ROBSON
DEPUTY SECRETARY OF THE TREASURY
INTERNATIONAL INSTITUTE FOR SECURITIES MARKET DEVELOPMENT
APRIL 30, 1991
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.

Thank you, Terry (Chuppe). It is a great pleasure to be here to share some perspectives with our distinguished guests from around the world.

The countries represented here today are part of a new era-- a renaissance of nations that have embraced a free market philosophy and are trying to restructure economic systems that have, for too long, retarded their standards of living. And you in this room are the financial bricklayers of a vital part of successful free market economies -- efficient, fair, broad-based capital markets.

Proof of successful economic reforms spans the globe and captures the headlines every day. In Eastern Europe, Latin America, the Caribbean, and in Asian and African countries, reforms are taking hold with vigor. Many countries are simultaneously struggling not only to establish free market systems, but to nurture fragile democracies as well.

On every continent, countries are striving to build new and improved free market systems. In many, the accomplishments have been significant, and reformers can be proud.

But they cannot be complacent. Now is not the time for the architects of emerging free markets to relax and wait for a knock on the door of opportunity. Instead, they must muster the energy and political courage to implement the reforms necessary for continuing economic growth, and they must win the foreign trade and capital they need to succeed in the competitive global economy.

NB-1246

The competition for capital

These reforms are essential. Because, as your nations progress along the path to market economies, there will be a fierce competition around the world for a limited pool of financial capital to fuel economic growth. As traditional sources of capital become more preoccupied with their own needs--German reunification, infrastructure investment in Japan, and rebuilding after the Gulf War -- the competition will intensify.

Every successful economy depends on the free flow of capital -- the United States, Japan, Germany -- we all seek foreign investment and trade to keep our economies strong.

Of course, there will be winners and losers in the global competition for capital. The winners will be those countries able to provide stable and open economic regimes that welcome foreign investment and are free of the governmental barriers that block productive activity.

In return, foreign companies and entrepreneurs will seek those countries for investment opportunities, bringing new technology and managerial skills. Businesses will open factories that are built and operated by their citizens. Their agricultural and manufactured goods will be traded competitively on the international markets. Their economies will grow and prosper. And their standards of living will rise.

Sound economic policies

Fundamental to creating domestic capital and attracting foreign investment is the pursuit of economic policies that favor stability and growth. Sound macroeconomic policies will provide the foundation for a dependable economic development. Excessive regulation, inflation and rapidly fluctuating exchange rates can only frighten away investors.

That is why the United States is helping many countries develop policies and build the institutions essential for long-term growth and prosperity. As President Bush said, "our challenge in this country is to respond in ways to support the positive changes now taking place...We must forge a genuine partnership for free market reforms." This conference is one example. And there are many others.

But foreign assistance can only be a catalyst -- not a crutch. Successful economic reforms depend on long-term changes from within.

And if the leaders of emerging free markets are serious about building a lasting foundation for growth -- serious about competing for the world's capital resources -- then it's time to adopt structural reforms that liberalize investment regimes and create private sector opportunity.

It's time to create environments where investors feel comfortable doing business. That means less red tape, less regulation by the government and more incentives for private businesses to take hold.

Less government interference

The argument against government intervention is as old as democracy itself. In the United States, we've been having the same vigorous debate for over 200 years. And now, we hear the same debate in new places. In Peru, the famous economist Hernando de Soto put it this way:

> "The challenge...is to come up with a legal and institutional system...which transfers to private individuals those responsibilities which the state has thus far monopolized unsuccessfully."

Simply put, emerging free markets should take off the gloves of government to shake hands with the private sector. Let your economies work -- even if the system seems imperfect. Allow a little untidiness. The beauty of the free market is that the smaller problems will usually work themselves out.

In Mexico, there is an ongoing effort by the government to unleash its hold on hundreds of business entities. In 1982, the state owned over 1,100 entities. By 1990, it had cut the number in half.

That's a real victory for the Mexican people, who can look forward to running more businesses on their own. Moreover, it is tangible proof to foreign investors that Mexico is serious about attracting more capital. And, what better evidence of success: flight capital is now flowing back into Mexico.

Creating financial institutions

Still, there is more you can do. A successful and attractive free market must also be the home of safe, sound and established free market institutions. Efficient banks and securities markets are all essential. That is why you here today have such an important role to play in the future prosperity of your homelands. That is why Chairman Breeden and the Securities and Exchange Commission are sharing their expertise with you. And that is why the United States is helping many nations to learn the basic elements of management in a competitive marketplace.

For many nations with young market economies, the most ignored link in the reform chain is the banking system. Banks are not functioning as efficient allocators of credit. They are not creating incentives for savings. Instead, these countries are stuck with financial dinosaurs -- banks that have no capital and no customers. So, it's time to set up new banks and convince the people that their money can do more for their country in a bank than under the mattress.

The same is true of securities markets. It is essential to start providing capital infusions -- even very modest ones -- for small business owners. Small and medium businesses are the lifeblood of any economy, and you must do what you can to get those businesses started and help them expand.

Under the skin of most of humanity beats the ambitious heart of the entrepreneur. This is especially so in emerging democracies -- where butchers, bakers, mechanics and artists seek to own the shops, garages and businesses once owned by the government. Now, the setting is ripe for privatization and investment. But potential owners need that first, important loan or capital infusion to get started.

<u>Don't wait for the advanced structure</u>

It doesn't take much to start a bank, a stock market, or a commodity exchange. The early banks in the United States were only small offices with a safe, a ledger and a few pencils. The first stock market in New York was not much more than a simple auction of company stocks on the street curb.

The fact is, high-tech computers and hundreds of employees are not prerequisites to starting financial institutions that will attract foreign capital. Investors are not looking for perfection; they're looking for progress and signs of life. The advanced computers and systems will come in time.

A common mistake in the early stages of emerging free markets is to strive for the same sophisticated financial institutions that exist in the advanced, industrial West. But it is neither realistic nor necessary to achieve in two years what the United States has achieved in over two centuries. It is more important to put in place something that meets your current needs and on which you can build future technological expansion.

Changing attitudes

Perhaps the most important thing leaders of emerging free markets can do now is to begin changing the attitudes of people who have struggled under statist regimes.

Free markets work when they enjoy the trust and understanding of the people who stand to benefit. Therefore, you need a continuous campaign to inspire faith and recapture the free market mentality.

The campaign can start with the people in this room. You can be important missionaries for the free market. Any American business executive will tell you that the best advertising tool is not television or radio -- it's word of mouth and example. Convince the people that market economies will work, and you'll have much of the hard work behind you.

Conclusion

The process of economic reform is difficult. Outsiders can help, but in the end, successful transitions to free markets will be accomplished primarily through the skills and the fortitude of the people involved.

I'm confident that many countries represented here can, in time, attain the same prosperity achieved in Western Europe after World War II. But it will take hard work and commitment; it will take access to capital; and it will take a change of ideas and attitudes.

I look forward to applauding your future positive economic developments. Good luck to all of you as you work to become flourishing partners in the global economic community.

Thank you.

###

TREASURY NEWS

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

PREPARED FOR DELIVERY CONTACT: CHERYL CRISPEN
(202) 566-2041

STATEMENT OF
THE HONORABLE ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY FOR FINANCE
BEFORE THE
BUSINESS EDITORS ASSOCIATION

April 30, 1991

Good morning. Let me begin by stating the obvious. The banking industry and the Bank Insurance Fund are under stress. The fundamental problems which banks face require comprehensive reforms.

If the banking system remains weak, inefficient and unable to compete, no bank insurance fund is large enough to protect the taxpayers and their $2 trillion in insured deposits. If we only tinker with the problem -- for example, by simply recapitalizing the Bank Insurance Fund -- then we will not have addressed the underlying causes that have brought the Fund to its present state. Our motto must be "fix it, don't just fund it." Otherwise, the chances are good that we will be recapitalizing the Fund again, the next time perhaps with taxpayer money. That is a prospect no one could relish.

The evidence of a financial system under stress is clear. The Bank Insurance Fund, after increasing steadily for over 50 years, has now dropped to its lowest level in history as a percentage of insured deposits. In the 38 year period between 1942 and 1980, there were a total of 198 bank failures, or about 5 per year. In 1989 alone, there were 206 failures. In 1990, another 161 banks failed, including 131 small banks with under $100 million in assets. The FDIC predicts that a further 180 to 230 banks could fail in 1991, and 160 to 210 more in 1992, in each case over 70% of them being small banks. No one can reasonably claim that the current system is working well for our banking institutions, large or small. In fact, at year-end 1990, the top 25 U.S. banks had the same market capitalization as IBM.

Why are all these failures occurring? One reason is that, over the years, banks have become less competitive as banks' traditional business has migrated to new products in other parts of the financial services industry -- products that are off limits for banks due to outdated laws. This trend has left the banks to do too much risky lending to LBOs, Third World countries and other less attractive borrowers. Another reason is that, while we now allow interstate <u>banking</u> throughout almost the entire nation, we impose enormous unnecessary costs on banks by preventing them from branching across state lines. A third reason is that our overextended deposit insurance safety net has eliminated most of the incentive for sophisticated, large depositors to monitor the activities of banks and check excessive risk taking.

In part due to our failure to modernize, our international competitive position has declined to the point where we have no banks among the top 25 in the world. And as the economy has slowed, some regions have experienced "credit crunches." Weak banks have not been able to lend even to good customers, which has exacerbated the recession and hampered recovery.

Fundamental Reforms

We believe comprehensive reform is needed to accomplish three fundamental objectives. First, we must make deposit insurance safe for taxpayers and depositors. That means better capitalized banks, stronger supervision, and the return of deposit insurance to its original purpose of protecting small unsophisticated depositors in this country. It also means a well-capitalized Bank Insurance Fund.

Second, we must modernize archaic laws to let banks catch up with their customers and deliver products more efficiently to consumers across the country -- which translates into greater convenience, lower interest rates and transaction fees for customers, and more bank capital.

Third, we need to restore the international competitiveness of our banking industry. Our economy is twice the size of our nearest competitor's, and a world class economy demands a world class banking system.

We believe that our legislation will help accomplish each of these objectives. Let me discuss each in turn.

MAKE DEPOSIT INSURANCE SAFE FOR DEPOSITORS AND TAXPAYERS

Deposit insurance should be returned to its historical purpose of protecting small, unsophisticated depositors and avoid bank runs. The bill does this in four ways.

First, it reduces the overextended scope of deposit insurance and returns the system to its original purpose -- protecting smaller unsophisticated savers. Federal deposit insurance has become overextended, both in the size and inclusion of coverage. When federal deposit insurance was introduced in 1933, accounts were covered up to $2,500, or about $25,000 in today's dollars. This ceiling now stands at $100,000, resulting in a quadrupling of effective coverage. In addition, the type of accounts protected have been broadened to include, for example, brokered deposits, pension pass-throughs and bank insurance contracts (BICs). It is therefore not surprising that the amount of insured deposits has doubled in only the last 9 years from $1 trillion to $2 trillion; and insured deposits as a percent of total deposits have risen from 45% in 1934 to 76% in 1990.

The Administration's legislation addresses these concerns by reforms which protect the small unsophisticated saver while at the same time reducing the risk of a taxpayer bailout. We have proposed eliminating insurance coverage for brokered deposits and BICs and have carefully tried to eliminate "pass through" coverage for depositors that are least in need of protection. Defined benefit pension plans with professional management, employer liability, and guarantees from the Pension Benefit Guaranty Corporation are not in need of deposit insurance protection as well. At the same time, however, the legislation would preserve pass-through protection for self-directed defined contribution plans, where individuals choose their own investments and bear the risk of any loss.

Likewise, the use of multiple insured accounts has gotten out of hand. It is time to impose limits, and ours is $100,000 per depositor per bank for most accounts, with a separate $100,000 in coverage for retirement savings. While this limit is important, it is obviously not radical. A couple can still get up to $400,000 in insurance coverage in each bank, which is hardly a small sum. Only about 3% of American households have over $100,000 in any one institution. Since households typically have several members, our proposal would most likely affect substantially less than 3% of households. And insurance for business accounts would not change.

Those who suggest that such clearly reasonable limits would destroy the banking system or deprive the elderly of safe places to invest are just plain wrong -- and worse, are irresponsibly and needlessly stirring up depositor fears.

Second, <u>our legislation generally limits the FDIC to paying off only insured deposits</u>. Over the last 6 years (1985-90), the FDIC has paid off about 99% of uninsured deposits, thereby effectively guaranteeing all deposits in full. Our legislation would generally require the FDIC to cover only insured deposits, using the least costly resolution method.

As a consequence, the FDIC's current "too big to fail" policy would be changed. The legislation would essentially eliminate the FDIC's discretion to protect uninsured depositors in bank failures. But it would also preserve the government's ability to protect the financial system when necessary, even if that requires the rare protection of uninsured depositors. We believe this is critical for the stability of the financial system.

Yet, some argue that the government should never protect uninsured depositors. I believe it would be foolhardy for the government to surrender its ability to protect uninsured depositors were the entire financial system is at stake. No foreign government has embraced that restriction.

Others argue that the government should always protect uninsured depositors to be equally "fair" and would achieve this goal by expanding the safety net to legally cover all bank deposits. That would be equally foolhardy -- what about fairness to the taxpayer? Why should the taxpayer have to pick up the tab?

The best way to address this problem is to create stronger banks that don't fail, which is what this legislation would do.

Third, the bill focuses on increased bank capital, by applying Prompt Corrective Action (early supervisory intervention) to undercapitalized banks to cut down on bank failures and potential cost to the taxpayer.

Our proposal recognizes that our regulatory system must be better designed to catch problems early, before they mushroom into costly failures. The combination of rules and flexibility in our system of Prompt Corrective Action will help foster two desirable results: regulators will be able to take action more swiftly as capital declines. More importantly, banks will be more likely to maintain strong levels of capital if they face the certainty of decisive regulatory action as their capital declines.

Some critics claim that capital is not a good leading indicator of problems, and that Prompt Corrective Action relies exclusively on capital. Both allegations are false. Numerous studies have shown that capital is an excellent leading indicator and simple to measure. But it is not a perfect early warning system, and our legislation specifically recognizes its limits. Even a well-capitalized bank will trigger supervisory intervention if it is in an unsafe and unsound condition due to loan concentrations or other regulatory problems. Prompt Corrective Action does not rely exclusively on capital.

Fourth, the bill recapitalizes the Bank Insurance Fund by increasing bank insurance premiums and authorizing FDIC borrowings from the Federal Reserve. It does so in a way where sufficient resources -- $25 billion -- are provided to the FDIC to do the foreseeable job; it is financed by the banking industry without substantially impairing its health; and it relies on generally accepted accounting principles -- no "smoke and mirrors."

MODERNIZE ARCHAIC BANKING LAWS

Out-of-date laws no longer fit the way individuals and corporations use banks today. Banks have to be allowed to catch up to, and provide for, the needs of their traditional customers, especially in times of credit crunch. (Otherwise banks' profit potential becomes even more hollowed out, thereby encouraging involvement in riskier activities.) This updating can be achieved while making the U.S. banking system more efficient, by providing banking organizations nationwide interstate branching, a full range of financial activities, and regulatory restructuring. Commercial firms would be able to own banking organizations through diversified holding companies, thereby allowing the banking system to benefit from their capital and managerial know-how. The resulting benefits should be lower borrowing rates for customers, lower bank operating costs, and higher earnings and capital.

Nationwide banking and branching. Interstate branching is a perfect example. Now that 48 of the 50 states allow some form of interstate banking, it is fair to say that the philosophical debate over interstate banking is over. Yet interstate branching is still virtually prohibited, imposing unnecessary costs on banks. Our legislation would move to end these artificial barriers, but in a way that recognizes the legitimate interests of state governments. A state would still be able to restrict intrastate branching of all state and national banks operating within its borders. It would also have the ability to establish activities restrictions for all of its own state banks and all in-state branches of banks chartered in another state. The Community Reinvestment Act would continue to apply, and states could continue to apply state consumer protection laws to branches or all out-of-state banks. Finally, states could tax branches of all banks, state or national, to avoid any adverse revenue impact resulting from changes in the law.

Nationwide interstate banking and branching would provide tremendous benefits to consumers. Experience shows that greater ease of entry would mean greater competition, which in turn would lead to increased availability of credit and other financial products, and to lower prices. The many consumers who live in multistate areas would have easier everyday access to branches of their banks. And more regionally diverse banking organizations would be less vulnerable to regional economic woes, and therefore less likely to fail.

Critics argue that these interstate activities would reduce the need for small banks, draw funds out of local communities and deprive rural areas of much needed sources of credit. There is no credible evidence to support these hypothetical fears. Today, in spite of interstate banking in 48 states, I am aware of no evidence that out-of-state institutions are overrunning the community banks. In fact, the evidence is to the contrary. Studies show that community banks not only survive entry by out-of-state rivals, they also tend to outperform them. In states like New York, larger banks have actually decreased the number of their branches in recent years in the face of stiff competition from community banks. In California as well, community banks continue to thrive and to compete quite effectively with larger rivals, both in-state and out-of-state. Smaller banks that serve local communities appear to have a competitive advantage that their larger and more diversified rivals cannot match -- they know their customers and their communities. We fully expect that to continue to be the case.

Broader activities for banking organizations. Banking organizations that are well capitalized would be permitted to engage in a broader range of financial activities. The proposed changes reflect the reality of the way that banking organizations already do business. Banks already engage in many aspects of the securities and insurance businesses through a patchwork system created by changes to state laws, exceptions in federal laws, and regulatory interpretations. But this hodgepodge system is costly and burdensome, with numerous restrictions that keep our financial companies from competing fairly, evenly and effectively.

Under our proposal, bank holding companies would become financial services holding companies and could engage in all of the currently authorized financial services activities, and those who maintained highly capitalized banks could engage in a broad range of financial activities through affiliates.

But important safeguards would be in place to protect banks from risks associated with new activities and to prevent unfair competition. Any new activities would be carried out in separately capitalized affiliates whose capital could not be double counted as capital of the bank. Only companies with well-capitalized banks could take advantage of these new activities, and only if their banks were not in an unsafe or unsound condition and were not engaging in unsafe or unsound practices. If the bank's capital level should decline or if it otherwise falls into an unsafe or unsound condition, the holding company would have to fix the problem or face the prospect of strong remedial action. This could include divestiture of either the new financial activities or the bank itself, or, if that did not occur, holding company capital requirements, dividend restrictions, and much closer supervision.

In addition, a number of strict firewalls would exist between the bank and its new affiliates. Section 23A of the Federal Reserve Act would be strengthened to prevent certain transactions between the bank and its affiliate. In addition, banks would have to give prior notice to the regulator of any loan exceeding 5 percent of capital. At the same time, under revised section 23B of the Federal Reserve Act, bank loans to <u>customers</u> of affiliates would also have to be conducted on an arm's-length basis.

Strict disclosure rules would apply to sales of non-deposit products not only by banks, but by affiliates of banks. Customers would have to sign plainly worded forms acknowledging that such products were <u>not</u> covered by federal deposit insurance. The sale of securities of bank affiliates could not occur on the bank's premises where deposits are accepted. And most important, regulators have broad regulatory authority to impose limits on transactions between banks and affiliates to prevent conflicts of interest, unfair competition, and unsafe and unsound banking practices.

Consumers would be a direct beneficiary of these reforms. Consumers would choose from a much broader array of financial products at the bank, with strengthened disclosure requirements. And the increased competition provided by banks would lead to lower transaction costs and lower interest rates. Finally, broader financial activities would lead to better capitalized, and safer and sounder banks.

<u>Regulatory Restructuring</u>. The bill would reorganize the current federal regulatory structure for banks, which virtually everyone admits is overlapping and often duplicative. The goal is greater accountability, efficiency and consistency of regulation and supervision, and a separation of the regulator and the insurer. The new structure would have one federal regulator for each banking organization, with the Federal Reserve responsible for all state-chartered banks and their bank holding companies and a new entity under the Treasury responsible for all nationally-chartered banks and their bank holding companies. The FDIC would primarily focus on insurance and resolutions. I believe the result will be a simplified federal regulatory structure that will be able to effectively administer the Prompt Corrective Action program I mentioned earlier.

<u>Diversified Holding Companies</u>. The bill would also allow diversified holding companies to own financial services holding companies. These diversified holding companies would have no limits on the type of activities in which they could engage. They would provide a critical new source of capital for banks, since 80 percent of the capital in this country is in commercial companies. But these companies must be prepared to put up this capital if they want to own banks -- again, their ownership of

banks would be contingent on maintaining high bank capital levels, and they would be subject to similar Prompt Corrective Action penalties if bank capital should ever drop and the holding company was unwilling to restore capital.

All of the firewalls that apply to bank transactions within the financial services holding company would apply to bank transactions with affiliates in the diversified holding company -- with one crucial difference. No bank, and no bank affiliate within a financial services holding company, could provide loans of any kind to the diversified holding company or its subsidiaries. The bank simply could not become a commercial company's "piggy bank" for private sources of credit. We believe that this restriction, along with the other safeguards described above, will be more than adequate to protect against abusive lending practices.

Credit Crunch. The bill helps to address the current credit crunch issue. Unless we are prepared to see the current lending retrenchment by banks reoccur with each subsequent downshift in the economy, comprehensive reform is necessary to allow banks to perform their traditional role as the primary shock absorber in the financial system. To have a banking system where certain banks have lower credit ratings than the companies they serve does not bode well for the future. If the country does not have strong banks, a credit crunch will become a recurring problem with every cyclical downturn.

Prospects for Comprehensive Reform

What are the prospects for comprehensive reform? There is an increasingly clear public awareness that a problem exists and that it must be promptly addressed. Editorial writers around the country acknowledge the issue, many on Capitol Hill recognize the need for reform, and the Administration has put forward a major legislative proposal.

However, it is not surprising that such a broad bill would attract the criticism of myriad special interest groups, each opposed to one or more specific portions of the bill. In addition, the banking industry itself is divided. Finally, many in Congress, living through the S&L crisis, are frightened by the prospects of broad change and appear to favor as little action as possible -- perhaps as little as only BIF recap and stronger bank supervision.

Our response is clear: pass comprehensive legislation now. If Congress does not face the fundamental problems confronting the industry, it will simply have to face the issue later. The S&L experience taught us the expensive lesson that avoiding the need for fundamental reform will delay action but increase the cost. The need for reform is clear. It cannot be ducked. It must be faced; now rather than later.

Thank you.

* * * * *

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

STATEMENT OF
SECRETARY OF THE TREASURY
NICHOLAS F. BRADY
AT THE MORNING SESSION
OF THE DEVELOPMENT COMMITTEE
OF THE WORLD BANK AND THE INTERNATIONAL MONETARY FUND
WASHINGTON, D.C.
APRIL 30, 1991

INTRODUCTION

Mr. Chairman, fellow Governors and distinguished guests: It is a pleasure for me to welcome the Development Committee to Washington for its spring session.

I wish especially to welcome Chilean Finance Minister Foxley as the new Chairman and express my appreciation to Yves Fortin for his distinguished service as Secretary to the Committee for the last three and a half years.

In addition, let me give my personal thanks to World Bank President Barber Conable for five years of distinguished service. It has been my pleasure to have known him and worked with him in his many years of leadership in the U.S. Congress as well as at the Bank.

FOREIGN INVESTMENT

I welcome the Committee's decision to revisit the vital topic of the role of foreign investment in the development process. The world has changed significantly in recent years, as indicated by the momentous events in Central and Eastern Europe, as well as the sweeping reforms underway in Latin America. The Bank and the majority of its member nations have begun to recognize the key role of the local private sector in development. Fortunately there is now also growing awareness of the beneficial role which foreign direct investment can play. Foreign investment can serve as a partner to the local private sector, generating jobs and providing a dynamic effect on an expanding local economy. It can help underwrite successful privatization, as well as provide long term technology transfer and access to export markets.

NB-1248

The Bank must help developing countries adopt appropriate institutional and policy reforms that would attract foreign direct investment, and encourage the return of flight capital. In particular, it needs to develop further an investment sector lending program which can be instrumental in encouraging the required reforms to support directly the private sector. These efforts are especially important for the severely indebted nations. A discussion of this issue is particularly timely in light of the proposed IFC capital increase.

IFC CAPITAL INCREASE

The United States fully appreciates the vital and unique role of the IFC within the overall World Bank Group. The IFC has a solid record in providing capital for worthy projects and investments throughout the developing world. We believe that the IFC should build on this record of many years and strengthen and broaden its role in the 1990s. For this to be done the IFC will need additional capital. We are prepared to support a capital increase in the appropriate circumstances. For additional capital to be most effective, however, we believe actions are needed in three broad areas:

First, measures to enhance the focus, operations, and priorities of the IFC itself.

Second, measures to strengthen communication and collaboration between the IFC and the rest of the World Bank Group.

Finally, measures to strengthen the focus of the World Bank on the private sector so that the IFC is not operating in isolation, but is part of a comprehensive World Bank effort in support of private sector development.

We look forward to a comprehensive action plan to provide a clear framework for the Bank's evolution towards the private sector in the years ahead.

POVERTY ALLEVIATION

We commend the Bank for the increasing attention it is giving to poverty alleviation. The U.S. believes strongly that poverty considerations are integral to development and should be a top priority for all countries. Assessments of whether a country's policies and programs are consistent with the reduction of poverty should be prepared for each borrowing nation, and updated regularly. A country's commitment to poverty alleviation is critical and should be taken into account in the allocation of Bank resources.

DEBT

The debt situation of several developing countries is improving through a combination of reform efforts, commercial bank packages which include debt and debt service reduction as well as new financing, and continued support from official creditors.

By offering support for commercial bank debt and debt service reduction, the international debt strategy has allowed debtor country officials to turn their attention to the key issues of reforming and liberalizing their economies at home. In a number of cases -- Mexico, Chile, and Venezuela -- these efforts are reaping tangible results -- economic growth, return of flight capital, new investment flows, and access to spontaneous foreign financing. This signal of a return to creditworthiness is especially gratifying.

Official creditors are continuing to provide strong support for debtor nations. For Poland and Egypt, we have supported exceptional action due to their extraordinary situations. For heavily indebted, low income countries, the Paris Club is reviewing the implementation of existing options under Toronto Terms, as well as possible additional measures to assist these countries.

As a part of our commitment to assist the poorest countries on a bilateral basis, the United States has agreed to forgive approximately $1.1 billion in debt owed by Sub-Saharan African countries. We also expect to begin implementing new authority this year to reduce food assistance obligations of least developed countries.

ENVIRONMENT

The U.S. is pleased to participate in the meeting of the Global Environment Facility that will take place later this week. Over the three year life of the facility, we intend to provide up to $150 million in parallel financing through our Agency for International Development.

We see the facility as an experimental pilot program. It should test new approaches and techniques, fund projects which would otherwise go unfunded, and fold the lessons learned into mainstream development operations.

Our first priority will be to address outstanding issues of organization and governance. The process should be open and transparent, and provide opportunities for an exchange of views with the scientific and technical community and NGOs. The U.S. is prepared to review projects to ensure that the work program is balanced, and that the projects provide global benefits and lessons that can be incorporated into the ongoing and regular lending programs of the Bank. It is essential to establish the credibility of the facility through the selection of "good" projects. We must therefore resist the temptation to move too quickly until a proper foundation for operations has been laid.

URUGUAY TRADE ROUND

I would also like to mention the important subject of international trade. Maintenance of a vibrant multilateral trading system characterized by free and open markets will provide a sound basis upon which developing countries can improve their economic prospects. A successful Uruguay Round of multilateral trade negotiations is necessary to strengthen the trading system and improve market access for developing countries.

Developing countries which have integrated themselves into the global trading system and have begun or accelerated trade liberalizing programs can greatly assist their own economic prospects and maximize their gains from the trade negotiations. It is in the economic interest of all trading nations to work toward a successful Uruguay Round. Indeed, each of our nations has the responsibility to ensure that the negotiations produce broad ranging and sustainable results as quickly as possible. Until we achieve such a conclusion to the Round, we must consider our work, regrettably, unfinished.

CONCLUSION

It is clear that there are a number of important issues facing us in the near future. I am sure the work of this Committee under the able leadership of Chairman Foxley will meet these challenges. Thank you.

Report to the Congress on Property and Casualty Insurance Company Taxation

Department of the Treasury
April 1991

Report to the Congress on Property and Casualty Insurance Company Taxation

Department of the Treasury
April 1991

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

April 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Section 1025 of Public Law 99-514, the Tax Reform Act of 1986, directs the Secretary of the Treasury or his delegate to conduct a study of (1) the treatment of policyholder dividends by mutual property and casualty insurance companies, (2) the treatment of property and casualty insurance companies under the minimum tax, and (3) the operation and effect of, and revenue raised by, the property and casualty insurance tax provisions of the Tax Reform Act of 1986. Pursuant to that directive, I hereby submit this "Report to the Congress on Property and Casualty Insurance Company Taxation."

I am sending a similar letter to Senator Bob Packwood.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

April 1991

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Section 1025 of Public Law 99-514, the Tax Reform Act of 1986, directs the Secretary of the Treasury or his delegate to conduct a study of (1) the treatment of policyholder dividends by mutual property and casualty insurance companies, (2) the treatment of property and casualty insurance companies under the minimum tax, and (3) the operation and effect of, and revenue raised by, the property and casualty insurance tax provisions of the Tax Reform Act of 1986. Pursuant to that directive, I hereby submit this "Report to the Congress on Property and Casualty Insurance Company Taxation."

I am sending a similar letter to Representative Bill Archer.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

TABLE OF CONTENTS

LIST OF TABLES

CHAPTER 1. INTRODUCTION AND SUMMARY

The Tax Reform Act of 1986 (Public Law 99-514) (the 1986 Act) changed substantially the taxation of corporate income by reducing the top corporate tax rate from 46 percent to 34 percent, broadening the corporate income tax base, and adopting an alternative minimum tax. In addition to those general changes, the 1986 Act contained specific provisions that changed the taxation of property and casualty insurance companies. In order to monitor the effect of the specific provisions on property and casualty insurance companies, the Congress required the Treasury Department to study the property and casualty insurance tax provisions and to examine whether the revenue targets projected for the provisions were met.[1]

The 1986 Act also required the Treasury Department to study the tax treatment of policyholder dividends paid by property and casualty insurance companies. Under present law, mutual and stock property and casualty insurance companies may deduct dividends and similar distributions paid to their policyholders, but stock property and casualty insurance companies may not deduct dividends paid to shareholders. The Congress recognized that it may be appropriate, as in the case of life insurance companies, to treat a portion of the policyholder dividends of mutual property and casualty insurance companies as a distribution of earnings on equity of the company. However, the Congress also recognized that the rule that applies this concept to life insurance companies is both controversial and complex. Thus, the 1986 Act required the Treasury Department to study the tax treatment of policyholder dividends paid by mutual property and casualty insurance companies before the life insurance company rule or similar rule is considered for property and casualty insurers.

This report responds to the Congressional mandate contained in the 1986 Act. The principal findings and conclusions of this report are the following:

- The 1986 Act changes in the taxation of property and casualty insurance companies increased liabilities for the regular tax for calendar year 1987 by approximately the estimated amount ($1.5 billion). It was not possible to calculate the effect of the alternative minimum tax (AMT) on property and casualty insurance companies, because tax return data generally contain AMT information only on a consolidated basis.

- Although the specific property and casualty insurance company tax provisions were either over- or underestimated, estimating errors were largely offsetting. These errors are related largely to the difficulty in forecasting taxpayers' responses to the significant changes enacted under the 1986 Act and to limitations in the available data.

- The Treasury Department recommends that Congress not extend a limitation on the deduction for policyholder dividends to property and casualty insurers because the conceptual basis for such a limitation is flawed. The "prepayment" analysis shows that mutual company policyholder dividends should be fully deductible to provide equal corporate-level tax treatment of equity-like returns to mutual and stock company investors.

---

[1] Appendix 1 contains the requirement for this study.

- The prepayment analysis does not address the problem that investment returns to certain policyholders of mutual and stock insurance companies may enjoy a policyholder-level advantage because policyholder dividends are not generally taxable income to policyholders but dividends are taxable income to shareholders. An exception to this policyholder-level advantage arises when the policyholder is a business rather than an individual. Businesses deduct premiums paid but include policyholder dividends in income.

- While the disparity in the treatment of policyholders and shareholders at the individual level could justify a corporate-level proxy tax on the equity-like returns contained in policyholder dividends, this disparity is considerably smaller for property and casualty insurance companies than for life insurance companies. Policyholder dividends paid by property and casualty insurers are substantially less and are paid primarily to business policyholders. The imposition of a proxy tax would impose a compliance burden but would have a modest revenue yield. Therefore, the Treasury Department does not recommend the imposition of a proxy tax at this time.

The remainder of this report is organized as follows. Chapter 2 describes prior tax law and the changes in property and casualty insurance taxation and the alternative minimum tax under the 1986 Act. Chapter 3 examines the effects of the property and casualty insurance company provisions enacted under the 1986 Act on tax liabilities of property and casualty insurance companies for calendar year 1987. Chapter 4 evaluates the tax treatment of policyholder dividends paid by insurance companies and presents the Treasury Department's recommendation with respect to policyholder dividends paid by property and casualty insurance companies.

CHAPTER 2. THE TAX REFORM ACT OF 1986

2.1 Introduction

The Tax Reform Act of 1986 (the 1986 Act) changed substantially the taxation of corporations and their shareholders. The 1986 Act adopted base-broadening measures designed to increase the overall level of corporate income taxes, while at the same time reducing the maximum corporate tax rate from 46 percent to 34 percent. The corporate base broadening was accomplished primarily by limiting depreciation deductions, reducing the dividends received deduction, enacting the corporate alternative minimum tax, and adopting important changes in accounting rules. The 1986 Act also repealed the investment tax credit. In addition to the general base-broadening measures that affect the tax liabilities of all companies, the 1986 Act included several provisions that specifically affected the measurement of taxable income of property and casualty insurance companies.

This chapter provides background for the evaluation of the revenue effects of the changes in the 1986 Act on property and casualty insurance companies contained in Chapter 3. The chapter describes in detail the 1986 Act's changes in the taxation of property and casualty insurance companies (Section 2.2). The chapter also includes a detailed discussion of the alternative minimum tax (Section 2.3). The tax changes described in this chapter became effective for taxable years beginning after December 31, 1986.

2.2 Changes in Property and Casualty Insurance Company Taxation

The 1986 Act changed the taxation of property and casualty insurance companies by requiring: (1) discounting of unpaid losses; (2) the inclusion in income of 20 percent of unearned premiums; (3) prorating of tax-exempt income; (4) repeal of the protection against loss account (PAL) for mutual property and casualty insurers; and (5) adoption of a single deduction for all small companies. These provisions are discussed below.

Discounting of Unpaid Losses

Under tax rules prior to the 1986 Act, property and casualty insurance companies were allowed a deduction for losses paid during the taxable year and for the net increase (from year-end to year-end) in losses incurred but unpaid (unpaid losses) and for loss adjustment expenses (LAE). Unpaid losses were reduced (and the reduction included in taxable income) when future losses were actually paid. For tax purposes, unpaid losses and LAE were calculated on a nominal (undiscounted) basis, that is, without reference to the fact that the present value of future liabilities (unpaid losses) is less than their nominal value. The net effect of this tax treatment allowed property and casualty insurance companies a current deduction for future costs. This deduction effectively understated a property and casualty insurance company's income by the difference between the nominal value and the present value of the company's liability to pay its unpaid loss claims.

The 1986 Act continued to allow the current deduction of unpaid losses and loss adjustment expenses. However, the Act required that such amounts be calculated as the discounted value of unpaid losses as defined by section 846 of the Internal Revenue Code. The discounting of unpaid losses generally reduces the current tax deduction for unpaid losses. The 1986 Act required the Secretary of the Treasury to calculate discount factors annually for each line of business shown on annual statements filed with the National Association of Insurance Commissioners (NAIC) using certain interest rate and loss payment patterns.[1] These factors are used by companies to determine their deduction for unpaid losses.[2]

The rules outlined in The General Explanation of the Tax Reform Act of 1986 call for relatively slower loss payment pattern assumptions for the five lines of business included in Schedule P of the annual statement -- auto liability, other liability, workers' compensation, medical malpractice, and multiple peril -- than the relatively fast loss payment assumptions of the lines of business contained in Schedule O.[3] The discounting rules specify maximum loss payment periods of 15 years for the unpaid losses of the Schedule P lines and 3 years for unpaid losses of Schedule O lines. The General Explanation also indicates that loss payment patterns used for the calculation of discount factors for each line of business are to be redetermined every five years.

In each loss payment pattern determination year, loss payment patterns for each line of business are generally assumed to follow loss payment patterns based on the most recently published aggregate loss payment data illustrated in examples in The General Explanation.[4] Discount rate factors for unpaid losses in various future years are then calculated for the losses incurred each year using the determined loss payment patterns and the statutory interest rate for discounting. For any calendar year, the interest rate to be used for discounting is the average of the Federal mid-term interest rates in the 60 months preceding the beginning of the year, as illustrated in The General Explanation. The discounting rules were generally expected to have a relatively greater effect in reducing unpaid losses -- and the associated tax deductions -- for Schedule P lines because of the longer loss payment patterns for these lines.

---

[1] The details are contained in Joint Committee on Taxation, The General Explanation of the Tax Reform Act of 1986 (May 4, 1987), pages 600 - 618.

[2] Schedules in the annual statements show loss payment patterns for the unpaid losses of each accident year shown on the schedules, e.g., the schedules show the amount of loss incurred in certain prior years but unpaid at the beginning of the current year as well the amount of these losses that are paid during the current year for each line of property and casualty insurance business.

[3] Under certain circumstances companies may also elect to use their historical experience for determining discount factors.

[4] Beginning in 1989, the NAIC annual statements combine Schedule O and P into Schedule P.

This change was intended to correct the prior overstatement of the true economic value of the insured loss. Without discounting, the longer the period between the claim and the actual payment, the greater the overstatement. Since prior law failed to reflect the time value of money, it permitted companies to understate their income.[5]

Inclusion in Income of 20 Percent of Unearned Premiums

The underwriting income of a property and casualty insurance company begins with earned premiums. Prior to the 1986 Act, in determining premiums earned, the increase in unearned premiums shown on the NAIC annual statement was deductible from gross income. However, expenses incurred, including acquisition expenses attributable to unearned premiums, were currently deductible. As a result, prior law mismatched income and expenses by permitting a deferral of an undiscounted portion of unearned premium income while allowing a current deduction for the associated costs of earning the deferred income.

The 1986 Act reduced the current deduction for the increase in unearned premiums, which has the same effect as denying current deductibility for a portion of the premium acquisition expenses.[6] The 1986 Act generally required property and casualty insurance companies to reduce their deduction for unearned premiums by 20 percent, which was deemed to represent the expenses incurred in generating the unearned premiums.[7] The Act also provided for the inclusion in income of 20 percent of unearned premiums outstanding prior to January 1, 1987.[8]

Prorating of Tax-Exempt Income

Prior to the 1986 Act, property and casualty insurance companies were subject to a tax on investment income which generally included interest, dividends, and rents. However, a property and casualty insurance company that included tax-exempt interest in income was allowed to deduct this interest. Property and casualty insurance companies were also allowed deductions for dividends received.

These companies were also taxed on their underwriting income which consisted of premiums earned reduced by losses (and expenses) incurred. The deduction for losses incurred generally reflected the losses paid during the year plus any increase in losses incurred but unpaid. No reduction in the deduction for unpaid losses was required to take account of the fact that deductible increases in unpaid losses could be funded with tax-exempt income.

---

[5] See The General Explanation, pages 601 and 602.

[6] See The General Explanation, page 595.

[7] The 1986 Act generally required the deduction for unearned premiums for insuring bonds to be reduced by 10 percent.

[8] For bond insurance, the inclusion factor for the six years is 10 percent.

The 1986 Act reduced the deduction of property and casualty insurance companies for losses incurred by 15 percent of the insurer's: (1) tax-exempt interest income, and (2) dividends received deduction.[9] This tax change is often referred to as prorating of tax-exempt income.

Protection Against Loss Account

Prior to the 1986 Act, mutual property and casualty insurance companies were permitted deductions for contributions to protection against loss (PAL) tax accounts. The intent of the PAL provision was to provide mutual companies with a source of capital in the event of a catastrophic loss, since mutual companies, unlike stock companies, are unable to raise capital in capital markets.

The amount of the deduction was generally one percent of the underwriting losses incurred for the year plus 25 percent of the underwriting income, plus certain windstorm and other losses.[10] In general, contributions to PAL accounts were taken into income over a 5 year period. The PAL account thus produced a 5 year deferral of certain mutual company underwriting income. However, PAL account rules required the reduction of PAL balances for each dollar of NOLs used to offset current taxable income. Subractions from PAL account balances increased taxable income, dollar for dollar, until the PAL account balance was zero.

The 1986 Act repealed the deduction for contributions to PAL account balances. Congress believed that the deduction for contributions to the PAL account was not serving its intended purpose principally because the PAL account provided the greatest benefit where least needed, i.e., for mutual companies with current taxable income that could benefit from deferral.[11]

Small company provisions

Under prior tax law, mutual property and casualty insurance companies with less than $150,000 in gross receipts were exempt from tax. Mutual companies with gross receipts from $150,000 to $500,000 could generally elect to be taxed only on investment income.[12] Mutual property and casualty insurance companies with gross receipts between $500,000 and $1,110,000 generally benefited from

---

[9] The 1986 Act also requires inclusion in income of any excess of the required reduction in the deduction for discounted unpaid losses over the increase in discounted unpaid losses. These changes do not apply to the income from stock or obligations acquired before August 8, 1986.

[10] Additions to PAL accounts were zero for companies for which the sum of investment income and underwriting income was negative.

[11] See The General Explanation, pages 618 and 619.

[12] In addition, companies that elected to be taxed on investment income could benefit from a special rule which phased in regular tax on investment income as gross receipts increased from $150,000 to $250,000.

special provisions that lowered their tax liabilities. Mutual property and casualty insurance companies with gross receipts exceeding $1,110,000 were generally taxed like other corporations. There were no special tax provisions for small stock companies.

The 1986 Act repealed these rules and, in their place, exempted net written premiums or direct written premiums from tax for mutual and stock property and casualty insurance companies with less than $350,000 of net written premiums or direct written premiums (whichever is greater). The 1986 Act also allowed property and casualty insurance companies with net or direct written premiums (whichever is greater) between $350,000 and $1,200,000 to elect to be taxed only on investment income.[13]

These changes were intended to simplify the prior law rules applying to certain small and ordinary mutual companies. The changes also eliminated the distinction between small mutual and other companies by extending the benefits to all eligible companies, whether stock or mutual.[14]

2.3 Corporate Alternative Minimum Tax

In general, under prior law, corporations paid a minimum tax of 15 percent on certain tax preferences, to the extent that the aggregate amount of these preferences exceeded the greater of the regular corporate income tax or $10,000. This tax was paid in addition to the corporation's regular tax. The items treated as tax preferences included accelerated depreciation in excess of straight line depreciation; percentage depletion in excess of basis; a portion of net capital gains; and excess bad debt reserves of financial institutions.

The purpose of the minimum tax was to ensure that no taxpayer with substantial economic income could avoid significant tax liability by using exclusions, deductions, and credits. Congress concluded, however, that the prior minimum tax was inadequate because it was not designed to define a comprehensive income tax base. Moreover, since many important tax preferences were not included or were defined narrowly, Congress concluded that even with the add-on minimum tax, corporations were not being taxed on their economic income. Congress also concluded that the goal of taxing corporations with substantial economic income could not be achieved by broadening the list of tax preferences and wanted to ensure that whenever companies publicly reported earnings they would pay some tax for the year.

In order to address these perceived deficiencies in the corporate minimum tax, the 1986 Act repealed the existing minimum tax and created a new minimum tax for corporations known as the alternative minimum tax (AMT). The AMT was designed to ensure that in each taxable year the taxpayer generally must pay a significant tax on an amount more nearly approximating economic

---

[13] To determine net and direct written premiums for the purpose of these tests, premiums of affiliated companies generally must be taken into account.

[14] See The General Explanation, page 620.

income. In addition, the Act addressed the concern that companies that reported substantial earnings paid no tax. It required that corporations include in the AMT tax base an adjustment based on financial statement income reported by the taxpayer pursuant to public reporting requirements or in disclosures made for non-tax reasons to regulators, shareholders, or creditors. This "book income adjustment" was required for taxable years beginning in 1987 through 1989. For taxable years beginning after 1989, the book income adjustment is replaced by an adjustment based on a broad, but statutorily defined, measure of economic income known as adjusted current earnings (ACE).

Generally, the tax base for the corporate AMT is the corporation's taxable income, increased by tax preferences for the year and adjusted in a manner designed to negate the deferral of income or acceleration of deductions resulting from the regular tax treatment of certain items. The resulting amount of alternative minimum taxable income (AMTI), reduced by an exemption amount, is subject to a 20 percent tax rate. The exemption amount is $40,000, reduced by 25 percent of the amount by which AMTI exceeds $150,000. The amount of minimum tax liability so determined may then be offset partially by the minimum tax foreign tax credit, and to a limited extent by investment tax credit carryovers. A corporation is effectively required to pay the higher of the AMT or the regular tax for the taxable year.[15]

The computation of corporate AMTI is a two-step process. First, taxable income is adjusted to reflect specific statutory adjustments and preferences. Second, the resulting amount of AMTI is adjusted further to take into account the book income adjustment for taxable years beginning in 1987 through 1989, or the ACE adjustment for taxable years beginning after 1989.

The more significant adjustments and preferences include those related to accelerated depreciation, depletion, intangible drilling costs, mining exploration and development costs, long-term contracts, installment sales, tax-exempt interest, and charitable contributions. The adjustment for the net book income of corporations is computed by increasing AMTI by 50 percent of the amount by which the net book income of a corporation exceeds unadjusted AMTI, i.e., AMTI determined without regard to the book income adjustment or the AMT net operating loss deduction.[16] The net book income for this purpose generally is the net book income shown on a taxpayer's applicable financial statement.

---

[15] Technically the regular tax continues to be imposed, and the excess of the tentative minimum tax over the regular tax is added on. Corporations are allowed a minimum tax credit to the extent the excess of the AMT over the regular tax is attributable to preferences or adjustments involving the timing of a deduction or income inclusion. This credit is allowed as a reduction of regular tax liability of the taxpayer in any subsequent taxable year, but may not be used to reduce regular tax below AMT for the subsequent year.

[16] The amount of the AMT net operating loss for any taxable year generally is equal to the amount by which the deductions allowed in computing AMTI for the taxable year (other than the deduction for carryovers to the taxable year of AMT net operating losses) exceed the gross income includable in AMTI for the taxable year. In computing AMTI, NOLs available for reducing AMTI are limited to 90 percent of AMTI before NOLs.

For taxable years beginning after 1989, the book income adjustment is replaced by the ACE adjustment. The ACE adjustment is equal to 75 percent of the amount by which the adjusted current earnings of a corporation exceed unadjusted AMTI, i.e., AMTI determined without regard to the ACE adjustment and the AMT net operating loss deduction. If unadjusted AMTI exceeds ACE then AMTI is reduced by 75 percent of the difference. However, this reduction is limited to the aggregate amount by which AMTI has been increased by the ACE adjustment in prior years. Generally, ACE is the corporation's unadjusted AMTI increased by items includable in computing earnings and profits but excluded from unadjusted AMTI and items deductible in determining unadjusted AMTI but not deductible in determining earnings and profits. ACE also includes various rules governing the treatment of specific items.

CHAPTER 3. EFFECT OF THE TAX REFORM ACT OF 1986 ON TAX LIABILITIES

3.1 Introduction

At the time of the 1986 Act, the specific property and casualty insurance tax changes were estimated to increase regular tax receipts by $7.5 billion between fiscal years 1987 and 1991.[1] In order to monitor the effect of these provisions and the alternative minimum tax (AMT) on property and casualty insurers, Congress required the Treasury Department to study the regular and minimum tax and to examine whether the revenue targets projected for the property and casualty insurance company tax provisions were met.

This chapter presents the results of the Treasury Department's analysis of the effect of the property and casualty insurance company tax provisions on regular tax liabilities for calendar year 1987. It compares the increase in tax liabilities in 1987 attributable to the 1986 Act's property and casualty insurance tax provisions with estimates made when tax reform was enacted. It reconciles the difference between changes in actual tax liabilities for 1987 and the estimates and discusses reasons for the differences.

This chapter also examines minimum tax information provided on consolidated tax returns filed by property and casualty insurance companies and their affiliates.[2] It is not possible to compare actual AMT liabilities to an AMT revenue estimate for property and casualty companies, because AMT receipts were not estimated separately for each industry when tax reform was enacted.

3.2 Revenue Estimates Prepared in 1986

Revenue estimates associated with changes in tax legislation are measures of the differences between expected tax revenues under the new law and the amount that would have been collected in the absence of the change in law. However, only the actual collections after the tax law change are observable. The collections that would have occurred in the absence of the change in law are not observable. Thus, it is never possible to know with certainty the actual revenue effect of enacted legislation, because only one of the two amounts required to determine that revenue effect is directly observable.

---

[1] The revenue effect for the property and casualty insurance company provisions excludes the effect of the 1986 Act's changes in the taxation of Blue Cross-Blue Shield companies. The revenue effect from changes affecting these companies was reported separately and included in the total for life insurance companies.

[2] Regular and minimum tax liabilities and related information for 1987 are based on a sample of 1987 tax returns filed by property and casualty insurance companies and companies filing consolidated tax returns with property and casualty insurance companies. Appendix 2 contains a description of the sample of tax returns used in this report.

Estimates of the effect of tax law changes require estimates of both the base level of collections (i.e., estimates of collection levels that would have occurred absent the change in law) and the effect of the change in law on that base. The estimates of the property and casualty insurance company tax changes of the 1986 Act were the result of this two-stage estimating process. Comparisons of the initial revenue estimates of a change in tax law with subsequent estimates of the actual effects (the subject of this chapter) are complicated by the need to disentangle the effect of the change in law, changes in the baseline forecast, and interactions between the two.

Estimating the revenue effects of proposed tax legislation requires accurate forecasts of many different factors, including the following: (1) the level of economic activity, including both the macro-economic national forecast and the market share of the particular economic activity affected; (2) the taxpayer's economic situation, including types of products sold, portfolio choice, and form of organization; (3) the effect of specific changes in the tax law on particular taxpayers' economic situations independent of behavioral changes; and (4) the taxpayers' reaction to the tax law changes. If these factors are misspecified or forecasted incorrectly, estimated receipts will differ from actual collections.

Forecasts of these factors for the revenue estimates for the property and casualty insurance company tax provisions were generally based on historical data from annual financial statements filed with the National Association of Insurance Commissioners and tax returns.[3] These data were difficult to use as the basis for forecasting for two reasons. First, the Tax Reform Act of 1986 significantly changed income taxation and the rules that apply specifically to property and casualty insurance companies. These changes were likely to affect historical relationships among financial variables and trends in financial data. Second, the available data from annual financial statements and tax returns define the property and casualty insurance industry differently, and use different rules to measure income and to consolidate affiliated companies. Moreover, the available corporate tax return data were outdated.

The potential misclassification of property and casualty insurance companies in the available data sources is a possible source of estimating errors. For regulatory purposes, companies are classified as life or property and casualty insurance companies based upon the type of charter for which they originally applied. However, because of the legal definitions of life insurance companies and property and casualty insurance companies for Federal income tax purposes, some companies chartered as life insurance companies file property and casualty insurance tax returns (1120PC) and some companies chartered as property and casualty insurance companies file life insurance tax returns (1120L). Thus, the use of annual statement data may misclassify certain companies for Federal income tax purposes. Moreover, the tax return data from the IRS Statistics of Income (SOI) program may misclassify some property and casualty insurance companies because consolidated tax returns are classified by industry group based on the industry group from which the largest percentage of total receipts is derived.

---

[3] Annual statement data are compiled by A.M. Best Co.

Another difficulty is that measures of income differ for tax and financial accounting purposes. For example, annual statement rules allow a deduction for the nominal increase in unpaid losses of property and casualty insurers, whereas the tax rules limit the deduction to the change in discounted unpaid losses. Thus, the use of annual statement data requires adjustments to account for these differences and such adjustments are a potential source of error.

Consolidation rules differ for annual statement and tax reporting. Annual statement reporting rules do not allow consolidation with non-property and casualty insurance companies, whereas tax rules generally allow such consolidation. As a result, annual statements lack reliable data on net operating losses (NOLs) and current losses of companies filing consolidated tax returns with property and casualty insurance companies. These amounts were estimated from tax return data.

In addition, special rules for consolidation between life insurance and nonlife companies can limit the amount of revenue from the property and casualty insurance company changes. The rules limit the losses of a property and casualty insurance company that can be used to offset life insurance company income to the lesser of 35 percent of life insurance income or 35 percent of the property and casualty insurance company losses. Because of these limitations, it is possible that the 1986 Act's changes could have no current effect on consolidated taxable income.

The 1986 Act contained six changes in property and casualty insurance taxation.[4] The Act required:

(1) discounting of unpaid losses;

(2) the inclusion of 20 percent of the annual increase in unearned premiums in taxable income (10 percent for bond insurance);

(3) the inclusion of 20 percent of the 1986 year-end unearned premiums in taxable income (10 percent for bond insurance income) over the six year period beginning in 1987;

(4) a reduction in deductions for losses by a specified proportion of tax-exempt interest and dividends received (the proration rule);

(5) repeal of protection against loss (PAL) accounts; and

(6) adoption of a single tax rule for small property and casualty insurance companies.

Table 3.1 contains the revenue estimates made at the time of 1986 Act for the six provisions described above. The Treasury Department and the Joint Committee on Taxation (JCT) estimated that the provisions would increase regular tax receipts by $7.5 billion between fiscal years 1987 and 1991.

---

[4] These changes are discussed in Chapter 2.

Table 3.1

Revenue Estimates for the Property and Casualty Insurance Company Tax Provisions
Under the 1986 Act
($ millions)

Provision	Fiscal Years 1987	1988	1989	1990	1991	Total
Treasury Estimates:						
Discounting of unpaid losses	374	667	757	714	566	3,078
Changes in unearned premiums:						
Inclusion in income of 20 percent unearned premiums	230	318	255	234	245	1,282
Unearned premiums for outstanding balances	254	432	469	512	495	2,162
Proration rule	19	74	156	258	358	865
Repeal of PAL account	58	76	68	44	24	270
Adoption of small company provision	-14	-33	-27	-25	-24	-123
Total	921	1,534	1,678	1,737	1,664	7,534
Joint Committee on Taxation Estimates:						
Total	871	1,454	1,636	1,745	1,842	7,548

Department of the Treasury
Office of Tax Analysis

April 1991

Approximately 41 percent of the revenue was estimated to result from the unpaid loss discounting change. The temporary and permanent unearned premium changes were expected to account for 29 percent and 17 percent of the revenue increase, respectively. The proration rule and PAL account changes were expected to account for 11 and 4 percent of the revenue increase, respectively. The small company changes were estimated to lower the total revenue gain by approximately 2 percent.

The revenue estimates for the property and casualty insurance company provisions were calculated after taking into account corporate tax rate reductions. Since the estimates sought to determine the amount of receipts that would result from the property and casualty insurance company tax changes, they take into account losses, NOLs, and credits of all companies filing consolidated returns with property and casualty insurance companies.

The revenue estimates exclude the effect of the property and casualty insurance company tax provisions on corporate minimum tax receipts. These effects were included in the estimate of total corporate minimum tax receipts which were reported separately by Treasury and the JCT.

3.3 Impact of the Property and Casualty Insurance Tax Provisions on Regular Tax Liabilities: 1987

When tax reform was enacted, the Treasury Department estimated that the change in calendar year liabilities for the regular tax attributable to the property and casualty insurance company provisions would be $1.5 billion for calendar year 1987. Table 3.2 shows that the actual changes in liabilities nearly equaled the estimate ($1.5 billion). Although the actual change in liabilities for certain provisions differed substantially from the estimate, these differences were largely offsetting.

Actual tax liabilities attributable to the 1986 Act's changes were $1,472 million for calendar year 1987, about $63 million (4 percent) lower than the $1,535 million of estimated liabilities. Table 3.2 compares actual and estimated changes in liabilities for each provision for calendar year 1987. The unpaid loss discounting provision and proration rule increased liabilities by a larger amount than estimated. The unearned premium changes and the PAL account change increased liabilities by less than estimated, and the small company change provision reduced liabilities by a smaller amount than anticipated.

Reconciliation of Actual and Estimated Receipts

Table 3.3 reconciles the actual and estimated effects of the discounting of unpaid loss discounting, the proration rule for tax-exempt income, and the temporary and permanent changes in the deduction for unearned premiums on taxable income and tax after credits. These provisions were estimated using a detailed computer model. The PAL account and small company changes were projected separately and are also discussed below.

Table 3.2

Comparison of Actual and Estimated Changes in Tax Liabilities from the Property and Casualty Insurance Company Provisions under the 1986 Act: Calendar Year 1987*

	Actual Change in Liabilities ($ millions) (1)	Estimated Change in Liabilities ($ millions) (2)	Difference (1) - (2) ($ millions) (3)	Actual Share of Total (percent) (4)	Estimated Share of Total (percent) (5)
Discounting of unpaid losses	947	623	324	64	41
Changes in unearned premiums:					
Inclusion in income of 20 percent unearned premiums	139	383	-244	9	25
Unearned premiums for outstanding balances	324	423	-99	22	28
Proration rule	60	32	28	4	2
Repeal of PAL account	1	97	-96	0	6
Small company provision	**	-23	23	0	-1
Total	1,472	1,535	-63	100	100

Department of the Treasury
Office of Tax Analysis

April 1991

* Excludes the minimum tax. Details may not add to totals because of rounding.

**Less than $1 million revenue loss.

Table 3.3

Reconciliation of Actual and Estimated Effect of Selected Property and Casualty Insurance Company Tax Reform Provisions on Changes in Taxable Income, Losses, Tax Credits, and Tax After Credits: Calendar Year 1987
($ millions)

	Actual Effect (1)	Estimated Effect (2)	Difference (1) - (2)
Change in:			
Taxable income (before current losses and NOLs) attributable to			
1. Discounting of unpaid losses	6,213	3,515	2,698
2. Inclusion in income of 20 percent unearned premiums	916	1,978	-1,062
3. Inclusion in income of 20 percent of beginning of year unearned premiums	2,134	2,198	-64
4. Proration rule	397	95	302
Total	9,661	7,786	1,875
Current losses and NOLs	4,861	3,845	1,016
Taxable income after NOLs and current losses	4,800	3,941	859
Tax before tax credits	1,800	1,462	338
Tax credits	328	0	328
Tax after tax credits	1,472	1,462	10

Department of the Treasury
Office of Tax Analysis

April 1991

Note: Details may not add to totals because of rounding.

Table 3.3 shows that the change in taxable income before current losses and NOLs attributable to unpaid loss discounting, the changes in the unearned premium deduction, and the proration rule were underestimated by $1.9 billion. However, the use of NOLs and current losses were underestimated by $1.0 billion and tax credits were underestimated by $0.3 billion. The underestimate of the change in taxable income was largely offset by the underestimates of the changes in the use of NOLs, current losses, and tax credits. These effects are discussed in detail below.

Discounting of unpaid loss

The impact on taxable income of the requirement to discount unpaid losses was underestimated by $2.7 billion (Table 3.3). This underestimate resulted from errors in the forecasts of the growth in undiscounted unpaid losses and loss expenses and the impact of discounting on the tax deduction for these amounts.

The estimated change in undiscounted unpaid losses was $31.8 billion compared to the actual change of $33.8 billion. Growth rates for unpaid losses have varied considerably over time and thus are difficult to predict. The model estimated that the 1987 discounting calculations would reduce the tax deduction for the increase in unpaid losses to 88.9 percent of its undiscounted value. The actual reduction factor was 81.6 percent.

The discounting factors in the model were based on 1984 loss payment patterns and distribution of losses between various lines of business. The actual discounting factors were based on the 1987 distribution of unpaid losses by line of business and 1985 loss payment time patterns, both of which resulted in a general lengthening of the time distribution of loss payments relative to the loss payment patterns implicit in the model's calculations. Typically, the Multiple Peril and Auto Liability lines of business have relatively short payout patterns compared to the Workers' Compensation, Medical Malpractice, and Other Liability lines of business. Table 3.4 shows that net written premium growth for the shorter payout lines generally exceeded the growth for the longer payout lines in the years preceding 1984 (the most current year for which annual statement data was available at the time the estimates were made).[5] From 1985 through 1987, premium growth was generally more rapid for lines of business with longer loss payout periods. Table 3.4 also shows that Schedule O lines, which generally have faster loss payment patterns, had smaller average growth rates than the Schedule P lines in 1985 and 1986.

Longer loss payment patterns result in greater discounting of unpaid losses and therefore a smaller tax deduction. In addition, the discount rate assumed by the model was 7.0 percent compared to the actual discount rate of 7.2 percent. Higher discount rates reduce the discounted value of future losses and thus reduce the deduction for discounted unpaid losses. Further, the discounting

[5] Premium information by line of business in the table is limited to lines of business for which Schedule P Annual Statement information was available in 1987. The impact of discounting is generally greatest for these lines since the discounting calculation rules for Schedule P lines assume losses are paid out over longer periods of time than other (e.g., Schedule O) categories of unpaid losses.

Table 3.4

Net Written Premiums for Schedule P and O Lines: 1978-89

Year	Schedule P Lines: Faster Payout Lines: Auto Liability	Multiple Peril Lines	Slower Payout Lines: Other Liability	Workers Compensation	Medical Malpractice	All Schedule P Lines	Schedule O Lines
	($ millions)						
1978	20,383	14,057	6,490	11,300	1,216	53,446	25,293
1979	22,102	15,977	6,612	13,164	1,204	59,060	27,857
1980	23,319	17,261	6,415	14,238	1,276	62,508	31,221
1981	24,395	18,269	6,046	14,616	1,338	64,666	32,800
1982	26,226	19,425	5,668	13,945	1,490	66,756	35,249
1983	28,080	20,496	5,679	14,005	1,568	69,829	37,140
1984	30,217	22,229	6,479	15,107	1,775	75,807	38,832
1985	36,087	26,933	11,544	17,048	2,769	94,380	38,267
1986	44,081	32,241	19,365	20,431	3,492	119,609	46,335
1987	49,205	34,774	20,874	23,429	4,004	132,285	56,240
1988	52,520	35,636	19,077	26,135	4,028	137,397	62,242
1989	56,024	36,084	18,434	28,241	4,278	143,061	63,181
	Growth Rates (percent)						
1979	8	14	2	16	(1)	11	10
1980	6	8	(3)	8	6	6	12
1981	5	6	(6)	3	5	3	5
1982	8	6	(6)	(5)	11	3	7
1983	7	6	0	0	5	5	5
1984	8	8	14	8	13	9	5
1985	19	21	78	13	56	25	(1)
1986	22	20	68	20	26	27	21
1987	12	8	8	15	15	11	21
1988	7	2	(9)	12	1	4	11
1989	7	1	(3)	8	6	4	2

Source: A.M. Best Company, Aggregates and Averages, Property and Casualty 1984-89 Editions.

computations may have overestimated the value of the election under Section 846(e) of the Internal Revenue Code that allowed some companies to use their own loss payment patterns to compute discount factors by line of business rather than published IRS discount factors. All these factors contributed to underestimating the effect of the rules requiring the discounting of unpaid losses.

Unearned Premium Changes

The effect on taxable income of including 20 percent of the increase in the unearned premiums was overestimated by $1.1 billion (Table 3.3). Historically, growth rates in unearned premiums have varied greatly from year to year, closely tracking the growth in net written premiums (Table 3.5). The model used aggregate net written premium growth rate assumptions to estimate the change in unearned premiums. For 1987, a net written premium growth of 15 percent was assumed while the actual premium growth was 9 percent. This difference accounts for most of the overestimate.

The estimate for the effect on taxable income of including 20 percent of 1986 end of year unearned premiums in taxable income ratably over the next six years was underestimated by $64 million. Estimates of 1987 unearned premium levels were based on estimates of average net written premium growth rates. Annual premium growth rates are more variable (Table 3.5).

Proration Rule

The model underestimated the effect on taxable income of the proration rule -- including 15 percent of certain previously tax-exempt income in taxable income -- by $0.2 billion (Table 3.3).[6] Property and casualty company purchases of tax-exempt bonds increased in response to the 1986 Act changes. Interest income from tax-exempt bonds declined from $6.4 billion to $6.3 billion from 1984 to 1985, and then grew to $7.3 billion in 1986 and $9.1 billion in 1987.[7] The discounting and unearned premium changes caused some property and casualty companies to be regular taxpayers. The general lowering of tax rates reduced the spread between taxable and tax-exempt bonds. The combined impact of these changes provided incentives for purchases of tax-exempt bonds by property and casualty companies. Most of the underestimate of the proration rule on taxable income is explained by the underestimate of the impact of the 1986 Act changes on the purchase of tax-exempt bonds by property and casualty companies. The remainder is attributable to underestimates of tax-exempt bond yields and the dividends that were subject to the proration rule.

NOLs and Current Losses Used

The increase in the use of NOLs and current losses was underestimated by $1.0 billion. The estimates of NOLs and losses underestimated the use of losses of consolidated affiliates and NOLs to

---

[6] The income from tax-exempt bonds purchased after August 7, 1986, and the tax deductible portion of dividends received on stock purchased after August 7, 1986, were subject to proration.

[7] A. M. Best Co., Best's Aggregates and Averages, Property-Casualty, 1985-88 Editions.

Table 3.5

Net Written Premiums and Unearned Premiums for
Property and Casualty Insurance Companies: 1973-89

Year	Net Written Premiums ($ millions)	Change in Net Written Premiums (percent)	Unearned Premiums ($ millions)	Change in Unearned Premiums (percent)
1973	42,480		18,944	
1974	45,152	6.3	19,881	4.9
1975	49,967	10.7	21,529	8.3
1976	60,959	22.0	24,850	15.4
1977	73,030	19.8	28,387	14.2
1978	82,341	12.7	31,375	10.5
1979	91,359	11.0	34,585	10.2
1980	96,556	5.7	36,446	5.4
1981	100,294	3.9	37,816	3.8
1982	104,038	3.7	40,126	6.1
1983	109,247	5.0	42,302	5.4
1984	118,591	8.6	45,832	8.3
1985	144,860	22.2	56,850	24.0
1986	176,993	22.2	67,374	18.5
1987	193,689	9.4	72,302	7.3
1988	197,885	2.2	76,831	6.3
1989	220,620	11.5	79,941	4.0

Department of the Treasury
Office of Tax Analysis

April 1991

Source: A.M. Best, Aggregates and Averages, Property and Casualty, 1975-90 Editions.

offset increases in the income of property and casualty insurance companies resulting from the 1986 Act changes to the property and casualty insurance company tax rules. This error resulted from lags in the availability of tax return data combined with tax reporting conventions and data limitations, particularly about current losses of companies in other industries filing consolidated returns with property and casualty insurance companies.

Tax Credits

The use of tax credits was underestimated by $0.3 billion. This estimating error resulted primarily from data limitations related to the definition of the industry for SOI tax statistics (discussed above). Many of the credits used against the income of property and casualty insurance companies were earned by companies in other industries filing consolidated returns with property and casualty insurance companies. The SOI tax statistics include these credits in the totals for other industries. Some of the credits used were investment tax credit (ITC) carry-overs from 1986, the year the ITC was repealed.

