U.S. Department of Treasury

PRESS RELEASES

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 3, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,025 million of 13-week bills to be issued June 6, 1991 and to mature September 5, 1991 were accepted today (CUSIP: 912794XE9).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.57%	5.74%	98.592
High	5.60%	5.78%	98.584
Average	5.59%	5.76%	98.587

$1,270,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 10%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	35,655	35,655
New York	27,770,280	8,686,780
Philadelphia	24,115	24,115
Cleveland	38,590	38,590
Richmond	42,330	40,330
Atlanta	20,650	19,750
Chicago	1,637,760	160,260
St. Louis	54,585	15,585
Minneapolis	8,870	8,870
Kansas City	34,515	34,515
Dallas	24,420	24,420
San Francisco	601,740	82,730
Treasury	853,325	853,325
TOTALS	$31,146,835	$10,024,925
Type		
Competitive	$27,275,135	$6,153,225
Noncompetitive	1,567,110	1,567,110
Subtotal, Public	$28,842,245	$7,720,335
Federal Reserve	2,253,530	2,253,530
Foreign Official Institutions	51,060	51,060
TOTALS	$31,146,835	$10,024,925

An additional $91,940 thousand of bills will be issued to foreign official institutions for new cash.

NB-1303

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 3, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,001 million of 26-week bills to be issued June 6, 1991 and to mature December 5, 1991 were accepted today (CUSIP: 912794XQ2).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.68%	5.95%	97.128
High	5.72%	5.99%	97.108
Average	5.71%	5.98%	97.113

Tenders at the high discount rate were allotted 28%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	31,995	31,995
New York	24,772,100	8,563,730
Philadelphia	16,295	16,295
Cleveland	36,005	36,005
Richmond	37,105	37,105
Atlanta	26,525	25,525
Chicago	1,737,455	367,455
St. Louis	39,515	20,915
Minneapolis	6,705	6,705
Kansas City	41,245	41,245
Dallas	17,480	17,480
San Francisco	606,865	238,865
Treasury	597,655	597,655
TOTALS	$27,966,945	$10,000,975
Type		
Competitive	$24,183,625	$6,217,655
Noncompetitive	1,143,980	1,143,980
Subtotal, Public	$25,327,605	$7,361,635
Federal Reserve	2,350,000	2,350,000
Foreign Official Institutions	289,340	289,340
TOTALS	$27,966,945	$10,000,975

An additional $511,360 thousand of bills will be issued to foreign official institutions for new cash.

NB-1304

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
JUNE 4, 1991

CONTACT: Barbara Clay
202-566-5252

REVIEW OF CLARKE'S FINANCES COMPLETED

At the specific request of Robert L. Clarke, the Comptroller of the Currency, Treasury Department ethics officers and lawyers have reviewed his activities and holdings reflected in his financial disclosure statements, focusing on several specific issues, and have concluded that the circumstances of his financial investments and activities did not give rise to any conflicts of interest.

We urge the Senate to act expeditiously and hold a confirmation hearing on the renomination of Robert Clarke for the position of Comptroller of the Currency.

oOo

NB-1305

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
June 4, 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 $20,000 million, to be issued June 13, 1991. This offering will provide about $1,300 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $18,699 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, June 10, 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 $10,000 million, representing an additional amount of bills dated March 14, 1991 and to mature September 12, 1991 (CUSIP No. 912794 XF 6), currently outstanding in the amount of $8,748 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $10,000 million, to be dated June 13, 1991 and to mature December 12, 1991 (CUSIP No. 912794 XR 0).

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

The bills will be issued for cash and in exchange for Treasury bills maturing June 13, 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 $ 764 million as agents for foreign and international monetary authorities, and $ 4,341 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-1306

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

(Corrected Version)

FOR IMMEDIATE RELEASE
June 5, 1991

CONTACT: ROBERT LEVINE
(202) 566-2041

STATUS OF NEGOTIATIONS OF TAX TREATIES AND TAX INFORMATION EXCHANGE AGREEMENTS

The Treasury Department announced today the countries with which it is currently engaged in tax treaty and tax information exchange agreement (TIEA) negotiations and invited comments from interested persons. Comments should be submitted in writing to Philip D. Morrison, International Tax Counsel, Room 3064, Treasury Department, Washington, DC 20220. This release updates Treasury News Release NB-935 of August 30, 1990.

I. INCOME AND ESTATE TAX TREATIES

A. Treaties entering into force since August 1990:

Finland
India
Indonesia
Spain
Tunisia

B. Treaties ratified by the United States but not yet in force:

Germany

Multilateral Convention on Mutual Administrative Assistance in Tax Matters

C. Active Negotiations; Meetings Scheduled

Canada - negotiation of a protocol to existing treaty to continue in Washington in late summer.
The Netherlands - discussions June 26-27 in the Hague to be followed by another round of negotiations November 18-22 in Washington.
Portugal - second round scheduled July 8-12 in Lisbon.
Venezuela - second round anticipated August or October 1991, Caracas.
Mexico - fourth round August 26-30 in Washington.
Czechoslovakia - second round September 23-27, Prague.
Denmark - renegotiation tentatively scheduled for November, Copenhagen.

NB-1307

D. Other Active Negotiations; No Meetings Scheduled

Bangladesh - correspondence on open issues.
Barbados - protocol to income tax treaty almost completed.
Belgium - correspondence on open issues.
Bulgaria - negotiations held May, 1990 and March, 1991; correspondence on a few open issues.
France - further meeting expected in fall, 1991 to discuss protocols to income and estate tax treaties.
Germany - protocol to estate tax treaty under discussion.
Israel - protocol to pending treaty nearing completion.
Italy - protocols to income and estate tax treaties, meeting possible fall, 1991.
Pakistan - negotiation of a new treaty likely to be completed by correspondence.
Sweden - text of new treaty undergoing final review.
Sri Lanka - correspondence on open issues.
Switzerland - new treaty under negotiation; nothing scheduled.
Taiwan - second round possible late 1991.
Thailand - correspondence on open issues; another round of negotiations likely this year.
Trinidad & Tobago - correspondence on open issues.
Turkey - correspondence on open issues.
USSR - correspondence on open issues.
Zambia - correspondence on open issues.

E. Negotiations Initiated; No Meetings Scheduled

Austria
Brazil
Ireland
Kuwait
Malaysia
Singapore
Yugoslavia

II. TAX INFORMATION EXCHANGE AGREEMENTS

A. In Effect

Barbados (effective November 1984)
Bermuda (effective December 1988)
Costa Rica (effective February 1991)
Dominica (effective May 1988)
Dominican Republic (effective October 1989)
Grenada (effective July 1987)
Jamaica (effective December 1986)
Marshall Islands (effective March 1991)
Mexico (effective January 1990)
St. Lucia (effective April 1991)
Trinidad & Tobago (effective February 1990)

B. <u>Signed, But Not Yet In Effect</u>

Peru
Honduras

C. <u>Active Negotiations</u>

Guyana

TREASURY NEWS

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

June 3, 1991

STATEMENT BY
THE HONORABLE DAVID C. MULFORD
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON DEFICITS, DEBT MANAGEMENT
AND INTERNATIONAL DEBT
COMMITTEE ON FINANCE
UNITED STATES SENATE

It is a pleasure to provide you with a written statement on the critical interactions between debt restructuring and environmental conservation in developing countries. Environmental considerations play an increasing role in economic policy decisions, since sustainable growth depends upon appropriate use of scarce environmental resources.

The U.S. Government has moved to provide potentially significant resources for the environment in Latin America and the Caribbean. On June 27, 1990, President Bush announced the Enterprise for the Americas Initiative, which aims to support economic growth in Latin America and the Caribbean through increased trade, investment flows, and official debt reduction. The Initiative will be a major force for environmental action. Increased trade, investment, and growth will ease the pressure on scarce resources and permit more attention to pressing environmental problems. The Initiative also contains specific programs aimed at promoting environmental conservation in the region with the participation of non-governmental organizations.

Debt Reduction under the Enterprise for the Americas Initiative

Under the Enterprise for the Americas Initiative (EAI), the United States will reduce substantially the bilateral official debt obligations of Latin American and Caribbean countries that have strong economic and investment reform programs. In last year's farm bill, the Administration gained authorization to reduce PL-480 debt for qualifying countries. Under the legislation, countries qualify for debt reduction if they: (1) have in effect, or in exceptional circumstances are making significant progress toward, International Monetary Fund reform programs and, as appropriate, World Bank adjustment loans; (2) have in place major investment reforms in conjunction with an investment sector loan from the Inter-American Development Bank (IDB) or are making significant progress toward open investment regimes; and (3) where commercial bank debt is a large share of outstanding debt, have negotiated agreements to reduce debt and debt service, as appropriate. The Administration is currently seeking authorization to reduce AID debt based on the same criteria.

Many countries currently can make only minimal or no principal payments and are also forced to reschedule through the Paris Club a significant portion of interest payments. The rescheduled interest is capitalized -- added to the stock of debt -- thereby increasing debt service obligations. Over time, reschedulings can significantly increase the stock of debt, aggravating the disincentives to trade and investment.

Debt reduction under the Initiative will change this dramatically. The stock of concessional PL-480 and AID debt will be substantially reduced at the outset. New dollar payments will be at or below the level of payments currently expected from these countries based on their past payment levels and economic circumstances. The extent of debt reduction will be determined on a case-by-case basis through the National Advisory Council (NAC). Moreover, new dollar payments on this reduced debt will go directly to retire principal. As a result, a country's concessional debt to the United States could be eliminated within a period ranging from 5 to 20 years. This mechanism will significantly benefit debtor countries by making debt burdens more manageable, eliminating the debt overhang, and improving investor confidence. As a creditor, the U.S. government would be assured of repayment of a realistic sum.

This approach is a significant improvement over the rescheduling process in other ways as well. The relief from scheduled payments through EAI debt reduction is permanent, while the Paris Club ordinarily provides cash relief only on an annual basis. Reschedulings cannot be relied upon as routine methods of relief far into the future. The certainty of sharply reduced payment obligations under the EAI can provide a major benefit for debtor countries weary of continual renegotiations, permitting them to focus on the priority needs of domestic growth and development.

<u>Environmental Aspects of EAI</u>

The debt reduction aspect of the Initiative includes specific provisions to support environmental activities in the

Americas. Interest on the new, reduced debt will be paid in local currency if a qualifying country has entered into an Environmental Framework Agreement establishing an Enterprise for the Americas Environmental Fund into which these interest payments would be deposited. This encourages a commitment to allocate domestic resources to the environment in exchange for significant debt reduction. The Environmental Funds will be administered by local committees -- composed of one or more host country and U.S. government representatives, and representatives of local non-governmental organizations, who will be in the majority. A public/private Environment for the Americas Board is being established in Washington to review the implementation of this element of the Initiative.

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. With a limited amount of resources, we believe that this program can make a significant contribution 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 the local committees, we can promote a partnership that will help these countries devote greater attention to the protection and preservation of their invaluable environmental resources.

Although the local currency payment will be in addition to a country's expected hard currency payment, it would not be a major burden for participating countries in the context of a significant reduction of their debt stock. Furthermore, we are prepared to consider alternative payment structures, as appropriate, to meet individual countries' financing capabilities.

In addition, the Administration has taken the lead in promoting debt-for-nature swaps with official debt. Debt-for-nature swaps are an effective way to transform limited hard currency resources into substantial environmental/conservation commitments by debtor governments. In a traditional debt-for-nature swap, an environmental organization purchases a country's debt paper at a discount and relinquishes it to the country's Central Bank in exchange for an environmental commitment. Such commitments can include the creation of a nature preserve or natural park, specific policy actions, or provisions of local currency -- often in the form of bonds -- to local non-profit groups to carry out environmental projects.

In order to facilitate debt-for-nature, debt-for-development, or debt-for-equity swaps in qualifying countries, the Administration is seeking authority to sell or cancel a portion of Export-Import Bank loans and Commodity Credit

Corporation (CCC) assets acquired through CCC's export credit guarantee programs. Qualification for sale of Eximbank and CCC debt would depend on a country's progress in implementing the market-oriented reforms needed for debt reduction under the EAI. In addition, countries would need to have a national debt swap program in place.

The NAC would determine whether the necessary reforms were in place and the portion of eligible debt, which would normally be up to 20 percent of a country's outstanding obligations. To ensure that the official debt swaps do not compete with commercial swaps, the United States would inform the debtor nation of the amount of potentially eligible debt and secure a commitment that the country would expand its existing swap program.

The debt reduction provisions of the Enterprise for the Americas Initiative were designed to help increase the incentives for countries to undergo the reforms necessary to attract the investment they need to grow. By encouraging a commitment of local currency to support the environment and promoting official debt swaps, we can help ensure that the growth they achieve will be sustainable.

Environmental and Social Impact of IMF and World Bank Programs

The Administration recognizes that it is crucial to incorporate, as appropriate, environmental and poverty concerns into reform programs supported by the IMF and the World Bank. Increased attention to environmental and social issues in lending by the international financial institutions will reinforce our efforts to promote environmentally sound and broad-based development. We are committed to working with the Fund and Bank to address adverse environmental and social effects of necessary economic reforms.

Treasury has been working hard to ensure that IMF and World Bank adjustment programs incorporate environmental and social concerns. In speeches at the annual meetings of the World Bank and the IMF last September, President Bush and Secretary Brady emphasized the importance of environmental issues. U.S. representatives at the spring and fall meetings of the Development Committee of the World Bank also stressed these points, including the need for environmental impact assessments. We have also strongly supported IMF and World Bank steps to address the social impact of adjustment lending.

IMF policy advice and financial support offer countries a more orderly path toward the economic reforms needed to achieve sustained growth and the alleviation of poverty. There are, however, inevitable short-term costs associated with macroeconomic structural reforms. The Fund has devoted much attention and considerable resources to protecting the poorest and most vulnerable segments of populations from these costs. These efforts are showing positive results. Virtually every Fund program includes support for social safety-nets such as targeted subsidies and unemployment compensation. For the poorest countries, IMF Policy Framework Papers (PFPs) include an assessment of the adjustment program's effects on the poor and steps to reduce potential negative side-effects. The U.S. Executive Director at the Fund continues to promote increased attention to poverty issues in IMF programs.

IMF adjustment measures at times can have indirect effects on environmental concerns. At the urging of the United States, the Fund has established a group of economists to serve as a liaison with other organizations on environmental research and advise the Fund on addressing environmental concerns. With World Bank assistance, the Fund has begun incorporating measures consistent with environmental protection into PFPs and some stand-by and extended arrangements. IMF Article IV consultations have included discussions of environmental issues. These steps are a significant move in the right direction, and the Administration will continue to advocate expanded consideration of IMF programs' environmental impact, consistent with the Fund's mandate.

The World Bank is also making strong progress on social and environmental issues. In designing structural adjustment programs, the Bank has pinpointed labor intensive growth policies as the way to assure equitable economic development. Job creation is an essential ingredient in achieving broad-based growth in developing countries. The Bank recognizes that structural adjustment can adversely affect the poor in the short-term through tighter government budgets and economic austerity. To forestall this result, the Bank emphasizes the improvement and expansion of basic social services to the poor, such as women's health care and potable water and sanitation projects. In addition, to ease the effects of poverty, the Bank engages in specifically targeted measures, such as direct transfers for food security for households headed by elderly or handicapped people.

The Bank has increasingly integrated environmental protection into its structural adjustment lending. Environmental objectives are often built into adjustment lending; four structural adjustment loans in FY 1989 explicitly addressed environmental issues, and there were nine such loans in FY 1990. These programs encourage reforms to improve the management of individual countries' natural resources. Even where there is no explicit environmental component, structural adjustment lending often has positive effects on the environment. For instance, reduced government subsidies for pesticides will improve water quality. Furthermore, the Bank has recognized the need to anticipate potential adverse environmental consequences in designing adjustment programs, and to avoid undesirable consequences through compensatory mechanisms when appropriate.

We believe that the World Bank and the IMF have been making significant progress on environmental and social impact assessment over the past year. We will continue to push hard in these institutions for rapid progress on specific issues.

Environmental Linkages and the Brady Plan

Some NGOs have proposed broader linkages between environmental concerns and the international debt strategy in order to require both debtor governments and commercial banks to facilitate debt-for-nature swaps. In our judgment, there are two major constraints on incorporating environmental concerns into commercial bank debt and debt service reduction under the Brady Plan. First, an environmental linkage must not impede the negotiation of commercial bank debt/debt service reduction, which is vital to debtor countries' efforts to reform their economies and achieve sustainable growth. Adding independent environmental criteria to the determination of countries' eligibility for debt/debt service reduction could block progress in negotiating such accords. Debtor countries already must secure an IMF/World Bank program, implement necessary economic reforms while negotiating with commercial banks, and finalize financing packages by coordinating various forms of official support. Requirements outside IMF/World Bank programs would complicate the process further, reducing the incentive for countries to undertake essential economic policy reforms.

Second, it must be recognized that the United States has a limited ability to influence negotiations carried out directly between debtor countries and commercial banks. The U.S. Government is not in a position to advocate particular options or to impose unilaterally additional conditions on the negotiations.

With these constraints in mind, Treasury has encouraged both debtor nations and commercial banks to consider debt-for-nature swaps as an item on the menu of options negotiated by debtor countries and their commercial banks. While such an option might not be appropriate for all countries, it could provide a means of attracting participation by banks willing to contribute a portion of their portfolio for environmental purposes. Nonetheless, commercial banks may consider such donations financially less advantageous than other options under consideration.

Conclusion

The environment has been an extremely important element in the United States' approach to economic issues in recent years. International debt policy offers a promising opportunity for the

United States to promote far-reaching environmental protection and preservation in debtor countries.

The Administration has worked actively toward this end by putting forth a creative and feasible program to convert official debt into funding for environmental programs in Latin America and the Caribbean. We look forward to working with Congress to implement this program and lay the foundation for sustainable economic growth in our hemisphere.

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

Contact: Cheryl Crispen
(202) 566-2041

Statement by the Honorable John E. Robson
Deputy Secretary
The Department of the Treasury
on the Announcement of
EPA's Proposed Rule on Lender Liability

June 5, 1991

The EPA proposed rule announced today will provide greater certainty to bankers and other lenders, both private and governmental, that they will not be subject to Superfund liability or to the effects of costly litigation when they work with troubled borrowers, take necessary steps to protect the value of collateral, provide credit to borrowers with a known environmental clean-up requirement, and foreclose on defaulted loans.

Furthermore, this rule protects the interests of taxpayers in that it provides greater certainty to governmental entities such the Resolution Trust Corporation and the Federal Deposit Insurance Corporation. The proposal clarifies that these agencies do not assume strict liability under Superfund for the imprudent acts of borrowers when they act as conservator or receivers of insolvent financial institutions.

We are pleased that EPA, with assistance from the Office of the Vice President and the Justice Department, has crafted a rule that offers lenders and other security holders this improved clarity. I believe that this proposal will significantly improve the lending climate and is a positive contribution to the Administration's efforts to fight the "credit crunch" that hinders the economy's return to growth.

###

NB-1308

FINANCIAL ACTION TASK FORCE

ON MONEY LAUNDERING

---oOo---

REPORT

1990 - 1991

Paris, May 13, 1991

SUMMARY

ACCOMPLISHMENTS OF FATF-2

The delegations agreed to continue FATF for a period of five years, with a decision to review progress after three years, and to reconsider the continuing need, mission, and work program for this specialized group.

The group agreed to four ongoing tasks for FATF-3 and its successors : (1) self-reporting and mutual assessment (monitoring and surveillance) on the adoption and implementation of FATF recommendations by all members ; (2) coordination and oversight of efforts to encourage non-members to adopt and implement the recommendations ; (3) making further recommendations and evaluations of counter-measures while serving as a forum for considering developments in money laundering techniques domestically and worldwide, and for the exchange of information on enforcement techniques to combat money laundering ; and (4) standing ready to facilitate cooperation between organizations concerned with combatting money laundering and between individual countries or territories.

The decision to continue was taken as part of a critical political commitment to implementation of the recommendations each member government has endorsed. Members agreed to continue the self-evaluation process begun in FATF-2 to measure their progress in implementing the 40 recommendations, and, in a decision that underscores the great importance attached to this process, the members agreed to initiate a process of mutual evaluation. The decision was that each member would normally be subject to being evaluated on progress measures three years after endorsing the FATF-1 recommendations.

These decisions, perhaps unique to bodies of this kind, assure the global community that the major financial center countries are truly determined to adopt and implement effective countermeasures against money laundering.

The self-evaluation process begun in 1991 utilized a compliance grid which produced comprehensive evaluation of progress on legal and financial matters, although this was to some extent subjective, given the current lack of harmonization of laws and therefore of responses. It was encouraging that the majority of members have substantially implemented the FATF-1 recommendations on legal matters. Substantial progress has also been made on complying with the recommendations relative to the role of the financial system, and strengthening international cooperation, but some countries need to make a greater effort in these matters.

FATF-3 will see a refinement and extension of the self-evaluation process, with an emphasis that goes beyond ratification of international conventions such as the Vienna an Strassburg convention and adoption of laws, to implementation and practice.

FATF-2 proved a useful forum for discussing the wide range of issues not yet concluded as action recommendations, issues which will be further explored by FATF-3. The legal issues group discussed possible refinements of existing recommendations, including those involving predicate crimes, corporate criminal liability, mutual legal assistance, and asset sharing. Similarly, the financial cooperation group, which included special presentations by financial enforcement officials of money laundering typologies and investigative practices, took note of the increasing use of non-bank and non-traditional financial institutions and other businesses and professions to convert the proceeds of drug and other crime. The group noted the need to continue monitoring new money laundering practices, and called for further work on developing a common action plan with respect to non-bank financial institutions and other businesses and professions.

A third working group charged with planning the future of FATF, which proposed an extension of the mutual evaluation process, also developed the plan of succession to the FATF Presidency, and outlined procedures for establishing a Secretariat within an existing international organization. The recommendation was that FATF Presidency be supported in the future by a steering group, and would work with and through this Secretariat. The members agreed to negotiate the creation of a specialized Secretariat with the Organization for Economic Cooperation and Development (OECD).

Finally, FATF-2 proposed that the organization, acting through its Secretariat, and drawing upon the expertise of its members, should attempt to help guide the provision of technical assistance between members or to non-members, upon request by either, subject to the availability of resources among the members who agree to provide such assistance.

INTRODUCTION

In July 1989, in Paris, the Heads of State or Government of the seven major industrialized countries, and the president of the Commission of the European Communities, convened a Financial Action Task Force, the FATF, under French presidency, with the aim of fighting money laundering. In addition to summit participants (United States, Japan, Germany, France, United Kingdom, Italy, Canada, and the Commission of the European Communities), eight countries (Sweden, Netherlands, Belgium, Luxembourg, Switzerland, Austria, Spain and Australia), joined the Task Force in order to enlarge its expertise and also to reflect the views of other countries particularly concerned by, or having particular experience in the fight against money laundering, at the national or international level.

In April 1990, the Task force issued a report with a comprehensive progam of forty recommendations to fight money laundering. This report was endorsed by the Finance ministers or other competent ministers of all FATF members in May 1990.

At the Houston Summit of the Heads of State or Government of the seven major industrialized countries, in July 1990, the Task Force was, as agreed at the May meeting of Task Force Finance Ministers, reconvened for a second year, still under the chairmanship of France, to assess and facilitate the implementation of the forty recommendations, and to complement them where appropriate. It was agreed that all OECD and financial center countries that would subscribe to the recommendations of the Task Force should be invited to participate in this exercise. All other countries were invited to participate in the fight against money laundering and to implement the recommendations of the FATF. It was agreed that the report of the second FATF should be completed before the next meeting of the Heads of State or Government of the Seven.

In addition to the initial members, experts of Denmark, Finland, Greece, Ireland, New Zealand, Norway, Portugal, Turkey, Hong Kong and the Gulf Cooperation Council participated in some or all the meetings, together with law enforcement specialists of Interpol and the Customs Cooperation Council. Almost all these participants(*) subsequently endorsed the report, and thus qualified for membership of the FATF.

Five series of meetings were held in Paris. More than 160 experts from various ministries, law enforcement authorities, and bank supervisory and regulatory agencies, met and worked together during six months. To facilitate the work of the Task Force, and to take advantage of the expertise of its participants, three working groups were created, which focused respectively on the implementation of recommendations relating to legal matters (working-group 1, presidency : United States), on the implementation of recommendations pertaining to the role of financial systems and international cooperation (working-group 2, presidency : Belgium), and on external mobilization and follow-up (working-group 3, presidency : United Kingdom). Their comprehensive reports constitute the key background material of this report.

Building upon this work, this report gives an assessment of the implementation of existing recommendations (part I), provides an overview of the geographical extension of the FATF program against money laundering (part II), and proposes guidelines as regards the follow-up to the second FATF (part III).

(*) The designations employed in this report do not imply the expression of any opinion whatsoever on the part of the group concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

I - ASSESSMENT OF THE IMPLEMENTATION, AND ENHANCEMENTS TO THE EXISTING RECOMMENDATIONS

A - LEGAL MATTERS

On the mutual legal assistance matters, the group assessed the implementation of FATF recommendations 4 through 8 and 32 through 40 and discussed possible enhancements to existing recommendations.

Of particular concern to the group was that the recommendations be implemented in a way that would maximize cooperation in international money laundering cases.

1 - Global overview of the implementation

A legal issues surveillance grid was established, on the basis of answers by participants to a standardized questionnaire. Participants also provided a narrative explanation of the status of implementation. The participants were also requested to indicate how the differences in the scope and application of money laundering offences might affect mutual legal assistance.

All the FATF-1 participants have responded to the compliance grid and questionnaire.

All new participating countries and territories also responded.

However, the Task Force noted that, to some extent, the compliance grid format resulted in a subjective measure of progress of uncertain reliability, because there has been no harmonization of the national answers.

Nevertheless, it is encouraging that the vast majority of the answers to the surveillance grid are positive, (A : measure already implemented, or B : measure soon to be implemented) and that very few answers "C" (measure whose implementation is not foreseen) were obtained.

The majority of FATF-1 members have substantially implemented the full range of FATF recommendations within the scope of legal questions. Most of these countries have added legislation or taken other steps in 1990 which places them in the substantial implementation category. It is encouraging to note that several new participants are in a similar situation.

A limited number of nations are still evaluating how best to effect implementation and have not introduced legislation or taken other steps towards implementation.

2 - Ways to facilitate the implementation of some recommendations

The Task Force discussed how to solve the difficulties that are still obstacles to a fully efficient international cooperation to combat money laundering. It has examined how to improve domestic legislation, as required by recommendations 4 to 8, in order to facilitate the mutual legal assistance (recommendations 32 through 40).

The FATF is based on the premise that meaningful progress against money laundering can only be made through international cooperation, by minimizing both the barriers that remain in domestic laws and their effects on mutual assistance. It is clear that progress still needs to be made in these directions.

It was agreed that countries should periodically review their legislation and make whatever modifications that may be required to respond to changes in money laundering methods.