PAL Account and Small Company Changes

In addition to the four tax changes discussed above, the 1986 Act repealed PAL accounts, which allowed mutual property and casualty insurance companies to defer tax on a portion of their income. It also liberalized the rules that exempted some small property and casualty insurance companies from tax and allowed others to elect to exclude their underwriting income from taxable income. The 1987 calendar year estimates for the repeal of PAL accounts and the small company changes were $97 million and -$23 million, respectively. Based upon the data from the sample of tax returns in the SOI corporate tax data base for 1987, it appears that the combined effect of these provisions on liabilities was $1 million.[8]

Since reliable data on the magnitude and distribution of NOLs were unavailable at the time estimates for these provisions were made, the estimates exaggerated the revenue loss attributable to these special tax deferral and tax reduction measures in pre-tax reform periods. Thus, the revenue increase from the repeal of PAL accounts was overestimated. The overestimates of revenue effects of the repeal of the PAL accounts and the changes in small company provisions were also largely attributable to underestimates of available NOLs. PAL account balances and the associated tax deferral are reduced dollar for dollar by NOLs used. In addition, the larger exclusion for small companies did not reduce revenues by the amount estimated because the use of NOLs by such companies was underestimated.

---

[8] The SOI corporate data base was used to evaluate actual receipts for these provisions, because companies in the special sample (described in Appendix 2) had minimal PAL balances and generally had net or direct written premiums that exceeded the small company thresholds.

3.4 Alternative Minimum Tax Liabilities for Property and Casualty Insurance Company Consolidated Returns: 1987

This section presents information on minimum tax liabilities of property and casualty insurance companies and companies in other industries that file consolidated returns with property and casualty insurance companies. Because minimum tax liabilities are determined on a consolidated basis, it was not possible to estimate the minimum tax liability attributable to companies in the property and casualty insurance industry. Data from tax returns generally included only the information needed to compute minimum tax liabilities on a consolidated basis, such as minimum tax adjustments, preferences, and NOLs. Moreover, it is not possible to compare estimated receipts for the property and casualty insurance companies with actual liabilities because only aggregate corporate minimum tax receipts were estimated for the 1986 Act.

The minimum tax liabilities for property and casualty insurance companies and affiliated companies were $175 million for 1987 (Table 3.6). Approximately 32 percent of the property and casualty insurance companies' consolidated tax returns in the sample had minimum tax liabilities.

Table 3.6 provides information on the composition of the alternative minimum (AMT) tax base by tax status of the consolidated returns. Companies that paid only the minimum tax (and no regular tax due to the property and casualty insurance company changes) owed approximately $115 million. Generally, these companies had no regular tax liability because NOLs offset the increase in taxable income before NOLs attributable to the property and casualty insurance companies tax changes. Because the use of NOLs to offset alternative minimum taxable income is limited, these companies paid AMT. The minimum tax paid by these companies is largely attributable to the book income preference, which accounted for 64 percent of the minimum tax base before NOLs.

Returns in the sample that paid both regular tax and minimum tax paid $60 million in alternative minimum tax. Generally these companies paid the minimum tax because NOLs reduced regular tax liability below minimum tax liability, but were insufficient to eliminate regular tax liability. Approximately 55 percent percent of the consolidated returns in the sample paid only regular tax. For these companies, the tax effect of the larger minimum tax base was more than offset by lower minimum tax rate.

The remaining 13 percent of returns in the sample with no minimum tax had no regular tax liability attributable to the property and casualty insurance company tax changes. Most of these companies were not taxable because current losses before NOLs more than offset minimum tax preferences. Some companies that paid no taxes due to the property and casualty insurance company tax changes filed consolidated returns with life insurance companies and paid tax on their life insurance income.

3.5 Conclusion

The actual increase in regular tax liabilities for calendar year 1987 for the property and casualty insurance company tax provisions nearly equaled the amounts estimated at the time of the 1986 Act. The specific provisions, however, were either over- or underestimated. These errors are

Table 3.6

Alternative Minimum Tax Base and Liabilities
by Tax Status of Companies Filing P&C Consolidated Tax Returns*
($ millions)

	Minimum Tax Paid; No Regular Tax From P&C Tax Changes	Minimum Tax Paid; Regular Tax From P&C Tax Changes	No Minimum Tax Paid; Regular Tax From P&C Tax Changes	No Minimum Tax Paid; No Regular Tax From P&C Tax Changes
Regular taxable income before NOLs	1,192	1,785	15,287	177
Minimum tax adjustments	730	39	220	6
Minimum tax preferences **	119	42	117	29
Book income preference	3,615	744	1,418	469
Minimum tax base before NOLs	5,656	2,610	17,042	681
Alternative tax NOLs	3,892	846	3,949	734
Exemptions	***	***	***	***
Alternative minimum taxable income	1,764	1,764	13,093	402
Tentative minimum tax	353	353	2,619	80
AMT foreign tax credit	220	34	492	2
Tentative minimum tax	133	319	2,127	78
Income tax before credits				
Minus foreign tax credit****	8	259	4,383	112
Alternative minimum tax	115	60	0	0
Percent of companies	24	8	55	13

Department of the Treasury
Office of Tax Analysis

April 1991

* Details may not add to totals because of rounding.

** Excludes book income preference.

*** Less than $1 million.

**** Includes regular tax on income not attributable to the property and casualty company tax changes.

related largely to the significance of the changes enacted under the Tax Reform Act of 1986 and to limitations in the available data, particularly with respect to NOLs and credits. Estimating errors were largely offsetting, so that the aggregate estimated change in liabilities for the property and casualty insurance tax provisions nearly equaled the actual change in liabilities for 1987.

CHAPTER 4. THE TAX TREATMENT OF POLICYHOLDER DIVIDENDS PAID BY INSURANCE COMPANIES

4.1 Introduction

Under present law, mutual and stock insurance companies generally are allowed to deduct dividends and similar distributions paid to their policyholders. These distributions are included in the income of the recipient only after the full amount of premiums paid has been recovered (unless the policyholder deducted the premiums). Dividends paid to individual shareholders by stock insurance companies are not deductible by the company and are included in the income of the shareholder.[1]

An exception to the general rule that provides for deductibility of policyholder dividends paid arises for mutual life insurance companies. Under the Deficit Reduction Act of 1984 (the 1984 Act) mutual life insurance companies must reduce the deduction for policyholder dividends paid.[2] Congress enacted this limitation because it believed that a portion of the policyholder dividends paid by mutual life insurance companies is a distribution of corporate earnings to the policyholders as owners. Absent such a limitation on the deduction for policyholder dividends, it was argued, mutual life insurance companies would be provided a tax advantage because stock life insurance companies cannot deduct amounts paid to their shareholders as dividends.

Although Congress significantly overhauled the tax treatment of property and casualty insurance companies under the Tax Reform Act of 1986 (the 1986 Act), it did not extend the application of a limitation on the deductibility of policyholder dividends to mutual property and casualty insurance companies. Congress recognized that the limitation on the deduction for policyholder dividends as applied to life insurance companies has been both complex and controversial.[3] Thus, the 1986 Act required the Treasury Department to study the tax treatment of policyholder dividends paid by mutual property and casualty insurance companies before a limitation on the deductibility of policyholder dividends or other approach is considered for such insurers.

The appropriate tax treatment of policyholder dividends is problematic because in the insurance industry customers (policyholders) often also participate as owners or part owners of the business, since they provide capital to the business that earns income. A major difficulty in taxing the income of mutual and stock insurance companies is that the total income of companies selling "participating" policies cannot be identified directly. A "participating" policy is one through

---

[1] See generally, Sections 808(a)(2), 832(c)(11), 72(e)(5)(c), 301(c) of the Internal Revenue Code.

[2] See Internal Revenue Code Section 809.

[3] Joint Committee on Taxation, <u>General Explanation of the Tax Reform Act of 1986</u>, May 4, 1987, p. 621.

which a policyholder effectively buys not only insurance protection, but also an equity-like interest in the insurance company. The return that a participating policyholder may receive on the 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 amounts credited to policy cash values. Further, policyholder dividends may blend together many elements, including price reductions, interest payments (reflecting the companies' use of any redundant premiums between receipt and repayment), repayment of the policyholder's investment principal, and equity-like returns. Not all of these items are appropriately taxed at the corporate level. Moreover, the identification and measurement of equity-like returns to participating policyholders is even more difficult in the case of stock companies because these policyholders share the equity risk with stock company shareholders.

The 1984 Act required the Treasury Department to study the effects of the Act's life insurance tax provisions, including the tax treatment of life insurance company policyholder dividends. The Treasury Department's Final Report to the Congress on Life Insurance Company Taxation (the Final Report) included an evaluation of the limitation on the deduction for policyholder dividends paid by mutual life insurance companies and concluded that the limitation is conceptually flawed.[4] This conclusion relies to a large extent on the "prepayment analysis," which shows that under certain assumptions the full deductibility of policyholder dividends does not confer a tax advantage on mutual life insurance companies.

According to the prepayment analysis, a limitation on the deduction for policyholder dividends is unnecessary because any deduction of corporate earnings through mutual company policyholder dividends is exactly offset by the additional tax due from mutual companies when they raise capital through premiums by selling participating insurance policies. Stock companies, in contrast, are not required to include in income capital contributions of their shareholders. Under the prepayment analysis, a tax on paid-in capital combined with the full deductibility of the return to contributors (policyholder dividends) provides the same after-tax return at the company level and the same tax to the government in present value as the exclusion of paid-in capital combined with no deduction for dividends paid to shareholders. Since the prepayment analysis shows that the conceptual basis for a limitation on the deduction for policyholder dividends for mutual life insurance companies is flawed, extending this approach to mutual property and casualty insurance companies is inappropriate.

The prepayment analysis does not address the problem that policyholders enjoy a tax advantage at the investor level. The following section discusses the policyholder-level tax advantage and evaluates its significance for investors in property and casualty insurance companies.

---

[4] See the Department of the Treasury, Final Report to the Congress on Life Insurance Company Taxation, (August 1989), Chapter 5. A study by the General Accounting Office also reached this conclusion. See United States General Accounting Office, Allocation of Taxes Within the Life Insurance Industry (October 1989).

4.2 Policyholder-Level Taxation of Policyholder Dividends Paid by Property and Casualty Insurance Companies

Policyholders enjoy a tax advantage at the investor level because returns to capital contained in policyholder dividends generally are excluded from taxable income but shareholders' dividends are taxed when received (and stock appreciation is taxed when the stock is sold). This tax advantage accrues to participating policies issued by both stock and mutual insurance companies.

An exception to the policyholder-level tax advantage occurs when the policyholder is a business rather than an individual. Businesses are permitted to deduct premiums paid, but include fully in taxable income policyholder dividends received.[5] To the extent that a portion of premiums represents an equity-like contribution through a redundant premium, the current deduction of the redundant premium and the later inclusion in income of policyholder dividends is equivalent in present value to the absence of a deduction for share purchases and the exclusion from income of shareholder dividends received by corporations.[6] Thus, policyholder equity generally has no policyholder-level tax advantage over shareholder equity when the policyholder is a business. The following sections examine data on policyholder dividends paid by property and casualty insurers for business and personal coverage.

4.2.1 Policyholder Dividends By Line of Business

Data on policyholder dividends for property and casualty insurance companies by line of business for 1989 show that most policyholder dividends were paid on workers' compensation policies, which are sold primarily to businesses (Table 4.1). Property and casualty insurance companies paid 63 percent of policyholder dividends in the workers' compensation line, 17 percent in the personal auto lines, and 20 percent in all other lines. For the workers' compensation line, policyholder dividends were 6 percent of premiums. Policyholder dividends as a percent of premiums were 2.3 percent or less for all other lines.

Table 4.2 shows the breakdown of policyholder dividends for stock and mutual property and casualty insurance companies by line of business for 1989. Policyholder dividends in the workers' compensation line predominate for both stock and mutual property and casualty insurance companies.

---

[5] See generally Internal Revenue Code Sections 162, 61, and 63.

[6] Equity investments in a mutual company and in a stock company are not fully equivalent because up to thirty percent of shareholder dividends received by corporations are taxable. See Internal Revenue Code Section 243.

Table 4.1

Policyholders Dividends and Premiums Earned for
Property and Casualty Insurance Companies by Line of Business: 1989

	Policyholder Dividends		Premiums Earned		Dividends/ Premiums (percent)
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total	
Fire	17.8	0.7	4,675.7	2.3	0.4
Allied Lines	10.4	0.4	2,054.8	1.0	0.5
Farmowners Multi Peril	7.9	0.3	922.7	0.4	0.9
Homeowners Multi Peril	83.0	3.1	17,349.7	8.4	0.5
Commercial Multi Peril	64.3	2.4	17,402.2	8.4	0.4
Ocean Marine	3.7	0.1	1,222.5	0.6	0.3
Inland Marine	9.7	0.4	4,324.1	2.1	0.2
Financial Guaranty	0.0	0.0	351.0	0.2	0.0
Medical Malpractice	95.1	3.5	4,222.7	2.0	2.3
Earthquake	1.8	0.1	360.1	0.2	0.5
Group Accident & Health	0.0	0.0	2,739.6	1.3	0.0
Credit Accident & Health	0.0	0.0	243.0	0.1	0.0
Other Accident & Health	0.1	0.0	1,532.2	0.7	0.0
Workers' Compensation	1,715.1	63.2	28,069.0	13.6	6.1
Other Liability	86.3	3.2	18,522.6	9.0	0.5
Auto Liab. (Private)	267.2	9.8	43,073.9	20.9	0.6
Auto Liab. (Commercial)	108.6	4.0	11,934.7	5.8	0.9
Auto Damage (Private)	197.5	7.3	29,397.4	14.3	0.7
Auto Damage (Commercial)	27.8	1.0	5,196.3	2.5	0.5
Aircraft	0.0	0.0	583.7	0.3	0.0
Fidelity	0.8	0.0	942.1	0.5	0.1
Surety	10.6	0.4	1,693.6	0.8	0.6
Glass	0.3	0.0	21.2	0.0	1.3
Burglary and Theft	1.5	0.1	103.3	0.1	1.5
Boiler and Machinery	0.9	0.0	621.4	0.3	0.1
Credit	0.0	0.0	899.0	0.4	0.0
International	0.0	0.0	170.3	0.1	0.0
Reinsurance (A,B,C, & D)	1.2	0.0	7,063.1	3.4	0.0
Write-ins	1.5	0.1	550.0	0.3	0.3
Total	2,713.1	100.0	206,242.2	100.0	1.3

Department of the Treasury
Office of Tax Analysis

April 1991

Source: A. M. Best Company

Table 4.2

Table 4.2

Policyholder Dividends and Premiums Earned for Stock and Mutual
Property and Casualty Insurance Companies by Line of Business: 1989

	Stock Companies					Mutual Companies				
	Policyholder Dividends		Premiums Earned		Dividends/	Policyholder Dividends		Premiums Earned		Dividends/
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total	Premiums (percent)	Amount ($ millions)	Percent of total	Amount ($ millions)	Percent of Total	Premiums (percent)
Fire	5.0	0.4	2,903.6	2.3	0.2	12.9	0.9	1,772.1	2.2	0.7
Allied Lines	2.9	0.2	1,396.9	1.1	0.2	7.4	0.5	657.9	0.8	1.1
Farmowners Multi Peril	0.0	0.0	332.8	0.3	0.0	7.9	0.6	589.9	0.7	1.3
Homeowners Multi Peril	1.6	0.1	8,192.5	6.5	0.0	81.4	5.6	9,157.3	11.4	0.9
Commercial Multi Peril	47.0	3.7	12,682.6	10.1	0.4	17.3	1.2	4,719.6	5.9	0.4
Ocean Marine	0.0	0.0	1,075.9	0.9	0.0	3.7	0.3	146.5	0.2	2.5
Inland Marine	0.4	0.0	3,234.9	2.6	0.0	9.3	0.6	1,089.1	1.4	0.9
Financial Guaranty	0.0	0.0	343.1	0.3	0.0	0.0	0.0	7.8	0.0	0.0
Medical Malpractice	9.0	0.7	2,106.9	1.7	0.4	86.1	6.0	2,115.8	2.6	4.1
Earthquake	0.0	0.0	190.6	0.2	0.0	1.8	0.1	169.4	0.2	1.1
Group Accident & Health	0.0	0.0	1,202.5	1.0	0.0	0.0	0.0	1,537.1	1.9	0.0
Credit Accident & Health	0.0	0.0	207.9	0.2	0.0	0.0	0.0	35.1	0.0	0.0
Other Accident & Health	0.0	0.0	541.8	0.4	0.0	0.1	0.0	990.4	1.2	0.0
Workers' Compensation	1,065.6	84.0	19,773.1	15.7	5.4	649.6	45.0	8,295.9	10.3	7.8
Other Liability	30.7	2.4	15,549.5	12.3	0.2	55.7	3.9	2,973.1	3.7	1.9
Auto Liab. (Private)	7.9	0.6	19,037.2	15.1	0.0	259.3	18.0	24,036.7	29.9	1.1
Auto Liab. (Commercial)	58.5	4.6	8,889.8	7.1	0.7	50.1	3.5	3,044.9	3.8	1.6
Auto Damage (Private)	4.4	0.3	13,196.5	10.5	0.0	193.1	13.4	16,200.9	20.2	1.2
Auto Damage (Commercial)	22.9	1.8	3,962.0	3.1	0.6	4.8	0.3	1,234.3	1.5	0.4
Aircraft	0.0	0.0	503.7	0.4	0.0	0.0	0.0	80.0	0.1	0.0
Fidelity	0.7	0.1	817.4	0.6	0.1	0.0	0.0	124.7	0.2	0.0
Surety	10.3	0.8	1,527.2	1.2	0.7	0.2	0.0	166.4	0.2	0.1
Glass	0.3	0.0	16.8	0.0	1.6	0.0	0.0	4.4	0.0	0.2
Burglary and Theft	1.5	0.1	81.1	0.1	1.8	0.1	0.0	22.3	0.0	0.3
Boiler and Machinery	0.4	0.0	404.6	0.3	0.1	0.5	0.0	216.8	0.3	0.2
Credit	0.0	0.0	889.6	0.7	0.0	0.0	0.0	9.5	0.0	0.0
International	0.0	0.0	111.2	0.1	0.0	0.0	0.0	59.0	0.1	0.0
Reinsurance (A,B,C, & D)	0.1	0.0	6,281.2	5.0	0.0	1.1	0.1	781.9	1.0	0.1
Write-ins	0.1	0.0	530.5	0.4	0.0	1.4	0.1	19.5	0.0	7.3
Total	1,269.3	100.0	125,983.6	100.0	1.0	1,443.8	100.0	80,258.6	100.0	1.8

Department of the Treasury
Office of Tax Analysis

April 1991

Source: A. M. Best Company

The workers' compensation line accounted for 84 percent of policyholder dividends paid by stock companies and 45 percent of policyholder dividends paid by mutual companies. For mutual companies, private auto lines accounted for 31 percent of policyholder dividends. On average, mutual companies pay more policyholder dividends as a percent of premiums than stock companies. The ratio of policyholder dividends to premiums in 1989 was 1.8 percent and 1.0 percent for mutual companies and stock companies, respectively.

Associations representing the property and casualty insurance industry (both stock and mutual companies) argue that the importance of policyholder dividends in the workers' compensation line reflects a form of price competition in a regulated market. Base rates for workers' compensation coverage are established by state law and insurers generally are prevented from charging less than the base rates without regulatory approval. Policyholder dividends provide a mechanism for reducing the effective price of a workers' compensation contract because insurers are prevented from adjusting premiums when the contract is sold. Thus, it is argued that policyholder dividends are the result of price competition and are not return on equity.[7]

The extent to which policyholder dividends comprise price rebates, returns on equity, or return of capital cannot be determined with available data. As noted above, however, the prepayment analysis shows that when policyholders are businesses, as appears to be the case for workers' compensation policyholders, the present tax treatment of policyholder dividends does not confer a policyholder-level tax advantage. The lines of business for which a policyholder-level tax advantage may be relevant are the personal lines.

4.2.2 Policyholder Dividends for Personal Coverage

It is not possible to measure precisely policyholder dividends for personal coverage, because the available data on policyholder dividends generally do not distinguish between personal and commercial lines of insurance business. The exceptions are homeowners multiple peril, private passenger auto liability, and private passenger physical damage, which are identified personal lines. However, other lines that may be viewed as primarily commercial include some personal coverage, such as accident and health, fire, and allied lines. Thus, the data for homeowners multiple peril and the personal auto lines provide an indication of the importance of policyholder dividends for personal coverage.

Table 4.3 shows that policyholder dividends for the three lines of business that are primarily personal (homeowners multiple peril and the private auto lines) were $548 million in 1989, or 20 percent of total policyholder dividends paid by property and casualty insurers. Table 4.4 shows that mutual companies paid $534 million in policyholder dividends for personal coverage (97 percent of the industry total) compared with $14 million for stock companies (3 percent of the industry total). Policyholder dividends for personal coverage averaged 1.1 percent of premiums for mutual companies and were insignificant for stock companies.

---

[7] Alliance of American Insurers, National Association of Independent Insurers, and National Association of Mutual Insurance Companies, Report Concerning Taxation of Mutual and Stock Property and Casualty Insurers (January 8, 1990), pp. 8-9.

Table 4.3

Policyholder Dividends and Premiums Earned for Property and Casualty Insurance Companies for Personal and Commercial Coverage: 1989

	Policyholder Dividends		Premiums Earned		Dividends/ Premiums (percent)
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total	
Total Personal Lines:	547.7	20.2	89,821.1	43.6	0.6
Homeowners MP	83.0	3.1	17,349.7	8.4	0.5
Auto Liab (Priv.)	267.2	9.8	43,073.9	20.9	0.6
Auto Phys (Priv.)	197.5	7.3	29,397.4	14.3	0.7
Total Commercial Lines:	2,165.4	79.8	116,421.1	56.4	1.9
Workers' Comp	1,715.1	63.2	28,069.0	13.6	6.1
Other	450.3	16.6	88,352.1	42.8	0.5
Total All Lines	2,713.1	100.0	206,242.2	100.0	1.3

Department of the Treasury
Office of Tax Analysis

April 1991

Source: A. M. Best Company

Table 4.4

Policyholder Dividends and Net Written Premiums for Stock and Mutual Property and Casualty Insurance Companies for Personal and Commercial Coverage: 1989

	Stock Companies					Mutual Companies				
	Policyholder Dividends		Net Written Premiums			Policyholder Dividends		Net Written Premiums		
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total	Dividends/ Premiums	Amount ($ millions)	Percent of total	Amount ($ millions)	Percent of Total	Dividends/ Premiums
Total Personal Lines:	13.9	1.1	40,718.4	32.2	0.0	533.8	37.0	50,514.6	61.6	1.1
Homeowners MP	1.6	0.1	8,261.5	6.5	0.0	81.4	5.6	9,409.4	11.5	0.9
Auto Liab (Priv.)	7.9	0.6	19,302.8	15.3	0.0	259.3	18.0	24,673.7	30.1	1.1
Auto Phys (Priv.)	4.4	0.3	13,154.0	10.4	0.0	193.1	13.4	16,431.4	20.1	1.2
Total Commercial Lines:	1,255.4	98.9	85,721.7	67.8	1.5	910.0	63.0	31,433.3	38.4	2.9
Workers' Comp	1,065.6	84.0	19,738.3	15.6	5.4	649.6	45.0	8,503.1	10.4	7.6
Other	189.8	15.0	65,983.4	52.2	0.3	260.5	18.0	22,930.2	28.0	1.1
Total All Lines	1,269.3	100.0	126,440.1	100.0	1.0	1,443.8	100.0	81,947.9	100.0	1.8

Source:

The data presented in Tables 4.3 and 4.4 include both companies that paid policyholder dividends and those that did not. As a result, the average ratio of policyholder dividends to premiums understates the average for companies that actually paid such dividends. Table 4.5 provides data on policyholder dividends and premiums for companies that paid policyholder dividends, i.e., it excludes companies that did not pay policyholder dividends for the particular line of business. Table 4.5 shows that policyholder dividends for personal coverage averaged 2 percent for mutual companies that paid such dividends, compared with 0.2 percent for stock companies. For mutual companies policyholder dividends as a percent of premiums for personal coverage varies by line of business. Policyholder dividends as a percent of premiums were more than twice as large for homeowners multiple peril than for the personal auto lines for mutual companies that actually paid policyholder dividends for those lines.

Industry representatives argue that, if policyholder dividends for personal coverage contain an element of return on equity that confer a tax advantage, they would be significant and paid primarily by mutual companies.[8] Table 4.3 shows that policyholder dividends for personal coverage are less than one percent of premiums. However, mutual companies account for virtually all policyholder dividends for personal coverage and pay them at a higher rate than stock companies (Table 4.4). Approximately 7.6 percent of the mutual companies that wrote business in the personal lines paid policyholder dividends for personal coverage, compared with 2.5 percent of stock companies (Table 4.6). Thus, these data provide some support for the industry view that policyholder dividends are small relative to premiums and are paid by a relatively small fraction of companies that provide personal coverage.

Industry representatives also note that the ratio of policyholder dividends to premiums varies among personal lines and policyholders, and suggest that policyholder dividends reflect a firm's circumstances in a particular market.[9] If mutual company policyholder dividends are a return on equity, it is argued, they would be paid proportionately to all policyholders, as is the case with respect to dividends paid to shareholders of the same class of stock.[10]

However, differences in the rate at which policyholder dividends are paid among lines of business may reflect differences in the degree of risk. In addition, differences in the rate at which policyholder dividends are paid may reflect the fact that policyholder dividends are not a precise measure of the returns that a participating policyholder receives on his equity interest.

---

[8] Letter to Kenneth Gideon, Assistant Secretary for Tax Policy, Treasury Department, from Alliance of American Insurers, National Association of Independent Insurers and National Association of Mutual Insurance Companies, May 31, 1990.

[9] Ibid, p. 7.

[10] Alliance of American Insurers, National Association of Independent Insurers, and National Association of Mutual Insurance Companies, Report Concerning Taxation of Mutual and Stock Property and Casualty Insurers, p. 10.

Table 4.5

Policyholder Dividends and Premiums Earned by Line of Business for Stock and Mutual Property and Casualty Insurance Companies that Paid Policyholder Dividends for Personal Coverage: 1989

	Stock Companies					Mutual Companies				
	Policyholder Dividends		Premiums Earned		Dividends/	Policyholder Dividends		Premiums Earned		Dividends/
	Amount ($ millions)	Percent of Total	Amount ($ millions)	Percent of Total	Premiums (percent)	Amount ($ millions)	Percent of total	Amount ($ millions)	Percent of Total	Premiums (percent)
Total Personal Lines:	13.9	1.1	6,317.8	6.2	0.2	533.8	37.0	24,727.6	36.8	2.2
Homeowners MP	1.6	0.1	880.3	0.9	0.2	81.4	5.6	1,574.2	2.3	5.2
Auto Liab (Priv.)	7.9	0.6	3,490.9	3.4	0.2	259.3	18.0	13,969.7	20.8	1.9
Auto Phys (Priv.)	4.4	0.3	1,946.6	1.9	0.2	193.1	13.4	9,183.7	13.7	2.1
Total Commercial Lines:	1,255.4	98.9	95,916.9	93.8	1.3	910.0	63.0	42,532.9	63.2	2.1
Workers' Comp	1,065.6	84.0	19,137.5	18.7	5.6	649.6	45.0	8,007.1	11.9	8.1
Other	189.8	15.0	76,779.3	75.1	0.2	260.5	18.0	34,525.8	51.3	0.8
Total All Lines	1,269.3	100.0	102,234.6	100.0	1.2	1,443.8	100.0	67,260.5	100.0	2.1

Department of the Treasury
Office of Tax Analysis

April 1991

Source: A. M. Best Company

Table 4.6

Number and Percent of Property and Casualty Insurance Companies that Paid Policyholder Dividends for Personal Coverage: 1989

	Stock Companies		Mutual Companies		Total	
	Number	Percent	Number	Percent	Number	Percent
Total Personal Lines:	17	2.5	33	7.6	50	4.5
Homeowners MP	5	0.7	26	6.0	31	2.8
Auto liability (private)	12	1.8	19	4.4	31	2.8
Auto physical (private)	11	1.6	19	4.4	30	2.7

Department of the Treasury
Office of Tax Analysis

April 1991

Source: A. M. Best Company

As discussed in the previous section, policyholder dividends may blend together price reductions, interest payments, and equity-like returns. Moreover, equity returns for participating policyholders may be received in a variety of ways, such as through reduced premiums. However, to the extent that policyholders change insurers, it is less likely that equity-like returns would be paid in the form of reduced premiums. Both the extent to which policyholder dividends contain equity returns and equity returns are received in other forms are impossible to determine empirically.

4.3 Arguments Relating to Differences between Property and Casualty Insurance and Life Insurance

Representatives of the property and casualty insurance industry also argue that a limitation on policyholder dividends should not be imposed on property and casualty insurers because property and casualty insurance differs from life insurance in several respects.

First, representatives of the property and casualty insurance industry contend that the resemblance that a mutual company policyholder bears to an owner is closer with a life insurance policy than with a property and casualty insurance policy. Because life insurance policies generally are longer-term commitments based on relatively predictable mortality rates, they may be more closely tied to the company's investment performance. In contrast, property and casualty policies are short-term contracts often for more highly variable risks. Whereas certain life insurance policies are held for many years, property and casualty insurance coverage tends to have a short duration, such as six-months to one year. Thus, it is argued that a property and casualty insurance policyholder's relationship only weakly resembles a traditional ownership relationship.[11]

Although property and casualty insurance contracts are short-term, the extent to which policyholders renew their policies with the same company and thus are affiliated with their property and casualty insurance company for long periods is unclear. The duration of property and casualty contracts may not accurately reflect either the duration of the relationship between the policyholder and the insurance company or the closeness of that relationship to a traditional ownership interest.

Representatives of the property and casualty insurance industry argue that property and casualty insurance policyholders are unlikely to receive an investment-like return during the term of the policy because the policies are short term.[12] This argument more appropriately addresses the amount and form of payment of any investment-like return. Policyholder dividends for short-duration contracts contain an investment-like return because the insurance company invests the redundant

---

[11] See Emil M. Sunley, Federal Income Taxation of Mutual and Stock Property/Casualty Insurance Companies (November 28, 1988), pp. 31-2.

[12] Alliance of American Insurers, National Association of Independent Insurers, and National Association of Mutual Insurance Companies, Report Concerning Taxation of Mutual and Stock Property and Casualty Insurers, p. 17.

premiums it receives. Thus, policyholder dividends contain an policyholder-level advantage with respect to any investment-like element for participating policies of both mutual and stock companies.[13]

The duration of an insurance contract may also affect whether the investment-like return is paid in the form of policyholder dividends or premium adjustments. Life insurance industry representatives point out that life insurance companies may set premiums over a period of years and reflect favorable experience through policyholder dividends, while property and casualty insurers may reflect favorable experience by periodically resetting premiums.[14]

Property and casualty insurance industry representatives also note that unlike many life insurance policies, property and casualty policies do not generate a cash surrender value. Thus, it is argued that the purchaser of property and casualty insurance is purchasing insurance and is not making an investment.[15] Although cash value policies are likely to contain larger investment returns, short-term policies also earn investment-like returns since property and casualty insurers invest the premiums they receive. Thus, policyholder dividends may provide a policyholder-level advantage with respect to this investment return, regardless of whether the policy has a cash surrender value.

Finally, it is argued that property and casualty insurance is riskier than life insurance, because property and casualty insurance companies cannot measure the magnitude of their risks with as much precision. Life insurance policies pay the face amount of the policy when the insured dies and life insurers are able to predict the occurrence of death accurately for members of large groups of individuals. Property and casualty insurers do not know whether a particular policy will produce a loss, the number of losses that will occur with respect to the policy, or the amount of the loss.[16] Whether property and casualty insurance is riskier than life insurance is beyond the scope of this report. Nevertheless, if the industry's argument is accepted, one likely outcome is that the expected return on equity will be larger to compensate investors for the greater risk.

4.4 Summary and Conclusion

The Treasury Department recommends that Congress not extend a limitation on the deduction for policyholder dividends to property and casualty insurance companies because the conceptual basis for

---

[13] Emil M. Sunley, Op. Cit., p. 33.

[14] Letter to Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury, from Theodore R. Groom and Matthew J. Zinn, dated August 8, 1990.

[15] Letter to Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury from Donald C. Alexander, April 3, 1990.

[16] Alliance of American Insurers, National Association of Independent Insurers, and National Association of Mutual Insurance Companies, Report Concerning Taxation of Mutual and Stock Property and Casualty Insurers, p. 14-17.

a limitation is flawed. The prepayment analysis shows that mutual company policyholder dividends should be fully deductible to provide equal corporate-level tax treatment of equity-like returns to mutual and stock company investors. According to the prepayment analysis a tax on paid-in capital combined with a full deduction of dividends to policyholders is equivalent in present value terms to the exclusion of capital contributions combined with no deduction for dividends to shareholders.

The prepayment analysis does not address the problem that returns to participating policyholders of mutual and stock insurance companies may enjoy a policyholder-level advantage because policyholder dividends are not taxable income to policyholders but dividends are taxable to shareholders. An exception to this policyholder-level advantage arises when the policyholder is a business rather than an individual. Since businesses deduct premiums paid but include policyholder dividends in income, a policyholder-level tax advantage generally does not arise between conventional equity and policyholder equity.

Data on policyholder dividends paid by property and casualty insurers show that most policyholder dividends are paid in the workers' compensation line. Since workers' compensation policies are purchased primarily by businesses, it is unlikely that a significant policyholder-level tax advantage arises with respect to policyholder dividends on these policies. However, a policyholder-level tax advantage arises with respect to the investment-like return contained in policyholder dividends for personal coverage, such as the homeowners multiple peril and the personal auto lines of business.

Current law generally does not tax the equity-like income of participating policyholders of life insurance companies or property and casualty insurance companies at the individual level. This problem is not limited to mutual company policyholders, since both stock and mutual companies issue participating policies. The disparity in the treatment of policyholders and shareholders at the individual level could justify a corporate-level tax on the equity return contained in policyholder dividends as a proxy for the absent individual-level tax. However, as an empirical matter, this disparity is considerably smaller for investors in property and casualty insurance companies than for life insurance companies because the amount of policyholder dividends paid by property and casualty insurers is substantially smaller than that paid by life insurers and policyholder dividends paid by property and casualty insurers are paid primarily to business policyholders. Since the imposition of a proxy tax on property and casualty insurance companies would impose a compliance burden but would have modest revenue yield, the Treasury Department does not recommend a proxy tax at this time.

APPENDIX 1 - REQUIREMENT FOR THE REPORT

The Tax Reform Act of 1986 (P.L. 99-514) contains the following reporting requirement:

"Sec. 1025. STUDY OF THE TREATMENT OF PROPERTY AND CASUALTY INSURANCE COMPANIES.

The Secretary of the Treasury or his delegate shall conduct a study of--

(1) the treatment of policyholder dividends by mutual property and casualty insurance companies,

(2) the treatment of property and casualty insurance companies under the minimum tax, and

(3) the operation and effect of, and revenue raised by, the amendments made by this subtitle.

Not later than January 1, 1989, such Secretary shall submit to the Committee on Ways and Means of the House of Representatives, the Committee on Finance of the Senate, and the Joint Committee on Taxation, the results of such study, together with such recommendations as he determines to be appropriate. The Secretary of the Treasury shall have authority to require the furnishing of such information as may be necessary to carry out the purposes of this section."

Section 11831 of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) extended the date for filing this study to January 1, 1992.

APPENDIX 2 - DESCRIPTION OF THE SAMPLE AND METHODOLOGY

The Sample and Sample Weights

The estimates of actual 1987 tax liabilities are based on data from a sample of tax returns of the largest property and casualty insurance companies. The sample consisted of 96 of the 100 largest, as measured by net written premiums, affiliated property and casualty insurance company groups. For many company groups, some property and casualty insurance companies in the group filed separate tax returns so the data collection process involved the assembly of data from multiple tax returns. Much of the data needed for the study came from an IRS corporate SOI data tape and a special IRS data project. The Treasury Department obtained additional data required for the study from the companies.

The sample companies had approximately 85.5 percent of net written premiums for the industry in 1987. The estimates of regular and minimum taxes for the companies not in the sample were calculated by multiplying the average of tax to net premiums written for the sample companies by the difference between net written premiums for the industry and net written premiums for the sample companies. If the ratio between tax and premiums is invariant with respect to the level of premiums, these ratio estimates (and therefore the tax estimates for the missing companies) are unbiased. The invariance condition was tested by comparing the ratio of the top 50 companies to the rest of the sample. It was not possible, at the 95 percent confidence level, to reject the hypothesis of invariance.

Data Checking and Error Resolution Procedures

The internal consistency of data items required for the computation of the changes in taxable income were tested and data errors corrected. For example, in some cases the consistency testing resulted in the detection of incorrectly transcribed Schedule E and F data from the 1120PC form, which was used to determine the potential effect of the discounting, prorationing, and unearned premium reserve changes on the company's taxable income. In these cases, copies of tax returns were used to correct the underlying data transcription problems. Net written premiums from each company group were compared to net written premiums for the company group Best Company data tapes were used to determine company groups which filed multiple 1120PC tax returns. Supplemental tax data were collected from such companies when preliminary available data were determined to be insufficient. When data on undiscounted reserves were not reported on tax returns, the undiscounted reserve data were obtained from Best Co. data tapes.

Computation Procedures

Tax return data from the sample companies were used to estimate the maximum potential increase in taxable income attributable to the 1986 Act provisions. For each tax return, the actual effect of the provisions on the taxable income shown on the return was also determined. The actual effect could be less than the potential effect if the property and casualty insurance company or any of the consolidated companies had current losses or NOLs that offset the impact of the property and casualty insurance company tax changes. In determining the actual effect of the property and casualty insurance company changes on the income shown on consolidated tax returns, the 35 percent rule for life-nonlife consolidated returns was taken into account. This rule limits the use of nonlife losses against life income to the minimum of 35 percent of eligible nonlife losses or 35 percent of life insurance subgroup income. For several companies in the sample, consolidated taxable income was solely attributable to life subgroup income and the use of nonlife losses was constrained by life subgroup income. For such companies, consolidated taxable income and tax was unchanged by the 1986 Act provisions even though the tax changes reduced the nonlife losses of the companies.

BIBLIOGRAPHY

Alexander, Donald C., Letter to the Treasury Department, Re Taxation of Property and Casualty Companies, April 3, 1990.

A. M. Best Company, Aggregates and Averages, Property-Casualty, 1984 through 1990.

Alliance of American Insurers, National Association of Independent Insurers, and National Association of Mutual Insurance Companies, Letter to Treasury Department (and attachment), Report Concerning Taxation of Mutual and Stock Property and Casualty Insurers, January 8, 1990.

Alliance of American Insurers, National Association of Independent Insurers, and National Association of Mutual Insurance Companies, Letter to Treasury Department Re Policyholder Dividends Paid by P & C Companies in Personal Lines: A Supplement to Report Concerning Taxation of Mutual Property and Casualty Insurers, May 31, 1990.

Groom, Theodore R. and Matthew J. Zinn, Letter to the Treasury Department, Re Taxation of Mutual Property and Casualty Companies, August 9, 1990.

Insurance Services Office, Inc., Tax Law Changes and Property and Casualty Insurers, A Comprehensive Analysis, September 1989.

Price Waterhouse, Property and Casualty Insurance Industry, Survey of 1987 Federal Income Tax Liability, April 20, 1989.

Price Waterhouse, Property and Casualty Insurance Industry, Survey of 1988 Federal Income Tax Liability, March 27, 1990.

Sunley, Emil, Federal Taxation of Mutual and Stock Property/Casualty Companies, November 1988.

U.S. Congress, General Accounting Office, Allocation of Taxes within the Life Insurance Industry, October 1989.

U.S. Congress, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, May 4, 1987.

U.S. Department of the Treasury, Interim Report to Congress on Life Insurance Company Taxation, June 1988.

U.S. Department of the Treasury, Final Report to the Congress on Life Insurance Congress on Life Insurance Company Taxation, August 1989.

Department of the Treasury
Washington, D.C. 20220

Official Business
Penalty for Private Use, $300

Report to Congress on the

Depreciation of Business - Use Passenger Cars

Department of the Treasury
April 1991

Report to Congress on the

Depreciation of Business - Use Passenger Cars

Department of the Treasury
April 1991

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

April 1991

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Section 7612(f) of Public law 101-239, the Omnibus Budget Reconciliation Act of 1989, directs the Secretary of the Treasury or his delegate to conduct a study of the proper class life for cars and light trucks and submit a report to the Congress within one year of enactment. The Omnibus Budget Reconciliation Act of 1990 extended the date for submission of the report to April 15, 1991. Pursuant to those directives, I hereby submit the "Report to Congress on the Depreciation of Business Passenger Cars." A report on the depreciation of light trucks is expected to be submitted in July.

I am sending a similar letter to Representative Bill Archer.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

April 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Section 7612(f) of Public law 101-239, the Omnibus Budget Reconciliation Act of 1989, directs the Secretary of the Treasury or his delegate to conduct a study of the proper class life for cars and light trucks and submit a report to the Congress within one year of enactment. The Omnibus Budget Reconciliation Act of 1990 extended the date for submission of the report to April 15, 1991. Pursuant to those directives, I hereby submit the "Report to Congress on the Depreciation of Business Passenger Cars." A report on the depreciation of light trucks is expected to be submitted in July.

I am sending a similar letter to Senator Bob Packwood.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

Table of Contents

Table of Figures

Table of Tables

Chapter I. Introduction and Principal Findings

A. Mandate for This Study

This study of the depreciation of business-use passenger cars has been prepared by the Office of Tax Analysis (OTA) in response to a Congressional mandate in the Omnibus Budget Reconciliation Act of 1989 (P.L 101-239). Section 7612(f) of the Act, which became effective December 19, 1989, directed Treasury to conduct a study on the proper class life for cars and light trucks and to report its findings to the Congress within one year. The Omnibus Budget Reconciliation Act of 1990 extended the due date for the report to April 15, 1991. A report on the depreciation of light trucks is expected to be submitted to Congress later this year.

OTA conducts studies of the depreciation of other assets, including assets not expressly requested for study by the Congress, as part of its general mandate under Section 168(i)(1)(B) of the Internal Revenue Code (IRC), as modified by the Tax Reform Act of 1986. (See Exhibit 1 of Appendix A.) This provision directed the Treasury to "monitor and analyze actual experience with respect to all depreciable assets", and granted Treasury the authority to change the classification and class lives of assets. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) repealed Treasury's authority to alter asset classes or class lives, but the revised Section 168(i) continued Treasury's responsibility to "monitor and analyze actual experience with respect to all depreciable assets" (see Exhibit 2 of Appendix A).

The *General Explanation of the Tax Reform Act of 1986* indicates that the determination of the class lives of depreciable assets should be based on their anticipated useful lives and the anticipated decline in their value over time, after adjustment for inflation (see Exhibit 3 of Appendix A). Under current law, the useful life of an asset is taken to be its entire economic lifespan over all users combined, and not just the period it is retained by a single owner. The *General Explanation* also indicates that, if the class life of an asset is derived from the decline with age of its market value, such life (which, to avoid confusion, is hereafter referred to as its equivalent economic life) should be set so that the present value of straight-line depreciation over the equivalent economic life equals the present value of the decline in value of the asset (both discounted at an appropriate rate of interest).

As described in Chapters III and IV, an unadjusted equivalent economic life was derived for a broad spectrum of business-use passenger cars. In its study of the depreciation of rental clothing (tuxedos), where it was assumed that separate accounts were not kept for each tuxedo, OTA computed the equivalent economic life from the estimated decline in value with age of the tuxedos, without considering the potential gains or losses incurred upon the retirement of each tuxedo[1]. In this report, such calculated equivalent economic life is referred to as the *unadjusted* equivalent economic life.

Business-use passenger cars have unique characteristics. Unlike most other business equipment, passenger cars are typically sold before the end of their useful life as vehicles. Moreover, unlike a number of other business assets for which an established resale market exists, used business-use passenger cars are nearly always acquired for household (or non-business) use.[2] The analysis of the depreciation of business-use passenger cars in this report is thus somewhat different from the analysis used in prior OTA depreciation studies. In those studies the analysis took into account the decline in the asset's market value with age, the pattern of asset retirements, and the tax consequences of the retirements. Such analysis, however, ignores the economic implications of the relatively infrequent sales of used assets. By contrast, an *adjusted* equivalent economic life for business passenger cars was derived in this study that accounts not only for the decline in value of the cars with age, but also for their conversion from business to non-business use and the tax gains and losses that arise from their sale at different ages. However, because of the relatively short period passenger cars remain in business use, retirements are ignored in calculating their adjusted equivalent economic life.

Under current law, passenger cars used in a trade or business, including taxicabs, have a class life of three years, regardless of whether they are owned, leased, or rented by their business users. Under Section 168(e)(3)(B)(i) of the IRC, however, passenger cars are assigned to the five-year property recovery class, regardless of their class life. Likewise, under Section 168(g)(3)(D), the alternative depreciation system recovery period for passenger cars is five years.

B. Principal Findings

A distinction between fleet and non-fleet vehicles is generally recognized in the industry, which is briefly described in Chapter II. Fleet vehicles are defined by the industry as passenger

---

1 Treasury submitted a report to Congress in August 1989 on the depreciation of rental clothing (*Report to Congress on the Depreciation of Clothing Held for Rental*). In March 1990, Treasury submitted separate reports to Congress on the depreciation of scientific instruments, fruit and nut trees, and horses (*Report to Congress on the Depreciation of Scientific Instruments; Report to Congress on the Depreciation of Fruit and Nut Trees; Report to Congress on the Depreciation of Horses*).

2 For this study, OTA accepts the industry assertion that nearly all sales of business-use passenger cars are made directly or indirectly to households.

cars held by their business owners in groups of 10 or more. All other business-use passenger cars are defined as non-fleet vehicles. Fleets mostly include vehicles owned by long-term leasing firms and daily rental firms, but also include vehicles owned directly by their business users (private fleets). Non-fleet vehicles include passenger cars owned by their business users as well as cars leased by their business users from non-fleet lessors and retail dealerships.

The principal findings of this study are that passenger cars used in business fleets have an adjusted equivalent economic life of 2.8 years, and that non-fleet business-use passenger cars have an adjusted equivalent economic life of 4.5 years.[3] Weighting the present values underlying the two lives by each sector's share of tax-depreciable investment in passenger cars yields an average adjusted equivalent economic life ranging from 3.5 years to 3.8 years, depending on the relative weight given to non-fleet leased vehicles. This weighting issue is discussed in more detail in Chapter V.

While the estimated equivalent economic lives are significantly different for fleet and non-fleet passenger cars, OTA does not recommend establishing separate asset classes for business-use passenger cars under the Modified Accelerated Cost Recovery System (MACRS). As discussed in Chapter V, the difference in economic lives for fleet and non-fleet vehicles is explained mostly by differences in miles travelled during the first two years of service. While mileage and other use-related characteristics are closely correlated with fleet/non-fleet status, such status does not by itself determine a vehicle's intensity of use. Moreover, any distinction based on ownership would pose difficult administrative problems of definition and enforcement.

As noted in Chapter VI, based on the above findings Treasury recommends that the class life for MACRS asset class 00.22 (Automobiles, Taxis) be changed from 3 years to 3.5 years.

3 Passenger cars are defined as four-wheeled vehicles manufactured or sold primarily for use on public streets, roads, and highways, and rated at 6,000 pounds unloaded vehicle weight or less. Limousines and taxi cabs are included without regard to weight. Multipurpose vehicles, sport utility vehicles, and passenger vans are not included in this report.

Chapter II. Industry Background

While sales of passenger cars to households are an important part of the national economy, sales to businesses are also significant. According to the Bureau of Economic Analysis (BEA), business spent $50 billion in 1989 on new passenger cars, accounting for one-third of total domestic passenger car sales and about 12 percent of total business investment in new equipment.

As noted, for this study business-use passenger cars have been classified into two major categories: fleet cars and non-fleet cars. According to industry classification, fleets consist of cars owned by firms with 10 or more cars. All other business-use cars are defined for this study as non-fleet cars. The majority of fleet cars are owned by long-term (30 days or more) leasing firms and short-term (less than 30 days) rental firms, with a small portion owned directly by their business users (private fleets). Non-fleet cars are mostly owned by small and medium-sized business firms in a wide variety of industries, including small lessors. These distinctions by type of ownership are of interest due to the differences observed in resale prices and holding periods. Table 1 shows 1989 investment in passenger cars by each industry sector.

Table 1.--Investment in Business-Use Passenger Cars by Industry Sector, 1989 (Units in Thousands, Dollars in Billions)

Industry Sector	Number of Vehicles	Acquisition Cost	Percentage Distribution	
			Number	Cost
Fleet	1,953	25.0	56.3	49.9
Lease	894		25.8	
Rental	907		26.2	
Private	152		4.4	
Non-fleet	1,514	25.1	43.7	50.1
Total	3,467	50.1	100.0	100.0

Sources: Bureau of Economic Analysis, *Automotive Fleet Fact Book.* Acquisition cost by sector estimated by OTA.

The composition of passenger cars acquired for business purposes differs somewhat from those acquired for non-business purposes. Table 2 compares the distribution by size class of all passenger cars sold in model year 1989 with that for business fleets.[4] Business fleets are more heavily concentrated in compact and intermediate models, with lease and private fleets especially heavily concentrated in intermediate-sized models. The results presented in this study, though, are for the depreciation of business-use vehicles only. Because the depreciation pattern varies by size class, and because the distribution by size class differs between vehicles acquired for household use and business use, the results shown in this report for business-use cars cannot be generalized to all passenger cars.

Table 2.--Distribution of Passenger Car Sales, Model Year 1989 (Number of Cars in Thousands)

Size Class	All Passenger Cars		Business-Fleet Passenger Cars	
	Number	Percent	Number	Percent
Domestic plus selected imports	8,409.5	81.5	1,922.5	92.6
Subcompact	2,264.7	21.9	334.1	16.1
Compact	2,110.9	20.5	544.2	26.2
Intermediate	2,428.8	23.5	676.7	32.6
Standard	832.7	8.1	178.9	8.6
Luxury	772.4	7.5	188.6	9.1
Other imports	1,908.5	18.5	154.3	7.4
Total	10,318.0	100.0	2,076.8	100.0

Source: *Automotive Fleet Fact Book*, p. 22.

4 The classification of cars in this table differs from that used elsewhere in this report. *Automotive Fleet Fact Book* includes government fleet cars, and classifies only selected imports in the specific size class categories. While adjustments to fleet data were generally made in this report to exclude government cars and to include all imports in a single category ("foreign"), such adjustments were not made in Table 2 for comparability with the available data for "All Passenger Cars".

Chapter III. Data Collection and Methodology

A. Public meetings

Public meetings were held at the Treasury Department in January and March of 1990 to determine the scope of the study, discuss the study design and general methodology, and describe the kind of data needed for the study. The first public meeting was announced in the Federal Register on December 21, 1989, and invitations were extended to each of the major trade associations representing different sectors of the business-use car and light truck industry. Invitations were also sent to executives of the largest leasing and rental firms in the United States.

At these meetings, it was determined that the scope of the study should include all automobiles and light/medium duty trucks designed for use over-the-road and used in a trade or business. This coverage was generally understood by Treasury and industry participants to include both fleet and non-fleet vehicles, and vehicles that are leased or owned by their users. Although no attempt was made to define "light" or "medium-duty" trucks, data collection for trucks was limited to those with a gross vehicle weight of 33,000 lbs. or less. This decision effectively eliminated large tractor-trailer trucks from the scope of the study, and it preserved flexibility in ultimately defining light and medium duty trucks for classification purposes.

Unlike many of the previous depreciation studies conducted by OTA, no survey of the industry was conducted or proposed. Instead, data were solicited directly from a limited number of owners of business-use vehicles based on vehicle specifications that were proposed and developed at the public meetings. This data-collection procedure was adopted because of the relatively short time frame granted by the Congress for completion of this study, and because of the availability of machine-readable data from several of the firms that agreed to participate in the study.

B. Description of the Data

Firms participating in the study were asked to provide OTA with detailed data on characteristics of cars and light trucks either disposed of during the last few years or in their fleet inventory at the time the data were provided. Each observation in each data set was to include, at a minimum, the vehicle's Vehicle Identification Number, original acquisition cost, the month and year of acquisition, the sale price (net of refurbishing costs), and the month and year of disposition. Some data sets also included the type of disposition and the mileage of the cars at disposition. All of the data were received by OTA from May through August of 1990.

Data for fleet passenger cars were received from four major national leasing firms and three large private fleet owners[5]. Data for non-fleet vehicle dispositions and mileage were obtained from a sample of business tax returns prepared by the Statistics of Income Division of the Internal Revenue Service. Despite repeated requests to the major rental car trade associations and other industry representatives, OTA was unable to obtain passenger car data from the daily rental sector of the industry.

Although the daily rental sector accounts for nearly one-half of fleet passenger car purchases, not all of this investment is capitalized and depreciated for tax purposes, since many of the vehicles are sold within the same tax year they are acquired. This holding period has declined in recent years, as both domestic and foreign auto manufacturers (some of whom hold large equity stakes in daily rental firms) have increased their sales to such firms by agreeing to re-purchase the cars at guaranteed prices after just several months of use. These cars are then typically sold by the manufacturers to their retail dealerships and are in turn sold by such establishments to households as "nearly new" used cars.

Passenger car data from three of the leasing firms and two of the private fleet firms were analyzed in detail.[6] Although OTA had requested data on dispositions for the period 1983 through 1989, only one of the leasing firms was able to provide a significant number of dispositions prior to 1985. Thus, the great majority of the dispositions represent sales, wrecks, and other dispositions during the years 1985 through 1989.

C. Structuring the Data

Since depreciation of passenger cars is likely to vary by model and class, and since the composition of passenger car fleets varies over time, passenger cars were classified by manufacturer's model whenever possible. A manufacturer's model is defined as a set of

5 The American Automotive Leasing Association (AALA) and the National Association of Fleet Administrators (NAFA) assisted in this study by coordinating the collection of data from their participating member firms.

6 Data provided by one of the leasing firms and one of the private fleet firms were not analyzed because the data were incomplete. However, due to the relatively large sample of complete data, these firms were not asked to resubmit their information. The five data sets that were analyzed provided in total useable observations for 773,000 passenger cars, with 469,000 dispositions and 304,000 cars in inventory. The vast majority of the observations (97 percent) were provided by the three leasing firms.

passenger cars with the same basic design features over a number of different model years, and includes all passenger car observations with those features from all relevant model years. By construction, it includes cars that may differ in characteristics such as body type, engine type, and optional equipment.[7]

For the fleet analysis, 35 specific domestic models and 11 foreign nameplates were identified that represent all major manufacturers (both domestic and foreign) and six different classes. Models were chosen for study only when there were a sufficiently large number of vehicle dispositions spread over several years. Consequently, little or no weight was given in the overall results to models discontinued early in the sample period or introduced late in the sample period.

Since many of the same models occurred in more than one data set, a total of 145 model-data sets were separately analyzed. (See Appendix B for a listing of the models studied and the number of dispositions observed for each class.) Lease fleets included a much wider variety of models than private fleets. The models and nameplates listed in Appendix B account for 392,121 passenger car dispositions, or about 84 percent of the total useable passenger car observations in the sample. Non-fleet vehicles could not be stratified by make, model, or size class due to the relatively small number of observations for this sector.

Both the unadjusted and adjusted equivalent economic lives were derived (as described below in Section D) for each model chosen for study in each data set. Data from model years 1985 and 1986 were analyzed separately in obtaining the adjusted equivalent economic lives for fleet vehicles.[8] Models were then grouped into one of six size classes, as defined by *Automotive Fleet Fact Book.* A weighted average equivalent economic life was derived for each class in each data set, with weights equal to the firm's model year 1989 investment in that model.[9] These results were than aggregated over firms (data sets) to obtain equivalent economic lives for each class.

---

7 Models were identified consistently across data sets and over time using the standard 17 digit Vehicle Identification Number (VIN) assigned by the manufacturer. For example, the "Ford Taurus" model includes all observations with a VIN car line/series code indicating Ford Taurus for model years 1986 through 1990, including four-door sedans and station wagons. Due to smaller sample sizes, foreign cars were generally analyzed at the broader "nameplate" level, which refers to all of the models produced by one production division of a manufacturer.

8 A model year is defined as a manufacturer's annual production period that includes January 1 of the year referenced. A model year typically begins in September or October, but can start earlier.

9 In deriving the weighted average, the estimated equivalent economic lives for each model were converted to present values, and these were weighted by each model's share of investment. The weighted average present value was then converted into an average equivalent economic life. This weighting procedure was followed at each level of aggregation.

Finally, equivalent economic lives for each class were weighted by the observed fleet share of 1989 investment in the class to obtain a single equivalent economic life for fleets. The non-fleet sample was too small (121 new passenger car dispositions) to stratify by model, model year, or class. Consequently, a single equivalent economic life for non-fleet vehicles was estimated over all models and model years.

D. Methodology

As suggested in the *General Explanation of the Tax Reform Act of 1986*, the class life of an asset is to be determined from the decline in its value with age. This life (which for clarity has been referred to as the asset's equivalent economic life) can be either longer or shorter than its useful life (i.e., the period over which the asset provides service), depending upon whether the pattern of its decline in value with age (its "age-price profile") is more or less rapid than straight-line depreciation. An asset that declines in value less rapidly than straight-line depreciation has a longer economic life, and an asset that declines more rapidly in value than straight-line depreciation has a shorter economic life, than the asset's useful life. (For a more complete discussion see Hulten and Wykoff [1981].)

For each model chosen for study in each data set, both an unadjusted equivalent economic life and an economic life adjusted for sales were derived. The unadjusted equivalent economic life was obtained by equating the present value of economic depreciation (i.e., the decline in value of the asset) with the present value of straight line depreciation, both discounted at a four percent real rate. The straight line depreciation is calculated over a recovery period equal to the unadjusted economic life. In calculating the unadjusted equivalent economic life, the tax implications of the actual sales (from which the age-price profile is obtained) are ignored. In particular, both straight line depreciation and economic depreciation are considered over the entire useful life of the vehicles.[10] (See Appendix C for a more detailed description of the analysis.)

The decline in value is obtained from an estimated age-price profile, which represents the average inflation-adjusted value of the model (relative to its average initial acquisition cost) at each age. In contrast to the Box-Cox procedure used by Hulten and Wykoff (1981) and Wykoff (1989), in this study the age-price profile for each model was determined statistically by fitting

10 The unadjusted equivalent economic life is obtained numerically using a computer program that chooses a test solution for that life, uses this solution to calculate the present value of straight line depreciation, and then determines a new solution based on the resulting difference in present values. This process continues until the present value of depreciation over the straight line life equals the present value of economic depreciation with a very small tolerance.

a fifth-order polynomial of vehicle age (in months) to inflation-adjusted relative resale prices. All normal sales over the entire sample period for the model were used to determine the parameters of the regression equation.[11]

It was important to estimate the decline in value of a model from fairly complete data that include, at a minimum, the first two years of each model's life. In general, only model years 1985 and 1986 met these conditions. Since data for dispositions prior to 1985 were generally not provided by the industry, a large percentage of first-year and second-year sales for model years prior to 1985 were missing. Conversely, relatively few cars in model year fleets from 1987 through 1989 had been disposed of by late 1989 or early 1990.

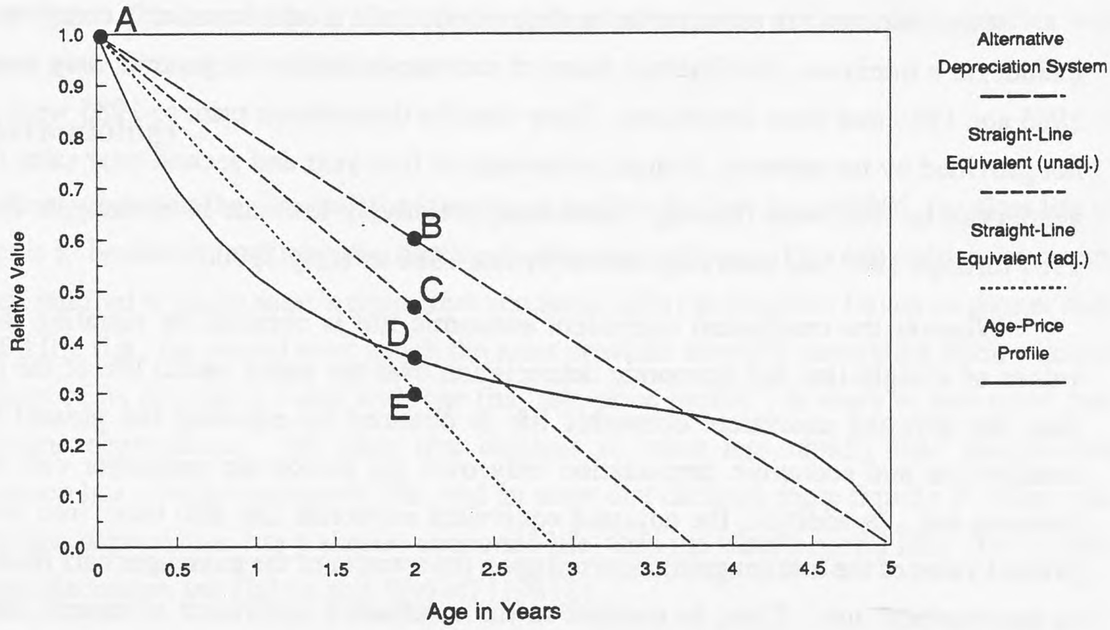
Whereas the unadjusted equivalent economic life is obtained by equating the present values of straight-line and economic depreciation over the entire useful life of the passenger cars, the adjusted equivalent economic life is obtained by equating the present values of straight-line and economic depreciation only over the period the passenger cars remain in business use. In addition, the adjusted equivalent economic life also takes into account the present value of the loss (or gain) incurred upon the transfer of the passenger cars from business to non-business use. Thus, in contrast to the unadjusted equivalent economic life, the tax implications of sales of vehicles (which result in their transfer to non-business use) are taken into account.

The straight line depreciation is calculated over a period equal to the adjusted equivalent economic life, and both straight-line and economic depreciation are considered only up to the date of sale. Gains and losses are computed as the difference between the straight-line adjusted basis and the actual value at the time of sale. Because most of the vehicles are sold well before the end of their useful life and experience a present value of economic depreciation over their retention period that exceeds the present value of the (hypothetical) straight-line depreciation (including the gain or loss on disposition), the adjusted equivalent economic life is less than the unadjusted equivalent economic life.

Figure 1 illustrates the relationship between the age-price profile and various straight-line depreciation schedules: the current law alternative depreciation system (ADS), the unadjusted straight-line equivalent economic life, and the adjusted straight-line equivalent economic life,

11 Ackerlof (1970) suggested that because buyers of used passenger cars have imperfect information regarding the quality of the car purchased, only "lemons" are sold. Although this point may have some relevance for household-use vehicles, it would appear to be less important for business-use cars, most of which are sold after a relatively short period of use.

Figure 1: Relationship Between Age-Price Profile and Various Straight-Line Depreciation Schedules



for a single representative domestic compact model. The age-price profile (solid line) drops rapidly over the model's first year of service, and then at successively slower rates over ages two, three, and four, before turning down sharply after age four.[12] The adjusted basis as calculated under ADS (long-dashed line in Figure 1) reaches zero after five years for all passenger cars. (For convenience, the applicable half-year convention is ignored.)

For this model, the adjusted basis using the unadjusted straight-line equivalent schedule (short-dashed line) reaches zero at 3.8 years. As discussed below, when this model's observed pattern of dispositions is taken into account (and the resulting gains and losses included in the analysis), the adjusted basis under the *adjusted* straight-line equivalent schedule (dotted line in Figure 1) reaches zero after 2.9 years.

Representatives of the lease sector of the industry have argued that the current law alternative depreciation system (which enters the adjusted current earnings component for corporate taxpayers subject to the alternative minimum tax) is too slow, especially when the

12 The estimated age-price profile is determined by fitting a fifth-order polynomial through the actual relative price observations. Although the polynomial crosses the x axis at an age of about 5 years, there are no observations for cars older than 4.5 years.

relatively short retention period of passenger cars characteristic of their industry is recognized.[13] Thus, if a car from the model shown in Figure 1 were sold at age two by a taxpayer using ADS, the taxpayer's adjusted basis in the car at that age would be about 60 percent of the car's original cost (point B in Figure 1), whereas its sales price, as reflected in the age-price profile, would be about 37 percent of its original cost.

While such taxpayers would be able to claim a tax loss, the present value of the depreciation deductions (represented by the path AB in Figure 1) plus the present value of the loss (represented by the distance BD), would be much less than the present value of economic depreciation (represented by the path AD). If the cars remained in business use after their disposition, this deficiency over the first two years would not be particularly relevant, since the present value of the depreciation deductions and disposition gains and losses would be considered over the entire useful life of the car, regardless of ownership changes. However, industry representatives claim that no more than five percent of the business-use cars sold are purchased by other business users. In accepting this statement describing a unique aspect of the resale market for business-use vehicles, OTA also accepts the corresponding implication that the present values should be equated only over the more limited period during which passenger cars are used for business purposes.

Even if taxpayers were allowed to depreciate the cars along the unadjusted straight-line equivalent schedule (short-dashed line), the present value of the depreciation deductions (represented by the path AC) plus the present value of the loss incurred at disposition (represented by the distance CD) would still be less than the present value of economic depreciation to the time of disposition. This is not surprising. By construction, the present values of depreciation under the unadjusted equivalent straight-line schedule and that of economic depreciation are equal only when the asset is held until the end of its useful life. A disparity will always arise if the asset is typically converted to non-business use prior to that age.

The adjusted equivalent straight-line schedule is designed to reflect both the disposition of the cars prior to the end of their useful life and the gains and losses incurred upon disposition. If taxpayers depreciated their cars along this schedule (represented by the path AE), then a gain (rather than a loss) would occur when the car is sold at age two (represented by the distance ED in Figure 1). The adjusted straight-line equivalent schedule reflects the entire observed pattern of dispositions, and not just those dispositions at age two. Thus, even if the taxpayer were to

---

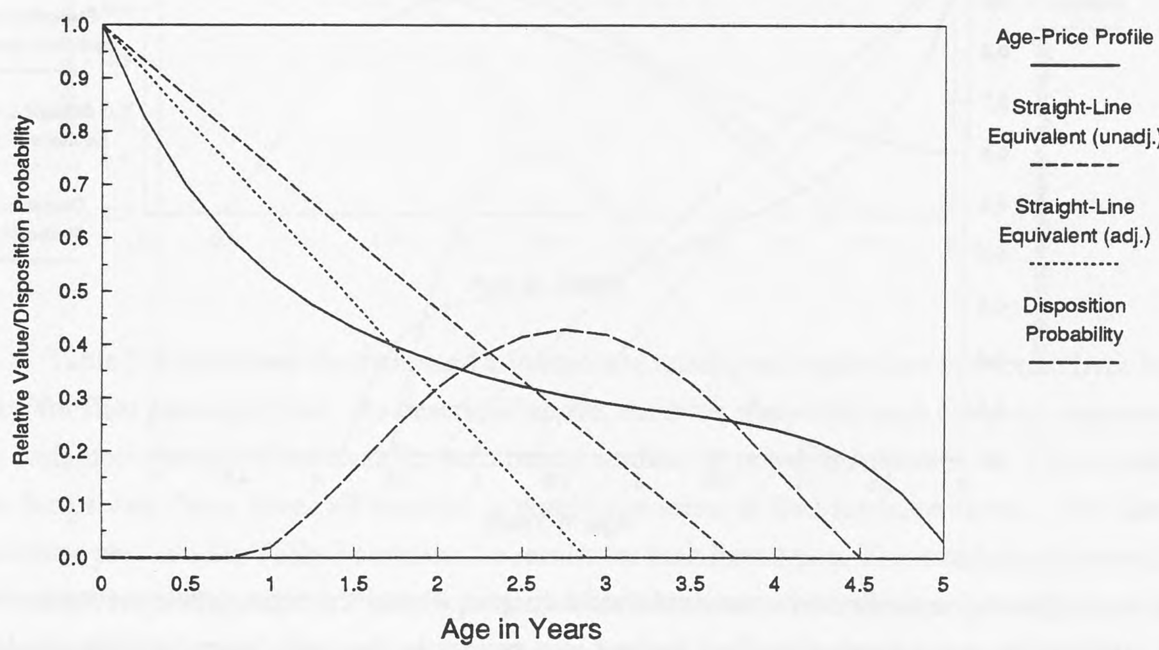
13 See, for example, Pies and Fischer (1990).

use this schedule, a disparity in present values would generally arise. The present values over the period of the cars' business use will be equal only on average for all taxpayers who own this particular model of passenger car.

Chapter IV. Results of the Analysis

This chapter presents the results of applying the methodology described above in Chapter III. For illustration, four specific models (representative compact, intermediate, standard, and foreign models) are discussed. The aggregate results for fleet and non-fleet passenger cars are then presented. In Figure 2, the age-price profile for the representative compact model (model year 1986) owned by lease firm A is again shown, together with the unadjusted and adjusted straight-line equivalent schedules. Also shown is the observed disposition probability curve (long-dashed line in Figure 2). Lease firm A on average holds this model 2.8 years, and no cars of this model are held by this firm beyond 4.5 years.

Figure 2: Representative Compact Model
Age-Price Profile, Straight-Line Equivalent Schedules, and the Disposition Probability

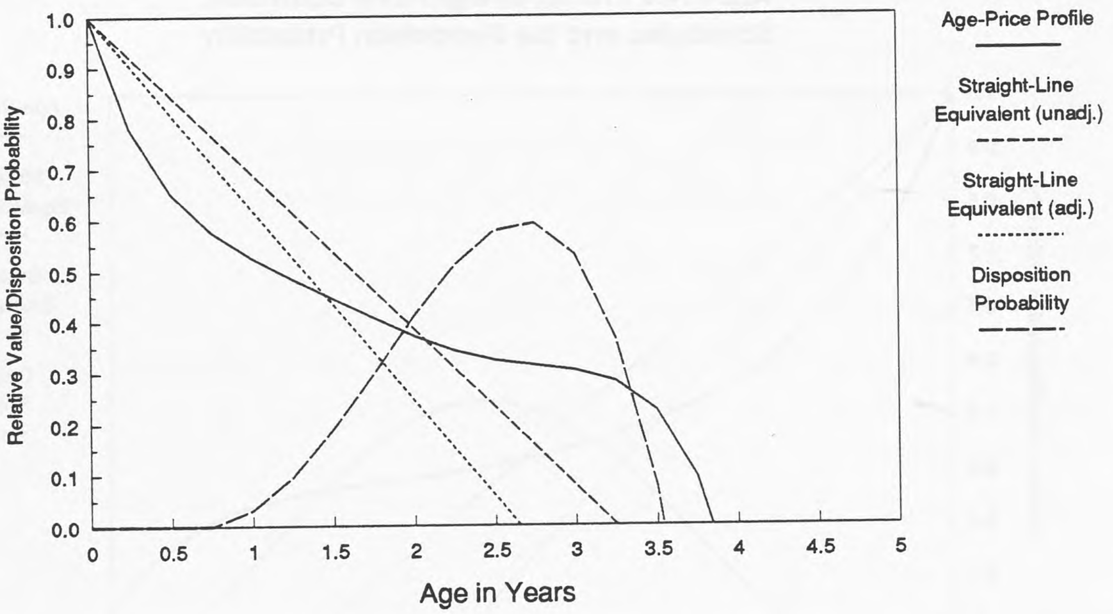


Figures 3 through 5 show the age-price profile, unadjusted and adjusted straight-line equivalent schedules, and disposition probability curve for representative intermediate, standard, and foreign models, respectively, that were among the 46 models studied for this report. The intermediate model (model year 1986) is owned by lease firm B, the standard model (model year 1986) is owned by lease firm C, and the foreign model (model year 1985) is also owned by lease firm B.

While the shapes of the age-price profiles for the representative compact model (Figure 2) and the representative intermediate model (Figure 3) are similar over the first three years, the curve for the intermediate model declines more rapidly after age three, resulting in a shorter unadjusted equivalent economic life for that model. While the adjusted equivalent economic life for the intermediate model is also shorter, the difference in adjusted equivalent economic lives between the two models is not very significant. This is the result of a somewhat wider range of holding periods for the compact model, which results in relatively more dispositions in later years at a gain than for the intermediate model.

Figure 3: Representative Intermediate Model

Age-Price Profile, Straight-Line Equivalent Schedules, and the Disposition Probability



For the representative standard model (Figure 4) and the representative foreign model (Figure 5), the age-price profiles decline less rapidly in the early years, resulting in longer unadjusted equivalent economic lives than for the compact and intermediate models.[14] The adjusted equivalent economic life for the representative foreign model (3.6 years) is longer than

14 The slight upturn in the age-price profile at 4.5 years for the representative foreign model in Figure 5 is a result of sparse data on dispositions after age 4. The fitted curve turns down after age 5 and reaches zero at 5.7 years of age.

for any of the representative domestic models. This is due not only to a higher unadjusted equivalent economic life (4.7 years), but also a longer average holding period (3.1 years) relative to the representative domestic models.

Figure 4: Representative Standard Model
Age-Price Profile, Straight-Line Equivalent Schedules, and the Disposition Probability

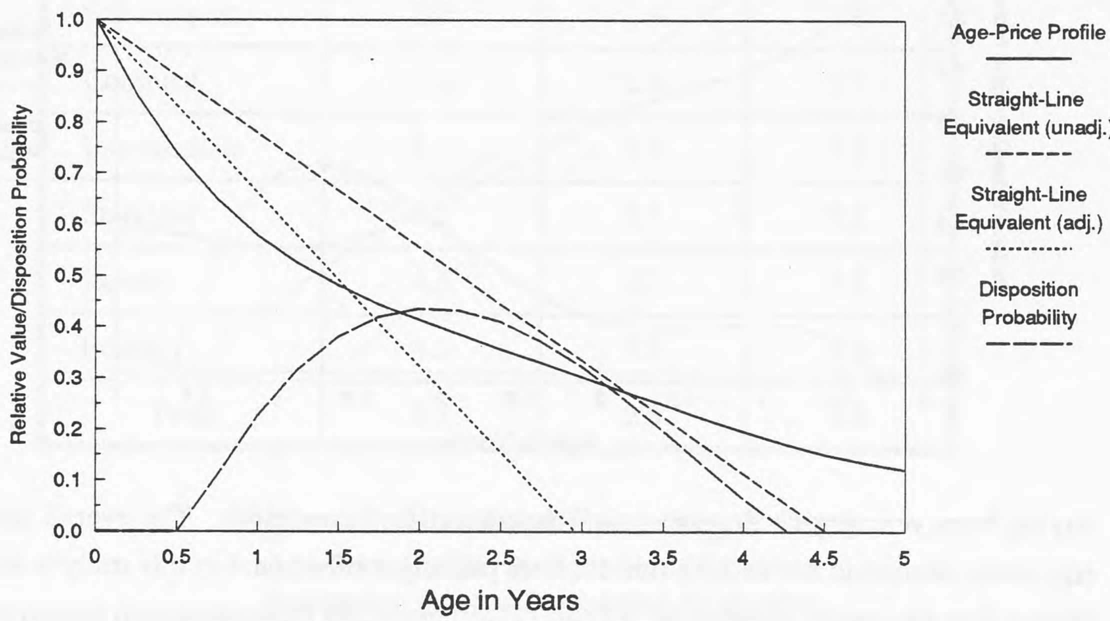
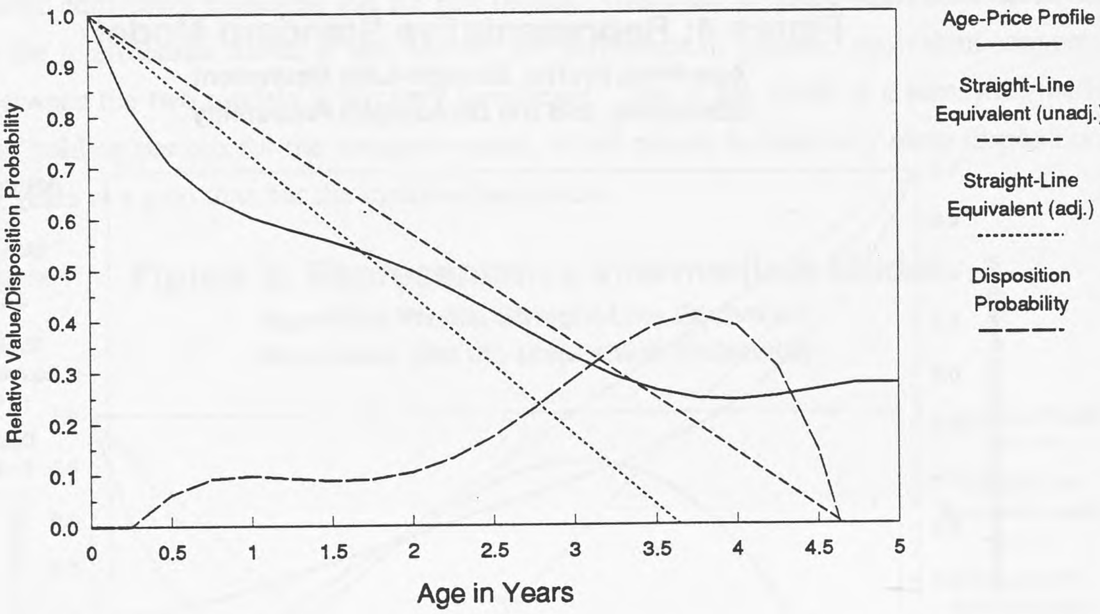


Table 3 summarizes the estimated adjusted and unadjusted equivalent economic lives by class for fleet passenger cars. As described above, the lives shown for each category represent the weighted average of the lives for each model studied, as noted in Appendix B. The overall life for private fleets (over all models) is nearly the same as that for lease fleets. The fleet estimates presented in Table 3 combine the results for both fleet types. This similarity in overall lives is not surprising, since industry representatives claim that private fleets are managed much the same way as lease fleets, and that private non-leasing firms will switch between leasing and

Figure 5: Representative Foreign Model

Age-Price Profile, Straight-Line Equivalent Schedules, and the Disposition Probability



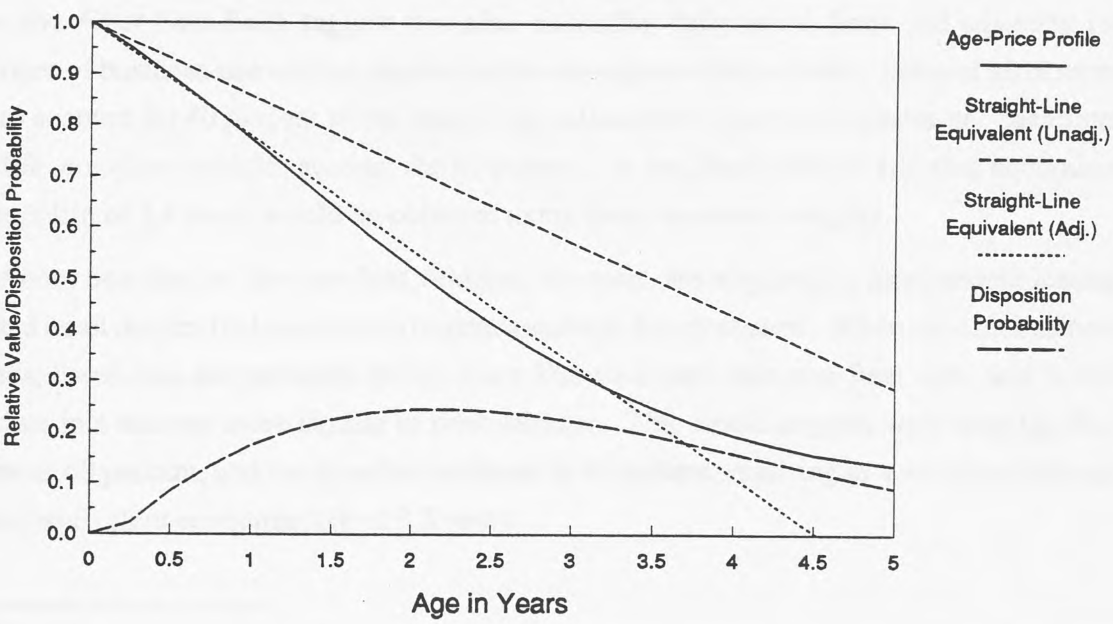
buying from year to year depending on market and firm conditions. The overall unadjusted equivalent economic life of 3.7 years for fleet passenger cars found in this study is somewhat shorter than the results reported by Wykoff (1989) regarding business-leased passenger cars.[15]

Figure 6 presents the age-price profile, unadjusted and adjusted straight-line schedules, and disposition probability curve for the entire sample of non-fleet passenger cars. It is clear that the age-price profile for the non-fleet vehicles drops less rapidly in the first two years of service than for any of the fleet categories shown in Figures 2 through 5. In addition, the pattern of dispositions is different than for fleet vehicles, with significant disposition probabilities at both relatively young and relatively old ages.

15 Wykoff reported annual economic depreciation rates for business-leased passenger cars that imply an unadjusted equivalent economic life of about 4.5 years. These depreciation rates were estimated for four specific passenger car models owned by a leasing firm. Although Wykoff's study differs somewhat from this one in scope and methodology, the difference in unadjusted equivalent economic lives appears to be largely due to a higher first-year rate of depreciation found in this study.

Table 3.--Unadjusted and Adjusted Equivalent Economic Lives of Fleet Cars by Size Class			
		Adjusted Life	
Size Class	Unadjusted Life	Model Year 1985	Model Year 1986
Subcompact	3.3	2.4	2.3
Compact	3.6	2.6	2.7
Intermediate	3.6	2.7	2.7
Standard	4.2	3.1	3.1
Luxury	4.5	3.5	3.5
Foreign	4.5	3.8	3.9
Total	3.7	2.8	2.8

Figure 6: Nonfleet Passenger Cars
Age-Price Profile, Straight-Line Equivalent Schedules, and the Disposition Probability



Although not evident in Figure 6, the age-price profile does not reach a minimum value until age 10, and the unadjusted straight-line equivalent schedule reaches zero at 7.0 years. The relatively large difference between the unadjusted equivalent economic life (7.0 years) and the adjusted equivalent economic life (4.5 years) for these cars can be attributed mostly to the slow decline in value that occurs after age five.

Chapter V. Issues in Setting Class Lives

A. Estimation Issues

Several estimation issues arose during the course of the study and their resolution affects the final results. The most important issue concerns the reliability of the estimated adjusted equivalent economic life for non-fleet vehicles, and the related matter of properly weighting that estimate in computing the overall adjusted equivalent economic life. Since the fleet estimates were based on nearly 400,000 dispositions and the non-fleet estimates were based on only 121, non-fleet estimates are far more uncertain than fleet estimates.

Nevertheless, the difference in the estimated adjusted equivalent economic lives (2.8 years for fleet vehicles vs. 4.5 years for non-fleet vehicles) appears reasonable in light of differences in intensity of use. Mileage data provided by fleet firms show that fleet vehicles are driven an average of 25,000 miles per year in each of the first two years of service. Data on mileage patterns for non-fleet vehicles obtained from a sample of business tax returns indicate that such vehicles are driven an average of 15,000 miles per year during the first two years. Moreover, the results for non-fleet vehicles are consistent with the findings of other studies that were based on non-fleet passenger cars.[16]

Given the large difference in estimated lives, properly weighting the estimates into a single class life becomes very important. Data from the Bureau of Economic Analysis and the *Automotive Fleet Fact Book* suggest that after excluding daily rental firms and adjusting for lower rates of business-use and tax capitalization among non-fleet vehicles, fleets of 10 or more vehicles account for 40 percent of the annual capitalized investment in business-use passenger cars while non-fleet vehicles account for 60 percent. A weighted average adjusted equivalent economic life of 3.8 years would be obtained using those shares as weights.

About one-third of the non-fleet vehicles, however, are acquired by independent leasing firms and retail dealers for lease to both business and non-business users. When used for business purposes, these cars are probably driven more like fleet cars than non-fleet cars, and would depreciate in a manner more similar to fleet vehicles. This would suggest weighting the *fleet* estimate at 60 percent, and the non-fleet estimate at 40 percent, resulting in a weighted average adjusted equivalent economic life of 3.5 years.

---

16 Wykoff (1989) reported that the unadjusted present values of economic depreciation estimated from five studies based mainly on household-use cars averaged .873 (pp. 280-282). This study found an unadjusted present value of economic depreciation for non-fleet passenger cars of .874.

Another important estimation issue concerns the weighting of the adjusted equivalent economic lives derived for the different fleet classes. As shown in table 3, these lives range from a low of 2.3 years for domestic subcompact vehicles to highs of 3.5 years for domestic luxury vehicles and 3.9 years for foreign vehicles. The overall fleet adjusted equivalent economic life of 2.8 years was derived by weighting the size class lives by the sample firms' model year 1989 investment in vehicles in each of those classes. An alternative is to weight the size class lives by industry-wide fleet investment in those classes. This would result in an aggregate fleet unadjusted equivalent economic life of 3.1 years. However, industry-wide investment data include rental firm investment, which is not separately identified. Industry sources indicate that rental fleets are more heavily concentrated in domestic luxury cars and imports than are lease and private fleets.

A final estimation issue concerns the use of the half-year convention for tax depreciation purposes and its impact on the calculated equivalent economic life. In its study of the depreciation of rental clothing, OTA found that consideration of the generally required use of the half-year convention for tax purposes reduced the calculated equivalent economic life by about one-half year. However, this result was largely due to the seasonal pattern of investment in rental clothing, which placed most investment in the first half of the fiscal year. Fleet passenger car investment is fairly smoothly distributed over firms' fiscal years, with about one-half of vehicles acquired by the middle of the fiscal year. Assuming that non-fleet investment follows a similar pattern, the neglect of the half-year convention for the analysis in this report is not likely to be significant.

B. Administrative Issues

The significant difference in estimated adjusted equivalent economic lives for fleet vehicles and non-fleet vehicles raises the issue of establishing separate MACRS classes for business-use passenger cars based on type of use, ownership, or some other related criterion. While the data clearly indicate that vehicles held in fleets depreciate more rapidly than non-fleet business cars, this difference appears to arise from difference in the intensity with which such vehicles are used, rather than their ownership or use. A classification of passenger cars based on anticipated mileage patterns or anticipated holding period at the time vehicles are placed in service would pose major definitional and enforcement problems.

A classification system that distinguishes vehicles based on the size of a firm's leasing activity would approximate a classification based on intensity of use, and would be simpler to administer (although still not without some difficult problems). Such a classification system, however, would create an incentive for leasing as compared to owning passenger cars that is not necessarily desirable. Additional accounting and compliance complexity would be introduced for firms that both own and lease vehicles. Both the American Automotive Leasing Association, which represents large leasing firms, and the National Vehicle Leasing Association, which represents small and mid-sized leasing firms, have expressed reservations to Treasury concerning the establishment of separate MACRS classes for passenger cars based on ownership.

C. Conceptual Issues

The *General Explanation* of the Tax Reform Act of 1986 states that the class life for an asset class should be determined primarily by equating the present value of straight-line depreciation and the present value of economic depreciation. It did not indicate whether the fact that the owners of the assets may in some cases not be able to claim depreciation deductions over a portion of the assets' useful life should be considered. Treasury believes that in the case of business-use passenger cars, a very large fraction of which are transferred from business use to non-business use well before the end of the vehicle's useful life, this fact should be considered. More specifically, Treasury believes that in equating the present values of straight-line and economic depreciation for business-use passenger cars, only that part of the useful life over which the asset is used for business purposes is relevant. Treasury believes that the gains or losses incurred by taxpayers at the time the asset is converted from business use to non-business use should also be considered in determining the class life. For this reason, the recommendations in the following chapter are based on the estimated adjusted equivalent economic life of passenger cars, which takes these factors into account.

The unadjusted equivalent economic lives, which do not take these factors into account, have also been presented in this report. These estimated unadjusted equivalent economic lives are, however, longer than the economic lives OTA would have estimated had it focused on the entire useful life of passenger cars (and not just the period over which the cars are used in business). More specifically, the reported equivalent economic lives do not allow for the ultimate retirement (scrappage) of the vehicles. This is not a very significant omission when attention is focused only on the period the vehicles are held for business use, but it is important when vehicles are studied over their entire useful life. In such case, a more conceptually correct economic life is derived from the retirement-adjusted age-price profile. The latter is obtained by multiplying the unadjusted age-price profile by the survivor function, which is the fraction of investment of a given vintage that remains in service at each age.[17]

This study estimated an unadjusted equivalent economic life for non-fleet passenger cars of 7.0 years. Based on a survivor function for all passenger cars derived from results reported by Hu (1983), the equivalent economic life adjusted for retirements is 6.3 years. This life is quite close to the 6.2 year retirement-adjusted equivalent life that corresponds to the economic depreciation for passenger cars observed by Hulten and Wykoff (1981). Thus, although the data obtained for this study cover only the period passenger cars are used in business, the data for non-fleet vehicles provide an estimate of a total equivalent economic life for passenger cars that is nearly the same as that suggested by the work of Hulten and Wykoff.

17 See, for example, page 22 of *Report to Congress on the Depreciation of Scientific Instruments*.

Chapter VI. Conclusion and Recommendations

This study has found that the adjusted equivalent economic life of fleet passenger cars, excluding daily rental fleets, is 2.8 years, while the adjusted equivalent economic life of non-fleet passenger cars is 4.5 years. These differences appear to be attributable to differences in miles driven during the first two years of service. While there is some merit to establishing separate asset classes for these two different classes of passenger cars, the benefits do not appear to exceed the considerable definitional and compliance problems that would arise.

When the estimated economic lives are weighted by business investment in fleet and non-fleet passenger cars, an average economic life ranging from 3.5 years to 3.8 years is obtained, depending on the relative weight given to non-fleet vehicles. Due to the relative uncertainty of the non-fleet estimate, and the exclusion of daily rental fleets from the study, a class life of 3.5 years seems appropriate. Thus, Treasury recommends that the class life for MACRS asset class 00.22 (Automobiles, Taxis) be changed from 3 years to 3.5 years.

Under current law, this recommendation, if adopted, would have no effect on the depreciation deductions claimed by taxpayers for passenger cars. Section 168(e)(3)(B)(i) assigns automobiles and light general purpose trucks to the five-year property recovery class, regardless of their class lives. If this provision were repealed, passenger cars would be assigned to the three-year property MACRS recovery class, whether or not the recommended change in the class life were enacted. (The three-year property recovery class generally includes property with a class life of four years or less.) Likewise, under Section 168(g)(3)(D), the alternative depreciation system recovery period for automobiles and light general purpose trucks is five years, regardless of their class lives. If this provision were repealed, taxpayers using the alternative depreciation system could depreciate their passenger cars over three years (based on the current law class life) or over 3.5 years (based on the recommended class life).

Appendix A. The Mandate for Depreciation Studies

Exhibit 1.

Section 168(i)(1)(B) of the Internal Revenue Code as Revised by the Tax Reform Act of 1986

(i) Definitions and Special Rules.

For purposes of this section--

(1) **Class Life.**

(B) Secretarial authority. The Secretary, through an office established in the Treasury--

(i) shall monitor and analyze actual experience with respect to all depreciable assets, and

(ii) except in the case of residential rental property or nonresidential real property--

(I) may prescribe a new class life for any property,

(II) in the case of assigned property, may modify any assigned item, or

(III) may prescribe a class life for any property which does not have a class life within the meaning of subparagraph (A).

Any class life or assigned item prescribed or modified under the preceding sentence shall reasonably reflect the anticipated useful life, and the anticipated decline in value over time, of the property to the industry or other group.

Exhibit 2.

Section 168(i)(1) of the Internal Revenue Code as Revised by the Technical and Miscellaneous Revenue Act of 1988

Definitions and Special Rules.

For purposes of this section--

(1) **Class Life.** Except as provided in this section, the term "class life" means the class life (if any) which would be applicable with respect to any property as of January 1, 1986, under subsection (m) of section 167 (determined without regard to paragraph (4) and as if the taxpayer had made an election under such subsection). The Secretary, through an office established in the Treasury, shall monitor and analyze actual experience with respect to all depreciable assets.

Exhibit 3.

Provisions for Changes in Classification from the General Explanation of the Tax Reform Act of 1986 (pp. 103-104)

The Secretary, through an office established in the Treasury Department is authorized to monitor and analyze actual experience with all tangible depreciable assets, to prescribe a new class life for any property or class of property (other than real property) when appropriate, and to prescribe a class life for any property that does not have a class life. If the Secretary prescribes a new class life for property, such life will be used in determining the classification of property. The prescription of a new class life for property will not change the ACRS class structure, but will affect the ACRS class in which the property falls. Any classification or reclassification would be prospective.

Any class life prescribed under the Secretary's authority must reflect the anticipated useful life, and the anticipated decline in value over time, of an asset to the industry or other group. Useful life means the economic life span of property over all users combined and not, as under prior law, the typical period over which a taxpayer holds the property. Evidence indicative of the useful life of property, which the Secretary is expected to take into account in prescribing a class life, includes the depreciation practices followed by taxpayers for book purposes with respect to the property, and useful lives experienced by taxpayers, according to their reports. It further includes independent evidence of minimal useful life -- the terms for which new property is leased, used under a service contract, or financed -- and independent evidence of the decline in value of an asset over time, such as is afforded by resale price data. If resale price data is used to prescribe class lives, such resale price data should be adjusted downward to remove the effects of historical inflation. This adjustment provides a larger measure of depreciation than in the absence of such an adjustment. Class lives using this data would be determined such that the present value of straight-line depreciation deductions over the class life, discounted at an appropriate real rate of interest, is equal to the present value of what the estimated decline in value of the asset would be in the absence of inflation.

Initial studies are expected to concentrate on property that now has no ADR midpoint. Additionally, clothing held for rental and scientific instruments (especially those used in connection with a computer) should be studied to determine whether a change in class life is appropriate.

Certain other assets specifically assigned a recovery period (including horses in the three-year class, qualified technological equipment, computer-based central office switching equipment, research and experimentation property, certain renewable energy and biomass properties, semiconductor manufacturing equipment, railroad track, single-purpose agricultural or horticultural structures, telephone distribution plant and comparable equipment, municipal waste-water treatment plants, and municipal sewers) may not be assigned a longer class life by the Treasury Department if placed in service before January 1, 1992. Additionally, automobiles and light trucks may not be reclassified by the Treasury Department during this five-year period. Such property placed in service after December 31, 1991, and before July 1, 1992, may be prescribed a different class life if the Secretary has notified the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate of the proposed change at least 6 months before the date on which such change is to take effect.

Appendix B. Models Studied and Sample Sizes [18]

Subcompact (16,636)

Chevy Cavalier (4)
Ford Escort (3)
Ford Mustang (2)

Compact (64,472)

Dodge Lancer (3)
Ford Tempo (4)
Pontiac Grand AM (2)
Mercury Topaz (3)
Plymouth Reliant (4)
Olds Cutlass Calais (1)
Dodge Aries (3)

Standard (34,501)

Ford Crown Victoria (3)
Chevy Caprice (5)
Mercury Grand Marquis (3)
Olds Delta 88 (4)
Buick LeSabre (3)

Intermediate (247,831)

Dodge 600 (3)
Chrysler New Yorker (3)
Chevy Celebrity (4)
Pontiac 6000 (5)
Pontiac Grand Prix (3)
Olds Cutlass Ciera (4)
Olds Cutlass Supreme (3)
Buick Century (4)
Ford Taurus (3)
Ford Thunderbird (3)
Chevy Citation (3)
Chrysler LeBaron GTS (3)
Mercury Sable (3)
Mercury Marquis (3)
Plymouth Caravelle (3)

Luxury (21,347)

Buick Electra (4)
Cadillac (3)
Ford LTD Brougham (4)
Lincoln (3)
Olds Delta 98 (1)

Foreign (7,334)

Mercedes-Benz (3)
Honda (3)
Jaguar (3)
Nissan (3)
Toyota (3)
Volvo (3)
BMW (3)
Mazda (3)
Volkswagen (3)
Porsche (3)
Audi (3)

18 The total number of dispositions for all models in the class is shown in parenthesis after the class name; the number of data sets in which a particular model appeared is shown in parenthesis after the model name.

Appendix C. Determination of Equivalent Economic Lives from the Age-Price Profile and Pattern of Sales

This appendix first describes the equations used to calculate the unadjusted equivalent economic life for each specific passenger car model. The computation of the adjusted equivalent economic life, which allows for the disposal of assets before the end of their useful life, is then discussed.

The first step involves obtaining the age-price profile for a particular model. The relative value of the cars as a function of age is obtained for each model by fitting the observed average sales prices (excluding wrecks) at each age by a fifth degree polynomial. Average disposition prices are calculated for each month in which dispositions take place. All sale price observations are adjusted for inflation and divided by the initial cost of cars to obtain relative values, V(t). The regression equation is:

$$V(t) - 1 = a_1 t + a_2 t^2 + a_3 t^3 + a_4 t^4 + a_5 t^5, \tag{1}$$

where the normalized value is unity at age zero, t represents age, and the a_i are the regression coefficients[19]. The negative of the derivative of the fitted function V(t) provides the asset's economic depreciation as a function of its age. The present value of this economic depreciation function (PVED) is the total discounted value of economic depreciation. It is found by integrating the discounted value of depreciation from age zero to the age at which the asset value is at a minimum (typically zero).

$$PVED = -\int_{t=0}^{M} (a_1 + 2a_2 t + 3a_3 t^2 + 4a_4 t^3 + 5a_5 t^4) e^{-rt} dt \tag{2}$$

where M is the age at which the minimum asset value is reached (its useful life), and r is the discount rate.

The present value of straight-line depreciation over a life L is given by:

$$PVSL(L) = \int_{t=0}^{L} \frac{e^{-rt}}{L} dt = \frac{1 - e^{-rL}}{rL}. \tag{3}$$

The straight-line life with the same present value as PVED can be determined from Equation 3 by numerical methods. This life is the unadjusted equivalent economic life.

---

19 Average sale price observations are weighted in the regression by the initial cost of the cars represented.

The fact that the assets are not all held until the end of their useful life is now considered. Current law requires the taxpayer to treat as a gain (or claim a loss) an amount equal to the difference between the adjusted basis of the asset and its sales value. Equation 4 corrects Equation 3 to include the fact that assets are converted (via sale) to non-business use prior to the end of their useful life, and to take account of the tax gain or loss claimed when the assets are sold.

$$PV(E) = \int_y^E D(t)\left(\frac{1-e^{-rt}}{rE} + \left(1 - \frac{t}{E} - V(t)\right)e^{-rt}\right)dt + \int_E^z D(t)\left(\frac{1-e^{-rE}}{rE} - V(t)e^{-rt}\right)dt \tag{4}$$

where y is the shortest and z is the longest holding period in the disposition probability distribution characterized by the function D(t), and where E is the adjusted equivalent economic life. In this study, the value of D(t) is obtained from the observed pattern of dispositions[20].

The first integral provides the present value of straight-line depreciation, plus any gains or losses for passenger cars retired before the adjusted economic life weighted by the disposition probability, D(t). The first term in the outer bracket of the integrand reflects the aggregate present value of straight-line depreciation up to the time of sale. The terms in the inner bracket express the present value of the gain or loss at the time of sale. The gain or loss is the difference between the remaining basis, 1 - t/E, and the relative value, V(t), of the asset at the time of disposition. Similarly, the second integral provides the present value of economic depreciation for the portion of assets disposed of after the adjusted equivalent economic life. The first term in the bracket in the integrand reflects the present value of straight-line depreciation, while the second term likewise adjusts for the present value of the gain on sale (the adjusted basis for cars of age greater than E is zero).

Equation 5 corrects Equation 2 to allow for the fact that not all the cars are held until the end of their useful life:

$$PVED' = -\int_y^z D(T)\left(\int_0^T (a_1 t + 2a_2 t + 3a_3 t^2 + 4a_4 t^3 + 5a_5 t^4)e^{-rt}\,dt\right)dT. \tag{5}$$

Equation 4 is solved for that life, E, that provides the same present value as determined from Equation 5 using a combination of analytical and numerical techniques. This is the adjusted equivalent economic life reported for each model type. For fleet vehicles, separate adjusted equivalent economic lives were calculated for 1985 and 1986 model years for each of the models and data sets. A single estimate was obtained for the non-fleet vehicles.

---

20 The disposition probability distribution is calculated by first fitting the cumulative disposition function, which measures the fraction of the initial cost that has been sold by age t, by a fifth degree polynomial function. This function is then differentiated to obtain the disposition probability distribution D(t). Where appropriate, the function is truncated so that only the bell shaped portion of this function is used to represent the disposition probability distribution.

References

Ackerlof, George, "The Market for Lemons," *Quarterly Journal of Economics* 84 (1970), pp. 488-500.

Bobit Publishing Co., *Automotive Fleet Fact Book*, 1990, Vol. 29 Supplement, Redondo Beach, CA.

Hu, Patricia, "Scrappage and Survival Rates of Passenger Cars and Trucks in 1970-1982," submitted to Department of Energy (1983), Oak Ridge National Laboratory, Oak Ridge, TN.

Hulten, Charles R. and Frank C. Wykoff, "The Measurement of Economic Depreciation," in *Depreciation, Inflation, and the Taxation of Income From Capital*, ed. by C. Hulten, The Urban Institute (Washington, D.C., 1981) pp. 99-103.

Pies, Roger A. And David J. Fischer, "How Dispositions Affect Determination of Depreciation Class Life," Tax Notes, April 2, 1990, pp. 85-96.

U.S. Department of Commerce, Bureau of Economic Analysis, unpublished capital stock worksheets, 1990.

Wykoff, Frank C., "Economic Depreciation and the User Cost of Business-Leased Automobiles," in *Technology and Capital Formation*, ed. by D.W. Jorgenson and R. Landau, MIT Press (Cambridge, 1989).

Acknowledgments

This report was prepared by Robert E. Yuskavage and Hudson Milner. William Chen and James Dutrow provided programming assistance.

Department of the Treasury
Washington, D.C. 20220

Official Business
Penalty for Private Use, $300

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

FOR IMMEDIATE RELEASE
APRIL 30, 1991

CONTACT: BARBARA CLAY
202-566-5252

CHARLES H. DALLARA
ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS
TO LEAVE TREASURY

Secretary of the Treasury Nicholas F. Brady announced today that Charles H. Dallara, Assistant Secretary for International Affairs, will leave the Treasury Department to accept a position in the private sector.

In announcing Mr. Dallara's departure, Secretary Brady said, "Charles has had a long and distinguished career at Treasury. His breadth of experience has proved invaluable. His sound judgment, depth of knowledge, and tireless efforts will be missed by me both professionally and personally."

Mr. Dallara has served as Assistant Secretary for International Affairs since May 1989. Prior to assuming this post, Mr. Dallara served in a number of other senior positions at the Treasury Department. From October 1988-May 1989, Mr. Dallara served as Assistant Secretary for Policy Development and Senior Policy Advisor to the Secretary. From 1984-1989, he had the dual responsibilities of U.S. Executive Director at the IMF and Senior Deputy Assistant Secretary for International Economic Policy. Prior to that, Mr. Dallara was the Deputy Assistant Secretary of Treasury for International Monetary Affairs (1983-1984) and U.S. Alternate Executive Director at the IMF (1982-1983).

During his tenure at the Treasury Department, Assistant Secretary Dallara has played a central role in U.S. international economic policy. He was instrumental in the development of the international economic policy coordination process. In his current position, Mr. Dallara has worked closely with Secretary Brady and Under Secretary David C. Mulford in the development and implementation of the "Brady Plan," the international debt strategy. He was also involved in the launching and conduct of the Structural Impediments Initiative (SII), trade negotiations initiated by President Bush in 1989 to reduce structural trade barriers in both the Japanese and U.S. economies.

Mr. Dallara holds a Bachelor of Science degree (B.S.) from the University of South Carolina, as well as a Master of Arts (M.A.), a Master of Arts in Law and Diplomacy (M.A.L.D.) and a Ph.D from the Fletcher School of Law and Diplomacy, Tufts University. He resides in Falls Church, Virginia, with his wife, Carolyn, and their two children, Stephen and Emily.

NB-1249

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

FOR IMMEDIATE RELEASE
AS PREPARED FOR DELIVERY

Contact: Cheryl Crispen
202-566-2041

THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
50TH ANNIVERSARY DEDICATION CEREMONY
U.S. SAVINGS BONDS STAMP
APRIL 30, 1991
WASHINGTON, D.C.

Thank you. It is a great pleasure to be here and an honor to join Postmaster General Anthony Frank, Treasurer Cathi Villalpando, and the rest of our Savings Bonds supporters for this celebration.

We are here to dedicate a special postage stamp honoring the 50th Anniversary of U.S. Savings Bonds. It was fifty years ago, on this same date in 1941, that President Franklin Roosevelt announced the introduction of the Series E Savings Bond to the nation. It was a new idea -- a government security at an affordable price. And President Roosevelt called on all Americans to join in a "great partnership" to make the new program work for the American people.

History proves that the resulting partnership was a success. By the end of World War II, Americans had bought more than $50 billion in Bonds. Since then, we've purchased at least $250 billion more -- including the $8 billion sold by last year's top-flight Savings Bonds team.

Over the years, the Treasury Department has worked with bankers, business men and women, labor leaders and other volunteers to maintain the strength and endurance of the program. It has been a partnership in the best tradition of American volunteerism -- the public and private sectors working together for the national good.

Today, we are fortunate to have with us some of the committed individuals who represent that partnership. And there are thousands of others who share in the same commitment -- from local leaders to national organizers. You all make positive and lasting contributions to the Savings Bonds effort.

As Franklin Roosevelt said, when he kicked off the first bond campaign 50 years ago: "Th[e] character of the campaign is national in the best sense of the word -- for it is going to reach down, I hope, to the individual and the family in every community, and on every farm, in every State and possession in the United States."

NB-1250

As Savings Bonds sales have grown, so has the number of dedicated volunteers. You know the true value of a solid investment, and you know the benefits this program will generate for the American people. I believe FDR's hope for a broad national campaign was justified and his aspirations met.

Savings Bonds are strong investments that work for everyone. They offer benefits to savers, to companies offering the Payroll Savings Plan, and the United States.

For savers, the Bonds offer a unique combination of benefits, including market-based interest rates and earnings that are not subject to state and local taxes. Savings Bonds also are backed by the full faith and credit of the United States Government -- making them the safest savings instrument available.

For companies, the payroll savings program offers a unique partnership with the federal government that encourages national saving.

For the United States, bond sales contribute to financing the nation's government.

This stamp we are dedicating today recognizes the importance and longevity of the Savings Bonds program. While the stamp honors the solid tradition of our past, it serves as a reminder that Savings Bonds can help Americans save for the future -- for a new home, a college education, or retirement. Americans know they can turn to Savings Bonds for a safe and sound investment opportunity.

Special thanks go to Postmaster General Anthony Frank, whose personal support helped bring about the unveiling of this commemorative design. This new stamp is not only an honor for the Savings Bonds program -- it's also one heck of an advertising campaign. There aren't many ads that reach out and touch as many people as the U.S. Mail.

U.S. Savings Bonds are now the most widely-held government security in history, and they remain a basic way for all Americans to save and invest. During this 50th anniversary celebration, it is a great honor to see our program commemorated on a U.S. Postage stamp. It is a fitting tribute to the hard work of Americans who have made Savings Bonds a distinguished tradition for our nation.

Thank you.

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

FOR RELEASE AT 4:00 P.M.
April 30, 1991

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 $17,200 million, to be issued May 9, 1991. This offering will result in a paydown for the Treasury of about $2,950 million, as the maturing bills are outstanding in the amount of $20,140 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, May 6, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Daylight Saving time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately $8,600 million, representing an additional amount of bills dated February 7, 1991, and to mature August 8, 1991 (CUSIP No. 912794 XB 5), currently outstanding in the amount of $10,552 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $8,600 million, to be dated May 9, 1991, and to mature November 7, 1991 (CUSIP No. 912794 XM 1).

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 May 9, 1991. In addition to the maturing 13-week and 26-week bills, there are $10,139 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 $1,479 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $1,679 million as agents for foreign and international monetary authorities, and $7,523 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).

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 competitive 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
April 30, 1991

Contact: Barbara Clay
202-566-5252

TREASURY NAMES LIBYAN FRONTS

The Treasury Department today identified 48 companies, banks, and organizations as entities and agents of the Government of Libya. The action is part of an ongoing Treasury investigation of Libyan efforts to engage in financial transactions and acquire goods and services in circumvention of the U.S. economic embargo against Libya.

In announcing today's action, R. Richard Newcomb, the Director of Treasury's Office of Foreign Assets Control (OFAC), stated that, "Libya's policies and actions, including its continued refusal to disavow terrorism as a tool of international policy, make such a listing particularly useful in redirecting public attention to the comprehensive sanctions program in place against Libya."

As a result of today's action by OFAC, the listed entities are now considered "Specially Designated Nationals", or agents of the Government of Libya, bringing them under the existing embargo and asset freeze put in place against Libya by President Reagan in January 1986. All assets of Specially Designated Nationals of Libya within U.S. jurisdiction, including overseas branches of U.S. banks, are blocked. Transactions by U.S. persons with Specially Designated Nationals of Libya are prohibited unless licensed by the Treasury Department. The last known address is given for each Specially Designated National of Libya.

Doing business with a Libyan Specially Designated National is equivalent to doing business with the Government of Libya, which carries criminal penalties of up to $500,000 per violation for corporations and up to $250,000 per violation for individuals, as well as prison sentences of up to 12 years for individuals and senior corporate officers. In addition, OFAC may impose administrative civil penalties of up to $10,000 per violation.

The list of Specially Designated Nationals of Libya may be expanded or amended at any time, as new information becomes available to the Treasury Department. Persons with information on companies or individuals trading with Libya or acting on behalf of the Government of Libya may call the OFAC Enforcement Division at 202-566-5021. All calls will be kept confidential.

oOo

NB1252

TREASURY NEWS

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

PREPARED STATEMENT OF R. RICHARD NEWCOMB
DIRECTOR, OFFICE OF FOREIGN ASSETS CONTROL
DEPARTMENT OF THE TREASURY

before the

SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

May 1, 1991

Chairman Pickle and members of the subcommittee:

Good morning. I am R. Richard Newcomb, the Director of the Office of Foreign Assets Control (FAC) at the United States Department of Treasury. I appear before the subcommittee today to discuss FAC's role in formulating, administering, and enforcing the economic sanctions programs imposed against Iraq, Kuwait, and Libya.

FAC has primary responsibility within the Executive Branch for implementing the financial and trade sanctions currently in effect with respect to a number of countries. In addition to the Iraq, Kuwait, and Libyan sanctions, we administer comprehensive sanctions against Cuba, Vietnam, North Korea, and Cambodia. FAC also administers the import embargo currently in effect against Iran. We currently administer and interpret the import and new investment prohibitions imposed against South Africa by the Comprehensive Anti-Apartheid Act of 1986, and continue to exercise residual World War II-origin assets controls affecting the Baltic Republics. In recent years, we administered successful economic sanctions programs against the Sandinista regime in Nicaragua and the Noriega regime in Panama.

In view of your expressed interest in the programs affecting the Middle Eastern countries, my comments today will be directed to the Iraq, Kuwait, and Libyan programs, our assessment of the effectiveness of those programs, and specific strategies we have employed in fulfilling our mission, including a vigorous Specially Designated Nationals program.

NB-1253

Description and Regulatory Evolution of the Iraq, Kuwait, and Libyan Sanctions Programs

As you know, Iraq's invasion of Kuwait on August 2 resulted in the immediate declaration of a national emergency by the President under the International Emergency Economic Powers Act ("IEEPA") and the issuance of Executive Orders No. 12722 and No. 12723, freezing all Iraq and Kuwait government assets in the United States, or under the control of U.S. persons, and imposing a comprehensive trade embargo against Iraq similar in scope to the one imposed under IEEPA against Libya in 1986.

Following the August 6 resolution of the United Nations Security Council calling on U.N. member states to impose sweeping economic sanctions against Iraq and occupied Kuwait, the President on August 9 issued Executive Order No. 12724 broadening the sanctions previously imposed against Iraq and Executive Order No. 12725 extending the same comprehensive sanctions program to Kuwait, then under Iraqi control. With respect to Iraq, the August 9 Executive order prohibited the following transactions, most of which had been prohibited under the August 2 order:

(1) imports and exports between the United States and Iraq, including activity promoting such transactions;

(2) dealing in property of Iraqi origin exported from Iraq after August 6;

(3) transactions related to travel to Iraq (with limited exceptions);

(4) transactions related to transportation to or from Iraq, including the use of Iraqi-registered vessels or aircraft;

(5) the performance of contracts in support of projects in Iraq; and

(6) the commitment or transfer of funds or other financial or economic resources to the Government of Iraq.

The August 9 order also continued in effect the blocking of Iraqi government property.

Since the liberation of Kuwait by the Allied Military Forces in Operation Desert Storm, the prohibitions of August 9 on most trade and financial transactions with respect to Kuwait have been removed by the issuance of general licenses authorizing such transactions. Except for seven Kuwaiti banks, the U.S. property of the Government of Kuwait has now been effectively unblocked by general license. The seven banks, while remaining blocked, have been issued specific licenses to use their assets to settle pre-August 2 obligations. Also the seven banks have been licensed to engage in letter of credit and foreign exchange transactions. We anticipate that the banks will be unblocked and fully able to operate in the United States by the end of this month.

A comprehensive economic sanctions program similar to that against Iraq was imposed by the President against Libya in January 1986. Although these sanctions were also imposed under the authority of IEEPA, they were a deliberate response to Libya's longstanding support of international terrorism (including hostage-takings and bombings), rather than an immediate response to a particular act of aggression. As in the case of the Iraq and Kuwait sanctions, the Libyan sanctions were developed by Treasury with the assistance of the Departments of State and Justice, the White House staff, and the National Security Council.

The Libyan sanctions block the U.S. property of the Government of Libya, prohibit imports to and exports from Libya, prohibit financial transactions with Libya (including extensions of credit), and prohibit travel transactions. As I will discuss in greater detail shortly, the Libyan Sanctions Regulations ("LSR") 31 C.F.R. Part 550, promulgated by FAC to implement the Libyan sanctions, include within the definition of the "Government of Libya" any organization or person designated by the Secretary of the Treasury as having been determined to be owned or controlled by, or acting on behalf of, the Government of Libya. The Iraqi Sanctions Regulations ("ISR"), 31 C.F.R. Part 575, provide the Director of FAC with similar authority in defining the "Government of Iraq."

Effectiveness of Implementation of Iraqi Sanctions and Kuwaiti Asset Protections

The objectives of the August 2 and 9 Executive orders were to deprive Iraq of any economic or financial benefit as a result of its illegal invasion and occupation of Kuwait, and to preserve and protect the substantial U.S. assets of the Government of Kuwait for the benefit of their rightful owner. Due to the swift and coordinated actions of the President, the National Security Council, and the Treasury and State Departments on the night of the Iraqi invasion, the legal authority to implement the sanctions was in place and the operational responsibility assigned before U.S. financial markets opened on August 2.

We believe much of the initial success in implementing the sanctions after the decisive steps taken by the President can be attributed to the quick and rational application of the restrictions by the Treasury administrative apparatus to the complex commercial and financial relationship that existed between the United States, Kuwait, and Iraq. In many cases, these actions set the pace or became the model for the sanctions programs administered by other countries.

The most immediate and pressing problems we faced in the aftermath of the Executive orders were identifying which institutions were actually owned or controlled by the Governments of Kuwait and Iraq, winding down financial and commercial transactions entered into prior to the sanctions, and structuring a regulatory program that provided a reasonable degree of investment flexibility for the billions of dollars of blocked Kuwaiti property while ensuring that the property remained fully protected.

The President's orders immediately and effectively immobilized tens of billions of dollars of Kuwaiti and Iraqi government-owned assets in the United States. These orders interfered with or halted altogether billions of dollars of capital flows. These included foreign exchange contracts, oil payments, repurchase agreements and currency swaps, payments to international banking syndicates, and a wide variety of overnight investment arrangements involving capital markets in different political jurisdictions.

Resolving the problems resulting from the blocking orders was a complicated and difficult task, especially in today's sophisticated capital markets with their international scope and highly developed dependence on the execution of interlocking contractual obligations. We have had considerable experience over the years in freezing the assets of adversarial countries, but not since World War II have we been tasked with imposing and administering such a large scale protective asset freeze involving a country with such complex and extensive multinational investment holdings as Kuwait. In addition, most past asset freezes had not occurred suddenly, but after a period of escalating international tensions; this freeze was imposed literally overnight.

Almost immediately, our blocking program developed into a two track approach. First, we had to identify and make known to the financial and export communities the Kuwaiti banks and other institutions frozen by the Executive orders and how pre-existing financial and other contractual arrangements could be completed, wound down, or continued without violating the freeze order. Second, we had to identify, license, and develop operational guidelines for the Kuwaiti government-owned institutions determined to be under the control of legitimate authorities so they could continue to function within the international framework established by the U.N. sanctions program.

The day after the freeze, Friday, August 3, we issued guidance to U.S. persons concerning the completion of existing contracts involving pre-invasion oil shipments en route to the U.S., securities transactions, foreign exchange contracts, and letter of credit payments to U.S. exporters for goods and services exported to Iraq or Kuwait prior to the effective date. That day we also began what became an extensive and ongoing cooperative consulting process with the Kuwaiti authorities, as well as with many of the companies and financial institutions affected by the freeze. Over the weekend of August 5, we developed and transmitted to the Federal Reserve Bank of New York ("FRBNY") the first in a series of determinations concerning the blocked status of certain prominent Middle Eastern, Pan-Arab, and Kuwaiti banks and financial institutions. We also met with U.S. and Kuwaiti representatives of various companies affected by the freeze order.

Over the next couple of months we met daily with a wide variety of parties affected by the freeze. We issued numerous interpretative rulings involving a wide variety of transactions and additional blocking status determinations concerning various institutions. These complicated and fact-intensive determinations, especially those involving banks in which other countries had interests, had to be made under severe time constraints. These constraints arose because delays of just a day or two in determining the status of a bank could cause severe runs by concerned depositors who feared their funds might incidentally be caught in the freeze if the bank were determined to be owned or controlled by the Governments of Kuwait or Iraq. It also became apparent to us over this period that many other countries were taking blocking actions with respect to the individual institutions based upon our determinations.

We also worked extensively with the Government of Kuwait during this period to ascertain which of the blocked Kuwaiti governmental institutions had sufficient senior officials and management personnel outside of Kuwait to resume limited operations. We met with CEO's and other senior officials of the Kuwait controlled institutions to tailor specific FAC licenses designed to permit U.S. persons, including holders of blocked property belonging to the institutions, to engage in specified types of transactions involving the institutions. This licensing scheme was followed to ensure that transactions permitted by the licenses remained subject to U.S. jurisdiction and control while allowing the institutions sufficient flexibility to resume operations. Most of these institutions were owned or controlled by the Kuwait Investment Office or the Kuwait Investment Authority.

In addition to the regular meetings with the Kuwaitis and other affected parties since August 2, we have consulted regularly with the Federal Reserve Bank of New York and various U.S. Government agencies, including the Departments of State, Commerce, and Defense, the Customs Service, the FBI, the NSC, and members of the intelligence and law enforcement communities. We also established an ongoing program with foreign governments to meet regularly with their embassies to coordinate actions and ensure uniform application of all U.N. resolutions and participated in coordination meetings with our allies in such forums as the Bank for International Settlements, the Organization for Economic Cooperation and Development, the European Economic Community Commission, and the United Nations.

On the domestic side, we believe the longer term effectiveness of the sanctions can be attributed to the intensive efforts of the many U.S. Government agencies affected and the high level of cooperation exhibited by the Federal Reserve System, the other bank supervisory and regulatory agencies, and the financial and export communities. The Customs Service was in a position to assist us by monitoring all imports and exports and did so completely and effectively. Many exports to Iraq or Kuwait already on the high seas were returned to the United States; others were diverted to other destinations, either voluntarily or by direction of the naval forces participating in the quickly-assembled multinational blockade. Internationally, the unprecedented level of cooperation and unanimity of purpose exhibited by the U.N. member states participating in the sanctions program has been remarkably successful in preventing inadvertent leaks in any particular political jurisdiction from turning into a serious hemorrhaging of the embargo.

The same level of cooperation and unanimity of purpose was exhibited domestically as well. FAC's Enforcement Division conducts and coordinates investigations of substantive violations of the embargo and accordingly maintains daily operational liaison with the U.S. Customs Service and the Federal Bureau of Investigation. Similarly, FAC routinely coordinates its activities with the Departments of State, Defense, Commerce, and Justice, and the intelligence community.

<u>Census of Blocked Iraqi Assets and Claims Against Iraq</u>

On February 8, we issued regulations requiring that all United States persons holding blocked Iraqi property, and all United States nationals with claims against Iraq, file reports of such assets or claims with FAC. Since the reporting deadline of March 15, we have been reviewing, tabulating, and evaluating the reports filed.

The reports filed reveal that the value of blocked Iraqi property in the United States exceeds $1.2 billion. This property consists principally of bank deposits frozen on August 2, amounts subsequently paid into blocked accounts by purchasers of Iraqi oil en route to the United States on

August 2, and a miscellaneous variety of Iraqi government-owned tangible properties and credits. Approximately $420 million additional was reported as blocked in the offshore branches of U.S. banks, primarily in the United Kingdom.

Almost 1,100 individuals, corporations, banks, and U.S. Government agencies have reported billions of dollars in claims against Iraq. These range from claims asserted by individuals for personal property looted in Kuwait to losses of future business and concession rights. Inasmuch as these claims have not been submitted to a formal claims resolution body, much less adjudicated, it would be inappropriate to speculate as to their actual aggregate value. The process by which the claims will be adjudicated and settlements funded will be determined once the details of the U.N. reparations plan are worked out.

We have already held several meetings with the larger claimants who have raised issues we believe require examination in order to obtain a clearer and more complete picture of their losses. These meetings enable us to more effectively evaluate the various settlement options or scenarios likely to be put forth.

Specially Designated Nationals

As noted earlier, the ISR and LSR provide the Secretary of the Treasury with authority to include within the definition of the target country government those individuals and entities which have been determined to be acting on behalf of, or controlled by, the target government. This authority greatly enhances the effectiveness of these sanctions programs by forestalling a potential avenue of sanctions evasion by Specially Designated Nationals--agents and front companies of Iraq and Libya.

The effect of being designated a Specially Designated National, or SDN, is significant. The SDN is exposed internationally as a target government agency, instrumentality, or controlled entity acting either overtly or covertly as a front, and all of the SDN's property within the jurisdiction of the United States (including financial assets in U.S. bank branches overseas) is blocked. U.S. persons are prohibited from engaging in any transaction involving property in which the SDN has an interest, which includes all financial and trade transactions, and all holders of SDN property must report those holdings to FAC. In the case of Iraq, which is subject to multinational sanctions, being identified as an Iraqi SDN by the United States provides a basis for other governments to take similar steps to include the specifically identified individuals and entities within their sanctions programs.

Through information obtained by FAC from a combination of investigative sources, including other U.S. agencies, we have undertaken a major initiative to identify front companies and agents used to acquire technology, equipment, and other resources for Iraq. On April 1, Treasury formally identified 52 businesses and 37 individuals as Iraqi SDNs and 160 merchant ships as Iraqi-owned or controlled, thus prohibiting their use by U.S. businesses and individuals. This action was the culmination of many months of domestic and international investigative effort coordinated by Treasury with domestic and foreign investigative resources. Approximately half of the designated Iraqi SDNs are part of the Iraqi military-industrial network.

In practice, an Iraqi SDN is an Iraqi government body, representative, intermediary, or front (whether overt or covert) that is located outside Iraq and functions as an extension of the Government of Iraq. It may be a firm created by the Iraqi Government, or it may be a third-party company that otherwise becomes owned or controlled by the Iraqi government or that operates on behalf of the Government of Iraq. No criminal linkage is necessary for being placed on the SDN list. Ownership or control by the Iraqi government or acting on its behalf would suffice to qualify a person for designation.

For U.S. persons, dealing with an SDN is equivalent to doing business with the government of the target country, an activity which is prohibited and subject to severe penalties. For example, under the Iraq Sanctions Act, civil penalties of up to $250,000 may be imposed administratively. Criminal fines of up to $1 million per violation may be imposed on both individuals and corporate entities, and prison sentences of up to 12 years are authorized for individuals, including officers, directors, or agents of a corporation who are knowingly involved in a corporate violation of the sanctions.

U.S. persons may be designated as SDNs and, as such, would have their assets blocked by FAC, effectively putting them out of business. It should also be noted that a U.S. firm in which Iraq holds a controlling interest was immediately blocked under terms of the August 2 Executive order.

Among the entities identified as SDNs were the Matrix-Churchill Corporation of Solon, Ohio, and Bay Industries, Inc., of Santa Monica, California, two U.S. corporations on which FAC had previously served blocking notices. Matrix-Churchill's role in Iraq's international arms and technology acquisition network, performed under cover of a seemingly innocuous machine tool sales and service business, has received widespread publicity in recent months.

Yesterday, we named 48 entities, all located outside the United States, as Libyan SDNs. Libya's policies and actions, including its continued refusal to disavow terrorism as a tool of international policy, make such a listing particularly useful at this time in redirecting public attention to the comprehensive sanctions program in place against Libya.

Neither the Libyan nor the Iraqi SND list is intended as a static document, but will be continuously augmented as additional front companies and agents are identified.

It was a pleasure appearing before this subcommittee this morning. I will be pleased to respond to any questions.

#####

TREASURY NEWS

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

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
May 1, 1991

CONTACT: Office of Financing
202/376-4350

TREASURY MAY QUARTERLY FINANCING

The Treasury will raise about $18,025 million of new cash and refund $18,976 million of securities maturing May 15, 1991, by issuing $13,500 million of 3-year notes, $11,750 million of 10-year notes, and $11,750 million of 30-year bonds. The $18,976 million of maturing securities are those held by the public, including $1,099 million held, as of today, by Federal Reserve Banks as agents for foreign and international monetary authorities.

The three issues totaling $37,000 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 $3,662 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.

The 10-year note and 30-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-1254

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
MAY 1991 QUARTERLY FINANCING

May 1, 1991

Amount Offered to the Public	$13,500 million	$11,750 million	$11,750 million
<u>Description of Security</u>:			
Term and type of security	3-year notes	10-year notes	30-year bonds
Series and CUSIP designation	Series S-1994 (CUSIP No. 912827 A7 7)	Series B-2001 (CUSIP No. 912827 A8 5)	Bonds of May 2021 (CUSIP No. 912810 EJ 3)
CUSIP Nos. for STRIPS Components . .	Not applicable	Listed in Attachment A of offering circular	Listed in Attachment A of offering circular
Issue date	May 15, 1991	May 15, 1991	May 15, 1991
Maturity date	May 15, 1994	May 15, 2001	May 15, 2021
Interest rate	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
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	November 15 and May 15	November 15 and May 15	November 15 and May 15
Minimum denomination available . . .	$5,000	$1,000	$1,000
Amount required for STRIPS	Not applicable	To be determined after auction	To be determined after auction
<u>Terms of Sale</u>:			
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	None
<u>Payment Terms</u>:			
Payment by non-institutional investors	Full payment to be submitted with tender	Full payment to be submitted with tender	Full payment to be submitted with tender
Deposit guarantee by designated institutions	Acceptable	Acceptable	Acceptable
<u>Key Dates</u>:			
Receipt of tenders	Tuesday, May 7, 1991	Wednesday, May 8, 1991	Thursday, May 9, 1991
a) noncompetitive	prior to 12:00 noon, EDST	prior to 12:00 noon, EDST	prior to 12:00 noon, EDST
b) competitive	prior to 1:00 p.m., EDST	prior to 1:00 p.m., EDST	prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):			
a) funds immediately available to the Treasury	Wednesday, May 15, 1991	Wednesday, May 15, 1991	Wednesday, May 15, 1991
b) readily-collectible check	Monday, May 13, 1991	Monday, May 13, 1991	Monday, May 13, 1991

TREASURY NEWS

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

EMBARGOED UNTIL GIVEN
EXPECTED AT 10:00 A.M.

TESTIMONY OF
THE HONORABLE JEROME H. POWELL
ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON EDUCATION AND LABOR
SUBCOMMITTEE ON LABOR-MANAGEMENT RELATIONS

May 2, 1991

Chairman Williams, Representative Roukema, and members of the Subcommittee, thank you for the opportunity to address the implications of the Administration's legislative proposal, H.R. 1505, the Financial Institutions Safety and Consumer Choice Act of 1991, for pension plan participants of private employers and state and local governments. I am especially honored to present these views to the Subcommittee on Labor-Management Relations, a Committee before which the Treasury Department rarely has the opportunity to appear.

Purpose of the Administration's Proposal

Let me begin by putting our pass-through insurance proposal in the context of our overall bill. H.R. 1505 is the Administration's comprehensive approach to modernize our outdated banking laws to make our banking system stronger and safer. It is the legislative culmination of an 18-month study by the Treasury Department of the banking system, as mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). We believe this comprehensive approach to banking reform is the only way to truly resolve the underlying problems in the banking system -- merely recapitalizing the Bank Insurance Fund, as some have suggested, will only put off the day of reckoning and increase the exposure of the taxpayer. As Secretary Brady has said many times, we need to <u>fix</u> the banking problem, not just <u>fund</u> it.

We believe that comprehensive reform must accomplish three fundamental objectives:

-- First, we must make deposit insurance safe for taxpayers and depositors. That means stronger supervision, better capitalized banks, and the return of deposit insurance to its original purpose of protecting average depositors. It also means a better capitalized Bank Insurance Fund.

-- Second, it is time to modernize archaic laws to let banks catch up with their customers to deliver products more efficiently to consumers across the country -- which translates into greater convenience, lower interest rates and transaction fees for consumers, and more bank capital.

-- Third, we need to restore the preeminent international position of our banking industry. Our economy is twice the size of our nearest competitor's, and a world class economy requires a world class banking system.

We believe that our legislation will help accomplish each of these objectives.

Moreover, an important piece of this comprehensive legislation is the subject of today's hearing. This is our proposal to reduce the taxpayer's current exposure to losses from "pass-through" deposit insurance, while preserving basic deposit insurance coverage for those pension plan participants that truly require protection.

My testimony today will explain how pass-through deposit insurance currently works, how it sometimes exposes the taxpayer to large losses, and how the Administration's bill would limit this exposure. Throughout this discussion it is critical to keep in mind one fundamental point: the more deposit insurance is used to cover new kinds of bank deposits, the more the taxpayer is exposed to losses. We must therefore be very careful about <u>any</u> expansion of deposit insurance coverage beyond its original purpose of protecting small, unsophisticated depositors. This is exactly why the Administration and a number of members of Congress have proposed legislation to scale back pass-through coverage, including Congressmen Gonzalez, Wylie, Roukema, and others.

<u>How Pass-Through Insurance Works</u>

Despite the explicit $100,000 limit on federal deposit insurance for any <u>one</u> deposit account, a single deposit account well in excess of $100,000 may be fully protected with pass-through insurance. This pass-through coverage can occur when a fiduciary deposits funds for the benefit of beneficiaries, with $100,000 of deposit insurance "passing through" to each of the beneficiaries. Because these fiduciary accounts are maintained for the benefit of others -- and not for benefit of the fiduciary that actually deposits the funds and is the nominal "owner" of the account -- the Federal Deposit Insurance Corporation (FDIC) has often determined that "pass through" treatment is appropriate.

In making these determinations, the FDIC has established two conditions that must be satisfied to ensure that a deposit account is truly held for the benefit of others. First, the account must be held as either an irrevocable trust or by an agent, nominee, custodian, conservator, guardian, or trustee on behalf of true, identifiable owners (the "beneficial" owners). This ensures that the nominal owner of the account is not the true beneficiary.

Second, the beneficiaries must be truly likely to receive the funds placed in the account, which in more technical language means that the interests of the beneficial owners must be determinable without the consideration of certain contingencies. Thus, for example, an irrevocable trust in which the beneficiary is to receive funds only upon completion of medical school involves a contingency that may very well not occur; pass-through coverage would therefore be denied. But an irrevocable trust in which the beneficiary is to receive funds upon the death of the grantor involves a contingency that will occur; pass-through coverage would therefore apply.

This two-prong eligibility test appears plausible at first, and the results sometimes make sense. For example, in cases where deposited funds are not used for investment purposes or where the trustee is not a sophisticated investor, it may be appropriate for deposit insurance to pass through to the beneficiaries. Thus, escrow accounts established by either lawyers for clients or landlords for tenants would appear to be a prudent use of pass-through insurance.

Nevertheless, the test can also produce broad expansions of deposit insurance coverage, and indeed, the trend of FDIC determinations has clearly been to expand pass-through treatment beyond these focused examples. As a result, deposit insurance has extended to larger and larger classes of depositors whose funds are managed by increasingly sophisticated investors. In particular, pass-through deposit insurance now applies to the deposits of large, professionally-managed pension plans, most of which already have important protections for beneficiaries that are already required by the laws governing pension plans. In addition, pass-through protection has also been interpreted to extend to certain kinds of deposits that are marketed to pension plans and have unusual interest rate risk features -- so-called Bank Investment Contracts, or "BICs."

It is these last expansions of deposit insurance -- and therefore taxpayer exposure -- that the Administration's bill is intended to address. To understand our proposal, however, it is important to set forth in somewhat greater detail the types of pension plans that receive pass-through coverage. These include both defined benefit plans and defined contribution plans.

Defined Benefit Plans. A defined benefit plan provides a definite formula under which the amount of a participant's pension is determined, such as a specific dollar amount for each year of credited service. In defined benefit plans, the amount of the employer's contribution is actuarily determined each year based upon such factors as the number and age of the participants and the investment returns of plan assets.

Participants in defined benefit plans enjoy five layers of protection from the investment risk associated with the investment of plan assets. Each of these protections fully applies to plan deposits in banks, wholly apart from deposit insurance. First, the fiduciaries that deposit plan assets in banks are subject to strict fiduciary laws that require prudent investment decisions. Second, these plans, especially the larger ones, typically employ sophisticated investment professionals to make informed decisions on how best to safely invest plan assets -- unsophisticated plan participants are not responsible for investment decisions. Third, the plan sponsor, typically the employer, is responsible for making additional contributions to the pension plan if the assets of the plan are inadequate to cover the plan's obligations -- or put another way, the plan sponsor bears the investment risk. Fourth, if the plan sponsor fails, any controlled group of which it is a member is responsible. Finally, if all else fails, defined benefit plans are generally insured by the Pension Benefit Guaranty Corporation (PBGC).

In short, pass-through deposit insurance for defined benefit plan deposits in banks represents a sixth and unnecessary layer of investment risk protection for plan participants. In fact, amounts paid through deposit insurance when a bank fails have the principal effect of insulating the employer from his responsibility to fund the pension.

Defined Contribution Plans. Unlike a defined benefit plan, a defined contribution plan provides an individual account for each participant. A participant's beneficial interest is determined by the value of his or her account, which is based on the amount of contributions allocated to the account, adjusted for any income, expenses, and investment gains or losses charged against the account. Money purchase plans, profit-sharing plans, stock bonus plans, 401(k) plans, and employee stock ownership plans are all types of defined contribution plans.

Unlike beneficiaries of defined benefit plans, beneficiaries of defined contribution plans bear the investment risk of plan investments (rather than plan sponsors), and such plans are not covered by PBGC insurance. Nevertheless, persons with control over plan assets are still governed by fiduciary investment laws that require prudent investment, and many defined contribution plans employ professional money managers to invest plan funds wisely. When such professionally managed defined contribution plans invest funds in bank deposits, pass-through deposit insurance becomes an additional and unnecessary layer of protection for plan beneficiaries.