The Task Force determined to put forward refinements or extensions of existing recommendations, as discussed below.

a) Recommendation 4 (Working definition of money laundering)

This definition, based on the relevant provision of the Vienna Convention, is an important step to the harmonisation of legislation. All the participants who answered the surveillance grid are, or should be very soon, in compliance with recommendation 4.

b) Recommendation 5 (Predicate crimes)

Recommendation 5 provides in part that "...each country should consider extending the offense of drug money laundering to any other crimes for which there is a link to narcotics..." while recommendations 5 also sets forth the alternative possibility of criminalizing based on all or specified serious crimes.

Very few countries have in fact enacted specific money laundering legislation in which all or most serious proceeds- generating offenses were included as predicate crimes. **Nonetheless, two international documents have been or are about to be completed which intersect with recommendation 5.** Specifically, the Council of Europe convention on laundering, tracing, seizure and confiscation of proceeds of crime, and the European Communities proposed directive on the prevention of use of the financial system for the purpose of money laundering, on which a common position was reached on 14 February, 1991, and which will be finalized in the near future.

The Council of Europe convention requires parties to adopt measures to enable confiscation of the proceeds of any criminal offense. With respect to money laundering, it allows parties to declare that the offense of money laundering is limited to specified predicate offenses.

The common position on the EEC directive provides for money laundering to cover drug offenses and any other serious criminal activities designated as such for the purposes of this Directive by each member state.

Given the pervasiveness of money laundering in many fields of criminal activity, few countries expressed the sentiment that was expressed in FATF-1 that money laundering should be limited to drug crimes. Hence, important progress towards consensus was made in FATF-2 on this issue, although no agreement was reached on the scope of the predicates.

c) Recommendation 7 (Corporate criminal liability)

Recommendation 7 provides in pertinent part "... where possible, corporations themselves - not only their employees - should be subject to criminal liability". There was extensive discussion on this point. **There was general agreement that the concept of corporate criminal liability, or at least, the availability of stringent civil or administrative actions is an important part of an effective anti-money laundering program.** Yet, almost half of the FATF member countries do not have corporate criminal liability law and a number of these countries have only limited authority to respond with civil or administrative actions with respect to criminal offenses by corporations. It was observed that constitutional or fundamental legal principles precluded a country from enacting corporate criminal sanctions. In other instances, it was simply a matter of no legislation having been enacted to criminalize corporate conduct. **The intention to continue to study the issue with a positive mind was generally expressed.**

d) Recommendations 33 to 40 (Mutual legal assistance and other forms of cooperation)

Most participants soon should be able to provide mutual legal assistance to each other in international money laundering cases. But the improvement of this cooperation depends in furtherhand also on the adaptation of the domestic legislation

Most FATF members have developed a network of bilateral and multilateral conventions to facilitate mutual legal assistance, as required by recommendation 34. Austria generally prefers multilateral agreements. Japan does not plan at this stage to develop bilateral or multilateral agreements, but notes that, in its case, the conclusion of such bilateral or multilateral agreements are not prerequisite in rendering legal assistance.

Recommendations 37 and 38 (compulsory measures to be ordered by the way of mutual assistance, such as identifying the proceeds from a narcotic offence forfeiture, seizure...), will be applied very largely by all the states in the near future, as well as recommendation 40 dealing with extradition.

However, the issue of corporate criminal liability and differences in criminal offenses led to a lengthy discussion on the concern about how the manner in which countries implement the FATF recommendations could actually inhibit mutual legal assistance in money laundering cases and cooperation in related extradition and confiscation matters.

Differences in criminal offenses of money laundering very often create difficulties in implementing recommendations 32 through 38, which reinforce the need for a comprehensive mutual legal assistance system for money laundering and asset confiscation.

In a significant number of countries, the application of the principle of dual criminality would in all likelihood preclude extradition and mutual legal assistance if the request relates to a predicate not covered by the money laundering offense in the requested country. In the view of several countries, this result indicates another reason to enact money laundering offenses that cover a wide range of predicate offenses or all serious crimes.

It also was noted that in many countries the perpetrator of a crime cannot be prosecuted for laundering the proceeds of his crime. As far as possible, differences in approach to the liability of the perpetrator of the underlying offense should not inhibit the provision of assistance.

On the other hand, differences in corporate liability would affect mutual legal assistance in only a few countries. It was felt that a country that does not have corporate criminal liability should strive to honor a request for assistance in a case in which the requesting country is prosecuting a corporation for money laundering, e.g., by resorting to civil or administrative actions available under its laws.

Finally, it was pointed out that with respect to the different forms of international cooperation in criminal matters (mutual legal assistance, extradition, asset confiscation, etc.), different standards of dual criminality might evolve in national or international legislation or practice commensurate with the object and purpose of each specific type of cooperation.

For the purposes of mutual legal assistance, it was felt that participants should have an attitude of some flexibility in relation to the issue of dual criminality. Difficulties in practice, should not affect their readiness to provide one another with mutual legal assistance (apart from extradition).

To the extent that dual criminality remains a problem in progress towards facilitating mutual legal assistance and cooperation, the harmonization of domestic legislations may be the surest way in the longer run. In the shorter term, bilateral and multilateral agreements in these areas are probably more achievable.

e) Recommendation 39 and international asset sharing

Recommendation 39 encourages arrangements for coordinating seizure and confiscation proceedings which may include the sharing of confiscated assets. Actually, very few cases of sharing of assets confiscated in international money laundering operations have occurred. This may result, among other reasons, from the difficulty in determining the "fair" share to be given to other countries. Public accounting rules may also discourage this.

Ways to further facilitate the implementation of recommendation 39, with regard to international asset sharing, remains a matter for further discussion in the FATF.

B - ENHANCEMENT OF THE ROLE OF THE FINANCIAL SYSTEM, AND STRENGTHENING OF INTERNATIONAL COOPERATION

The group has assessed the implementation of recommendations 9 to 32. Substantial progress has been made to implement most of them, but some participating countries, should still devote great efforts on the furtherance and the completion of this process in the months and years to come (section 1).

Money launderers have increasingly turned to non-traditional financial institutions or other businesses or professions to convert the proceeds of their illegal activities into legitimate funds - as countries have tightened their control on traditional financial institutions or professions. Action should be undertaken to address this situation along the lines sketched out in section 2 a), and new money laundering practices should be updated regularly, with great care.

Relations with countries which do not or insufficiently apply the FATF recommendations require periodic exchange of information among law enforcement authorities (section 2 b).

The administrative systems to detect money laundering receive more support when they apply to cash movements at the border than when they consist in reporting all currency movements (section 2 c).

In general, more comprehensive cooperation is needed among all authorities involved in the fight against money laundering. Considerable progress has still to be made to exchange information at all levels (section 2 d).

1 - Global overview of the implementation.

As with legal matters, a "surveillance" grid has been established on the basis of voluntary answers by countries to a questionnaire. It is a useful gauge, but only a first attempt to get a global view of the implementation, since all the answers were not harmonized. A more thorough surveillance will result from a detailed examination of each country, as proposed in section III. At this time, the uncertain reliability of the answers led the group to the opinion that any publication of the grid would be premature.

When assessing the implementation status of recommendations 9 to 32 (enhancement of the role of financial system, and strengthening of international administrative cooperation), one has to give special attention to the answers of the 16 members of FATF-1, and to notice that only 18 recommendations (out of 24) are relevant for analysis, the remaining six calling for further study (n°s 11, 23, 24, 30, 31) or for an alternative aproach (rec. n° 19).

It is very encouraging that, one year after the recommendations of FATF-1 have been drafted, the vast majority of the answers to the surveillance grid by the FATF-1 members are positive of which roughly half are measures "already implemented" (A) and close to half "measures soon to be implemented"(B), no later than Jan 1, 1993 in most cases.

Another interesting feature of the answers is that most of the negative ones apply to three recommendations (n°s 21, 23 and 24) which are considered difficult to implement by most countries, and are discussed below in this report.

It should also be noted that the EC Directive, which will be approved by mid 1991 and implemented before January 1, 1993, enforces 15 of the recommendations among its member countries, the remaining ones (21 to 25, 30 to 32) being either outside the objectives of the directive or unnecessary in the case of EC members (Rec. 19).

In summary, the implementation of most of the recommendations 9 to 32 appears already fairly good among members of FATF-1, and few cases of non compliance should remain by year-end 1992.

As regards these juridictions which participated in FATF-2 before being formal "members", it proved difficult for some to provide a detailed report, although the majority did so and the majority of these respondants reported substantial implementation of the recommentations.

2 - <u>Ways of facilitating the implementation of certain recommendations</u>

Law enforcement authorities of participating countries as well as representatives of Interpol and of the Customs Cooperation Council were invited to share, during a full-day meeting on March 15, their technical experience regarding the new money laundering practices they encounter, which countries or areas do not or insufficiently apply FATF recommendations, and the cooperation between them.

Their discussions helped to determine some ways of facilitating the implementation of recommendations 11, 21/22, 23/24, and 31/32.

a) <u>New money laundering practices and implementation of recommendation 11</u>.

As countries have significantly tightened their control on deposit taking financial institutions, money launderers have increasingly turned to other financial institutions and other professions and businesses which handle significant amonts of cash, to convert the proceeds of illegal activities into legitimate funds. It was noted that, as regards other financial institutions and professions, first steps have been taken.

Today, non-traditional financial institutions or other businesses or professions are involved in a growing number, possibly a majority, of money laundering cases, estimated from the number of seizures in the cases unveiled in some countries(*).

Non-traditional financial institutions or professions provide "bank-like" services, thus running the risk that they can be used by money launderers in ways similar to traditional financial institutions or professions, while not being subject to the same regulations and controls.

In order to facilitate a wider implementation of regulations against money laundering, a report was prepared on a typology of money laundering practices for non-traditional financial institutions or professions, by the US Customs Service on the basis of the information on actual cases made available by the United States, the United Kingdom and the Hong Kong competent authorities.

(*) Countries participating in the FATF process reported numerous incidents in which money launderers were utilizing the non-traditional systems within their respective countries. Examples of these incidents include : (a) cash from cocaine crack sales deposited into a bureaux de change, funds transferred abroad for collection in US dollars, funds collected abroad in US dollars ; (b) cash from drug sales used to purchases gambling chips in a casino, proceeds returned in the form of "winnings" through a casino check, casino check deposited into bank account represented as "winning" ; (c) drug cash used to purchase antique firearms and art from auction houses and private individuals abroad, property returned and sold through domestic auction houses, fund transferred abroad and then returned to purchase real estate ; and, (d) a solicitor accepting drug cash from drug trafficking client, placing the funds into the solicitor's trust account, the solicitor utilizing the funds in the trust account to purchase real estate in the solicitor's name on behalf of the drug trafficking client. Variants of these schemes abound.

The group, reflecting the opinion of law enforcement specialists, made it clear that the FATF should not try to make an exhaustive, single list of all non-traditional financial institutions or professions that might be involved in money laundering practices, but should rather seek to address them as a whole, and mention, as an example, some "high risk" professions or institutions that could possibly be used in the cash-placement stage of the money laundering process.

These professions or institutions can be classified under four broad headings :

1 - organizations whose prime function is to provide a form of financial service but which, at least in some FATF member countries, fall outside the scope of the regulated financial sector. For example, bureaux de change, cheque cashers and money transmission services, including those provided through correspondent relationships outside the formal banking sector.

2 - Organizations whose primary purpose is to offer some form of gambling activity. For example : casinos, lotteries and various games of chance.

3 - Organizations whose primary function is to buy and sell high value items. For example : precious metal and gem dealers, auction houses, real estate agents ; automobile, aeroplane and boat dealers.

4 - Professionals who, in the course of providing their professional services, offer, in some countries, client account facilities. For example : lawyers, accountants, notaries and certain travel agents.

This typology ought to facilitate the implementation of recommendation 11 with the degree of flexibility that is necessary from one country to another, given the differences in the use of cash and in the effective role of each profession.

Outside the formal financial sector, professions which provide any of the financial services listed in the annex of the Second Banking Coordination Directive of the European Community, as well as life-insurance coverage, should be subject as far as possible to recommendations 12-22 and 26-29. However, recommendation 27 is not intended to oblige member countries to establish one supervisory institution for each and any of these professions : the nature of regulations and the means to ensure compliance are to be decided by each country. The group considered that the organisations cited under heading n° 1 of the typology, and the professionals cited under heading n° 4 of the typology, belonged to this category. However, with respect to the professionals, law and practices relating to professional confidentiality restrict in many countries the possibility of implementing some recommendations.

Some other types of business or professions can also be used in the cash placement stage of money laundering, for instance those cited under headings n° 2 and 3 of the typology, although their effective role is different from one country to another. For such activities, it would be extremely difficult for governments to ensure across the board compliance with the relevant FATF recommendations. **But there are steps that governments could take to raise awareness among those businesses most at risk and to combat their being used by launderers : dialogue with professional organizations which represent them, issuance of guidance notes - especially on how to recognize suspicious transactions - and, for some of these professions as designated by each government, implementation of the customer identification and record keeping requirements above a specific size of transaction, and, where possible, implementation of a suspicious transaction reporting scheme.**

While offering such guidance to facilitate the implementation of recommendation 11 by governments, the group felt it wise not to add anything to the existing recommendations 9 to 11, considering that money laundering is an evolving process and that discrepancies in the actual field of activity for the same business exist between countries. With this in mind, the importance was stressed of identifying and regularly updating "vulnerable businesses/professions", i.e. businesses or professions with a potential for misuse by money launderers, and to exchange information about them. **To this end, it was suggested that, in the future, the FATF keep itself informed about the evolution of money laundering practices and exchange information about actual cases of money laundering.**

b) Implementation of recommendations 21/22.

The Group has thoroughly examined how useful it would be to refine recommendations 21 (relation with countries which do not or insufficiently apply these recommendations) and 22 (application of the recommendations to branches and majority owned subsidiaries located abroad).

The Group observed that one way to facilitate the implementation of recommendation 21 would be to establish an internationally agreed "black list" of countries which do not or insufficiently apply the FATF recommendations. But the group felt, and law enforcement authorities confirmed, that the FATF should not attempt to produce, for the time being, a public common minimal list. Each country will be in a position to decide which jurisdictions must receive special attention, based on the answers given by its own financial institutions in accordance with recommendation 22. The absence of any list of "regulatory havens" makes it difficult however for financial institutions to focus their special attention in the sense required by recommendations 21 and 22.

Geographical zones where money laundering schemes develop, or might develop, are, in some cases, well-known and, in any case, can be characterised by some criteria. Such criteria include the lack of any legal requirement for institutions or professions to maintain records for the identification of their clients or the transactions performed, the absence of a legal permission for law enforcement authorities to have access to these records, and the impossibility for them of communicating these records to law enforcement authorities of others countries.

c) Administrative Systems to detect money laundering (recommendations 23, 24).

Recommendation 23

Some countries strongly support the implementation of measures to detect or monitor important cash movements at the border to address the problem of cross border shipments of illegal source currency, either through a system of mandatory reporting of these movements, or through the possibility of freezing suspected assets(*) or through any other means that does not restrict the freedom of capital movements. Other countries emphasize that the information gathered in such a fashion should only be used to fight money laundering practices. This issue should be addressed again in the future.

(*) This way of implementing recommendation 23 would consist in measures whereby cash, monetary instruments, precious metal/stones, and other valuable movable property, which are to be imported to or exported from their jurisdiction, may be seized/detained by the competent law enforcement/judicial authorities pending investigation and/or proceedings to freeze such property where there are reasonable grounds to believe that such property directly or indirectly represents the proceeds of a criminal activity.

Recommendation 24

A large majority of the participating countries continue to consider that the implementation of a system to report all important currency transactions is difficult to envisage. They feel that at least similar results can be attained through the less burdensome system of a properly implemented suspicious transactions reporting scheme. Countries which have a currency transactions reporting scheme believe that it is an essential complement to suspicious transactions reporting.

d) Cooperation between law enforcement authorities, outside mutual legal assistance, and ways to improve bilateral exchanges (rec 31 and 32).

Law enforcement authorities reported that they are sometimes faced with legal or technical difficulties when cooperating - such as the right to privacy, confidentiality privileges or the sensitivity of some countries to tax-related issues. It was pointed out that a number of international agreements already provide an adequate basis for cooperation, but that, even in cases where such agreements exist, satisfactory cooperation does not always exist in practice.

The reasons for these shortcomings range from differences in the definition of the predicate offense (underlying crime), sometimes the absence of personal relations with their counterparts, to refusals to answer the questions from another country. All these elements hamper the efficiency of bilateral cooperation among administrative authorities.

Strong efforts should therefore be made to improve the cooperation among law enforcement authorities, enabling a more efficient implementation of recommendations 31 and 32.

"Contact lists" should be made available for instance through the UNIDCP (United Nations International Drug Control Program). Countries should also communicate to each other intelligence information, either in the framework of a legally organized cooperation, or informally - in which case the information should be used according to guidelines to be specified(*).

If was felt that law enforcement authorities and other relevant experts should regularly meet to exchange their views about money laundering practices and geographical networks. Their findings should be reported to the FATF.

Interpol and the Customs Cooperation Council could have a special responsability for gathering and disseminating this information. In addition, to help identifying geographical networks involved in money laundering, the FOPAC (Fonds provenant des activités criminelles), a division of Interpol which collects data about proceeds of criminal activities, could provide a good basis for such exchanges, in cooperation with the CCC.

Furthermore, exchanges of information on suspicious transactions, persons or corporations, should take place between Interpol and the Customs Cooperation Council. This information should then be disclosed to their members at their request, with the appropriate level of confidentiality.

(*) The information passed on to authorities of other participating countries should be used only for anti-money laundering purposes, and for the investigation of the underlying offenses, and could be submitted to restrictions. In practice, informal exchanges could reveal themselves very useful for implementation of recommendations 31 and 32.

II - GEOGRAPHICAL EXTENSION OF THE FATF PROGRAM AGAINST MONEY LAUNDERING

Money laundering channels, at least those on a broad scale, generally involve international operations. This enables money launderers to use differences in national laws, regulations and enforcement practices.

For instance, a money laundering operation could involve the following stages : money from illegal activities e.g. drugs cash proceeds would be exported from regulated countries to unregulated ones ; then the cash can be placed through the domestic formal financial system of these" regulatory havens" ; the subsequent stage could then be a return of these funds to regulated countries with safe layering and integration opportunities, particularly through wire transfers. Of course, informal financial systems in "regulatory havens" are also a cause of concern

This type of money laundering operation, based on cash shipments abroad, probably plays an important role. However, once drug cash has been introduced into the formal financial institution, other techniques may be used by launderers to transfer funds abroad, using offshore companies. For instance, using the technique of "double invoicing", goods may be purchased at inflated prices by domestic companies owned by money launderers, from offshore corporation which they also own. The difference between the price and true value can be deposited offshore and paid to the offshore company. It then can be repatriated at will. Variations of the "double invoicing" technique bound . Some regulatory havens make it easy to set up shell companies, and to keep company ownership anonymous in the hope of attracting both license revenue and business for their own firms.

When the funds are repatriated after laundering abroad, the detection of their criminal origin is extremely difficult. Even if detected, differences in national laws, regulations and enforcement practices seriously impair the efficiency of enquiries and law enforcement measures.

This has been the rationale behind the effort to extend worldwide the FATF program against money laundering, and to give special attention to relations with countries which have a significant financial system, but do not or insufficiently apply this program.

A - GEOGRAPHICAL EXTENSION

The Houston Summit recommended that "all OECD and financial center countries that subscribe to the recommendations of the Task Force should be invited to participate in the FATF", and appealed to "all other countries to participate in the fight against money laundering and to implement the recommendations of the FATF".

The first step to broaden the geographical coverage is an effort throughout the world to present and explain the FATF recommendations, with a view towards obtaining formal endorsements, and, as far as possible, universal effective implementation to these recommendations. This worldwide mobilization against money laundering was launched in three directions.

1 - OECD countries and other major financial centers

a) The nine OECD countries which had not participated in the FATF-1 (Denmark, Finland, Greece, Iceland, Ireland, New-Zealand, Norway, Portugal, Turkey), were invited to participate in the FATF-2, provided they accepted the existing recommendations. All these countries, except Iceland, took part to the meetings of FATF-2, in order to help them clarify what would be at stake if they endorsed the recommendations, and to share with them experiences in the field of fighting money laundering. A meeting, on December 17, was specially devoted to briefing them.

At this stage, **Denmark, Finland, Ireland, New-Zealand, Norway, Portugal and Turkey have endorsed the FATF recommendations, and thus qualified for membership.**

b) In addition, the FATF decided that the three most important off-shore banking centers and areas, Hong-Kong, Singapore and the Gulf, would be invited, under the same conditions, to participate.

Hong-Kong attended FATF meetings and participated actively. It endorsed the recommendations, thus qualifying for membership. It has already taken major steps to implement the recommendations.

In order to reach a number of financial center countries in the Gulf, it was decided to invite the **Gulf Cooperation Council** (composed of Saudi Arabia, Bahrain, the United Arab Emirates, Oman, Qatar and Kuwait) to participate, rather than invite the individual countries in the area at this time. A representative of the GCC did participate in one of the meetings, but because of the situation in area, has not been able to coordinate a decision on endorsement of the recommendations among the GCC member countries as yet. The GCC will continue to be invited to future sessions.

Singapore has yet to endorse the FATF-1 recommendations, and formally accept the invitation. However, discussions have commenced and hopefully, they will lead to Singapore endorsing the recommendations and joining the group. It is, of course, appropriate that a country which has such eminence as a financial centre should join in the international effort against money laundering which membership of the Task Force provides. Singapore representatives have recently informally indicated their intention to participate, on the same basis as others.

2 - Other financial centers

Specific countries or territories were identified as being particularly exposed to money laundering, due to the importance of their international financial activities, to their geographical location -territories close to important drug producing, transit or consuming countries-, or, in some cases, to the low degree of regulation of their financial system, or to the involvement of one or several of their financial institutions in past money laundering operations. Contacts with these financial centers were undertaken by FATF members having close ties with them, or being geographically close to them.

Some of these centres are related to FATF members. The Netherlands confirmed that their endorsement of the FATF recommendations also covered the **Netherlands Antilles and Aruba** and that the Kingdom had full responsibility for the territories. **Jersey, Guernsey** and the **Isle of Man** are Crown Dependencies of the United Kingdom. They have all introduced legislation to trace, freeze and confiscate the proceeds of drug trafficking, including the criminalisation of drugs money laundering. Guernsey and the Isle of Man have endorsed the recommendations of the Task Force and Jersey has confirmed that it is fully committed to preventing the use of the Island by those engaged in drug money laundering.

The contacts with other financial centres led to the following results.

a) **Cayman Islands, Montserrat, Anguilla, British Virgin Islands, Turks and Caicos Islands and Bermuda**, which are all British Dependent Territories, have been sent the Task Force recommendations and encouraged to endorse them. They have been asked to provide details of legislative and other measures which they have taken or are intending to take to combat money laundering. They have all introduced legislation to trace, freeze and confiscate the proceeds of drug trafficking, including the criminalisation of drugs money laundering. The legislation is very similar to that in the UK. They have confirmed, in general terms, that they support the FATF recommendations. They are currently working on detailed responses to the recommendations and considering the need for administrative measures in the context of local budgets and resource constraints.

b) **Gibraltar** - The authorities in Gibraltar, which is also a British Dependent Territory, have been sent the FATF report and encouraged to endorse its recommendations. They, also, are working on a detailed response which will describe the legislative and administrative measures that they have already taken, and are intending to take, to combat money laundering.

c) **Liechtenstein** - Liechtenstein is an independent state with special relationship to Switzerland mainly due to treaties on customs and monetary policy. Switzerland assumes however no responsibilities for Liechtenstein in regard to almost all of the issues in the scope of the FATF. According to its own assessment, Liechtenstein already applies a large number of the FATF recommendations. The majority of the rest will be implemented by or in connection with the planned bill criminalizing money laundering inspired by the Swiss legislation and entering the parliamentary process this year.

d) **Monaco** - Monaco is an independent state with a special relationship with France. It is preparing for the near future a complete set of texts, very close to the French ones, to fight money laundering.

The government of Monaco has officially expressed its intention to implement the FATF recommendations.

e) **Andorra** - Andorra is a territory under co-principality of the President of the French Republic and the bishop of Seo d'Urgell, Spain. The Bishop co-prince has been officially informed by the Spanish authorities of the 40 recommendations and has received an offer to get the necessary explanatory background. Following a request by the French co-prince, the Bishop of Seo d'Urgell has officially agreed to incorporate the FATF recommendations into local regulations. The implementation will have to take into account the specificities of the status of Andorra. Andorra has taken steps to give effect to provisions of the Vienna Convention. At this stage, bank regulations in Andorra are incomplete, and there is no banking supervisory authority. However, Andorran banks have established a code of conduct. The implementation of the FATF recommendations in Andorra will be conducted in cooperation with the relevant Andorran bodies, with a close involvement of the French authorities, and of the Spanish competent authorities upon request.

These contacts with financial centers will have to be continued, in order to obtain from those who have not done so a formal endorsement of the recommendations, to help the implementation if necessary, and to ensure that this implementation is effective. Furthermore, other financial centers might be identified in the future as requiring the same approach.

3 - Regional mobilization

In order to provide for the widest coverage of the FATF program, other countries or territories were or will be contacted through a process of mobilization on a regional basis. This process, launched by the FATF and undertaken by various countries or regional organisations, is only a first step. As with the financial centers, the aim is to assess where the countries or territories of the regional area stand in the fight against money laundering, to obtain as soon as possible full endorsement of the recommendations by most of them, to help implement these recommendations if necessary, and to ensure that this implementation is effective.

This first step takes the form of meetings associating some FATF members, and most or all countries or territories of the region concerned. In these meetings, the FATF report is presented in detail (it had been already transmitted in June 1990 to all countries having an embassy in Paris by the FATF secretariat) and the regional countries and territories express their views on the report.

The meeting for Asia was organised by Japan, together with the Economic and Social Commission of the United Nations for Asia and the Pacific (ESCAP). It was held in Tokyo on February 13 to 15, 1991. Forty five countries or territories (see list in Annex) sent delegates to this meeting. The general feeling was that the success of the fight against money laundering depends crucially on the harmonization of national programs. The participants called for an early endorsement of the FATF report by the countries and areas concerned.

The meeting for countries of central and eastern Europe was organised by the Commission of the European Communities, in Brussels, on March 4, 1991. Poland, Czechoslovakia, Hungary, Bulgaria, Romania and Yugoslavia sent delegates, together with several FATF members. These countries expressed their readiness to fight money laundering, and shared the view that the design of their new financial systems should include from the beginning regulations in this regard. However, some countries expressed reservations regarding the declarations of suspicious transactions : it was underlined that strong bank secrecy was essential to obtain the confidence of the population in the new financial system, because in the old system, a general obligation existed to report any suspicion of any illegal activity. The delegates will encourage their governments to endorse as soon as possible the FATF recommendations.

A meeting of the Carribbean Islands and Central American States (see list in Annex), was organised in Aruba as early as June 1990. The experts welcomed the FATF report, added some recommendations to address specific regional issues, and urged their governments to endorse and implement the FATF program. A second meeting should take place in Kingston, Jamaïca, in June 1991, with a view to formally endorsing the FATF report.