The situation is different, however, for defined contribution plans that are "self-directed." Participants in self-directed defined contribution plans have varying levels of discretion to choose how funds in their accounts will be invested. The number of investment options provided to each participant depends on the structure of the plan. Some plans permit participants a broad range of discretion to choose individual securities or any other type of investment. The more typical plan provides several broad investment vehicles from which to choose, such as equity funds, bond funds, money market funds, or bank deposits.

Where broad discretion is permitted, there is obviously little or no professional management provided to the participant. But even where professionally managed investment options are provided, the effect of professional management is reduced by the discretion of the participant to allocate contributions among the options -- put another way, there is no professionally managed diversification of risk.

In short, unlike the beneficiaries of defined benefit plans, the participants in self-directed defined contribution plans make their own investment decisions and allocations, bear the full risk of loss, and receive no back-up federal protection from the PBGC. When such participants decide to place their money in a bank, their situation is not much different from the average depositor outside of a pension plan that saves money for retirement in a savings account. In this situation the need for federal deposit insurance appears much more compelling.

__Statistical Data__

Data provided by the Department of Labor suggest the expansion of taxpayer exposure through pass-through deposit insurance. Let me caution the Subcommittee, however, that the data represent approximations based on year-end 1988 surveys, and that more precise statistics are not available at this time.

Current estimates show nearly $150 billion in employee benefit plan assets on deposit with depository institutions. Of some 740,000 private pension plans, approximately 610,000 maintain deposits of less than $100,000 in depository institutions. These smaller pension plans obviously are not affected by proposals to reduce pass-through coverage since the deposits of such plans are fully insured up to $100,000 in each bank, even without pass-through coverage.

The approximately 130,000 remaining private pension plans do maintain deposits of more than $100,000 in depository institutions, with pass-through treatment applying to amounts in excess of $100,000. These plans cover more than 33 million participants and hold almost $700 billion in total assets. Moreover, these plans have deposited 13 percent, or about $90 billion, of their assets in depository institutions. Of this total, at least $13 billion would receive ordinary deposit insurance coverage based on the fact that the first $100,000 in each account would be insured.

Therefore, assuming that no individual participant's benefits exceed $100,000, pass-through deposit insurance coverage would apply to the remaining $77 billion. This $77 billion represents a rough approximation of the taxpayer's additional exposure from the application of pass-through deposit insurance to private pension plans.

<u>The Administration's Proposal</u>

With this background, let me now explain the Administration's proposal. H.R. 1505 provides that pass-through insurance would no longer extend to the deposits of defined benefit plans and defined contribution plans that are <u>not</u> self-directed. At the same, pass-through treatment would remain in effect for the deposits of defined contribution plans that <u>are</u> self-directed. Finally, deposit insurance would be eliminated altogether for Bank Investment Contracts that create significant interest rate risk for the issuing banks, and this elimination would apply regardless of whether the BICs were deposits of defined benefit plans or defined contribution plans.

Our policy reasons for reducing pass through coverage in this manner should now be apparent, at least in part. First, any expansion of deposit insurance coverage directly increases taxpayer exposure, and pass through treatment for pensions plans is clearly a broad expansion of the "federal safety net."

Second, the recommended reductions in pass-through coverage only apply to pension plan beneficiaries that already have other protections from investment risk under federal law and otherwise. We recognize that pension plan beneficiaries often fit the profile of the small, unsophisticated depositors that deposit insurance was designed to protect. Nevertheless, unlike depositors outside of pension plans, a number of these pension fund beneficiaries receive other important protections that make deposit insurance unnecessary. As described above, beneficiaries of defined benefit plans have five layers of protection from losses stemming from bank deposits, obviating the need for a sixth layer of protection in deposit insurance. By contrast, participants in self-directed defined contribution plans have less protection since they make their own investment decisions and bear the entire risk of loss; they would keep their pass-through coverage.

Third, pass-through deposit insurance eliminates market discipline from some of the very participants who would be the best able and most likely to provide it -- sophisticated professional investors. Indeed, there is very little difference between a professional investor who manages money for a pension fund and one who manages money for a money market mutual fund. Each is paid to invest other people's money; each is required by a set of federal laws to invest this money prudently; and each invests substantial sums in bank deposits. Yet the deposits of the sophisticated pension fund manager receive total deposit insurance coverage, while the deposits of the money market fund manager are almost entirely uninsured.

Such differential treatment makes little sense. While it has been argued that pension fund managers have not relied extensively on pass-through insurance to date because of certain legal ambiguities, this reluctance to rely on the federal guarantee will disappear as pass through insurance becomes more widely recognized. Now is the time to remove the unnecessary part of the guarantee, before it becomes a crutch for all professional pension fund managers and before it is used extensively to fund weak institutions.

Finally, the Administration's bill removes deposit insurance from Bank Investment Contracts to prevent the federal guarantee from extending to a deposit instrument that can create substantial interest rate risk for issuing banks. Let me elaborate on exactly how this provision would work.

Bank Investment Contracts

Some BICs, called "bullet" contracts, have relatively simple terms that resemble a traditional certificate of deposit. Others are more complicated, providing for a "window" period when deposits may be made at a contractually guaranteed interest rate. Some BICs also allow plan sponsors or participants to withdraw funds at book value prior to the contract's maturity. In the case of "window" BICs, unanticipated changes in prevailing interest rates above or below the contract interest rate during the window period may result in unanticipated deposit inflows or withdrawals, thereby exposing the bank to interest rate risk. Although hard data are difficult to obtain, it is estimated that about $10 billion is currently invested in BICs of all kinds.

In traditional certificates of deposit, interest rate risk is shared with the depositor. If market rates go up during the term, the customer "loses." Conversely, the bank "loses" if market rates go down during the term. However, customers are allowed to fund BICs with a pre-determined yield over a period of time. Therefore, depending on the contractual arrangements of the BIC, the customer may be able to take advantage of any change in market interest rates to the detriment of the bank. Should market rates go down, the customer may be able to invest more funds in the BIC at a contractually higher interest rate than he might have originally planned. Should rates go up, the customer may deposit less.

Our bill would eliminate pass-through insurance for "window" BICs because of the interest rate risk problems they pose. Banks would still be permitted to offer "window" BICs to pension fund managers, but without federal deposit insurance. At the same time, bullet BICs would be treated like any other deposit for pass-through purposes.

State and Local Plans

Before closing, let me briefly discuss pension plans for state and local governments. The Administration's pass-through proposal does not disturb the status quo for these plans -- defined benefit plans would continue to receive pass-through treatment, while so-called "457 Plans" would continue to be ineligible for pass-through treatment.

Most state and local government plans are defined benefit plans. However, unlike private defined benefit plans, beneficiaries are not protected from bank losses by federal safeguards included in the Empoyee Retirement Income Security Act of 1974 ("ERISA"), and plans are not insured by the Pension Benefit Guaranty Corporation. Moreover, many of these plans are smaller, have no professional management, and rely heavily on insured deposits as a safe vehicle to invest funds. Community banks also rely heavily on these investments. Accordingly, the Administration concluded that it was not appropriate to eliminate pass-through coverage in these circumstances.

Another type of plan used by state and local governments, and also some non-profit organizations, is authorized under Section 457 of the Internal Revenue Code. These are the so-called 457 Plans, which are really deferred compensation plans rather than pension plans. The FDIC has determined that 457 Plans are not eligible for pass-through deposit insurance. Because Section 457 of the Internal Revenue Code states that the funds of such plans are required to "remain solely the property and rights of the employer," the FDIC decided that the employer was the true owner of the bank deposits of such plans, rather than the employees whose compensation was deferred. Accordingly, the FDIC determined that deposit insurance coverage could not "pass through" to beneficiaries that do not technically own their accounts.

The now defunct Federal Savings and Loan Insurance Corporation, however, permitted pass-through coverage for 457 Plans. Pursuant to authority granted to it under FIRREA, the FDIC has determined that savings associations may not continue to accord 457 Plans with pass-through coverage beyond January 29, 1992.

H.R. 1505 would preserve the status quo for all 457 Plans: plan deposits in banks would not receive pass-through treatment, and plan deposits in thrifts would only continue to receive such treatment until the FDIC phase-out rule takes effect. The Administration does not believe that pass-through treatment should be extended to plans where it does not currently extend.

Conclusion

In conclusion, some may argue that pension plan participants represent those very same average individuals deposit insurance serves to protect. As depositors, that may often be true. But as beneficiaries of pension plans covered by several layers of financial protection, the analogy breaks down. Only participants in self-directed defined contribution plans exercise the personal control and risk necessary to render their status comparable to that of the average depositor. And in these cases, we believe it is entirely appropriate to continue pass-through coverage.

Let me close by again stressing the importance of comprehensive reform. None of us wants to visit these issues again, especially if we have to ask the taxpayers for assistance. Yet, I fear that we are likely to find ourselves in that very position if we opt for a piecemeal approach to reform.

Thank you again, Mr. Chairman, for the opportunity to present the Administration's views to the Committee. I will be happy to answer any questions you may have.

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
May 2, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 52-WEEK BILLS

Tenders for $11,811 million of 52-week bills to be issued May 9, 1991 and to mature May 7, 1992 were accepted today (CUSIP: 912794YM0).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.69%	6.05%	94.247
High	5.71%	6.07%	94.227
Average	5.71%	6.07%	94.227

Tenders at the high discount rate were allotted 72%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	23,745	23,745
New York	30,245,485	11,021,430
Philadelphia	14,280	14,280
Cleveland	28,645	28,645
Richmond	27,255	27,255
Atlanta	20,770	18,770
Chicago	1,221,780	116,780
St. Louis	20,560	14,000
Minneapolis	10,280	10,280
Kansas City	28,190	28,190
Dallas	12,735	12,735
San Francisco	838,715	97,715
Treasury	397,185	397,185
TOTALS	$32,889,625	$11,811,010
Type		
Competitive	$28,844,215	$7,765,600
Noncompetitive	845,410	845,410
Subtotal, Public	$29,689,625	$8,611,010
Federal Reserve	3,000,000	3,000,000
Foreign Official Institutions	200,000	200,000
TOTALS	$32,889,625	$11,811,010

An additional $20,000 thousand of bills will be issued to foreign official institutions for new cash.

NB-1256

Report of
THE SECRETARY OF THE TREASURY
on
GOVERNMENT-SPONSORED ENTERPRISES

THE DEPARTMENT OF THE TREASURY 1789

April 1991

Report of

THE SECRETARY OF THE TREASURY
on
GOVERNMENT-SPONSORED ENTERPRISES

April 1991

294-104 O - 91 - 1 QL 3

THE SECRETARY OF THE TREASURY
WASHINGTON

April 29, 1991

The Honorable J. Danforth Quayle
President of the Senate
United States Senate
Washington, D.C. 20510

Dear Mr. President:

I am pleased to transmit the April 1991 Report of the Secretary of the Treasury on Government-sponsored Enterprises. This Report has been prepared to meet the statutory requirements in section 1404 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)(Pub. L. No. 101-73) and in section 13501 of the Omnibus Budget Reconciliation Act of 1990 (OBRA)(Pub. L. No. 101-508).

FIRREA requires the Treasury to assess in two annual studies the financial safety and soundness of the GSEs and to study the impact of GSE operations on Federal borrowing. The Treasury submitted the first annual report under FIRREA in May 1990. OBRA requires the Treasury to assess the financial soundness of GSEs, the adequacy of the existing regulatory structure for GSEs, the financial exposure of the Federal Government posed by GSEs, and the effects of GSE activities on Treasury borrowing.

The enclosed study, which is intended to meet the requirements of FIRREA and OBRA, presents principles that are essential to effective financial safety and soundness regulation. It also includes an analysis of the financial condition of the GSEs performed by the Standard & Poor's Corporation, and updates the findings in the 1990 Report regarding the impact of GSE activities on Treasury borrowing. We will submit proposed legislation shortly implementing the recommendations in this study to authorize Federal regulation of the financial safety and soundness of the GSEs.

I am also transmitting the Report to the Speaker of the House of Representatives.

Sincerely,

Nicholas F. Brady

Nicholas F. Brady

Enclosure

THE SECRETARY OF THE TREASURY
WASHINGTON

April 29, 1991

The Honorable Thomas S. Foley
Speaker of the House
House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

I am pleased to transmit the April 1991 Report of the Secretary of the Treasury on Government-sponsored Enterprises. This Report has been prepared to meet the statutory requirements in section 1404 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)(Pub. L. No. 101-73) and in section 13501 of the Omnibus Budget Reconciliation Act of 1990 (OBRA)(Pub. L. No. 101-508).

FIRREA requires the Treasury to assess in two annual studies the financial safety and soundness of the GSEs and to study the impact of GSE operations on Federal borrowing. The Treasury submitted the first annual report under FIRREA in May 1990. OBRA requires the Treasury to assess the financial soundness of GSEs, the adequacy of the existing regulatory structure for GSEs, the financial exposure of the Federal Government posed by GSEs, and the effects of GSE activities on Treasury borrowing.

The enclosed study, which is intended to meet the requirements of FIRREA and OBRA, presents principles that are essential to effective financial safety and soundness regulation. It also includes an analysis of the financial condition of the GSEs performed by the Standard & Poor's Corporation, and updates the findings in the 1990 Report regarding the impact of GSE activities on Treasury borrowing. We will submit proposed legislation shortly implementing the recommendations in this study to authorize Federal regulation of the financial safety and soundness of the GSEs.

I am also transmitting the Report to the President of the Senate.

Sincerely,

Nicholas F. Brady

Nicholas F. Brady

Enclosure

TABLE OF CONTENTS

EXCERPT FROM THE FINANCIAL INSTITUTIONS REFORM RECOVERY AND ENFORCEMENT ACT OF 1989 PUBLIC LAW NO. 101-73

Section 1404. Studies of Relationship Between Public Debt and Activities of Government-sponsored Enterprises.

(a) In General. In order to better manage the bonded indebtedness of the United States, the Secretary shall conduct 2 annual studies to assess the financial safety and soundness of the activities of all Government-sponsored enterprises and the impact of their operations on Federal borrowing.

(b) Access to Relevant Information.

(1) Information from GSE's. Each Government-sponsored enterprise shall provide full and prompt access to the Secretary to its books and records, and shall promptly provide any other information requested by the Secretary.

(2) Information from Supervisory Agencies. In conducting the studies under this section, the Secretary may request information from, or the assistance of, any Federal department or agency authorized by law to supervise the activities of any Government-sponsored enterprise.

(3) Confidentiality of Information.

(A) In General. The Secretary shall determine and maintain the confidentiality of any book, record, or information made available under this subsection in a manner generally consistent with the level of confidentiality established for the material by the Government-sponsored enterprise involved.

(B) Exemption from Public Disclosure Requirements. The Department of the Treasury shall be exempt from section 552 of title 5, United States Code, with respect to any book, record, or information made available under this subsection and determined by the Secretary to be confidential under subparagraph (A).

(C) Penalty for Unauthorized Disclosure. Any officer or employee of the Department of the Treasury shall be subject to the penalties set forth in section 1906 of title 18, United States Code, if--

(i) by virtue of his employment or official position, he has possession of or access to any book, record, or information made available under this subsection and determined by the Secretary to be confidential under paragraph (A); and

(ii) he discloses the material in any manner other than--

(I) to an officer or employee of the Department of the Treasury; or

(II) pursuant to the exceptions set forth in such section 1906.

(c) Assessment of Risk. In assessing the financial safety and soundness of the activities of Government-sponsored enterprises, and the impact of their activities on Federal borrowing, the Secretary shall quantify the risks associated with each Government-sponsored enterprise. In quantifying such risks, the Secretary shall determine the volume and type of securities outstanding which are issued or guaranteed by each Government-sponsored enterprise, the capitalization of each Government-sponsored enterprise, and the degree of risk involved in the operations of each Government-sponsored enterprise due to factors such as credit risk, interest rate risk, management and operations risk, and business risk. The Secretary shall also report on the quality and timeliness of information currently available to the public and the Federal Government concerning the extent and nature of the activities of Government-sponsored enterprises and the financial risk associated with such activities.

(d) Reports to Congress. The Secretary shall submit to the Congress--

(1) by May 15, 1990, a report setting forth the results of the 1st annual study conducted under this section; and

(2) by May 15, 1991, a report setting forth the results of the 2nd annual study conducted under this section.

(e) Definitions. For purposes of this section:

(1) Government-sponsored Enterprise. The term "Government-sponsored enterprise" means--

(A) the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Bank System, the Farm Credit Banks, the Banks for Cooperatives, the Federal Agricultural Mortgage Corporation, the Student Loan Marketing Association, the College Construction Loan Insurance Association, and any of their affiliated or member institutions; and

(B) any other Government-sponsored enterprise, as designated by the Secretary.

(2) Secretary. The term "Secretary" means the Secretary of the Treasury or his delegate.

EXCERPT FROM THE OMNIBUS BUDGET RECONCILIATION ACT OF 1990 PUBLIC LAW NO. 101-508

Section 13501. Financial Safety and Soundness of Government-sponsored Enterprises.

(a) Definition. For purposes of this section, the terms "Government-sponsored enterprises" and "GSE" mean the Farm Credit System (including the Farm Credit Banks, Banks for Cooperatives, and Federal Agricultural Mortgage Corporation), the Federal Home Loan Bank System, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and the Student Loan Marketing Association.

(b) Treasury Department Study and Proposed Legislation.

(1) The Department of the Treasury shall prepare and submit to Congress no later than April 30, 1991, a study of GSEs and recommended legislation.

(2) The study shall include an objective assessment of the financial soundness of GSEs, the adequacy of the existing regulatory structure for GSEs, the financial exposure of the Federal Government posed by GSEs, and the effects of GSE activities on Treasury borrowing.

(c) Congressional Budget Office Study.

(1) The Congressional Budget Office shall prepare and submit to Congress no later than April 30, 1991, a study of GSEs.

(2) The study shall include an analysis of the financial risks each GSE assumes, how Congress may improve its understanding of those risks, the supervision and regulation of GSEs' risk management, the financial exposure of the Federal Government posed by GSEs, and the effects of GSE activities on Treasury borrowing. The study shall also include an analysis of alternative models for oversight of GSEs and of the costs and benefits of each alternative model to the Government and the markets and beneficiaries served by GSEs.

(d) Access to Relevant Information.

(1) For the studies required by this section, each GSE shall provide full and prompt access to the Secretary of the Treasury and the Director of the Congressional Budget Office to its books and records and other information requested by the Secretary of the Treasury or the Director of the Congressional Budget Office.

(2) In preparing the studies required by this section, the Secretary of the Treasury and the Director of the Congressional Budget Office may request information from, or the assistance of, any Federal department or agency authorized by law to supervise the activities of a GSE.

(e) Confidentiality of Relevant Information.

(1) The Secretary of the Treasury and the Director of the Congressional Budget Office shall determine and maintain the confidentiality of any book, record, or information made available by a GSE under this section in a manner consistent with the level of confidentiality established for the material by the GSE involved.

(2) The Department of the Treasury shall be exempt from section 552, of title 5, United States Code, for any book, record, or information made available under subsection (d) and determined by the Secretary of the Treasury to be confidential under this subsection.

(3) Any officer or employee of the Department of the Treasury shall be subject to the penalties set forth in section 1906 of title 18, United States Code, if--

(A) by virtue of his or her employment or official position, he or she has possession of or access to any book, record, or information made available under and determined to be confidential under this section; and

(B) he or she discloses the material in any manner other than--

(i) to an officer or employee of the Department of the Treasury; or

(ii) pursuant to the exception set forth in such section 1906.

(4) The Congressional Budget Office shall be exempt from section 203 of the Congressional Budget Act of 1974 with respect to any book, record, or information made available under this subsection and determined by the Director to be confidential under paragraph (1).

(f) Requirement to Report Legislation.

(1) The committees of jurisdiction in the House shall prepare and report to the House no later than September 15, 1991, legislation to ensure the financial soundness of GSEs and to minimize the possibility that a GSE might require future assistance from the Government.

(2) It is the sense of the Senate that the committees of jurisdiction in the Senate shall prepare and report to the Senate no later than September 15, 1991, legislation to ensure the financial safety and soundness of GSEs and to minimize the possibility that a GSE might require future assistance from the Government.

(g) **President's Budget.** The President's annual budget submission shall include an analysis of the financial condition of the GSEs and the financial exposure of the Government, if any, posed by GSEs.

PREFACE

The failure of many federally insured thrift institutions in the 1980s, and the massive Federal funding required for their resolution, have focused the attention of the Administration and Congress on other areas of taxpayer exposure to financial risk. With this concern in mind, Congress enacted legislation requiring the Secretary of the Treasury to study and make recommendations regarding the financial safety and soundness of Government-sponsored enterprises (GSEs).

TREASURY STUDY REQUIREMENTS

FIRREA

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires the Secretary to "conduct two annual studies to assess the financial safety and soundness of the activities of all Government-sponsored enterprises and the impact of their operations on Federal borrowing."[1] The first of these studies was submitted to Congress on May 31, 1990, while the second is due on May 15, 1991.

The May 1990 Report of the Secretary of the Treasury on Government Sponsored Enterprises (1990 Report) fulfilled the statutory requirements set out in FIRREA. It discussed the history and development of each GSE and analyzed its financial safety and soundness taking into consideration business risk, credit risk, interest rate risk, and management and operations risk. It analyzed the level of capital of each GSE in relation to the risks it undertakes. It reviewed the timeliness and quality of the financial information that each GSE provides to the public and the Federal Government. Finally, it reported on the impact of GSE activities on Federal borrowing.

OBRA

Release of the 1990 Report resulted in increased focus on the financial condition of the GSEs, the need for reform of their current Federal regulation, and the appropriate structure for regulation. The debate resulted in additional legislation, a provision of the Omnibus Budget Reconciliation Act of 1990 (OBRA), which requires the Secretary of the Treasury to provide "an objective assessment of the financial soundness of GSEs, the adequacy of the existing regulatory structure for GSEs, the

---

[1] Subsection 1404(a) of FIRREA.

financial exposure of the Federal Government posed by GSEs, and the effects of GSE activities on Treasury borrowing."[2]

1991 Treasury Study Approach

This 1991 report is designed to meet the study requirements of FIRREA and OBRA. It includes an objective assessment of the financial soundness of the GSEs. In this regard, the Treasury contracted with the Standard & Poor's Corporation (S&P) for an analysis of the financial safety and soundness of the GSEs.[3] S&P has assessed the likelihood that a GSE might not be able to meet its future obligations from its own resources and has expressed that likelihood as a traditional credit rating. This likelihood correlates directly with the risk to the taxpayer that a GSE will become financially troubled and need a Federal Government rescue entailing an expenditure of, or a commitment to spend, taxpayer money.

As required by OBRA, Treasury has analyzed the adequacy of the existing regulatory structure for each of the GSEs and has developed what it considers to be the essential principles of effective financial safety and soundness regulation.

Finally, Treasury has also updated and expanded upon its findings in the 1990 Report regarding the impact of GSE activities on Treasury borrowing.

---

[2] Subsection 13501(b) of OBRA.

[3] S&P was not asked to examine Connie Lee, because S&P has rated the claims-paying ability of Connie Lee as triple A on a stand-alone basis, nor Farmer Mac, since it has not yet become fully operational.

EXECUTIVE SUMMARY

The Need for Greater Taxpayer Protection from GSE Financial Risk

-- The public missions of the GSEs and the importance of their activities to the U.S. economy have led investors to believe that Congress would rescue a GSE if it were in financial difficulty. As a result, they ignore the usual credit fundamentals of GSEs and look to the Federal Government as the ultimate guarantor of GSE obligations.

-- The concentration of potential taxpayer exposure from GSEs is obvious when compared to the thrift and banking industries. The total of credit market debt plus mortgage pools of the five GSEs included in this study is greater than the total deposits of the more than 2,000 insured S&Ls and about one-third the size of the deposits of the more than 12,000 insured commercial banks.

-- Consequently, the potential taxpayer exposure from GSEs, rather than being dispersed among many thousands of institutions, is dependent upon the managerial abilities of the officers of a relatively small group of entities.

-- Because the GSEs are insulated from the private market discipline applicable to other privately owned firms, more effective Government regulation is needed to provide sustained outside discipline to these entities.

Effective Financial Safety and Soundness Regulation

-- Treasury has developed regulatory principles that will reduce the likelihood of another financially painful Government rescue.

-- Any regulatory framework should embody the following principles:

- Financial safety and soundness should be given primacy over other public policy considerations in GSE regulation.
- The regulator must have sufficient stature to avoid capture by the GSEs or special interests.
- Private market risk assessment mechanisms can be used to help the regulator assess the financial safety and soundness of the GSEs.

-- The basic statutory authorities for financial safety and soundness regulation should be consistent across all GSEs. In this regard, the regulator should have the authority to set capital standards; require financial disclosure; prescribe, if necessary, adequate standards for books and records and other internal controls; conduct examinations; and enforce compliance with the rules and standards which it establishes.

Adequacy of Existing Regulatory Structure for GSEs

-- The regulatory structure for the GSEs has lapses of varying degrees when compared to the proposed regulatory principles.

-- It would be beneficial to make the scope of HUD's regulatory authorities more explicit. HUD has proposed new regulations to deal with specific aspects of its general regulatory authority. Safety and soundness oversight should be given primary consideration in HUD's regulatory role.

-- The Federal Housing Finance Board has the necessary regulatory authorities and the stature needed to regulate effectively the financial safety and soundness of the Federal Home Loan Banks.

-- The primary focus of the Farm Credit Administration is on the financial safety and soundness of the Farm Credit System and Farmer Mac. Consequently, it has all of the necessary regulatory authorities and the stature to be an effective financial safety and soundness regulator of the System. However, the FCA needs to have increased authority over Farmer Mac.

-- Sallie Mae is virtually unregulated. Thus, no Federal agency has the necessary authorities to provide it with effective financial safety and soundness regulation.

Impact of GSE Operations on Treasury Borrowing

-- Major macroeconomic trends that cannot be separated from the impact of GSE financing activities have offset any potential upward pressures on Federal borrowing costs from GSE activity. Accordingly, the available statistical evidence does not show that GSE borrowing has had a direct effect on the cost of Federal borrowing.

S&P Ratings

-- At the Treasury's request, S&P assessed the likelihood that a GSE might not be able to meet its future obligations from its own resources and has expressed that likelihood as a traditional credit rating. The S&P ratings for the GSEs as of April 1991 are:

The Farm Credit System	BB
The Federal Home Loan Bank System	AAA
Freddie Mac	A+
Fannie Mae	A-
Sallie Mae	AAA

These ratings are not intended to supersede the AAA assessments S&P has given the various securities of the GSEs presently trading in the market.

Recommendations

-- Proposed regulatory structure: four regulators with basic statutory authorities

Separate "arms-length" Bureau of HUD

- Financial oversight over Fannie Mae and Freddie Mac through creation of a separate "arms-length" bureau of HUD.

Federal Housing Finance Board

- Retain financial oversight over the FHLBanks.

Farm Credit Administration

- Retain financial oversight over the Farm Credit System and Farmer Mac.

Treasury

- Enhance financial oversight over Sallie Mae.

-- <u>Necessary changes to current structure</u>

HUD

- Safety and soundness oversight of Fannie Mae and Freddie Mac should have primacy over other regulatory goals.

- Transfer responsibility for financial safety and soundness oversight of Fannie Mae and Freddie Mac to a new separate "arms-length" bureau of HUD. The Director of the new bureau will be appointed by the President and confirmed by the Senate, and may be removed only by the President; the Director will operate with the general oversight of, and report directly to, the Secretary of HUD; the bureau should be separately funded through assessments on Fannie Mae and Freddie Mac, as proposed in the President's 1992 Budget; and the bureau will provide an annual report on its operations to Congress.

Federal Housing Finance Board

- Amend the statute to make financial safety and soundness of the FHLBanks the Finance Board's primary regulatory goal.

Farm Credit Administration

- Increase financial oversight over Farmer Mac, particularly with respect to authority to set capital standards.

- Give the Insurance Corporation access to the capital of the associations.

Treasury

- Increase financial oversight over Sallie Mae to make it consistent with the safety and soundness authorities of the other regulators.

-- <u>Proposed capital standards</u>

- The regulator should have the authority to promulgate risk-based capital standards. The standards should take into account the differing risk characteristics of on- and off-balance sheet classes of assets. While risk categories may be established for different lines of business, the overall capital requirement should be for the whole firm.

- The regulator can use stress tests and/or other analytical techniques deemed appropriate by the regulator to determine the necessary amount of capital to protect against credit risk and interest rate risk. An additional amount of capital should be required to protect against management and operations risk and business risk.

- For financially significant new activities, the regulator needs the flexibility to determine in advance how the risks of the activity should be assessed for purposes of the capital requirements.

- The regulator can contract with nationally recognized statistical rating organizations to assess the financial health of the GSEs. If a GSE is rated the highest investment grade, it will be exempt from regulatory capital requirements and the frequency of reports and examinations may be reduced.

- The regulator should ensure achievement of such capital requirements through the use of suitable enforcement powers, including the right at all times to take action in the event the GSE engages in an unsafe and unsound practice.

CHAPTER 1

THE NEED FOR FINANCIAL REGULATION

The Federal charters and other substantial ties to the Government of the GSEs have led to the perception in the securities markets that there is an implied Government guarantee of GSE obligations.[1] The public policy missions of the GSEs, which include financial intermediation in agriculture, housing, and education, the importance of their activities to the U.S. economy, their growing size, and the rescue of the Farm Credit System in the 1980s also have led credit market participants to conclude that the Government would rescue a GSE if it were in financial difficulty.

As a result of the belief that Congress would use taxpayer funds to prevent the failure of a GSE, investors ignore the usual credit fundamentals of the GSEs and look to the Federal Government as the ultimate guarantor of GSE obligations. Therefore, some GSEs are in a position to increase financial leverage virtually unconstrained by the market or by effective oversight. Greater leverage results not only in higher returns for GSE shareholders (see Table 1), but also in potentially greater taxpayer exposure if a GSE experiences financial difficulty.

Table 1

After-Tax Return on Equity
(percent)

	1990	1989	1988	1987
Fannie Mae*	33.9	30.7	24.9	25.1
Freddie Mac*	20.4	25.0	27.6	28.2
Sallie Mae*	27.4	30.5	30.2	27.3
FHLBanks*	11.4	12.0	9.9	10.4
Mortgage bankers**	n.a.	0.0	0.7	5.3
Comm. banks***	7.8	7.8	13.3	2.0
S&P 500	12.0	13.6	14.8	11.8

Source: * - Standard and Poor's.
** - Mortgage Bankers' Association. Estimate for 1989 is the latest available.
*** - FDIC, for FDIC-insured commercial banks.

[1] For a table presenting GSE links to the Federal Government, see the introduction to the 1990 Report.

Because GSEs are insulated from the private market discipline applicable to other privately owned firms, more effective Government regulation can provide sustained outside discipline to these entities. Providing such discipline is an important public policy goal because mismanagement of the GSEs would pose serious risks to the U.S. economy. Financial insolvency of even one of the major GSEs would strain the U.S. and international financial systems and could result in a taxpayer-funded rescue operation.

Thus, the Government has an interest in establishing effective financial safety and soundness regulation for GSEs to protect the taxpayers' interests more than private market mechanisms have done.

MAGNITUDE AND CONCENTRATION OF GSE ACTIVITY

A look at the magnitude and growth of GSE activity in the financial markets gives an indication of the immense size of their operations. The outstanding obligations of the GSEs, including direct debt and mortgage-backed securities, totaled $981 billion at the end of calendar year 1990 (see Table 2). GSE debt represents almost 90 percent of the outstanding debt of all private domestic financial intermediaries. In 1990, GSE obligations accounted for nearly 14 percent of all funds raised in the credit markets (see Table 3). That represents more than four times the volume of activity of all other private domestic financial intermediaries combined.

The concentration of potential taxpayer exposure with GSEs is obvious when compared to the thrift and banking industries. The total of credit market debt plus mortgage pools of the five GSEs included in this report is greater than the total deposits of the more than 2,000 insured S&Ls and about one-third the size of the deposits of the more than 12,000 insured commercial banks (see Chart 1). Consequently, the Federal Government's potential risk exposure from GSEs, rather than being dispersed across many thousands of institutions, is dependent on the managerial abilities of the officers of a relatively small group of entities.

NO IMMINENT THREAT, BUT CONCERNS NOT HYPOTHETICAL

The Treasury concluded in its last report on GSEs that none of these institutions poses an imminent financial threat. That conclusion has been reaffirmed by the assessment of the financial

Table 2
Outstanding Debt *

($ billions, end of calendar year)

	Annual					
	1980	**1986**	**1987**	**1988**	**1989**	**1990**
Business	1,438.1	2,724.8	2,945.5	3,182.2	3,399.9	3,528.2
Financial Intermediaries	291.8	730.4	864.5	990.0	1,078.8	1,103.7
GSEs**	177.2	536.7	655.3	748.1	862.6	981.0
Federal Government						
Treasury (From public)	737.8	1,811.7	1,955.2	2,095.2	2,245.2	2,536.6
Other Federal***	98.9	266.3	322.2	368.9	405.3	467.7
State & local	286.6	510.1	558.9	604.5	634.1	648.8
Foreign	197.2	238.3	244.6	253.9	261.5	284.8
Households	1,430.2	2,596.1	2,879.1	3,191.5	3,501.7	3,834.1
Total Credit Market Borrowing	4,657.8	9,414.4	10,425.3	11,434.3	12,389.1	13,384.9
Memo:						
** GSEs						
Debt Issues						
Fannie Mae	55.2	93.6	97.1	105.5	116.1	123.4
Freddie Mac	4.6	13.4	17.5	24.8	24.1	28.4
FHLBanks	37.3	88.8	116.4	136.5	136.1	117.9
Farm Credit System	63.0	62.3	55.2	54.6	56.6	56.1
Sallie Mae	****	12.2	16.5	22.0	28.6	39.0
Total Debt Issues	160.1	270.3	302.7	343.4	361.5	364.8
Mortgage-backed securities						
Fannie Mae	****	97.2	140.0	178.3	228.2	299.8
Freddie Mac	17.1	169.2	212.6	226.4	272.9	316.4
Total Mortgage-backed	17.1	266.4	352.6	404.7	501.1	616.2
Total GSE	177.2	536.7	655.3	748.1	862.6	981.0
*** Other Federal						
Fed Agency	5.0	3.6	5.2	22.6	24.2	32.4
GNMA Mortgage Pools	93.9	262.7	315.8	340.5	368.4	404.1
FICO & REFCORP	****	0.0	1.2	5.8	12.7	31.2
Total Other	98.9	266.3	322.2	368.9	405.3	467.7

Sources: Federal Reserve Board Flow-of-Funds data; GSE balance sheets.

* Changes in outstandings will not necessarily be equal to flows reported by the Federal Reserve Board due to changes in universe coverage and changes in accounting (valuation) methods.

Table 3
Net Market Borrowing

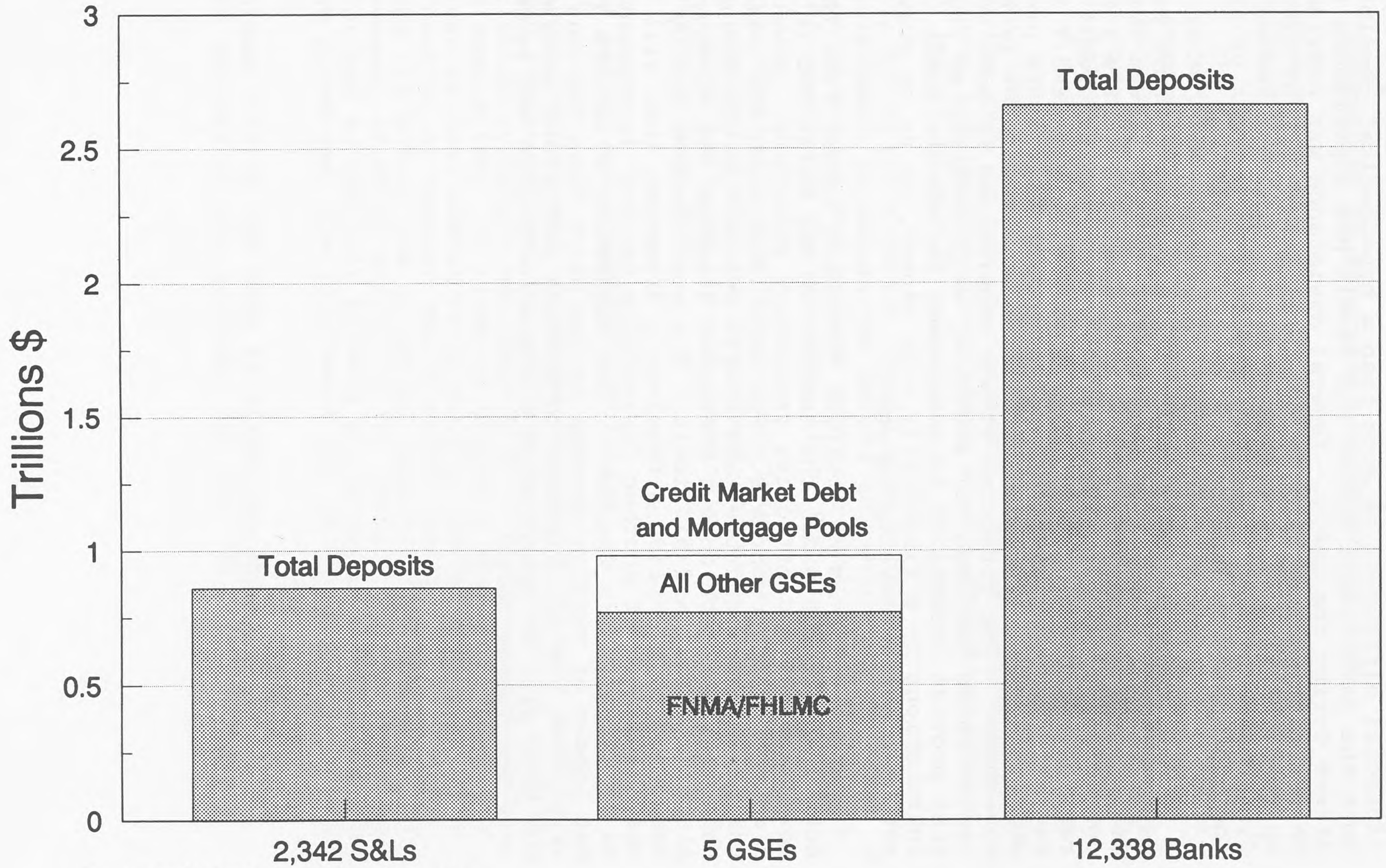
($ billions, calendar year)

	Period		Annual				
	1980–85	1986–90	1986	1987	1988	1989	1990
Business	1,104.6	1,053.2	292.6	191.0	242.8	211.9	114.9
Financial Intermediaries	313.5	447.1	111.1	127.4	125.6	56.3	26.7
GSEs*	263.1	567.7	123.4	118.6	92.8	114.5	118.4
Federal Government							
Treasury (From public)	938.5	912.5	214.7	143.4	140.0	150.0	264.4
Other Federal**	134.0	252.2	51.0	55.8	46.7	36.3	62.4
State & local	199.0	174.8	36.2	48.8	45.6	29.6	14.6
Foreign	90.6	54.7	9.7	4.5	6.3	10.9	23.3
Households	1,017.8	1,455.2	293.0	302.2	314.9	285.0	260.1
Total Credit Market Borrowing	4,061.0	4,917.4	1,131.7	991.7	1,014.7	894.5	884.8
Memo:							
* GSEs							
Debt Issues							
Fannie Mae	45.5	29.5	−0.3	3.5	8.4	10.6	7.3
Freddie Mac	8.1	16.6	1.6	4.1	7.3	−0.7	4.3
FHLBanks	44.0	43.5	14.4	27.6	20.1	−0.4	−18.2
Farm Credit System	16.7	−13.0	−6.8	−7.1	−0.6	2.0	−0.5
Sallie Mae	8.6	30.4	3.6	4.3	5.5	6.6	10.4
Total Debt Issues	122.9	107.0	12.5	32.4	40.7	18.1	3.3
Mortgage–backed securities							
Fannie Mae	55.0	244.8	42.2	42.8	38.3	49.9	71.6
Freddie Mac	85.2	215.9	68.7	43.4	13.8	46.5	43.5
Total Mortgage–backed	140.2	460.7	110.9	86.2	52.1	96.4	115.1
Total GSE	263.1	567.7	123.4	118.6	92.8	114.5	118.4
** Other Federal							
Fed Agency	−2.4	29.1	0.4	1.5	17.4	1.6	8.2
GNMA Mortgage Pools	136.4	191.9	50.6	53.1	24.7	27.8	35.7
FICO & REFCORP	****	31.2	****	1.2	4.6	6.9	18.5
Total Other	134.0	252.2	51.0	55.8	46.7	36.3	62.4

Sources: Federal Reserve Board Flow-of-Funds data; GSE balance sheets.

Chart 1

Concentration of Potential Federal Exposure
December 31, 1990



Sources: FDIC, OTS, and GSE balance sheets.

safety and soundness of the GSEs by S&P that was done at the request of the Treasury. However, that GSEs can get into financial difficulty is more than a hypothetical possibility. Both the Farm Credit System and Fannie Mae experienced financial stress during the 1980s. Federal assistance was provided to the Farm Credit System: the Agricultural Credit Act of 1987 provided up to $4 billion of Federal guarantees for bonds issued to assist System institutions and authorized Federal payment of interest on the guaranteed obligations.

The financial difficulties encountered by Fannie Mae in the early 1980s, for which direct Federal assistance was not required, is an example of the potential for a GSE's financial condition to deteriorate while its access to the credit markets remains unimpeded. Fannie Mae, unlike the Farm Credit System, was able to pursue strategies that worked to restore profitability without the benefit of financial assistance from the Government. The financial strain experienced by both GSEs demonstrates the need for sensible, well-constructed regulations that provide incentives to management to operate their institutions in a financially safe manner, so as to prevent such situations from developing again.

Since there is no imminent financial threat from the activities of the GSEs, the temptation may exist not to create a more sensible and effective regulatory structure. However, such a course is inappropriate. The experience with the troubled thrift industry and the Farm Credit System vividly demonstrates that taking action once a financial disaster has already taken place is costly and difficult. The most prudent policy goal should be to establish a regulatory framework that will reduce the likelihood of another financially painful Government rescue. As is discussed in Chapter 4, the regulatory structure for GSEs has lapses of varying degrees to the point that the current structures are not adequate to provide sufficient assurance that the GSEs will be operated in a financially safe and sound manner over the longer term.

CHAPTER 2

EFFECTIVE FINANCIAL SAFETY AND SOUNDNESS REGULATION

PRINCIPLES OF EFFECTIVE REGULATION OF GSES

A framework of effective regulation of GSEs should adhere to the following principles:

First, the primary focus of GSE regulation should be financial safety and soundness. Effective financial safety and soundness regulation of GSEs can only be performed by agencies that have the goal of maintaining GSE solvency as their primary regulatory role. Maintaining GSE solvency and ensuring the long-term financial viability of GSEs should be the principal objective of the Federal Government.

Second, the regulator must have sufficient stature to avoid capture by the GSEs or special interests. To be effective and avoid capture, the regulator must have strong statutory powers and highly qualified staff.

Third, the private sector should play a role in helping the Federal Government to assess the safety and soundness of GSEs. A combination of public and private sector oversight would reduce the risk of regulatory failure and, thus, GSE insolvency.

Fourth, the basic statutory authorities for safety and soundness regulation must be consistent across all GSEs. Oversight can be tailored through regulations that recognize the unique nature of each GSE.

Primacy of safety and soundness regulation

Financial safety and soundness regulation of GSEs must be the primary statutory goal of regulators, or regulatory conflict in the existing structure may compromise effective safety and soundness regulation. In times of economic stress, a regulator with unclear or dual statutory objectives (safety and soundness versus promotion of another public policy goal) may decide to subordinate its safety and soundness responsibility in favor of the achievement of other public policy goals. Therefore, unless a regulator has an explicit primary statutory mission to ensure safety and soundness, the Government may be exposed to excessive risk.

Congress created the GSEs to serve the credit needs of particular sectors of the economy, and the GSE charters define the specific program missions they were assigned to accomplish.[1] However, by virtue of the other characteristics bestowed on the GSEs that create the impression that they are similar to Federal agencies, the GSEs are effectively insulated from private market discipline. Thus, the nucleus of any regulatory structure should be financial safety and soundness in order to maintain financial solvency and to ensure the long-term financial viability of the GSEs so that they can perform their missions as Congress intended.

While it is true that one responsibility of Government is to choose among competing objectives, the current regulatory structure for GSEs does not impart to financial safety and soundness concerns the preeminent position that these concerns should have. This structure can be improved so as to reduce conflicts in agency missions in order that the public interest objective of assuring that the GSEs are managed prudently is performed effectively.

Sufficient regulatory stature

The responsibility for financial safety and soundness regulation needs to be performed by an agency with sufficient stature to withstand political pressure, from whatever source, to weaken regulatory standards in order to meet other goals. The agency needs the ability to withstand any tendency to be captured.

The problem of avoiding capture appears to be particularly acute in the case of regulation of GSEs. The principal GSEs are few in number; they have highly qualified staffs; they have strong support for their programs from special interest groups; and they have significant resources with which to influence political outcomes. A weak financial regulator would find GSE political power overwhelming and even the most powerful and respected Government agencies would find regulating such entities a challenge. Clearly, it is vital that any GSE financial regulator be given the necessary support, both political and material, to function effectively.

Highly motivated and exceptionally qualified staffs are necessary to regulate the GSEs effectively. Both the prestige of the agency and the level of pay are important in this connection. While pay levels can be adjusted to be competitive, the prestige of the agency will be both a function of the agency's management

---

[1] Given that the charters are designed to establish the general range of the operations of the GSEs, there are decisions to be made on whether proposed new programs are within the scope of a GSE's intended authority.

and the importance ascribed to its function by the executive and legislative branches.

Funding for the regulatory agency should be provided by assessments on the GSEs. The GSEs should have the responsibility to fund regulation designed to assure their safety and soundness, and certainly they have the financial ability to do so. The regulatory agency's budget should be exempt from the normal appropriations process. This exemption is justified since taxpayer funds are not being expended. Also, removal from the normal appropriations process should assist the regulator in dealing with the capture problem.

The Treasury Department is under no illusions concerning the capture problem. No regulatory structure can ensure that it will not happen. Continued recognition of the importance of ensuring prudent management of the GSEs and vigilance in this regard by both the executive and legislative branches will be necessary.

Use of private market risk assessment mechanisms

The traditional structure and elements of financial oversight are an important starting point for GSE regulation. However, Governmental financial regulation over the last decade has failed to avert financial difficulties in the banking and thrift industries. Additionally, the financial services industry has become increasingly sophisticated in the creation of new financial products, and the pace of both change and product innovation has accelerated in the last several years. As a result, to avoid the prospect that GSEs might operate beyond the abilities of a financial regulator and to protect against the inherent shortcomings in applying a traditional financial services regulatory model to entities as unique as GSEs, it would be appropriate for the regulator to enlist the aid of the private sector in assessing the creditworthiness of these firms.

Nationally recognized statistical rating organizations (NRSROs) are one example of private sector entities that have extensive experience in assessing the credit quality of diverse business entities, and they represent a private sector resource that can be used in assessing the financial condition of the GSEs. The regulator should have the ability to use NRSROs or other private sector entities to assess the financial health of the GSEs. The information from the private sector would serve as an independent source of information that would assist the regulator in assuring financial safety and soundness.

294-104 O - 91 - 2 QL 3

Basic regulatory powers for financial safety and soundness

There are certain basic, but essential, regulatory powers that should form the core of effective financial oversight for each GSE. Taken together, these powers would ensure regulatory consistency for all GSEs while, at the same time, allowing for regulatory discretion in overseeing safety and soundness of individual GSEs.

Consistency of financial oversight does not imply that the regulatory burden is the same irrespective of the GSEs' relative risk to the taxpayer. Weaker GSEs should be subjected to much closer scrutiny than financially sound GSEs. However, the basic powers of the regulator to assure financial safety and soundness should be essentially the same for all GSEs.

Regulatory discretion is necessary within these broad powers because the GSEs are unique entities and, as such, need capital requirements that reflect the nature of the risks inherent in the way each conducts its business. Additionally, because financial products and markets change rapidly, regulatory discretion would allow for flexibility to deal with the changing financial environment.

The elements of effective financial safety and soundness regulation include the following authorities for the regulatory agency:

(1) authority to determine capital standards;

(2) authority to require periodic disclosure of relevant financial information;

(3) authority to prescribe, if necessary, adequate standards for books and records and other internal controls;

(4) authority to conduct examinations; and

(5) enforcement authority, including cease and desist powers, and the authority to take prompt corrective action for a financially troubled GSE.

These authorities are discussed below.

Capital standards. The ability to establish standards prescribing the capital adequacy of GSEs is the single most important regulatory tool needed to ensure their financial safety and soundness. Capital requirements should be stringent enough to assure that the possibility of GSE insolvency is remote; however, they should not be set so high that a GSE cannot reasonably be expected to carry out its public purpose mission effectively.

The perception of credit market participants of an implied Government guarantee of GSE obligations gives GSEs virtually unlimited access to borrowed capital irrespective of their financial condition. By way of example, one GSE, Fannie Mae, has stated, "We can fund all across the yield curve, in quantities we determine [emphasis added]."[2] Furthermore, Fannie Mae has asserted that it has "proven, assured, and relatively low-cost liquidity, even in tough times...."[3] As a result, if a GSE encounters financial difficulty, management is in the position to employ even greater financial leverage in an effort to restore the GSE to profitability. GSE status makes this option attractive because the potential gains will accrue to stockholders, while potential losses, if severe, can be left for the taxpayer to cover. Currently, some GSEs are among the most thinly capitalized of U.S. financial entities (see Chart 2).

An appropriate capital standard serves three functions. First, by putting shareholder capital at risk, it provides a GSE with incentives traditionally imposed by the market to manage risk carefully, thus providing taxpayer protection. Second, it helps ensure the long-term financial viability of GSEs so that their services remain available to their intended constituencies. Third, it serves as a monitoring device for changes in a GSE's financial condition.

Regulatory discretion in establishing capital standards is important. Because the nature of the risks that GSEs undertake can change over time, the regulator should have flexibility to determine and, subsequently, to modify capital rules.

A capital standard should be linked to the risks and the amount of business a GSE undertakes. The principal risks are interest rate risk, credit risk, management and operations risk, and business risk. Interest rate risk relates to the sensitivity of a GSE's financial performance to changes in interest rates and in the differentials of interest rates for various maturity sectors. Credit risk is the exposure of a GSE to borrower default on the loans it has made, purchased, or guaranteed. While judgment needs to be exercised in assessing these risks, they can be mathematically modeled after certain key assumptions have been made by the regulator.

Management and operations risk and business risk are not easily modeled. Assessments of the quality of a GSE's management and the efficiency of its operations are subjective. Assessment of the business climate for a GSE is also hardly subject to

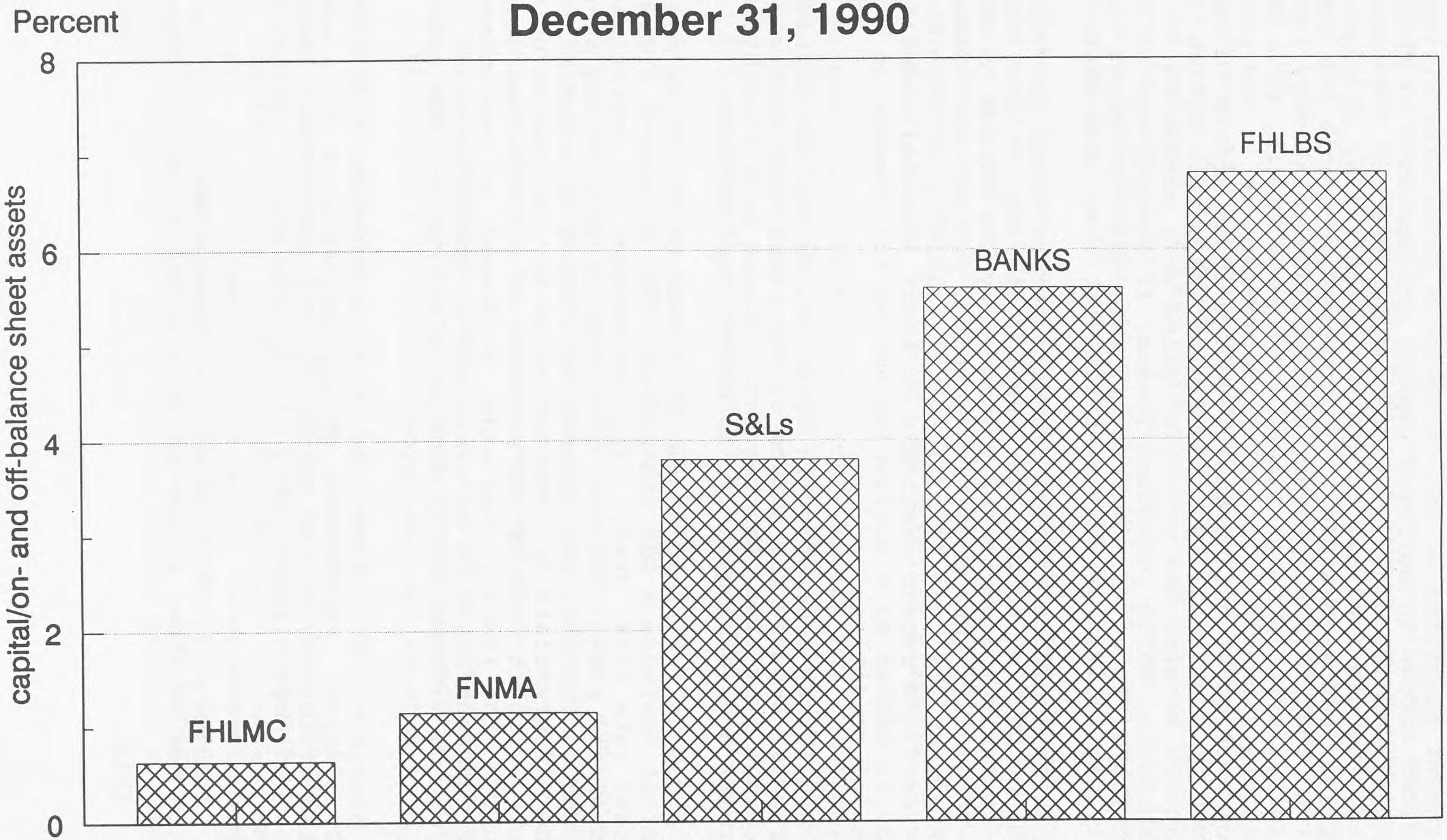
---

[2] February 28, 1991 letter from Fannie Mae to S&P, p. 2. (Fannie Mae provided a copy of this letter to the Treasury.)

[3] Ibid.

Chart 2

Major Providers of Mortgage Credit
Capital*-to-Asset** Ratios
December 31, 1990



* Capital includes common stock, additional paid-in capital, and retained earnings, but not loan-loss reserves or subordinated debt.

** Total assets include on-balance sheet assets plus off-balance sheet contingent liablities risk adjusted according to appropriate institutional criteria.

Sources: Federal Reserve, Office of Thrift Supervision, and GSE balance sheets.

precise measurement. Nevertheless, there should be an additional capital requirement to cover these types of risk, over and above the amount deemed necessary to cover interest rate and credit risk.

Finally, for financially significant new activities of the GSEs, the regulator needs the flexibility to determine in advance how the risks of the activity should be assessed for purposes of capital requirements. While it can be argued that, for the larger GSEs, any new program at its inception will be small when compared to the GSE's established activities and thus cannot conceivably threaten the financial health of the corporation, the regulator should also not be faced with a fait accompli. The regulator needs to be able to assess the financial implications of new activities for the risk profile of the GSE and set capital levels accordingly. Moreover, the regulator should be able to modify initial capital treatment as experience demonstrates that this is appropriate.

Financial disclosure. Access to information on a timely basis is a key ingredient of financial safety and soundness regulation. The financial safety and soundness regulator should have the authority to require periodic reporting of relevant financial information in order to monitor the financial condition of the GSEs it regulates.

While access to every conceivable GSE record may not be necessary, the ability of the regulator to obtain all relevant financial information should be unquestioned and not subject to any delaying tactics or legal challenge. The regulator must have the ability to monitor developments affecting the financial health of the GSEs.

Books and records and internal controls. The safety and soundness regulator needs to have the ability to assure that internal controls and information systems are adequate. Deficiencies in this area can jeopardize the financial safety and soundness of a GSE just as surely as inadequate capitalization. The regulator needs to be able to assess the adequacy of internal controls and information systems through examinations. The regulator should also have the authority to prescribe rules in this area as it deems necessary.

Examination authority. The safety and soundness regulator should be required to perform a full examination of each GSE at least annually to assure that all requirements are being met and that the organization is being managed prudently. Examinations are crucial to assure the accuracy of information being provided to the regulator and the effectiveness of internal management controls.

Examinations should prove useful to both the regulator and the GSE. As a result of these examinations, the staff of the regulatory agency would become familiar with, and understand the operations of, the GSE and may uncover potential problems so that corrective action can be taken before trouble occurs. This is in the interest of both the GSE and the regulator because an uninformed regulator can just as easily err on the side of excessive caution as on the side of laxness.

Finally, knowledge that there will be thorough financial examinations periodically will provide management with additional incentives to run their operations efficiently.

Enforcement authority. The regulator needs to have sufficient enforcement authority to assure compliance with financial safety and soundness standards. While it should rarely become necessary to utilize the more draconian of such powers, having them ensures that the regulator has sufficient authority to perform its mission.

It is contemplated that the regulator should be able to interact with the GSEs in a more informal manner than a listing of enforcement powers might suggest. Similar to other regulators, the GSE regulator should find it possible to reach understandings with the GSEs on issues and enter into letters of agreement or memoranda of understanding.

However, in order for the regulator to be taken with the utmost seriousness by the GSEs, the regulator should be given a full panoply of enforcement powers. The use of the more serious enforcement tools, it is hoped, would never prove necessary. Their availability to the regulator, though, should assist it in effectively assuring the financially safe and sound management of the GSEs.

The regulator should have the authority to require GSEs to rectify deficiencies in capital, information reporting, recordkeeping, and internal controls. It should also have cease-and-desist powers and the ability to remove, for cause, the directors and top management of the corporation in extreme situations. Finally, it should have the authority to take prompt corrective action for a GSE that falls below certain minimum capital levels.

Not all regulatory authorities should be punitive in nature. A GSE that can demonstrate financial safety and soundness of the highest order should be subject to less oversight than weaker GSEs. This could take the form of exemption from regulatory capital requirements, reduction in the frequency of reports and examinations, and possible elimination of the requirement of prior approval for new activities.

Receivership and conservatorship. The authority to put insolvent entities in receivership or conservatorship is most commonly discussed and used in the regulation of banks and thrifts. In fact, the FCA and the Finance Board have this authority for Farm Credit institutions and the FHLBanks, respectively. However, the issue becomes more complicated for the other GSEs.

As a practical matter, receivership is not a credible regulatory option for an entity as large as certain GSEs. GSE financial difficulties would not develop overnight, and effective financial regulation should preclude the need to focus on receivership as a regulatory alternative. Nevertheless, given the significance to the economy of a financial failure of the magnitude that a GSE failure would represent, the ability to appoint a conservator may be appropriate.

If any of the GSEs were to approach insolvency, Congress might act to avert a GSE failure because of the significant economic impact involved and the implication for domestic social policy. However, such future developments cannot be foreseen. While it is extremely unlikely that conservatorship power would ever be used, it would be prudent for a regulator to have this power in order to manage a fast-moving disaster with both domestic and international economic implications.

CHAPTER 3

EXISTING REGULATORY STRUCTURE OF GSEs

OVERVIEW

Responsibility for regulatory oversight of the GSEs is currently divided among several Federal agencies. HUD has primary regulatory responsibilities over Fannie Mae and Freddie Mac. The Federal Housing Finance Board is the regulator for the FHLBank System. The Farm Credit Administration has regulatory oversight of the Farm Credit System and Farmer Mac. The Treasury and the Department of Education have only minimal regulatory authority over Sallie Mae.

Each agency exercises varying degrees of oversight over the GSE(s) which it regulates. At the one extreme are the FHLBanks which are regulated by an agency that has broad administrative powers, including control over budgets, salaries, and the appointment of several FHLBank directors. At the other extreme is Sallie Mae which is virtually unregulated.

The regulatory environment for most of the GSEs includes frequent interaction with the Department of the Treasury. With the exception of the Farm Credit System and Farmer Mac, the Secretary of the Treasury must approve most of the debt and mortgage-related securities issued by the GSEs.[1] However, the Treasury uses its authority to coordinate the timing of issuances of Federal agencies and GSEs so that the securities are marketed in an orderly way. Treasury does not analyze the business operations or capital adequacy of the GSE as part of the approval process; therefore, it does not function as a financial safety and soundness regulator.

With the exception of the Farm Credit System, the President has the authority to appoint a fixed number, though a minority, of directors to each GSE's board of directors. The duties and responsibilities of Presidentially appointed directors are the same as those of shareholder-elected directors. Directors are traditionally responsible for seeing that management maximizes a corporation's profits and thus shareholder wealth, and for ensuring adherence with the corporate charter as well as all applicable laws and regulations. In addition, <u>all</u> GSE directors must ensure that the GSE's public policy purposes are fulfilled in accordance with its Federal charter. However, no director currently has an explicit obligation to minimize taxpayer exposure to risk.

---

[1] For the specific security approval powers of the Secretary of the Treasury for each GSE, see the 1990 <u>Report</u>.

This chapter examines the existing regulatory structure for the GSEs with respect to financial safety and soundness regulation. The following descriptions are based on information provided to the Treasury by the various agencies.

FEDERAL NATIONAL MORTGAGE ASSOCIATION AND FEDERAL HOME LOAN MORTGAGE CORPORATION

Description of Regulatory Environment

HUD oversees the activities of Fannie Mae and Freddie Mac. HUD was created by the Department of Housing and Urban Development Act of 1965 to promote the sound development of the nation's communities and metropolitan areas.[2] Under the Act, HUD's duties are to act as housing and urban development policy advisor to the President and as coordinator of Federal programs promoting housing and fostering growth in urban areas.[3]

Within the broad scope of the duties outlined above, HUD was given both general and specific regulatory authority over Fannie Mae in 1968 and Freddie Mac in 1989.[4] The Charter Acts of Fannie Mae and Freddie Mac state that HUD "shall have general regulatory power over [Fannie Mae and Freddie Mac] and shall make such rules and regulations as shall be necessary and proper to ensure that the purposes of [the Charter Acts] are accomplished."[5] The Charter Acts also give HUD certain specific powers over Fannie Mae and Freddie Mac which help to define its role as a regulator (see below).

Historically, HUD's focus as a regulator has centered on ensuring that its interpretation of the purposes of the Charter Act were carried out; however, its philosophy and application of

---

[2] 42 U.S.C. 3531 <u>et seq</u>.

[3] 42 U.S.C. 3532.

[4] HUD was given regulatory authorities over Fannie Mae in Fannie Mae's Charter Act (12 U.S.C. 1717 <u>et seq</u>.) and Freddie Mac under the Federal Home Loan Bank Act (12 U.S.C. 1451 <u>et seq</u>.), as amended by FIRREA.

[5] The statement of HUD's general regulatory power over Fannie Mae is contained in 12 U.S.C. 1723a(h), and the statement regarding its power over Freddie Mac is in 12 U.S.C. 1452(b).

regulatory authority have varied over the years.[6] In fact, prior to acquiring regulatory responsibilities over Freddie Mac, HUD did not have any full-time staff assigned to Fannie Mae regulation; staff resources were devoted to Fannie Mae regulation on an as-needed basis.[7]

Financial Institutions Review Board

Since the passage of FIRREA, HUD has expanded its regulatory focus to include supervising, on a full-time basis, the financial safety and soundness of Fannie Mae and Freddie Mac. HUD created a new regulatory review board and staff to coordinate and exercise its existing regulatory oversight over Fannie Mae and its new oversight authority over Freddie Mac. The Financial Institutions Review Board (FIRB) consists of the Deputy Secretary of HUD, the General Counsel, the Assistant Secretary for Housing-FHA Commissioner, the Assistant Secretary for Policy Development and Research, the Assistant Secretary for Community Planning and Development, and the President of GNMA.

The Board determines HUD's policy with respect to the regulation of Fannie Mae and Freddie Mac and in connection with the Secretary of HUD's responsibilities as a member of the Oversight Board of the Resolution Trust Corporation. FIRB is authorized to have a staff consisting of a Director, three economists, and one financial institutions examiner. Funding for the regulatory oversight of Fannie Mae and Freddie Mac is determined by the Executive Branch, and salary levels for its staff are set by the General Schedule. HUD does not have the authority to assess Fannie Mae or Freddie Mac for the cost of regulation. The President's 1992 Budget contains a proposal that, if enacted by Congress, would authorize HUD to collect fees to cover its expenses in regulating Fannie Mae and Freddie Mac.[8]

HUD has drafted new regulations for Freddie Mac and has prepared a revised draft of its regulations for Fannie Mae. These regulations are under review within the Administration at this time. The intent of the new regulations is to ensure that both Fannie Mae and Freddie Mac are operating under similar and

---

[6] Under Secretary Alfred A. DelliBovi stated before the Senate Banking Committee on February 9, 1990 that "It is fair to say that HUD has not had a systematic approach in either the philosophy or the management of its regulation of [Fannie Mae]."

[7] HUD response to a Treasury question concerning regulation of Fannie Mae and Freddie Mac, February 26, 1991.

[8] Budget of the United States Government, Fiscal Year 1992, Part 4-721.

uniform regulatory oversight, as well as to update the regulations for Fannie Mae.

HUD interprets its general regulatory authority over Fannie Mae and Freddie Mac to include authority to establish regulations that go beyond its specific statutory powers, as contained in Fannie Mae's and Freddie Mac's Charter Acts. Fannie Mae and Freddie Mac have differing interpretations of HUD's general regulatory authority.[9] Fannie Mae officials believe that the general regulatory power does not authorize HUD, for example, to issue capital directives or cease and desist orders, or to disapprove risky activities. Freddie Mac officials, on the other hand, believe HUD has broad flexibility to promulgate rules defining its powers over Freddie Mac.

Current Regulatory Authorities of HUD

According to statute, HUD has the following specific authorities relating to the financial safety and soundness of Fannie Mae and Freddie Mac.[10]

Capital standards

HUD has statutory authority to regulate the capital level of Fannie Mae and Freddie Mac as it relates to levels of outstanding unsecured debt.[11] FIRREA imposes a capital requirement of unsecured debt to total capital of 15-to-1 on Freddie Mac and reaffirms the same capital requirement for Fannie Mae. HUD has the authority to increase the statutory ratio, that is, to make the capital requirement less stringent, and has done so, but it cannot lower it below 15-to-1.[12]

While the statutory ratio requirement can be a constraint on the growth of Freddie Mac or Fannie Mae because it sets a maximum leverage requirement, it is not an appropriate measure for overall capital adequacy. The outstanding mortgage-backed

---

[9] Fannie Mae and Freddie Mac responses to Treasury questions regarding regulatory oversight and structure, February, 1991.

[10] HUD's specific powers over Fannie Mae are set forth in 12 U.S.C. 1717(b), 1718(c), 1719(b), and 1723a(h). Its powers over Freddie Mac are set forth in 12 U.S.C. 1452(b).

[11] Regulatory capital for Fannie Mae and Freddie Mac includes equity, reserves, and subordinated debt.