A meeting for Africa (see in annex list of participating countries) has taken place in Abidjan, Ivory Coast, on May 9, 1991, just after the annual meeting of the African Development Bank. During this meeting, it appeared clearly that it was in the interest of all african countries to participate in the fight against money laundering. Participants welcomed the FATF recommendations, and will submit them to their governments for endorsement.

A meeting with countries of Latin America , organized at the initiative of the United States under the auspices of the Organization of American States, will take place in Washington on May 21 to 24.

This process of regional mobilization will have to be pursued in the future, in a flexible way, with a view to ensuring, as far as possible, world-wide implementation of the FATF program. This will require formal endorsements of the report, as well as follow-up procedures to ensure that the implementation is effective. For many countries, technical assistance might also be necessary.

B - MEASURES DIRECTED AT NON COOPERATIVE COUNTRIES

1 - The problem of "regulatory havens" and non cooperative countries or territories and existing measures to address it

The issue of how to cope with the problem of countries with no or insufficient anti- money laundering measures, was adressed in last year's report of FATF, through recommendations 21 (special attention by financial institutions to transactions and business relations with persons located in "regulatory havens"), 22 (extension of the vigilance principles applicable to financial institutions, to their branches and subsidiaries located abroad) and 23 (detection or monitoring of cash at the border).

There was also general agreement that the wider the geographical extension of the FATF program, the easier the measures to deal with non cooperative countries or territories could be implemented. For instance, to be able to implement satisfactorily recommendation 21, financial institutions would need to know which countries or territories are to be considered as "regulatory havens", in order to focus their vigilance on a small number of transactions and business relations.

In the process of geographical extension of the recommendations, it appeared clearly that some countries or territories could remain reluctant to join in the international effort against money laundering. The motivations for this reluctance are generally easy to understand. Some jurisdictions who wish to establish a financial services industry as a supplementary source of income for the national finances - through the sale of authorization for shell companies and banking licenses - and to create employment for the population, use their lack of regulations as a competitive advantage. In addition, there are administrative costs in applying anti-money laundering sanctions. "Regulatory havens" may therefore be motivated by a wish to supplement their budgetary receipts, gain a marketing advantage for their financial services industry, or avoid imposing a cost on their financial services industry, or any combinatuion of all three. Finally, extreme cases, where governments cooperate with their financial institutions in large scale money laundering operations, cannot be excluded.

These kinds of motivations to avoid taking measures against money laundering, reflect clearly a short term view : a money laundering operation, once detected, can put at risk the whole financial system in these countries or territories, through the loss of credibility and confidence.

However, the problem of "regulatory havens" and non cooperative countries or territories in the fight against money laundering remains crucial, and deserves special attention.

2 - Additional measures

Some non cooperative countries or territories can already be identified, in particular those having denied assistance, in enquiries about international money laundering operations. The FATF devoted a special meeting to an exchange of views on this matter (see par. I-B 2b) : it was agreed that no "black list" of non cooperative countries or jurisdictions would be established, and that the results of this exchange of views would principally serve, at this stage, to help national efforts against money laundering. In order to lead these countries to more cooperative behaviour, it was felt that, for the time being, public and peer pressure could be sufficient, although FATF members could of course decide to go further on an individual basis, provided the Task Force was kept informed.

Public pressure could be exercised, in a "soft" way, through the publication of a "white list" of countries or territories which have implemented FATF recommendations and can thus be considered as fully participating to the international effort against money laundering. This publication would also facilitate national efforts to detect suspicious transactions. However, it was felt that it was too early to make a definitive assessment of which countries have satisfactorily implemented the FATF. This procedure cannot be envisaged before all countries have been given time to implement the FATF program, as a consequence of the geographical mobilization program described above, and before a thorough review of the degree and quality of this implementation has been conducted, through the assessment process descibed under part III-A. Furthermore, although a narrow majority of task force members would favor this course, there is at this stage no consensus on it.

Should this peer and public pressure prove insufficient, additional measures might be envisaged in the future.

Several types of measures were mentioned. For instance, an upgrading of the implementation of recommendation 21 might be considered, in order to submit all transfers/payments with these jurisdictions to a specific examination, which would at least increase the cost of transactions with them and thus compensate for the competitive advantage of the financial institutions located in the non cooperative country or territory. A systematic declaration to competent authorities of these transfers/payments might also be considered. The efficiency of these measures would of course be greater, if they were decided and implemented in a coordinated way, within the FATF.

III - FOLLOW-UP TO THE SECOND FATF

The group discussed arrangements which could ensure a full implementation of its program. The consensus was to maintain the group for the time being, to conduct four tasks :

1 - self-reporting and mutual assessment (monitoring and surveillance) on the adoption and implementation of FATF recommendations by all members ;

2 - co-ordination and oversight of efforts to encourage non-members to adopt and implement the recommendations ;

3 - making further recommendations and evaluations of counter-measures while serving as a forum for considering developments in money laundering techniques domestically and worlwide and for the exchange of information on enforcement techniques to combat money laundering ;

4 - standing ready to facilitate co-operation between organisations concerned with combating money laundering and between individual countries or territories.

A - FUTURE ROLE OF THE FATF

1 - Process of future assessments

a) Assessment among FATF members

The procedures adopted this year to assess the implementation among task force members, helped to determine guidelines for future assessments.

In the future, the essential objective should be to maintain the informality which the FATF has adopted and to avoid a rigid bureaucratic approach. The procedure could be for FATF members to complete answers to a standard questionnaire each year concerning the status of their implementation of the FATF recommendations. Surveillance grids could be used -provided they would be filled in a harmonized way, that is two countries in the same situation would give the same answer-, but FATF members would have to supply information supporting their responses on implementation status and the effect of their measures as well as explain their co-ordinated strategy against money laundering against the background of their particular characteristics. Consideration might also be given to more detailed surveillance grids, focusing on the key elements of the core recommendations.

The responses to the questionnaires would be circulated to all members by a Secretariat. The Secretariat would simultaneously circulate a summary of the various responses. This would form the self-reporting stage of the procedure.

There would then be a yearly meeting of the FATF members to consider the responses and discuss any problems arising out of them. Individual members would be chosen for examination by the FATF with the examination carried out by selected other members of the FATF, according to an agreed protocol for examination and agreed selection criteria. The objective would be to examine every FATF member by the end of 1996. Each year the FATF would select the members to be examined in the following year. Unless they wished to be examined earlier, members would not be subject to being examined until three years after their endorsement of the FATF-1 recommendations, except if the group decides otherwise, in exceptional circumstances. Each year a final assessment report would be prepared by the Secretariat under the supervision of the FATF. This would complete the mutual assessment process.

Assessment reports concerning individual countries would in principle not be published, but executives summaries would be.

During FATF meetings, particular questions related to FATF tasks might be discussed. Regular yearly meetings could be augmented by special meetings by agreement of the FATF. Working groups could also be established by the FATF if required.

b) Mobilisation and assessment in non member countries or territories

The contacts with "other financial centers" and "regional areas", as described above (part II-B : "geographical coverage") could be continued, for the time being, along the following lines : they would be pursued by individual FATF members, or in appropriate cases by steering groups of FATF members with the support of the Presidency/secretariat. Relevant FATF members would remain responsible for their associated or dependant territories as appropriate. Individual FATF members, or regional steering groups in appropriate cases, would also maintain contact with non-member financial centers and regionals areas. Reports would be made on developments in the relevant countries or territories. The annual meetings of the FATF would provide the opportunity to review progress and consider solutions to any problems.

An important part of this assessment process would be, upon request, the provision of technical assistance, in particular in drafting laws and regulations, and adapting bank supervisory and law enforcement authorities' structures. This could be provided by individual task force members, or by the secretariat, within the limits of its ressources.

Non-FATF members which subscribed to the FATF-1 recommendations, might join in the self-reporting process and complete the questionnaire on their adoption and implementation of the FATF recommendations. Such jurisdictions would be invited to attend the meetings at which their reports are discussed.

2 - Other tasks

In addition to the ongoing self-reporting/mutual assessment and co-ordination/oversight work, the FATF should also keep under review developments in money laundering trends and techniques and share information on legal, financial and enforcement counter-measures. Issues with regional or global implications could be discussed at the annual FATF meetings and consideration might be given to the development of further recommendations where appropriate.

FATF meetings will also provide the opportunity for informal exchange of information between members.

In this regard, the FATF would not be used as a formal intermediary for exchanges of information relating to suspicious transactions, or persons and corporations involved in these transactions ("hot information") : the exchange of "hot information" should take place, either bilaterally or through multilateral existing institutions, according to FATF recommendations. However, should difficulties arise in this matter, either between FATF participants, or between participants and non-participants, there should be a possibility for task force members to raise this issue in the FATF, in order to enable it to find a solution acceptable for all parties.

B - INSTITUTIONAL ARRANGEMENTS

The FATF could continue to function as an ad hoc group for the time being, reporting to finance Ministers or other competent Ministers and authorities. It should remain as flexible and informal as it is now. The question of the continuation of the FATF, and of its statute and future works should be addressed again in three years.

1 - Presidency

The FATF would continue to meet under the Presidency of an individual member. The Presidency would rotate on a yearly basis. The Presidency might run from 1 September to 31 August with the FATF making an annual report to Ministers or other competent authorities, enabling the FATF to report to suitable Ministerial and international fora in May-July. The President would be chosen by the FATF, taking into account as much as possible geographical locations and membership of various international groupings. A steering group would be set up including representatives of the Presidency, the Presidency for the last year and the next year, plus the chairmen of working groups, if any.

2 - Secretariat

The OECD could be invited to act as a secretariat for the FATF. The criteria used for this choice were : experience in areas related to those covered by the FATF ; multi-disciplinary nature ; and compatibility with the aims of the FATF. The OECD has confirmed that it has no difficulty in acting as a secretariat for a body which contains non-OECD members. The group is also grateful to UNIDCP for its offer to provide secretariat facilities.

The OECD would limit itself to secretariat functions, collating, co-ordinating and summarising responses from FATF members and supporting the FATF presidency. It could conduct studies by further decision of the FATF. It would not become involved in any enforcement activity.

The size and cost of this secretariat should be extremely limited, probably in the range of 2 to 4 millions francs each year. The burden sharing between FATF participants might be based on the standard OECD contribution formula. Countries, which are in a position to do so, might consider paying their contribution with a part of the funds stemming from assets seized in money laundering operations involving international cooperation.

3 - Future membership of the FATF

The FATF membership should not be further widened, in order to preserve the efficiency of the Task Force. However, countries who were invited to participate in this year, but who did not endorse the recommendations, would still be able to join.

Competent international organisations could be invited to participate as observers, at the discretion of the Presidency. They include the UNIDCP, the IMF, Interpol and the Customs Cooperation Council, the Bank of International Settlements and related committees, and the Council of Europe. Regional organisations wishing to play a role in the fight against money laundering could also be invited.

CONCLUSION

Relevant Ministers or other competent authorities of member jurisdictions will circulate this report to their Heads of State or Government. Their decisions, as well as further guidance from the Summit of the Heads of State or Government of the seven major industrial nations, will be crucial as regards the follow-up to the task force.

In order to ensure the success of the FATF program against money laundering, a high degree of mobilization in industrial and other financial center countries or territories is essential. This implies that those countries or territories which have not done so already, fully implement without delay the recommendations. This implies also the pursuit of the external mobilization effort which has been launched by the FATF-2, and a reinforcement of joint actions to deal with non cooperative countries or territories, in order to ensure that no financial center can put at risk the effectiveness of the fight against drug trafficking and other serious crimes.

The political commitment to fight money laundering, which enabled the establishment of an internationally agreed far-reaching program against money laundering in a record time, does not permit any abatement in the efforts of the Task Force, until the success of this program has been ensured. This success will provide a decisive contribution to the fight against criminal activities and above all against drug trafficking, and will improve the soundness of the international financial system.

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

STATEMENT OF J. FRENCH HILL
DEPUTY ASSISTANT SECRETARY (CORPORATE FINANCE)
DEPARTMENT OF THE TREASURY

BEFORE THE HOUSE COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS

SUBCOMMITTEE ON POLICY RESEARCH AND INSURANCE

JUNE 6, 1991

Mr. Chairman, I am pleased to come before you today on behalf of the Department of the Treasury and the Administration to discuss what has commonly become known as "lender liability" under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA).

Legislation has been introduced in the Congress that seeks to resolve the lender liability issue, including H.R. 1450, introduced by Mr. LaFalce, and S. 651, introduced by Senator Garn. These bills have been instrumental in focusing the debate on the lender liability problem. The Administration supports the objectives of these bills, and believes that the rule released by EPA yesterday achieves those objectives with precision and clarity. We support EPA's rule because it provides a much needed measure of certainty for lenders seeking to avoid liability when extending credit. With respect to the security interest exemption, if the Congress believes that the rule should be codified, the Administration will support legislation that only enacts the security interest provisions contained in the proposed EPA rule.

NB-1309

It is important to emphasize at the outset that the issues involved in "lender liability" that are addressed by EPA's rule affect more than private lenders, such as banks and other financial institutions, although they are certainly the most obviously affected. The same issues are of critical concern to --

- o the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) when they become conservators or receivers of troubled or failed depository institutions
- o all Federal agencies that lend funds, guarantee or insure loans, or guarantee mortgage-backed securities, such as the Farmers Home Administration (FmHA), the Small Business Administration (SBA), the Department of Energy, the Department of Veterans Affairs, the Department of Housing and Urban Development, and the Government National Mortgage Association
- o all Federal agencies that acquire security interests in the course of carrying out their statutory functions, such as through the seizure and forfeiture of assets of drug traffickers
- o non-lending Federal agencies such as the Internal Revenue Service, which can acquire property through a lien for delinquent taxes, and the U.S. Customs Service which can acquire liens on vessels by operation of law.

In general, CERCLA imposes strict liability on owners and operators of property for the release or threatened release of hazardous substances. When it enacted CERCLA in 1980, the Congress made special provisions to exempt from this strict liability persons who, without participating in the management of a borrower's business, hold indicia of ownership, such as a deed of trust or mortgage, to protect a security interest. The intention of the exemption is that a lender who holds title to property (a mortgage is the typical example) is protected from strict liability, even if the lender is forced to acquire the property to protect the security interest. The Administration strongly supports this rational and commercially necessary exemption from liability.

Underlying the lender liability issue is the extent to which CERCLA contemplates that bankers and other lenders are to assume the role in our society of insuring or guaranteeing the environmental purity of borrowers. We find nothing in CERCLA to support such a contention. CERCLA does not impose any requirement that lenders conduct environmental audits or inspections prior to lending funds. Instead, the security interest exemption only demands that lenders refrain from participating in the management of a borrower's enterprise when holding indicia of ownership to protect a security interest.

However, as a result of a few recent court decisions, there is now uncertainty regarding the scope the security interest exemption. Banks and other lenders do not know when, in the course of ordinary dealings with a borrower, they may be deemed to participate in the management of a borrower's business and therefore incur strict liability. This uncertainty places an invisible barrier between lender and borrower and is generally destabilizing to the banking system because it discourages the conduct of normal business relationships, particularly when a borrower is having financial troubles. Similarly, lenders do not know what actions taken to protect a security interest will void the exemption.

Because there are instances where lenders have been held strictly liable under CERCLA, we believe there has been an overall chilling effect on both commercial and industrial and real estate lending. Many lenders are simply not making loans to borrowers whose businesses involve hazardous substances or whose properties may have been associated with hazardous substances under a prior ownership. Moreover, many lenders are writing off bad loans for fear of environmental liability, thereby incurring losses that weaken the banking system. Lenders are also refusing to extend additional credit to troubled borrowers, which can result in bankruptcy and layoffs.

If we allow this situation to continue, we believe there are potentially serious consequences for our economy, the Federal deposit insurance funds, and our efforts to clean up the environment.

We believe that lender uncertainty over CERCLA liability is exacerbating the "credit crunch" and may well jeopardize our economic recovery and growth. To the extent Federally insured depository institutions incur strict liability under CERCLA, that liability poses a serious threat to the Federal deposit insurance funds and all taxpayers. The cost of a CERCLA cleanup and attendant liability could erode minimum capital levels and force an institution into Federal conservatorship or receivership at a significant cost to the Federal deposit insurance funds.

To the extent that Federal lending agencies continue to be exposed to strict liability under CERCLA merely because they are carrying out their statutory mandates, those programs will be curtailed as funds intended for loans are diverted to pay CERCLA liability, and as agencies limit program operations for fear of incurring liability.

If Federal law enforcement agencies continue to be exposed to strict liability under CERCLA merely because they seize and forfeit property of persons who violate the law, critical tools will be eliminated from our law enforcement arsenal.

Finally, exposing lenders to the risk of strict CERCLA liability merely because they extend credit simply is not consistent with sound environmental policy. Instead of fostering a climate in which the lending community is a willing partner in our national efforts to clean up the environment by loaning the necessary funds, the uncertainty of lender liability is denying financial resources to those businesses that need them the most.

The Administration is committed to providing private and governmental lenders and holders of security interests with clear and unambiguous certainty concerning their potential liability under CERCLA. Resolving the lender liability issue will benefit lenders, Federal agencies, the economy and the environment.

Since last fall, the Departments of Treasury and Justice, many other Federal agencies, and the President's Council on Competitiveness, have been working with EPA to develop a rule that would resolve the lender liability problem. This has been difficult task in view of the legitimate competing policy interests involved, and we are pleased that EPA has been able to develop a rule that provides the certainty needed by lenders, properly protects Federal agencies, and maintains effective protection of the environment.

The EPA proposed rule released yesterday embodies the following principles:

PRIVATE AND GOVERNMENTAL LENDERS AND HOLDERS OF SECURITY INTERESTS

- PRE-LOAN ACTIVITIES. Strict liability under CERCLA cannot result from any action taken prior to the creation of a security interest.
- PARTICIPATION IN MANAGEMENT WHILE BORROWER IN POSSESSION OF COLLATERAL. Strict liability under CERCLA cannot result while the borrower is in possession of the collateral unless the holder of the security interest participates in the management of the borrower's affairs by either --
    - exercising actual decisionmaking control over the borrower's environmental compliance, such that the holder has undertaken responsibility for the borrower's waste disposal or hazardous substance handling practices which results in a release or threatened release, or
    - exercising control at a management level encompassing the borrower's environmental compliance responsibilities comparable to that of a manager of the borrower's enterprise, such that the security holder has assumed or manifested responsibility for the

management of the enterprise by establishing, implementing or maintaining the policies and procedures encompassing the day-to-day environmental decisionmaking of the borrower's enterprise.

This principle (1) encourages the maximum amount of cooperation between lenders and borrowers, (2) ensures that ordinary and customary dealings between lenders and borrowers do not result in strict liability under CERCLA, and (3) clarifies that CERCLA strict liability does not arise if a lender provides financial advice and other services in areas totally unrelated to environmental compliance.

o <u>POST-FORECLOSURE PROTECTION OF THE SECURITY INTEREST</u>.

A foreclosing security holder is deemed to be acting to protect the security interest and therefore not subject to CERCLA strict liability unless it is shown that the security holder has held the property for any other purposes as evidenced by --

- o a failure to offer the property for sale or to otherwise seek to divest his interest in the property, or
- o a rejection a bona fide written offer of fair consideration from a qualified purchaser.

This principle recognizes that lenders are ordinarily not in the business of investing in foreclosed collateral -- they are in the business of making loans. In fact, the law prohibits national banks from holding real property for investment purposes, and provides that they may hold foreclosed property for up to 10 years if that is necessary to recover on a bad loan (see 12 U.S.C. 29). For this reason, the rule provides that a foreclosing lender will be protected from CERCLA liability as long as it continues to protect the security by making a good faith effort to sell or otherwise divest foreclosed collateral for fair consideration.

This principle also furthers two legitimate policy objectives.

- o It protects the real estate market by ensuring that lenders are not forced to "dump" foreclosed properties in times of weak markets thereby further depressing real estate values.

- o It avoids forcing lenders to wind down an ongoing enterprise -- a shopping center or a factory for example -- to avoid CERCLA liability. Not only may winding down operations reduce the value of the collateral and make it more difficult to sell, but it also eliminates jobs, reduces the tax base of State and local governments, and increases government unemployment compensation costs.

o <u>BURDEN OF PROOF</u>. The burden should be on the plaintiff seeking to impose strict liability on a security holder to prove --

- o that a holder participated in management (as defined above) while the borrower was in possession of the collateral, or

- o that a foreclosing holder has not acted to protect the security interest (as defined above).

<u>GOVERNMENT-APPOINTED CONSERVATORS AND RECEIVERS</u>

o Government-appointed conservators and receivers (including the FDIC and the RTC) are entitled to assert the security interest exemption with respect to the loan portfolios (including already foreclosed upon properties) of troubled or failed depository institutions.

o Government-appointed conservators and receivers are deemed to involuntarily acquire the assets of troubled or failed depository institutions and therefore have a defense to CERCLA liability under section 101(35).

o To the extent liability attaches to property in a Government conservatorship or receivership, liability of the Government-appointed conservator or receiver shall not exceed the market value of the property less the amount of the security interest.

These principles protect the Federal deposit insurance funds from becoming a deep-pocket, either directly or indirectly, for CERCLA liability.

Finally, the Administration also is seriously concerned about a CERCLA liability problem unrelated to the question of lender liability. This concerns the potential CERCLA liability attaching to acquisitions of property of Federal agencies that are "involuntary" in nature. Many Federal agencies, particularly the law enforcement agencies of the Departments of Justice and Treasury that seize and compel forfeiture of property need assurances that such actions will not subject them to CERCLA liability. The EPA rule proposes language that would implement such a provision and the Administration strongly supports it to provide the necessary protection to Federal agencies that acquire property involuntarily.

This concludes my formal remarks, and I would be pleased to answer any questions you and the Committee may have.

TREASURY NEWS

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

For Release Upon Delivery
Expected at 9:30 AM
May 31, 1991

STATEMENT OF
GERALD MURPHY
FISCAL ASSISTANT SECRETARY
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I welcome this opportunity to provide an overview of the Minority Bank Deposit Program (Program) with emphasis on elements relevant to United National Bank of Washington (UNB). I will also provide what information I can concerning UNB and then answer the questions posed in your May 28 letter to Secretary Brady.

Minority Bank Deposit Program

The Program is an Executive Branch initiative, authorized by Executive Order, to foster minority banking enterprise. The Program is a voluntary effort to encourage Federal agencies to establish depositary/financial agent relationships with Program financial institutions. The Treasury Department administers the Program; the Treasury Financial Management Service (FMS) (which I monitor) has operational responsibilities for the Program.

Eligible participants include commercial banks which are minority-owned or minority-controlled. These terms and their meanings have been used since the mid-1970's and are well- publicized in all Program materials, applications and self- certification forms, etc.

The term "minority ownership" means that more than 50 percent of an institution's outstanding stock is owned by members of minority groups. The term "minority control" (relevant with respect to UNB) applies when minority persons hold by voting trust and/or proxy agreements enough shares so that when added to the shares owned by minority persons there is minority control over more than 50 percent of the outstanding voting stock. The voting trust and/or proxy agreements must have a life of at least three years and be irrevocable, and the trustee (a member of a minority group) must have unfettered discretion in voting the stock. Minority control does not refer to the number of minority directors and officers.

Additional Program information relevant with respect to UNB is that an eligible financial institution applies, and self- certifies its minority status, to FMS and thereafter becomes a participant in the MBDP. (There are 187 financial institutions in the MBDP). A Program participant is expected to notify FMS of any change in status that could affect MBDP eligibility. Qualified Program participants are included on a Program roster maintained, updated and distributed by FMS to Federal agencies, contractors and other public and private sector organizations.

United National Bank of Washington

United National Bank (UNB) was organized as a minority bank in 1964 and became a participant in the Minority Bank Deposit Program in the early 1970's on the basis of minority ownership. In November 1989, FMS requested all participants to self-certify their minority status. UNB President Joseph Aston replied on December 29, 1989, advising that he believed that UNB was operated and controlled by minorities, but that UNB was no longer under minority ownership due to a merger between UNB Bancshares, Inc., and James Madison, Limited. This was the first notice to FMS that UNB no longer claimed minority ownership.

The documentation submitted by UNB to support minority control did not meet the criteria I mentioned earlier and accordingly UNB was not included in the roster of Program participants issued in January 1990. UNB appealed the decision to senior Treasury levels and agreed to submit additional information to the Treasury Office of General Counsel. In August 1990, after considerable review, the UNB appeal was denied.

Questions Answered

1. The opening of my Statement provides the overview you requested of the Minority Bank Deposit Program.

2. UNB was deleted from the roster of Program participants as of January 1990.

3. UNB was deleted from the roster after it was discovered that the bank had been purchased by non-minority interests and it was determined not to be under effective minority control.

4. The MBDP is voluntary for both participants and Executive Branch agencies. Therefore, Treasury's FMS has relied on participants to advise us of any change that might affect their status as minority-owned or controlled. UNB did not notify Treasury when the change occurred. Treasury

discovered the change in status during a general request to all Program banks in November of 1989. At that point, UNB acknowledged that it was no longer minority owned. UNB, however, believed it met the criteria for minority control. Treasury disagreed and dropped UNB from the Program in January of 1990. The bank appealed the decision; it was reviewed and a final decision to deny the appeal was made in August of 1990.

5. There is no record that Madison or UNB notified Treasury that UNB was no longer minority controlled before December

1989.

6. There is no record that the Office of the Comptroller of the Currency or the Federal Reserve Board notified Treasury that UNB was no longer minority-owned. During the Spring and early Summer of 1990, after UNB appealed, there were telephone conversations among my Office, the Office of the Comptroller of the Currency and the Federal Reserve Board to discuss possible methods proposed by UNB by which it might qualify as minority-controlled. Nothing came of these discussions that could justify restoring UNB's eligibility.

Mr. Chairman, that concludes my prepared testimony. I'll be happy to answer any questions that you may have.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
June 6, 1991

CONTACT: Barbara Clay
202-566-5252

BRADY ANNOUNCES NEW EBRD FIRST VICE PRESIDENT

Treasury Secretary Nicholas Brady today announced that Ronald Freeman has been chosen by the Board of Directors of the newly formed European Bank for Reconstruction and Development to fill the position of First Vice President, Merchant Banking.

"Ron Freeman's background and experience will be particularly valuable in shaping the bank's support for the emerging private sector needs of Eastern Europe," Brady said.

In his new position, Freeman will be responsible for overseeing the new bank's private sector development activities, the largest part of its portfolio.

Freeman, aged 51, a lawyer and a banker, joined Salomon Brothers in 1973. He was admitted to the firm's general partnership in 1979. He most recently served as Head of European Investment Banking, located in London. Prior to that, he served as Managing Director and Co-Head of Salomon Brothers' Strategic Services Group and was also Head of International Mergers and Acquisitions based in New York.