[12] The ratio for Fannie Mae has been altered through changes in regulations five times, to as high as 30-to-1, which was in effect between late 1982 and the spring of 1987. The ratio was last changed on December 31, 1988 when it was lowered from 25-to-1 to 20-to-1.

securities (MBS) guaranteed by these GSEs are not accounted for in the statutory requirement and, therefore, MBS issuance is not restrained by a requirement that it be supported by a specific level of capital. Moreover, the statutory capital requirement does not take into account the quality of assets or the interest rate risk in the portfolio. In order to be meaningful, any capital requirement must, at a minimum, include off-balance sheet obligations; thus, the capital requirement should include MBS, since they represent a significant portion of the risk of the operations of Fannie Mae and Freddie Mac.

Financial disclosure

HUD has statutory authority to require Fannie Mae and Freddie Mac to make reports on their activities as it deems advisable. Through its general regulatory power, HUD has required extensive periodic reports on specific Fannie Mae activities, as well as an annual study that details Fannie Mae's business plans.[13] Since FIRREA, HUD has requested additional extensive information from both Fannie Mae and Freddie Mac. HUD has used this data from the operations of both GSEs to develop models that enable it to assess credit risk and interest rate risk.

Books and records and internal controls

HUD does not have explicit statutory authority to prescribe rules to ensure the adequacy of internal controls and information systems at Fannie Mae and Freddie Mac. However, HUD believes it has powers in this area under its general regulatory authority.

Examination authority

HUD is authorized to examine and audit the books and financial transactions of Fannie Mae and Freddie Mac. HUD has never conducted an extensive examination or audit of Fannie Mae in the past. HUD officials state that the Department is currently building the capacity to conduct bank-type examinations of both GSEs. HUD is also in the process of contracting with a private-sector firm to conduct an initial examination and to set up procedures and criteria for future examinations.

Enforcement authority

According to HUD, its general regulatory authority gives it sufficient enforcement powers over Fannie Mae and Freddie Mac. HUD also has specific statutory enforcement powers. Its only specific statutory authorities are its ability to limit dividends

---

[13] 24 C.F.R. 81.21-25.

and to change capital requirements, subject to the 15-to-1 minimum, but both authorities suffer defects as true enforcement powers. HUD only has specific authority to limit cash dividends on common stock to a rate determined to be a fair rate of return after consideration of current earnings and capital condition. Moreover, as described previously, its specific authority over capital standards is limited to on-balance sheet activities, and HUD is unable to impose stricter capital standards than the statutory 15-to-1 leverage ratio.

Other regulatory authorities

Prior approval. HUD has the power to approve, prior to initiation, programs of Fannie Mae and Freddie Mac involving the purchase, servicing, sale, or lending on the security of, or otherwise dealing in, conventional mortgages. Historically, HUD's criteria for new programs have included consideration of both housing goals and the risk to the Government, but with different emphases at different times. Since FIRREA, HUD has increased the emphasis given to the risks to the Government posed by new programs.

Low- and moderate-income requirements. HUD may require that a reasonable portion of the mortgage purchases of Fannie Mae and Freddie Mac be related to the national goal of providing adequate housing for low- and moderate-income families, but with reasonable economic return to the GSEs. HUD currently requires 30 percent of Fannie Mae's annual mortgage purchases to be secured by housing for low- and moderate-income families.[14]

FEDERAL HOME LOAN BANKS

Description of Regulatory Environment

The Finance Board is an independent agency within the Executive Branch that oversees the FHLBanks. It was created by FIRREA, which transferred the authority of the Federal Home Loan Bank Board with respect to the FHLBanks to the Finance Board.

The Finance Board expects to be fully staffed at 88 employees by June 1991 and is funded through semiannual assessments on the FHLBanks. FIRREA directs the Finance Board to consult with, and maintain comparability with the compensation of, the Federal banking regulators. The Finance Board recently adopted a permanent compensation plan modeled after that of the Federal Deposit Insurance Corporation and the Resolution Trust Corporation Oversight Board.

---

[14] See 24 C.F.R. 81.2 for HUD's definition of low- and moderate-income families.

The Finance Board is composed of four part-time directors and one full-time director, who are appointed by the President, and the Secretary of HUD who serves ex officio. FIRREA requires that the directors have extensive experience in housing finance or a commitment to providing specialized housing credit. At least one director must be from an organization representing consumer or community interests. The Finance Board's appointed directors were sworn in on December 18, 1990.

The statutory mission of the Finance Board includes both financial safety and soundness and programmatic responsibilities. FIRREA set forth the following duties for the agency:

(1) to supervise the FHLBanks;

(2) to ensure that the FHLBanks carry out their housing finance mission;

(3) to ensure the FHLBanks remain adequately capitalized and able to raise funds in the capital markets; and

(4) to ensure that the FHLBanks operate in a safe and sound manner.[15]

The agency's two stated strategies for fulfilling its statutory mission are establishing its credibility as a safety and soundness regulator and establishing the Bank System as the nation's premier housing lender.[16] The Finance Board views its primary mission as ensuring the safe and sound operations of the FHLBanks through examinations, audits, and financial reporting. The second strategy involves ensuring that the FHLBanks meet their public purpose by providing housing finance as efficiently as possible. This includes providing the leadership to help the FHLBanks adapt to changes in the thrift industry and expand their lending to commercial banks and credit unions.

Current Regulatory Authorities of the Finance Board

The Finance Board has broad statutory powers over the FHLBanks. It uses these powers to ensure the safety and soundness of the FHLBanks and to ensure that they carry out their public purpose of providing home finance. These powers enable the Finance Board to take preventive action to protect individual FHLBanks which are jointly and severally liable for the Bank System's consolidated obligations. The FHLBank Act provides that

---

[15] 12 U.S.C. 1422a(a).

[16] Response of the Finance Board to Treasury questions regarding regulation of the FHLBanks, February 19, 1991.

individual FHLBanks may exercise their powers subject to the approval of the Finance Board.[17] The Finance Board also approves applications for new members to the Bank System.

Capital standards

The Finance Board has an explicit statutory duty to ensure that the FHLBanks remain adequately capitalized. The FHLBanks are currently subject to both legislative and regulatory capital requirements. The FHLBank Act requires members to hold capital stock in their FHLBank equal to the greater of .3 percent of the member's total assets, one percent of the member's mortgage-related assets, or 5 percent of a member's outstanding advances.[18] The Finance Board is developing credit-risk-based capital standards for the FHLBanks that will include off-balance sheet items.[19] However, the statutory stock purchase requirement for advances effectively sets the capital-to-advances ratio at a minimum of 5 percent.

The regulatory requirement, which is also required by consolidated bond covenants, mandates that the Bank System's consolidated obligations not exceed 12 times the sum of its capital stock and reserves. As of year-end 1990, consolidated obligations comprised about three-quarters of the Bank System's liabilities.

The Finance Board also controls the FHLBanks' capital holdings through its approval of the FHLBanks' quarterly dividends. Quarterly dividend data are reviewed to determine regulatory and financial appropriateness of projected individual FHLBank dividends. If a FHLBank were found to have insufficient capital, its permissible dividend payments could be reduced.

Finally, the Finance Board can limit the redemption of capital stock should a FHLBank's financial condition warrant. Every institution that belongs to the Bank System must purchase stock, which is not traded on a secondary market. The stock is redeemable at par value ($100 share), unless the Finance Board determines that a FHLBank's paid-in capital is, or might be,

---

[17] 12 U.S.C. 1432(a).

[18] Advances have traditionally constituted virtually all of the Bank System's assets, although the advance-to-asset ratio has declined recently, from 90 percent in 1980 to 71 percent at year-end 1990.

[19] The Finance Board expects to address interest rate risk through a separate policy which would limit a FHLBank's exposure to interest rate risk.

impaired. In this case, the Finance Board may order the FHLBank to withhold a pro-rata share of the impaired capital.[20]

Financial disclosure

As noted above, the Finance Board collects a wide variety of financial data on a regular basis, which are used to monitor interest rate, credit, and lending concentration risk of individual FHLBanks and the Bank System as a whole. The Finance Board recently developed a model to measure FHLBanks' exposure to interest rate risk. The Finance Board plans to use the model to monitor and set limits on the FHLBanks' interest rate risk exposure.[21]

Debt financing requests by individual FHLBanks are used to forecast monthly debt requirements of the Bank System and ensure adequate financing coordination among the FHLBanks. Internal audit reports on FHLBank operations and external audit reports on FHLBank financial statements are provided on an annual basis. Finally, the Finance Board reviews the minutes of the meetings of the FHLBank boards of directors and their committees.

Books and records and internal controls

The Finance Board has the authority to ensure that the internal controls and information systems of the FHLBanks are adequate. If deficiencies are found in this area, the Finance Board can issue a supervisory letter or directive that would require the FHLBanks to promptly correct the deficiencies.[22]

Examination authority

The FHLBank Act requires the FHLBanks to be examined annually.[23] The Finance Board began on-site examinations in

---

[20] 12 U.S.C. 1426(e).

[21] The model measures the durations of equity for each of the FHLBanks under current interest rate conditions and after 200 basis point increases and decreases in interest rates.

[22] The Finance Board states it has the authority to do so under 12 U.S.C. 1422b(a), which gives it the power to issue orders necessary to fulfill the provisions of the FHLBank Act.

[23] 12 U.S.C. 1440.

March 1991.[24] The Examination Division currently employs three individuals; it is slated to have a staff of eight in place by the end of 1991. The scope of the examinations generally focuses on credit/collateral positions, funding operations, management, and regulatory compliance. In addition, the Finance Board will perform special and follow-up examinations as necessary. Finance Board officials believe that much of the information-gathering, monitoring, and analysis associated with oversight of the FHLBanks does not require an on-site presence. They expect to monitor and examine some issues off-site, based on specific information requests and other documentation and information routinely received.

The Finance Board reviews daily information on certain balance sheet items, off-balance sheet activity, investments, and consolidated obligations to monitor compliance with minimum reserve (liquidity) requirements, leverage ratio limitations, and investment limitations. Operational information is used to monitor director eligibility[25] and the FHLBanks correspondent banking services' compliance with the Private Sector Adjustment Factor. FHLBank monthly balance sheets, income statements, cash flow statements, and investment activities are reviewed as well. The Board receives updated 12-month income projections as part of the FHLBanks' quarterly dividend proposals.

All internal audit departments prepare an annual audit plan, which is reviewed by the Finance Board. Finance Board staff attends FHLBank audit committee meetings. In addition, the Finance Board receives copies of all internal audits and minutes and reports of the FHLBanks' audit committees.

Enforcement authority

The statute gives the Finance Board authority to suspend or remove officers and directors for cause.[26] The Finance Board may also issue supervisory letters, supervisory and capital directives, and restrict dividends. The Finance Board states it has implicit authority to issue temporary and permanent cease and

---

[24] In 1990, supervisory visits were made to all FHLBanks. In addition, the Finance Board has conducted analyses of each FHLBank's internal audit department, financial performance and regulatory compliance.

[25] Under FIRREA, no person who is an officer or director of a member institution that fails to meet any minimum applicable capital requirement is eligible to become a director of a FHLBank.

[26] 12 U.S.C. 1422b(a)(2).

desist orders, although FIRREA did not give it the explicit authority to do so.[27] The statute does not authorize the Finance Board to assess civil money penalties.

The Finance Board has initiated several enforcement actions since August 1989. Most of these actions were supervisory letters addressing investments in excess of authorized levels. Another matter involved the violation of the Finance Board's limitation on a FHLBank president's compensation.

Other regulatory authorities

Prior approval. The Finance Board has the power to approve new and existing activities.[28] Permissible types and amounts of FHLBank investments are set forth in the Finance Board's funds management policy. A FHLBank must petition the Finance Board if it wants a waiver from the guidelines. The Finance Board generally reviews petitions on safety and soundness grounds. For example, last year it withheld approval of a request by the FHLBank of Dallas to purchase participations in construction loans on the grounds that the proposed investments did not satisfy statutory requirements.[29]

The Finance Board also approves the FHLBanks' debt offerings. It can limit indirectly other activities through approval of the individual FHLBank budgets.

Budgets. Analysis of FHLBank budgets includes review of budgeted expenditures, projected advances, net income, and variances between each FHLBank's approved operating and capital budgets and actual expenditures. Beginning with the 1991 FHLBank budgets, the Finance Board established specific performance goals for each FHLBank, including targets for operating expenses relative to income.

Officers and directors. For each of the 12 FHLBanks, the Finance Board appoints six of the directors and supervises the election of the remainder, for a total of at least 14 directors. By statute, at least two of each FHLBank's appointed directors

---

[27] The Finance Board states it has the authority under 12 U.S.C. 1422b(a), which gives it the power to issue orders necessary to fulfill the provisions of the FHLBank Act, and under 12 U.S.C. 1432(a)(1), which gives the Finance Board authority to restrict powers granted to the FHLBanks by law.

[28] 12 U.S.C. 1432(a) and 1422b(a).

[29] The Finance Board is in the process of revising the funds management policy.

must be representatives from organizations representing consumer or community interests. The Finance Board designates the chair and vice-chair of each FHLBank's board of directors and the geographic area of elective directorships in each district. The Finance Board approves the compensation of FHLBank presidents and directors.

Strategic planning. The Finance Board has established a strategic planning directorate, which has as its primary responsibility the strategic planning for the Bank System, including membership and credit product issues. The regulator also reviews and approves annual strategic plans for the individual FHLBanks (from which capital and operating plans are developed) and mid-year updates of the strategic plans. These are used to monitor the FHLBanks' goals and objectives.

Liquidations/reorganizations of FHLBanks. The Finance Board has broad powers in this area, within a statutory framework that mandates that there be at least eight, but not more than twelve, FHLBanks. The statute provides that the Finance Board may liquidate or reorganize a FHLBank whenever it finds such action will aid the efficient and economical accomplishment of the FHLBank Act. In the case of any liquidation or reorganization, another FHLBank may, with the approval of the Finance Board, acquire assets of any such liquidated or reorganized FHLBank and assume part or all of the liabilities.

FARM CREDIT SYSTEM

Description of Regulatory Environment

The Farm Credit Administration is an independent agency in the Executive Branch, created to regulate and examine the banks, associations, and related institutions and organizations of the Farm Credit System chartered under the Farm Credit Act of 1971, as amended (the Act). Prior to 1985, the FCA actively promoted the System, essentially acting as the System's voice on most matters affecting it. The FCA had a 13-member board, all appointed by the President. Twelve of these members, however, were selected from lists of nominees selected by System representatives in the twelve Farm Credit districts. As a result, these members were more likely to have allegiances to the System. The FCA had no explicit enforcement powers and used its numerous prior approval authorities to exert influence on the day-to-day decisions of System banks, including credit decisions on individual loans.[30]

With the Farm Credit Amendments Act of 1985, Congress gave the FCA a mandate to be a stronger regulator.[31] The 1985 legislation and the Agricultural Credit Act of 1987 gave the FCA enforcement powers, changed the board structure and, to a large extent, removed the FCA from the day-to-day management activities of System institutions.

The management of the FCA is vested in a full-time, three-member board, appointed by the President with the advice and consent of the Senate. The board members, one of whom is designated as chairman by the President, serve six-year terms and are required to be "broadly representative of the public interest."[32]

The Chairman, who also serves as the agency's chief executive officer, is required to consult on a regular basis with:

(1) the Secretary of the Treasury concerning System borrowing;

(2) the Board of Governors of the Federal Reserve System concerning the effect of System lending activities on national monetary policy; and

(3) the Secretary of Agriculture concerning the effect of System policies on farmers, ranchers, and the agricultural economy.

---

[30] The FCA has had numerous other approval authorities, including approval of interest rates on loans offered by each of the System banks.

[31] The House Report for the Farm Credit Amendments Act of 1985 (H. Rep. No. 425, 99th Cong., 1st Session, 1985, p. 3) reads as follows:

> The Farm Credit Administration, an existing federal agency that supervises Farm Credit System activities, would be reorganized and strengthened. The Farm Credit Administration would abandon past practices that amount to day-to-day participation in management of System activities and would become an arm's-length regulator like other similar federal agencies.

[32] 12 U.S.C. 2242.

The FCA is organized into six functional offices and has 526 employees, 356 of whom are in the Office of Examination.[33] FCA operating expenses are covered by assessments on System institutions.

Current Regulatory Authorities of the FCA

The FCA's general authorities include the authority to promulgate rules and regulations for the implementation of the Farm Credit Act, to examine and regulate System institutions, and to require such reports from System institutions as it deems necessary.[34] The FCA also has more specific, enumerated authorities which include the authority to establish standards for System institutions with respect to loan security requirements and to conduct loan and collateral security review. In addition, the FCA has the authority to regulate the borrowing, repayment, and transfer of funds and equities among System institutions.

The FCA's authorities with regard to setting capital standards, examining System institutions, requiring reports and other financial disclosure, taking enforcement actions, and forcing mergers or liquidations are spelled out in the Act. The following sections contain more thorough descriptions of these authorities, as well as the FCA's prior approval authorities.

Capital standards

The Agricultural Credit Act of 1987 required the FCA to "establish minimum permanent capital adequacy standards" for System institutions; these standards were required to "specify fixed percentages representing the ratio of permanent capital of the institution to the assets of the institution, taking into consideration relative risk factors as determined by the Farm Credit Administration."[35] The definition of permanent capital includes retained earnings, allocated and unallocated earnings, surplus (less allowance for losses), and at-risk stock.[36]

---

[33] Data are from FCA, as of March 11, 1991.

[34] 12 U.S.C. 2243.

[35] 12 U.S.C. 2154; section 301(a) of P.L. 100-399.

[36] At-risk stock includes voting and nonvoting stock (including preferred stock), equivalent contributions to a guaranty fund, participation certificates, and allocated equities. It does not include stock and allocated equities protected as a result of the 1987 Act. (12 U.S.C. 2154a).

Although the FCA has little discretion regarding the definition of permanent capital, it retains significant discretion as to the appropriate level of capital and the risk weighting of assets. The FCA issued regulations in 1988 setting risk-based capital standards of 7 percent for all System institutions.[37] The risk weightings of assets for these standards are roughly comparable to those promulgated by the commercial bank regulators. For example, cash has a 0 percent weighting; Treasury securities have a 10 percent weighting; State and local government obligations backed by full faith and credit have a 20 percent weighting; and rural housing loans secured by first lien mortgages have a 50 percent weighting. One difference between these standards and those adopted by the commercial bank regulators is that the general allowance for losses does not count as a component of capital.[38]

The failure of an institution to meet its minimum capital standard may be deemed by the FCA to constitute an unsafe and unsound practice, thus giving the FCA the authority to take one of a number of enforcement actions. The FCA may also require an institution with inadequate capital to submit and adhere to a plan describing the means and timing by which the institution will achieve its required capital level. The FCA may consider the institution's progress in adhering to its plan when the institution seeks the FCA's approval for any proposal that would divert earnings, diminish capital, or otherwise adversely affect the ability of the institution to comply with its plan. Finally, System institutions may not pay dividends, patronage refunds, or retire stock, if doing so would cause the institution to fail to meet its minimum capital standards.[39]

Another component of the FCA's capital standards requires the System's Banks for Cooperatives (BCs) to add at least 10 percent of annual earnings to unallocated surplus until unallocated surplus is equal to one-half of their 7 percent minimum capital requirement.[40] The FCA argued that this was

---

[37] 12 C.F.R. 615.5205.

[38] Under the guidelines adopted by the Office of the Comptroller of the Currency, the allowance for loan losses may be counted as a part of Tier 2 capital, up to 1.25% of risk-weighted assets.

[39] 12 U.S.C. 2154.

[40] This requirement was the FCA's response to a practice common to the BCs at the time the FCA issued these capital standards. "Allocated surplus" is a non-cash distribution to stockholders. Like cash dividends, it decreases a BC's taxable income; however, it also counts as capital for purposes of a BC's

necessary because the BCs only had a small level of capital funds not allocated to their borrowers. Therefore, in the interest of safety and soundness, the FCA required a buffer consisting of unallocated equity. This requirement is conceptually similar to the Tier 1 and Tier 2 classifications of capital for commercial banks. It may be appropriate to consider a similar requirement for all other System institutions, particularly given some of Treasury's concerns expressed in the 1990 Report regarding the quality of borrower stock as capital.

Financial disclosure

The FCA has the authority to regulate the preparation by System institutions of information on their financial condition and operations for dissemination to stockholders and investors. The FCA has used this authority to issue regulations containing minimum information requirements for System institutions' quarterly and annual reports to shareholders. These reports are required to include financial statements prepared in accordance with generally accepted accounting principles and audited by a qualified public accountant.[41]

Each System institution is also required to submit a quarterly report of condition and performance, or call report, to the FCA. These call reports are similar in format and level of detail to those filed by banks and thrifts with their Federal regulators.[42]

The FCA also has a loan accounting report system (LARS), which consists of detailed loan data at the individual loan level. The FCA requires System institutions to submit this data on computer tapes on a quarterly basis. LARS is used as an additional tool to assist the FCA's examination process, as well as for special projects.

---

minimum capital standards. The FCA issued the additional standard for the BCs to create a buffer between allocated equities (borrower stock and allocated surplus) and any losses greater than the reserve for loan losses. (53 C.F.R. 40045 (1988)).

[41] There are several exceptions to generally accepted accounting principles that are established by statute.

[42] 12 C.F.R. 621.10.

Books and records and internal controls

The FCA has broad statutory authorities to regulate and examine System institutions, as well as specific authorities to monitor management effectiveness and prescribe uniform financial reporting standards. These authorities give the FCA adequate power to require effective internal controls and information systems.[43]

Examination authority

The FCA is required to examine System institutions at least once each year.[44] These examinations are required to include an analysis of credit and collateral quality and capitalization of the institution, an appraisal of the institution's management, and an appraisal of the institution's application of policies carrying out the Farm Credit Act, FCA regulations, and the institution's effectiveness in servicing all eligible borrowers.[45] This last requirement seems to imply that the FCA's responsibilities could be construed to include forcing System institutions to make loans to all "eligible borrowers." However, during discussions on this topic, FCA staff suggested that, in practice, the FCA's sole concern is that System institutions' extension of credit be sound from a business perspective.

Like other financial institution regulators, the FCA uses a rating system (CAMEL) which rates institutions on a scale of one to five for capital adequacy, asset quality, management and administration, earnings, and liquidity. Examiners calculate 26 key statistics and are expected to consider numerous qualitative factors when rating institutions. Any institution receiving a CAMEL rating of 3 (or worse) is automatically referred to the Office of Regulatory Enforcement, which must then consider whether (and in what form) to take action.

FCA examiners do not generally examine each loan in an institution's portfolio, but use sampling techniques which are likely to concentrate more heavily on new, large and troubled loans. Institutions which are considered riskier generally receive more comprehensive examinations. For example, one part of an examination consists of the examiner's recommendations for

---

[43] 12 U.S.C. 2254 and 12 U.S.C. 2257(a).

[44] Except Federal land bank associations, which the FCA is only required to examine once every three years.

[45] 12 U.S.C. 2254.

future examination requirements, including follow-up activities and the time and staffing required for such activities.

The FCA is authorized to publish the report of examination of any System institution that fails to comply with an FCA recommendation (based upon an examination) within 120 days of receiving notification of the recommendation. The FCA board may also require examinations of the condition of any organization (other than a federally regulated financial institution) with a loan from any System institution.

Enforcement authority

The FCA has essentially the same enforcement powers that commercial bank regulators have. These include the authority to issue cease and desist orders, to suspend or remove directors and officers, and to require payment of civil money penalties.

Cease and desist orders. If the FCA believes that an institution is engaging in an unsafe or unsound practice, or is violating a law, rule or regulation, the FCA may fix a time and place for a hearing to determine whether a cease and desist order should be issued.[46] However, if the FCA determines that an institution's actions are likely to cause insolvency or substantial dissipation of assets or earnings prior to completion of a hearing, the FCA may issue a temporary cease and desist order.[47]

Suspension or removal of directors or officers. The FCA may remove a director or officer of a System institution if the FCA believes that the individual has violated a law, rule or regulation, or has engaged in an unsafe or unsound practice, or has breached a fiduciary duty.[48] The FCA may also remove a director or officer who has been charged with a felony if that individual's continued service might pose a threat to the interests of the institution's shareholders or investors in System obligations (or impair public confidence in the institution or the System).[49]

Civil money penalties. If an institution, officer, director, or employee violates the terms of a final cease and desist order, the FCA may require payment of a civil money

---

[46] 12 U.S.C. 2261.

[47] 12 U.S.C. 2262.

[48] 12 U.S.C. 2264.

[49] 12 U.S.C. 2265.

penalty of up to $1,000 per day. The FCA may also require payment of a civil money penalty of up to $500 per day for a violation of a regulation or provision of the Farm Credit Act.[50]

Since 1986, the FCA increasingly has made use of its enforcement powers, particularly for issues involving asset quality and credit administration, capital adequacy, and quality of management. In 1990, the FCA took 89 enforcement actions, including 10 cease and desist orders.[51]

Other regulatory authorities

Prior approval. The FCA continues to have a number of prior approval authorities, such as the offering of new services[52], the issuance of most Systemwide obligations, modifications of the boundaries of farm credit districts, and the merger, consolidation, or division of the territories of System institutions.

Mergers or liquidations of system institutions. The FCA may require an association to merge with another association if it determines, with the concurrence of the board of the supervising bank, that an association has failed to meet its outstanding obligations or failed to conduct its operations in accordance with the Act.[53] The FCA may also appoint a conservator or receiver for any System institution if it determines that one of the following conditions exists:

(1) The institution is insolvent.

(2) There has been a substantial dissipation of assets or earnings due to violations of law, rules or regulations, or to any unsafe or unsound practice.

---

[50] 12 U.S.C. 2268.

[51] Other enforcement actions included 16 supervisory letters, 6 agreements, 36 follow-up letters, 15 conditions of reorganization, 2 amended cease and desist orders, and 4 conditions of corporate restructuring.

[52] The FCA has issued regulations requiring System institutions to seek FCA prior approval for new services. (12 C.F.R. 618.8000). Numerous sections of the statute were cited as the authority for these regulations, including 12 U.S.C. 2020, 12 U.S.C. 2076, and 12 U.S.C. 2128.

[53] 12 U.S.C. 2183.

(3) The institution is in an unsafe or unsound condition.

(4) The institution has committed a willful violation of a final cease and desist order.

(5) The institution is concealing its books, papers, records, or assets, or is refusing to make such materials available for inspection to an FCA examiner.

(6) The institution is unable to make a timely payment of principal or interest on any insured obligation issued by the institution.

The last forced liquidation of a System institution involved an association in 1989. Prior to that the Federal Land Bank of Jackson was put into receivership in 1988.

Farm Credit System Insurance Corporation

The Insurance Corporation was created by the Agricultural Credit Act of 1987 to ensure "the timely payment of principal and interest on notes, bonds, debentures, and other obligations" of System banks.[54] The Insurance Corporation is also required to satisfy any defaults of System institutions on their Financial Assistance Corporation bond interest and principal payments and to ensure the retirement of any liquidated institution's protected borrower stock. In addition, the Insurance Corporation may provide assistance to troubled banks.

The members of the Board of the Insurance Corporation are also the members of the FCA Board, although the Insurance Corporation's Chairman is required to be a member other than the FCA Chairman. The Insurance Corporation will not assume its full statutory authorities until January 1, 1993.

The Insurance Corporation's sources of funds include $260 million which was transferred from the FCA (the "revolving fund"), premiums assessed on System banks, and interest earned from investments. The target level for the fund, the "secure base amount," is set by statute at two percent of insured obligations.[55] As of December 31, 1990, the net worth of the

---

[54] 12 U.S.C. 2277a-1.

[55] 12 U.S.C. 2277a-4. Premium levels are also set by statute: 15 basis points on the banks' accrual loans; 25 basis points on banks' nonaccrual loans; 1.5 basis points on the guaranteed portions of federally guaranteed loans made by the banks (and in accrual status); and 3 basis points on the

Insurance Fund was about $300 million, or just under one-third of the secure base amount.

One of the principal reasons for the Insurance Corporation's creation was the difficulty of implementing the "joint and several liability" mechanism during the 1980s.[56] This mechanism (which will stand behind the Insurance Corporation when it becomes fully operational in 1993) legally binds all System banks to stand behind all Systemwide obligations, should one bank be unable to redeem its share of a maturing obligation. One problem with joint and several liability that is shared by the Insurance Corporation, however, is the difficulty of accessing capital in the System at the association level. Because only System banks are bound by the joint and several liability agreement, there was in the past significant reluctance on the part of some associations to inject additional capital into a troubled bank in which they held stock. Similarly, under current law, the Insurance Corporation does not have the authority to tap association capital when a bank fails.

Powers of the Insurance Corporation

The Insurance Corporation is authorized to make examinations and require information and reports from System institutions. If the FCA finds reason to appoint a conservator or receiver for a System institution, the conservator or receiver is required to be the Insurance Corporation. The Insurance Corporation may make loans to, purchase the assets or securities of, assume the liabilities of, or make contributions to, any troubled insured bank for one of the following reasons:

(1) to prevent putting the bank in receivership;

(2) to restore the bank to normal operation; or

(3) to reduce the risks to the Insurance Corporation when severe financial conditions threaten numerous banks.

Before giving assistance to a System bank, the Insurance Corporation must determine that the cost of assistance is less than the cost of liquidation.

---

guaranteed portions of State government-guaranteed loans made by the banks (and in accrual status). When the secure base amount is reached, the Insurance Corporation is required to reduce the premiums to an amount sufficient to ensure maintenance of the secure base amount.

[56] See discussion on page D-53 of 1990 Report.

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Description of Regulatory Environment

The Agricultural Credit Act of 1987, which chartered Farmer Mac as an institution of the Farm Credit System, gave the FCA general supervisory authorities over the corporation.[57] The FCA may assess Farmer Mac for the costs of these regulatory activities.[58]

Current Regulatory Authorities of the FCA

The FCA's regulatory authorities with respect to Farmer Mac include examination, safety and soundness supervision and enforcement authorities, but not general rule-making authority. During consideration of the 1990 Farm Bill, the FCA failed in an attempt to have its statutory authorities over Farmer Mac expanded to include an express grant of general rule-making authority. The FCA argues that such authority is needed in order to make its ability to use safety and soundness enforcement powers more effective. The FCA contends that without general rule-making authority, it is limited to taking reactive, "after the fact" enforcement actions, rather than preventive actions through rules and regulations.

Farmer Mac staff indicated that the FCA's current authorities are more than adequate for it to act in response to any safety and soundness concerns. Indeed, Farmer Mac believes that general rule-making authority would give the FCA too much influence over Farmer Mac's day-to-day business and management decisions.

Capital standards

The FCA believes that capital must be adjusted periodically to reflect the risk in an institution's operations and, thus, is an appropriate subject for examiner review. However, without general rule-making authority, it is not certain that the FCA has the authority to set capital standards by regulation.

---

[57] 12 U.S.C. 2279aa-1.

[58] 12 U.S.C. 2279aa-11.

Financial disclosure

Farmer Mac is required to publish an annual report prepared in accordance with generally accepted accounting principles, containing such information as required by the FCA. This report is also required to be audited by an independent public accountant.[59] The FCA also requires Farmer Mac to file a call report on a quarterly basis.

Examination authority

The FCA has the authority to examine Farmer Mac's condition and financial transactions and to promulgate rules and regulations for implementing such examinations.[60] The FCA is required to examine Farmer Mac at least annually.

Enforcement authority

The FCA, in its role as supervisor of Farmer Mac's safety and soundness, has the same enforcement powers that it has for other System institutions. These include the authority to issue cease and desist orders, suspend or remove directors and officers, and require payment of civil money penalties.

Other regulatory authorities

Prior approval authority. The FCA has no prior approval authorities over Farmer Mac.

STUDENT LOAN MARKETING ASSOCIATION

Description of Regulatory Environment

No Federal agency has statutory authority to regulate Sallie Mae business operations or capital adequacy. The Higher Education Act of 1965 specifically states that:

> Nothing in this section [pertaining to Department of Education and Treasury approval of Sallie Mae obligations] shall be construed so as to authorize the Secretary of Education or the Secretary of the Treasury to limit,

---

[59] Ibid.

[60] Ibid.

> control, or constrain programs of the Association or support of the Guaranteed Student Loan Program by the Association.[61]

The Department of Health and Human Services is also without authority to regulate Sallie Mae.

Sallie Mae is subject, from time to time, to the same type of review of its student loan servicing operations that applies to other holders of guaranteed student loans. Such reviews are undertaken by the General Accounting Office, the Department of Education, and the Department of Health and Human Services. These reviews are confined to Sallie Mae guaranteed loan servicing operations and do not analyze overall business operations or capital adequacy.

The Department of Education Office of Postsecondary Education and the State and private nonprofit guarantee agencies which insure Guaranteed Student Loan Program (GSLP) loans conduct reviews of Sallie Mae compliance with Department of Education due diligence regulations (pertaining to loan servicing) and other aspects of lender participation in GSLP.[62] The Department of Education Inspector General also has authority to conduct periodic reviews of Sallie Mae participation in GSLP. The findings and recommendations of these offices may result in regulatory or legislative changes affecting the GSLP and Sallie Mae loan servicing operations.

Sallie Mae is required to submit a report of its annual audit by a certified independent auditing firm to the Secretary of the Treasury and is required to provide the Secretary of the Treasury with access to all Sallie Mae books and records.[63] The Secretary, in turn, is required to report to the President and Congress on the financial condition of Sallie Mae, including "a report of any impairment of capital or lack of sufficient capital noted in the audit."[64] In recent years, Sallie Mae has submitted its publicly available annual reports to the Secretary of the Treasury and other financial information upon request of Treasury staff. The Treasury has not noted any impairments of

---

[61] 20 U.S.C. 1087-2(h)(2).

[62] 34 C.F.R. 682.208, 682.411. For example, interest and special allowance billings and loan disbursements. (34 C.F.R. 682.207, 682.304, 682.414(c)(2)).

[63] 20 U.S.C. 1087-2(j).

[64] 20 U.S.C. 1087-2(k).

Sallie Mae capital. Sallie Mae is also required to submit annual reports on its operations and activities to the President and Congress.[65]

[65] 20 U.S.C. 1087-2(n).

CHAPTER 4

ADEQUACY OF THE EXISTING REGULATORY STRUCTURE FOR GSEs

This chapter examines the adequacy of the existing regulatory structure for GSEs with respect to the principles of financial safety and soundness regulation established in Chapter 2 of this report. This examination reveals that, to varying degrees, the structure falls short of the necessary elements for effective safety and soundness regulation.

ADHERENCE TO PRINCIPLES OF EFFECTIVE REGULATION

Primacy of financial safety and soundness regulation

The primary focus of GSE regulation should be financial safety and soundness. Unfortunately, not all of the current regulators have explicit statutory authority that makes financial safety and soundness oversight the primary regulatory goal. Indeed, one GSE, Sallie Mae, has no safety and soundness regulator.

HUD has general regulatory powers over Fannie Mae and Freddie Mac to ensure that the housing-related public purposes of the two GSEs are accomplished. Historically, HUD's regulatory focus has centered on considerations of housing goals and the risk to the Government, but with different emphases at different times. Thus, financial safety and soundness oversight of Fannie Mae has not always been the primary regulatory goal.

Three of the four statutory duties of the Finance Board relate to safety and soundness oversight. They are:

(1) to supervise the FHLBanks;

(2) to ensure that the FHLBanks remain adequately capitalized and able to raise funds in the capital markets; and

(3) to ensure that the FHLBanks operate in a safe and sound manner.

The remaining statutory directive requires the Finance Board to ensure that the FHLBanks carry out their housing finance mission.

The FCA has statutory safety and soundness authorities, and the legislative history surrounding the 1985 reorganization of the FCA clearly suggests that Congress intended for the FCA to be a financial safety and soundness regulator. Moreover, Congress

294-104 O - 91 - 3 QL 3

patterned FCA enforcement powers after those of commercial bank regulators.

Regulatory stature

Stature helps to determine how effective a regulator can be in the financial safety and soundness oversight of GSEs. As discussed in Chapter 2, stature is determined by a number of factors including a clear political mandate to ensure financial safety and soundness, financial independence, and the regulator's slate of authorities, particularly its ability to establish and enforce meaningful capital standards. The current regulatory structure for the GSEs lacks some of these necessary factors.

HUD needs a clear statutory mandate to make safety and soundness its primary regulatory role. As discussed below, HUD does not have a well-defined set of regulatory powers for effective financial safety and soundness regulation. It would benefit from clarification of its financial safety and soundness regulatory powers. Also, HUD should have the ability to charge Fannie Mae and Freddie Mac assessments to cover the costs of effective regulation. Alone among current regulators, HUD does not have this authority.

In contrast to HUD, the FCA has clear enforcement authorities, a statutory mandate to ensure safety and soundness, and the ability to fund its operations through assessments on the FCS. The Finance Board also has sufficient enforcement authorities and the ability to charge the FHLBanks to cover the costs of regulation. However, the Finance Board needs its regulatory goal clarified in statute in order to make safety and soundness its primary focus.

Use of private market mechanisms for risk assessment

None of the GSE regulators currently uses private market mechanisms, such as NRSROs, to supplement their ability to oversee the financial safety and soundness of the GSEs. The use of private market mechanisms would help to diminish the chances of regulatory failure by providing an independent assessment of risk exposure to the Federal Government. Any inconsistencies between the private and public sector assessments of risk would need to be resolved. This resolution process would serve to enhance the body of regulatory knowledge, thereby reducing risk to the Government.

Basic regulatory powers for financial safety and soundness

The current regulatory structure does not embody a consistent set of basic regulatory powers for the financial oversight of each GSE. The Treasury and the Department of Education have minimal regulatory authority over Sallie Mae. The Finance Board has broad regulatory powers. The FCA's powers parallel those of bank regulators and are adequate for effective financial oversight of the FCS; however, its powers over Farmer Mac are not sufficient. To avoid any questions concerning its authority, HUD should be provided with a statutory listing of enumerated regulatory powers.

Capital standards. With respect to Fannie Mae and Freddie Mac, the current statutory leverage ratio is inappropriate as an overall measure of capital adequacy. This ratio does not reflect off-balance sheet activity, and it is not linked to the risks undertaken by Fannie Mae and Freddie Mac. Consequently, the statutory capital requirements cannot be used effectively by HUD to cover the risks undertaken.

The FCA has significant discretion in determining the appropriate level of capital and the risk weighting of assets for the FCS. However, at-risk stock is included in capital by statute. Future legislation might again convert at-risk stock to the functional equivalent of debt, as happened in 1987. Also, it is not certain that the FCA has the authority to set appropriate capital standards by regulation for Farmer Mac.

The Finance Board has the ability to set risk-based capital standards, although it has not yet done so. It currently requires a Bank Systemwide maximum debt-to-equity ratio of 12-to-1. The ability of the Finance Board to determine risk-based capital standards for the FHLBanks, however, is constrained somewhat by the statutory stock purchase requirement for advances. The stock purchase requirements are related to most, but not all, on- and off-balance sheet items.

Financial disclosure. All of the GSEs are subject to financial disclosure requirements. Information on GSE activities, financial statements, and risk assessment are reported regularly to regulators.

Books and records and internal controls. FCA and the Finance Board both have the authority to prescribe rules and standards to ensure the adequacy of internal controls and information systems. HUD's existing regulations do not specifically address its authority in this area.

Examination authority. The FCA, the Finance Board, and HUD have statutory authority to examine the books and records of the GSEs they regulate. The FCA examines System institutions and

Farmer Mac at least once each year and uses the bank regulatory CAMEL rating system to rate institutions for capital adequacy, asset quality, management and administration, earnings, and liquidity. The Finance Board recently began its annual examinations of the FHLBanks. These examinations are designed to cover the FHLBanks' credit/collateral positions, funding operations, management, and regulatory compliance.

HUD, in contrast, has yet to conduct an examination of Fannie Mae or Freddie Mac. HUD is in the process of contracting with the private sector to conduct an initial examination and to set up procedures and criteria for future examinations. However, HUD itself may have difficulty conducting quality examinations in the future without the ability to offer the competitive salaries necessary to attract highly qualified examiners.

The Secretary of the Treasury has access to all Sallie Mae books and records and is required by statute to report annually to the President and Congress on the financial condition of Sallie Mae.

Enforcement authority. Enforcement authority varies markedly among the GSE regulators. The FCA has essentially the same enforcement powers that bank regulators have. The Finance Board has many of the important enforcement authorities needed by a financial safety and soundness regulator, but lacks explicit authority for others. HUD believes that its general regulatory authority gives it sufficient enforcement authority over Fannie Mae and Freddie Mac. The Treasury has no enforcement powers regarding Sallie Mae.

<u>Cease and desist orders</u>. The FCA has statutory authority to issue cease and desist orders if it determines that an institution is engaging in an unsafe or unsound practice, or is violating a law, rule or regulation. The FCA has increasingly made use of this authority. The Finance Board, on the other hand, does not have explicit statutory authority to issue cease and desist orders. However, the Finance Board believes that it has implicit authority to do so based on its authority to issue orders necessary to fulfill the provisions of the Federal Home Loan Bank Act. To date, the Finance Board has not issued a cease and desist order.

<u>Other enforcement powers</u>. In addition to cease and desist orders, the FCA's other enforcement powers include the authority to suspend or remove directors and officers and require payment of civil money penalties.

The Finance Board also has the power to suspend or remove directors and officers for cause and limit dividends. However, the Finance Board has not developed a set of guidelines or regulations that would trigger early intervention at predetermined levels of safety and soundness.

Receivership and conservatorship. The FCA has the power to appoint a conservator or receiver for any FCS institution under a set of strict conditions comparable to those of bank regulators. However, it is unclear that FCA has the authority to appoint a conservator or receiver for Farmer Mac. The Finance Board has the power to put a FHLBank into receivership and conservatorship under its powers to liquidate and reorganize the FHLBanks. HUD, however, does not have explicit receivership and conservatorship authority over Fannie Mae and Freddie Mac.

Other regulatory powers.

Prior approval. HUD, the Finance Board, and the FCA (with the exception of the FCA's authority over Farmer Mac) all have prior approval authorities over new activities. All three regulators have used their prior approval authority (HUD only recently) for safety and soundness concerns.

Low-and moderate-income requirements. HUD currently requires 30 percent of Fannie Mae's annual mortgage purchases to be secured by housing for low- and moderate-income families.

Budgets. The Finance Board analyzes and approves FHLBank budgets.

Officers and directors. For each of the 12 FHLBanks, the Finance Board appoints six of the directors and supervises the election of the remainder, for a total of at least 14 directors. The Finance Board designates the chair and vice-chair of each FHLBank's board of directors. The Finance Board approves the compensation of FHLBank presidents and directors. Neither HUD nor the FCA have similar authorities with respect to the officers and directors of the GSEs that they regulate.

Strategic planning. The Finance Board has established a strategic planning directorate, which has as its primary responsibility the strategic planning for the Bank System. HUD and the FCA do not have authorities in this area.

Mergers or liquidations/reorganizations. The Finance Board may liquidate or reorganize a FHLBank whenever it finds such action will aid the efficient and economical accomplishment of the FHLBank Act.

The FCA may require an association to merge with another association if it determines, with the concurrence of the board of the supervising bank, that an association has failed to meet its outstanding obligations or failed to conduct its operations in accordance with the Act.

CONCLUSIONS AND RECOMMENDATIONS

HUD does not have financial safety and soundness as its primary regulatory goal and, therefore, suffers from regulatory conflict. HUD also lacks the appropriate regulatory funding mechanism. To avoid controversy over HUD's regulatory authority, it would be beneficial to make the scope of its regulatory authorities more explicit.

The financial safety and soundness oversight of Sallie Mae is nonexistent. No Federal agency has the safety and soundness authorities necessary for effective financial oversight. The Treasury should be given increased oversight responsibilities, consistent with the safety and soundness authorities of the other regulators.

The Finance Board has the necessary regulatory powers and the stature needed to effectively regulate the financial safety and soundness of the FHLBank System. However, its statute should be modified to make its financial safety and soundness mission its primary regulatory role.

Congress restructured the FCA in 1985 to make it more of a financial safety and soundness regulator. The FCA has as its primary goal the safety and soundness regulation of the FCS, and it has the regulatory powers and stature to be an effective safety and soundness regulator for the FCS. With regard to Farmer Mac, the FCA also has safety and soundness authorities, although it does not have general rule-making authority. The FCA needs to have increased authorities over Farmer Mac.

CHAPTER 5

IMPACT OF GSE OPERATIONS ON FEDERAL BORROWING

FINDINGS

The Treasury's analysis of the impact of GSE operations on Federal borrowing in the 1990 Report using the flow-of-funds framework was updated for this report. This analysis was supplemented with an extensive review of the economic literature related to the impact of GSE operations on Federal borrowing costs. Based on this analytical work, the Treasury's conclusion remains as stated in the 1990 Report:

> One might expect the GSE financing activities to raise the cost of Federal borrowing. Given their close, favored relationship with the U.S. Government, the GSEs generate credit market instruments that for market participants are relatively close substitutes for Treasury securities.
>
> The available statistical evidence does not show that GSE borrowing has had a direct effect on the cost of Federal borrowing. Major macroeconomic trends that cannot be separated from the impact of GSE financing activities offset any potential upward pressures on Federal borrowing costs from GSE activity.[1]

RE-ASSESSING THE IMPACT ON TREASURY BORROWING COST

The statistical evidence for the last decade does not show that GSE borrowing had a direct effect on the cost of Federal borrowing. In fact, Chart 3 shows that GSE financing activities were inversely associated with observed movements in Treasury yields during much of the period, or that net new GSE borrowing rose while Treasury yields fell.

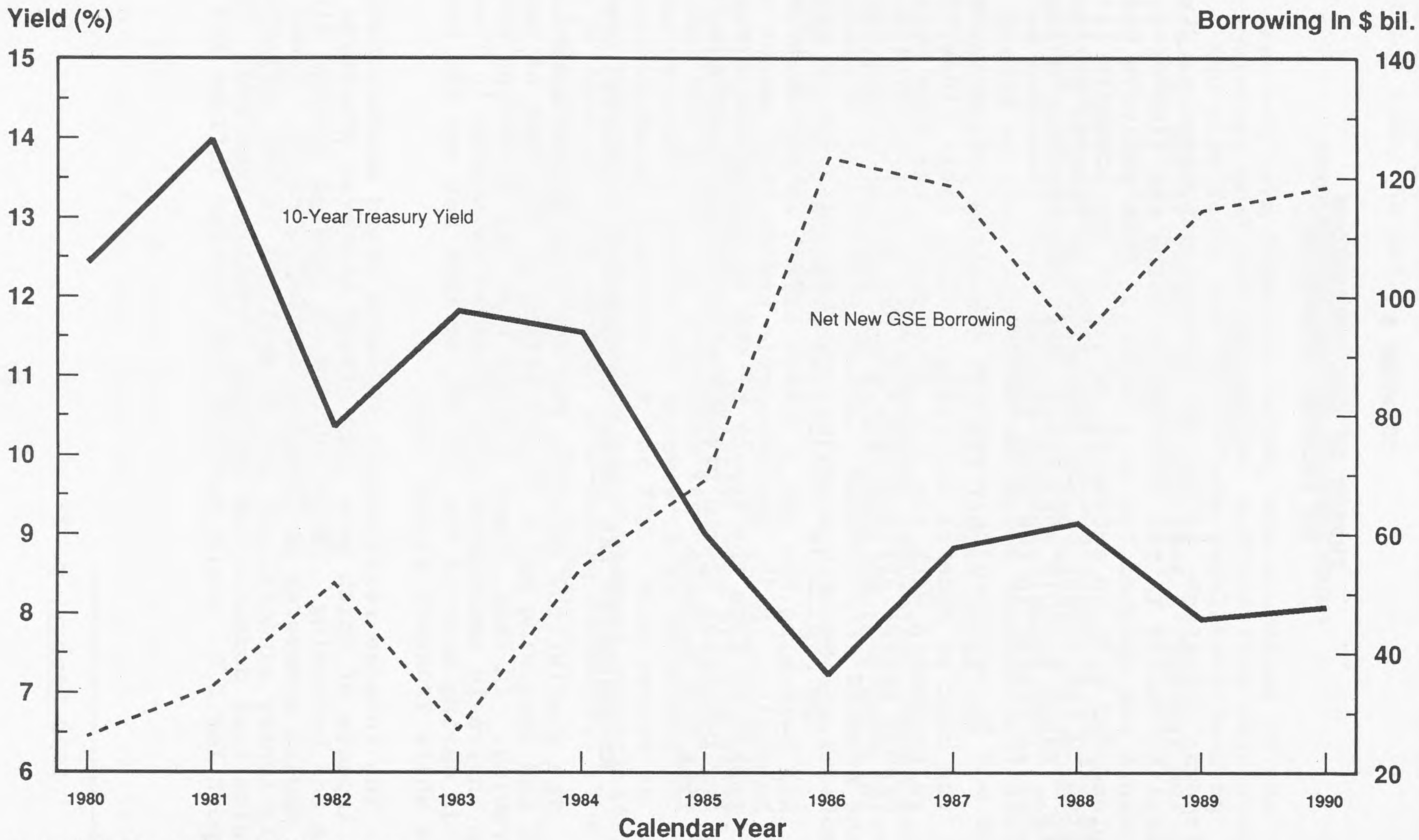
The inverse relationship reflects broad macroeconomic trends the impacts of which more than offset whatever pressures arose from GSE borrowing. Large inflows of foreign savings mitigated any upward pressures on Treasury borrowing rates. Lower inflationary expectations led to declines in the inflation premium that domestic and foreign investors required. The support for U.S. credit markets from foreign inflows and lower

---

[1] 1990 Report, p. 27.

Chart 3

Treasury Yields Versus Net New GSE Borrowing



Source: Yield on Last Trading Day of Year, Treasury
Federal Reserve Board Flow-of-Funds (Adjusted).

inflation led to lower interest rates, including mortgage yields.[2]

In addition, total borrowing declined substantially after peaking in 1986 and helped to obscure whatever pressures GSE borrowing may have exerted on Federal borrowing costs. Also, a large part of the increase in GSE obligations in the 1980s resulted from exchanges (or swaps) of whole mortgages for GSE mortgage-backed securities (see Chart 4). These swaps led to increases in outstanding GSE obligations without increasing the total demand for credit.

Using the results of portfolio models, inferences can be drawn that GSE operations raise Federal borrowing costs, although measures of the cost impacts vary greatly. GSE borrowing converts the illiquid, high-risk debt of GSE-assisted sectors into new highly liquid capital market securities that bear a GSE guarantee against default. Converting private-sector obligations into GSE obligations generates securities that are close substitutes for Treasury securities. From 1980 through 1990, $830.8 billion of these close substitutes for Treasury securities were issued, or 45 percent of the $1,851.0 billion in net new issuance of Treasury debt held by the public (see Table 3 in Chapter 1). From 1986 through 1990, net additions to GSE securities as a percent of net additions to Treasury securities averaged 62.2 percent per year.

One portfolio model that analyzed the substitution between Federal obligations and broad categories of other debt concluded that an increase in the volume of private borrowing can lead to a small increase in Treasury yields, perhaps one basis point or less.[3] The broad categories of financial assets used in this model did not include GSE securities. One could argue, however, that GSE borrowing has a greater impact on Treasury yields because the characteristics of GSE securities result in a higher degree of substitutability between GSE and Treasury securities than between the other debt categories that were used in the study and Treasury securities.

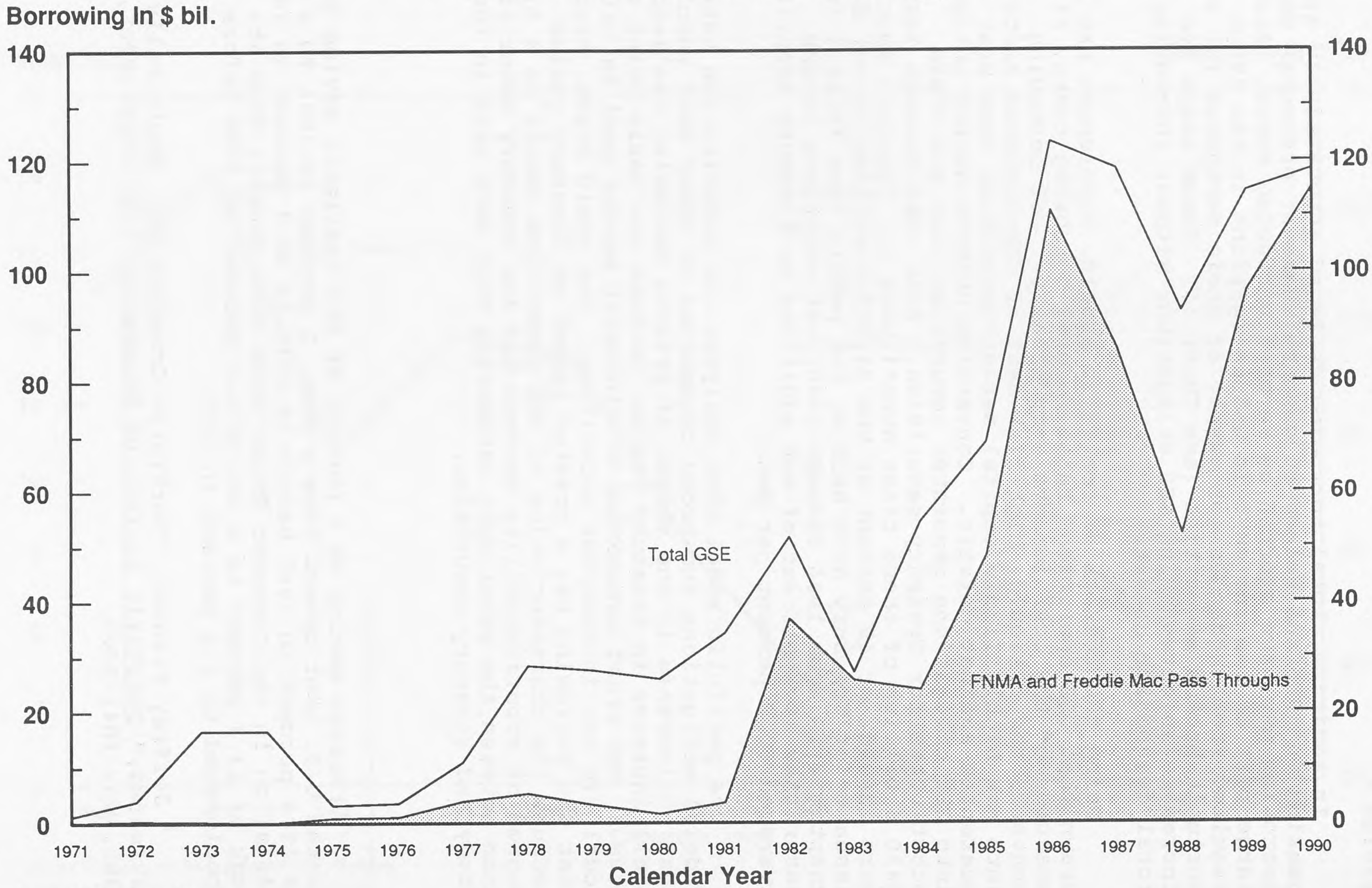
---

[2] Foreign saving as a percent of the available saving pool in the U.S. shot upward from a mere .2 percent in 1982 to a peak of 18.9 percent in 1987 before it fell to 11.1 percent in 1989. Inflation in the Consumer Price Index fell sharply from its 1979 peak of 13.3 percent to a low of 1.1 percent in 1986 before it accelerated to 6.1 percent in 1990.

[3] Jeffrey Frankel, "Portfolio Crowding-Out, Empirically Estimated," Quarterly Journal of Economics, 100, Supplement, 1985, pp. 1041-1065.

Chart 4

Net New GSE Borrowing



Source: GSE Balance Sheets

Another model based on portfolio theory implied that increases in the volume of GSE securities relative to Treasury securities would have a strong impact on the difference between GSE and Treasury yields in the short run, but not in the longer run.[4] The analysis concluded that arbitrage would reduce the impact of relative quantities on the spread between GSE and Treasury yields over time. In the absence of highly segmented markets, any impact of a change in relative quantities on a specific yield spread would eventually be arbitraged across all categories of securities. Over the longer run, prepayment risks, liquidity considerations, and other technical factors are likely to dominate spreads among categories of financial assets.

IMPACT OF GSE OPERATIONS ON OVERALL INTEREST RATES

If GSE borrowing were to increase the total demand for credit, the overall level of interest rates could rise.[5] For example, if GSEs increase the flow of credit into housing, consumer borrowing for goods, such as refrigerators and carpets that are complements of purchases of homes, could increase. Including the impacts of complementary demands, simulations from flow-of-funds models constructed in the early 1970s, before mortgages were securitized on a large scale, show that interest rates rose, perhaps by as much as 10 basis points per $1.0 billion of incremental credit demand in the mortgage markets, in response to higher overall expenditures associated with an increase in GSE borrowing.[6]

The advent of Government National Mortgage Association and GSE mortgage-backed securities in the early 1980s improved the efficiency of mortgage markets and reduced mortgage rates by

---

[4] Barry Bosworth, Andrew Carron, and Elizabeth Rhyne, The Economics of Federal Credit Programs (Washington, D.C.: The Brookings Institution, 1987), Appendix A, p. 203.

[5] A number of econometric studies have attempted to measure the impact of fiscal policy in general on interest rates, but the empirical tests have reached different conclusions and have not resolved the controversy. For a review of some of these studies, see either U.S. Treasury Department, "The Effects of Deficits on Prices of Financial Assets: Theory and Evidence", Treasury Bulletin, March 1984, or The Congressional Budget Office, Deficits and Interest Rates: Theoretical Issues and Empirical Evidence, (Washington, D.C.: The Congressional Budget Office, 1989).

[6] Bosworth, Carron, and Rhyne, op. cit., Appendix A, pp. 184-186.

around 30 basis points.[7] Lower mortgage yields helped to stimulate demands for home purchases and purchases of complementary goods and services. Yet, more recent flow-of-funds models, including the quarterly Federal Reserve model, estimate only small impacts on Treasury yields, in contrast to results of the earlier models.[8]

CONCLUSIONS

The law of supply and demand would suggest that GSE net new demands for credit should raise Treasury borrowing costs. Additionally, GSE borrowing that lowers the relative borrowing costs of subsidized sectors and stimulates increases in complementary credit demand can raise total borrowing and pressure the overall level of interest rates higher. However, as observed in the 1980s, upward pressure on interest rates generated directly or indirectly by GSE operations can be offset by macroeconomic forces, including inflows of foreign savings, declines in inflationary expectations, structural changes, and reductions in the demand for credit from other sectors of the economy. The substitution of GSE securities for Treasury securities can raise Treasury yields relative to GSE yields, but over time the impact of substitution can be arbitraged across all categories of securities.

---

[7] Patric Hendershott and James Shilling, "The Impact of the Agencies on Conventional Fixed-Rate Mortgage Yields," Journal of Real Estate, Finance, and Economics, Vol. 2 (June 1989), pp. 2: 101-115.

[8] "The Effects of Mortgage-Related Securities on Corporate Finance," a study prepared by the Federal Reserve Board of Governors, August 1986, pp. 29-31.

CHAPTER 6

S&P EVALUATION OF THE SAFETY AND SOUNDNESS OF THE GSEs

The Treasury contracted with S&P for an analysis of the financial safety and soundness of the GSEs. S&P has assessed the likelihood that a GSE might not be able to meet its future obligations from its own resources and has expressed that likelihood as a traditional credit rating. These ratings are not intended to supersede the AAA assessments S&P has given the various securities of the GSEs presently trading in the market.

There have been a number of studies that have examined the relationship between credit ratings and actual default experience.[1] Although statistical assumptions and methodologies differ among the studies, they show clearly that credit ratings and actual default experience are strongly inversely related. For example, as Table 1 shows, the 15-year cumulative default rate for corporate bonds that had initially been rated Aaa was 1.7 percent. The rates rise to 6 percent for the low end of investment grade (Baa) and to nearly 30 percent for B-rated firms.

Table 1

15-year Cumulative Default Rates for Corporate Bonds vs. Initial Credit Rating (1970-1989, percent)

Rating	15-yr. Default Rates
Aaa	1.7
Aa	1.9
A	2.4
Baa	6.1
Ba	18.0
B	28.7

Source: "Corporate Bond Default Rates, 1970-1989", Moody's Investor Service, April 1990.

[1] See for example, Edward I. Altman, "Measuring Corporate Bond Mortality and Performance", July 1988, and "Corporate Bond Defaults and Default Rates, 1970-1989", Moody's Investor Service, April 1990.

APPENDIX

FINAL REPORT

CONTRACT NO. TOS-91-4

Evaluation of Safety and Soundness

Farm Credit System
(including the Farm Credit Banks and Banks for Cooperatives)

Federal Home Loan Bank System

Federal Home Loan Mortgage Corporation

Federal National Mortgage Association

Student Loan Marketing Association

April 8, 1991

TABLE OF CONTENTS

INTRODUCTION

The Treasury Department has asked Standard & Poor's (S&P) to provide an assessment of the financial safety and soundness of certain government sponsored enterprises (GSE's). The GSE's to be included are:

Farm Credit System
(including the Farm Credit Banks and Banks for Cooperatives)
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal National Mortgage Association
Student Loan Marketing Association

This report provides an assessment of the financial safety and soundness of these GSE's in the form of a rationale and a risk to the government credit rating for each GSE expressed in traditional letter symbols. The report also summarizes the major factors which lead to each conclusion, including analysis of key balance sheet information. Finally, balance sheet information relevant to the analysis is provided for each GSE.

In making the determination of the degree of risk involved in the operations of each GSE, S&P has incorporated the evaluation of such factors as credit risk, interest rate risk, management and operations risk, and business risk where these factors are relevant to the GSE.

In our analysis S&P assumed that the GSE operates within its authorizing legislation and we assume that there is no infusion of cash from the federal government. Authorizing legislation provides some benefits to the GSE such as attractive cost of funds but also can be constricting in that the GSE can only do business as defined in the legislation and cannot diversify if warranted by economic conditions or other factors. This is S&P's approach to assessing the risk to the government of these GSE's and other entities with implicit federal support.

The assessment of the financial safety and soundness is presented in the form of a rating symbol which is used by S&P. Our rating symbols range from 'AAA' at the highest end to 'D' at the lowest. 'D' is automatically assigned when an issuer defaults on its debt or files for bankruptcy protection. S&P has provided debt ratings publicly since 1923 and uses the following symbols as defined below:

'AAA': Debt rated 'AAA' has the highest rating assigned by S&P. Capacity to pay interest and repay principal is extremely strong.

'AA': Debt rated 'AA' has a very strong capacity to pay interest and repay principal and differs from the highest rated issues only in small degree.

'A': Debt rated 'A' has a strong capacity to pay interest and repay principal although it is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debt in higher rated categories.

'BBB': Debt rated 'BBB' is regarded as having an adequate capacity to pay interest and repay principal. Whereas it normally exhibits adequate protection parameters, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal for debt in this category than in higher rated categories.

'BB': Debt rated 'BB' has less near-term vulnerability to default than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial or economic conditions which could lead to inadequate capacity to meet timely interest and principal payments.

'B': Debt rated 'B' has a greater vulnerability to default but currently has the capacity to meet interest payments and principal repayments. Adverse business, financial or economic conditions will likely impair capacity or willingness to pay interest and repay principal.

'CCC': Debt rated 'CCC' has a currently identifiable vulnerability to default, and is dependent upon favorable business, financial and economic conditions to meet timely payment of interest and repayment of principal. In the event of adverse business, financial or economic conditions, it is not likely to have the capacity to pay interest and repay principal.

'CC': The rating 'CC' is typically applied to debt subordinated to senior debt that is assigned an actual/implied 'CCC-' debt rating.

'C': The rating 'C' is typically applied to debt subordinated to senior debt which is assigned an actual/implied 'CCC-'. The 'C' rating may be used to cover a situation where a bankruptcy petition has been filed, but debt service payments are continued.

'D': Debt rated 'D' is in payment default. The 'D' rating category is used when interest payments or principal payments are not made on the date due even if the applicable grace period has not expired, unless S&P

believes that such payments will be made during such grace period. The 'D' rating also will be used upon the filing of a bankruptcy petition if debt service payments are jeopardized.

Plus (+) or minus (-): The ratings from 'AA' to 'CCC' may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.

An S&P rating expresses our opinion of credit quality in the form of these letter symbols. A credit rating is not a recommendation to purchase, sell or hold a particular security. The rating performs the isolated function of credit risk evaluation. The rating does not mean that S&P has performed an audit, nor does it attest to the authenticity of the information provided by the GSE and upon which the rating may be based. Ratings do not create a fiduciary relationship between S&P and users of the ratings as there is no legal basis for the existence of such a relationship.

Over time, ratings may change as a result of the dynamics of an ongoing business as well as economic and other factors. A rating can be provided on a one-time basis as of a specific date or can be monitored over time. These GSE ratings are being provided on a one-time basis.

The risk to the federal government evaluation as expressed in our traditional rating symbols is comparable to ratings used to assess other issuers. S&P uses the same symbols to express ratings for entities including corporations, municipalities, sovereign governments and financial institutions. While each type of issuer has unique characteristics, the rating symbols as defined above apply to all.

Each GSE evaluation was done by a committee of analysts, including senior members of the Ratings Group. In accomplishing this work S&P used teams of analysts who had expertise in the areas related to the business of each GSE. For example, for housing related GSE's, analytic expertise was utilized from three different rating departments which deal in residential mortgages and lending. Bringing these teams together provided the best input to evaluate these GSE businesses.

These GSE's have been evaluated on a going concern basis, assuming that they are ongoing, operating businesses. A variety of quantitative and qualitative factors were analyzed and considered in the determination of the risk to the government rating. The resulting credit opinion was determined by reviewing all relevant factors - no one factor drives the conclusion. All factors are interactive and weighed within their relevance to the creditworthiness of the particular GSE.

S&P has followed four of the five GSE's since 1983. The Federal Home Loan Banks were added in 1986. While the risk to the investor relies on the implicit support of the federal government and not the underlying financial situation of the GSE, S&P has monitored the underlying credit quality of the GSE's. In 1987, the U.S. Department of Housing and Urban Development asked S&P to provide such an evaluation of the credit quality of the Federal National Mortgage Association.

In 1989 the Senate Banking Committee asked S&P to provide an assessment of the underlying credit quality of certain GSE's. Using public information, S&P provided our assessment of the risk to the government for the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks, the Farm Credit System and the Student Loan Marketing Association. Since that time these evaluations have been widely discussed and reported. The evaluations provided for this report used the same methodology S&P used previously.

FARM CREDIT SYSTEM
(including the Farm Credit Banks and Banks for Cooperatives)
(FCS or System)

Risk to Government Credit Rating: 'BB'

Rationale

The Farm Credit System has undergone significant change in the last few years and continues to undergo change. Many of the factors contributing to its near collapse in the mid-1980's have been improved: the System is consolidating, working towards better enforcement of more uniform underwriting and loan review standards, instituting more sophisticated interest rate risk management procedures, and moving towards instituting quasi-market discipline mechanisms. However, the monoline character of its business, coupled with weak capitalization and earnings power, and continued poor asset quality lead S&P to the below investment grade assessment on the Farm Credit System. Even a moderate farm recession is likely to cause some banks to require assistance, leaving the system as a whole undercapitalized. If the "joint and several" provision proves difficult to enforce or a substantial amount of the capital stock is redeemed at par, the requirement for assistance could be heavier.

Factors Supporting Conclusion.