Prior to joining Salomon Brothers, he was employed by McKinsey & Co., 1967-73, and by Baker and McKenzie, 1965-67.

oOo

NB-1310

PUBLIC DEBT NEWS

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

FOR RELEASE AT 3:OO PM
June 6, 1991

Contact: Peter Hollenbach
(202) 376-4302

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

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

Dollar Amounts in Thousands

Principal Outstanding (Eligible Securities)	$520,322,741
Held in Unstripped Form	$394,659,506
Held in Stripped Form	$125,663,235
Reconstituted in May	$2,978,540

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-57

TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, MAY 31, 1991
(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding			Reconstituted This Month[1]
		Total	Portion Held in Unstripped Form	Portion Held in Stripped Form	
11-5/8% Note C-1994	11/15/94	$6,658,554	$5,613,754	$1,044,800	$11,20
11-1/4% Note A-1995	2/15/95	6,933,861	6,499,141	434,720	22,40
11-1/4% Note B-1995	5/15/95	7,127,086	5,871,406	1,255,680	1,92
10-1/2% Note C-1995	8/15/95	7,955,901	7,391,901	564,000	-0-
9-1/2% Note D-1995	11/15/95	7,318,550	6,137,350	1,181,200	3,60
8-7/8% Note A-1996	2/15/96	8,575,199	8,343,199	232,000	-0-
7-3/8% Note C-1996	5/15/96	20,085,643	19,871,243	214,400	-0-
7-1/4% Note D-1996	11/15/96	20,258,810	19,967,610	291,200	-0-
8-1/2% Note A-1997	5/15/97	9,921,237	9,840,037	81,200	-0-
8-5/8% Note B-1997	8/15/97	9,362,836	9,330,836	32,000	-0-
8-7/8% Note C-1997	11/15/97	9,808,329	9,792,329	16,000	-0-
8-1/8% Note A-1998	2/15/98	9,159,068	9,149,788	9,280	-0-
9% Note B-1998	5/15/98	9,165,387	9,135,387	30,000	-0-
9-1/4% Note C-1998	8/15/98	11,342,646	11,213,846	128,800	-0
8-7/8% Note D-1998	11/15/98	9,902,875	9,896,475	6,400	-0
8-7/8% Note A-1999	2/15/99	9,719,623	9,716,423	3,200	-0
9-1/8% Note B-1999	5/15/99	10,047,103	9,176,703	870,400	-0
8% Note C-1999	8/15/99	10,163,644	10,081,619	82,025	-0
7-7/8% Note D-1999	11/15/99	10,773,960	10,765,960	8,000	-0
8-1/2% Note A-2000	2/15/00	10,673,033	10,673,033	-0-	-0
8-7/8% Note B-2000	5/15/00	10,496,230	10,414,630	81,600	-0
8-3/4% Note C-2000	8/15/00	11,080,626	11,080,626	-0-	-0
8-1/2% Note D-2000	11/15/00	11,519,682	11,519,682	-0-	-0
7-3/4% Note A-2001	2/15/01	11,312,802	11,312,802	-0-	-0
8% Note B-2001	5/15/01	12,398,063	12,398,063	-0-	-0
11-5/8% Bond 2004	11/15/04	8,301,806	3,668,206	4,633,600	16,0
12% Bond 2005	5/15/05	4,260,758	1,667,708	2,593,050	68,3
10-3/4% Bond 2005	8/15/05	9,269,713	8,304,113	965,600	136,0
9-3/8% Bond 2006	2/15/06	4,755,916	4,755,916	-0-	-
11-3/4% Bond 2009-14	11/15/14	6,005,584	1,316,784	4,688,800	90,4
11-1/4% Bond 2015	2/15/15	12,667,799	2,102,199	10,565,600	129,6
10-5/8% Bond 2015	8/15/15	7,149,916	1,736,156	5,413,760	137,2
9-7/8% Bond 2015	11/15/15	6,899,859	2,229,459	4,670,400	140,8
9-1/4% Bond 2016	2/15/16	7,266,854	6,710,854	556,000	48,8
7-1/4% Bond 2016	5/15/16	18,823,551	17,140,351	1,683,200	140,
7-1/2% Bond 2016	11/15/16	18,864,448	15,206,848	3,657,600	315,
8-3/4% Bond 2017	5/15/17	18,194,169	6,726,649	11,467,520	226,
8-7/8% Bond 2017	8/15/17	14,016,858	9,479,258	4,537,600	64,
9-1/8% Bond 2018	5/15/18	8,708,639	2,388,639	6,320,000	174,
9% Bond 2018	11/15/18	9,032,870	1,574,470	7,458,400	170,
8-7/8% Bond 2019	2/15/19	19,250,798	4,993,198	14,257,600	289,
8-1/8% Bond 2019	8/15/19	20,213,832	10,559,752	9,654,080	380,
8-1/2% Bond 2020	2/15/20	10,228,868	3,898,868	6,330,000	366,
8-3/4% Bond 2020	5/15/20	10,158,883	2,808,163	7,350,720	15,
8-3/4% Bond 2020	8/15/20	21,418,606	9,256,686	12,161,920	24,
7-7/8% Bond 2021	2/15/21	11,113,378	11,004,578	108,800	-
8-1/8% Bond 2021	5/15/21	11,958,888	11,936,808	22,080	4,
Total		520,322,741	394,659,506	125,663,235	2,978,

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

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

A BILL

To amend the Securities Exchange Act of 1934 to extend the regulatory authority of the Secretary of the Treasury under the Government Securities Act of 1986, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This act may be cited as the "Government Securities Act Amendments of 1991".

SEC. 2. GOVERNMENT SECURITIES REGULATORY AUTHORITY.

(a) Extension of Rulemaking Authority.-- Section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o-5) is amended by repealing subsection (g).

(b) Additional Rulemaking Authority.-- Section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o-5) is amended in subsection (b), by redesignating paragraphs (3), (4), (5), and (6) as paragraphs (5), (6), (7), and (8) and inserting after paragraph (2) the following new paragraphs:

"(3) The Secretary may propose and adopt rules --

"(A) which define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative with respect to transactions in government securities effected by government securities brokers and government securities dealers; and

"(B) designed to promote just and equitable principles of trade with respect to transactions in government securities effected by government securities brokers or government securities dealers that are financial institutions."

"(4) In furtherance of the objective of assuring adequate dissemination of government securities price and volume information:

"(A) (i) The Secretary may propose and adopt rules and regulations designed to:

"(I) assure the prompt, accurate, reliable, and fair reporting, collection, processing, distribution, and publication of information with respect to quotations for and transactions in government securities and the fairness and usefulness of the form and content of such information;

"(II) assure that all government securities information processors may, for purposes of distribution and publication, obtain on fair and reasonable terms such information with respect to quotations for and transactions in government securities as is reported, collected, processed, or prepared for distribution or publication by any processor of such information (including self-regulatory organizations) acting in an exclusive capacity; and

"(III) assure that all government securities brokers, government securities dealers, government securities information processors, and, subject to such limitations as the Secretary, by rule, may impose as necessary or appropriate for the protection of investors or maintenance of fair and orderly markets, all other persons may obtain on terms which are not unreasonably discriminatory such information with respect to quotations for and transactions in government securities as is published or distributed.

"(ii) No self-regulatory organization, government securities information processor, government securities broker, or government securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to report, collect, process, distribute, publish, or prepare for distribution or publication any information with respect to quotations for or transactions in any government security, to assist, participate in, or coordinate the distribution or publication of such information, or to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any government security in contravention of any rules or regulations promulgated under this paragraph.

"(B) The Secretary may, by rule, as the Secretary deems necessary or appropriate in the public interest or for the protection of investors, after due consideration of any effects on the liquidity or efficiency of the government securities market, require any government securities broker or government securities dealer who has induced, attempted to induce, or effected the purchase or sale of any government security by use of the mails or any means or instrumentality of interstate commerce to report purchases, sales or quotations for any government security to a government securities information processor, national securities exchange, or registered securities association and require such a processor, exchange, or association to make appropriate distribution and publication of information with respect to such purchases, sales or quotations.".

(c) Technical Amendment.-- Section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o-5) is amended in subsection (d) by revising paragraph (2) to read as follows:

"(2) Information received by any appropriate regulatory agency, any Federal Reserve Bank, or the Secretary from or with respect to any government securities broker or government securities dealer or with respect to any person associated therewith may be made available by the Secretary, the recipient agency or the Federal Reserve Bank to the Commission, the Secretary, any appropriate regulatory agency, any self-regulatory organization, or any Federal Reserve Bank."

SEC. 3. RULES BY REGISTERED SECURITIES ASSOCIATIONS.

Section 15A(f)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3(f)(2)) is amended --

(1) in clause (E), by striking the word "and" at the end thereof;

(2) in clause (F), by striking the period at the end thereof and inserting instead ", and"; and

(3) by adding at the end thereof the following new clause:

"(G) with respect to transactions in government securities, to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade, provided such rules are consistent with any rule adopted by the Secretary of the Treasury pursuant to section 15C(b)(3)(A) of this title.".

SEC. 4. OVERSIGHT OF REGISTERED SECURITIES ASSOCIATIONS.

Section 19 of the Securities Exchange Act of 1934 (15 U.S.C. 78s) is amended --

(1) in subsection (b), by adding at the end thereof the following new paragraph:

"(5) The Commission shall consult with and consider the views of the Secretary of the Treasury (Secretary) prior to approving a proposed rule change filed by a registered securities association pursuant to section 15A(f)(2)(G) of this title, except where the Commission determines that an emergency exists requiring expeditious or summary action and publishes its reasons therefor. If the Secretary comments in writing to the Commission on such proposed rule change that has been published for comment, the Commission shall respond in writing to such written comment before approving the proposed rule change."

(2) in subsection (c), by adding at the end thereof the following new paragraph:

"(5) With respect to rules adopted pursuant to section 15A(f)(2)(G) of this title, the Commission shall consult with and consider the views of the Secretary before abrogating, adding to, and deleting from such rules, except where the Commission determines that an emergency exists requiring expeditious or summary action and publishes its reasons therefor."

SEC. 5. AMENDMENTS TO DEFINITIONS.

Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended --

(1) in paragraph 34(G) (relating to the definition of appropriate regulatory agency), by amending clauses (ii), (iii), and (iv) to read as follows:

"(ii) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a foreign bank, an uninsured State branch or State agency of a foreign bank, a commercial lending company owned or controlled by a foreign bank (as such terms are used in the International Banking Act of 1978), or a corporation organized or having an agreement with the Board of Governors of the Federal Reserve System pursuant to section 25 or section 25(a) of the Federal Reserve Act;

"(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System or a Federal savings bank) or an insured State branch of a foreign bank (as such terms are used in the International Banking Act of 1978);

"(iv) the Director of the Office of Thrift Supervision, in the case of a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act) the deposits of which are insured by the Federal Deposit Insurance Corporation;";

(2) by amending paragraph (46) (relating to the definition of financial institution) to read as follows:

"(46) The term 'financial institution' means --

"(A) a bank (as defined in paragraph (6) of this subsection);

"(B) a foreign bank (as such term is used in the International Banking Act of 1978); and

"(C) a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act) the deposits of which are insured by the Federal Deposit Insurance Corporation."; and

(3) by adding at the end thereof the following new paragraph (relating to the definition of government securities information processor):

"(53) The term 'government securities information processor' means any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any government security; or (ii) distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise) on a current and continuing basis, information with respect to such transactions or quotations. The term 'government securities information processor' does not include any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation, any self-regulatory organization, any bank, government securities broker, government securities dealer, or savings association (as defined in section 3(b) of the Federal Deposit Insurance Act), if such bank, government securities broker, government securities dealer, or association would be deemed to be a government securities information processor solely by reason of functions performed by such institutions as part of customary banking, brokerage, dealing, or association activities, or any common carrier, as defined in section 3(h) of the Communications Act of 1934, subject to the jurisdiction of the Federal Communications Commission or a State commission, as defined in section 3(t) of that Act, unless the

Commission determines that such carrier is engaged in the business of collecting, processing, or preparing for distribution or publication, information with respect to transactions in or quotations for any government security.".

GOVERNMENT SECURITIES ACT AMENDMENTS OF 1991

ANALYSIS

SECTION 1.

Short title.

SECTION 2. GOVERNMENT SECURITIES REGULATORY AUTHORITY.

Subsection (a) would repeal section 15C(g) of the Securities Exchange Act of 1934 (1934 Act). Section 15C(g), as added by section 101 of the Government Securities Act of 1986 (GSA) (Pub. L. 99-571), provides that the authority of the Secretary of the Treasury to promulgate regulations and issue orders under the GSA governing transactions in government securities by government securities brokers and dealers expires on October 1, 1991. The repeal of subsection (g) would permanently extend the regulatory authority of the Secretary. This amendment is necessary to preserve the current regulatory structure of the government securities market and to ensure continuity of regulatory policy.

Subsection (b) would amend section 15C(b) of the 1934 Act, as added by GSA section 101(b), which concerns rules adopted and implemented by the Secretary of the Treasury. This amendment would grant the Secretary of the Treasury discretionary authority to prescribe sales practice rules that are reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices for all government securities brokers and dealers, including financial institutions. Vesting Treasury with this authority would ensure that such rules provide comparable protection to customers of both bank and non-bank brokers and dealers. This amendment would also grant the Secretary discretionary authority to prescribe sales practice rules to promote just and equitable principles of trade applicable to government securities brokers and dealers that are financial institutions. These authorities, together with the granting of authority to registered securities associations (i.e., the National Association of Securities Dealers (NASD)) to prescribe just and equitable principles of trade for their members pursuant to section 15A(f)(2)(G) of the 1934 Act (as proposed herein), are intended to provide government securities investors with sales practice protections (e.g., prohibitions against excessive mark-ups, suitability guidelines, and customer authorization requirements) that are comparable to those available in other securities markets.

This subsection would also grant the Secretary discretionary authority, similar to the existing authority of the Securities and Exchange Commission (SEC) with respect to non-exempt securities transaction information, to regulate disclosure of and access to government securities price and volume information. The Secretary would be authorized:

- To assure the prompt, accurate, reliable, and fair reporting, collection, processing, distribution, and publication of government securities transaction information and the fairness and usefulness of the form and content of such information;

- To propose and adopt rules designed to assure that all government securities information processors have access, for purposes of distributing or publishing on reasonable and nondiscriminatory terms, to government securities quotation and transaction information reported, collected, processed or prepared for distribution or publication by any processor acting in an exclusive capacity regarding such information.

- To assure that all persons, including government securities brokers and dealers, and government securities information processors, as the Secretary deems appropriate, have access on reasonable and nondiscriminatory terms to quotations and transaction reports published.

This subsection also would make it unlawful for any self-regulatory organization, government securities information processor, or government securities broker or dealer to perform the functions of a government securities information processor or to purchase or sell any government security in contravention of any rules prescribed by the Secretary.

This subsection would also permit the Secretary to determine that it would be in the public interest to require the reporting of government securities quotation, purchase, or sale information by any government securities broker or government securities dealer to a government securities information processor, national securities exchange, or registered securities association, and to require recipients to make appropriate distribution and publication of the information.

Subsection (c) clarifies that information concerning any government securities broker or government securities dealer may be received from or provided to the Federal Reserve Banks as well as the Board of Governors of the Federal Reserve System.

SECTION 3. REGISTERED SECURITIES ASSOCIATIONS.

This section would amend section 15A(f)(2) of the 1934 Act, which concerns rules that registered securities associations may adopt and implement with respect to members of such associations. The amendment would grant registered securities associations (i.e., the NASD) discretionary authority to prescribe government securities sales practice rules for their members, provided such rules are consistent with sales practice rules adopted by the Secretary of the Treasury under section 15C(b)(3)(A) of the 1934 Act. In adopting sales practice rules, registered securities associations should take care not to unnecessarily impair the liquidity or efficiency of the government securities market. The provision requiring consistency parallels a provision in section 19(b)(2) of the 1934 Act which requires proposed rules of self-regulatory organizations to be consistent with the requirements of the 1934 Act and the regulations thereunder. The consistency requirement is thus intended to prevent the promulgation of any rules that would require or appear to permit government securities brokers and dealers to engage in conduct that is inconsistent with the requirements of applicable Treasury rules.

When enacted, the GSA did not rescind the restriction placed on registered securities associations that prohibits them from adopting or applying sales practice rules to government securities transactions. This amendment would rescind this restriction, and is intended to enhance customer protection by facilitating the ability of registered securities associations, specifically the NASD, to enforce compliance with sales practice rules applicable to members that are government securities brokers or dealers.

SECTION 4. OVERSIGHT OF REGISTERED SECURITIES ASSOCIATIONS.

This section would amend section 19 of the 1934 Act, which concerns registration, responsibilities, and oversight of self-regulatory organizations. This amendment would require the SEC to consult with and consider the views of the Secretary of the Treasury prior to approving government securities sales practice rules proposed by registered securities associations, specifically the NASD. The amendment would grant the SEC authority to approve such rules without consulting with Treasury if an emergency arose requiring expeditious or summary action. The amendment would also require the SEC to respond in writing to any written comment submitted by the Secretary relating to such proposed rules before it approves the rules.

Further, the amendment would require the SEC to consult with and consider the views of the Secretary before abrogating, adding to, and deleting any government securities sales practice rules developed by registered securities associations. The SEC would be able to abrogate, add to, and delete such sales practice rules without consulting with Treasury if an emergency warranted such action.

SECTION 5. AMENDMENTS TO DEFINITIONS.

<u>Paragraph (1)</u> would conform section 3(a)(34)(G) of the 1934 Act, as added by GSA section 102(b) (concerning the definition of "appropriate regulatory agency"), with existing bank regulatory agency supervisory authorities.

First, the Board of Governors of the Federal Reserve System (FRB) would be designated as the appropriate regulatory agency for financial institutions that are Edge or Agreement corporations. Without this modification, supervisory responsibility for the government securities activities of these entities would continue to rest with the SEC.

since the FRB already exercises bank regulatory and supervisory responsibilities for these entities pursuant to the Federal Reserve Act, this amendment would eliminate inefficiencies and reduce costs resulting from duplicative examinations. In addition, the transfer of supervision from the SEC to the FRB is appropriate since the FRB routinely examines financial institutions, while the SEC supervises the broker and dealer activities of institutions that are not generally financial institutions.

Second, the Federal Deposit Insurance Corporation (FDIC) would be designated as the appropriate regulatory agency for insured State branches of foreign banks (the FRB would retain jurisdiction for uninsured State branches and State agencies of foreign banks). This amendment will ensure that the FDIC, which currently examines insured State branches of foreign banks pursuant to the International Banking Act, would be responsible for the examination of government securities activities conducted by such institutions. The amendment would eliminate the costs associated with duplicative examinations.

Finally, as a technical amendment, this provision would insert a parenthetical reference to the definition of "savings association" contained in the Federal Deposit Insurance Act. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) amended clause (iv) to designate the Director of the Office of Thrift Supervision (OTS) as the appropriate regulator for savings associations. The term "savings association," however, is not defined in the Act.

Paragraph (2) would technically amend the definition of "financial institution" contained in section 3(a)(46) of the 1934 Act. Prior to FIRREA, section 3(a)(46) referenced the definition of "insured institutions" (including insured thrifts) contained in the National Housing Act (NHA). FIRREA, however, repealed the referenced NHA definition. The amendment would clarify the definition of "financial institution" by reincluding entities that were formerly insured by the Federal Savings and Loan Insurance Corporation. Consistent with FIRREA section 744(u), this provision would include savings associations insured by the FDIC and subject to supervision by the OTS within the definition of "financial institution."

Paragraph (3) would add to section 3(a) of the 1934 Act a definition of the term "government securities information processor." The term is based on the definition of a "securities information processor" found at section 3(a)(22)(A) of the 1934 Act and is defined as any person engaged in the business of collecting, processing, or preparing for distribution or publication information with respect to transactions in or quotations for any government security and also any person engaged in distributing or publishing such information on a current and continuing basis. The press and common carriers subject to the jurisdiction of the Federal Communications Commission or a State commission, would be exempted from the definition unless such carrier is engaged in the business of preparing for or coordinating the distribution or publication of such information. Self-regulatory organizations would also be exempt from the definition, as would banks, government securities brokers, government securities dealers, or savings associations if the latter four organization types would be government securities information processors merely because they engage in functions customary for such institutions.

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 10, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,049 million of 13-week bills to be issued June 13, 1991 and to mature September 12, 1991 were accepted today (CUSIP: 912794XF6).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

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

Tenders at the high discount rate were allotted 85%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	27,305	27,305
New York	27,683,280	8,341,020
Philadelphia	19,295	19,295
Cleveland	62,645	62,615
Richmond	50,185	50,185
Atlanta	35,555	33,555
Chicago	1,436,915	420,665
St. Louis	58,880	18,880
Minneapolis	8,485	8,485
Kansas City	48,985	48,985
Dallas	22,105	22,105
San Francisco	602,505	77,280
Treasury	918,675	918,675
TOTALS	$30,974,815	$10,049,050
Type		
Competitive	$27,039,845	$6,114,080
Noncompetitive	1,669,640	1,669,640
Subtotal, Public	$28,709,485	$7,783,720
Federal Reserve	2,141,155	2,141,155
Foreign Official Institutions	124,175	124,175
TOTALS	$30,974,815	$10,049,050

An additional $47,325 thousand of bills will be issued to foreign official institutions for new cash.

NB-1311

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 10, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,059 million of 26-week bills to be issued June 13, 1991 and to mature December 12, 1991 were accepted today (CUSIP: 912794XR0).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.76%	6.03%	97.088
High	5.78%	6.05%	97.078
Average	5.78%	6.05%	97.078

$5,000,000 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	25,805	25,805
New York	22,491,240	8,682,540
Philadelphia	18,720	18,720
Cleveland	28,805	28,805
Richmond	135,285	84,285
Atlanta	25,075	24,055
Chicago	1,399,460	294,260
St. Louis	38,550	23,450
Minneapolis	7,240	7,240
Kansas City	52,300	51,280
Dallas	15,640	15,640
San Francisco	608,395	205,345
Treasury	597,225	597,225
TOTALS	$25,443,740	$10,058,650
Type		
Competitive	$21,645,170	$6,260,080
Noncompetitive	1,131,445	1,131,445
Subtotal, Public	$22,776,615	$7,391,525
Federal Reserve	2,200,000	2,200,000
Foreign Official Institutions	467,125	467,125
TOTALS	$25,443,740	$10,058,650

An additional $189,975 thousand of bills will be issued to foreign official institutions for new cash.

NB-1312

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

FOR IMMEDIATE RELEASE
June 11, 1991

Contact: Barbara Clay
(202) 566-5252

Bank of America Forest Conservation Donation
Press Conference
June 11, 1991
Remarks by Secretary Brady

Thank you, Dick. I am happy to be here and to recognize the leadership of the Bank of America in making the largest donation of LDC debt to date in support of environmental objectives. The project embarked upon today by the Bank of America and its partners (the Smithsonian, World Wildlife Fund, and Conservation International) is a vital contribution to the protection of Latin American rainforests.

Furthermore, this donation is an important development in the history of debt-for-nature swaps. Through the work of a range of environmental organizations over the last five years, debt-for-nature swaps have made an important contribution to conservation and environmental protection efforts. In the past, these swaps have been undertaken primarily through the purchase of commercial bank debt by environmental organizations. Bank of America's donation of debt illustrates a new way to accomplish swaps.

This action is complementary to President Bush's Enterprise for the Americas Initiative (EAI). The EAI calls for interest payments on reduced PL-480 and AID debt to be made in local currency to fund grass roots environmental projects. We expect to enter into the first PL-480 debt reduction and environmental framework agreements this summer as countries become eligible. In addition, we are working to gain the authority and funding from Congress to reduce AID debt, which is the largest share of the debt owed to the United States by Latin American and Caribbean countries.

NB-1313

Providing resources for environmental projects is an important part of the Enterprise for the Americas Initiative, but there is much more. The initiative is a comprehensive effort to address the major economic problems facing Latin America and the Caribbean -- trade, investment, and debt. Through their courageous actions to open their economies, leaders in the region are creating new opportunities for economic growth. This in turn provides the foundation for the protection of their environment in a comprehensive way.

This important action by the Bank of America should encourage other banks to take steps to help protect the world's valuable natural resources. In addition, it is hoped that Congress will act to authorize and fund the Enterprise for the Americas Initiative, which would provide important additional support for the environment in Latin America.

Thank you.

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
June 11, 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 $20,000 million, to be issued June 20, 1991. This offering will result in a paydown for the Treasury of about $6,075 million, as the maturing bills total $26,063 million (including the 17-day cash management bills issued June 3, 1991, in the amount of $7,068 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, June 17, 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 $10,000 million, representing an additional amount of bills dated March 21, 1991, and to mature September 19, 1991 (CUSIP No. 912794 XG 4), currently outstanding in the amount of $8,474 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $10,000 million, representing an additional amount of bills dated December 20, 1990, and to mature December 19, 1991 (CUSIP No. 912794 WX 8), currently outstanding in the amount of $11,799 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 June 20, 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 $1,070 million as agents for foreign and international monetary authorities, and $4,240 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-1314

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

PREPARED FOR DELIVERY
EMBARGOED UNTIL 4:00 a.m. (EDT)
June 8, 1991

Contact: Barbara Clay
202-566-5252

THE HONORABLE JOHN ROBSON
DEPUTY SECRETARY OF THE TREASURY
1991 IEWSS INTERNATIONAL CONFERENCE
JUNE 8, 1991
BARDEJOV, CZECHOSLOVAKIA

Thank you. It is a great pleasure to join all of you for this important and timely conference -- and to share in the celebration of Bardejov's 750th anniversary. This anniversary not only reminds us of the long and rich history of your people, but it stands in sharp contrast to the brief time that the truly revolutionary political and economic reforms in this part of the world have been underway -- reforms that have captured the profound admiration of all those who love free politics and free markets.

Even in this brief time, the Czech and Slovak Federal Republic -- and much of Central and Eastern Europe -- have made substantial progress along the way to becoming durable democracies and free market economies. And we have learned some important lessons about the techniques, the problems, the effects, the expectations and the respective responsibilities of the reforming nations and the industrialized democracies in this difficult process of economic reform.

We have learned just how hard it is to make the transition from an economic system where almost everything is owned and decided by government, to a system where ownership and economic decisions are in the hands of private citizens in a competitive marketplace.

We have learned that the transition to free markets is not for the faint-hearted -- that the ropes of government command must be cleanly severed. Reforming countries cannot succeed by controlling from the center and trying to gently and painlessly phase in the forces of the marketplace over a lengthy period. Success is likely to come soonest to countries that convert to the free market quickly -- with no turning back.

We have learned the importance of firm political leadership and solid public support for the success of economic reform. And we have seen some splendid examples of such leadership by President Havel, Minister Klaus, and others in this Republic.

NB-1315

We have learned that becoming a free market is a complex, multi-faceted process where many actions must be synchronized -- currency convertability, price liberalization, tax reform, financial sector development, private property rights, removal of trade barriers, privatization of state enterprises, and the establishment of "safety nets" to help cope with unemployment -- to name a few. Also, national budgets must be controlled by reducing subsidies.

Perhaps the most fundamental lesson is that the design and implementation of economic reform is the responsibility of the reforming nations. While the industrialized democracies have a large stake in your success and can help you along the way, this is principally your challenge.

You do not undertake these difficult and frequently painful economic reforms for us, but because you understand they offer the only path to prosperity and a higher standard of living for your people. Economic reform has its own rewards, and they will come to you as they have to other countries -- through hard work, prudent saving and wise investment. Lip service only to economic reform will not suffice. In the end, you will be rewarded and measured by what you do, not by what you say.

These are some of the lessons that have become apparent during the short period of economic transformation. I believe they have helped to clarify our respective responsibilities and expectations.

And what are those responsibilities and expectations? What assistance can you expect from the industrialized democracies, and what can we expect from you in justifying and facilitating such assistance?

To begin, the industrialized nations have a responsibility to pursue economic policies that foster global growth without inflation. And reforming nations should have reasonable opportunities to trade with these developed markets. Such policies offer the greatest long-term prospect for widespread economic opportunity and the flows of needed capital.

In addition, East and Central European nations can expect, and in fact are receiving, substantial technical assistance from the West. Our expertise in building the legal and institutional foundations for a market economy may not yield immediate and visible benefits, but it can greatly accelerate the pace of reform and help you avoid some pitfalls. Certainly, this is where the U.S. has focused its assistance efforts -- to help with privatization, banking, capital markets, commercial law, management training and to spur entrepreneurial activity.

On their part, recipient nations must organize themselves to be efficient donees -- and be candid in indicating where assistance is failing. They must analyze and identify the specific ways in which assistance can be improved. Remember, we're new at this, too, and we don't want to waste our time and money any more than the reforming nations do.

As to large, long-term direct bilateral assistance from the industrialized community for structural reforms and balance of payments support, I have more modest expectations. While reforming countries are currently receiving substantial balance of payments assistance, budget considerations and competing demands at home will limit the capacity of industrialized nations for large resource commitments in the future.

In the near and mid-term, I believe that economically reforming countries will have to rely principally on the international financial institutions -- the IMF, the World Bank, and the new European Bank for Reconstruction and Development. We expect the IMF's resources will increase by 50 percent by the end of the year, and the EBRD will become a major source of financing for East Europe during the next year.

What about private investment? Often we hear complaints that private sector businesses are too slow and too stingy in making investments in East and Central European countries. But there is little we in government can do about it. We can and do encourage our private businesses to come here and examine the opportunities, and we convey our personal optimism about the future of your companies. But it is their money.

Experience tells us that the private sector will invest first in those countries that are the most open, the least burdened by government regulation and interference, and the most able to demonstrate that a free market is reliably in place. Those countries will be winners in the increasingly intense global competition for capital. And success in that competition depends on their own leadership and their own people.

So, we have come full circle -- back to the basic responsibility of individual nations. Many of you have made impressive progress in your reforms. And I can assure you that decisions by governments for assistance and the private sector for trade and investment will be predominantly influenced by how much progress you continue to make. As President Bush stated:

> "The surest way to long term economic growth and development is through the entrepreneur. And entrepreneurship is not a function of massive foreign aid transfers, but rather free and open societies."

We urge you to stay on the course of economic reform, recognizing that it will require courage, determination, political skill and some luck to succeed. As economic reforms take hold, the path to successful market economies may become temporarily more difficult. Be patient. Do no let unrealistic expectations about how quickly you can create a prosperous free market -- or about what other nations will do to assist you -- defeat your historic efforts.

Your situation is not so dissimilar to that facing the United States when our nation was born 200 years ago. Our new democratic government was fragile. We had exorbitant debts to foreign and domestic creditors, our monetary system was in disarray, and inflation was rampant. And things got worse before they got better. But strong leadership and faith among the American people carried us through.

I believe that your leadership and your people will do the same. Thank you.

###

TREASURY NEWS

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

PREPARED FOR DELIVERY
EMBARGOED UNTIL 7:00 a.m. (EDT)
June 10, 1991

Contact: Barbara Clay
202-566-5252

REMARKS BY
THE HONORABLE JOHN ROBSON
DEPUTY SECRETARY OF THE TREASURY
ON THE SIGNING OF A
MEMORANDUM OF UNDERSTANDING WITH THE
STATE BANK OF CZECHOSLOVAKIA
TO ESTABLISH AN INSTITUTE OF BANKING AND FINANCE
JUNE 10, 1991
PRAGUE, CZECHOSLOVAKIA

I am pleased to join my friends from the State Bank of Czechoslovakia in signing a Memorandum of Understanding to establish an Institute of Banking and Finance for this reforming nation. This joint initiative for education and training of future employees of banks and other financial institutions will be a crucial step to improve the banking system that is vital to Czechoslovakia's economic reform efforts and, indeed, to the very functioning of the country's economy.

In today's tough global marketplace, private business cannot exist without a modern, dependable and efficient banking system. Banks function as the allocators of credit for businesses -- large and small -- and as the fundamental facilitators of commerce through the payment system. Banks also create incentives for savings among individuals, families, entrepreneurs and large corporations. In turn, those savings provide the capital that fuels the economy and helps businesses take advantage of new opportunities for growth in competitive markets.

Yet, we have found that for many countries trying to shift from a planned economy to a free market, one of the most ignored links in the reform chain is the banking system. Under the old regimes in these countries, including Czechoslovakia, banks had become the instruments of central planning, serving the narrow interests of the government rather than the broad interests of the population. It is clear that these countries now need full-service banking systems that help consumers purchase washing machines and cars, that safeguard the savings of couples who want to buy a house, that help businesses export to the United States or raise capital to expand their capacity.

Today, the United States and Czechoslovakia are entering into a pledge to work together in establishing a better banking system for this nation. Since a banking system is only as effective as the people who operate it, our agreement focuses on developing the human resources necessary to integrate Czechoslovakia's banks and capital markets into the broader international economy.

Specifically, the United States Treasury Department intends to work with existing and to be formed commercial banks, and the State Bank of Czechoslovakia, to provide comprehensive training in banking and finance. We plan to help Czechoslovakia establish an Institute of Banking and Finance with a practical curriculum geared toward both entry-level technicians and mid-level managers. And, we also plan to initiate programs to train instructors from your country, enabling the Institute to become self-sustaining as soon as possible.

But while the United States is helping the Czech and Slovak people in the rebirth of your commercial banking industry, the real work will be done by the Institute itself. With critically needed help from the Czech and Slovak Bankers Association and the State Bank of Czechoslovakia, I hope we can work together to have the Institute up and running in the next few months.

I am confident the spirit of cooperation will continue to ensure the success of this agreement. The establishment of this Institute for Banking and Finance will be a strong move in the continued development of a sound banking system for Czechoslovakia. It will be a solid foundation for economic stability, sustained growth, and all of the fruits of free enterprise and market economics.

Thank you.

###

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.
Tuesday, June 11, 1991

TESTIMONY OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS
BEFORE THE HOUSE COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS

June 11, 1991

I am pleased to be here today to testify on the treatment of foreign banks under the Administration's financial modernization legislation, Section 231 of H.R. 1505, the Financial Institutions Safety and Consumer Choice Act of 1991 (FISCCA).

I would like to thank you, Mr. Chairman and Members of the Committee, for working with the Administration to complete a comprehensive reform package to strengthen the U.S. banking system this year. In proposing a long-term financial services framework for the coming decades, the Treasury Department has sought to be fair and consistent, offering the same opportunities to U.S. and foreign banks.

As of December 31, 1990, there were 727 foreign bank establishments operating in the United States. These entities represented 294 foreign bank families from 60 countries and held 21 percent of U.S. banking assets. As their substantial presence in the U.S. economy demonstrates, foreign banks have benefitted in competition with U.S. banks from the openness of our market and the privileges accorded to them in it. U.S. consumers and the U.S. economy have also benefitted from the financial services and increased competition in our market provided by foreign banks.

ADMINISTRATION PROPOSAL

The Administration's proposal would replace treatment for foreign banks, which in some cases is preferential, with national treatment, according foreign banks the same treatment as U.S. banks. FISCCA would liberalize the U.S. banking system by offering U.S. and foreign banking organizations the opportunity to branch across state borders and, if the bank is well-capitalized, to engage in new securities and insurance activities through a financial services holding company structure.

NB-1317

TREATMENT OF FOREIGN BANKS

The Administration's bill would allow foreign banks that are engaged only in commercial banking to maintain their existing branches and agencies. They would also be allowed to branch in most states and, after three years, in all states on a full national treatment basis.

The proposal would introduce important changes in the treatment of foreign banking organizations that are engaged in securities activities through affiliates in the United States. Prior to 1978, foreign banks could establish direct branches in more than one state and could own full-service investment banks in the United States. These activities were denied U.S. banks, which were prohibited from branching across state borders by the McFadden Act and from engaging in securities activities by the Glass-Steagall Act.

The International Banking Act of 1978 (IBA) adopted the general principle of national treatment for foreign banks by applying the McFadden Act and the general prohibitions of the Glass-Steagall Act to foreign banks in the United States. In fact, the IBA stopped short of full national treatment by grandfathering securities affiliates and interstate branches that existed in 1978. These grandfather provisions have permitted some foreign banks to retain their preferential treatment, thereby conferring a competitive advantage over domestic banks in the U.S. market.

Under FISCCA, foreign banks that wish to engage in new securities and insurance activities are required to adopt the U.S. organizational structure. This would entail establishing a financial services holding company and rolling up existing branch and agency operations into one or more well-capitalized U.S. bank subsidiaries of the holding company.

Both U.S. and foreign banking organizations with "Section 20" securities affiliates, which can derive up to 10 percent of their annual revenues from securities underwriting and dealing in bank ineligible securities, would need to choose between discontinuing those specific securities activities or restructuring for full securities powers. Foreign banks with IBA-grandfathered securities affiliates would face a similar decision. Twenty-four of the 294 foreign bank families represented in the United States at the end of 1990 have IBA-grandfathered or Section 20 securities affiliates.

Requiring foreign banks to form U.S. subsidiaries to take advantage of far greater liberalization and expanded activities is consistent with national treatment by eliminating the better-than-national-treatment preferences retained in 1978.

Concerns that have been raised about the proposal include the segmentation of capital and its impact on foreign bank lending in the United States, the lack of grandfathering and the impact on the deposit insurance system.

CAPITAL REQUIREMENTS AND FINANCIAL EFFECTS

Concerns have been raised that the structure proposed in Section 231 of FISCCA would cause foreign banks to segregate their capital. In fact, under Federal and State law foreign banks already maintain funds in the United States in the form of capital equivalency deposits and similar asset maintenance requirements at many of their U.S. branches.

Under the Administration's proposal, U.S. financial services holding companies must have well-capitalized banks to engage in these new activities. They must meet standards above minimum Basle risk-based capital requirements as well as leverage ratios. This is not in contravention of the standards of the Basle Committee on Banking Regulations and Supervisory Practices. In fact, the Basle Committee stated that the agreed capital adequacy framework was designed to "establish <u>minimum</u> levels of capital for internationally active banks. National authorities will be free to adopt arrangements that set higher levels." And if a bank's capital falls below specified levels, the holding company could be required to divest the securities or insurance operations. This would be true whether the holding company and bank were owned by U.S. interests or foreign interests.

Under present tax law, foreign banks restructuring branches into subsidiaries will lose their deductions of net operating losses accumulated while operating in branch form. This may have potentially significant effects. Assistant Secretary of the Treasury for Tax Policy Kenneth Gideon will be testifying on the tax implications of FISCCA for foreign banks next week before the House Committee on Ways and Means and will address this issue more fully.

A major objective of FISCCA is to improve the safety and soundness of the U.S. banking system by, among other things, creating incentives to increase the capital of U.S. banks. <u>We believe it is important to impose the same requirements on foreign and U.S. banks engaged in the same activities.</u> Some of the alternative approaches that have been discussed could possibly result in extraterritorial application of U.S. law or might be judged to imply that foreign banks deserve different safety and soundness standards than U.S. banks.

FOREIGN BANK LENDING

Foreign banks have indicated that their preferred form of operation in the United States is through branches of the parent. Branching gives a bank maximum flexibility in deploying its resources.

Most of the 294 foreign bank families in the United States are likely to choose to continue to concentrate on commercial banking. These banks will not need to convert branches to subsidiaries.

Foreign banking organizations that seek expanded activities will no longer be able to branch directly into the United States. These banks will need to establish a financial services holding company with a U.S. bank subsidiary and transfer capital to the United States. They would be lending from a smaller capital base than a branch since legal lending limits would be based on capital held in the U.S. subsidiary.

In drafting the proposed legislation, we considered the possibility that, as a result of the legislation's requirements, some foreign banks might reduce their lending in the United States. However, some of the potential constraints can be alleviated. For example, the subsidiary can transfer loans that exceed lending limits back to its parent. Additional capital can be transferred into the United States to support larger loans. Loans that exceed lending limits of the subsidiary also could be provided cross-border from the parent. Most potential tax problems arising directly from such cross-border loans could be resolved through bilateral tax treaties.

GRANDFATHER ISSUE

Foreign banks have argued that their present operations should be grandfathered under the proposed legislation. Their arguments were accepted in 1978, when the International Banking Act subjected foreign banks to the same restrictions on their operations as U.S. banks. In 1978, there were only two alternatives for the foreign securities affiliates -- to be grandfathered or divested. Now the Administration is offering a full range of expanded activities to well-capitalized foreign banks.

Foreign banks are a much more important segment of the U.S. banking market than they were in 1978. As of the end of 1990, foreign banks operated 370 branches, 224 agencies and 101 subsidiaries in the United States and controlled 21 percent of U.S. banking assets. Leaving nearly a quarter of the U.S. banking market outside the requirements of FISCCA would weaken the effectiveness of the proposal. Grandfathering foreign bank operations today could confer upon them new competitive advantages over U.S. banks that will be required to establish holding companies and meet higher capital standards.

DEPOSIT INSURANCE FUND

The majority of foreign banks in the U.S. now operate through branches not insured by the FDIC. Those foreign banks engaged exclusively in wholesale commercial banking which do not seek new powers could continue these operations and would continue to maintain a competitive advantage over U.S. banks by avoiding deposit insurance assessments. Domestic banks must participate in the deposit insurance system, regardless of whether they conduct retail deposit-taking activities or not.

Under the Administration's proposal, foreign banks expanding into new activities would be required to establish insured bank subsidiaries. But rather than weaken the deposit insurance fund, the contributions of foreign bank subsidiaries would strengthen the fund. By meeting the Zone 1 capital requirements, these bank subsidiaries would be among the strongest banks, and much less likely to draw on the fund.

TRENDS IN FOREIGN MARKETS

The Administration's proposal is consistent with recent trends in foreign markets:

- o In the last decade, Australia, Canada, Finland, New Zealand, Norway and Sweden liberalized commercial banking activities, to allow foreign banks to operate in their markets -- but only through a subsidiary structure. (In the Nordic countries, there are plans that would eventually allow foreign commercial banks to branch.)

- o Germany allows foreign banks to branch, but limits loans to one borrower to a percentage of the capital that the branch maintains in Germany rather than the bank's worldwide capital. In effect, U.S. bank branches in Germany must bring capital into the country to support their operations and they cannot lend locally based on their parent's capital.

- o The European Community's Second Banking Directive requires foreign banks to establish a subsidiary to take advantage of the single European passport. The single passport will allow a bank subsidiary established in the EC to establish branches throughout the Community. Direct branches of non-EC banks will still be allowed, although they will be subject to the laws of each individual country and will not necessarily be entitled to engage in the same securities activities that the EC passport will allow.

We seek national treatment and liberalization in foreign markets. In our market, we will be offering national treatment, liberalization and expanded activities. Under these circumstances, we do not believe it is appropriate to provide foreign banks with preferential treatment through grandfathering. We believe foreign governments will come to recognize that the long-term benefits of our liberalization will outweigh the costs.

FEDERAL RESERVE BOARD'S FOREIGN BANK SUPERVISION ENHANCEMENT ACT

I would like for a moment to turn to H.R. 2432, the Federal Reserve Board's proposed "Foreign Bank Supervision Enhancement Act of 1991." The Treasury supports several important portions of the Federal Reserve's bill and shares the objective of establishing enhanced federal supervision of diverse foreign banking operations in the United States. We would also point out that in several respects, the Board's bill is inconsistent with portions of FISCCA.

I must stress that the Treasury does not consider the Board's proposal a substitute for FISCCA. The bill is a specific proposal that must be considered in its own right in relation to the broader need for enhanced supervision of foreign banks in the United States and in light of recent cases of foreign bank violations of U.S. law. The Administration's proposal includes a major revision of foreign bank regulation in the United States, while the Board's bill makes improvements in the present structure. Any changes to foreign bank supervision should be consistent with the overall approach of the Administration's proposal for regulatory restructuring.

First, the Treasury Department supports federal licensing and supervision of representative offices of foreign banks. Under present law Treasury registers but cannot supervise foreign bank representative offices in the United States. We believe these offices should be supervised by a federal banking regulator.

Second, the Treasury supports, and has itself proposed in Section 265 of FISCCA, Board approval of state-supervised foreign bank offices in the United States. This process in many cases will allow greater Federal-level scrutiny of state branches, agencies, and commercial lending companies before they are established in the United States without undue harm to the dual banking system. The approval provision in the Board's bill is consistent with the division of regulatory responsibility in the Administration's proposal.

Third, we support the provisions that enhance federal jurisdiction and supervision over foreign banks through additional criteria for approval, regulation, and termination of foreign bank offices in the United States. In addition, we support the bill's objectives of encouraging the sharing of information between U.S. and foreign bank supervisors and assuring greater attention of foreign bank supervisors to their banks' operations in the United States. One suggestion we would make to improve the Board's bill would be to enhance the authority of the Comptroller of the Currency to close federal branches and agencies by legislating criteria consistent with the criteria proposed by the Board for itself in connection with closing state branches and agencies.

Despite our general support, the Treasury Department does have some specific concerns with the Federal Reserve's proposal, resulting chiefly from the differences in regulatory approach between the two bills. Treasury has proposed a functional and streamlined regulatory regime in FISCCA that provides for effective regulation of foreign and domestic banks and their affiliates.

The Board's proposal would eliminate the requirement under Federal law that the Board use the examinations conducted by other Federal bank regulators. This provision differs from the regulatory scheme in FISCCA and present law, both of which provide for efficient use of Federal examination resources and protect against conflicting regulation at the Federal level.

The Board's legislation proposes new authority for the Board to supervise and examine any affiliate or office of a foreign bank in the United States, including Federal branches and agencies.

This proposal would circumvent the "functional" regulation proposed in FISCCA that would require the Board to consult with regulators of securities and insurance affiliates before examining these affiliates.

Clearly the Board's proposal for foreign banks would have to be modified in these respects if the Treasury approach to functional regulation were adopted.

CONCLUSION

Let me reiterate that we are offering foreign banks national treatment, including expanded market opportunities on the same terms as U.S. banks. We are seeking to be fair and consistent and we welcome the participation of foreign banks in our market. We hope that those foreign banks which find it in their strategic interest will participate in the liberalization offered by FISCCA.

TREASURY NEWS

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

<u>FOR RELEASE ON DELIVERY</u>
Expected at 9:30 A.M.
June 11, 1991

STATEMENT OF THE HONORABLE
JEROME H. POWELL
ASSISTANT SECRETARY OF THE TREASURY
(DOMESTIC FINANCE)
BEFORE THE
SUBCOMMITTEE ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT
OF THE HOUSE AGRICULTURE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here today to discuss the results of the Treasury's second study of Government-sponsored enterprises and the Administration's legislation that will provide for more effective financial oversight of these important institutions.

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 has been submitted.

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.

NB-1318

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.

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.

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 policy 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 deficiencies in the existing regulatory structure for some GSEs. However, the Farm Credit Administration has as its primary goal the safety and soundness regulation of the Farm Credit System, and it has the regulatory powers and stature to be an effective safety and soundness regulator for the Farm Credit System.

Both the analysis that we did for our 1990 study and the analysis that S&P did for our study this year indicate that the Farm Credit System has made significant progress since the Agricultural Credit Act of 1987 was passed. However, the fact remains that S&P's rating for the System, "BB", is below investment grade, and is the lowest rating received by a GSE. Indeed, since last year's study, and at a time when the agricultural economy has enjoyed a sustained rebound, another Farm Credit Bank (Spokane) required assistance in 1990. We believe that there are a number of changes that can and should be made to ensure a more financially sound Farm Credit System.

Funding Corporation Authority Should Be Clarified

A major concern of ours involves the extent to which the System banks lack consistent standards for managing the substantial risks with which they are confronted. In the 1990 study, we supported the Funding Corporation's efforts to address these problems with its Market Access and Risk Alert Program, and we recommended that the Funding Corporation continue to develop the program.

In order to facilitate these efforts, the Administration's bill would clarify the Funding Corporation's current authority, which includes the requirement to determine "the conditions of participation by the several banks in each issue of joint, consolidated or System-wide obligations." Our bill would simply clarify that this authority specifically includes the ability to obtain information from System banks and associations to monitor their financial performance, to establish financial condition and performance standards, and to institute economic incentives designed to encourage compliance with these standards.

System Consolidation

Our 1990 study and the President's Budget for Fiscal Year 1992 recommended the consolidation of System institutions. This would have a number of benefits, including increased geographical diversification as well as the reduction of overhead expenses. While there have been discussions among numerous System banks along these lines during the last year, no definitive steps have been taken. The Administration's bill would require the Farm Credit Banks (and the Jackson FICB) to consolidate in order to ensure geographic and crop-based diversity and to reduce overhead; if the banks were unable to submit a merger plan to the FCA within two years, the FCA would be required to prescribe a merger plan.

Changes for the Insurance Corporation

The Administration's bill also includes a number of reforms to the Farm Credit System Insurance Corporation which we believe will enhance the Insurance Corporation's ability to perform its important duties when it becomes fully operational in 1993.

First, our bill would create a separate board of directors for the Insurance Corporation, consisting of three Presidential appointees, one of whom will be the Chairman. This separate board would also include an FCA board member (other than the Chairman) and the Secretary of Agriculture as non-voting members. This proposal is consistent with the lesson learned from the debacle in the thrift industry: if financial institutions are to be insured, that insurer must be concerned <u>only</u> with safety and soundness and the integrity of the fund. A separate board for the Insurance Corporation translates into more protection for the taxpayer.

Second, our bill would give the Insurance Corporation the authority to access the capital of a System bank's associations if that bank is assisted by the Insurance Corporation. Because the associations which own a bank would directly benefit from any assistance to that bank, they should be required to support the bank. From a safety and soundness perspective, this would create the incentive for associations to impose more financial discipline on the other associations in their district, as well as on their bank.

Finally, our bill would require the Insurance Corporation to develop a system of risk-based premiums for System institutions. The current, statutory premium formula charges higher premiums for non-accruing loans, but it does not give the Insurance Corporation the authority to set premiums based upon the entire risk profile of a System institution. As a result, there may not be adequate disincentives to cause risky, poorly run institutions to change their ways. This proposal is consistent with the recommendations contained in the Administration's banking bill.

More Outside Directors on Boards of System Institutions

The analysis in both this year's and last year's studies discussed the potential conflicts inherent in a cooperatively owned structure with borrowers as equity holders and board members. Our bill would address this concern by increasing the number of outside directors on the boards of System institutions to one-third of all directors.

Repayment of FAC Debt

The Agricultural Credit Act of 1987 contained several unclear passages regarding the repayment of the assistance given to System banks. This uncertainty is a source of concern both to the Administration, and to System institutions, which have been making considerable efforts to implement a mechanism for setting aside funds for repayment. The Administration's bill contains several technical changes which we believe would facilitate this process.

The FCA Needs Additional Authority Over Farmer Mac

Finally, while we believe that the FCA generally has the regulatory authorities necessary for it to be an effective safety and soundness regulator of the System, it does not have a full complement of regulatory authorities over Farmer Mac. Our bill would give the FCA these additional authorities, which include general rulemaking authority.

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. We believe that the passage of the Administration's proposed 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 RELEASE UPON DELIVERY
EXPECTED AT 9:30 A.M.
JUNE 12, 1991

STATEMENT OF
KENNETH W. GIDEON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to be here today to present the views of the Administration on a number of revenue measures. We are generally concerned about the revenue costs of these proposals in view of the pay-as-you-go system adopted as part of the Omnibus Budget Reconciliation Act of 1990 (the "1990 OBRA").

1. Repeal the Luxury Tax on Boats

Current Law

The Omnibus Budget Reconciliation Act of 1990 added various luxury taxes to the Internal Revenue Code ("Code"). Under new section 4002, if the actual retail sales price of a new boat exceeds $100,000, a 10 percent tax is imposed on the excess. The tax is also imposed on parts and accessories that are installed on a new boat within 6 months of the purchase and on the use of a boat before there has been a retail sale. The tax does not apply to boats sold for export, but does apply to new and used boats that are imported into the United States. The tax applies to sales between January 1, 1991 and December 31, 1999.

Proposal

The proposal would repeal the luxury tax on boats.

Administration Position

We do not support repeal of the luxury boat excise tax at this time. The tax has been in effect for less than 6 months, a period which coincided with the economic downturn. It is simply too early to assess what its actual impact will be in terms of effect on the industry, revenues realized, or difficulty of administration. On the last point, I might note that excises generally have been among the simplest taxes for the Internal Revenue Service to administer. Proposed regulations issued at the end of last year should be made final in the relatively near future.

2. Amend the Tax Treatment of Payments Under Life Insurance Contracts for Terminally Ill Patients

Current Law

Undistributed investment income ("inside buildup") credited under a contract that is a life insurance contract for tax purposes is not taxed currently to the contractholder. Section 101(a) of the Code provides further that proceeds of life insurance contracts that are payable by reason of the death of the insured are excluded from gross income. As a result, inside buildup amounts that are paid out as death benefits escape tax completely. If an insurance contract is not a modified endowment contract ("MEC"), amounts not exceeding the cash value of the policy may be borrowed tax free, and any pre-death distribution of the contract's cash value is tax free to the extent of the policyholder's basis in the contract. If a policy is a MEC, loans or pre-death distributions are treated as coming first out of income and only thereafter as recovery of basis. Consideration received from the sale or assignment of a life insurance contract is includable in gross income.

Under section 7702, a policy that is a life insurance contract under the applicable state or foreign law qualifies for the tax benefits available to life insurance if it satisfies one of two alternative tests: (1) the cash value accumulation test or (2) the guideline premium/cash value corridor test. The cash value accumulation test is satisfied if the contract's cash surrender value does not at any time exceed the net single premium that would be required at that time to fund future benefits under the contract. The guideline premium/cash value corridor test is satisfied if the premiums paid under the contract do not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums, and the death benefit under the contract is not less than a prescribed statutory percentage (which decreases with the increasing age of the insured) of the cash surrender value of the contract.