Market Position

The FCS was created in 1916 to serve as reliable source of agricultural credit, when alternative sources were few. This remains its stated mission though within the prescriptions for making safe and sound loans. It now provides a diminished share of about 25% of agricultural credit, with commercial banks providing 36% and FmHA, insurance companies and pension funds providing the remainder. The ability to borrow at preferential rates helped it gain market share from 1950 to the mid-1980's. Especially during the 1973-1982 period, its policy of pricing loans on the basis of the average cost of funds, rather than the marginal, allowed it to offer loans at below market rates in a rising rate environment, fueling a burst of market share gains. That pricing policy worked in reverse when rates started to fall. Its objective after 1987 has been to price loans at a spread over the marginal cost of funds. With regulatory pressure to build retained earnings, the banks have had an incentive not to under-cut the competition in pricing. Thus, the erosion in market share has not been reversed.

During the period in the mid-1980's when FCS rates were above-market, it was presumably the least creditworthy who did not leave the system. The clientele is, however, far more creditworthy than that of the FmHA.

The FCS has another competitive advantage over the majority of the so called "ag banks" which are small and have limited legal lending limits. The size of its banks allows it to focus on loans to the larger of the small and medium-sized farmers. It has also been a major player in real estate lending, which is riskier than shorter term production loans.

Business Risk

The overriding risk for the FCS is that of being a monoline provider of credit. Notwithstanding the geographic diversity of the system, and the ability to provide the full spectrum of farm related loans, loan quality remains partly dependent on the health of the highly volatile farm economy. Farm incomes and land values are regularly buffeted by factors largely beyond farmers' control, such as weather, commodity prices and farm price support programs.

An additional business risk is the prospect of losing market share to competitors. Because many Farm Credit Banks' (FCB) need to build capital, they cannot capitalize on their cost of funds advantage to maintain share through favorable pricing. In addition, as the trend toward ever-larger farms continues, the FCS's natural market of medium-sized farmers will dwindle. The FCS could find itself at a competitive disadvantage to larger financial institutions able to service large farms. Losing share presents the hazard that the banks will be loathe to cut infrastructure apace, but will compete instead by tiering down to less creditworthy customers.

Structural Risk

One element of risk to the government is that the FCS operates with very little in the way of external or market sources of discipline, although this has been identified as a problem by the System and some progress has been made in evolving towards some form of discipline. The equity holders are likely to remain weak disciplinarians. It is inherent in a cooperatively owned structure that the borrowers could be subject to the conflicting incentives of keeping the borrowing terms favorable for themselves and their friends, and maintaining the safety of their capital. The latter incentive may be overshadowed by the former. In any case, their equity stake is very small, often just the lesser of $1000 or 2% of their loan amount, and is added to the loan principal.

There is also little in the way of market discipline through adjustment of funding costs. True, spreads widened on bonds when the FCS was perceived to be on the brink of failure but this did not address risk taking by individual banks. The FCB's can charge differential rates to the Associations to which they lend funds based upon risk but may be reluctant to do so except in cases of extreme underperformance.

Another risk is that the regulatory and other watchdog bodies have until now proven reluctant to enforce discipline at the very early stages. Many of the tools at hand are really a form of final solution that can lead to the closing of a bank. The Farm Credit Administration (FCA) can issue cease and desist orders and the Funding Corporation can deny funds. While extremely sensitive to making the heavy hand of central control felt, the System is developing towards improving its early disciplinary mechanism.

Interest Rate Risk

Asset/liability management has been vastly improved since the mid-1980's, but some moderate interest rate risk is likely to remain due to structural factors that cannot be managed away.

Foremost is the difficulty of managing prepayment risk. During the mid-1980's a mismatch emerged when a substantial number of borrowers left the System. They prepaid their loans, leaving the banks with a large proportion of high rate non-callable long term debt. In part, fear of losing their capital when the banks were troubled caused many borrowers to flee. The fact that capital stock is now more statutorily "at risk" means that this motivation for prepayment remains to some extent, though the ability to retire capital is contingent on the financial health of the bank. The other major factor that led to prepayments in the past, the availability of lower cost loans elsewhere, is less likely to come into play, however, because of the shift to marginal cost pricing. It should be noted that prepayment data are not available. While a database is being built, the predictive value may be limited by the greater diversity of factors affecting prepayments of farm loans compared to home mortgages.

Another factor affecting the ability to match maturities is the fact that variable rate loans are not tied to any market index, but are set at the discretion of management. The Funding Corporation, acting in an advisory capacity on asset/liability management can assist the banks on the long term advisability of moving rates in lockstep with the market, but has little power to dictate practice. However, there appears to be significant consensus among the banks to move rates with the market.

Asset/liability management is done on a very decentralized basis, compounding the difficulty of obtaining asset/liability reports with any assurance of comparability of data. Modeling capacities vary from institution to institution.

Manageable risk appears to have come down substantially since the mid-1980's, largely due to marginal cost or market pricing, as well as the consultation resource represented by the Funding Corporation and its ability to utilize derivative products and issue at a variety of maturity dates. On a gap analysis, the banks are slightly asset sensitive in the short term and matched longer term. The greatest vulnerability remains prepayment risk, and the will to maintain pricing spreads in a rising rate environment.

Much of the recent widening of the net interest margin has been due to a reduction in the drag from nonperforming assets. If the interest lost on problem loans is added back to interest income, the margin appears to have been remarkably steady for the past five years. In addition, the run-off and repurchases of high cost debt in the open market have helped reduce funding costs. If trends towards marginal cost pricing and reducing funding costs continue, the margin could stabilize between 2.0% and 3.0%. Some of the FCB's have already achieved those levels.

Credit Risk

By its very nature as a monoline provider of finance to a highly cyclical industry, the FCS takes a very high degree of credit risk. In addition, both because of its mandate to be a consistent provider of credit and because it is restricted from other types of lending, the FCS may be less likely to pull back from lending into an agricultural downturn than a more diversified lender would.

Underwriting standards appear to have been much improved since the mid-1980's. While setting underwriting standards remains the responsibility of the individual associations a consensus is being built around some guiding principles. For instance, land loans, which had often been underwritten purely on a collateral value basis through the mid-1980's, must now focus on the borrower's income capacity to meet payments. Loan to value ratios are limited to 85% of value. This is a very liberal limit; however, practice is more conservative. In addition, regulators and management seem to have an understanding that one of the problems in the mid-1980's farm depression was that land prices had outstripped the economic value of the land and that a recurrence of this phenomenon must be prevented.

In general, the recognition of problems in underwriting practices has been beneficial; nevertheless, underwriting standards appear to be uneven bank to bank, with some having more stringent controls and review procedures than others. Once again, the variability results from both variations in management sophistication and willingness to conform to outside pressures, and is inherent in any fragmented, confederate structure.

Another major concern relating to credit risk is concentrations of risk to single borrowers. The Associations other than the Banks for Cooperatives (BC'S) must limit loans to one borrower to 20% of capital, a very lenient standard. The BC's can have even greater concentrations of capital. According to the FCA, most Associations have some loans at their regulatory lending limit. The Farm Credit Administration is in the process of rewriting regulations on this point.

Even assuming good underwriting standards, agricultural lending would be very risky in the sense that there can be a great variability in loss experience over the course of an agricultural cycle. The financial troubles of the farm economy in the 1980's were the worst seen since the Great Depression. During the prior 50 years, cycles had been shallower. The 1980's recession was caused by a sharp fall in crop prices, and a sharp drop in farm exports, coupled with the bursting of a speculative bubble that had sent farm land prices far above its economic value as measured by the present value of any reasonable income assumptions. There can be no assurance, however, that an equally severe recession will not occur again.

To put some dimension on the extent of the problems in the mid-1980's, nonperforming assets (including 90 days past dues) for the FCS peaked at 16% in 1986. Net chargeoffs were about $3.5 billion cumulatively, or about 33% of peak nonperforming assets, and 5% of total loans. In addition, the cumulative income lost from the nonperforming assets since 1985 was about $2.5 billion. It should be noted that the Banks for Cooperatives fared much better and suffered relatively few problems.

On the surface the loss and nonperforming rates for the FCS were more favorable than those turned in by the major commercial bank agricultural lenders. However, while commercial banks' nonperformers have fallen sharply in the last few years, the FCS's have remained extremely high at 9.5%, despite four very good years for the farm economy. Chargeoffs were also lower than at commercial banks even though small commercial banks were granted regulatory forbearance to spread losses over several years.

The continued poor loan quality stems from a pronounced tendency to carry bad loans rather than write them off and/or foreclose. Within the portfolio of nonperforming loans, nonaccrual loans and Other Property Owned or Other Real Estate (ORE) have declined substantially, as many of the loans migrated to restructured loan status. The restructured loan category, which is loans that have been restructured on concessionary terms and are now performing according to those terms, is about 4% of loans, a much higher percentage than that found at commercial banks. A stipulation to restructure loans if that is a less costly option than foreclosure appears to have been interpreted as a requirement to favor the restructuring option. That the FCS also faces greater legal obstacles in foreclosing than do the commercial banks may also serve to encourage restructuring.

	1990	1989	1988	1987	1986
% Nonaccruals/loans	5.13	5.03	6.47	9.97	12.13
% Restructured/loans	3.72	4.67	4.00	2.52	0.62
% Nonaccrual+restructured/loans	8.85	9.70	10.47	12.49	12.75
% Nonperforming assets(NPA)/ Loans + ORE	9.46	10.53	11.61	13.92	14.37
% NPA + 90 days/loans	9.78	11.13	12.60	15.14	16.42
% All high risk loans/loans	13.95	14.77	16.78	21.93	24.05
% Interest lost/nonperforming loans(npl)	3.73	5.41	7.89	11.62	10.03
% Reserve/loans	2.96	3.11	3.61	5.62	6.24
% Reserve/NPA	31.10	29.29	30.71	39.71	42.61
% Reserve/npl	33.47	32.08	34.49	45.02	48.93
% Reserve/high risk total	21.09	20.87	21.26	25.21	25.47
% Net chargeoffs	0.04	-0.01	0.79	0.91	2.06
% Recoveries/chargeoffs	77.42	102.96	36.17	38.92	18.65

The reserve for loan losses is thin relative to potential losses in a severe agricultural recession. Interpretations of Generally Accepted Accounting Principles (GAAP) standards on reserves can vary. In general, reserves must be adequate to cover probable losses inherent in the portfolio. Depending on the economic assumptions built into the case for probable loss levels, reserve requirements can be set at varying levels. S&P believes that current reserve levels, are unlikely to suffice in a period of significant adversity.

Profitability

Most of the strength of profits since 1988 has been generated by reversals of the reserve for loan losses. However, underlying profitability also returned in 1988 and has improved in each year to what are now respectable but modest levels. Assuming a normalized level of provisions of about 0.25% of loans, operating profitability represented a 0.73% return on assets in 1990. This is largely a reflection of a reduced drag from nonperforming assets and expense controls. Overhead expenses have dropped to 54% of revenues in 1990, from 130% in 1987. Even normalizing for the effect of the reduced drag from nonperforming loans (adding back income lost from nonperforming loans), expenses show considerable improvement. Further improvements in profitability can come from widening the net interest margin, which may require a discipline of holding loan pricing above 2.0% over the marginal cost of funds, as well as some additional retirements of high cost debt from the early 1980's. In addition, further consolidations in the System could also yield cost savings.

	1990	1989	1988	1987	1986
% Net Interest Margin (NIM)	2.00	1.67	1.28	0.79	1.07
% NIM + income loss on loans	2.28	2.11	1.97	1.98	2.08
% Expense/revenues	53.81	64.56	81.87	130.53	89.01
% Expense/revenues +inc.loss	47.98	52.46	55.59	57.46	48.94
% Expense/loans	1.47	1.46	1.42	1.43	1.27
% Return on Assets (adjusted)	0.73	0.41	0.05	-0.50	-0.06
% Return on Assets (stated bet. extr. items.)	1.02	1.11	1.42	-0.03	-2.55

Funding

FCB's do not suffer liquidity crises in the way that commercial banks do because the FCS's implicit government support makes it virtually immune from a crisis of confidence. FCB's fail either because they become insolvent in an accounting sense, bringing regulatory intervention, or because they run out of collateral (including loans or securities), which is required to be able to tap System debt.

	1990	1989	1988	1987	1986
% Capital stk.+surp./Debt	6.90	6.01	3.68	2.44	2.33
% Cash+Investments/FCS debt	19.05	20.28	16.37	17.02	18.27
% Cash,Invest.+loans/FCS debt	110.00	110.00	111.00	112.00	111.00

Capital

By any definition of capital, FCS remains thinly capitalized for the riskiness of its business line. The higher cyclicality of agricultural lending compared to many other lines of lending, plus the FCS's tendency to carry the bad loans through rough times indicates the need for even more capital than many other types of monoline lenders. That need is offset by the consideration that given the FCS's agency status in accessing the capital markets, capital is not needed for the maintenance of investor confidence in order to retain access to funds. Capital is therefore more exclusively a loss absorbing reserve. A farm recession of the same severity as the mid-1980's would likely leave the System short of capital by regulatory standards.

It is important to discuss what is included in capital. Protected capital, which was stock purchased by borrowers prior to October 1988 upon which repayments are to be made at par, is clearly not at risk and should be classified among liabilities. Capital stock, which was contributed by borrowers as a condition of borrowing subsequent to October 1988, is statutorily "at risk" but can be retired at par when the borrower repays his loan as long as the institution is adequately capitalized. Thus, S&P considers capital stock a weaker form of capital, and look primarily to the surplus account for a measure of core capital strength. Restricted capital, or the accrued payments into the newly established insurance fund, is also a form of capital but while the insurance fund is intended to be drawn upon before "joint and several" liability is triggered in the potential event of default by an FCB, it is also intended to be used to repay Financial Assistance Corporation (FAC) preferred stock and redeem protected capital should a bank prove unable to do so.

In addition, in evaluating risk to the government, we consider the likelihood of repayment by banks receiving financial assistance from FAC. Of the $4 billion borrowing capacity of FAC, $1.3 billion has been used so far. S&P expects that only moderate use would be made of the remaining $2.7 billion of the FAC facility. Payment on the 15 year FAC bonds is made by the federal government for the first five years, 50% by the government and 50% by the FCS for the second five years and 100% by the FCS for the last five years, with the FCS responsible for the repayment of principal. The insurance fund can be channeled for this purpose. If the insurance fund target does not surpass the original goal of 2% of Systemwide Debt, or about $1.1 billion (up from $438 million now) the fund may not be available to do more than help repay FAC preferred stock over the intermediate term. Of the current $438 million fund, $350 million will be used to repay FAC assisted to the Federal Land Bank of Jackson.

Stronger forms of capital have been increasing in recent years, with protected capital being converted to "at risk" borrowers' capital, and surplus growing to 4.3% from 2.1% in 1986. "At risk" capital stock and surplus have grown to 6.3% of assets. Under the most generous interpretation of capital, including restricted capital, the ratio is 7.0%. Each bank is required to reach 7% permanent capital against risk adjusted assets by 1992. While the System as a whole surpasses that level, certain individual banks may not be in compliance. Loan leverage (capital stock + surplus + reserves/loans) remains very high, however, and the percentage of capital and reserves has not increased significantly since 1985, because most retained earnings have been generated from taking reserves back into income as loan quality improved.

	1990	1989	1988	1987	1986
% Capital stock+surplus + restricted capital/assets	7.24	5.88	3.27	2.16	2.07
% Cap. stk.+surp./assets	6.55	5.33	3.27	2.16	2.07
% Cap. stk.+surp.+reserve/loans	11.09	9.83	7.53	8.19	8.73
% Cap. stk.+surp.+res.-1/3 nonperformers/loans	7.92	6.30	3.61	3.47	3.86
% Surplus/assets	4.31	3.58	2.90	2.16	2.07
% Nonperforming assets/cap. stk.+surp.+ reserve	84.47	98.90	109.98	102.52	97.79
% Cap. stk.+surp./Debt	7.42	6.01	3.68	2.44	2.33

Another farm recession, may lead to losses that would reduce capital below adequate levels and require government assistance. The extent of that assistance will depend not only on the depth of the recession but potentially on the use of the "joint and several liability" provision. Given the apparent independent-mindedness of many of the Associations and banks, and the experience of the mid-1980's there may be resistance if this provision is ever invoked. The FCB's are by no means homogeneous in their financial strength. Therefore, it is not enough to assess the financial strength of the consolidated system. Several of the FCB's are currently very weak (Spokane, Louisville, St. Paul, Omaha, Western), and some operating with assistance from FAC at present. These are likely to experience significant stress in the event of even a moderate farm recession.

The extent to which government assistance may be needed for the FCS will also be interrelated with the level of federal farm support programs during periods of stress. Support programs have been at historically high levels during the last four years, contributing indirectly to the improved health of the FCS.

294-104 O - 91 - 4 QL 3

Farm Credit System (Consolidated)

Balance Sheet

($ in millions)	1990	1989	1988	1987	1986
Assets					
Real estate loans	29,416	30,245	32,182	34,346	NA
Intermediate loans	10,673	10,020	9,256	9,927	NA
Loans to co-ops	11,083	10,442	9,990	8,225	NA
Total loans	51,172	50,707	51,428	52,498	58,249
Reserves	1,516	1,578	1,858	2,951	3,635
Cash	290	273	238	299	437
Investments	10,392	11,236	8,703	9,109	10,976
Total assets	63,515	63,954	61,616	62,238	70,101
Avg. earning assets	61,671	60,316	61,636	64,303	73,259
Avg. assets	63,735	62,785	61,927	66,170	74,967
Liabilities					
Total FCS debt	56,072	56,739	54,621	55,275	62,478
Protected capital	1,241	1,683	3,289	* 3,684	* 4,188
Capital stock	1,422	1,117	227	0	0
Surplus	2,739	2,291	1,785	1,346	1,453
Restricted capital	438	350	0	0	0

**Capital stock prior to October 1988 could automatically be retired at par upon retirement of debt and will be considered protected capital for purposes of this worksheet.*

Farm Credit System (Consolidated)

Income Statement

($ in millions)	**1990**	**1989**	**1988**	**1987**	**1986**
Net interest income	1,235	1,006	787	509	781
Negative provision	41	285	681	196	-1,798
Nonint. inc. (before gains)	157	148	112	97	129
Noninterest expense (oper)	749	745	736	791	805
Nonrecurring income	31	67	79	-12	-233
Net income (stated, before extraordinary item)	647	695	878	-17	-1,913
***Net income (adjusted)**	466	258	33	-333	-46

Net income assuming a positive provision for loan losses of 0.25% of loans in each year and before nonrecurring income.

Farm Credit System (Consolidated)

Loan Quality

($ in millions)	1990	1989	1988	1987	1986
Nonaccrual loans	2,627	2,553	3,329	5,234	7,066
Restructured loan	1,902	2,366	2,058	1,321	363
Other property owned (ORE)	346	468	663	876	1,101
90 days past due	131	259	432	515	1,037
Total npa + 90 day	5,006	5,646	6,482	7,946	9,567
Other high risk	2,182	1,915	2,259	3,758	4,705
Total high risk	7,188	7,561	8,741	11,704	14,272
Chargeoffs	93	169	647	799	1,662
Recoveries	72	174	234	311	310
Net chargeoffs	21	-5	413	488	1,352

Farm Credit Banks

(September 30, 1990)

($ in millions)

	Columbia	St. Paul	Spokane	Baltimore	Springfield	St. Louis	Omaha*	Western	Wichita	Louisville	Texas
Loans	4,033	5,780	2,688	3,051	1,654	3,411	3,605	5,043	3,352	3,567	3,616
Allowance	153	248	87	36	40	117	213	122	163	76	106
Assets	5,366	6,914	3,302	3,666	2,010	4,204	4,237	6,185	4,059	4,045	4,923
FAC pfd. stk.		133	89				107			90	
Capital stock	37	117	25	109	74	20	10	159	54	133	208
Surplus	587	230	-26	336	162	333	199	246	419	283	373
Net income(bef. extr.)	61	66	4.2	14.0	6.2	35.2	48.2	13.1	54.8	61.9	30
Nonaccrual loans	174	432	405	27	18	255	237	600	113	137	169
Restructured	42	906	40	17	2	75	320	109	172	111	9
ORE	16	144	22	9	5	19	25	53	17	4	51
Net chargeoffs	1.6	4.4	2.4	-0.4	0.0	4.0	1.7	3.9	-0.5	-12.3	11.9
Ratios (%)											
Capital stk.+surpl/assets	11.63	5.02	-0.03	12.14	11.23	8.40	4.93	6.55	11.65	10.28	11.80
Allowance/loans	3.79	4.29	3.24	1.18	2.36	3.43	5.91	2.42	4.86	2.13	2.93
Npa's/loans	5.75	25.64	17.41	1.74	1.51	10.23	16.14	15.11	9.01	7.06	6.33
Npa's/cap.+surpl.+res.	29.86	249.08	544.19	11.02	11.47	74.26	137.91	144.59	47.48	51.22	33.33
ROA	1.58	1.27	0.18	0.53	0.41	1.10	1.15	0.27	1.33	2.12	0.79
NIM	3.02	2.09	1.39	2.30	2.66	2.50	2.42	1.60	2.69	3.24	2.24
Net chargeoffs	0.10	0.10	0.12	-0.02	0.00	0.16	0.05	0.10	0.00	-0.47	0.43

* *December 31, 1990*

FEDERAL HOME LOAN BANK SYSTEM
(FHLBanks or System)

Risk to the Government Credit Rating: 'AAA'

Rationale

The assessment of the Federal Home Loan Bank System reflects its strong risk adjusted capitalization, adequate levels of profitability, excellent credit loss experience, and the continuing importance of the role it plays in providing liquidity to residential mortgage lenders. Although the thrift industry, the primary user of the System's services in the past, has been contracting substantially, and is expected to continue to do so, the System still plays a role in serving the surviving portions of the industry. In addition, the liberalization of membership standards enacted by the Financial Institutions Reform and Recovery Act of 1989 (FIRREA) enables the System to attract new members. While profitability measures will likely suffer from reduced demand for advances, and capital levels have been restricted by heavy contributions in support of the thrift resolution process, the System as a whole should remain strong. Asset risk is minimal, given that advances to members are secured and collateralization standards are conservative. Even should pressures stemming from the desirability of increasing dividends to maintain current membership and attract new members lead to increased asset leverage, capitalization measures should remain appropriate for the rating category, given management's continuing commitment to strong capitalization.

Factors Supporting Conclusion.

Business/Market Position

The Federal Home Loan Bank System raises funds on a consolidated basis for its twelve member banks, which funds are then advanced to members (primarily thrifts) of the twelve banks. Given the radical contraction in the size of the thrift industry (the industry currently has about $1 trillion in assets, down from $1.4 trillion at its peak, and deposits of $850 billion, down from $1 trillion), the System's business position has been under pressure. At year-end 1990 advances outstanding dropped 17% to $117 billion from $142 billion a year earlier, reflecting the loss of membership from thrift failures and reduced financing needs for the thrift industry as a whole.

While Savings Association Insurance Fund (SAIF) insured thrifts must still belong to their local Federal Home Loan Bank, state chartered Bank Insurance Fund (BIF) insured thrifts have the option to belong or not. There was concern that voluntary members might leave the system after enactment of the Financial Institutions Reform and Recovery Act in August 1989, but few have chosen to do so to date. FIRREA took virtually all retained earnings (about $3 billion, including Financing Corporation (FICO) contributions) from the FHLBanks to support the thrift resolution process, mandated ongoing contributions (about $300 million a year) to support the process, and mandated funding for affordable housing (initially $50 million a year), all of which have led to reduced profitability and consequently lower dividends at the 12 banks, making membership less attractive.

FIRREA also opened up membership to commercial banks and credit unions, and about 116 new members have joined, with Norwest bank (assets of $12 billion) being the largest, and another 72 applications in process. Given the requirement that members contribute capital to the FHLBank to which they belong, as well as concern about the possibility of future contributions to support deposit insurance from the twelve banks, it does not appear likely that there will be a rush of larger commercial banks into the system. As a result, the FHLBank system is likely to remain primarily associated with the thrift industry, with its fortunes tied to that industry. As a result, further shrinkage in FHLBank advances is highly likely, at least for the immediate future. While this scenario could have adverse consequences upon System earnings, it would not jeopardize the System's capacity to make full and timely payment of consolidated obligations.

Management

The Federal Home Loan Bank System falls under the oversight of the Federal Housing Finance Board (FHFB), which was created by FIRREA. The recently created Board has assembled a staff in Washington and will focus upon the broad issues that will determine the future effectiveness of the System. Although the Board has the authority to influence to some degree the operating policies of the individual FHLBanks, there is no reason to believe that this influence would deter the FHLBanks from operating in the conservative manner that has long characterized their performance.

While the Board has broad oversight responsibilities for the System as a whole, it does not manage the individual banks within the System. S&P has met in recent years with the managements of most of the twelve individual banks. They are professional bankers who run their individual banks on conservative principles, within the mandate of the system as a whole to facilitate home finance. They are sharply sensitive to risk management issues as these relate to both credit and interest rate risk, and all, to varying degrees, are sensitive to the need to "market" their banks' services to present and potential members.

Asset Quality

The quality of the System's assets has historically been excellent, with no bank ever having had a credit loss. The banks are secured lenders to their members, and all establish their own lending policies within guidelines established by the FHFB. Although these policies vary slightly among the banks, requiring varying degrees of overcollateralization to secure advances, all are conservative. A provision of FIRREA, which restricts the type of collateral a bank may accept to secure advances, has served to further standardize lending practices among the banks. There is some exposure to the FSLIC Resolution Fund, since a few banks have taken FSLIC notes and yield maintenance agreements as collateral for advances. These notes, issued by FSLIC prior to 1989 primarily as part of the southwest plan, have become obligations of the Resolution Fund, which ultimately has recourse to the Treasury to meet its obligations. The FHLBank of Dallas has some $5 billion of this exposure, but S&P feels comfortable with the credit of the Resolution Fund because of its access to the Treasury.

In addition to the advances, the banks have investment portfolios, heavily invested in fed funds, repos and mortgage backed securities (MBSs). The fed funds are mostly overnight, with some maturities out to three months. Credit exposure is monitored and managed by the banks. Repos are secured and overcollateralized. Collateralized mortgage obligations (CMOs) held for investment are rated and are short tranches. In summary, the credit risks on the balance sheets of the twelve banks are limited. Barring a collapse in the value of mortgages, which constitute most of the collateral securing advances, credit losses in any material degree are not expected or likely.

Profitability

The System as a whole and each of the constituent banks have historically been good earners, reflecting their attractive funding as GSE's, their very low expense ratios, and their non-tax paying status. In effect, the banks have substantial control over their level of profitability, since even at a mark up to their own cost of funds they could still offer attractive financing to their members. The contribution of a significant proportion of their capital as a result of FIRREA and the ongoing contributions that they must make will impede profitability in the future, and has already begun to do so in 1990, when ROA fell to

.83% from 1.00% the year earlier. Nonetheless, even should profitability drop further, on a risk adjusted basis it would likely remain consistent with the rating.

Funding/Interest Rate Risk Management

The banks are principally funded by the proceeds from the consolidated obligations, supplemented with deposits placed by their members. Managements are keenly aware of interest rate risk, and the banks are closely matched in their assets and liabilities, substantially limiting exposure to changes in rates. They are protected against prepayment risk by borrower penalties that protect the banks for at least 90% of their exposure from prepayments. Given "agency status" for the consolidated securities, as well as very strong stand alone fundamentals, funding is a strength of the System as a whole and of the twelve member banks.

Capital

Even after contribution of some $3 billion for support of the thrift resolution process, the System as a whole and each FHLBank remains well capitalized, especially given their secured lending practices. Average equity/assets fell to 7.45% in 1990 from 8.36% a year earlier, reflecting the heavy thrift resolution process contributions, but these are now completed. Further contributions will come from ongoing earnings. In the face of the drop in both earnings and capital, many of the individual banks have switched to stock from cash dividends. Although the banks do not have any regulatory capital standards to which they must adhere, a regulation under which they operate mandates a 12:1 consolidated debt to equity ratio. Even should this regulation be changed to allow somewhat greater dividending and consequently higher leverage, it would be unlikely that the banks individually or the System as whole would fall below capital standards consistent with the rating, given management's sensitivity to the desirability of a strong capital position.

Although S&P's analysis has focused upon a consolidated view of the System as a whole, it is important to add that the twelve Federal Home Loan Banks each individually exhibit strong credit quality. Although the banks are independently managed and influenced by different economic conditions in their respective markets, their financial profiles are similar. They all have a history of very strong asset quality (no credit losses), good profitability (with a range of ROAs of 0.59% to 1.03% in 1990), and strong capital levels (which ranged from 5.67% to 9.54% at 1990 year-end).

Federal Home Loan Banks (Combined)

Balance Sheet
($ in millions)

Period End:	1990	1989	1988	1987	1986
Assets					
Advances	117,100	141,807	152,799	133,058	108,645
Cash and investment	45,389	35,196	18,530	18,132	20,054
Other assets	3,197	3,793	3,534	2,987	2,980
Total assets	165,686	180,796	174,863	154,177	131,679
Liabilities					
Deposits	31,114	25,913	19,050	20,355	26,952
Other borrowings	1,471	80	383	639	417
Consolidated oblig.	118,519	136,798	136,513	116,383	89,590
Other liabilities	2,957	3,800	3,397	3,055	2,912
Total liabilities	154,061	166,591	159,343	140,432	119,871
Equity	11,625	14,205	15,520	13,745	11,808
Tot. liabilities & equity	165,686	180,796	174,863	154,177	131,679

Federal Home Loan Banks (Combined)

Income Statement

($ in millions)

	1990	1989	1988	1987	1986
Interest income	14,414	17,026	13,514	11,279	10,630
Interest expense	12,899	14,951	11,899	9,979	9,525
Net interest income	1,515	2,075	1,615	1,300	1,105
Provision for loan losses	0	0	0	0	0
Other operating income	277	303	294	442	742
Other expense	371	599	458	403	370
Pretax income	1,421	1,779	1,451	1,339	1,477
Tax expense	0	0	0	0	0
Income before extraordinary	1,421	1,779	1,451	1,339	1,477
Extraordinary items	47	4	3	-11	-15
Net income	1,468	1,783	1,454	1,328	1,462

Federal Home Loan Banks (Combined)

Ratio Analysis

	1990	1989	1988	1987	1986
Profitability/Efficiency					
Net income ($ in millions)	1,468.00	1,783.00	1,451.00	1,328.00	1,462.00
Change in NI from previous year (%)	-17.67	22.63	9.49	-9.17	35.00
Return on assets (%)	0.85	1.00	0.88	0.93	1.20
Return on equity (%)	11.37	12.00	9.94	10.39	13.34
Non-int income/non-int exp. (%)	74.66	50.58	64.19	109.68	200.54
Overhead/adjusted oper. inc. (%)	20.70	25.19	23.99	23.13	20.03
Non-int exp/avg assets (%)	0.21	0.34	0.28	0.28	0.30
Effective tax rate (%)	0.00	0.00	0.00	0.00	0.00
Asset Quality					
Net chargeoffs/advances (%)	0.00	0.00	0.00	0.00	0.00
Non-performers/advances	0.00	0.00	0.00	0.00	0.00
Liquidity					
Advances/assets (%)	70.68	78.43	87.38	86.30	83.25
Capital					
Avg. equity/avg. advances (%)	9.98	10.06	10.24	10.53	10.99
Avg. equity/avg. assets (%)	7.45	8.36	8.89	8.94	8.99
Avg Asset Growth (%)	-2.58	8.09	15.11	17.28	117.51
Avg Advance Growth (%)	-12.12	3.06	17.79	21.68	122.05
Avg Equity Growth (%)	-13.10	1.57	14.53	16.61	116.85

Federal Home Loan Mortgage Corporation
(Freddie Mac)

Risk to Government Credit Rating: 'A+'

Rationale

The assessment reflects the company's consistent financial results, sound management and operating strategies, and solid capitalization relative to the risk profile of its total mortgage portfolio. Freddie Mac's financial and operating strategies are prudent as they focus on proactive credit risk management and containment of interest rate risk. Credit and interest rate revenue sources tend to complement each other and the resulting dynamic reduces earnings volatility under many volume and interest rate scenarios. Operations are vulnerable to declining national or regional housing values. A major risk to Freddie Mac is a sustained economic disruption with a resulting decline in housing values. Resources available to Freddie Mac to pay worst case losses include existing capital as well as the values in its off balance sheet guarantee business. Going forward, S&P anticipates that Freddie Mac will continue to build capital both in an absolute sense and relative to the growth of the portfolio.

<u>Factors Supporting Conclusion</u>:

Management and Corporate Strategy

S&P's opinion with regard to Freddie Mac's management and overall policies, planning and control functions is quite positive. For the most part, long tenure is the case for many senior managers. Department heads are generally knowledgeable, open, and well informed.

S&P's generally favorable assessment of the company's planning and risk management functions is qualified primarily to the extent that the company's multi-family program was not well managed prior to 1989. Management has subsequently dealt with problems promptly and openly and has established policies and organizational structures to attempt to avoid a recurrence of the problem.

Credit Risk

The cornerstones of Freddie Mac's financial and operating strategies have been the proactive management of credit risk and the ongoing confinement of interest rate risk. Freddie Mac's consistent historical outperformance of other residential mortgage lenders and residential

294-104 O - 91 - 5 QL 3

real estate financial guarantors in the areas of delinquency and default related losses seems primarily to be a function of a corporate-wide commitment to credit quality. S&P believes that this is evidenced by, among other things, Freddie Mac's willingness to suffer periodic credit policy related market share deterioration.

Credit policy is set at the highest management levels for all components of the risk management function. These include: underwriting guidelines, credit risk sharing, quality control, seller/servicer management, and geographic diversity. This commitment to credit risk management has not, over the long term, materially constrained growth or impaired the company's overall public purpose mission.

Interest Rate Risk

Over 95% of Freddie Mac's servicing portfolio of about $338.2 billion (12/31/90) was financed with pass through securities, resulting in an off balance sheet sale and a shifting of interest rate risk to the participation certificate investor. The company's on balance sheet mortgage portfolio ($16.8 billion net of match funded multi class securities as of 12/31/90), and associated interest rate risk exposure is viewed by Freddie Mac as something of an undesirable but manageable cost of doing business. It allows Freddie Mac to achieve scale and improve liquidity for new securities. As a benchmark, Freddie Mac's retained portfolio is capped at 5% of the total servicing portfolio. Management is committed to maintaining this relationship. It believes that a larger exposure relative to the sold portfolio would expose the firm to unnecessary risk and potentially severe losses, were interest rates to move by several hundred basis points. To better manage its interest rate risk, and measure its run-off or liquidation value, Freddie Mac calculates its market value net worth on a quarterly basis and subsequently stresses this calculation against a range of interest rate movements.

As part of the Treasury Department study of certain GSE's, Freddie Mac's model as of December 31, 1989 indicated that a 300 basis point increase in rates would reduce present value net worth to $4.5 billion. Correspondingly, a 300 basis point decrease would lower present value net worth to $3.5 billion. On this date market value net worth was $4.5 billion while book value was $1.9 billion. This moderate sensitivity principally benefits from the present value of the company's servicing "guarantor fee" component and the fact that its value is negatively correlated with the retained portfolio.

However, as with any modeling or valuation exercise, underlying assumptions play an important role. For example, Freddie Mac assumes that existing reserves represent a reasonable proxy for future losses. Nevertheless, based on its review of key model variables, S&P believes that Freddie Mac is about as insulated from shifting interest rates as it can be, given the nature of its business.

Business Review

Freddie Mac's only competition in the conforming conventional market is the Federal National Mortgage Association (Fannie Mae). Outstanding "insured" debt for this duopoly was in excess of $690 billion at the end of 1990, about 25% of total outstanding residential debt. The residential mortgage debt growth rate was about 10% form most of the 1980s. S&P's expectations for growth going forward is not unlike the current consensus of industry analyst opinion. Near term, lender and finance company capital adequacy constraints in combination with heightened investor credit quality concerns should contribute to continued Fannie Mae and Freddie Mac volume growth. Longer term, changing demographics could reduce demand for housing, potentially resulting in a lower volume and slower property appreciation in relation to historical trends.

Market share ($ in billions)

Year	FNMA Purchases	FHLMC Purchases
1985	$45.2	$44.0
1986	91.4	103.5
1987	83.8	76.8
1988	78.0	44.1
1989	92.3	78.6
1990	120.7	75.5

Given the incremental risks associated with a monoline insurance product, concentrations and development of insurance writing activity by state, Metropolitan Statistical Area (MSA), loan to value ratio, various product types and loan features were reviewed. Concentrations or positions in higher class risk categories ultimately result in more stringent loss assumptions as it pertains to S&P's capital adequacy assessment. For example, given the limited development history associated with the various adjustable rate mortgage products, especially payment shock concerns in a prolonged rising rate environment, ARM foreclosures in S&P's depression model are assumed to take place at a rate of 1.5 times that of fixed rate foreclosures, all other variables held equal.

As of December 31, 1990, Freddie Mac had off balance sheet contingent credit loss liabilities of about $316.3 billion plus mortgage assets totaling $21.8 billion. These were distributed by loan type as follows:

Single family fixed	$287.5
Single family ARM	38.4
Multi-family and other	12.3
	$338.2

Characteristic	Fixed*	ARM*	Multi-Family*
95 LTV	5.2%	8.5%	0.5%
80-90 LTV	14.5	22.3	7.7
<80 LTV	80.3	69.2	91.8
Current avg LTV	54.0	73.0	n.a.
Buydown	2.4%	0.4%	n.a.
2-4 units	4.8	4.5	n.a.
Non Owner	3.5	2.4	n.a.
Condos	5.9	11.3	n.a.

*expressed as a percentage within the sub-category.

When viewed in aggregate and compared to other residential lenders and financial guarantors, Freddie Mac has had an advantage in the area of historical credit risk management. Freddie Mac partially credits its thrift versus mortgage banker mix dominance as a positive contributing factor, since thrift strategy was primarily to swap and hold its participation certificates. As this mix changes, additional risk may be introduced. Because Freddie Mac is aware of this, S&P does not anticipate any material change in loss experience going forward.

By Freddie Mac's own admission, multi-family underwriting was woefully inadequate. In particular, Freddie Mac was not selective of its customers and borrowers and it was not adequately servicing its loans. While accounting for only about 3% of the total portfolio, it becomes more significant when viewed in terms of operating leverage at 4:1. Delinquencies (90 days or more) have risen to 0.56% for the fourth quarter of 1990 from 0.19% in 1986. Correspondingly, foreclosures in progress have increased from 0.55% in 1986 to 2.09% as of December, 1990. However, as previously mentioned, Freddie Mac has taken what appear to be reasonable steps and is aggressively addressing the problems.

The adjustable rate mortgage (ARM) sub-portfolio is second to the multi-family sub-portfolio in terms of incremental risk. ARM's comprise about 11.4% of Freddie Mac's total servicing portfolio. Current ARM loss development is moderate at a three month delinquency rate of 0.31% and foreclosures in process of 0.44% at the end of the fourth quarter of 1990. Nevertheless, concerns about this product's limited development history and potential payment shock related foreclosures relative to fixed rate loans remain.

A sometimes overlooked but extremely beneficial relationship from a credit loss perspective is Freddie Mac's relationship with the mortgage insurance industry. A comparison between Freddie Mac and the Mortgage Insurance Companies of America (MICA) of defaulted fixed rate 95% LTV business written in selected years demonstrates this point.

Ever to Date Defaults Processed by Year of Origination
Fixed Rate 95% LTV's

Year of Origination	FHLMC	MICA*
1981	13.1%	15.5%
1982	14.0	18.8
1983	8.6	12.8
1984	5.5	9.0

*Includes 95% LTV ARMS.

The interesting implication here is that Freddie Mac's underwriting as it pertains to this category of loans originated in 1981 and 1982 appears to have been only slightly better than the mortgage insurance industry's underwriting efforts. However, Freddie Mac's earnings greatly benefitted from its first loss mortgage insurance protection. Compared with Freddie Mac's exceptional earnings track record, the mortgage insurance industry in 1987 alone had underwriting losses (losses incurred less premiums earned) totaling almost $1 billion dollars.

Operations are vulnerable to declining national or large regional housing values. A major risk to Freddie Mac is a sustained economic disruption with a resulting decline in housing values. In addition, revenue is primarily a function of a monoline product line - residential mortgages. This constraint limits product and revenue stream diversification and can curb opportunities for reallocation of resources.

Finally, Freddie Mac is mandated to provide liquidity for low and moderate income housing with a reasonable economic return. Freddie

Mac's underwriting guidelines today are prudent and mitigate concern for taking on "risky" low and moderate income housing loans but Congressional sentiment and Freddie Mac's activity should be monitored going forward. Monitoring is made easier through Freddie Mac's organizational structure which designates an office specifically for affordable housing initiatives.

Operating Performance

In terms of most measures of growth, earnings and profitability, Freddie Mac has historically been a consistent performer in the finance and the financial service sectors. Notwithstanding its cost of funds and other GSE operating advantages, it has never had an unprofitable quarter in its history. Freddie Mac can access the capital markets in good times and bad, at favorable terms, because of its GSE status. In addition, the quality of earnings is strong as a generally conservative accounting approach is taken. Most importantly from an interest rate risk and capital adequacy standpoint, net interest margin and overall earnings are relatively less volatile as the dynamics of float, premium, and portfolio revenue tend to complement one another. Going forward, S&P's expectation is for continued consistent financial service sector operating performance.

Revenue ($ in millions)	1985	1986	1987	1988	1989	12/90
Int. and discount	1,349	1,336	1,114	1,442	2,016	2,053
Int. on investments	254	357	627	833	1,169	1,258
Mgt. and gty income	188	301	472	465	572	654
Total int. expense	1,291	1,394	1,422	1,783	2,668	2,692
Net int. margin	500	600	791	957	1,089	1,273
Other income	22	72	14	(5)	34	31
Provision for mtg loss	79	120	175	204	278	474
Administrative exp	81	110	150	194	217	243
Net income before tax	362	442	480	554	628	587

Operating revenue can be generally classified into three areas: management and guarantor fees, retained portfolio interest income, and float income. About 52% of total revenue in 1989 was guarantor fee related. This relationship was virtually unchanged through 1990 at 51%. Explosive growth for this revenue category was fueled by corresponding residential debt securitization growth. While sharp declines in interest rates will, from time to time, result in refinancing growth and reduction of the existing fee base, corresponding new guarantees should include many of those same canceled policies. S&P's expectation with regard to this scenario is for a minimal net impact.

1990 guarantor fee income grew by 14.3% on the strength of corresponding growth in the company's outstanding insurance guaranty (off balance sheet servicing portfolio) base. While there are reports from time to time of market share driven fee concessions, conversations with seller/servicers suggest that this is not a near term concern.

About 32% of 1990 total revenue, net of interest expense is float income. Freddie Mac benefits from about a thirty day float period between the time it receives principal and interest remittances from the respective servicers to the time that payments to investors are due. Going forward, market acceptance of the Gold P.C. will have the effect of reducing float income. Without consideration for volume gains, S&P's expectation is that this revenue loss will be offset by increased guarantor fee pricing.

Total interest income, net of interest expense, relating to the retained portfolio accounts for about 17% of total revenue. As previously mentioned, changes in interest income and float income due to interest rate movements tend to offset each other and result in lower net interest margin volatility. For example, revenue through 1989 was split 53% management fee, 32% float and 15% investment portfolio. As a result of a subsequent 100 basis point decline in short term rates, second quarter 1990 revenue was distributed as follows: management fee 53%, float 30% and investment portfolio 17%.

Freddie Mac's loan loss reserves are established for all loans serviced based upon general mortgage product type (single family fixed rate, ARM's, and multi-family) with higher reserve rates for the higher risk ARM's and multi-family. Annual reserve provisions are made for each year that the loan remains in the portfolio. Reserves as a percentage of total credit loss exposure for Freddie Mac have increased from about 0.15% in 1987 to about 0.19% at December 31, 1990. Also during this period, reserve provisions have comfortably exceeded losses actually incurred.

Capitalization

Over the past ten years, total assets have increased more than seven fold from $5.4 billion at year-end 1980 to $40.6 billion at December 31, 1990. Balance sheet growth has been funded primarily with debt. Over this period, the equity to total asset ratio has fluctuated between 4.0%

in 1980 and 5.5% at December 31,1990. The inclusion of $316.4 billion of guaranty related contingent liabilities results in an on and off balance sheet operating leverage ratio of about 167:1.

Recently, this ratio has been used by analysts attempting to draw comparisons with the failed thrift industry. While this relationship is a convenient starting point in a capital adequacy assessment, it is overly simplistic as it ignores several key capital adequacy determinants: underwriting quality, credit risk profile, and capital generation capabilities. Ultimately, capital is adequate or insufficient only within the context of the unique risks of a business.

S&P believes that, in borrowing from S&P's structured finance and private mortgage insurance criteria and the private mortgage insurance capital adequacy model, resources available to pay losses include not only capital and reserves, but also anticipated premium and investment income appropriately discounted for "depression" related expectations. In effect, the capital generation and recourse availability aspect of S&P's existing methodology is not unlike certain components of Freddie Mac's present value capital calculation. In addition to giving credit for resources to meet guarantee obligations which go beyond capital and reserves, about 18% of the total servicing portfolio is insured by the private mortgage insurance industry. Because a majority of these financial guarantors have claims paying ability ratings at or above 'AA', credit can be given for this most of this "ceded" insurance risk.

While overall exposure in the multi-family program is small compared to the total portfolio, ($10.7 billion in the fourth quarter of 1990) it is quite sizable relative to the capital base. Freddie Mac has, however, made appropriate response to the problem. It has reallocated key human and other resources to this area. In December 1989, as both delinquencies and losses trended upward, Freddie Mac altered its underwriting guidelines to lower LTV's to 70% and increase debt service coverage. In October 1990, Freddie Mac closed down new purchases of multi-family in its Cash Program. Virtually all losses were in the Cash Program.

For internal capital adequacy management purposes, Freddie Mac uses a mark to market (current property value) approach. The more conservative approach used by S&P and most capital market participants in estimating expected foreclosure frequency and loss severity relies on original loan to value ratios. This approach gives a lesser degree of property appreciation "credit" for loan seasoning. Based on the original LTV approach, Freddie Mac is able to withstand most loss scenarios. Therefore, S&P believes Freddie Mac to be in a strong capital position. S&P's expectation is that the company will continue to build capital going forward.

Federal Home Loan Mortgage Corp.

Balance Sheet
($ in millions)

	1990	1989	1988	1987	1986
Assets					
Cash and investments	6,808	5,397	5,525	4,670	3,612
Reverse repurchase agreements	9,063	5,765	9,107	5,859	4,495
Mortgages, net	21,395	21,329	16,815	12,258	13,012
Accounts receivable and other	2,199	1,772	1,509	1,325	144
Real estate owned	417	271	224	175	130
Unamortized mtge sales disc., etc	697	928	1,172	1,387	1,836
Total assets	40,579	35,462	34,352	25,674	23,229
Liabilities					
Due to PC investors	6,427	6,670	5,011	4,192	5,958
Total debt securities	28,375	24,102	24,846	17,461	13,378
Reserve for losses on sold mtges	495	347	289	238	197
Subordinated debt	2,566	2,045	2,036	2,086	1,997
Other liabilities	580	382	586	515	746
Total liabilities	38,443	33,546	32,768	24,492	22,276
Total shareholders' equity	2,136	1,916	1,584	1,182	953
Tot. liabilities & s'holders' equity	40,579	35,462	34,352	25,674	23,229

Federal Home Loan Mortgage Corp.

Income Statement
($ in millions)

	1990	1989	1988	1987	1986
Interest income	3,311	3,185	2,402	1,821	1,709
Interest expense	2,692	2,668	1,910	1,422	1,394
Net interest income	619	517	492	399	315
Other income					
Loan fees and service charges	654	572	465	392	292
Gain (loss) on sale of loans	-3	0	-2	13	31
Other	34	34	-3	1	38
Total other income	685	606	460	406	361
Other Expense					
General and administrative	243	217	194	150	114
Provision for loan and REO losses	474	278	204	175	120
Total other expense	717	495	398	325	234
Income bef taxes & extra items	587	628	554	480	442
Income taxes	173	191	173	179	195
Net income	414	437	381	301	247

Federal Home Loan Mortgage Corp.

Ratio Analysis

	1990	1989	1988	1987	1986
Profitability					
Net income ($ in millions)	414.00	437.00	381.00	301.00	247.00
Return on assets (%)	1.09	1.25	1.27	1.23	1.24
Return on equity (%)	20.43	24.97	27.55	28.21	28.52
G & A/Total Assets (%)	0.60	0.61	0.56	0.58	0.49
G & A/Total Revenues (%)	6.08	5.72	6.78	6.74	5.51
Effective tax rate (%)	29.47	30.41	31.23	37.29	44.12
Asset Quality					
Charge-offs/Avg Loans + PC (%)	0.10	0.08	0.06	0.06	0.03
Liquidity & Asset/Liability Mix					
Avg. total loans/Avg. total assets (%)	57.48	55.30	48.43	51.67	67.27
Total loans/total assets (%)	52.72	60.15	48.95	47.74	56.02
Capitalization					
Avg. equity/avg. loans (%)	9.27	9.05	9.51	8.44	6.47
Avg. equity/avg. assets (%)	5.33	5.01	4.61	4.36	4.35
Equity/total loans (%)	9.98	8.98	9.42	9.64	7.32
Equity/total assets (%)	5.26	5.40	4.61	4.60	4.10
Equity + res./tot. assets + PC (%)	0.77	0.78	0.76	0.63	0.62
Equity/total assets + PC (%)	0.60	0.62	0.61	0.49	0.48
Asset growth (%)	14.43	3.23	33.80	10.53	40.04
Equity growth (%)	11.48	20.96	34.01	24.03	22.34
Dividend payout ratio	23.43	27.23	21.78	23.92	29.55
Internal growth rate of capital (%)	15.65	18.17	21.55	21.46	20.09

FEDERAL NATIONAL MORTGAGE ASSOCIATION
(Fannie Mae)

Risk to the Government Credit Rating: 'A-'

Rationale

The assessment of the Federal National Mortgage Association reflects its strong market position, the improvement that it has made in managing interest rate risk, and the overall high quality of its assets, both on and off the balance sheet. These strengths are partially offset by concerns about the company's thin capital base and the narrowly margined nature of its two principal businesses. Since Fannie Mae maintains a sizable portfolio of primarily fixed rate mortgages on its balance sheet, which it funds with capital markets borrowings, results can be adversely affected by sustained moves in interest rates. While Fannie Mae maintains capital to protect against this risk, as well as credit risk in both the on and off balance sheet portfolios, the current levels of protection are, in S&P's view, consistent with the assigned rating. Moreover, Fannie Mae has not been immune to the historical earnings cyclicality that has characterized other entities involved in the mortgage business, and already thin margins earned on both its guaranty business and its portfolio of held mortgages could be pressured given adverse economic scenarios.

<u>Factors Supporting Conclusion</u>.

Market Position

Fannie Mae benefits from a strong market position in both of its principal businesses. That is, as a guarantor of conventional mortgages and as a portfolio holder of mortgages. Its only competition in the conventional market is the Federal Home Loan Mortgage Corporation. Outstanding guarantees for this duopoly were in excess of $620 billion at the end of 1989, about 25% of total outstanding residential debt of $2.5 trillion. The residential mortgage growth rate was about 10% a year for most of the 1980s. S&P's expectations for growth in the future mirror that of the consensus of industry opinion. Near term, capital adequacy constraints in the thrift and bank industries in combination with heightened credit quality concerns should contribute to continued Fannie Mae and Freddie Mac volume growth. Longer term, changing demographics could reduce demand for housing, possibly resulting in a lower volume of sales activity and slower property appreciation.

As market share data on loan purchases shows, Fannie Mae has outpaced Freddie Mac in recent years. This is all the more striking in that Fannie Mae only entered the guaranty business in 1981. In part, the gains represent Fannie Mae's being the first to guaranty adjustable rate mortgages (ARMs), as well as the flexibility that maintaining a portfolio on balance sheet provides, but they also suggest that Fannie Mae has been more aggressive than Freddie Mac in recent years in courting business.

Market share ($ in billions)

Year	**FNMA purchases**	**FHLMC purchases**
1985	$ 45.2	$ 44.0
1986	91.4	103.5
1987	83.8	76.8
1988	78.0	44.1
1989	92.3	78.6
1990	120.7	75.5

In its portfolio business, Fannie Mae benefits from its good access to funds at attractive rates. It does not have to compete as a depository for funds, but can raise what it needs from the capital markets, which are national and international in scope.

While Fannie Mae has historically specialized in guaranteeing single family and, to a much lesser degree, multifamily mortgages, new product initiatives, like its proposed purchase program for construction loans, bear monitoring in the future. While any new product initiatives are likely to remain limited in scope, they could have the potential to increase Fannie Mae's risk profile.

Management

Fannie Mae has had a recent change in leadership. David Maxwell, who had served as Chairman since 1981, resigned and James Johnson, who had served as Vice Chairman since early 1990, became Chairman in February 1991. The new Chairman has publicly stated that he will continue the policies and direction established by Mr. Maxwell. Fannie Mae can generally be characterized by stability in senior management. This has provided for continuity and consistency in pursuing strategic directions.

Asset Quality

Fannie Mae's primary balance sheet risk is in its mortgage portfolio, as the following shows:

	12/31/90 ($133,113)	12/31/89 ($124,315)	12/31/85 ($99,076)
Mortgage portfolio	85.5%	86.7%	95.4%
Investments	7.4%	6.7%	-
Cash	3.1%	2.8%	-
Int. receivable	0.8%	0.9%	-
Rec. currency swap	1.8%	1.4%	-
OREO	0.3%	0.4%	-
Other	1.1%	1.1%	4.6%

In addition to the balance sheet, MBS outstanding at 1990 year-end were $300 million, up from $228 million a year earlier and $55 billion at 1985 year-end.

The composition of the mortgage portfolio (not including off-balance MBS) was as follows:

	1990	1989	1985
Single family			
FHA/VA	10.0%	11.0%	28.0%
Fixed (30 yr)	62.0%	60.0%	46.0%
ARMs	18.0%	20.0%	17.0%
Seconds	1.0%	1.0%	3.0%
Multi-family			
FHA/VA	4.0%	4.0%	5.0%
Fixed (30 yr)	5.0%	4.0%	1.0%
ARMs	0.0%	0.0%	0.0%

Within the portfolio, certain trends are apparent. There has been a move away from single family FHA/VA mortgages; an increase in multi-family mortgages; and a slight move away from seconds; in all, a moderate pick-up in credit risk.

MBS Off-balance Sheet:

	1990 ($299,833)	1989 ($228,232)	1985 ($54,987)
Single Family			
Fixed (30 yr)	70.0%	68.0%	80.0%
Intermediate	13.0%	11.0%	6.0%
ARMs	14.0%	17.0%	12.0%
Multi-family			
Fixed	0.1%	1.0%	1.0%
ARMs	2.0%	3.0%	1.0%

The guarantee business remains overwhelmingly single family; there is a smaller proportion in 30 year fixed rate loans, with a greater proportion in ARMs and intermediate.

MBS breakdown by risk:

	Non-recourse	Recourse
1985	30%	70%
1989	59%	41%
1990	67%	33%

As apparent in the table above, Fannie Mae has taken on more credit risk, with the trend strongly towards non-recourse transactions. In recourse transactions Fannie Mae can turn to the seller of the mortgages to cover losses, but if the seller does not perform, Fannie Mae must; in non-recourse transactions Fannie Mae alone must cover losses. This trend towards non-recourse transactions is likely to continue, since for capital management purposes banks and thrifts want to rid themselves of recourse on mortgages that they sell.

Although Fannie Mae has not shared detailed portfolio and MBS characteristics with S&P, a substantial amount of information on these characteristics is public and has been factored into the analysis.

As of year-end 1990, 90% of both conventional single family mortgages in portfolio and MBS outstanding were in loans purchased since January 1, 1986, that is, when Fannie's new underwriting standards became operational. The revised guidelines, according to Fannie Mae, led to lower loan to value (LTV) on many purchased loans.

At year-end 1990, 77% of conventional single family loans in portfolio and backing MBS had original LTV of 80% or below, and 34% had LTV of 70% or below.

The mortgage portfolio and MBS are well diversified by region and by states within regions, but California alone accounted for 25% of the total. In general, Fannie Mae's portfolio and MBS have tended to reflect those markets that have experienced heightened mortgage origination activity, exposing itself to risk should these markets experience deterioration. This regional exposure, however, has been manageable within the context of its overall geographic diversification.

Fannie Mae's credit history has been good in the second half of the 1980's. Charge-offs to average portfolio loans plus MBS ran at 12 to 13 basis points in the mid-1980s, and have been on a declining trend since: down to 6 basis points in 1990. These numbers include multi-family experience. While current market conditions in several regional markets suggest that credit experience could be under some pressure in coming years, in S&P's view it is unlikely that potential deterioration would be substantial.

Reported delinquency (loans 90+ days past due, in relief, and in foreclosure) rates have also been good. Fannie Mae reports delinquency by number of loans, not outstanding balances, and only on Fannie Mae at risk (non-recourse) loans. The delinquency rate at 1990 year-end was .58% of total loans (1.02% of in portfolio loans and 0.33% in MBS), down from 0.69% a year earlier (1.11% in portfolio and 0.36% in MBS) and 1.48% at 1985 year-end.

Acquired property and foreclosure claims at 1990 year-end were 0.3% of the balance sheet, down from 0.4% a year earlier.

Based upon the available data, it is possible to conclude that Fannie Mae's credit history has been very strong over the past few years compared to that of most financial institutions, but a little weaker than that of several high quality thrifts operating in strong markets, which have historically had only a few basis points in charge-offs. Fannie Mae's good record reflects the preponderance of low LTV single family residential mortgages which it guarantees and are in its portfolio; the generally low loss recorded for single family mortgages throughout the country in recent decades; its tightened underwriting standards, which reflect the trend towards tightening of mortgage underwriting nationally in recent years; and the geographically diversified nature of its exposure.

Profitability

Fannie Mae has accomplished a strongly improving trend in profitability. Return on balance sheet assets was 0.91% in 1990, after consistently rising since the 1 basis point loss of 1984. Reflecting the narrow margined nature of both the portfolio and guarantee businesses, however, adjusted for MBS outstanding, ROA in 1990 was 0.31%, up from .026% in 1989. While profitability has been driven by fees generated in the guaranty business, portfolio profitability has also improved, as measured by the net interest margin: this was 1.39% in 1990, up from 1.16% in 1989 and 0.15% in 1985. General and administrative expense as a percent of revenues has been rising, but is still very modest at 2.25% in 1990, up from 2.20% in 1989 and 1.68% in 1986. The provision for losses has been a drain on income, but a modest one. Reflecting the competition with Freddie Mac, fees on MBS have been under pressure despite strong demand for the guarantees provided by both companies. Should demand weaken, pricing could be pressured further. While the strong improvement in profitability is a positive development, the relatively low adjusted profitability earned by Fannie Mae is a risk factor, since adverse developments that affect pricing, loss experience, or funding could have a severe effect upon already thin earnings power.

While the portfolio business generates both funding and interest rate risk, it does provide a valuable source of income for Fannie Mae, as well as providing some diversification. Should the guarantee business falter, Fannie Mae could still generate earnings from its portfolio.

Liquidity/Funding

As a GSE Fannie Mae has good access to capital markets for both long and short term funds, and this is a considerable strength. Fannie Mae has gone to great pains in recent years to correct the interest rate mismatch that caused it difficulty in the early 1980s. Management focuses upon the balance sheet's duration gap, which was down to 3 months at December 31, 1990, a vast improvement from the 36 months at 1980 year-end. Mortgage assets, as measured by Fannie Mae, have been shortened to an average life of 41 months from 62 months. While this reflects the greater proportion of ARMs and intermediate term loans in the portfolio, it also involves assumptions on prepayments. In addition, average life of liabilities has gone to 38 months from 26, reflecting efforts to issue more longer term debt.

Looking at the one year maturity gap, again as presented by Fannie Mae, there is much improvement. The gap moved from a negative 2% to a positive 4% from the end of 1985 through the end of 1989. It was a negative 16% at 1984 year-end.

In managing interest rate risk, Fannie Mae has issued more callable debt in recent years, lengthened the maturities of overall debt, and also uses hedging. While Fannie Mae has definitely made progress in managing its interest rate risk, it still could be adversely affected by changes in interest rates, especially if there is a sustained rise in rates to much higher levels. Despite good efforts to manage interest rate risk, Fannie Mae has about three quarters of its mortgage portfolio in long term fixed rate mortgages, which are funded relatively short. This embedded interest rate risk must be reflected in appropriate capitalization, along with credit risk.

Capitalization

Risk adjusted capitalization has been improving at Fannie Mae, and management has said that equity and reserves would total at least $6 billion by 1991 year-end. Balance sheet leverage has improved to 2.96% equity/assets at 1990 year-end, from 2.41% a year earlier and 1.02% at 1985 year-end. Significantly, and despite the very rapid growth in the guaranty business, leverage measures including the off balance sheet guarantees have also improved. Equity plus reserves/total assets plus MBS reached 1.06% at 1990 year-end, up from 1.01% a year earlier and 0.74% at 1986 year-end. Since capital must protect against credit,interest rate and other business risks, further progress in risk adjusted capitalization would have to be made for consideration to be given to a higher rating.

Federal National Mortgage Association

Balance Sheet
($ in millions)

	1990	1989	1988	1987	1986
Assets					
Cash and equivalents	4,178	8,338	2,672	2,142	1,630
Investments & other securities	9,868	3,532	5,476	3,783	232
Mortgage portfolio, net	113,875	107,756	99,867	93,470	93,949
Interest receivable	1,032	1,064	939	811	904
Receivable from currency swap	2,376	1,796	1,717	1,573	1,054
Acquired property	370	448	418	416	414
Other assets	1,414	1,381	1,169	1,264	1,438
Total assets	133,113	124,315	112,258	103,459	99,621
Liabilities					
Escrow deposits	346	346	353	352	340
Total debt	123,403	116,064	105,459	97,057	93,563
Other borrowings incl fed funds & rev repo	0	0	0	0	0
Accrued interest payable	2,418	2,424	2,173	2,145	2,305
Deferred income taxes	90	153	157	298	278
Payable from currency swap	1,755	1,355	1,150	958	779
Other liabilities	1,160	982	706	838	1,174
Total liabilities	129,172	121,324	109,998	101,648	98,439
Total shareholders' equity	3,941	2,991	2,260	1,811	1,182
Tot. liabilities & s'holders' equity	133,113	124,315	112,258	103,459	99,621

Federal National Mortgage Association

Income Statement

($ in millions)

	1990	1989	1988	1987	1986
Interest income	12,069	11,080	10,226	9,843	10,107
Interest expense	10,476	9,889	9,389	8,953	9,723
Net interest income	1,593	1,191	837	890	384
Other income					
Loan fees and service charges	536	408	328	263	175
Gain (loss) on sale of loans	7	9	12	-81	31
Other	107	60	69	53	83
Total other income	650	477	409	235	289
Other Expense					
Administrative	286	254	218	197	175
Provision for losses	310	310	365	360	306
Total other expense	596	564	583	557	481
Income bef taxes & extra items	1,647	1,104	663	568	192
Income taxes	474	297	156	192	87
Net income	1,173	807	507	376	105

Federal National Mortgage Association

Ratio Analysis

	1990	1989	1988	1987	1986
Profitability					
Net income ($ in millions)	1,173.00	807.00	507.00	376.00	105.00
Return on assets (%)	0.91	0.68	0.47	0.37	0.11
Return on equity (%)	33.87	30.73	24.90	25.12	9.58
G & A/Total Assets (%)	0.21	0.20	0.19	0.19	0.18
G & A/Total Revenues (%)	2.25	2.20	2.05	1.95	1.68
Net int. income/non-int. expense (%)	556.99	468.90	383.94	451.78	219.43
Net margin (%)	1.39	1.16	0.89	1.00	0.40
Effective tax rate (%)	29.00	27.00	24.00	34.00	45.00
Asset Quality					
Charge-offs/Avg Loans + MBS (%)	0.06	0.08	0.12	0.13	0.12
Liquidity & Asset/Liability Mix					
Avg. total loans/Avg. total assets (%)	86.09	87.76	89.63	92.29	94.84
Total loans/total assets (%)	85.55	86.68	88.96	90.34	94.31
Capitalization					
Avg. equity/avg. loans (%)	3.13	2.53	2.11	1.60	1.16
Avg. equity/avg. assets (%)	2.69	2.22	1.89	1.47	1.10
Equity/total loans (%)	3.46	2.78	2.26	1.94	1.26
Equity/total assets (%)	2.96	2.41	2.01	1.75	1.19
Equity + res./tot. assets + MBS (%)	1.06	1.01	0.94	0.90	0.74
Equity/total assets + MBS (%)	0.94	0.88	0.80	0.76	0.61
Asset growth (%)	7.08	10.74	8.50	3.85	0.55
Equity growth (%)	31.76	32.35	24.79	53.21	17.15
Dividend payout ratio	14.74	12.76	11.24	7.71	14.29
Internal growth rate of capital (%)	28.88	26.81	22.10	23.18	7.30

STUDENT LOAN MARKETING ASSOCIATION
(Sallie Mae)

Risk to the Government Credit Rating: 'AAA'

Rationale

The assessment of Sallie Mae reflects its consistently good operating performance, the high quality of its asset base, and its strong risk adjusted capitalization. Sallie Mae has managed well the servicing risks attendant upon guaranteed student loans, which, along with advances secured by such loans, comprise the preponderant part of the company's balance sheet. While student loans themselves do not have a good credit history, the insured nature of the loans either held or taken as collateral substantially protect the holder from risk. Moreover, capital is maintained at levels to protect against a variety of risks, including the remote risk of guarantor failure. Leverage has increased in recent years, reflecting an active stock buyback program, but Sallie Mae remains appropriately capitalized on a risk adjusted basis. Although pricing pressures on guaranteed student loans have contributed to a narrowing of margins, Sallie Mae has continued to achieve strong profitability, reflecting both its low operating expense and attractive cost of funds.

Factors Supporting Conclusion.

Market Position

Sallie Mae specializes in the purchase and holding of government guaranteed student loans, and also provides warehouse financing on a secured basis for financial institutions and others (state agencies and non-profit loan originators) that are active originators of government guaranteed student loans. Sallie Mae also maintains a sizable portfolio of short term investments for liquidity purposes and makes a limited number of loans to educational institutions for facilities construction and invests in student loan revenue and facilities bonds. Sallie Mae is not itself a student loan guarantor, but a provider of liquidity to the guaranteed student loan market. It has also capitalized the College Construction Loan Association (Connie Lee) with $53 million and has a commitment to provide another $25 million under certain conditions. Connie Lee, which is 75% owned by Sallie Mae, is a loan guarantor. It is rated 'AAA' by S&P on a stand alone basis.

The student loan business has been a growth area in recent years, with guaranteed loans going from outstandings of $23 billion in 1982 to some $53 billion at September 30, 1990. At the latter date, Sallie Mae held about 31% of outstandings, by far the largest market share. Growth in loans outstanding should continue to be healthy in future years, given the continuing strong interest in education among the American people and rising tuition expense. The guaranteed student loan programs, however, may come under tighter restrictions, reflecting governmental concern about the credit experience and overall cost to the government of these loans, which has worsened in recent years. In 1990, the program cost the government $4.4 billion, of which about $2.5 billion was gross default and claim costs, and the remainder subsidy expense. The brunt of any restrictions, however, would likely deal with trade school related loans, since this is where the bad credit experience has been centered, leaving financing for college and graduate school, which account for the bulk of the loans, unaffected. The growing unattractiveness of holding and servicing student loans by private financial institutions, a function of some widely publicized problems, could be to Sallie Mae's benefit in the longer term, facilitating its growth in market share.