The net single premium used in applying the cash value accumulation test and the guideline single premium or guideline level premiums used in applying the guideline premium/cash value corridor test are the amounts necessary to fund future benefits under the contract. Future benefits include the death or endowment benefit under the contract as well as the charges stated in the contract for providing certain "qualified additional benefits". Currently such benefits are limited to (1) guaranteed insurability, (2) accidental death or disability benefit, (3) family term coverage, and (4) disability waiver benefits. The treatment of a benefit as a qualified additional benefit therefore increases the section 7702 limitation to the extent of the discounted value of the stated charge for the benefit.

Section 7702 applies to contracts issued after December 31, 1984. For this purpose, contracts that are issued in exchange for existing contracts after December 31, 1984 are treated as new contracts issued after that date. Section 7702A, which provides a test for determining when a life insurance contract is a MEC, has a similar grandfather rule.

Proposal

The proposed legislation would amend section 101 to provide that amounts paid under the life insurance contract of a terminally ill insured would be treated as an amount paid by reason of the death of the insured and therefore excludable from gross income. A terminally ill insured is defined as an individual who has been certified by a licensed physician as having an illness or physical condition that can reasonably be expected to result in death in 12 months or less.

The proposed legislation would provide further that a "terminal illness rider," which permits the payment of benefits to an insured upon his becoming terminally ill, would be treated as a qualified additional benefit for purposes of applying the tests of section 7702 and that the addition of such a rider to an existing life insurance contract would not constitute an exchange of contracts for purposes of applying the effective date rules under sections 7702 and 7702A.

The bill also provides that applicants for or recipients of certain public assistance benefits may not be required to exercise any right to receive an accelerated death benefit as a condition of eligibility for such public assistance benefits.

Administration Position

We oppose the expansion of section 101 as proposed. Section 101 currently provides for the exclusion from income of amounts paid under a life insurance contract by reason of the death of the insured. We believe the fundamental family security rationale for the tax-favored treatment of the inside build-up in life insurance would be undermined if broadened in the manner proposed.

As we understand the proposal, there is no restriction on the use to which tax-free proceeds could be put. While the circumstances under which the withdrawal could be made compel our sympathy, we should recognize that any such expansion of section 101 will bring forward proponents of further expansions for similar needs -- such as long-term care -- or other worthy goals, such as education or housing. Such expansions and the potential adverse revenue consequences they entail would undoubtedly place section 101 under severe pressure. It is a journey we should not begin.

The goal of endeavoring to assist the terminally ill is a sympathetic one. Under the bill, however, assistance would not be equally available to all terminally ill persons. Only those terminally ill persons holding life insurance contracts at the time of their illness could avail themselves of the benefits, and the benefits would be greatest for those able to afford large life insurance policies.

Finally, the trigger proposed for early payment -- a physician's certification that the individual has less than one year to live -- raises serious problems of administration. "Audit" of such a certification would be difficult, to say the least. Yet if the standard is effectively unauditable, compliance concerns are certain to arise.

3. <u>Increase the Amount of Bonds Eligible for Certain Small Governmental Issuer Exceptions and Modify Other Tax Rules With Respect to Bonds Issued by State And Local Governments</u>

<u>Current Law</u>

The Internal Revenue Code contains restrictions on the issuance of tax-exempt bonds by State and local governments designed to prevent inappropriate arbitrage profits by issuers of such bonds and to prevent the benefits of tax exemption from inuring to other than intended beneficiaries as described in the Code. A requirement to rebate arbitrage was imposed on virtually all tax-exempt bonds by the Tax Reform Act of 1986. Among these restrictions are the following:

(i) Small governmental issuers with general taxing powers are exempt from the arbitrage rebate requirement only if they issue less than $5 million of governmental bonds during a calendar year. This is commonly referred to as the "small issuer exception" to arbitrage rebate.

(ii) A 2-year spend-down exception to the requirement to rebate arbitrage was enacted as part of the 1989 OBRA. This exception generally provides that bond issues used to finance construction projects are not subject to the rebate requirement if the proceeds are expended within 2 years of the date of issue of the bonds at rates specified in the statute (at least 10 percent within 6 months, 45 percent within 12 months, 75 percent within 18 months). The 2-year spend-down exception to arbitrage rebate is generally effective for bonds issued after December 19, 1989.

(iii) Section 265(b)(3) currently permits an issuer that reasonably anticipates issuing $10 million or less of governmental and qualified 501(c)(3) bonds during a calendar year to elect to exclude such issues (sometimes referred to as "bank qualified bonds") from the interest disallowance provisions of section 265(b)(3). Section 265(b)(3) provides generally that banks may not deduct interest expenses attributed to tax-exempt bonds under a formula provided in the statute.

(iv) Section 141(b)(3) of the Code currently prohibits more than 5 percent of proceeds of a governmental bond issue from being used for a private business use that is unrelated to the governmental use of the facility or that is disproportionate to the governmental use of the facility. This provision effectively reduces the 10 percent private business use threshold to 5 percent when the private business use is not related to the governmental use of the facility or the private use is disproportionate in multi-facility projects.

(v) Failure to restrict the yield on the investment of bond proceeds to the bond yield as required by section 148 may not be remedied by rebating the arbitrage to the Federal Government.

(vi) Under section 149 of the Code an issuer must generally rebate 100 percent of the arbitrage it earns to the Federal Government.

(vii) Certain advance refunding bonds the proceeds of which are invested in substantially higher yielding investments currently are not described as a device in income tax regulations under section 149(d).

Proposals

The proposal would remove or liberalize certain existing restrictions on tax-exempt bonds. The bill contains 7 specific proposals which may be summarized as follows:

(i) The $5 million small issuer exception from rebate in section 148(f)(4) would be increased to $25 million. The requirement in section 148(f)(4) that governmental units must have general taxing powers to be eligible for the exception would be eliminated. This would permit governmental units such as special service districts, authorities and similar entities with limited or no taxing powers to be eligible for the exception.

However, subordinate entities would still be required to be aggregated for purposes of the exception.

(ii) The 2-year spend-down exception to rebate in section 148(f)(4)(iv) would be made retroactive to the effective date of the Tax Reform Act of 1986 (generally August 15, 1986). The 2-year spend-down exception was substantially amended in the 1990 OBRA. The provision would not permit refunds of rebate paid prior to the date of enactment of the bill.

(iii) The small issuer exception (or "bank qualified bond" exception) from the interest expense disallowance provision of section 265(b)(3) relating to financial institutions would be increased from $10 million to $25 million.

(iv) The 5 percent test for private business use not related or disproportionate to government use financed by the issue in section 141(b)(3) would be repealed.

(v) Section 148 would be amended to permit the payment of rebate in lieu of restricting yield on investment of bond proceeds. Currently section 148 requires yield restriction as well as rebate, and a failure to yield restrict when required cannot be cured by rebating the improperly earned arbitrage. This provision would not apply to advance refundings. Treasury would be given authority to require yield restriction in circumstances in which the yield restriction requirement applies for purposes other than preventing the earning of arbitrage.

(vi) Section 148 would be amended to reduce the amount of rebate from 100 percent to 90 percent of arbitrage earned.

(vii) Define certain advance refunding bonds the proceeds of which are invested in substantially higher yielding investments as a device under section 149(d).

Administration Position

(i) We oppose increasing the $5 million small issuer exception from rebate to $25 million. The proposal would be expensive and would defeat in part the policy of discouraging arbitrage motivated transactions. We recognize that an argument can be made for increasing the small issuer exception to $10 million to conform it to the $10 million small issuer "bank qualified bond" exception under section 265(b)(3). However, absent an acceptable offset, we do not support even such a limited expansion.

(ii) We oppose the proposal to make the 2-year spend-down exception to rebate retroactive. Our opposition is based both on our general policy of opposing retroactive tax legislation and the fact that the proposal would provide a windfall to many issuers. Bonds issued after 1986 and before the effective date of the 2-year rule were structured and sized to take into account the rebate requirement.

(iii) We oppose the proposal to increase the $10 million bank qualified bond exception to $25 million. There is no justification for granting financial institutions additional relief under section 265.

(iv) We do not oppose the proposal to repeal the 5 percent private business use test provided there is an acceptable revenue offset. This part of section 141 is often misunderstood by issuers and not easily administrable by the Internal Revenue Service. Repeal would accomplish significant simplification without sacrificing significant policy objectives.

(v) We are in general agreement with the notion that it should not be necessary to apply both yield restriction and the arbitrage rebate requirement to the same bond issue. There may, however, be circumstances in which arbitrage rebate alone may not be sufficient to prevent issuances with a significant purpose of earning arbitrage. Accordingly, were the proposal revised to include residual, prospective Treasury regulatory authority to impose yield restriction (without a rebate alternative) where necessary to prevent abuse, we would support the change. We believe that the provision if so revised would not lose revenue.

(vi) We believe this proposal merits serious consideration. However, we have not completed our own analysis to determine what the optimal percentage division might be and whether the proposal involves significant revenue consequences. Currently, there is no economic motivation for an issuer to maximize or even achieve efficient investment yields on bond proceeds subject to the rebate requirement. This is so because once the investment yield equals the bond yield, the issuer has no motivation to earn a higher yield because earnings attributable to the yield in excess of the bond yield must be paid to the Federal Government in the form of rebate. While the income tax regulations require that bond proceeds be invested at arm's length, in practice this requirement is extremely difficult if not impossible to enforce.

A relaxation of the arbitrage rebate requirement of the sort contemplated by the rule raises significant policy issues as well since it would in effect permit -- and even encourage -- issuers to achieve some, though quite limited, arbitrage. We therefore recommend that this issue be formally studied to determine: (i) whether such "permitted arbitrage" would undermine the objectives of the arbitrage rebate provision, and (ii) what division of arbitrage profits would provide an incentive for issuers to maximize investment yield without encouraging them to issue bonds for the purpose of realizing an arbitrage profit.

(vii) We support the proposal to define certain advance refunding bonds as a device under section 149(d). Investment of "released revenues" in forward purchase contracts at an unrestricted yield in the manner proscribed by this provision results in the earning of arbitrage.

4. <u>Modify the Tax-Exempt Bond and Depreciation Rules With Respect to Infrastructure Facilities</u>

<u>Current Law</u>

Infrastructure facilities, such as sewage, solid waste disposal, hazardous waste disposal, and facilities for the furnishing of water may be financed as exempt facility private activity bonds. As private activity bonds, these obligations are subject to restrictions which include aggregate dollar limitations of issues by state volume caps, treatment of interest thereon as a preference item for purposes of the alternative minimum tax, and the limitations contained in section 147 including -- limitations on substantial users, 120 percent of economic life requirement, limitations on land and existing property acquisitions, limitations on skyboxes, airplanes and gambling establishments, public approval requirements and the 2 percent cap on costs of issuance. In addition, private activity bonds are not eligible for the 2-year spend-down exception from arbitrage rebate, generally cannot be advance refunded, and are subject to "change in use" restrictions under section 150(b) of the Code.

<u>Proposal</u>

The bill would accord bonds issued to finance "infrastructure facilities" the same treatment that non-private activity governmental bonds currently receive under the Code. Accordingly, infrastructure bonds would generally not be subject to the volume cap and other restrictions described above. (Governmentally owned solid waste disposal facilities are exempt from the volume cap under present law.) Accordingly such infrastructure bonds would also be eligible to be advance refunded.

(i) Infrastructure bonds would be defined as bonds issued to provide infrastructure facilities "which are available for the ultimate use of the general public (including electric utility, industrial, agricultural, commercial, nonprofit, or governmental users)". Infrastructure facilities would include: sewage facilities, solid waste disposal facilities, hazardous waste disposal facilities, facilities for the furnishing of water and facilities which are constructed, reconstructed, rehabilitated, or acquired for the purpose of achieving compliance by a state or local government with Federal statutes administered by the EPA.

Sewage, solid waste disposal, hazardous waste disposal, and water furnishing facilities are currently permitted to be financed as exempt facility private activity bonds under section 142. These categories of exempt facility bonds are repealed under the bill. The bill would liberalize the definition of hazardous waste disposal facilities by deleting the limitation that disposal be only by incineration or entombment and by requiring that the facility be "ultimately" used by persons other than the owner, operator or related persons.

(ii) The bill would also liberalize the 2-year exception to the arbitrage rebate requirement by providing a 3-year spend-down exception to the rebate requirement in addition to the 2-year exception. The 3-year exception would apply to any bonds other than private activity bonds and tax and revenue anticipation bonds and; unlike the 2-year exception, would not be limited to construction issues. The 3-year exception would require expenditure of bond proceeds as follows: 20 percent in the first year, 50 percent in the second year, and 95 percent in the third year. "Soft costs" such as costs of issuance would be included in the spend-down requirement if not made more than 1 year after the date of issue of the bonds.

(iii) The bill would also amend section 168(e) (relating to depreciation) and would classify infrastructure facilities as 7-year ACRS property with a 10-year ADR midpoint to the extent such facilities do not already have a shorter recovery period. Also, infrastructure facilities financed with tax-exempt bonds would not be treated as "tax-exempt" use property for purposes of section 168(h).

<u>Administration Position</u>

(i) We oppose treating infrastructure bonds as governmental bonds. This provision would result in a significant increase in the amount of tax-exempt bonds issued.

(ii) We oppose the proposed 3-year exception to arbitrage rebate. The proposal was considered and rejected when Congress reached an agreement with respect to the 2-year spend-down exception to arbitrage rebate.

(iii) We oppose treating infrastructure facilities as 7-year ACRS property which is exempt from treatment as tax-exempt use property. There is no justification for allowing accelerated depreciation on such facilities in addition to the implicit Federal subsidy arising from tax exemption on the indebtedness.

All three items would result in significant revenue loss.

5. <u>Treat Bonds Issued for Section 501(c)(3) Organizations in a Manner Similar to Governmental Bonds</u>

<u>Current Law</u>

If proceeds of a bond are used in the trade or business of a 501(c)(3) organization, the bond is treated as a private activity bond. Under section 145, qualified 501(c)(3) bonds may be issued as tax-exempt private activity bonds subject to a number of limitations. The most significant limitations with respect to qualified 501(c)(3) bonds are: (1) the amount of qualified 501(c)(3) bonds outstanding for non-hospital uses cannot exceed $150 million per 501(c)(3) organization, (2) if proceeds of qualified 501(c)(3) bonds are used to provide certain residential rental housing for family units, the housing units must meet the low- and middle-income targeting requirements of section 142(d), (3) under section 147, the maturity of the bonds cannot exceed 120 percent of the economic life of the property, (4) no portion of the bond proceeds may be used for skyboxes, airplanes or gambling establishments, (5) the bonds must be approved by the public, (6) costs of issuance financed with bond proceeds may not exceed 2 percent of the amount of the bonds, and (7) "change in use" restrictions with respect to facilities required to be owned by a governmental unit or a 501(c)(3) organization under section 150(b).

<u>Proposal</u>

The proposed legislation would generally treat bonds the proceeds of which are loaned to or used by 501(c)(3) organizations for their exempt 501(c)(3) purposes in the same manner as governmental bonds, effectively repealing the limitation on such bonds added in the Tax Reform Act of 1986. The provision does not apply to bonds the proceeds of which are used by 501(c)(3) organizations in unrelated trades or businesses. All of the restrictions under section 147 of the Code currently applicable to qualified 501(c)(3) bonds would no longer apply to such bonds other than the restriction under section 147(b) that the bonds not have an average maturity in excess of 120 percent of the average economic life of the bond-financed property and the requirement under section 147(f) that the bonds be approved by the issuing governmental unit after a public hearing or referendum. Also, the restrictions under section 150(b)(5) of the Code with respect to "change in use" of facilities required to be owned by governmental units or 501(c)(3) organizations would be retained. Additionally, bond proceeds used by a 501(c)(3) organization to provide certain residential rental housing for family units would remain private activity bonds and would be subject to the low- and middle-income targeting requirements of section 142(d).

Administration Position

We oppose this proposal. It would significantly expand a large class of tax-exempt obligations and would result in significant revenue loss to the Federal Government.

* * *

Mr. Chairman, I would be pleased to answer any questions which you and other Members of the Committee may have.

TREASURY NEWS

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

For release on delivery
expected at 10:00 am
June 13, 1991

STATEMENT OF
WILLIAM E. BARREDA
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
FOR TRADE AND INVESTMENT POLICY
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
JUNE 13, 1991

Mr. Chairman and Members of the Subcommittee:

I am pleased to discuss with you today the Administration's policies and recent developments concerning international negotiations to increase discipline over tied aid credits. Directions for these negotiations were developed by the Administration in light of Eximbank's 1989 report to Congress on the tied aid practices of other countries, a similar Commerce Department report to Congress last year, and concerns in the business community, Congress and the Administration itself.

As Assistant Secretary Dallara indicated to this Subcommittee in September, 1989, we began efforts to launch further negotiations in late 1989. A considerable portion of last year was devoted to gaining international agreement on the negotiating mandate and securing needed support at the political level for meaningful negotiations. Most notable was the support for renewed negotiations that evolved from the Organization for Economic Cooperation and Development (OECD) Ministerial and the Houston Summit last year.

The groundwork for negotiations had been fairly well laid for concentrated negotiations by mid 1990. Five separate negotiating sessions have been held since. We came very close to agreement prior to last week's OECD Ministerial, but final agreement escaped us at that moment.

I would now like to expand somewhat on the nature of the tied aid problem, the course of the negotiations, the current package of proposals, and on the prospects for a successful conclusion. I will also touch on Eximbank's role in the President's Enterprise for the Americas Initiative.

Tied Aid Credit Problem

Tied aid is defined as concessional financing linked to procurement of goods and services in the donor country. Its stated purpose is to assist developing economies through softer financing terms while promoting or maintaining an adequate constituency in support of aid budget allocations in donor legislatures. Difficult problems arise when commercial motivation overrides development assistance objectives, particularly when donors' aid programs differ substantially with respect to their support for capital projects.

The trade issue created by tied aid is primarily related to its use for capital projects. Tied aid financing for capital projects can be used for commercial reasons, to promote exports from the donor, rather than to promote development of the recipient. But aid financing of capital projects can have a legitimate place in promoting economic development, and tying aid can make it easier for donors to get aid appropriations from legislatures.

The negative impact of commercially motivated tied aid programs on U.S. exporters is obvious. The U.S. aid program is heavily targeted toward promoting U.S. foreign policy goals, particularly the pursuit of Middle East peace, and is heavily weighted toward Israel and Egypt. A large part of the remainder of U.S. aid is utilized for financing basic human needs and economic policy reform rather than infrastructure and capital projects. U.S. exporters, utilizing commercial or Eximbank financing, often cannot compete effectively with foreign firms that offer financing that includes a significant concessional financing component. Eximbank estimated in 1989 that U.S. capital goods exporters lost annual sales of between $400-800 million as the result of the tied aid practices of others.

It should be acknowledged that U.S. procurement policies also seek to ensure that many foreign assistance funds are spent on U.S. goods and services. AID estimates that in 1989 about 35 percent of all U.S. bilateral loans and grants resulted in direct procurement from the United States.

<u>International Negotiations</u>

The Administration initiated the new round of negotiations in 1989 because of concerns that the phased increase in minimum tied aid credit concessionality levels negotiated in 1987 had, to that point, not reduced the trade distortions resulting from tied aid credits as quickly as hoped. While some improvement may yet emerge, a high percentage of aid continues to go to middle income countries, and a high percentage of aid remains relatively "hard" or less concessional.

The objectives of the negotiations launched in the OECD toward the end of 1989 are to further discipline tied aid credits and to reduce remaining subsidies in the extension of standard export credits. We viewed a vigorous new negotiating effort as the most promising response to the trade distorting tied aid practices of other countries. We sought to reduce substantially -- not eliminate, which we consider impractical -- the trade distortions arising from the use of tied aid credits. The Administration also undertook a parallel effort in the Development Assistance Committee (DAC) to reduce the aid distortions that also arise when tied aid is used to promote commercial interests.

The continued popularity of tied aid credits despite the increases in the minimum concessionality level agreed in 1987 to reduce their use signals to us that there is little chance that these practices will be eliminated completely. Indeed, the Administration does not wish to prohibit the use of tied aid for projects that meet the legitimate development needs of recipient countries without creating distortions.

In support of these negotiations, the Administration sought, and Congress approved, renewal of the War Chest program with revised aims. Following the 1987 tied aid agreement, it had seemed appropriate to use the War Chest only defensively to police the agreement. With the restart of negotiations, the War Chest was used by Eximbank in cooperation with AID to aggressively initiate tied aid offers in LDC markets where our competitors were using tied aid credits extensively for commercially motivated transactions. This has, we believe, increased U.S. leverage in the negotiations process.

We successfully sought a negotiating mandate from Ministers at the 1990 OECD Ministerial and then were able to get a further endorsement for negotiations from the Houston Summit. At the Summit, other G-7 government leaders and the President of the Commission of the European Communities joined President Bush in expressing strong support for further progress in increasing multilateral discipline over the use of tied aid credits, and urged that the OECD begin work as soon as possible.

Over the course of the negotiations, numerous approaches have been suggested. We initially focused on key sectors and markets where tied aid is used extensively, in the belief that this would provide the maximum relief for our exporters with the least pain for others. Others suggested greater reliance on international competitive bidding, global untying, and improvements in the prior notification and consultation process for tied aid offers.

This year, working with the DAC on a methodology that would reduce both trade and aid distortions of commercially motivated tied aid practices, negotiations turned to the concept of disciplining tied aid for projects that should normally be commercially viable in a market economy and for which financing on market or Arrangement terms is available. This concept was widely accepted, at least at the intellectual level, and ultimately became the focus of the negotiations.

Limiting tied aid for projects that are commercially viable in a market economy is an attempt to replicate the efficient financing patterns of market economies. Projects that are productive enough to service debt on market terms should be allocated capital on market terms, thereby saving scarce concessional assistance for projects that cannot attract and support such financing. With strict adherence, this strategy should maximize total flows of capital available for development and allocate it more efficiently.

The Current Package of Proposals

The intensive negotiations over the past year produced what we believe to be a balanced package of disciplines. It would establish the principle that tied aid credits with a concessionality level of less than 80% should not be given for projects that should be commercially viable in a market economy and for which financing on commercial or OECD Export Credit Arrangement terms is available.

The goal of this discipline is to delineate projects that should normally be financed with export credits and those that legitimately require aid financing, whether tied or not. The commercially viable rule is a good starting point, but it will be in the consultations process that, over time, a body of "case law" will develop that will better define, for both export credit and aid agencies' ex ante guidance, the line between the two categories of projects.

The EC made it clear from the outset of these negotiations that, given the important role played by tied aid credits in their aid programs and their relations with key developing countries, any discipline would need to have an exception procedure. The current proposal for increased discipline depends heavily on strengthened notification and consultation procedures.

However, such exceptions must be prior notified, which means giving 30 days notice before making the formal offer/commitment. This provides ample time for other countries to offer matching financing.

This package also would eliminate remaining interest rate subsidies in standard export credit to middle income developing countries and reduce them for the poorest countries.

The formula for calculating market related interest rates for standard export credits denominated in dollars would also be revised to better track movements in market interest rates along the yield curve.

Prospects for Success

The prospects for agreement now depend primarily on the ability of the EC to reconcile remaining differences among its members. After a hesitant start, the EC has approached the OECD negotiations positively, I believe out of recognition of our common need to limit subsidies and avoid trade and aid distortions. It is clear that efforts will be pushed forward within the Community to resolve remaining problems as promptly as possible.

OECD Ministers set a target last week for completion of these negotiations by the end of this year if not sooner. The Ministers committed themselves to overcoming existing obstacles so as to be able to finalize such an agreement on this schedule. I am hopeful that the EC will be able to accept a package that all others have found acceptable despite the compromises required.

But, as we stated at the outset of these negotiations, the negotiating road was bound to be long and difficult. The end seems to be in sight, but we are not there yet.

Tied Aid Ban in Eastern Europe

Separately, we have been seeking agreement within the OECD to ban the introduction of tied aid credits into Central and Eastern Europe. The investment needs of these economies as they emerge from decades of economic stagnation are tremendous, and the potential cost of a tied aid credit race is staggering. We also believe that providing subsidies and introducing trade distortions into the region through the use of tied aid credits would not only run contrary to our advocacy of reliance on free and open markets, but also inhibit development through misallocation of scarce resources.

Last week OECD Ministers endorsed an agreement reached by the Export Credit Group Participants to try to avoid using tied aid credits in this region. In line with the U.S. proposal, exceptions to this agreement are to be made for stand alone grants and food and humanitarian aid.

A more binding commitment was not considered desirable given the highly uncertain economic and political situation in the region. We believe that this agreement will deter the use of tied aid except in the most unusual circumstances. We will continue to monitor developments closely to ensure that Central and Eastern Europe continues to be essentially a tied aid free zone.

EAI Initiative

Eximbank plays an important role in the President's Enterprise for the Americas Initiative (EAI). The EAI is conceived to deepen and expand for our mutual benefit the wide array of trade and investment ties that link the United States and its neighbors in Latin America and the Caribbean. This initiative rests on three pillars: trade; investment; and debt reduction. Each area represents a major priority for action. The principal Eximbank contribution is in the debt area.

As part of the debt pillar, the Administration is seeking authority and appropriations to sell or cancel a portion of Eximbank loans to facilitate debt-for-equity, debt-for-development and debt-for-nature swaps and to ease the burden of the region's non-concessional debt. We believe this will also promote private investment, encourage broad-based development, and fund environmental projects in qualifying countries.

There are strict criteria that a country must meet to qualify. Specifically, this would mean IMF and World Bank programs, implementation of investment reforms with the Inter-American Development Bank, and an agreement with the country's commercial banks, as appropriate. The methods for selecting the debt (or portions of debt) to be canceled are to be worked out between Treasury and Eximbank.

Under credit reform, the sale of Eximbank debt will require a budget appropriation and outlay in FY 1992 and thereafter. This is based on the subsidy cost of the debt swaps, and represents the difference between the actual sale price and the net present value of the expected stream of receipts. For this purpose, the Administration has requested an appropriation in FY 1992 of $19.2 million for Eximbank. We expect that the requested amount would be leveraged through debt swaps to permit debt reduction of up to $300 million, depending on country eligibility.

The proposed swap of Eximbank loans can make a contribution to economic growth in the region. We urge a quick enactment of the EAI legislation.

<u>Conclusion</u>

Mr. Chairman, this concludes my prepared remarks. Eximbank plays an important role in the areas I have discussed today in supporting the Administration's international economic goals. I will be happy to answer any questions.

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

Statement of
William E. Barreda
Deputy Assistant Secretary of the Treasury
for Trade and Investment
Before the Subcommittee on
Commerce, Consumer Protection, and Competitiveness
of the
Committee on Energy and Commerce
U.S. House of Representatives

Wednesday
June 12, 1991

Madam Chair and Members of the Subcommittee:

I appreciate the opportunity to appear before the Subcommittee to present the Administration's position on the draft you provided of the "Technology Preservation Act of 1991" (the draft Act). The draft Act would amend Section 721 of the Defense Production Act of 1950, known as the Exon-Florio provision.

My testimony will describe U.S. Government policy concerning foreign direct investment, international efforts to further that policy, the operations of the Committee on Foreign Investment in the United States (CFIUS), and will comment on the draft Act.

Foreign direct investment policy

The two elements of U.S. policy towards foreign direct investment are that: 1) the United States welcomes foreign direct investment and 2) the United States seeks to liberalize investment regimes abroad. At the same time, it is important that we ensure that our open investment policy does not compromise our national security.

We have adopted and maintained this policy for the simple reason that it serves U.S. national interests. It advances economic efficiency, promotes economic growth, and makes us more competitive internationally, while contributing to higher living standards in this country. A strong economy, of course, is essential to national security. This international investment policy reflects the reliance on market forces which underlies all of the Administration's economic policies. The Administration has pursued the policy consistently. The 1991 "Economic Report of the President" said:

> The Administration strongly opposes the erection of barriers to foreign investment in the United States and is continuing to work to reduce formal and informal barriers to investment throughout the world.

The complement to our open investment policy at home is liberalizing the investment regimes of our trading and investment partners. Freedom to invest in other countries' markets is a vital contribution to the viability of U.S. companies. As these companies gain greater access to markets abroad, exports from U.S. parents to their foreign subsidiaries translate into more jobs in the United States.

Data and trends

As of the end of 1990, the book value of foreign direct investment in the United States was $427 billion. (Revised 1990 data will be released by Commerce in late June.) The United Kingdom was the largest investing nation, with investments of $125 billion, followed by Japan with investments of $78 billion.

During 1990, the U.S. foreign direct investment position abroad increased by $36 billion, to $410 billion. Because U.S. foreign direct investment abroad in 1990 increased faster than foreign direct investment here, the gap in the book value between foreign direct investment here and abroad is narrowing.

This week the Commerce Department released a revaluation using market values for foreign direct investment in the United States and U.S. direct investment abroad at the end of 1989. This is the first time that Commerce has published other than historical book values for direct investment. It did so to address widely held views that book value understates significantly the value of U.S. investment abroad much of which is considerably older than foreign direct investment here. The new figures confirm the extent of that undervaluation.

According to the new figures, the 1989 market value of the U.S. direct investment position abroad was $805 billion (over twice the book value of $373 billion). The 1989 figure for the foreign direct investment position in the United States was $544 billion (book value, $401 billion). Based on market value, the U.S. direct investment abroad exceeded foreign direct investment here by over $260 billion, while, as I mentioned, based on book value foreign direct investment here exceeded U.S. investment abroad by $28 billion.

The presence of foreign direct investment in the U.S. is not large relative to the size of the overall economy. In 1990, the current cost value of foreign direct investment in the United States accounted for less than 3% of U.S. domestic net worth. Foreign direct investment has a significantly lesser role in the U.S. economy than in the economies of our major trading partners, with the exception of Japan.

Based on preliminary data, foreign direct investment inflows in 1990 fell sharply from previous levels. Inflows were down 64 percent compared to 1989, for example. By major countries the decline was 65 percent for the United Kingdom, 53 percent for Japan, and 82 percent for the Netherlands.

Although I would not wish to draw firm conclusions at this point, the reasons for the drop would include the increased use of borrowing in the United States, recession in the United States, tighter money abroad, and investment opportunities in other countries. It may also be that investors have been influenced by the debate over foreign direct investment. It cannot be comforting to foreign investors that legislation such as the draft Technology Preservation Act is under serious consideration.

To illustrate the benefits of foreign investment in the United States, at the end of 1988 non-bank U.S. affiliates of foreign firms:

-- employed 3.7 million Americans;

-- had payrolls of $112 billion;

-- paid $11 billion in Federal income tax;

-- spent $7 billion in research and development.

What is important are the jobs and job skills resulting from investment that accrue to American workers regardless of the nationality of the investor. In terms of employment, California ranked first, New York second, Illinois fourth, Pennsylvania sixth, Ohio seventh, North Carolina eighth, and Georgia tenth among the States. In terms of the value of fixed capital investment, California ranked first, New York third, Illinois fifth, Ohio sixth, Pennsylvania ninth, and North Carolina tenth.

Charts in the appendix provide additional data.

Concerns over policy

The growth of foreign investment in recent years has prompted new doubts in some quarters about the desirability of our open investment policy. Because of the surge of Japanese investment here, concentrated in certain sectors and geographic areas, special concern has been expressed over investment from Japan.

One concern, reflected in the title of this bill, is fear that the United States is being drained of technology through foreign direct investment. In particular, some observers believe Japan's investments here are motivated by designs to capture the fruits of American technology for Japan's home industries rather than by a desire to pursue profits in the United States and in so doing contribute to the U.S. economy.

Another impetus for a change in our investment policy focuses on the absence of a level playing field. I share this concern, and we are working actively to gain greater access to foreign markets, particularly Japan's. But I believe that it makes little sense for the United States to restrict foreign investment in our market because policies abroad deny U.S. business equivalent access. To do so would harm our own economic interest by denying ourselves the benefits of foreign direct investment while incurring the costs of a restricted capital market. Instead, our response has been to attack restrictive investment regimes and to do all we can to move our investors to a position where they have the same rights and opportunities abroad as do domestic investors.

I will touch on the technology issue later in this testimony. Let me now briefly describe our efforts to level the playing field.

<u>Efforts to liberalize foreign restrictive investment practices</u>

o In the General Agreement on Tariffs and Trade (GATT), we are seeking a binding, enforceable, legal obligation to prohibit certain government measures imposed on foreign investors. For example, we are seeking to prohibit measures that require the use of local parts to the detriment of imported parts. Such foreign requirements reduce American exports and harm U.S. workers. Disciplining these Trade-Related Investment Measures (TRIMs) is a high priority for us in the Uruguay Round.

o Bilaterally, we have negotiated 13 investment treaties which provide a framework of agreed principles. These complement the 48 Treaties of Friendship, Commerce, and Navigation currently in effect. A basic objective of these treaties is to obtain the right for U.S. firms to establish businesses and to compete in the territory of our treaty partners on equal terms with domestic firms. For example, last year we concluded negotiation with Poland of a Business and Economic Relations Treaty. One of the benefits of that agreement is that it enables U.S. firms to compete on a non-discriminatory basis with Polish and other foreign firms. We are negotiating similar agreements with other Eastern European countries and the Soviet Union. We also have entered into negotiations with a number of Latin American countries.

o Through the Structural Impediments Initiative (SII) with Japan, we have made some progress in our attempts to remove barriers to foreign direct investment in that country.

Japan

I am pleased to report that Japan has recently revised the laws governing its foreign investment regime. These changes represent an important step towards establishing a more open investment environment. The Government of Japan is now preparing the Ministerial Ordinances (regulations) to implement these revisions.

Prior notification of investments will be required only in sectors relating to national security and those covered by Japan's reservations under the Organization of Economic Cooperation and Development's Capital Movements Code. Previously, all incoming direct investment required prior approval. A broad positive list of sectors exempt from prior notification will be established in which restrictions on foreign investment could occur only in situations involving national emergencies.

In the implementing regulations, we expect that the positive list will be drawn by Japan as broadly as possible with provision made for periodic additions of new sectors, and the reservations under the OECD Code will be reduced and more narrowly and specifically defined.

Liberalizing the business practices needed to open up the Japanese economy is a far more difficult challenge than changing the legal regime for foreign investment. It requires that significant action be taken to open up the Keiretsu system. Since the Keiretsu system has significance control over the trade in and distribution of goods in Japan, the system is a formidable barrier to entry into the Japanese market through direct investment or exports.

In the SII effort to open up the Keiretsu system, the Government of Japan has recognized the importance of enhanced disclosure requirements in revealing anti-competitive or exclusionary business behavior and has taken steps to improve its disclosure regime.

Unfortunately, beyond these measures, Japan has not shown a clear recognition that the exclusionary aspects of Keiretsu are a problem. Furthermore, we regret the lack of willingness by Japan to address the problem of cross-shareholding. We will continue to press for a more open and transparent system in Japan.

Exon-Florio provision

The Exon-Florio provision authorized the President, or his designee, to investigate foreign acquisitions to determine their effects on national security. It also authorized the President to take such action as he deems appropriate to prohibit or suspend such acquisitions if he found that:

There is credible evidence to believe that the foreign investor might take action that threatens to impair the national security; and

Existing laws, other than the International Emergency Economic Powers Act and the Exon-Florio provision, do not provide adequate and appropriate authority to protect the national security.

If these criteria are satisfied, the President was authorized to direct the Attorney General to seek appropriate judicial relief -- including divestment. The President's findings were not subject to judicial review.

By Executive Order 12662 of December 27, 1988, the President designated the Committee on Foreign Investment in the United States (CFIUS) to receive notices from parties involved in foreign acquisition of U.S. companies, to determine whether investigations of those transactions should be undertaken, and to prepare a report and recommendation to the President with respect to transactions that have been investigated.

Summary of Exon-Florio Operations

We have received over 575 notices since the enactment of Exon-Florio. Of that total, twelve transactions have been subject to a 45-day investigation. Four of those transactions were withdrawn. Of the remaining eight, the President chose not to intervene in seven. The President chose to prohibit one transaction.

Beginning last fall, there has been a noticeable reduction in the number of notifications to CFIUS of transactions. This reduction has continued into 1991. Through May of this year CFIUS received 60 notifications, while during the same period last year CFIUS received 148 notifications. This decline in notifications probably reflects the decline in the inflow of direct investment as well, as perhaps greater selectivity on the part of investors in choosing which transactions to notify.

Lapse of Exon-Florio authority

As you know, Exon-Florio authority lapsed with the expiration of the Defense Production Act on October 20, 1990.

After consultations with Congressional staff, the business and legal communities, and other CFIUS agencies, Treasury announced on November 6, 1990, that CFIUS would continue to operate on an informal basis in accordance with the Exon-Florio criteria and calendar.

Although the President's authority under Exon-Florio is not currently available, parties to transactions have continued to cooperate with CFIUS in the expectation that Exon-Florio authority would be renewed retroactively.

During the period since the Exon-Florio provision lapsed, CFIUS has received over 100 notifications and undertaken one investigation. Our advice to prospective notifiers has been to proceed as though Exon-Florio had not lapsed, in expectation that the authority would be renewed retroactively, as has happened each time before. Under such a renewal, any transactions consummated in the interim would be automatically covered.

However, the Exon-Florio authority lapsed over seven months ago. The longer the period of lapse extends, the more difficult it becomes to continue to operate under interim arrangements. Consistent with the Administration position on the Defense Production Act, Treasury supports a short-term extension of Exon-Florio in its current form.

Criticism of CFIUS

Recent criticism of CFIUS has centered on the statistics, owing to the fact that in over 575 notifications, there have been only twelve 45-day investigations, and only one block. CFIUS, it is argued, cannot possibly be doing its job if the President has only blocked one deal, and CFIUS has only investigated twelve transactions.

I take a different view. As the Deputy Assistant Secretary with oversight responsibility for Treasury's CFIUS operations, I can assure you that CFIUS examines very closely notices of transactions during the initial 30-day period. At the same time, we take seriously the report of the Conferees that they did not intend, through Exon-Florio, to impose barriers to foreign investment. CFIUS has evolved an efficient analytic process, spurred by the tight deadlines under which CFIUS operates, to examine thoroughly the national security concerns of every transaction. These concerns are measured against Exon-Florio standards of whether credible evidence exists that the foreign investor might take action to harm the national security, and whether other laws are adequate to protect the national security.

During the 30-day review period CFIUS is able to amass a great deal of information with regard to a particular transaction. As necessary, following the receipt of the notification, we begin with an initial exchange of written questions and answers, followed by other rounds of questions and answers, and, as needed, one or more meetings with the parties to the transactions. I believe that those businessmen and attorneys who have been through the process will attest to its thoroughness.

This intensive process allows us to meet the requirements of Exon-Florio while sustaining our open investment policy. If at the end of the initial 30-day review, CFIUS staff does not have sufficient information to make a determination or a recommendation to policy officials, we extend the review into a 45-day formal investigation.

Alternatively, parties to the transaction may withdraw notice in cases where information is lacking; notice is resubmitted later when the information is made available to CFIUS. Withdrawals of notification have typically been used in instances in which CFIUS was not prepared to end its consideration of a transaction, but in which problems and possible solutions were clearly identified, and did not in and of themselves constitute a reason to contemplate prohibiting the transaction. Examples are the need to establish a procedure for assuring that access to sensitive technology is limited, giving additional time to meet Department of Defense concerns about safeguarding confidential information and contracts; and allowing time to verify the reliability of alternate suppliers, etc. Once these problems are overcome, parties to the transactions then are free to resubmit the transaction to CFIUS.

Thus far, about a dozen transactions have used this withdrawal procedure. It allows us to insure that existing laws are adequate and appropriate to protect national security, thereby enabling us to meet our responsibility without, however, unduly burdening the process or the President.

Beyond the strict implementation of Exon-Florio, CFIUS's impact has been significant. It includes a greater awareness in the business and legal communities of national security aspects of transactions. Moreover, CFIUS serves as a mechanism for case-by-case review of transactions designed to confirm that laws to protect security are appropriate and adequate to the task for the transaction under consideration. And CFIUS has produced a marked improvement in co-ordination and information sharing within the Executive Branch on national security implications of foreign purchases of U.S. businesses.

Technology

Madam Chair, the draft Act reflects the increased concern many have with the effect of foreign investment on our technological competitiveness. The principal concerns are:

-- Foreigners are increasingly targeting U.S. high technology sectors for takeover.

-- As a result, it is said, the United States loses more technology than it gains through foreign investment in the United States.

Let me address these concerns.

First, if foreigners are in fact targeting high-tech sectors, we would expect to see foreign direct investment increasing disproportionately in those sectors. However, available data (through 1988) do not provide evidence that this is occurring. According to Commerce Department data, the share of foreign direct investment inflows going to high-tech sectors decreased from 11.5% in 1980 to 9% in 1985 and then increased to 11.1% in 1988. Of course, foreign investment in all sectors increased during this time, so that actual investment in high-tech sectors has increased. But there is no clear trend of foreigners increasingly focusing on buying high-tech firms.

Second, foreign investment in the United States is not bleeding our technological base. In fact, the United States obtains more technology than it contributes through foreign investment here. Payments of royalties and license fees generally reflect the value companies place on technology. We looked at these intracompany payments as a measure of technology transfer. Transfers to the United States through U.S. affiliates of foreign companies have been more than five times larger than technology transfers out by them in the 1980-1989 period.

While, overall, U.S. firms do transfer more technology overseas than foreign firms transfer to the United States, 76% of U.S. technology transfers are from U.S. parents to their foreign affiliates, and 22% are from U.S. firms to unaffiliated companies. Only 2% of technology outflows are from U.S. affiliates to their foreign parents. Given that the market value of U.S. direct investment abroad is much greater than foreign investment in the United States, as the new Commerce data confirms, it should not be surprising that technology transfers abroad exceed inflows.

In addition, technology flows to the United States have been growing much faster than flows out of the United States. While transfers of technology out of the United States more than doubled from 1980-88, transfers into the United States more than tripled.

I believe that it is counterproductive to erect barriers to the free flow of technology when the United States has more than ever to gain from foreign research and technology. A recent study of worldwide patents and scientific citations found that, as other countries have developed their own research and technological capabilities, an increasing share of key technological developments are occurring outside the United States.

Finally, any attempt to restrict foreign ownership in certain "critical" high-tech sectors for other than national security reasons would at best be ineffective and at worst counterproductive. Restrictions would be ineffective because our export control laws rightly restrict the transfer of technology and know-how which could threaten our national security. It makes little sense to try to stop foreigners from getting technology through investment which they can easily get through trade or licensing agreements. Restrictions would discourage both foreign and domestic infusions of capital. Domestic investors would have less incentive to invest in a U.S. company whose value has been adversely affected because of restrictions on sale of the company to the highest bidder. We would end up starving for capital precisely those sectors we most hope to see flourish.

As Assistant Secretary of Commerce for Technology Policy Deborah Wince-Smith recently stated before the House Science, Space and Technology Committee:

> Rather than reducing the flexibility and freedom our firms have in forming business and financial alliances, the real issue we must address is creating an economic and cultural environment in the United States that is conducive to long-term investment in innovation and the rapid commercialization of new technology.

The President has made several proposals to boost our technological competitiveness. These include decreasing government dissaving by adhering to the budget agreement, increasing R&D funding, cutting the capital gains tax, improving our financial system, and removing regulatory impediments. This is what is ultimately needed to improve our technological competitiveness, not erecting barriers to foreign capital and know-how.

The Draft Technology Preservation Act

I would like to turn now to comment on the draft Technology Preservation Act. The Administration strongly opposes enactment of the draft Act. It would have a serious adverse effect on the U.S. economy, could have harmful consequences for U.S. business abroad, and would seriously erode global support for more open investment regimes.

For these reasons, Treasury and the other agencies of the Committee on Foreign Investment in the United States oppose the draft Technology Preservation Act. If it were presented to the President for signature in its current form, his senior advisors would recommend he veto it.

Our objections to the draft Act are based on the broad implications of the bill as well as on the bill's particular provisions.

First, the draft Act is not necessary, since the Exon-Florio provision, once renewed, together with other laws is adequate to protect national security.

Second, the draft Act would make fundamental changes in our existing investment policy. It compromises our policy of welcoming foreign direct investment and is contrary to our policy of providing foreign investors national treatment once established in the United States. Moreover, denial of national treatment could raise questions with regard to U.S. treaties and other international agreements.

Third, the draft Act would certainly discourage foreign direct investment and thereby harm our economy, which in recent years has depended on foreign savings to help sustain a level of investment necessary to maintain U.S. competitiveness.

Fourth, the draft Act would have a deleterious effect on the worldwide movement towards more liberal investment regimes. The United States has been at the forefront of this movement because it is beneficial to the U.S. and world economies.

Fifth, the draft Act would establish a system and a mandate for truly extensive government interference in the market place, on the implicit assumption that government officials can make better economic and technology decisions than the market can.

Sixth, the draft Act would require federal agencies to share information on acquisitions with the proposed interagency committee. Much of the information collected by the agencies is confidential and is collected for statistical purposes only. Giving the committee access to such information would set a precedent of nonstatistical use that would erode the integrity of our statistical system.

Finally, the draft Act would subject U.S. investment abroad to possible retaliatory action, with attendant adverse economic consequences here at home, as, for example lost income and jobs.

These effects result from particular provisions of the draft Act to which we have specific objection.

Presidential finding. The draft Act would amend the Exon-Florio provision to alter significantly one of the findings that the President must make if he is to take action to suspend or to prohibit a foreign investment. Under the bill, an investment could be blocked on the basis of foreign ownership alone rather than on action that the foreign owner might take.

This change is not minor; it would represent a major shift in U.S. direct investment policy. The draft Act would change the presumption we make with regard to foreign investment from one that considers such investment beneficial to one that considers foreign investment as potentially pernicious. The consequence of this presumption is embodied in the requirement in the bill that foreign investors must, under certain circumstances, accept performance requirements that will be policed by the U.S. government.

In addition to expanding the scope of the factors that the President or CFIUS must consider in reaching decisions, another effect of the change would be to broaden the focus from national security to "the industrial and technological base." The introduction of the term "industrial and technological base" into the Presidential finding brings into play a broad and vague concept. The proposed interagency committee would be called upon to make subjective judgments without clearly defined standards and could become subject to special interest lobbying. As you know, the Administration has consistently and strongly opposed industrial policy of the sort which would be required under the draft Act. It is ironic that at a time when other countries, including Japan as a result of the Structural Impediments Initiative, are moving away from applying such broad concepts to foreign direct investment, the draft Act proposes to move the United States in the opposite direction.

Screening. The draft Act would require that foreign investments involving "critical technologies" be investigated by the proposed interagency committee and that assurances be solicited with regard to the investment. These assurances would have to be published in the Federal Register, be reviewed at least annually, and constitute the subject of an annual report to Congress.

This process -- screening, obtaining assurances, and monitoring -- would substitute the judgment of government officials for decisions of the market.

Assurances. Although no specific penalties are provided for in the bill, failure by foreign direct investors to provide acceptable assurances would implicitly be grounds for blocking certain transactions, or divesting investments which failed to implement assurances given. Foreign direct investments under such a regime would be subject to a level of government scrutiny not imposed on other investments. Such scrutiny is open-ended. How long would assurances be policed? Under what standards? What if technology and the market change, as they assuredly will? These are troublesome questions that lead into uncharted waters for the United States.

As a matter of policy, the Administration opposes the imposition of performance requirements on domestic investors or on foreign investors here. They are an unnecessary intrusion and, when applied only to foreign investors, conflict with our policy and international obligations to provide "national treatment" to foreign investors operating in our economy.

Attempts of other countries which have actively employed interventionist policies in investment have demonstrated the folly of those policies. We should learn from these experiences, not repeat their mistakes. Recent history provides strong support for the view that market participants make better decisions than governments in these matters.

All direct investors look well down the road when making an investment at home or abroad. They must believe that they will be free to make the market decisions necessary to the success of their venture. Markets change in unpredictable ways. Businesses, whether foreign or American, must be able to change with them. If businesses are restrained in reacting to the market place by assurances given to the government, efficiency suffers and the economy is harmed. This holds true for foreign investment here and U.S. investment abroad. That is why a principal U.S. goal internationally has been to eliminate such performance requirements in other countries, so that government interference in markets will be minimized.

Conclusion

Our objections to the bill do not involve only one or a few of its provisions. The bill is fundamentally flawed. It contradicts basic Administration positions on investment screening, performance requirements, and economic efficiency. It contravenes the national treatment policy of the United States and compromises our ability to promote more liberal investment regulations in other countries. Finally, it is not necessary as existing laws provide adequate authority to ensure that foreign investment does not compromise our national security.

Foreign investment benefits the United States. We know that the market is the best allocator of resources. We risk significant economic damage by discouraging foreign investment and requiring government interference in the market. There is little question that enactment of the draft Technology Preservation Act would have these results.

Foreign direct investors pay close attention to the investment climate in the host country. The United States is not immune from scrutiny. In a global economy that is changing rapidly, the United States is not the only destination for investment capital. We should not knowingly place the U.S. economy at a disadvantage in international economic competition. We must continue to maintain policies that welcome foreign investment and attract capital.

In closing, I would like to reiterate two points:

1) An open investment policy is crucial to our international competitiveness;

2) An investment climate is fragile; the economic costs of unwise tampering are high.

Thank you. I will be happy to try to answer any questions you may have.