The proportion of loans held by Sallie Mae that are serviced in house has been rising significantly, and is now well over 50%. It maintains seven servicing centers and on a visit to one of the largest S&P found that it was technologically advanced. The company has a well organized and defined growth strategy as far as training, capacity and workflow are concerned. While there could be risk attendant upon the start up and rapid growth of newer centers, Sallie Mae's extensive experience in servicing student loans should enable it to manage this potential risk. Sallie Mae also uses outside services, and monitors their performance to mitigate risk.

Management

Last year the first CEO, Edward Fox, resigned, as did the General Counsel. Last July, Sallie Mae's Board appointed Lawrence Hough as President and Chief Executive Officer and Timothy Greene as General Counsel. Both Mr. Hough and Mr. Greene had experience at Sallie Mae prior to their current positions. At the same time, the Board appointed Albert Lord as Executive Vice President and Chief Operating Officer, a newly created position. Mr. Lord had previously served as the Chief Financial Officer. Even with these changes, management at Sallie Mae has followed consistent policies in recent years.

More attention has been given to credit policy, as evidenced by the creation of a high level credit function. In late 1989, Sallie Mae appointed William Wingate as Senior Vice President for Credit Analysis. Mr. Wingate's responsibilities are primarily directed at evaluating and monitoring counterparty risk, an important function in maintaining high quality, low risk asset exposure.

Asset Dispersion/Quality

Asset growth at Sallie Mae has been brisk in recent years: total assets of $41.1 billion as of December 31, 1990 were up 16% from 1989 year end and up 44% from 1988 year end. The composition of assets was as follows:

	1990	1989	1988
Insured loans	46.8%	45.1%	46.1%
Warehouse advances	23.2%	24.2%	27.9%
Cash & investments	27.3%	27.7%	22.9%
Other	2.7%	3.0%	3.1%

In terms of trends in asset dispersion, the single most noteworthy point is the growth in the investment portfolio as a proportion of the balance sheet and a corresponding decline in warehouse advances as a proportion.

The investment portfolio is maintained for liquidity reasons, and also generates income. Since Sallie Mae funds on a low cost basis as a GSE, it is able to make a spread between its cost of funds and the yield on this investment portfolio. This is a high grade, short term portfolio, comprised heavily of fed funds (69% of the portfolio at 1990 year-end), and supplemented primarily with Treasury securities, money market preferred stock (high grade issues), and student loan revenue and facilities bonds.

Sallie Mae's portfolio of insured student loans represents the largest part of its business. These loans are purchased from primary originators (banks, thrifts, state agencies, non-profit originators) and virtually all are ultimately insured by the U.S. Government. Insurance coverage aside, student loans do not have a very good credit history. The national default rate in 1990 was 6.8% (claims paid during the year to loans in repayment), and the cumulative national rate (total defaults since inception of the program to loans that have entered repayment) was 14.1% on a gross basis and 9.6% on a net basis (net takes into consideration recoveries). The insured nature of these loans provides considerable comfort to the holder or to a warehouse lender that has taken these loans as collateral, but there could be problems related to claims payments. Claims may be rejected if the holder has not followed proper procedures; for example, if it has not made adequate effort at collection. This underscores the importance of good servicing, which we believe Sallie Mae has; it has never had a significant problem with its claims.

Another area of risk to the holder of a guaranteed student loan stems from the system of reinsurance. Loans have a primary guarantor, usually a state agency or not for profit organization, which guarantor is in turn reinsured by the U.S. government. The loan holder makes claim to the primary guarantor, who pays the holder and seeks reimbursement from the government for losses. A guarantor is reimbursed 100% for claims it pays. However, if the loss experience of a guarantor exceeds certain levels, the government could limit reimbursement to 80%-90% of the loss amount. Primary guarantors maintain their own reserves, but limited reimbursement could jeopardize the ability of the primary guarantor to meet its obligations to the holder of the loan.

Warehouse loans made by Sallie Mae are secured credits, with protection provided by over collateralization levels geared to the type of collateral. The majority of collateral is GSLs, which are viewed as low risk. While Sallie Mae has a broad creditor base and monitors the credit of its borrowers, the collateral is an important element of protection, since many originators of student loans, especially thrifts, are not good unsecured credits.

Overall, student loan asset risk at Sallie Mae is limited, but advances and investments can pose additional risk. Moreover, the complexities involved in originating and servicing student loans underscore that holding them is not riskless, given the claims procedures risks and the reinsurance system, both of which expose the holder to potential loss. While Sallie Mae has mitigated servicing risk, it is exposed to some degree to reinsurance risk.

Profitability

Sallie Mae has and continues to be a strong earner. ROA has trended downwards from 0.94% in 1985 to 0.78% in 1990, in part reflecting the growth in the investment portfolio and the narrower returns on this line of business and in part tighter pricing on student loans. Reflecting increased leverage, ROE has actually increased to 28% in 1990 from 20% in 1985. Sallie Mae benefits from its funding as a GSE, as well as from its market position as a titan within the guaranteed student loan business. While Sallie Mae's margins are narrow, and have been declining, it benefits from an extraordinary low expense ratio. Overhead to operating income at 16% compares favorably to that of other financial institutions. The stability of Sallie Mae's ratio reflects the wholesale nature of its operations and also suggests good cost controls. Net income also benefits from the historical absence of any provision for loan losses, reflecting the minuscule credit losses sustained by Sallie Mae over the years.

Funding and Asset Liability Management

Sallie Mae's funds are raised in the public debt markets. As a government sponsored enterprise with significant links to the Treasury, Sallie Mae is perceived by the markets as an "agency" and benefits accordingly. Sallie Mae issues both long and short term debt, with a current breakdown between the two of 62% long term (maturities greater than one year) and 38% short term. The relative proportion of short term has risen in recent years, reflecting the growth in the investment portfolio, which tends to be short term in nature, mitigating any concern about the shift. The high proportion of long term debt mitigates liquidity risk.

Sallie Mae carefully manages its interest rate risk position and its reported gap position shows minimal exposure to interest rate risk. Student loans, while fixed to the borrower, are floating rate assets to Sallie Mae since the government pays a spread over T-bills to the holder of the loan. Its warehouse advances are either floating rate or matched funded to term, and its investment portfolio is also predominantly short term. Long term liabilities carry floating rates or fixed rates that are either matched to fixed rate assets or swapped into floating rates. Sallie Mae carefully monitors its swap exposure and counterparty risk.

Capital

Measured in terms of asset leverage or loan leverage, leverage has risen substantially in recent years. Average equity to loans has gone from 5.69% in 1985 to 4.11% in 1990 and average equity to assets has gone from 4.77% in 1985 to 2.83% in 1990. Although strong earnings, combined with a modest (20%) payout ratio, have led to good earnings retention, capital has been pressured by an aggressive policy of stock repurchasing. Given the rating category, in S&P's view, Sallie Mae is not overcapitalized and continued leverage could have negative implications. Nonetheless, capital is currently appropriate to the asset and business risks of Sallie Mae at the 'AAA' level.

Student Loan Marketing Association

Balance Sheet
($ in millions)

Period End:	1990	1989	1988	1987	1986
Assets					
Cash and investments	11,251	9,840	6,567	3,836	3,122
Insured student loans, net	19,242	16,029	13,202	10,043	8,175
Warehousing advances	9,528	8,601	7,989	8,357	6,527
Other assets	1,102	1,018	869	627	408
Total assets	41,123	35,488	28,627	22,863	18,232
Liabilities					
Short-term debt	14,801	14,965	9,820	6,571	4,517
Long-term debt	24,243	18,623	17,164	14,871	12,624
Other liabilities	987	862	844	737	436
Total liabilities	40,031	34,450	27,828	22,179	17,577
Equity	1,093	1,037	800	684	655
Tot. liabilities & equity	41,124	35,487	28,628	22,863	18,232

Student Loan Marketing Association

Income Statement

($ in millions)

	1990	1989	1988	1987	1986
Interest income	3,503	3,169	2,172	1,582	1,300
Interest expense	3,024	2,751	1,799	1,269	1,036
Net interest income	479	418	373	313	264
Other Expense	79	70	62	50	42
Pretax income	400	348	311	263	222
Tax expense	99	90	85	81	78
Net income	301	258	226	182	145

Student Loan Marketing Association

Ratio Analysis

	1990	1989	1988	1987	1986
Profitability					
Net income ($ in millions)	301.00	258.00	226.00	182.00	145.00
Change in NI from prev. year (%)	16.67	14.16	24.18	25.52	17.21
Return on assets (%)	0.78	0.79	0.80	0.88	0.80
Return on equity (%)	27.42	30.47	30.18	27.26	21.53
Net interest margin (%)	1.44	1.49	1.63	1.77	1.82
Overhead/adj. operating income (%)	16.49	16.75	16.62	15.97	15.91
Non-int exp/avg assets (%)	0.21	0.21	0.24	0.24	0.26
Effective tax rate (%)	24.75	25.86	27.33	30.80	35.14
Dividend payout (%)	22.59	18.60	14.60	14.84	15.86
Asset Quality					
Net charge-offs/loans (%)	0.00	0.00	0.00	0.00	0.00
Non-performing loans/loans (%)	0.00	0.00	0.00	0.00	0.00
Liquidity					
Loans/assets (%)	64.93	62.16	67.93	71.74	74.22
Temp. investments/assets (%)	27.36	27.73	22.94	16.78	17.12
Capital					
Avg. equity/loans (%)	4.11	3.83	3.84	4.05	4.96
Avg. equity/assets (%)	2.83	2.59	2.91	3.23	4.09
Avg. asset growth (%)	17.07	27.56	24.74	25.20	25.55
Avg. loan growth (%)	21.03	13.45	18.55	21.22	23.34
Avg. equity growth (%)	25.89	13.40	12.35	-1.04	7.53

U.S. GOVERNMENT PRINTING OFFICE : 1991 O - 294-104 QL 3

PUBLIC DEBT NEWS
Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
May 3, 1991

Contact: Peter Hollenbach
(202) 376-4302

BUREAU OF THE PUBLIC DEBT AIDS SAVINGS BONDS OWNERS AFFECTED BY KANSAS TORNADOS

The Bureau of the Public Debt took action to assist victims of the tornados that hit the Wichita, Kansas area by expediting the replacement or payment of United States Savings Bonds for owners in the affected area. The emergency procedures are effective immediately for paying agents and owners in Butler and Sedgwick counties and will remain in effect through May 31, 1991.

Public Debt's action waives the normal six-month minimum holding period for Series EE savings bonds presented to authorized paying agents for redemption by residents of the affected area. Most financial institutions serve as paying agents for savings bonds.

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. Bonds owners should include as much information as possible about the lost bonds on the form. This information should include inscriptions (including Social Security Numbers), approximate dates of issue, bond denominations and serial numbers if available. The completed form must be certified by a notary public or an officer of a financial institution. Completed forms should be forwarded to Public Debt's Savings Bonds Operations Office in Parkersburg, West Virginia.

The Bureau of the Public Debt is the Treasury agency charged with financing and accounting for the nation's public debt. Among its responsibilities is the administration of the U.S. Savings Bonds program.

oOo

PA-53

TREASURY NEWS

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

TEXT AS PREPARED
FOR RELEASE UPON DELIVERY
EXPECTED AT 11 A.M.

Remarks by
Secretary of the Treasury
Nicholas F. Brady
before the
Council of the Americas
Washington, D.C.
May 6, 1991

The Enterprise for the Americas Initiative: Realizing the Vision of Enhanced Growth and Prosperity

I can think of no more appropriate group to address on the Enterprise for the Americas Initiative. Those of you here today are acutely aware of the importance of the common cultural heritage shared by the nations in this hemisphere. All of us have been profoundly moved by the strong commitment to democratic values and market-based economic reforms demonstrated by the many new leaders of Latin America and the Caribbean. Moreover, each of us -- and the private sector organizations and governments we represent throughout the hemisphere -- have an important role to play in realizing the vision set forth by President Bush last June.

The Initiative sets us on a path toward a future in which:

- o markets are increasingly open;
- o private investors, both at home and abroad, provide new resources to help build stronger economies;
- o external debt burdens are reduced to manageable levels;
- o citizens throughout the hemisphere benefit from enhanced growth and prosperity;
- o resources are dedicated to support the preservation of the environment; and
- o democratic systems and values are reaffirmed and strengthened.

NB-1257

Such a future depends on establishing policies which foster efficient and robust market activity and active participation of all citizens in the economy. Sound macroeconomic policies, liberalized trade and investment regimes, and eased debt burdens are all critical to building the potential for sustained growth.

The major industrial countries have a special responsibility to pursue a dynamic strategy which fosters an open growing world economy. Such an approach is needed to encourage those countries pursuing reform and to contribute to the supportive economic environment to enable these efforts to succeed. At our recent meeting, the G-7 ministers recognized the importance of monetary and fiscal policies providing the basis for a reduction in real interest rates and a sustainable global economic recovery with price stability. Attainment of these goals will strengthen export markets and reduce debt service burdens, thereby enabling Latin America to achieve higher growth.

Advancing Free Trade

The first pillar of the Enterprise for the Americas Initiative focuses on trade. Free trade is a cornerstone of a broader economic system based on market principles. The Initiative aims to promote more open trade regimes, with the ultimate objective a hemispheric free trade area. A successful conclusion of the Uruguay Round will also make a key contribution to our goals of trade and investment liberalization under the Initiative, and we will continue working with Latin American and Caribbean countries towards this end.

We are beginning down this road towards free trade with Mexico and Canada. This step has been made possible by the remarkable reforms that have transformed Mexico's economy in the last few years. A Free Trade Agreement among our three countries would foster sustained economic growth for all three countries, which together compose a market of over 360 million people and $6 trillion in output. Gaining fast track authority from the U.S. Congress is essential for us to seize this moment, to build upon and cement the momentum towards more open economies and faster growth throughout the hemisphere.

We are also extending the potential for free trade throughout the hemisphere by negotiating framework agreements with individual countries and groups of countries in the region. Framework agreements establish fora for consulting on bilateral trade and investment issues and working towards trade liberalization. We are pleased that six countries have signed agreements since June, and we hope that negotiations with additional countries will also bear fruit in the near future. Through these agreements, we can discuss the requirements for free trade agreements and facilitate negotiations when the appropriate time arrives. Chile has expressed an interest in FTA negotiations and we are using the framework agreement to explore this possibility.

Latin American and Caribbean countries have given the Initiative an enthusiastic response. Last December I accompanied President Bush on his trip to Latin America, and witnessed that enthusiasm. During this trip Latin American leaders expressed personal views about the Initiative. Let me cite a few:

> President Menem of Argentina decleared: "... Argentina sees with hope the promising possibilities which may emerge from the ... Enterprise for the Americas."

> President Collor of Brazil stated: "The Bush Plan heralds the United States' will to build a constructive agenda vis-a-vis Latin America."

> In the words of President Lacalle of Uruguay: "Your historic Initiative of the Americas ... was scarcely unveiled when we realized that it implied a qualitative change in the hemispheric relations and because of this, Mr. President, we hastened to support and praise it ... "

> Finally, President Aylwin of Chile affirmed: President Bush's "... vision of a free trade area covering the whole continent is a bold concept, in line with the aspirations and interests of all Americans ... This could be an historic opportunity, and we should not let it slip through our fingers."

The prospect of hemispheric free trade encourages Latin American countries to deepen and accelerate an ongoing movement toward open markets, and with open borders it becomes increasingly difficult to subsidize government-controlled enterprises, restrict new competition, and set prices by decree.

Why is this a fair deal for the United States? First, we benefit from elimination of barriers to our exports of goods and services. Second, we will gain from having more prosperous neighbors, and therefore more valuable trading partners, as reforms give rise to faster growth. Third, open, dynamic economies will be stronger partners in the world trading system. Their success will encourage other countries to adopt similar policies. Finally, we have an interest in the prosperity of Latin America that goes beyond immediate economic benefits -- an interest that rests on a shared heritage, ties of family and culture, and geographical proximity.

Increasing Capital Flows to the Region

The need to attract capital is at the heart of every country's development challenge. Resources in today's world are limited. The role of commercial banks in providing external finance has shifted dramatically in recent years. Creditor governments also face budgetary constraints on their ability to provide economic assistance, while events in other areas such as Eastern Europe and the Middle East have added heavily to demands for such resources.

Private investment is therefore a new priority source of capital for development and growth. Latin American and Caribbean countries must compete aggressively to draw investment and to recover the savings of their own people.

Several countries in the region are already gaining improved access to voluntary bond markets, new investment flows, and a repatriation of flight capital. Mexico -- with a growth rate of 4% -- has recently received some $2-3 billion in foreign equity flows into its stock market, has successfully floated bonds on the Euromarket, and is now experiencing substantial demand for its Treasury offerings. One third of Venezuela's commercial banks chose to provide new money as part of a recent debt agreement, and capital is now being repatriated. Chile's dramatic success in reducing debt to commercial banks through its debt/equity swap program has helped pave the way for its recent $320 million Eurobond syndication with its commercial banks.

These developments are encouraging. They confirm the potential for economies in the region to make the transition from crisis to performance. But more needs to be done to improve the ability of Latin American and Caribbean countries to compete for capital.

The kinds of investment reforms that are needed include:

- the reform of financial sectors to facilitate private investment credits;
- the codification of liberal investment policies;
- the privatization of state-owned businesses; and
- the adoption of internationally accepted dispute settlement procedures.

To help countries undertake these reforms, the Inter-American Development Bank (IDB) is moving forward with a new investment sector lending program. It has begun, or will soon initiate, evaluations of investment regimes and discussions of possible reforms with Bolivia, Chile, Colombia, Costa Rica, Jamaica and Uruguay.

The IDB and International Investment Corporation (IIC) will continue to be essential to the overall adjustment efforts of Latin America and the Caribbean. However, we must go beyond the effort of the IDB and the IIC to provide targeted support, particularly of a grant nature, for technical assistance to help secure these reforms. Assistance is also needed to help moderate social dislocations resulting from sweeping investment reforms, and to improve access to capital for micro enterprises. We are therefore working to create a new $1.5 billion Multilateral Investment Fund, administered by the IDB, to provide the concentration of financial resources needed by countries poised to make a major commitment to radically overhauling and opening their investment regimes.

We are seeking Congressional authority for a U.S. contribution to this Fund of $500 million over five years. We are pleased that Japan has indicated that it will contribute an appropriate amount to the Fund, and we are optimistic that other creditor countries will provide the remaining resources.

Reducing Debt Burdens and Providing Support for the Environment

The external debt burdens of Latin American and Caribbean countries cannot be overlooked in our effort to help revitalize their economies. External debt problems have constrained growth and diverted attention from needed domestic reforms. Debt reduction can be an important complement to economic reforms in order to restore confidence in their economies.

Under the debt component of the Enterprise for the Americas Initiative we will reduce bilateral debt owed to the U.S. Government by countries which qualify, thereby helping them attract new investment capital and reinforcing the rewards of sound economic policies.

Debt reduction under the Initiative complements international efforts under the Brady Plan to address commercial bank debt problems. Reducing bilateral debt will be particularly important for the relatively small countries of the region that owe a substantial portion of their external debt to official creditors, rather than to commercial banks.

The Administration has gained authority from Congress to reduce concessional food assistance debt for countries pursuing strong economic and investment reform programs. Several countries -- including Chile, Jamaica, and Bolivia -- are well positioned to qualify for such debt reduction in the next few months. Other countries could also move to qualify in the near future. The potential for bilateral official debt reduction has been welcomed throughout the region and countries are eager to benefit -- we will begin discussing reduction of their food assistance debt as they meet necessary conditions.

I want to emphasize that by reducing bilateral official debt, we hope not only to ease countries' financial burdens but also to provide significant support for the environment. This will be accomplished by channeling interest payments in local currency to fund environmental projects in each country. While the resources provided through these funds will be limited, we believe that this program can make a significant difference by targeting small projects and building local community support for the environment.

To offer the full potential benefits of the debt reduction proposed under the Initiative, however, we must gain additional authority from Congress to reduce debts owed to A.I.D. and sell a portion of Eximbank loans and Commodity Credit Corporation (CCC) assets to facilitate debt-for-equity, debt-for-nature, or debt-for-development swaps. We are working hard to achieve such authorities this year.

<u>Stepping Up to the Challenge</u>

The United States shares with its neighbors high hopes for the future. As they turn toward stronger, market-oriented economies, Latin American and Caribbean leaders are embracing the Initiative as a means of achieving our common objectives of enhanced growth and prosperity. They cannot realize this vision alone. We must all do our part.

In many cases, governments throughout the region must do more to improve the prospects for productive trade and investment. The U.S. Government needs to follow through in gaining Congressional authority to carry out the Initiative.

However, without a receptive business community that is willing to respond to opportunities created, no amount of policy change can realize economic potential of our hemisphere. We must look to the private sector to both encourage policy change where it is needed, and to take advantage of the opportunities it provides. Latin America and the Caribbean already have moved to ease restraints in many areas; their markets are known to Americans; and the potential for growth in trade is substantial.

The Initiative gives us the chance to deepen and expand for the mutual benefit of all countries in the hemisphere the wide array of trade, investment, and cultural ties we share. We look forward to working with you toward this aim.

TREASURY NEWS
epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 6, 1991

CONTACT: Office of Financing
202/376-4350

TREASURY CHANGES TIME FOR ANNOUNCEMENT OF OFFERINGS

The Department of the Treasury today announced a new standard release time for all announcements of regularly scheduled bill, note, and bond issues. **The new release time will be 2:30 p.m., Eastern Time.** This will apply to all announcements previously made at 4:00 p.m., as well as the 52-week bill announcements which have been made at 12:00 Noon. The Department will continue to announce weekly bills on Tuesdays and 52-week bills on Fridays. Cash management bills will also be announced at 2:30 p.m. unless circumstances dictate otherwise.

The Department also announced that the next quarterly financing press conference, scheduled for July 31, 1991, as well as all subsequent press conferences, will begin at 2:00 p.m., Eastern Time.

oOo

NB-1258

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY PUBLIC DEBT

FOR IMMEDIATE RELEASE
May 6, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $8,601 million of 13-week bills to be issued May 9, 1991 and to mature August 8, 1991 were accepted today (CUSIP: 912794XB5).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.48%	5.65%	98.615
High	5.50%	5.67%	98.610
Average	5.50%	5.67%	98.610

Tenders at the high discount rate were allotted 77%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	41,810	41,795
New York	23,882,385	7,011,225
Philadelphia	24,435	23,985
Cleveland	49,200	49,200
Richmond	51,725	51,725
Atlanta	40,750	39,520
Chicago	1,456,880	192,780
St. Louis	51,935	19,635
Minneapolis	9,220	9,220
Kansas City	34,900	34,900
Dallas	23,300	23,300
San Francisco	580,910	163,660
Treasury	940,210	940,210
TOTALS	$27,187,660	$8,601,155
Type		
Competitive	$22,965,450	$4,378,945
Noncompetitive	1,798,395	1,798,395
Subtotal, Public	$24,763,845	$6,177,340
Federal Reserve	2,323,315	2,323,315
Foreign Official Institutions	100,500	100,500
TOTALS	$27,187,660	$8,601,155

NB-1259

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
May 6, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $8,603 million of 26-week bills to be issued May 9, 1991 and to mature November 7, 1991 were accepted today (CUSIP: 912794XM1).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.58%	5.84%	97.179
High	5.62%	5.88%	97.159
Average	5.61%	5.87%	97.164

Tenders at the high discount rate were allotted 83%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	34,815	34,815
New York	19,712,255	7,038,855
Philadelphia	11,785	11,785
Cleveland	40,805	40,805
Richmond	52,985	52,985
Atlanta	28,010	28,010
Chicago	1,399,625	453,375
St. Louis	37,695	26,845
Minneapolis	10,305	10,295
Kansas City	49,830	49,830
Dallas	17,130	17,130
San Francisco	417,785	159,285
Treasury	678,855	678,855
TOTALS	$22,491,880	$8,602,870
Type		
Competitive	$18,386,300	$4,497,290
Noncompetitive	1,276,380	1,276,380
Subtotal, Public	$19,662,680	$5,773,670
Federal Reserve	2,200,000	2,200,000
Foreign Official Institutions	629,200	629,200
TOTALS	$22,491,880	$8,602,870

NB-1260

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR RELEASE AT 3:OO PM
May 6, 1991

Contact: Peter Hollenbach
(202) 376-4302

PUBLIC DEBT ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR APRIL 1991

Treasury's Bureau of the Public Debt announced activity figures for the month of April 1991, of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS).

Dollar Amounts in Thousands

Principal Outstanding (Eligible Securities)	$495,965,790
Held in Unstripped Form	$372,715,075
Held in Stripped Form	$123,250,715
Reconstituted in April	$3,558,400

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.

oOo

PA-54

AUCTION RESULTS
PUBLIC DEBT NEWS
Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
May 7, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 3-YEAR NOTES

Tenders for $13,560 million of 3-year notes, Series S-1994, to be issued May 15, 1991 and to mature May 15, 1994 were accepted today (CUSIP: 912827A77).

The interest rate on the notes will be 7 %. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	7.07%	99.814
High	7.09%	99.761
Average	7.09%	99.761

$110,000 was accepted at lower yields.
Tenders at the high yield were allotted 59%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	40,965	40,965
New York	30,549,650	12,079,240
Philadelphia	35,935	35,930
Cleveland	53,190	53,160
Richmond	92,630	74,180
Atlanta	43,005	40,545
Chicago	2,075,065	697,355
St. Louis	73,275	62,455
Minneapolis	32,735	32,735
Kansas City	81,290	81,290
Dallas	25,215	25,215
San Francisco	550,630	188,930
Treasury	147,645	147,645
TOTALS	$33,801,230	$13,559,645

The $13,560 million of accepted tenders includes $1,080 million of noncompetitive tenders and $12,480 million of competitive tenders from the public.

In addition, $1,453 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $3,062 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1261

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M. CONTACT: Office of Financing
May 7, 1991 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 $18,400 million, to be issued May 16, 1991. This offering will result in a paydown for the Treasury of about $1,975 million, as the maturing bills are outstanding in the amount of $20,370 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, May 13, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Daylight Saving time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately $9,200 million, representing an additional amount of bills dated February 14, 1991, and to mature August 15, 1991 (CUSIP No. 912794 XC 3), currently outstanding in the amount of $10,292 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $9,200 million, to be dated May 16, 1991, and to mature November 14, 1991 (CUSIP No. 912794 XN 9).

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 May 16, 1991. 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 $964 million as agents for foreign and international monetary authorities, and $5,117 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-1262

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 competitive 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

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
May 8, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 10-YEAR NOTES

Tenders for $11,956 million of 10-year notes, Series B-2001, to be issued May 15, 1991 and to mature May 15, 2001 were accepted today (CUSIP: 912827A85).

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

	Yield	Price
Low	8.06%	99.593
High	8.07%	99.526
Average	8.07%	99.526

$288,000 was accepted at lower yields.
Tenders at the high yield were allotted 49%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	22,465	22,465
New York	33,526,314	11,675,333
Philadelphia	7,254	7,254
Cleveland	17,270	17,270
Richmond	94,899	25,899
Atlanta	14,600	14,600
Chicago	823,452	100,992
St. Louis	29,848	26,532
Minneapolis	11,707	11,707
Kansas City	21,914	21,914
Dallas	7,333	7,283
San Francisco	303,780	21,230
Treasury	3,393	3,371
TOTALS	$34,884,229	$11,955,850

The $11,956 million of accepted tenders includes $530 million of noncompetitive tenders and $11,426 million of competitive tenders from the public.

In addition, $17 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $400 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

The minimum par amount required for STRIPS is $25,000. Larger amounts must be in multiples of that amount.

NB-1263

TREASURY NEWS

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

EMBARGOED UNTIL GIVEN
EXPECTED AT 10:00 A.M.

TESTIMONY OF
THE HONORABLE ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

May 9, 1991

Chairman Carper, Mr. Ridge, and members of the Subcommittee, thank you for this opportunity to explain the Administration's proposal to roll back the Federal Deposit Insurance Corporation's "too-big-to-fail" policy, which currently results in the protection of all uninsured depositors in most bank failures, particularly larger ones. This broad expansion of the federal deposit insurance guarantee has greatly increased taxpayer exposure. It is also unfair to those smaller banks that do not receive this blanket de facto protection. Our proposal ends this routine protection of uninsured depositors without compromising the safety and stability of our financial system. We firmly believe that this is the most sensible way to address this very difficult problem.

Let me acknowledge at the outset that the Administration's proposal preserves the flexibility of the government to protect the nation's financial system in times of crisis. In rare cases this may result in the protection of uninsured depositors in bank failures. These rare occasions will no doubt raise some of the same questions of unfairness and taxpayer exposure as today's policy of routinely protecting most uninsured deposits. But a policy that risks our financial system to avoid an exceptional case of "unfairness" would be dangerous and irresponsible.

In the end, the only way to truly eliminate our continual confrontations with the unfairness of protecting uninsured depositors is to fix the underlying system. Other countries rarely confront the "too big to fail" issue because they rarely have bank failures. We simply must have fewer costly bank failures and fewer threats to our economy. That means comprehensive reform that results in stable and profitable banks; prompt corrective action for weak banks; streamlined supervision;

NB-1264

and a recapitalized bank insurance fund. And that, Mr. Chairman, is exactly what the Administration has set forth before Congress in H.R. 1505, the "Financial Institutions Safety and Consumer Choice Act of 1991."

With that introduction, let me now turn to the body of my statement, beginning with a description of what we do and don't mean when we use the term "too-big-to-fail."

Understanding Too-Big-to-Fail

The term "too-big-to-fail" is a misnomer. When the doctrine is invoked, the institution involved still fails -- shareholders are wiped out; subordinated debtors and unsecured creditors typically lose part of their investments; and management is replaced. There is no FDIC or taxpayer "bailout" of shareholders or managers.

Instead, "too-big-to-fail" is a part of the FDIC's current policy to routinely extend deposit insurance protection beyond the $100,000 limit to <u>uninsured</u> depositors. Indeed, over 99 percent of uninsured depositors have been protected in the resolution of failed banks during the last five years. In a very few of these situations, the failure to provide such protection would clearly have resulted in serious risk to the financial system. But in most cases, the protection of uninsured depositors occurred in resolutions that did not involve systemic risk through the routine use of so-called "purchase and assumption" transactions, or "P&As." Both situations are described in more detail below.

Protecting Uninsured Depositors to Prevent Systemic Risk

Protecting uninsured depositors to prevent systemic risk -- the classic "too big to fail" policy -- first gained notoriety in 1984 when the FDIC protected the uninsured depositors and other creditors of the Continental Bank of Illinois and its holding company. The policy came into sharp public focus again with the recent failure of the Bank of New England. In both of these cases it was feared that imposing losses on uninsured depositors would create genuine risk to the financial system.

What is systemic risk? Gerald Corrigan of the Federal Reserve Bank of New York described it as the danger "that failure or instability in one institution or in one segment of the financial markets can quickly be transmitted to other institutions or segments of the markets, thereby causing a more generalized crisis of confidence with all of its potential for instability in the financial and real sectors of the economy." This would include cases that threaten (1) widespread loss of consumer confidence and resulting contagious depositor runs, (2) potentially severe problems for the correspondent banking network, and (3) the breakdown of the payments system. Any or all of these events could result in major dislocations in the provision of regional or national business and trade credit, and potential disruption of domestic and international economic stability.

In the case of Continental there were significant concerns about the financial impact that bank closure and a deposit-payoff might have had on the large number of Continental's smaller, correspondent banks. Approximately 1000 banks had correspondent relationships with Continental at the time of its failure. Sixty-six of these banks had uninsured deposits exceeding 100 percent of capital, and 113 had deposits equalling 50-100 percent of capital. If Continental's uninsured depositors had not been protected, its failure would have substantially weakened a large number of its small correspondent banks with serious consequences for consumer confidence and the financial system.

More recently, the threat of systemic risk resulted in the protection of uninsured depositors of the Bank of New England. As you may recall, the situation was a tinder box. Uninsured credit unions in nearby Rhode Island had recently failed, with widespread publicity attending the inability of average depositors to withdraw their funds. As the Bank of New England teetered on the brink of insolvency, there were signs that even federally insured depositors in neighboring banks were beginning to line up for the withdrawal of their deposits. This volatile situation, along with the considerable concern over the impact closure and a deposit-payoff would have on the availability of credit in the fragile New England economy, led to the decision to protect uninsured depositors.

Much as we might not like it, the threat of systemic risk is real. While much progress has been made to reduce the threat of systemic risk in bank failures, and while more steps can and should be taken to further reduce such risk, we cannot blindly dismiss the fact that it remains with us. Indeed, to our knowledge no government has forfeited its ability and responsibility to protect the stability of its financial system, even if that means protecting uninsured depositors. None. We should not be the first to try this dangerous experiment.

Routine Protection of Uninsured Depositors in P&As

While the cases of genuine systemic risk caused by bank failures are relatively rare, the FDIC has nevertheless extended full insurance protection to virtually <u>all</u> uninsured depositors in recent years. This is so because of the almost exclusive reliance by the FDIC on purchase and assumption transactions. In P&A transactions, acquiring institutions purchase all of the assets and assume all of the liabilities -- including uninsured deposits -- of failed institutions.

How has this broad expansion of the federal safety net been justified? P&As have long been defended as less expensive to the FDIC than simply paying off insured depositors and liquidating an institution's assets. It has been argued that the cost of protecting uninsured deposits is offset by the premium paid by acquirers for core deposits and the going concern value of an intact institution. As a result, while one of every three failures -- the smallest ones -- received no FDIC coverage for uninsured depositors in recent bank failures, over ninety-nine percent of uninsured deposits have been fully protected during the record period of bank failures since 1985.

While the P&As may very well be less costly than an insured deposit payoff, they may not always be the least costly resolution method -- indeed, current law does not require the FDIC to adopt the least costly resolution method. An alternative resolution method, called an insured deposit transfer, may often be the least costly. In this method an acquirer pays a premium to acquire a failed bank's assets and only its insured deposits, not its uninsured deposits. Almost by definition, an insured deposit transfer will be less costly than a P&A whenever the failed bank's franchise value resides largely in its core deposits -- the FDIC receives essentially the same premium as it would in a P&A, but it would not incur the additional cost of protecting uninsured depositors.

Protecting uninsured depositors when it is not the least costly resolution method is an unjustified expansion of the federal deposit insurance guarantee that increases taxpayer exposure and removes market discipline from the system. It is also unfair to the smallest depository institutions that receive no such protection.

Problems from Protecting Uninsured Deposits

There are three fundamental problems arising from the current policy of routinely protecting most uninsured deposits: increased taxpayer exposure to losses; the removal of market discipline over weak and risky banks; and the unfairness of protecting some uninsured deposits but not others.

Increased Taxpayer Exposure. Increasing the scope of the federal guarantee directly increases taxpayer exposure whenever protecting uninsured deposits is not the least costly resolution method. By one estimate, protecting uninsured deposits in the six transactions involving systemic risk in the last five years cost the FDIC $883 million. In addition, the FDIC fully protected approximately $5 billion of uninsured deposits in purchase and assumption transactions where insured deposit transfers might have been a less costly resolution method.

Removal of Market Discipline. Deposit insurance is intended to provide stability to the banking system by protecting small, unsophisticated depositors. But it was never intended to cover sophisticated investors with large deposits in banks, who are an important source of market discipline on bank risk-taking. The routine extension of deposit insurance to all such investors removes this market discipline, allowing weak banks to stay in business longer and accumulate losses that will ultimately be borne by the insurance fund or the taxpayer. Such a policy also undermines the nominal statutory limits on deposit insurance coverage.

Unfairness. The protection of uninsured depositors in large banks but not small banks can give large banks an unfair funding advantage for large deposits. This unfairness was brought into sharp contrast with the recent decisions to protect uninsured depositors in the resolution of the Bank of New England, and not to protect them in the resolution of the Freedom National Bank in Harlem.

As we all know, the unfairness of protecting some uninsured depositors but not others has become the battle cry of smaller banks around the country, and with good reason. There are basically three ways to address this fairness problem.

The first is to expand the current practice even further -- that is, to simply protect all depositors, insured and uninsured, at all banks. This is the position preferred by small banks as being most fair because it would neutralize bank size as a major factor in the competition for funds. But it would not be fair to taxpayers. Their exposure could only go up. Extending the federal safety net of deposit insurance to all deposits eliminates all market discipline, even from sophisticated depositors, and that can only make the banking system more risky.

The second approach is never to protect uninsured deposits. This approach, too, would be "fair." Banks of all sizes would be treated identically and uninsured depositors would have no incentive to place funds on the basis of protection in the event of failure. But this approach creates problems of systemic risk. It is simplistic and dangerous.

We believe that the only sensible solution is a third approach that balances all of the factors involved -- one that rolls back the routine protection of uninsured depositors, preserves the government's ability to protect the financial system, and embraces new ways to reduce the systemic risk involved in bank failures.

The Administration's Proposal

In our recently completed study of deposit insurance and banking, the too-big-to-fail problem was among the most difficult addressed. We arrived at our recommendations only after a long and hard examination of the issue and considerable dialogue with the regulatory agencies, representatives of the industry, and other interested parties.

Our approach is intended to reduce taxpayer exposure and reduce unfairness to small banks. It would roll back the too-big-to-fail doctrine to true instances of systemic risk and make it the rare exception in bank failures. The routine coverage of uninsured deposits would be eliminated by demanding "least cost resolutions." The regulators would be made more visible and accountable when they do decide to protect uninsured depositors. And specific measures would directly reduce systemic risk.

Least Cost Resolution. Our legislation would amend the Federal Deposit Insurance Act to explicitly require the FDIC to choose the bank resolution method that results in the least cost to the insurance fund. While this provision does not prohibit the FDIC from using P&A transactions, we expect that it would generally lead to greater reliance on insured deposit transfers that would not protect uninsured depositors.

Systemic risk exception. While systemic risk could still be used as a reason to protect uninsured depositors, the Administration's proposal includes new procedures to make this a much more visible and accountable determination -- which we believe will help limit its use to rare instances of genuine systemic risk. The FDIC would not be permitted to factor systemic risk into its selection of a resolution method. Rather, the determination of systemic risk would be reserved to the Federal Reserve Board and the Treasury Department acting jointly, but in consultation with the Office of Management and Budget and the FDIC. Upon such a determination, these agencies could direct the FDIC to provide insurance coverage for all depositors or take other appropriate action to lessen risk to the system.

The Federal Reserve is responsible for financial market stability, and because government action could require Federal Reserve discount window loans, it ought to be formally involved in systemic risk decisions. Also, since the Administration is directly accountable to the taxpayer, the Treasury and OMB have a legitimate role to play in this determination. By broadening the decision-making in this way, both government flexibility and accountability can be achieved. Furthermore, we think that lodging this decision at the highest levels of government with high visibility will mean that uninsured depositors are protected much less often.

<u>Proposals to Reduce Systemic Risk</u>. Finally, our legislation would reduce systemic risk directly, which in turn will reduce the occasions when uninsured depositors need to be protected. Our principal proposal in this area is to improve the liquidity mechanism in bank failures.

Uninsured depositors that are unprotected in bank failures do not lose all their funds; instead, they typically receive a partial recovery based on their claim on bank assets. This partial recovery can be substantial, sometimes amounting to over 90 percent of the value of uninsured deposits.

The problem is that partial recovery can take long periods of time during which the value of the deposits can be tied up in a failed bank receivership. This temporary loss of liquidity magnifies the systemic risk problems associated with depositor losses, especially from the payments system and correspondent banking networks.

Our proposal authorizes a new means for the FDIC to provide immediate liquidity to uninsured depositors in bank failures based on the FDIC's average recovery experience from receiverships over a time period to be determined by the Agency. This provision in our bill, based on a proposal by the American Bankers Association, could significantly reduce the systemic risk involved in bank failures.

In addition, our legislation includes measures to reduce payments system risks, including (1) the bilateral netting of the mutual obligations of banks, (2) statutory elimination of the risk that a receiver or liquidator of a failed member of a clearing organization could negate the netting rules of the clearing organization, and (3) preemption of any injunction or similar order issued by a court or agency that would interfere with the netting procedures governed by the Act.

Indeed, our proposals build on the numerous efforts that have been made over the years to reduce the risks associated with payments, clearance and settlement arrangements. The Federal Reserve already has mechanisms in place to secure its large dollar payments system, Fedwire. These mechanisms include guaranteed final payment, bilateral caps among institutions, and real time monitoring of the flow of funds over the system. In a similar vein, the Clearing House for International Payments (CHIPS) not long ago instituted a cross guarantee arrangement among its member institutions that significantly reduces systemic risk in the event of a large bank failure.

We will continue to work to reduce threats of systemic risk based on liquidity problems and faulty payments mechanisms. By doing so we will progressively diminish the number of systemic risk situations that require uninsured depositor protection.

Paying for TBTF

The decision as to who pays for genuine systemic risk resolutions is a difficult one to make. It is argued by some that the cost should be borne by the taxpayer because of the far-reaching economic implications of a systemic breakdown. Protecting the financial system protects more than just banks, and banks should not be held uniquely accountable for the costs of maintaining stability.

On the other hand, preventing systemic risk uniquely benefits the banking industry, and not just the largest banks. Stability and depositor confidence are critical to the viability of all banks. And although the protection of large deposits in large banks clearly benefits large banks generally, it also directly benefits smaller correspondent banks and indirectly benefits all banks that are susceptible to contagious depositor runs.

On balance, because of these direct benefits, we believe that the industry should pay for the costs of preventing systemic risk. Accordingly, H.R.1505 requires the FDIC to pay for the cost of protecting uninsured depositors in the rare circumstances of systemic risk where it would be required.

H.R. 2094

Before concluding, let me provide some observations about the treatment of uninsured depositors in H.R. 2094, which was marked up in the Subcommittee on Financial Institutions last Tuesday. This bill prohibits the FDIC from protecting uninsured depositors beginning in 1995, even if it would reduce costs to the taxpayer. And while the bill was improved in Subcommittee with an amendment that would preserve the Federal Reserve's current authority to address liquidity problems in undercapitalized banks, we believe that even the amended text leaves too little flexibility to address systemic risk. We will continue to support amendments that would improve the language to address both of these problems.

Conclusion

In conclusion, we believe that ours is the most balanced approach to the problem of protecting uninsured depositors given the competing considerations of systemic risk, taxpayer exposure, market discipline, and fairness. Chairman Greenspan has said that not all large bank failures require a too-big-to-fail resolution. We agree, and we provide a specific mechanism for handling bank failures that should decrease the number of such resolutions without ignoring the dangers of genuine systemic risk situations.

Furthermore, by making the protection of uninsured depositors the rare exception, not the rule, we help to accomplish several fundamental objectives. Taxpayer exposure is reduced. Market discipline is increased, as the doctrine of "constructive ambiguity" becomes much more of a reality -- even depositors in the very largest banks will never be completely sure about whether their deposits will be fully protected, which is healthy. And small and large banks will be treated much more equally, resulting in few unfair funding advantages to large institutions.

Still, as long as we have repeated instances of costly bank failures, there will still be some unfairness resulting from systemic risk situations. What we really need to do is what I said at the outset -- fix the system so we don't continually have these costly failures. We cannot affort to keep putting ourselves in the position of having to make the choice between protecting small banks and protecting the taxpayer.

The key is to make the banking industry economically viable through comprehensive reform. Banking organizations must be able to offer a full range of services to compete with their rivals, domestically and internationally. They must be able to locate their places of business where they choose and attract capital from financial and non-financial firms. And they must be regulated more effectively with prompt corrective action that stops smaller problems from mushrooming into large losses to the insurance fund. H.R. 1505 addresses all of these requirements.

Those who suggest we must end the "too-big-too-fail" problem before we fix the system have it got it exactly backwards; instead, we must fix the system in order to eliminate the unfairness of "too-big-to-fail."

****

Mr. Chairman, that concludes my formal statement. I would now be pleased to answer any questions you or other members of the Subcommittee might have.

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

ADDRESS BY
GEORGE A. FOLSOM
GOVERNOR AD INTERIM FOR THE UNITED STATES
TO THE TWENTY-FOURTH ANNUAL MEETING OF
THE ASIAN DEVELOPMENT BANK
VANCOUVER, BRITISH COLUMBIA, CANADA
APRIL 25, 1991

Madam Chairman, President Tarumizu, fellow delegates, I welcome the opportunity to speak on behalf of the United States at the Twenty-Fourth Annual Meeting of the Asian Development Bank. Although we are far from Asia, it is fitting that our Canadian hosts have arranged for us to meet in Vancouver. We are within sight of the Pacific Ocean, which links many of the Bank's member countries and over which most of the trade, travel, and other communications between Asia and North America take place. On behalf of my delegation, I would like to thank our hosts for the kindness and hospitality they have extended to us.

I would also like to welcome the Mongolian People's Republic, which became a member of the Bank only two months ago, and Turkey, which joined just last week. The two bring different perspectives to the issues related to the Bank's operations, and both they and the Bank will benefit from their involvement in the Bank's activities.

Economic Developments

These annual meetings are valuable insofar as they offer us an opportunity to focus on the growing interdependence of our economies, the challenges we face, and the efforts underway to meet those challenges.

According to the International Monetary Fund (IMF), world economic growth declined from about three percent in 1989 to two percent in 1990. This decline is not particularly surprising, considering the shocks the international economy endured last year, including the conflict in the Middle East and the subsequent volatility in the price of oil; uncertainties associated with the restructuring of Eastern Europe and the unification of Germany; and the volatility of the economic situation in the Soviet Union. These events occurred at the same time as growth in a number of industrial economies was already declining.

The countries of Asia as a whole fared somewhat better than many in other areas of the world. Growth in the region slowed only slightly, to 5.25 percent, and overall increases in real per capita output were registered. As in previous years, growth has been strongest and most sustained in the NIEs -- Hong Kong, Korea, Taiwan, and Singapore -- as well as in China, Indonesia, Malaysia, and Thailand. The strength of economic activity in these economies is due in part to their access to foreign markets, strong domestic demand, and increased foreign investment.

We expect that this pattern will continue. The IMF projects that, if the Asian countries follow sound economic policies, growth in Asia will increase slightly, to an average of 5.5 percent in 1991.

For some countries, however, the road to further economic growth and development will be more difficult. Included in this group are a number of the Bank's developing member countries -- India, Bangladesh, Pakistan, Sri Lanka, and the Philippines. These countries experienced substantial increases in their oil import bills and/or significant drops in their current account earnings from lost exports and lost remittances from workers in the Gulf. The economic dislocations they suffered compounded policy-related economic problems they were already experiencing.

U.S. Links to Asia

The United States has supported international efforts to help these countries toward a speedy recovery from the effects of the recent crisis. We are motivated by my government's long-standing concern for their economic growth and development. But, at the same time, there is a strong measure of mutual interest involved. The Asia-Pacific region is by far our largest trading partner. Since 1980, when our Pacific trade first exceeded our Atlantic trade, U.S. trans-Pacific trade has increased by an average of 9 percent annually; during that period, trans-Atlantic growth averaged 7 percent. U.S. investment in the developing Asian countries is also significant, having totaled $20.9 billion in 1989. These and other economic ties bind us to the countries of Asia and give us a continuing strong interest in fostering their economic well-being. The active U.S. role in the Asia-Pacific Cooperation Conference is further evidence of this abiding interest.

Uruguay Round

In this connection, I want to pause for a moment to urge member countries to renew their commitment to maintaining the international trading regime as embodied in the General Agreement on Tariffs and Trade (GATT).

Trade plays an increasingly important role in determining the economic performance of individual nations. The growth of U.S. trade with the rest of the world in relation to our overall economic activity highlights this point: in 1970 the ratio of total U.S. merchandise trade to GNP was 8 percent; by 1990, the ratio was over 16 percent. Including services, trade as a share of U.S. GNP is over 20 percent.

Trade is also a major engine of growth for the global economy, particularly for economies in the Asian region. The ratio of exports of goods and non-factor services to GDP for the developing countries of East Asia increased from 8 percent in 1965 to 30 percent in 1988. The importance of trade to the Pacific Basin countries, as measured by the ratio of their total trade to GDP, was over 40 percent in 1988.

The countries of Asia will be significant beneficiaries of a successful Uruguay Round that is truly trade liberalizing -- encompassing industrial trade, agriculture, and financial and other services. The developing countries of the region should be among those with the greatest relative economic gains. And the developed countries and dynamic economies of the region will benefit by assuring and broadening their market access and accelerating their economic growth, innovation, and dynamism.

My government will do all that is practicable to ensure that the promise of the Uruguay Round is fulfilled. We call on all governments represented here to do the same.

Economic Reform

Increasingly, governments throughout the world are coming to understand that a free trade and investment regime supported by prudent fiscal and monetary policies is the key to economic growth and can contribute to political stability. The European Bank for Reconstruction and Development, whose inaugural meeting I attended just last week, will reinforce the reform movement in that region. Its purpose is to foster the transition of central and eastern European countries towards open, market-oriented economies which promote private and entrepreneurial initiative.

Likewise, leaders in Latin America, supported by the Inter-American Development Bank, increasingly are enacting sound, market-oriented economic policies that demonstrate their movement toward increased growth and sustained development. President Bush's Enterprise for the Americas Initiative is designed to support and strengthen these efforts.

Many of the countries of Asia are in the vanguard of the market-oriented reform movement. Indonesia, for example, has adopted outward-looking economic policies and macroeconomic adjustment programs. By virtue of its sound economic program, Indonesia has attracted high levels of investment, both domestic and foreign, and enjoys access to capital flows from international financial institutions and private sources. It is no surprise that last year Indonesia posted a GDP growth rate of over 7 percent, one of the highest in the region. Pakistan and Sri Lanka are two other countries that have been moving ahead in recent months with concrete steps to deregulate aspects of their economies and open them to market forces.

Unfortunately, although the wind is clearly blowing in the direction of reform, some countries have failed to move forward or have retreated from liberalizing measures instituted earlier. We now know beyond doubt which economic models for growth and development are most successful. It is unfortunate, therefore, that some governments continue to maintain measures such as disincentives to foreign investment, trade and tariff barriers, inappropriate exchange rates, and restrictive financial sectors. In some countries, fiscal imbalances remain unaddressed. A renewed commitment to structural reforms, including accelerated privatization; trade and investment liberalization; and reform of banking, securities, and exchange markets would stimulate economic growth, relieve balance of payments pressures, and contribute more fully to the adjustment of global imbalances.

ADF Negotiations

The Asian Development Bank has played a key role in encouraging many of the countries that have implemented successful economic reform programs. We believe the Bank could be even more influential in the future in helping them further and urging on the countries which have not yet accepted the need for reform. We will judge the success of the negotiations on the replenishment of the Asian Development Fund by the extent to which the agreed changes in its policies and programs enable it to realize that potential and thus enhance its contribution to the economic growth and development of its developing member countries.

Role of the Bank

I would like to focus on four important areas which we believe are critical for maximizing the impact of the Bank on the economies of its developing member countries:

-- promotion of sound, growth-oriented economic policies;

-- encouragement of market economies and the private sector;

-- strengthening of environmental policies and programs; and

-- improvement of the quality of its lending program.

I will also comment on other aspects of ADB operations as well.

Economic Policy. The Asian Development Bank has made important steps in recognition that an appropriate policy environment will pay rich dividends in the growth of borrowing countries, and directly enhance the success of the development projects it supports.

We believe, however, that there is room for improvement in the Bank's policy input. Its lending programs should be based on country strategies. These strategies should analyze the policy environment in the country concerned, recommend changes to speed growth, and define clear sectoral priorities for the Bank's lending. The Bank should establish procedures to assess country economic performance on an annual basis, and use the results of those assessments as an indicator for allocating loans.

A key element in the Bank's decisions on lending to a country should be whether it has a medium-term macroeconomic program. We believe that the Bank should operate in countries which have supportive economic environments which will ensure the success of the projects it supports. Where such conditions do not exist, the ADB should work with the government of the country concerned to ensure that appropriate policies are put in place.

Beyond that, the continuing policy dialogue should be conducted during country programming missions. Senior and middle managers should be directly involved. Policy dialogue should infuse both program and project lending, and lead to reforms reflected in loan covenants. We also believe that program lending should be used judiciously, in support of clearly defined economic reform programs when the likelihood of the measures being implemented is high.

We also place a great deal of importance on improved cooperation and collaboration between the ADB and other lenders in the region, particularly the World Bank and the IMF. We favor more frequent meetings between the ADB and World Bank staffs at the country level. A greater effort to increase such contacts through exchanges of visits to headquarters, meetings of field missions, joint missions, and other means would also be helpful.

<u>Market Economies/Private Sector</u>. We now know that development works best when public resources are directed to the tasks that government must perform, leaving the rest of economic activity to the private sector. A most important role for the Bank is to foster a hospitable economic and regulatory climate in borrowing countries. This must be based on market-oriented policies within which private enterprise can flourish. Policy-based lending to the financial and industrial sectors which encourages market-oriented economic policies, can play a key role.

The Bank can also be a catalyst in expansion of private investment. We supported strongly the decision last year to allocate $650 million for the ADB's private investments and loans through 1992. We believe it must use these funds in countries and sectors where it is a pioneer, not just another investor.

We also believe that the Bank should begin taking a "private sector first" approach to project design and selection. Private financial intermediaries should be utilized in preference to their more ineffective public sector counterparts. The Bank should actively encourage DMC governments to keep out of sectors best left to private enterprise. In project design, the Bank should examine how public services can be provided by private firms. In this regard, we welcome the Management's creation of a task force to study how to integrate private sector operations into the Bank's overall activities, and hope it will lead to dramatic advances in the directions we have suggested.

<u>Environment</u>. We congratulate the Bank's Management on its progress on environmental issues. A very important step forward was its establishment of an Environmental Office in the Office of the President and provision of greater budget and personnel support for the work program in that Office. We are pleased with the increases that have taken place in its technical assistance programs to strengthen the environmental capabilities of borrowing countries. We look forward to further emphasis on this area and to increases in lending levels for other environmentally-beneficial projects and programs.

We are also pleased with the Bank's plan to strengthen the environmental impact assessment (EIA) process. Furthermore, we want to urge Management to go forward with this plan as rapidly as possible. For us, this is the most important environmental issue in the Bank. The Management should make copies of assessments available to the Board of Directors at least 120 days in advance of Board action on specific projects. Copies of the assessments and/or comprehensive summaries of them should also be provided to the public.

Furthermore, we believe that public participation is an essential element of the environmental impact assessment process. Non-governmental organizations and local community groups are often seriously affected by some of the projects that the Bank helps to finance. They have views that should be considered in the development of projects, and they need an opportunity to express those views as part of the EIA process. After the end of this year, my government will be unable to support projects that have a significant effect on the environment unless the EIAs are made available to the Board and the EIAs or comprehensive summaries of them have also been provided to the public.

We have noted the Bank's intention to expand its support of programs to protect tropical forest resources. We encourage Management to accelerate its efforts in this direction over the next year. Conservation of primary forest areas and protection of biological diversity need much greater emphasis. Improvements in agricultural and land use policies and development of other relevant national strategies should be made only in the context of sound forest management practices. The Bank should also help promote implementation of a reformed and strengthened Tropical Forestry Action Plan and assist in formulating and implementing master plans for the sustainable use of forest resources.

Another focus of environmental concern has been the need for more intensive work on conservation and efficiency in the energy sector. There is a broad consensus that investments in energy conservation and efficiency measures can very often be more cost-effective than investments in additional generating capacity. We fully endorse the Bank's intention to give more attention to end-use efficiencies and the development of renewable energy resources. We also encourage the Bank to place greater reliance on integrated, least-cost planning and a higher priority for the environmental aspects of our energy assistance programs.

The Bank will find it difficult to manage its existing environment activities, as well as expand them or add new ones, without further increasing the staff resources it devotes to this area. We recommend that it take immediate steps to recruit or reallocate personnel to its expanded environmental work programs.

<u>Project Quality</u>. The ADB has traditionally been strongest in its project lending. In this area as well, however, we see considerable potential for the Bank to further improve the quality of its projects by:

-- devoting more resources to project preparation;

-- introducing more rigor into its risk analysis when calculating the economic rate of return of a project;

-- providing technical assistance to improve project implementation capability; and

-- strengthening the post-evaluation process so that the Bank's experience with past projects is taken more fully into account in the design of new ones.

We believe that the Bank's senior management must become more actively involved in monitoring project quality and supporting a uniform high standard for Bank projects. Management should provide clear guidance to the staff that projects of doubtful viability should be held back. The Bank's staff should also be encouraged to point out weaknesses in proposed projects and to innovate in project design. We recommend the creation of a project monitoring unit under a vice president to ensure that economic, financial, and feasibility standards are met. We also suggest that steps be taken to reduce the bunching of loans for consideration by the Board of Directors late in each year.

I would now like to turn to several other areas of the Bank's operations.

Poverty Alleviation

The deep-rooted poverty in many parts of Asia remains a serious concern of my government. The Bank's promotion of sustainable growth is a potent weapon in its efforts to assist borrowers in attacking poverty. The Bank can also help by carefully designing sustainable projects which emphasize income-generating activities or contribute to the development of human capital. Moreover, such projects are more likely to succeed when implemented through private and local agents, such as NGOS, than when government bureaucracies are relied on. We also believe that poverty alleviation projects can be evaluated by the same standards that apply to all Bank lending.

Women in Development

The Bank's poverty alleviation activities should also be closely integrated with its efforts to promote the role of women in development. The Bank has begun to address these issues in project design, but as distinctly separate elements. We believe that both should be approached in an integrated fashion from the point at which a project is conceived.

Pacific Island DMCs

The United States supports the Bank's efforts to address the unique development problems of the Pacific Island DMCS. The Board's approval of the recommendation of the Board-Management

Working Group on Bank Operations in the South Pacific to delegate substantial responsibilities to the South Pacific Regional Office was commendable, but we await Board discussion of a possible South Pacific Fund. We hope this reorganization will increase the effectiveness of our assistance to these countries in the years ahead.

Organizational issues

We believe that further changes in the Bank's organization are required. We support the Management's efforts to establish a strategic planning capability and hope that these efforts will result in the creation of a dynamic planning process which will provide the Bank a clear sense of direction for the years ahead.

We also favor the engagement of an outside group to examine the suitability of further organizational changes, such as a revitalization of the personnel and budget functions and a possible reorganization of the Bank along East-West lines. We believe such reforms would result in greater efficiency and effectiveness in the Bank's operations.

Staffing issues will continue to be an important concern in the 1990s, as the emphasis of the Bank's lending shifts to areas such as protection of the environment and promotion of the private sector. We applaud recent measures to codify the Bank's personnel policies and provide for external arbitration of personnel grievances. However, we believe that there is still a need for modification of the Bank's job classification and promotion policies to ensure that its recruitment and personnel practices are professional, merit-based, and competitive.

Financial Policies

The Bank continues to have an excellent reputation in the financial markets, which has enabled it to begin to move away from several highly conservative policies. We support last year's decision to elevate the level of Bank borrowings in relation to callable capital. This step, along with the calling of bonds with restrictive covenants on Bank borrowings, will allow the current general capital increase to be extended without adversely affecting the Bank's standing in the markets. We would also suggest exploring the sale of portions of the Bank's loan portfolio to the secondary market, perhaps through securitization.

Finally, we would recommend that the Bank provide its borrowers with greater transparency in their foreign exchange exposure on Bank loans, perhaps by using single-currency loans. We support the survey of borrowers' currency disbursement preferences currently underway, which could lead to progress in this area.

Conclusion

As the Bank moves into the 1990s, we are optimistic about the prospects for economic development in the region and the Bank's ability to play a part in encouraging that process. I want to convey the strong support of the United States for the Bank's efforts and to express appreciation for its past and present contributions to development in Asia and the Pacific. We look forward to working with other members of the Bank, along with its Management and staff, in shaping the Bank's strategy for the 1990s.

AUCTION RESULTS
PUBLIC DEBT NEWS
Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
May 9, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 30-YEAR BONDS

Tenders for $11,753 million of 30-year bonds to be issued May 15, 1991 and to mature May 15, 2021 were accepted today (CUSIP: 912810EJ3).

The interest rate on the bonds will be 8 1/8%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	8.19%	99.278
High	8.24%	98.728
Average	8.21%	99.057

$5,000 was accepted at lower yields.
Tenders at the high yield were allotted 41%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	2,529	2,529
New York	16,277,014	11,440,924
Philadelphia	3,133	3,133
Cleveland	2,120	2,120
Richmond	16,301	16,301
Atlanta	5,064	5,064
Chicago	725,926	225,026
St. Louis	8,211	8,211
Minneapolis	226	226
Kansas City	3,096	3,096
Dallas	4,440	4,440
San Francisco	301,727	41,677
Treasury	663	663
TOTALS	$17,350,450	$11,753,410

The $11,753 million of accepted tenders includes $239 million of noncompetitive tenders and $11,514 million of competitive tenders from the public.

In addition, $200 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

The minimum par amount required for STRIPS is $320,000. Larger amounts must be in multiples of that amount.

NB-1265

TREASURY NEWS

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

FOR RELEASE ON DELIVERY
Expected at 10:00 A.M.
May 10, 1991

STATEMENT OF THE HONORABLE
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
FOR FINANCE
BEFORE
THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Mr. Chairman and Members of the Committee:

It is a pleasure to be here today to discuss the results of the Treasury's second study of Government-sponsored enterprises or GSEs. This study was submitted to Congress on April 30.

The failure of many federally insured thrift institutions in the 1980s, and the massive Federal funding required for their resolution, have focused the attention of the Administration and Congress on other areas of taxpayer exposure to financial risk. With this concern in mind, Congress enacted legislation requiring the Secretary of the Treasury to study and make recommendations regarding the financial safety and soundness of GSEs.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires the Treasury to conduct two annual studies to assess the financial safety and soundness of the activities of all Government-sponsored enterprises. The first of these studies was submitted to Congress in May 1990.

The Omnibus Budget Reconciliation Act of 1990 (OBRA) requires the Treasury to provide an objective assessment of the financial soundness of GSEs, the adequacy of the existing regulatory structure for GSEs, and the financial exposure of the Federal Government posed by GSEs. In addition, OBRA requires the Treasury to submit to Congress recommended legislation to ensure the financial soundness of GSEs. Legislation reflecting the approach identified in the April 30th report will be submitted shortly.

The 1991 study is intended to meet the study requirements of FIRREA and OBRA. It includes an objective assessment of the financial soundness of the GSEs, which was performed by the Standard & Poor's Corporation (S&P) at the Treasury's request. The study also includes the results of the Treasury's analysis of the existing regulatory structure for GSEs and recommendations for changes to this structure.

Based on the S&P analysis of the financial safety and soundness of the GSEs, we have concluded, as we did last year, that no GSE poses an imminent financial threat. Because there is no immediate problem, there may be the temptation to follow the old adage "if it's not broke, don't fix it". We, however, believe that this course of action would be inappropriate. The experience with the troubled thrift industry and the Farm Credit System in the 1980s vividly demonstrates that taking action once a financial disaster has already taken place is costly and difficult.

Also, the immense size and concentration of GSE activities serve to underscore the need for effective financial safety and soundness regulation of GSEs. The outstanding obligations of the GSEs, including direct debt and mortgage-backed securities, totaled almost $1 trillion at the end of calendar year 1990. Thus, financial insolvency of even one of the major GSEs would strain the U.S. and international financial systems and could result in a taxpayer-funded rescue operation.

The concentration of potential taxpayer exposure with GSEs is obvious when compared to the thrift and banking industries. The total of credit market debt plus mortgage pools of the five GSEs included in this report is greater than the total deposits of the more than 2,000 insured S&Ls and about one-third the size of the deposits of the more than 12,000 insured commercial banks. Consequently, the Federal Government's potential risk exposure from GSEs, rather than being dispersed across many thousands of institutions, is dependent on the managerial abilities of the officers of a relatively small group of entities.

Despite the size and importance of their activities, GSEs are insulated from the private market discipline applicable to other privately owned firms. The public policy missions of the GSEs, their ties to the Federal Government, the importance of their activities to the U.S. economy, their growing size, and the rescue of the Farm Credit System in the 1980s have led credit market participants to view these GSEs more as governmental than as private entities. Because of this perception, investors ignore the usual credit fundamentals of the GSEs and look to the Federal Government as the ultimate guarantor of GSE obligations. Therefore, some GSEs are in a position to increase financial leverage virtually unconstrained by the market or by effective oversight. Greater leverage results not only in higher returns for GSE shareholders, but also in potentially greater taxpayer exposure if a GSE experiences financial difficulty.

Given the need for effective financial oversight of the GSEs, the Treasury has developed four principles of effective safety and soundness regulation. These principles are:

I. Financial safety and soundness regulation of GSEs must be given primacy over other public policy goals.

Regulation of GSEs involves multiple public goals. Without a clear statutory preference, a current GSE regulator need not give primary consideration to safety and soundness oversight. Therefore, unless a regulator has an explicit primary statutory mission to ensure safety and soundness, the Government may be exposed to excessive risk.

II. The regulator must have sufficient stature to avoid capture by the GSEs or special interests.

The problem of avoiding capture appears to be particularly acute in the case of regulation of GSEs. The principal GSEs are few in number; they have highly qualified staffs; they have strong support for their programs from special interest groups; and they have significant resources with which to influence political outcomes. A weak financial regulator would find GSE political power overwhelming and even the most powerful and respected Government agencies would find regulating such entities a challenge. Clearly, it is vital that any GSE financial regulator be given the necessary support, both political and material, to function effectively.

The Treasury Department is under no illusions concerning the capture problem. No regulatory structure can ensure that it will not happen. Continued recognition of the importance of ensuring prudent management of the GSEs and vigilance in this regard by both the executive and legislative branches will be necessary.

III. Private market risk mechanisms can be used to help the regulator assess the financial safety and soundness of GSEs.

The traditional structure and elements of financial oversight are an important starting point for GSE regulation. However, Governmental financial regulation over the last decade has failed to avert financial difficulties in the banking and thrift industries. Additionally, the financial services industry has become increasingly sophisticated in the creation of new financial products, and the pace of both change and product innovation has accelerated in the last several years. As a result, to avoid the prospect that GSEs might operate beyond the abilities of a financial regulator and to protect against the inherent shortcomings in applying a traditional financial services regulatory model to entities as unique as GSEs, it would be appropriate for the regulator to enlist the aid of the private sector in assessing the creditworthiness of these firms.

IV. The basic statutory authorities for safety and soundness regulation must be consistent across all GSEs. Oversight can be tailored through regulations that recognize the unique nature of each GSE.

The basic, but essential, authorities that a GSE regulator should have include:

(1) authority to determine capital standards;

(2) authority to require periodic disclosure of relevant financial information;

(3) authority to prescribe, if necessary, adequate standards for books and records and other internal controls;

(4) authority to conduct examinations; and

(5) authority to take prompt corrective action and administrative enforcement, including cease and desist powers, for a financially troubled GSE.

Consistency of financial oversight over GSEs does not imply that the regulatory burden is the same irrespective of the GSEs' relative risk to the taxpayer. Weaker GSEs should be subjected to much closer scrutiny than financially sound GSEs. However, the basic powers of the regulator to assure financial safety and soundness should be essentially the same for all GSEs.

Regulatory discretion is necessary within these broad powers because the GSEs are unique entities and, as such, need regulatory oversight that reflects the nature of the risks inherent in the way each conducts its business. Additionally, because financial products and markets change rapidly, regulatory discretion would allow for flexibility to deal with the changing financial environment.

The Treasury has analyzed the adequacy of the existing regulatory structure of the GSEs against the backdrop of the four principles of effective financial safety and soundness regulation. We have found some deficiencies in the existing regulatory structure for GSEs and recommend that the following changes be made to the structure in order to ensure more effective financial safety and soundness regulation of GSEs.

Separate "arm's-length" Bureau of HUD

Financial safety and soundness oversight of Fannie Mae and Freddie Mac should have primacy over other regulatory goals. Moreover, the responsibility for this oversight should be transferred to a new, separate "arm's-length" bureau of HUD. The Director of the new bureau should be appointed by the President and confirmed by the Senate, and be removable only by the President; the Director should operate with the general oversight of, and report directly to, the Secretary of HUD; the bureau should be separately funded through assessments on Fannie Mae and Freddie Mac, as proposed in the President's 1992 Budget; and the bureau should provide an annual report on its operations to Congress.

Federal Housing Finance Board

The Finance Board should retain financial oversight over the FHLBanks. However, its statute should be amended to make financial safety and soundness of the FHLBanks the Finance Board's primary regulatory goal.

Farm Credit Administration

The FCA should retain financial oversight over the Farm Credit System and Farmer Mac. Moreover, the FCA's financial oversight over Farmer Mac, particularly with respect to authority to set capital standards, should be increased. Also, the Insurance Corporation should be given access to the capital of the associations.

Treasury

The Treasury's oversight over Sallie Mae should be increased to make it consistent with the safety and soundness authorities of the other regulators.

In conclusion, given the immense size of GSEs and the tremendous concentration of potential risk in so few institutions, the taxpayer is entitled to expect Congress and the Administration to focus on more effective oversight of these institutions. The recommendations which I have outlined will form the basis for the GSE legislation the Administration will propose. We believe that the passage of this legislation will result in more effective safety and soundness oversight of these important entities, thereby sharply reducing the threat the taxpayer would be called upon for another costly and painful financial rescue. Moreover, effective safety and soundness oversight, by assuring the long-term financial viability of the GSEs, will enhance the effectiveness of these entities in achieving their public purposes. Action on this legislation will send a strong signal that we have learned some important lessons from the recent and painful difficulties we have experienced in the financial services industry.

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

o 0 o

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

For Immediate Release
March 13, 1991

Contact: Barbara Clay
566-5252

THE HONORABLE JOHN ROBSON
DEPUTY SECRETARY OF THE TREASURY
INTER-AMERICAN CENTER OF TAX ADMINISTRATORS
MAY 13, 1991

Thank you, Francisco (Gill, President of CIAT Executive Council). It is a great pleasure to welcome the ministers and international banking and tax officials with us today. You have an ambitious agenda for this conference, and I am confident you will continue to have a beneficial impact on tax administration throughout the hemisphere, as you have for nearly a quarter century since your founding.

The countries represented here today have similar economic goals and common needs for quality tax administration systems. We depend on each other for trade and reciprocal investment. And -- as the global economy grows increasingly interlinked and interdependent -- we recognize the importance of maintaining strong, growth-oriented economies in all nations.

Fundamental to creating capital and attracting foreign investment is the implementation of economic policies that favor stability and growth. Sound macroeconomic policies provide the foundation for sustained economic development. Excessive taxation, regulation and inflation -- and rapidly fluctuating exchange rates -- can only frighten away investors.

The design and administration of a nation's tax system has a major impact on whether it creates an environment hospitable to investment, trade, and economic growth. Repressive tax regimes will smother economic activity and deter investment. The tax system should offer incentives to entrepreneurs and risk-takers -- particularly no or low capital gains taxes, a tax structure that lets business make and keep a fair profit for its owners, and a tax system that is efficiently and even-handedly administered. So you in this room can influence importantly the prosperity of your respective homelands.

Today, the United States is helping many countries -- in this hemisphere, in Eastern Europe, and elsewhere -- develop policies and build the institutions essential for long-term economic growth and prosperity. As President Bush said, "our challenge in this country is to respond in ways to support the positive changes now taking place...We must forge a genuine partnership for free market reforms."

When President Bush travelled in Mexico and elsewhere in Latin America late last year, he was impressed with the vision and commitment of many of the leaders he met to pursue reforms that will improve their countries' economic prospects. To encourage and support these reforms, President Bush proposed the Enterprise for the Americas Initiative -- which aims to help Latin American and Caribbean countries achieve sustained economic growth by expanding trade, increasing investment, and reducing debt burdens.

Free trade is a cornerstone -- not only of the Enterprise Initiative -- but of a broader economic system based on market principles. The Enterprise for the Americas Initiative seeks to foster that broad free-market system and encourage Latin American economies to open themselves to imports and accept prices determined by market forces.

Our long term goal is to forge a hemispheric free trade area. A critical first step in this process is the North American Free Trade Agreement we propose to enter with Mexico and Canada. Such an agreement would foster economic growth for all three countries, which together compose a market of over 360 million people and $6 trillion in annual output.

This step toward expanding free trade has been inspired by the remarkable economic reforms that are transforming Mexico's economy. And these reforms are being mirrored in other countries throughout the hemisphere.

The Administration is negotiating framework agreements right now with individual countries and groups of countries throughout Latin America and the Caribbean to begin to reduce trade barriers. Since last June, framework agreements have been signed with six countries -- Columbia, Ecuador, Chile, Honduras, Costa Rica and Venezuela -- adding to those already in place with Mexico and Bolivia.

Investment and capital flows are also critical elements of economic growth. And to help countries attract needed capital, the Enterprise Initiative first looks to the Inter-American Development Bank to develop an investment-sector lending program -- conditioned on countries' liberalization of their investment regimes.

The President has also proposed the creation of a Multilateral Investment Fund within the IDB to provide additional support for investment reforms -- for instance, through technical assistance and worker retraining and education -- and to make credit and equity financing available to small enterprises. We welcome Japan's willingness to participate in the Multilateral Investment Fund, and we are encouraging other countries to do the same.

With regard to debt, the Initiative holds out the promise of reducing official bilateral debt to the U.S. in exchange for countries pursuing strong economic reforms -- including measures to open their investment regimes.

Environmental Framework Agreements are another important part of the President's plan. We are supporting a broad range of environmental projects within the hemisphere. And a recent proposal by the Administration to the U.S. Congress would authorize forgiveness of official debt and channeling local currency interest payments into environmental projects.

We also believe that a reduction in tax barriers to cross-border investment can contribute to economic growth. We are now in active negotiations with Mexico for a double tax convention and have held preliminary discussions with other countries in the hemisphere. We are encouraged by these developments.

These are exciting times, and we share your ambitious visions. Much is riding on the success of these trade, investment, environmental, and tax burden reduction opportunities. With your help, we will rise to the challenge and make our countries more competitive and prosperous in the decade ahead.

The last 25 years have been productive ones for CIAT members in terms of sharing information and developing cooperative technical programs. And with your current discussions focusing on strategic planning and tax modernization, I would be inclined to say that your best years are still ahead of you.

I salute you on 25 years of accomplishment. Your work now and in the future is crucial to moving this hemisphere toward sustained economic growth.

Thank you, and good luck for a successful conference.

###

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
May 13, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $9,224 million of 13-week bills to be issued May 16, 1991 and to mature August 15, 1991 were accepted today (CUSIP: 912794XC3).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.47%	5.64%	98.617
High	5.50%	5.67%	98.610
Average	5.50%	5.67%	98.610

Tenders at the high discount rate were allotted 81%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	36,515	36,515
New York	18,900,210	7,231,715
Philadelphia	21,970	21,970
Cleveland	47,505	47,505
Richmond	173,310	113,810
Atlanta	34,005	33,625
Chicago	1,648,235	358,635
St. Louis	55,465	15,465
Minneapolis	7,735	7,735
Kansas City	34,625	34,625
Dallas	25,060	25,060
San Francisco	655,980	286,980
Treasury	1,010,295	1,010,295
TOTALS	$22,650,910	$9,223,935
Type		
Competitive	$17,958,895	$4,531,920
Noncompetitive	1,918,305	1,918,305
Subtotal, Public	$19,877,200	$6,450,225
Federal Reserve	2,667,110	2,667,110
Foreign Official Institutions	106,600	106,600
TOTALS	$22,650,910	$9,223,935

NB-1268

May 9, 1991

The Honorable Robert Michel
Republican Leader
House of Representatives
Washington, DC 20515

Dear Mr. Leader:

I wanted to follow up personally on the President's May 1 letter to you regarding the critical importance of extending, unencumbered, fast track negotiating authority. The President has requested this extension to carry out a far-reaching trade agenda which includes: the Uruguay Round, the North American Free Trade Agreement (NAFTA), and the Enterprise for the Americas Initiative. Without the extension, our negotiating credibility would be called into question, seriously undermining the U.S. leadership role in world trade and our prospects for a strong global economy.

In the debate on fast track, Congress has focused on the proposed NAFTA. In my view, the case for giving the Administration the traditional tools to negotiate a NAFTA is compelling.

Mexico has embarked upon a process of economic reforms that has caused a dramatic increase in its market potential for U.S. exports. Already U.S. exports to Mexico have increased from $12.2 billion in 1986 to $28.4 billion in 1990, as Mexican economic growth has accelerated. Further liberalization under a free trade arrangement is certain to result in additional economic gains for both our countries:

- Mexico still has higher trade barriers than the United States, with tariffs averaging 10% as opposed to 4% for the United States. Significant nontariff barriers also remain, so there is room for greater U.S. export expansion.

- As Mexico develops economically, its consumers and industries will demand more goods and services. The United States particularly benefits from Mexican growth: for each dollar Mexico spends on imports, 70 cents is spent on U.S. goods; for each dollar of GNP growth in Mexico, 15 cents is spent on U.S. goods.

- According to the International Trade Commission, a NAFTA could present many new opportunities for U.S. exports, in such areas as: manufacturing, including telecommunications, computers, and electronic components; grain and oilseed growers; cement; and service providers, including U.S. banking and securities firms.

Environmental and labor issues have been the center of much attention in Congress. The President has sent to you a report outlining what has already been achieved and our plan for future bilateral efforts on these issues. Combined with Mexico's strong commitment, and the economic development Mexico will achieve through a NAFTA, our joint efforts will result in higher living standards, a better workplace and cleaner environment for all.

Mexico is taking a courageous and historic step by linking the future of its economy to ours. Both of our countries will draw strength and prosper from a NAFTA. With your support and your input, I am sure we can achieve this goal. I can assure you that we will continue consulting closely with Congress every step of the way to ensure that the agreement reached is in the best interest of the American people.

Sincerely,

Nicholas F. Brady

IDENTICAL LETTER SENT TO ALL MEMBERS OF CONGRESS

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
May 13, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $9,233 million of 26-week bills to be issued May 16, 1991 and to mature November 14, 1991 were accepted today (CUSIP: 912794XN9).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.61%	5.87%	97.164
High	5.63%	5.89%	97.154
Average	5.63%	5.89%	97.154

Tenders at the high discount rate were allotted 72%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	27,940	27,940
New York	21,309,790	7,952,550
Philadelphia	17,710	17,710
Cleveland	46,370	46,370
Richmond	68,820	68,820
Atlanta	37,365	34,835
Chicago	1,735,735	202,735
St. Louis	36,195	16,195
Minneapolis	7,785	7,785
Kansas City	39,475	37,475
Dallas	15,045	15,045
San Francisco	524,440	90,440
Treasury	714,620	714,620
TOTALS	$24,581,290	$9,232,520
Type		
Competitive	$20,092,710	$4,743,940
Noncompetitive	1,365,980	1,365,980
Subtotal, Public	$21,458,690	$6,109,920
Federal Reserve	2,450,000	2,450,000
Foreign Official Institutions	672,600	672,600
TOTALS	$24,581,290	$9,232,520

NB-1269

ANNUAL TRADE PROJECTION REPORT TO CONGRESS

Prepared Jointly by the Department of the Treasury
and the Office of the United States Trade Representative

April 1991

ANNUAL TRADE PROJECTION REPORT - 1991

Table of Contents

PART I: INTRODUCTION

The Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418) contains numerous reporting requirements, including, in Section 1641, a requirement for an Annual Trade Projection Report.

The report is to include: a review and analysis of key economic developments in countries and groups of countries that are major trading partners of the United States; projections for developments in various macroeconomic variables in the reporting year and the following year; conclusions and recommendations for policy changes to improve the outlook; and, a discussion of the impact on U.S. trade of market barriers and other unfair practices.

The legislation specifies that the report is to be prepared jointly by the Treasury Department and the Office of the United States Trade Representative, in consultation with the Chairman of the Board of Governors of the Federal Reserve System. The report is to be submitted on March 1 of each year to the Senate Finance Committee and the Ways and Means Committee of the House of Representatives.

Part II of this report reviews recent macroeconomic developments in countries or groups of countries that are major trading partners of the United States, as well as key recent developments in the U.S. economy. Part III presents projections for main macroeconomic variables in 1991 and 1992 for the same countries and country groups. These two parts are organized as follows: Section 1 discusses economic growth, trade and current account developments, and policy trends in the industrial countries; Section 2 discusses developments elsewhere in the global economy. Part IV reviews policy issues raised by these projections. Part V discusses the impact on U.S. trade of market barriers and other unfair practices. Parts I-IV were prepared by the Treasury Department; Part V was prepared by the Office of the Trade Representative.

Readers are, in addition, referred to the Treasury Department's semi-annual <u>Report to Congress on International Economic and Exchange Rate Policy</u>, which discusses key issues, including exchange rate developments, in considerable depth and provides a more detailed review of important recent historical trends. That report is also prepared pursuant to the Omnibus Trade and Competitiveness Act of 1988.

PART II: REVIEW AND ANALYSIS OF DEVELOPMENTS IN 1990

1. Industrial Countries

The macroeconomic performance of the major industrial countries in 1990 reflected a number of largely anticipated underlying trends as well as unanticipated developments arising in large part from the Persian Gulf crisis.

The slowdown in the overall pace of economic growth that was widely forecast for the second half of the year proved sharper than expected due in large part to heightened consumer/investor uncertainties and higher oil prices. Growth trends in the individual economies continued to diverge significantly, with strong growth persisting only in Japan and Germany, while the United States, U.K. and Canada slipped into recession by year-end. Measured inflation rates appear to have peaked in the middle/late part of the year for many countries, despite the oil price spike and other transitory developments, and underlying trends indicated a modest improvement in the "core" inflation picture toward year-end. The external adjustment process continued as further declines were recorded in the largest trade and current account imbalances.

A. U.S. Economic Performance

Latest available data confirm a pronounced slowdown in U.S. GNP growth in 1990, extending the steady loss of momentum underway since the first quarter of 1988. On an annual average basis, GNP rose 1.0 percent in real terms in 1990, after growth of 2.5 percent in 1989 and 4.4 percent in 1988. The slowdown was evident in each of the major national accounts line items except government consumption, which accelerated only slightly. As was the case in 1989, export growth was by far the strongest individual component (continuing to exceed real import growth by a large margin), and personal consumption growth the weakest. Total domestic demand grew more slowly than overall GNP (0.5 percent on average), extending an important trend that has been underway since 1987. Thus, improving net exports continued to make a positive contribution to growth.

Consumer prices rose 5.4 percent in 1990 after an increase of 4.8 percent in 1989. Excluding the more volatile food, shelter and energy components, consumer prices rose at an annual average rate of 4.9 percent in 1990 versus 4.4 percent in 1989. (Energy prices rose 8.3 percent on average and 18.1 percent on a December-to-December basis.) The broader, fixed weight GNP deflator rose only marginally to 4.6 percent (from 4.5 percent in 1989) though there was a pickup in measured price pressure during the second half.

On the external side, the merchandise trade deficit narrowed $6.2 billion to $108.7 billion, while the current account deficit narrowed $10.7 billion to $99.3 billion. On the national accounts basis, the deficit on net exports of good and services declined $20.3 billion in real terms, to $33.8 billion.

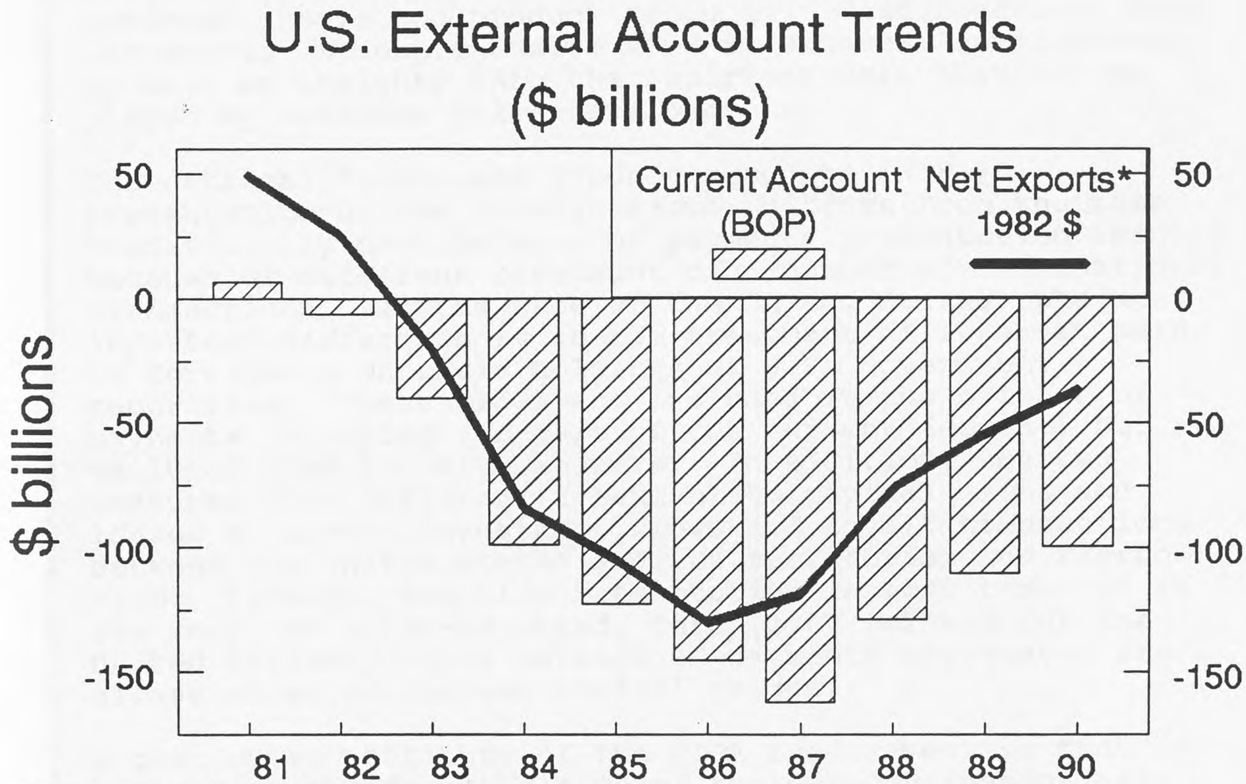
The improvement in the U.S. external position on the balance of payments basis derived from a decrease in the merchandise trade deficit, an increase in the surplus on services, and a shift to a surplus on investment income. The trade deficit in 1990 was equivalent to just under 2 percent of GNP, versus 3.5 percent of GNP when the deficit was at its nominal peak ($159.5 billion) in 1987. The current account deficit was equivalent to 1.8 percent of GNP last year versus 3.6 percent of GNP ($162.3 billion) in 1987.

The national accounts allow us to look at this movement in real terms. On this basis real net imports of goods and services fell to the equivalent of about 0.8 percent of GNP in 1990, a major improvement relative to its peak level of 3.5 percent of GNP in 1986. Since the 1986 peak, the deficit on net exports has declined about $96 billion. This shift on the external side has had a significant positive impact on overall U.S. GNP performance in recent years, accounting for approximately 21 percent of total U.S. GNP growth since 1986, and about 50 percent in 1990.

The external correction in 1990 reflected the continued relative strength of U.S. exports. Merchandise exports rose 8.8 percent, or $28.8 billion in value terms, in 1990 on the balance of payments basis; merchandise imports increased 5 percent, or $22.6 billion. In real terms (i.e., in 1982 prices), national accounts data indicate a 6.4 percent increase in goods and services exports in 1990 versus a 2.8 percent increase in imports. This continues the roughly 2:1 growth rate differential that has been observed since 1986.

External account trends on both the balance of payments basis and the national accounts basis are presented in the chart on the following page. Substantial progress has clearly been made by both measures, though the price-adjusted NIPA aggregate shows considerably more adjustment since 1986.

The reason for the discrepancy lies with differences in the behavior of export and import prices in recent years. Import price increases have exceeded export price increases (roughly 6 percent per year versus about 4 percent) since 1986, which tends to inflate the nominal value of imports relative to exports and therefore diminish the decline in the nominal deficit. (For example, the total bill for petroleum imports rose $11.2 billion, or 22 percent, in 1990 reflecting a 20 percent price increase but only a 1.3 percent volume increase.) When these price effects are filtered out, the underlying volume trends may be seen more clearly; and it is these developments which relate most directly to real variables such as output and employment.



* Net exports of goods and services on a national accounts basis

A number of important trends in U.S. bilateral and regional merchandise trade imbalances continued in 1990: the aggregate U.S. deficit with other industrialized countries improved further, as did the deficit with the Newly Industrialized Asian economies (NIEs); but the deficit with OPEC members widened.

The U.S. balance with the 12 European Community member countries continued to improve, registering its first surplus ($4.9 billion) since 1982. Since its peak deficit of $22.3 billion in 1986 the U.S. balance with the EC has improved $27.2 billion. Surpluses with the U.K. and the Benelux countries continued to increase, and the bilateral balance with France moved slightly into surplus. However, the U.S. bilateral deficit with Germany widened moderately (to $9.7 billion) due to a rebound in U.S. imports; U.S. exports to Germany continued to grow solidly.

ALTERNATE MEASURES OF EXTERNAL ACCOUNT TRENDS

External account developments may be gauged by two different measures, the balance of payments and the national income and product accounts. Used together, they can provide a comprehensive view of external developments, as well as insights into the important role that can be played by relative price developments.

The national income and product accounts (NIPA) presentation of the foreign sector differs from the more traditionally used balance of payments presentation largely because of different treatment of a number of international transactions. In the case of the United States, the most important difference is in the treatment of interest paid to foreigners on their holdings of U.S. government securities. These flows are included in the balance of payments reckoning (as part of the current account) but are excluded from the NIPA measure. In addition, the two measures give different treatment to capital gains and losses on direct investment flows and to all transactions between the United States and its territories and Puerto Rico. Finally, the NIPA presentation is most familiar in its real, or price-adjusted, form (1982 dollars for the United States), while balance of payments aggregates are always shown as current nominal values.

A particular attribute of the NIPA measurement is that by separating the domestic side of the economy (essentially private and public consumption and investment) from the external side (exports and imports of goods and services), it clearly identifies the relative contribution of each to the overall growth performance. In addition, current value NIPA aggregates may be adjusted with import and export price deflators to uncover underlying volume developments in goods and services flows. The resulting real aggregates are important in gauging the impact of external sector trends on output and employment. The balance of payments measure, on the other hand, provides the most comprehensive and internationally comparable picture of international transactions and is therefore more useful in analyzing developments in the context of financial market trends and global payment patterns.

The U.S. bilateral trade imbalance with Japan declined almost $8 billion further in 1990, albeit to a still high level of $41.8 billion. Total adjustment since the deficit peak in

1987 has been $15.1 billion. U.S. imports from Japan declined in 1990 for the first time since 1975 while U.S. exports continued to grow. Exports to Canada grew moderately, but slightly outpaced import growth, narrowing the U.S. bilateral deficit slightly to $9.4 billion. (Canada is by far the largest U.S. trading partner, with inward and outward flows accounting for nearly 20 percent of total U.S. trade.)

The U.S. deficit with OPEC rose to $24.8 billion, its highest level since 1981. As noted above, price developments were largely responsible for the increase. Since 1988, the U.S. trade deficit with OPEC has risen $15.5 billion, offsetting nearly half of the overall U.S. deficit reduction achieved with the rest of the world during the past two years and thus contributing importantly to the observed slowdown in the overall rate of trade deficit reduction.

The U.S. trade deficit with the non-OPEC member developing countries remained essentially unchanged at $39.4 billion. Bilateral deficits declined against each of the four Asian NIEs, bringing the combined deficit with the NIEs to $21 billion; deficit reduction against these countries has totaled nearly $14 billion. Despite reduced U.S. deficits with Mexico (the third largest U.S. trading partner) and Brazil, the U.S. deficit with other countries in the Western Hemisphere (excluding Canada) widened by about $1.5 billion to $10.1 billion.

A number of developments in the commodity composition of trade flows in 1990 are worth noting. Exports of non-automotive capital goods rose 11 percent (nominal terms, balance of payments basis) while such imports increased just under 4 percent. Consumer durables exports grew 20 percent while imports grew less than 1 percent, though the net U.S. deficit remained large ($33 billion). Exports of automotive products rose 5.5 percent while imports were essentially unchanged; however, the deficit also remains large (about $20 billion) in this sector.

B. Economic Developments in Other Industrial Countries

I. Growth Trends

Real GNP growth in the foreign industrialized countries (OECD members excluding the United States) continued to decelerate in 1990, slipping from 3.7 percent to 3.3 percent.

Japan was again the major country growth leader in 1990, as real GNP growth accelerated to 5.6 percent, from 4.7 percent in 1989. Domestic demand growth remained steady at 5.8 percent (vs. 5.7 percent in 1989). Thus, the growth gap between GNP and domestic demand has narrowed from 1.4 percentage points in 1988 to 1.0 percentage points in 1989 and 0.2 percentage points in

1990. Private consumption spending again advanced nearly 4.5 percent, balancing the competing influences of solid income gains and a late-year, Gulf war-related deterioration in consumer confidence. Rebounds in public and residential investment outlays offset a modest easing in business investment, keeping overall investment growth quite strong. On the external side, import and export growth rates (real terms; NIPA basis) both slowed substantially; import growth continued to exceed export growth, but by a smaller margin (12.5 percent vs. 10.7 percent) than in any year since 1987.

GNP growth in the **four largest European countries** slowed by about one-half of a percentage point, as did domestic demand growth. However, the divergences in the growth performances of the individual countries that had begun to emerge in 1989 widened further in 1990. Specifically, growth accelerated in Germany but slowed in France, Italy and the U.K.

Germany saw GNP growth strengthen from 3.8 percent in 1989 to an estimated 4.5 percent last year. Domestic demand growth accelerated even more sharply, from 2.7 percent to 4.6 percent. With real disposable income benefitting from higher wages, stable inflation, and a substantial tax cut, private consumption growth rose to its highest level in two decades (approximately 4.5 percent). Investment spending also accelerated, as unification-related demand bolstered both the equipment and construction sectors. On the foreign trade side, goods and services imports grew to meet the higher domestic demand while softer conditions in key markets slowed export growth somewhat. Nevertheless, external developments had a small net positive effect on German GNP in 1990. (Note: These data apply to western Germany only. GNP data for eastern Germany -- formerly the GDR -- have not been published by the German government.)

Growth slowed further in the **United Kingdom** in 1990, with pronounced weakness emerging during the second half of the year. Real GNP growth slipped to an annual average rate of 0.6 percent. Domestic demand growth fell by 0.3 percent as private consumption expenditures rose less than 2 percent and fixed investment outlays contracted by about 1.5 percent. However, the external picture improved substantially relative to 1989. Export growth picked up a bit to just under 5 percent, while import growth fell to less than 3 percent in the face of weak domestic demand; as a result, the foreign trade sector exerted a net expansionary effect on the U.K. economy in 1990.

France also experienced weaker growth in 1990, though the economy remains on a path of continued moderate expansion. Capital investment activity slowed, as did stock accumulation; private consumption held generally firm, although surveys suggested diminished consumer confidence toward year-end. On the external side, the rate of export growth was halved (to just under 5 percent) and lagged the rate of import growth by about one percentage point. In **Italy** real GNP remained on a path of continued, but appreciably weaker, growth; industrial production contracted in the second half and was slightly negative for the year. Investment activity lost steam -- as did household consumption and exports -- but all nonetheless remained on a positive track. As elsewhere, consumer and business surveys indicate a downturn in confidence during the second half.

The situation in **Canada** is similar to that of the U.K. in that it, too, is experiencing an anticipated adjustment to the excessive demand pressures that emerged in 1988. Private consumption growth remained positive in 1990, but much weaker, and fixed investment spending contracted; export growth picked up and import growth slowed. Overall, real GNP advanced 0.9 percent in 1990 (after 3.0 in 1989) and domestic demand growth dropped from 4.2 percent to zero.

The **smaller OECD countries** also turned in a generally weaker performance in 1990. Weighted average GNP growth in these countries (essentially the rest of Europe, plus Australia and New Zealand) slipped from about 3.8 percent in 1989 to an estimated 2.8 percent in 1990. As in the larger countries, domestic demand growth slowed more sharply, especially in Australia and New Zealand. In particular, investment activity cooled in most of the smaller economies after several years of unusual strength.

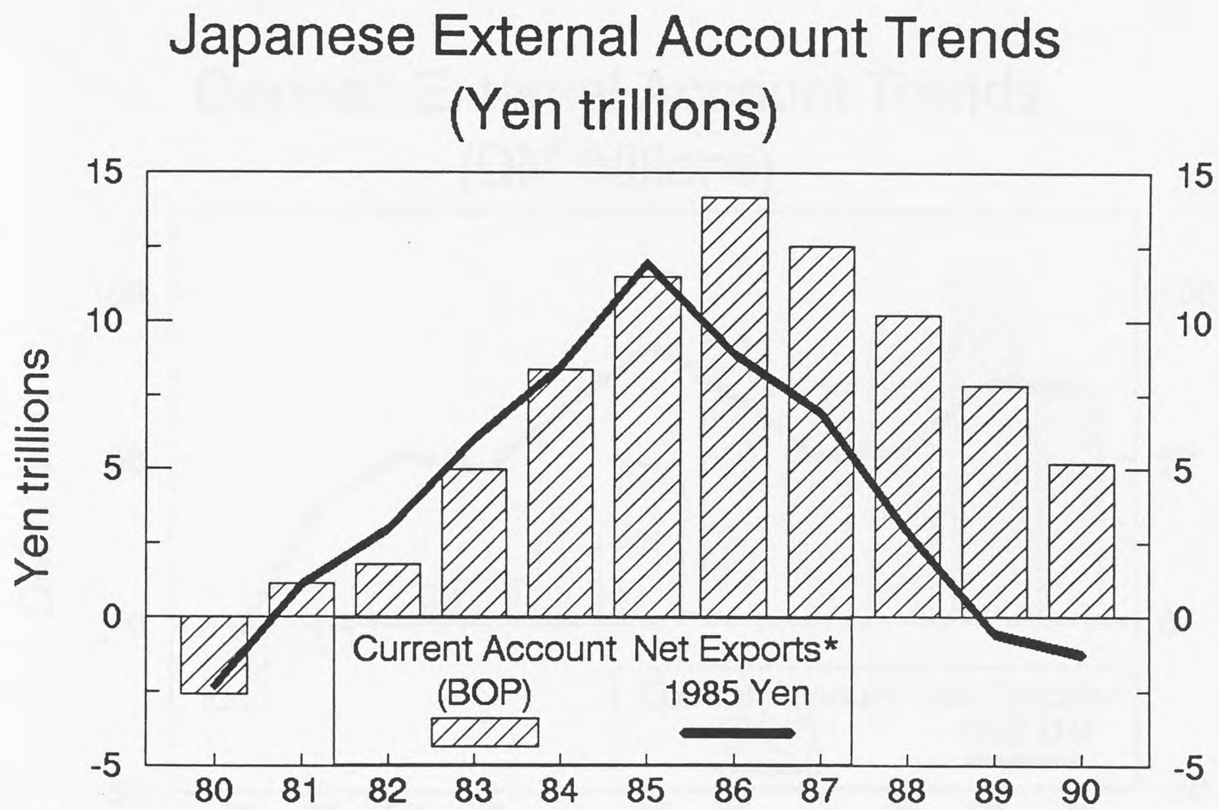
II. Trade and Current Account Developments

Additional progress was made in 1990 in reducing the largest trade and current account imbalances outside the United States (i.e., those of Japan, Germany and the U.K.). Numerous other OECD countries experienced moderate deteriorations in their external positions due in the main to the unanticipated oil price surge during the second half of the year.

Japan's current account surplus declined substantially again in 1990, falling $21 billion to $35.8 billion. The 1990 correction followed a $22 billion decline in 1989, and brought to $51 billion the total decline in the Japanese surplus since its peak in 1987. In terms of GNP, the current account surplus declined over the same period from 3.6 percent to the equivalent of 1.2 percent last year. The trade surplus declined an additional $14 billion in 1990 (to $64 billion, or 2.2 percent of GNP), bringing the total correction to about $32 billion since the 1987 peak. The invisibles deficit rose $19 billion over the same period.

Several factors contributed to the additional Japanese external adjustment in 1990. The growth of import volume (census basis) continued to exceed (though only marginally) that of exports, as has been the case since 1986. Secondly, the terms of trade moved against Japan again in 1990, due in part to the increase in oil prices: import unit values rose by 10.2 percent while export unit values rose 3.4 percent. Thus, volume changes aside, price changes alone would have boosted the import bill and reduced the surplus. In the invisibles account, higher deficits on travel, transportation, and transfers contributed to a $8.3 billion deficit increase.

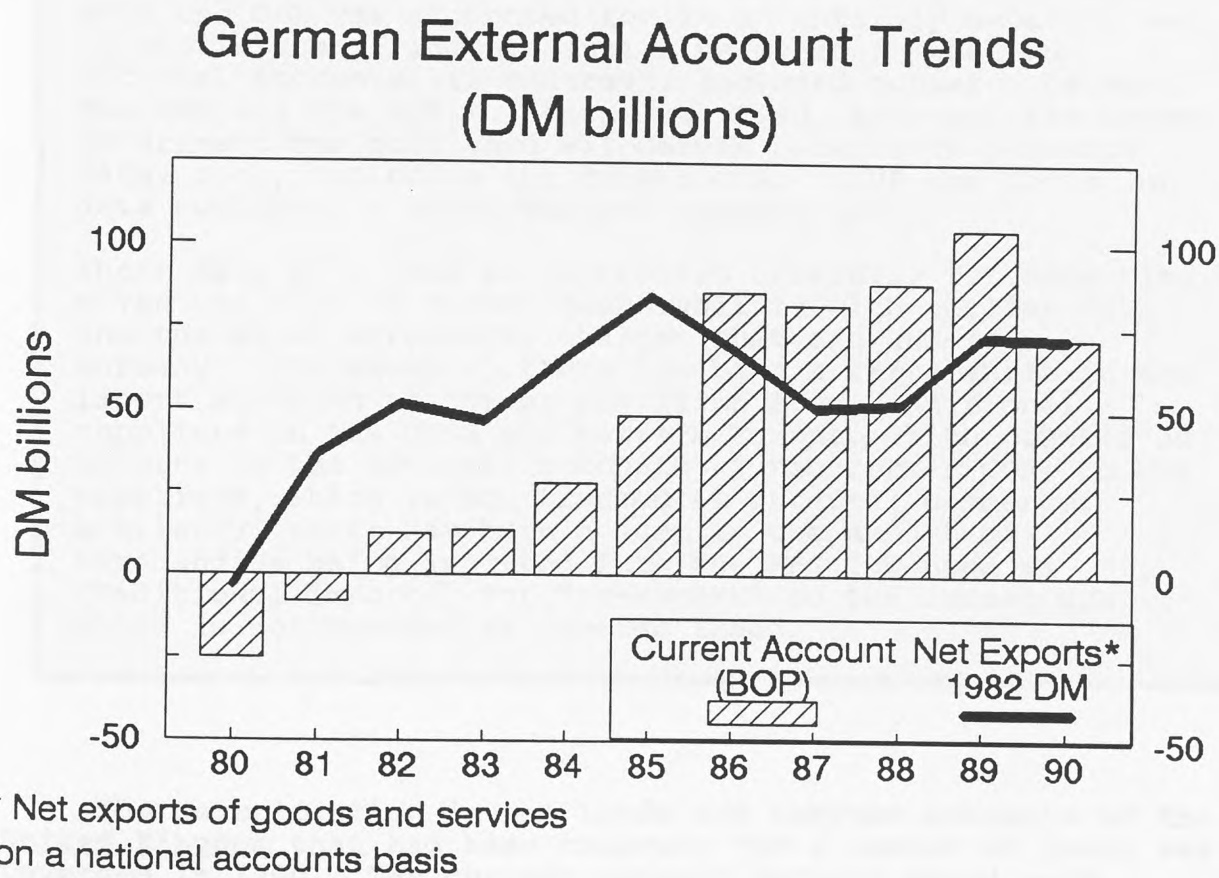
The external adjustment process in Japan mirrors that of the United States in one important respect: the nominal balance of payments data do not fully express the amount of underlying (i.e., price-adjusted) adjustment that has occurred. The chart below illustrates the differences.



* Net exports of goods and services
on a national accounts basis

In dollar terms, the Japanese current account surplus declined by about 60 percent between 1987 and 1990. However, on a price-adjusted national accounts basis the degree of adjustment has been larger. In volume terms, Japanese imports of goods and services increased 45 percent between 1986 and 1990 while export volume simultaneously rose about 14 percent.

German trade and current account surpluses declined substantially in 1990; in the case of the current account, this was the first time the surplus failed to increase in over a decade. In dollar terms the current account surplus declined almost $11 billion (19.5 percent) to $44.5 billion; the trade surplus declined $6.4 billion (9 percent) to $65 billion. Given the appreciation of the deutschemark against the dollar the correction was larger in DM terms: 31 percent and 12 percent, respectively. The correction on both the trade and current accounts was significant as a percent of GNP, though by this measure both remain quite large. (The trade surplus dropped from 6.3 to 4.4 percent of GNP; the current account surplus from 4.6 percent to 2.5 percent.)



* Net exports of goods and services
on a national accounts basis

The pronounced strengthening of domestic demand boosted import absorption significantly; volume rose nearly 11 percent in 1990 (balance of payments basis) after 7.7 percent in 1989. Export volume growth, on the other hand, was limited to 2 percent by slower demand growth abroad as well as by higher domestic absorption of goods that might otherwise have been exported. The picture on the national accounts basis in 1990 also reflected the external adjustment that was underway. Growth of goods and services exports slowed to about 9.6 percent in real terms while real import growth accelerated to 11.5 percent.

GERMAN EXTERNAL STATISTICS

Unification has necessitated some major presentational changes in Germany's foreign trade statistics and posed some challenges in interpreting the new data. Since the division of Germany, balance of payments data for the Federal Republic (FRG) did not include commerce with the German Democratic Republic (GDR), reflecting the fact that the GDR was not considered a separate country. Commerce with the GDR was accounted for in an entirely separate set of statistics. (The external line items in the FRG national accounts, in contrast, included commerce between the FRG and the GDR.) Since July 1990, however, the German government has published all-German balance of payments data, i.e., including the former GDR. (GNP and inflation data continue to cover western Germany only.)

These data will need to be treated carefully for some time given the lack of direct comparability with earlier data and the major structural changes that are underway in Germany. For example, there has been a large shift in the import sourcing of former GDR firms from traditional suppliers in the USSR and Eastern Europe, which counted as imports in the external accounts of the former GDR, to FRG suppliers, which is now treated as internal commerce. Similarly, there has been a jump in the amount of merchandise being imported into the FRG (counted as traditional imports) for "re-export" to the former GDR, which is not counted as foreign trade.

The deterioration in the trade and current accounts of the **United Kingdom** that had been underway for a number of years was reversed in 1990. The current account deficit eased back considerably from its 1989 peak of $31.3 billion to $22.8 billion; the trade deficit was reduced from $39 billion in 1989 to $31 billion last year. Both nevertheless remain fairly large in proportion to GNP: the trade deficit was equivalent to 3.4 percent of GNP; the current account deficit was 2.4 percent. The U.K.'s external correction in 1990 reflected several factors: the sharp cooldown in domestic demand (and imports); continued improved performance on the export side; and, a large increase in net direct investment earnings.

While the four largest external imbalances narrowed in 1990, developments in the **other major industrial countries** were mixed. In **France** the trade deficit widened moderately to about $9.5 billion reflecting higher oil import costs and some loss of external competitiveness due to the effective appreciation of the franc. **Italy's** trade deficit narrowed slightly due in part to an exchange rate related decline in import prices, while the current account deficit widened to about $12 billion due mainly to negative developments on the tourism account. **Canada's** trade surplus widened to about $9 billion reflecting both a modest export recovery and much weaker import growth; the current account deficit remained substantial, at $13.7 billion or 2.4 percent of GNP.

III. Macroeconomic Policy Developments

The growing divergence among the cyclical positions of the major countries combined with the heightened uncertainty arising from the outbreak of the Persian Gulf crisis to create a more challenging environment for economic policy makers. The main priorities remained achievement of sustained growth over the medium-term, low inflation, and consolidation of the public sector finances.

The monetary authorities in the industrial countries continued to focus primarily on trying to balance judgments about the prospects for inflation, on the one hand, against judgments about the cyclical position and underlying strength of the national economies on the other. As a general matter, the monetary authorities have continued the cautious approach they have pursued in recent years, with the reduction of inflation expectations being given particular emphasis.

The principal medium-term objective of fiscal policy remains to strengthen budgetary positions in order to increase national saving and complement monetary policies aimed at price stability. As a general matter, greater efforts have been made in recent years to limit the growth of public expenditures and to improve the efficiency of tax regimes. Nevertheless, budgetary developments in individual countries continue to be strongly affected by the impact of cyclical trends, as well as (in the case of Germany) unanticipated structural changes.

Japan's fiscal position strengthened further in 1990, with the general government budget surplus (including the equivalent of federal, state and local budgets) increasing to an estimated 2.8 percent of GNP. Revenue growth has been boosted by continued strong economic activity while expenditures have been restrained in the context of a long-standing commitment to reduce public borrowing. Monetary policy was maintained on the cautious side in 1990 reflecting the continued economic strength and concern about the potential inflationary implications of oil prices and wage negotiations; the Bank of Japan raised the discount rate twice during the year, from 4.25 percent to 6 percent.

Unification has dramatically changed the fiscal situation in **Germany**. After recording a small general government budget surplus in 1989 (0.2 percent of GNP), the overall public sector account (including the former GDR) moved sharply into deficit in 1990 (2.3 percent of GNP). Net public sector borrowing rose to an estimated 3.1 percent of GNP in 1990. The shift reflects the impact of both unanticipated expenditures associated with unification as well as the final stage of Germany's multi-year tax reform program. Introduction of German Economic and Monetary Union in mid-1990 (including the conversion of Ost Marks to Deutschemarks) makes it difficult to interpret trends in the monetary aggregates. Nevertheless, the Bundesbank's policy orientation was one of caution in the face of the perceived inflation potential of unification; the discount rate was raised from 6 to 6.5 percent in early 1991 and market interest rates rose appreciably at both the long and short ends.

The **French** authorities continued to pursue a policy of monetary restraint in order to preserve French export competitiveness against the background of the existing exchange rate parities within the European Monetary System's Exchange Rate Mechanism (ERM). Fiscal policy remained cautious and, on balance, mildly contractionary. In **Italy**, a trend toward lower interest rates persisted until the latter part of the year when a return to higher rates became necessary to preserve the lira's ERM parities. On the fiscal side, the authorities remained on a course of slow consolidation in an effort to continue to slow the rise in the burden of public debt and reduce a central government deficit that now stands at about 11 percent of GNP.

The **United Kingdom's** commitment to monetary restraint was given added impetus by its October 1990 entry into the ERM, and by the priority this accords to reducing substantially the U.K.'s relatively high inflation rate. The central government budget surplus remained broadly unchanged in 1990 (as a percent of GNP) as the government persisted with its program of medium-term fiscal restraint in support of its basic inflation objectives. Monetary conditions remained generally tight in **Canada** as well, reflecting concern about the potential inflation implications of several years of robust domestic demand growth. Fiscal policy continues to be formulated in the context of a medium-term effort to reduce the relatively large public sector deficit.

2. Economic Trends Outside the Industrial Countries

The economic performance of the developing countries (LDCs) generally deteriorated in 1990 and regional disparities widened relative to 1989. Real GNP growth (weighted average) slipped to just below 1 percent from an estimated 3.1 percent in 1989 reflecting the industrial country slowdown as well as the structural shifts underway in Eastern Europe and the unsettled situation in the Middle East. The median inflation rate moved up slightly to about 10 percent, though rates in a handful of individual countries were extremely high. The combined LDC current account deficit rose marginally: the fuel exporting countries moved into surplus for the first time since 1985 while the non-fuel exporters experienced a higher deficit.

The LDC growth slowdown in 1990 reflected reduced growth in each of the major geographic regions. **Asian** economy growth slipped slightly to about 5 percent but was still by far the best regional performance. A rebound of Korean growth helped maintain aggregate growth in the four Asian NIEs at about 6-1/2 percent, despite weaker expansion in Taiwan. The **African** economies continued to expand, though at a more moderate 2 percent estimated pace; the sub-Saharan economies maintained positive, but weaker, GNP growth but experienced a further decline on a per capita basis.

The European, Middle Eastern and Latin American LDCs contracted on average in 1990, particularly those with debt servicing difficulties. Despite the benefits accruing to some oil producing countries, economic activity in the **Middle East** region was strongly affected by the commercial and financial disruption of the Iraqi invasion of Kuwait. Most of **Latin America** was adversely affected by deteriorating terms of trade, although the oil producing countries were net beneficiaries. Mexico turned in its second consecutive year of real growth in the 3 percent range, and the Venezuelan economy rebounded strongly from its deep recession of 1989. In other cases, such as Brazil, transitional weakness in 1990 reflected in part the implementation of stabilization policies designed to address long-standing underlying economic imbalances.

The overall inflation picture in the LDCs continued to be seriously skewed by very high recorded rates in a relatively few larger economies. On a GNP weighted average basis, LDC inflation is estimated to have remained near its 1989 level of about 105 percent. **Latin American and European LDCs** continue to have the most serious inflation problems, as was the case during the entire decade of the 1980s. Argentina and Brazil both had annual average consumer price inflation in the range of 2,500 percent in 1990, though in both cases a deceleration was emerging by year end. In **Eastern Europe**, price reforms, a large monetary overhang, and higher oil prices produced a surge in measured inflation rates in some countries.

However, the inflation picture was less striking elsewhere. As noted above, the median LDC inflation rate is estimated to have been closer to about 10 percent in 1990, or little changed from 1989. Indeed, preliminary estimates suggest that weighted inflation rates may have declined somewhat in Africa, Asia, and the Middle East in 1990.

The overall current account position of the LDCs changed relatively little in 1990, with their aggregate deficit increasing from $21 billion to about $27 billion. However, some substantial regional divergences emerged, largely reflecting developments in commodity markets, especially for oil. The major oil exporters moved from rough balance in 1989 to a surplus of about $15 billion as export volumes and prices rose.

Meanwhile, the combined current account deficit of the non-oil LDCs increased, mainly reflecting a deterioration in their terms of trade (import price increases in excess of export price increases) and weaker demand growth in key export markets. The aggregate surplus of the four **Asian NIE**s declined for the third consecutive year, to about half of the $30 billion peak surplus recorded in 1987. (Of the approximately $6 billion decline in the NIEs' trade surplus in 1990, about $4 billion was accounted for by the group's declining bilateral surplus with the United States.) **Eastern Europe**'s trade deficit widened in 1990 as a result of higher oil bills and import growth; thus, higher net transfer receipts notwithstanding, the region's current account moved into a small deficit.

PART III: PROJECTED DEVELOPMENTS IN 1991 and 1992

The global economic expansion underway since 1983 is forecast to continue this year -- albeit at a slower pace than in 1990 -- and to gain renewed strength in 1992. As usual, the global trend will mainly reflect developments in the industrial countries, where aggregate real GNP growth of around 1 percent in 1991 is expected to pick up to the 2-1/2 to 3 percent range in 1992. The LDCs are expected to record modestly improved growth this year (just under 1 percent) and return to about a 3-1/2 percent rate in 1992. Consumer price inflation in the industrial countries this year should ease slightly from 1990's 5 percent rate and then drop back to the 4 percent range in 1992. Average inflation in the LDCs is forecast to decline substantially in 1991 and 1992 as rates are brought down in Eastern Europe and Latin America.

World trade growth (in real terms) should continue to run at its historical rate of just over twice the pace of output growth, or 2-1/2 percent in 1991 and around 5-1/2 percent in 1992. Thus, international trade will remain an important source of stimulus and support for output growth. The continued cyclical divergences among the major economies should support some further current account adjustment this year, particularly in terms of GNP. With these divergences expected to narrow in 1992, however, some renewed widening in key current account imbalances cannot be ruled out.

Projections for Foreign Industrial Economies

A. Economic Growth

Economic expansion is expected to continue, albeit at a slower aggregate pace, in industrial countries outside of the United States in 1991 and to regain some of its momentum in 1992. The major cyclical divergences which emerged clearly in 1990 are forecast to persist this year but then narrow significantly in 1992. Specifically, the current recession in the U.K. and Canada should give way to recovery later this year and in 1992 while the rapid growth rates observed in Japan and Germany in 1990 give way to a more moderate pace this year and next.

There are likely to be some significant shifts in the composition of growth in the industrial countries this year and next. Weak (or negative) private consumption growth in the recessionary economies in 1991 is expected to pull the industrial country average to well below rates recorded during the expansion to date. This applies as well to private investment growth, which for the past several years has been a principal source of dynamism in the industrial economies. As recovery takes hold in the English-speaking countries in 1992, however, the overall picture is likely to "normalize," with private consumption and investment rates trending back toward a level more consistent with historical experience.

International trade activity should continue to track closely with industrial country output trends. Trade volume growth is therefore forecast to slow somewhat further this year but then pick up again in 1992. Given the technical assumption of stable oil prices and exchange rates, current account developments should be driven mainly by cyclical trends and the shifts in competitiveness that have already been observed. Thus, the relatively weak economies should see reduced external deficits this year, as should Germany given its special circumstances. The expected return to a more uniform growth pattern in the major economies in 1992, however, suggests that substantially less adjustment may be in prospect; indeed, a lull in the foreign adjustment process, or even a reversal in some cases, cannot be ruled out.

Japanese growth is forecast to slow this year but should nevertheless remain the highest among the Summit countries. Consumer spending will probably ease relative to 1990, but will continue to get support from high employment and wage growth, as well as a post-war improvement in confidence. Investment spending is likely to slow substantially in 1991, the product of a squeeze on profits, higher capital costs, and several years of very strong investment activity. These trends, coupled with continued restraint on public sector spending growth, will pull domestic demand off its recent 6 percent growth path, though it should continue to outstrip GNP growth by a small margin. GNP prospects for 1992 would appear to be broadly similar, with private consumption and investment maintaining growth rates in about the ranges likely to be observed this year. Over the two year 1991-92 period, therefore, annual GNP growth in the 3-1/2 to 4 percent range is anticipated.

Prospects for the **German** economy are more uncertain than at any time during the past decade, with the still insufficiently understood costs and effects of unification being felt throughout the economy. Nevertheless, with the passage of some of the special growth-boosting factors at play in the domestic economy last year, German GNP expansion is likely to slow during the course of the next 7 quarters. Private consumption growth is expected to be contained by the absence of the stimulus of last year's tax cut, the new tax increases to finance unification, and the generally heightened level of uncertainty among households. Plant and equipment investment growth is also likely to ease after two consecutive years of impressive strength, though unification-related construction demand (both residential and business) will provide continued support. Overall GNP growth averaging about 2-1/2 percent this year and next can realistically be anticipated.

Indications thus far suggest that 1991 will be an important transition year for both the **U.K.** and **Canada**. Both economies finished 1990 on a contractionary note, and while some renewed growth momentum should develop over the next few quarters, latest IMF projections suggest that GNP growth for 1991 as a whole could be moderately negative. Domestic demand growth is likely to be weaker than GNP as high interest rates and strained profit positions will continue to put pressure on investment spending while household budget consolidation (and a tax increase in Canada) limits private consumption to only minimal growth. The recovery forecast for the latter part of this year is expected to gain some strength in 1992. Contributing factors should be a return to positive investment growth (aided by a more supportive inflation/monetary environment) and some rebound of consumer spending (partly reflecting improved sentiment).

The **other industrial countries** (including France and Italy) are expected to follow a pattern of slower growth in 1991 giving way to renewed, though moderate, strengthening in 1992. Most of these economies entered 1991 with a significant loss of momentum in both consumption and investment growth, reflecting the slowdown in the English-speaking countries, the effects of high real interest rates, and the uncertainty generated by the Persian Gulf crisis and the oil price spike. Consumer and business confidence fell sharply throughout **continental Europe** during the second half of 1990, and made itself felt in weaker order books and employment data.

However, the restoration of growth in the recessionary economies during the course of this year, coupled with an improved outlook in the wake of the Persian Gulf war, should support stronger growth during the latter part of this year and into 1992. The overall pattern of private consumption and fixed investment is thus likely to be a dip to a lower rate of growth this year followed by a rebound in 1992. An average real GNP growth rate of about 2 percent in 1991 should be followed in 1992 by a return to roughly last year's 2-1/2 percent rate.

B. External Account Developments

The general pattern of major country growth forecast for 1991 -- relatively strong growth in the main surplus countries and relatively weak growth in the deficit countries -- should support further reductions in the largest trade and current account imbalances.

In **Japan**, export volume growth is expected to slow further this year reflecting demand weakness in key foreign markets. However, Japanese import absorption is also likely to slow due to

CURRENT ACCOUNT SITUATION IN PERSPECTIVE

The net current account surplus of the six foreign Summit countries (i.e., excluding the United States) has been reduced from $123 billion in 1986 to an estimated $22 billion in 1990. Divergences in individual country imbalances measured as a percent of GNP have also been sharply reduced. In 1986 the United States had a current account deficit equivalent to 3.4 percent of GNP; at the same time, Germany had a surplus of 4.4 percent and Japan a surplus of 4.3 percent. By last year the U.S. deficit had been cut to about 1.8 percent of GNP, while the Japanese and German surpluses were reduced to 1.2 and 2.9 percent of GNP, respectively.

the less robust pace of domestic demand, and the technical assumption of relative stability for oil prices will eliminate a very important reason for last year's higher import bill. These factors are expected to limit the scope for further trade surplus reduction in 1991, even though in volume terms the expansion of imports will continue to exceed that of exports. Any correction that does emerge may therefore be relatively small (especially compared to the large adjustment observed last year), and a modest increase in the Japanese trade surplus cannot be ruled out. The current account, moreover, will remain strongly influenced by the rising deficit on the invisibles account (services and transfers). In particular, Japanese official transfers will rise sharply on a one-time basis in connection with contributions in support of coalition efforts in the Persian Gulf. Thus, the current account surplus may well increase marginally from its $35.8 billion level of 1990.

Developments in 1992 should reflect a number of factors. Import growth should gain support from the anticipated acceleration of domestic demand, while exports benefit from the recovery of demand growth in foreign markets. However, given the still substantial gap between imports and exports, a reduction in the Japanese trade surplus will require total imports to grow at least 25 percent faster than total exports. Due in part to the inevitable uncertainty about price developments in 1992, it is an open question whether this differential will obtain. Changes in the invisibles account are expected to normalize after this year's unusual developments: a continued increase in investment income earnings balanced against further growth in tourism outflows. Overall, a moderate nominal increase in the Japanese current account surplus is anticipated; in terms of GNP it may move slightly above the 1-1/2 percent mark.

External account developments in **Germany** will continue to be strongly affected by the structural shifts in trade arising from unification as well as some important developments in official transfers. On the trade side, imports will reflect domestic demand growth which should remain solid (albeit less strong than the unusual surge in 1990), as well as the incremental import need associated with restructuring in the former GDR. Exports are likely to be limited by both weaker growth elsewhere in Europe as well as the trade diverting effects of unification. In addition, trade trends in the former East Germany (included in the balance of payments accounts since 1990) will have an important impact. The Eastern states registered a large surplus in 1990 as imports collapsed (due to a switch in sourcing to the FRG) while exports remained fairly steady. This year, however, "east" German exports to the CMEA countries are expected to fall dramatically due to the introduction of trade on a hard currency basis. Finally, the invisibles deficit will be boosted this year by Persian Gulf support, as well as assistance for the USSR and debt relief for Eastern Europe. In aggregate, the German current account surplus is expected to decline substantially this year to under 1 percent of GNP (versus almost 3 percent in 1990).

Determinants of trade account developments in 1992 are expected to include: the anticipated revival of foreign demand growth in 1992 (especially among Germany's major European trading partners); a partial fading of Germany's unification-related import surge; and, the assumed absence of any special developments in oil prices or exchange rates. On the current account, investment income growth will be balanced against the continuation of transfers at relatively high levels. Thus, Germany's trade and current account adjustment is likely to slow in 1992, and may well reverse.

The **United Kingdom** is forecast to record trade and current account deficits in 1991-1992 that are appreciably lower than those recorded in the 1988-1990 period. The pronounced weakness of U.K. demand this year, coupled with the relative strength of demand abroad, should both support British export growth and compress import growth. However, this adjustment impulse is expected to lose some force in 1992 with the narrowing of the cyclical divergence between the U.K. and key trading partners. Given the linkage of the pound to the European Exchange Rate Mechanism, the U.K.'s relative inflation performance will have important implications for its competitiveness in future years; current inflation differentials would imply a loss of British competitiveness in import-competing and export sectors. Thus, the British trade and current account deficits are forecast to decline substantially this year in both nominal terms and as a percent of GNP, but then increase again slightly in 1992.

The relatively small current account deficit in **France** is expected to change little this year but decline in 1992 due in large part to cyclical factors and the relatively solid competitive position of French exports. Prospects for improvement of trade and current account deficits in **Italy** remain constrained by relatively high unit labor cost increases. Nevertheless, with Italian demand slowing relative to some of its key trading partners, modest declines in both deficits in 1991 and 1992 cannot be ruled out.

The **smaller industrial countries** are not expected to register any dramatic external account shifts in the 1991-92 period; the aggregate current account deficit of the group is forecast to remain at around the $30 billion level of 1990. **Spain** will continue to have the single largest deficit, followed by **Australia**. Both **Sweden** and **Finland** have turned in substantially higher deficits recently, the product of both higher oil prices and relatively strong domestic demand growth; in neither case is a quick turnaround seen as likely. Natural gas exports have protected the **Netherlands** from the oil price shock, while exports have been buoyed by German demand; as a result, the Dutch current account surplus has strengthened, and should expand further, given slowing domestic absorption.

C. Policy Directions

As a general matter, the industrial countries continue to follow a fiscal policy course directed to improving the strength and balance of the public finances over the medium term. Discretionary policies remain generally geared toward expenditure restraint, the loss of momentum of the current expansion notwithstanding. Fiscal restraint is seen increasingly as an essential complement to a monetary policy approach geared especially toward price stability and the preservation of national competitiveness over the longer term.

The immediate situation in **Germany** is obviously very different, reflecting as it does the compelling and unanticipated requirements associated with unification. Years of successful fiscal consolidation cut the general government budget from a deficit of 3.7 percent of GNP in 1982 to a surplus of 0.2 percent of GNP in 1989. However, heavy unification-related costs, coupled with long-planned tax relief, overwhelmed additional growth-generated revenue in 1990 and boosted the deficit sharply to about 2.1 percent of GNP. A combined federal, state and municipal government deficit (all-Germany) of about DM 140 billion (or about 5 percent of GNP) has been officially targeted for 1991, and additional tax measures were recently taken to achieve this objective. There are good prospects for declining deficits over the medium term, but continued large borrowing needs can nevertheless reliably be anticipated.

Budget surpluses in **Japan** continued to grow in 1990, the product of growth-driven revenue gains as well as a cautious approach on the expenditure side. Between 1983 and 1990 the general government budget moved from a deficit equivalent to 3.6 percent of GNP to a surplus equivalent to an estimated 2.8 percent of GNP. The central government budget deficit (excluding the large social security surplus) fell to a low level in 1990.

Projections for Non-Industrial Countries

Economic prospects for the less developed countries continue to differ significantly along regional lines. As a group, however, the LDCs are expected to show modestly better output growth this year, accelerating to a higher level in 1992. The aggregate LDC current account deficit is forecast to widen substantially in 1991 and 1992 due mainly to reconstruction and oil price effects in the Middle East and growing deficits in Eastern Europe.

The **Asian** NIEs are likely to continue as the LDC growth leaders, remaining on a path of steady 6 percent aggregate growth driven less by exports than during the 1980s. Most countries in the region will benefit from the assumed stability of oil prices at around their pre-war level as well as, in 1992, the forecast growth acceleration in the industrial countries. Other Asian economies should also benefit from the (at least partial) restoration of interrupted worker remittance flows from the Gulf region.

Import volume growth that remains in excess of export volume growth is forecast to contribute to a further reduction in the current account surplus of the NIEs this year. However, a portion of this correction may be reversed in 1992 as strengthening growth in trading partner countries narrows somewhat the cyclical differential between the NIEs and the Industrial countries.

Aggregate growth in **Latin America** is expected to improve after last year's contraction as the benefits of market-oriented stabilization programs begin to emerge. With effective implementation of these measures, inflation could be substantially reduced and real GNP growth restored to the 3 percent level in 1992. For a number of countries, the adoption of comprehensive adjustment measures has cleared the way for significant debt reduction agreements and promoted private capital inflows and a return of flight capital.

Latin America's aggregate current account deficit is expected to narrow slightly in 1991-92 relative to the higher level of 1990. While the earnings of oil producing countries will decline, those of other commodity exporters should improve, and recovery in North America should support better export performance.

Economic prospects for the **Middle East** remain highly uncertain in light of continued political unrest and the regional effects of the U.N. mandated economic sanctions against Iraq. With numerous countries likely to recover only slowly from direct war damage and the disruption of important commercial ties, the regional economy as a whole is expected to contract somewhat further this year. However, growth prospects for 1992 would appear substantially better given the expectation of reconstruction activity, renewed oil production in some countries, and restoration of some traditional commercial links.

Reconstruction demands, resumed growth, and relative oil price stability will, however, put pressure on external accounts. Thus, after registering a roughly $12 billion surplus in 1990, the aggregate Middle East current account position is likely to move back into deficit this year and next.

Growth in **Africa** was limited last year in part by negative terms of trade effects (higher oil prices coupled with lower prices for important commodity exports) as well as the slowdown in world trade growth. Positive elements of the picture for 1991 and 1992 are the assumed stability of oil prices, demand recovery outside the region, and a possible modest recovery in non-fuel commodity prices. Overall output growth is therefore expected to pick up moderately to the 3 to 4 percent range through 1992.

The current account improvement recorded for Africa as a whole in 1990 was due in large measure to earnings gains by oil exporters. Market developments assumed for this year and next, however, will reverse much of this improvement through negative terms of trade effects, in addition to the negative effect of slower world trade growth.

The countries of **Eastern Europe** are in a state of fundamental economic and political transition and will remain so for many years. Far-reaching institutional and structural changes are being implemented against the background of a vulnerable economic situation characterized by large underlying imbalances, both domestic and external. Together with substantial revisions in basic data for these economies, this makes the near-term forecasting challenge more than usually difficult. For most of Eastern Europe, output is likely to continue to contract this year, though at a much slower pace than in 1990. Contributing factors are expected to be: the transition to hard currency trade arrangements; financial restraint to combat inflation pressures; and, the ongoing shake-out in the manufacturing sector. Pursuit of appropriate policies will help arrest the downturn and contribute to a moderate output recovery in 1992.

A further increase in the combined current account deficit of the Eastern European countries in 1991-92 seems virtually assured. Key elements will be the fact that hard currency imports are being substituted for internal CMEA trade flows in manufactured goods, and the renegotiation of oil trade arrangements with the USSR guarantees a higher oil bill even at current world prices.

PART IV: POLICY ISSUES

The industrial countries will continue to pursue economic policies to achieve two fundamental objectives: (1) to ensure sustained output growth in the industrial countries in an environment of low inflation; and, (2) to promote the continued growth of international trade, sustainable external imbalances, and the smooth functioning of the international financial system.

The current economic situation presents the major industrial countries with both challenges and opportunities. Macroeconomic and structural policy tools need to be employed on a mutually supportive and complementary basis, and in a manner that gives appropriate balance to meeting near-term needs and enhancing the prospects for economic health and stability over the longer run. Such a recovery will be crucial in supporting policy reforms and economic growth and adjustment in Eastern Europe and the developing countries.

On the fiscal side, this implies a generally cautious approach to overall public sector expenditure growth, as well as a commitment to improving the underlying strength of the public finances by eliminating spending of questionable merit. For the monetary authorities, the challenge is to pursue a course that provides adequate scope for near-term investment and growth while at the same time avoiding policies that lead to reignition of inflation. Recent and prospective developments suggest the need for authorities to focus their efforts on ensuring a sound, low-inflation recovery in the industrialized world.

At present for some countries, such as the United States, the United Kingdom and Canada, this means returning to a path of moderate and sustainable growth, along with continued external adjustment. For Japan and the countries of continental Europe, it means ensuring adequate low-inflation growth in 1991 to support global expansion and shared objectives in Eastern Europe and Latin America.

In the structural area, policy efforts need to focus on reducing or eliminating rigidities which impede the effectiveness of traditional macroeconomic policies, distort investment decisions, and prevent efficient competition and resource allocation in goods and services markets, both domestically and internationally.

These broad objectives are discussed and pursued at the annual Economic Summits, ministerial level meetings of the Organization for Economic Cooperation and Development, meetings of the G-7 Finance Ministers and Central Bank Governors, and meetings of the policy-making Interim Committee of the International Monetary Fund.

These bodies serve, in varying degrees, as focal points for the international policy consultation and coordination process, whose principal purpose is to translate these general objectives into specific policy actions that reflect the unique circumstances of the individual countries. The coordination process is therefore both systematic and flexible, and over the years its scope has evolved to reflect changing economic realities.

Prospects for long-term success in these areas will be enhanced by the successful conclusion of the Uruguay Round of trade negotiations. Strengthening and expanding the scope of GATT disciplines would constitute a structural improvement of enormous importance, offering potentially major gains in the efficiency of global trade.

The need for appropriate and forward-looking policies does not end with the industrial countries. The developing countries also have major responsibilities for their own long-term economic growth and development, and for strengthening the international system upon which all countries depend. There is no substitute for open, market-oriented approach to regulatory and structural issues, and sound and balanced fiscal and monetary policies. Excessive public intervention should be eliminated; prices, interest rates, and exchange rates should be determined by market forces; investment policies should encourage a return of flight capital and greater engagement of foreign investors; and trade policies should focus on increasing domestic integration with the global economy. In particular, full developing country participation in and adherence to Uruguay Round agreements is essential.

Over the past decade, real progress has been made in a number of important areas: in the growth and inflation performance of the industrial economies; in the understanding of international economic and financial linkages; in developing effective, coordinated responses to complex international economic problems; and, in the growing, worldwide recognition that outward-looking, market-oriented policies offer the best prospects for prosperity. Today's challenge is to extend these achievements and make further progress on the problems that still remain.

PART V: IMPACT OF TRADE BARRIERS

The Congress requires the reporting of foreign barriers to U.S. trade in the National Trade Estimate Report on Foreign Trade Barriers, as revised by Section 1304 of the Omnibus Trade and Competitiveness Act of 1988. The law also requires quantification, where feasible, of the estimated effects of individual barriers to U.S. exports of goods and services and on U.S. foreign direct investment. This National Trade Estimate Report was sent to the Congress on March 29, 1991. For a listing of foreign trade barriers and their impact on U.S. trade and investment, the Congress is referred to the National Trade Estimate Report.

There are, however, certain fundamental observations which can be made regarding the impact of foreign trade barriers on U.S. trade. Trade barriers can and do have substantial impact on exports, imports, production and trade balances for specific product areas and, to a lesser extent, for specific U.S. bilateral trade relations. However, trade barriers may have little impact on the aggregate imbalance in U.S. trade in the long run. Macroeconomic factors play the major role in determining trade balances.

Summing the estimated effects of individual trade barriers would overestimate the impact of the elimination of foreign trade barriers on the U.S. trade balance. The "partial equilibrium" framework in which trade barrier effects are usually estimated, in fact, precludes the drawing of any derivative implications of specific trade barriers for the aggregate trade balance.

Trade barriers have particular economic importance because they introduce microeconomic inefficiencies (resource misallocation) in production and impose real costs on the nation. They impair productivity and restrict the growth in real incomes. However, their effect on aggregate trade balances or the projection of aggregate trade balances is limited.