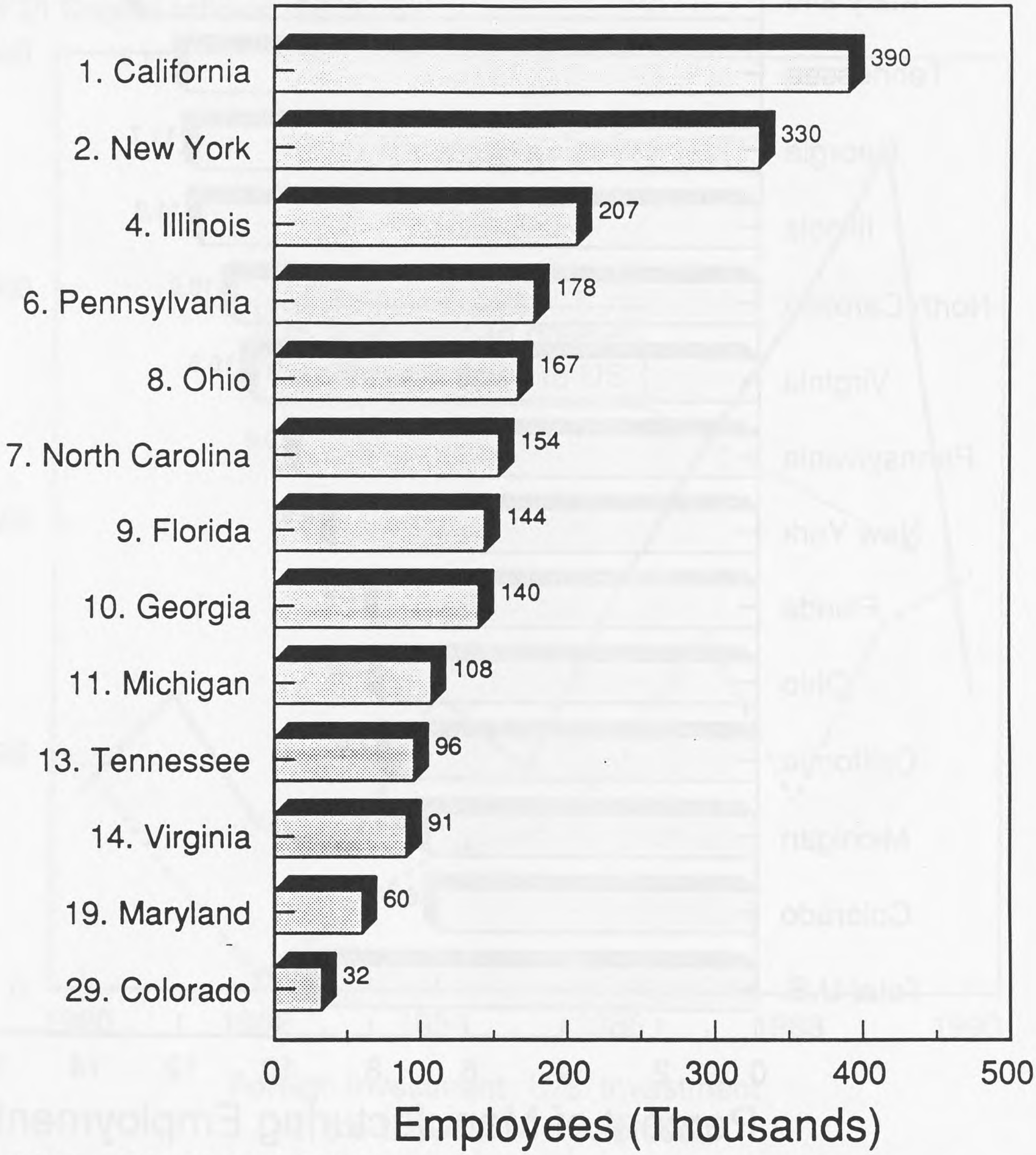
APPENDIX

CHARTS ON

FOREIGN DIRECT INVESTMENT

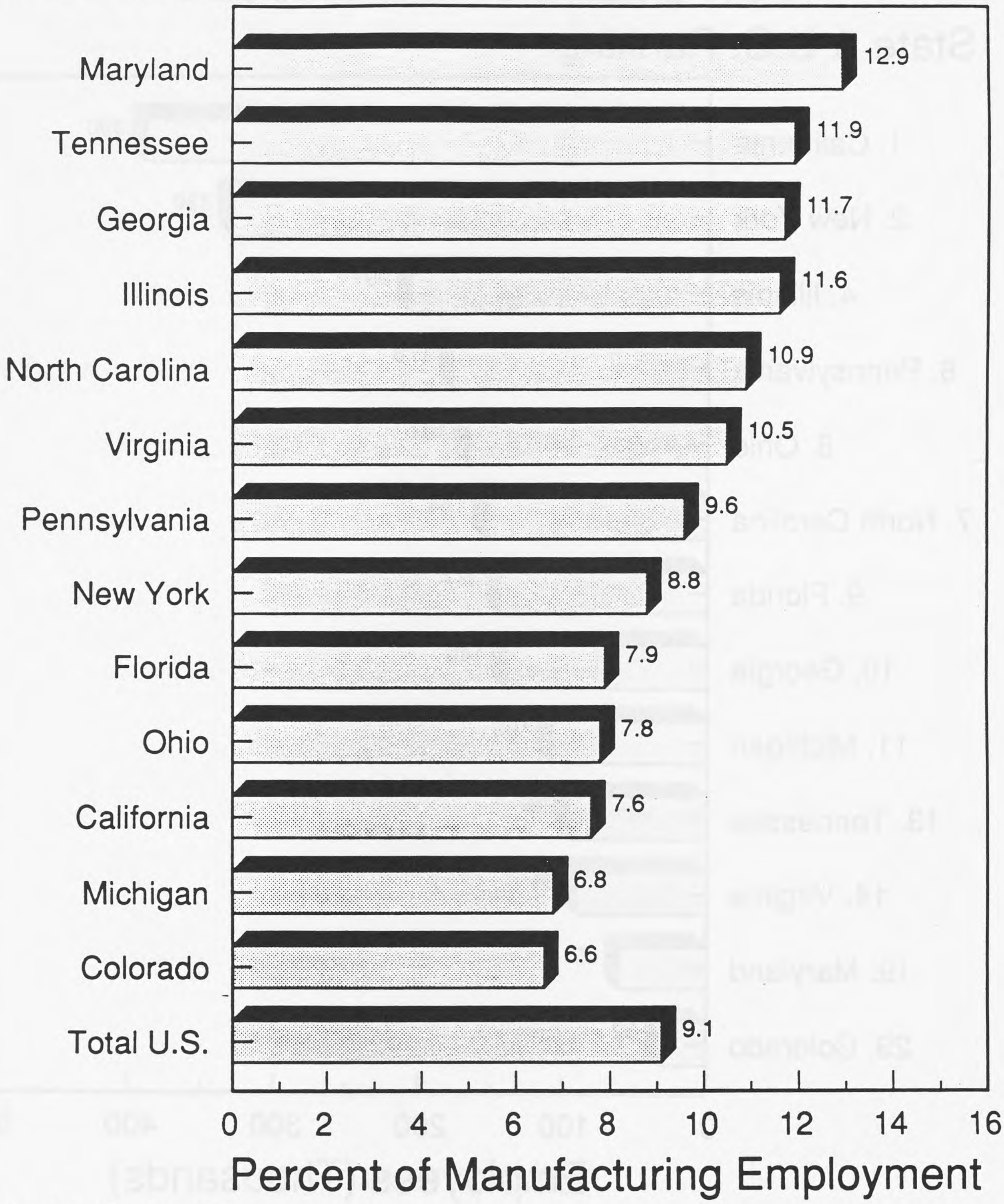
IN 1988 FOREIGN-OWNED FIRMS ACCOUNTED FOR OVER 3.6 MILLION JOBS

State & U.S. Ranking



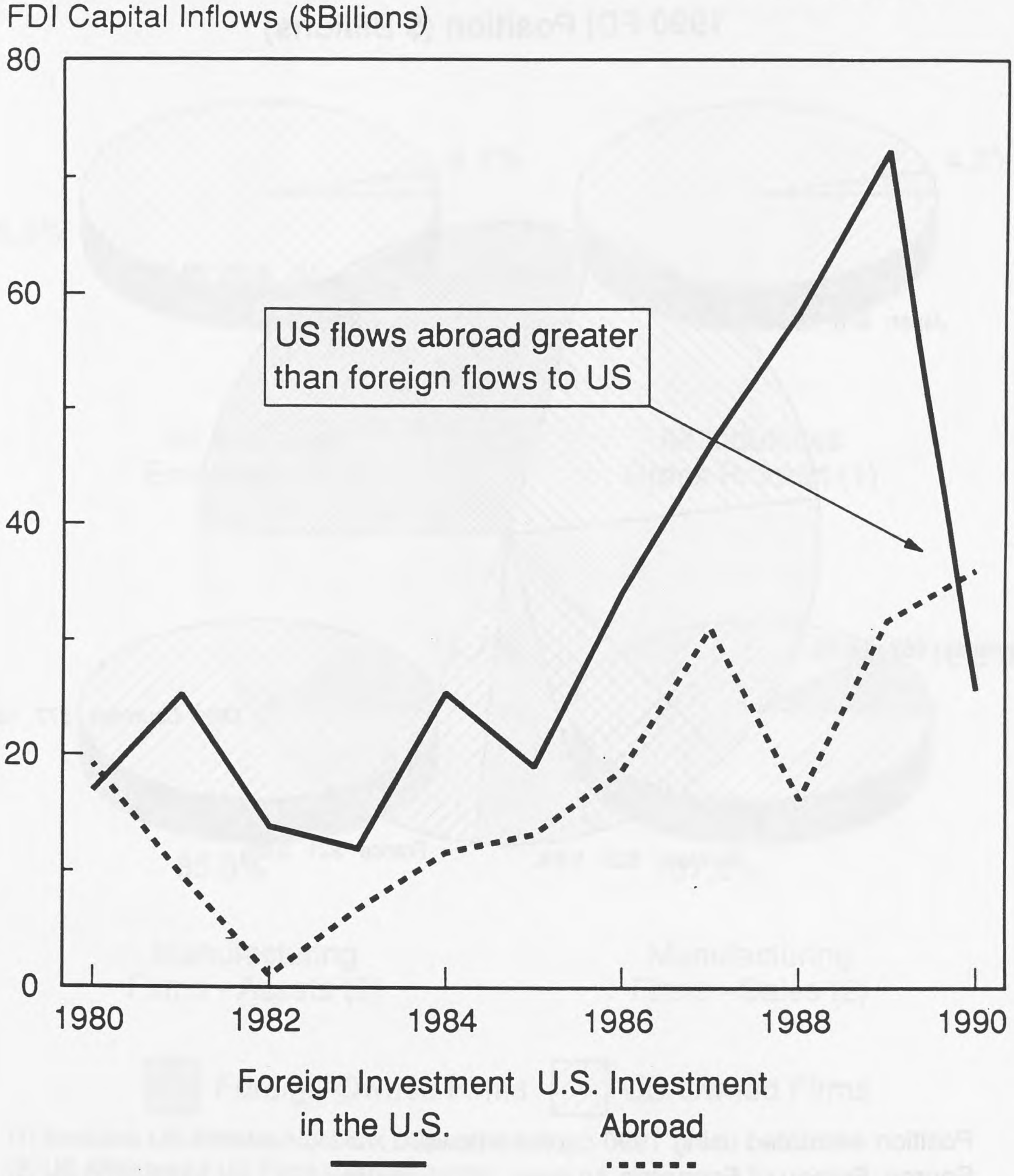
Employment in nonbank US affiliates
Source: Bureau of Economic Analysis

IN 1988 FOREIGN-OWNED FIRMS ACCOUNTED FOR IMPORTANT PORTION OF MANUFACTURING JOBS



Sources: Bureau of Economic Analysis,
Bureau of Labor Statistics

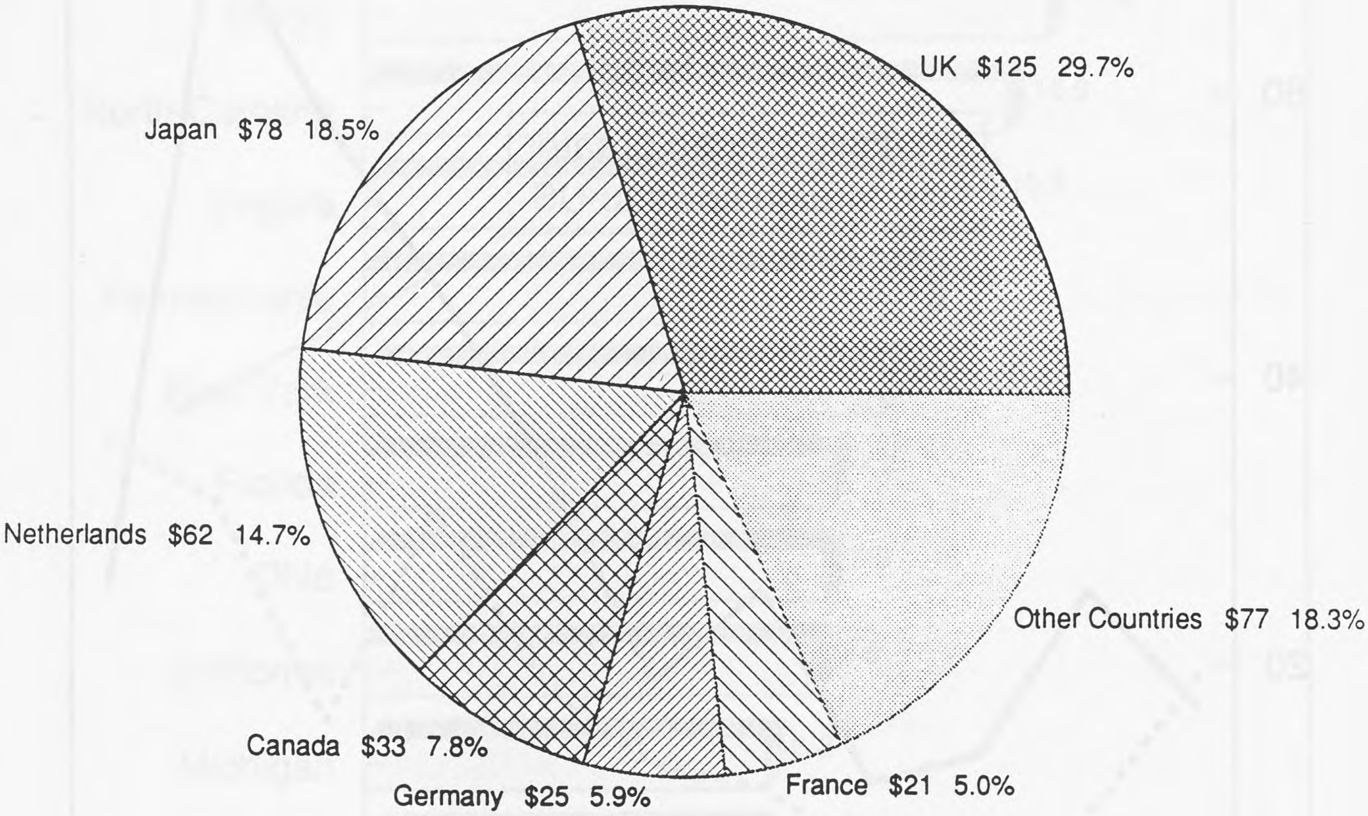
AFTER INCREASING DURING THE 1980s, IN 1990 CAPITAL INFLOWS OF FOREIGN INVESTMENT TO THE U.S. DECREASED SIGNIFICANTLY



Source: Survey of Current Business

UK, JAPAN, & NETHERLANDS LARGEST FOREIGN INVESTORS IN THE US

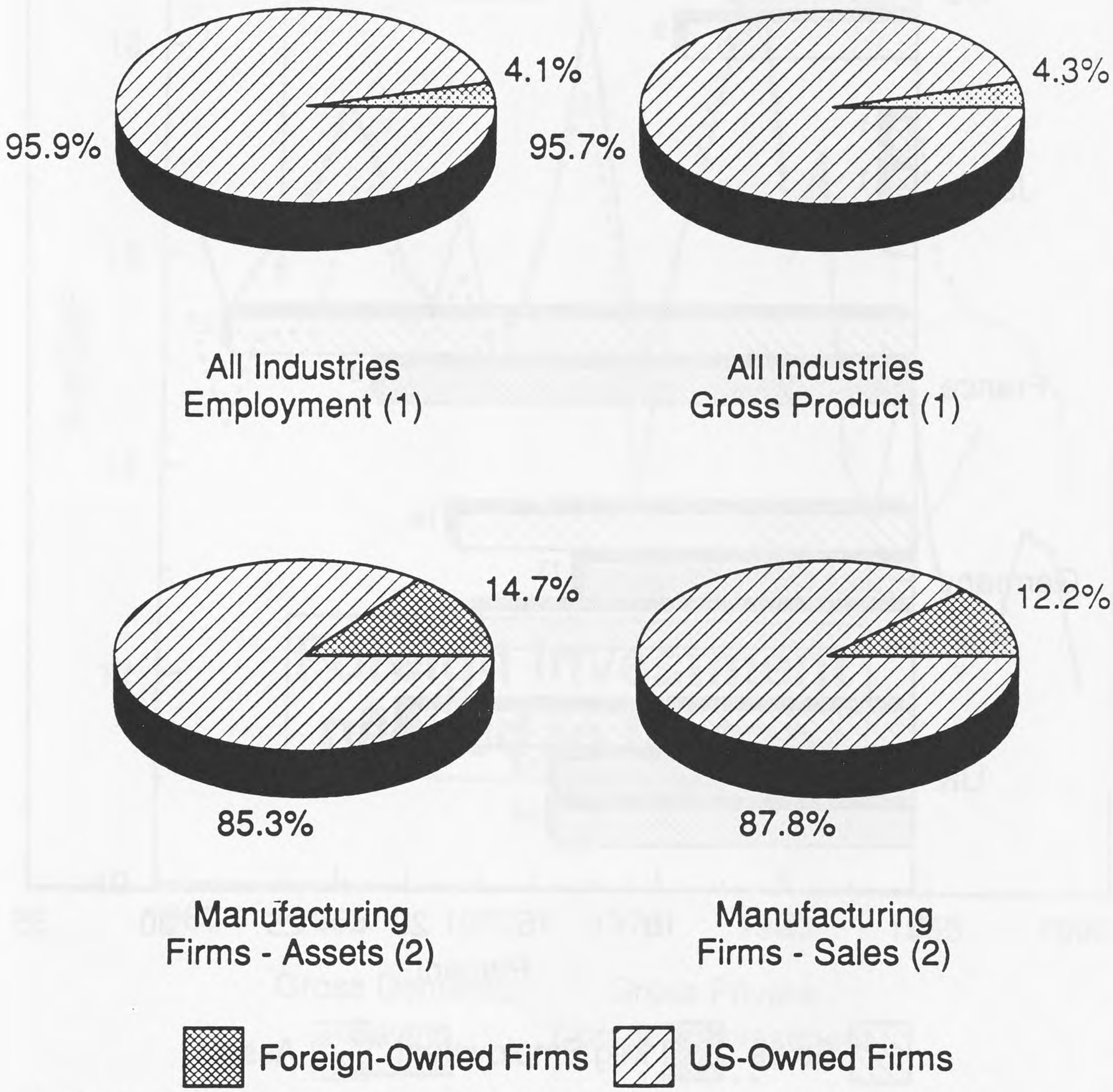
1990 FDI Position ($ Billions)



Position estimated using 1990 capital inflows
Source: Bureau of Economic Analysis

FOREIGN-OWNED FIRMS ACCOUNT FOR ONLY A SMALL PART OF US ECONOMY

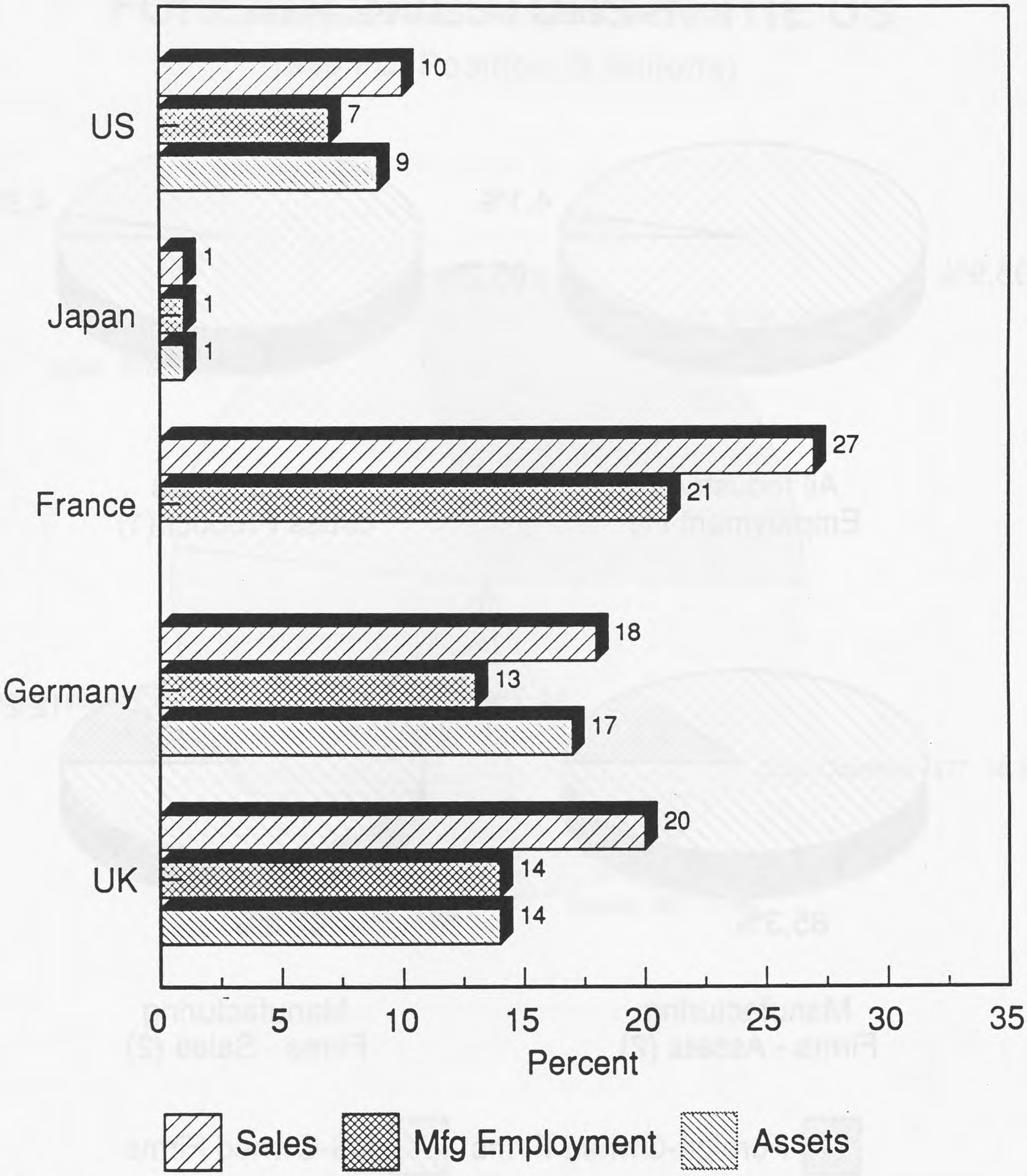
1988 Data, Except for Gross Product (1987)



(1) Nonbank US Affiliates/Nonbank US Businesses
(2) US Affiliates/All US Firms (Manufacturing)
Source: Survey of Current Business

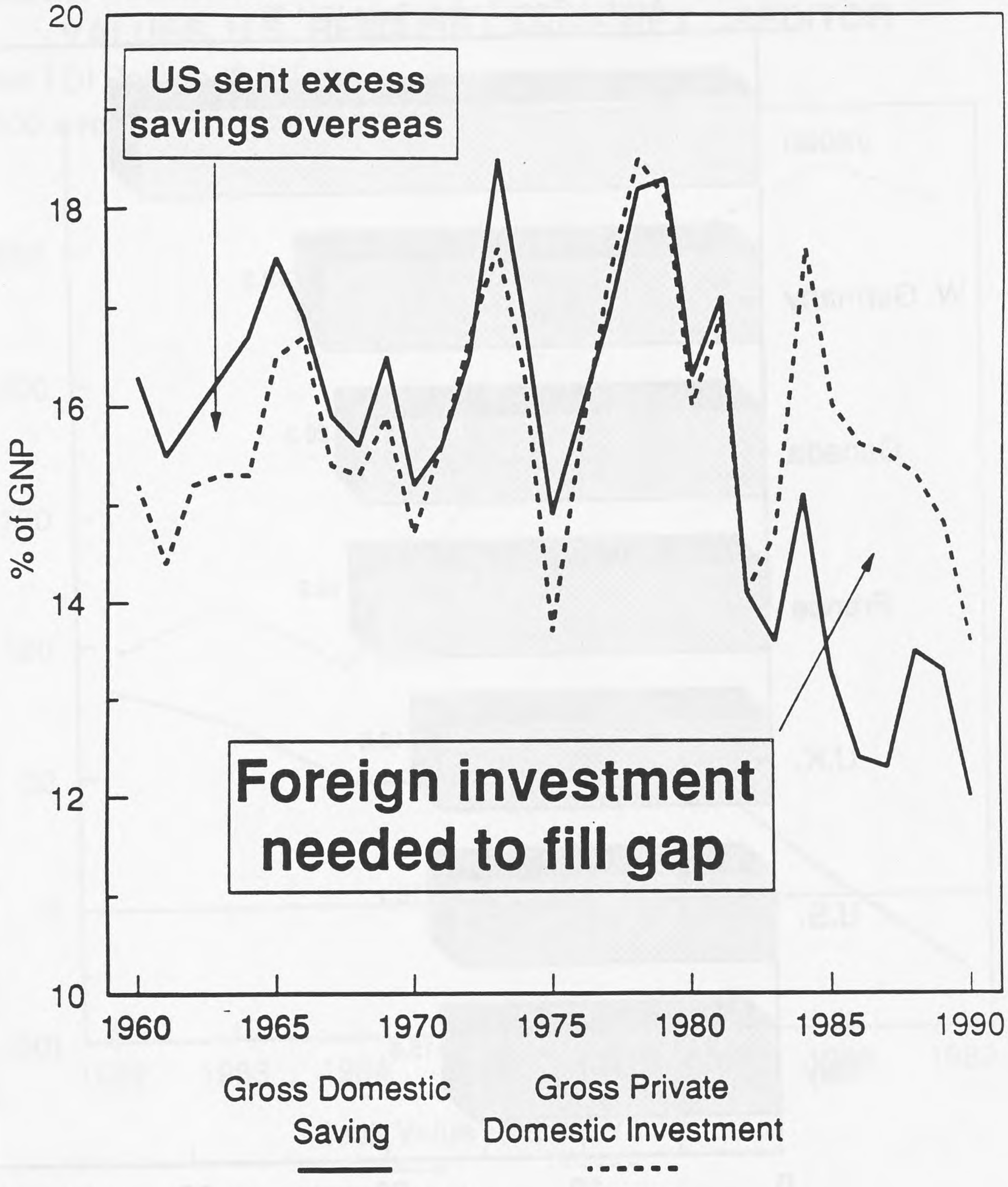
EXCEPT FOR JAPAN, OTHER MAJOR TRADING PARTNERS ACCEPT HIGHER LEVELS OF FOREIGN INVESTMENT

1986 Data (asset data not available for France)



Source: Julius & Thomsen, "Foreign-Owned Firms, Trade & Economic Integration", Tokyo Club Papers 2, Royal Institute for International Affrs, 1988

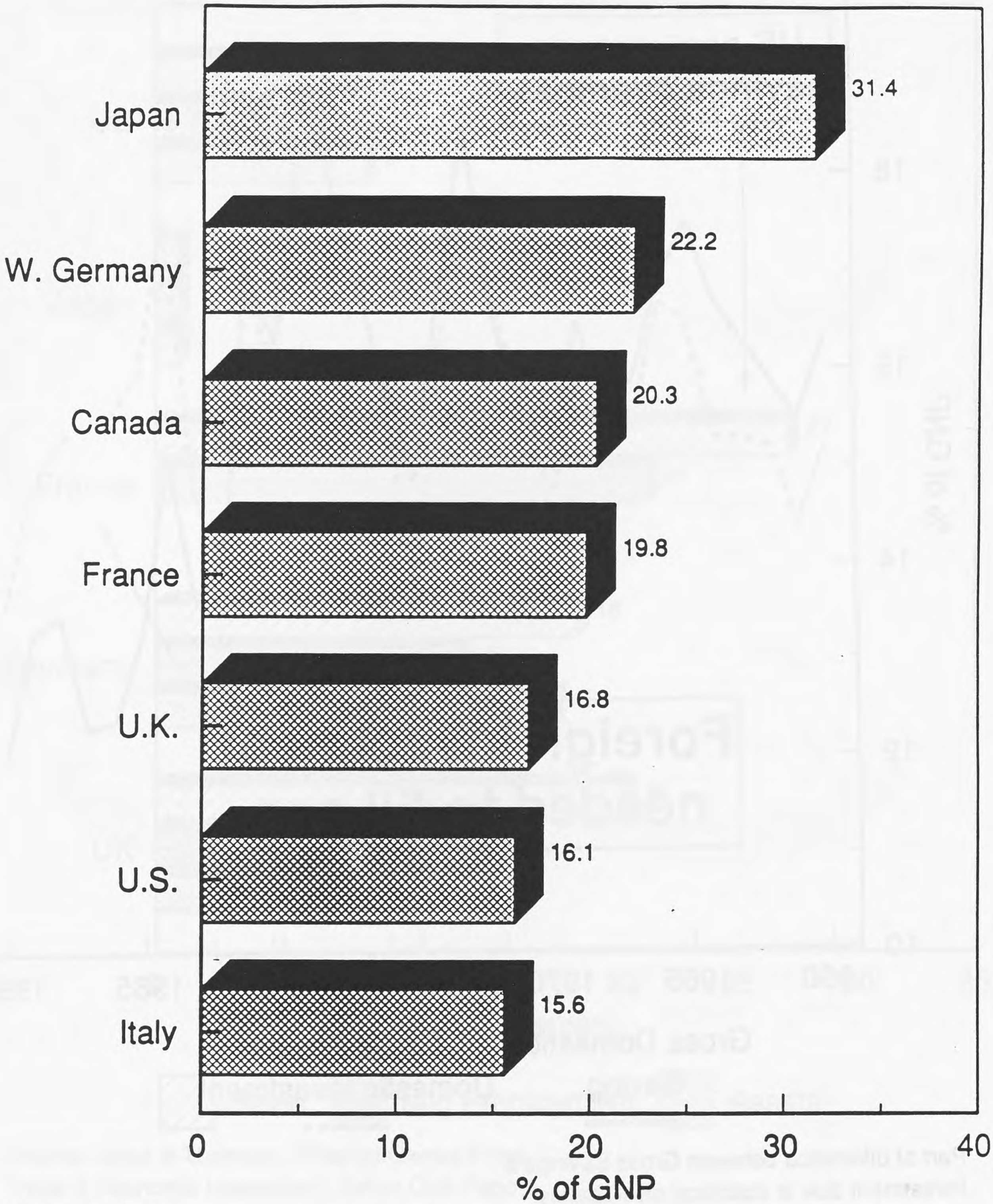
FOREIGN INVESTMENT HELPED US MAINTAIN DOMESTIC INVESTMENT DESPITE DECLINING SAVINGS RATE



Part of difference between Gross Savings & Investment due to statistical discrepancy
Source: 1991 Economic Report of the President

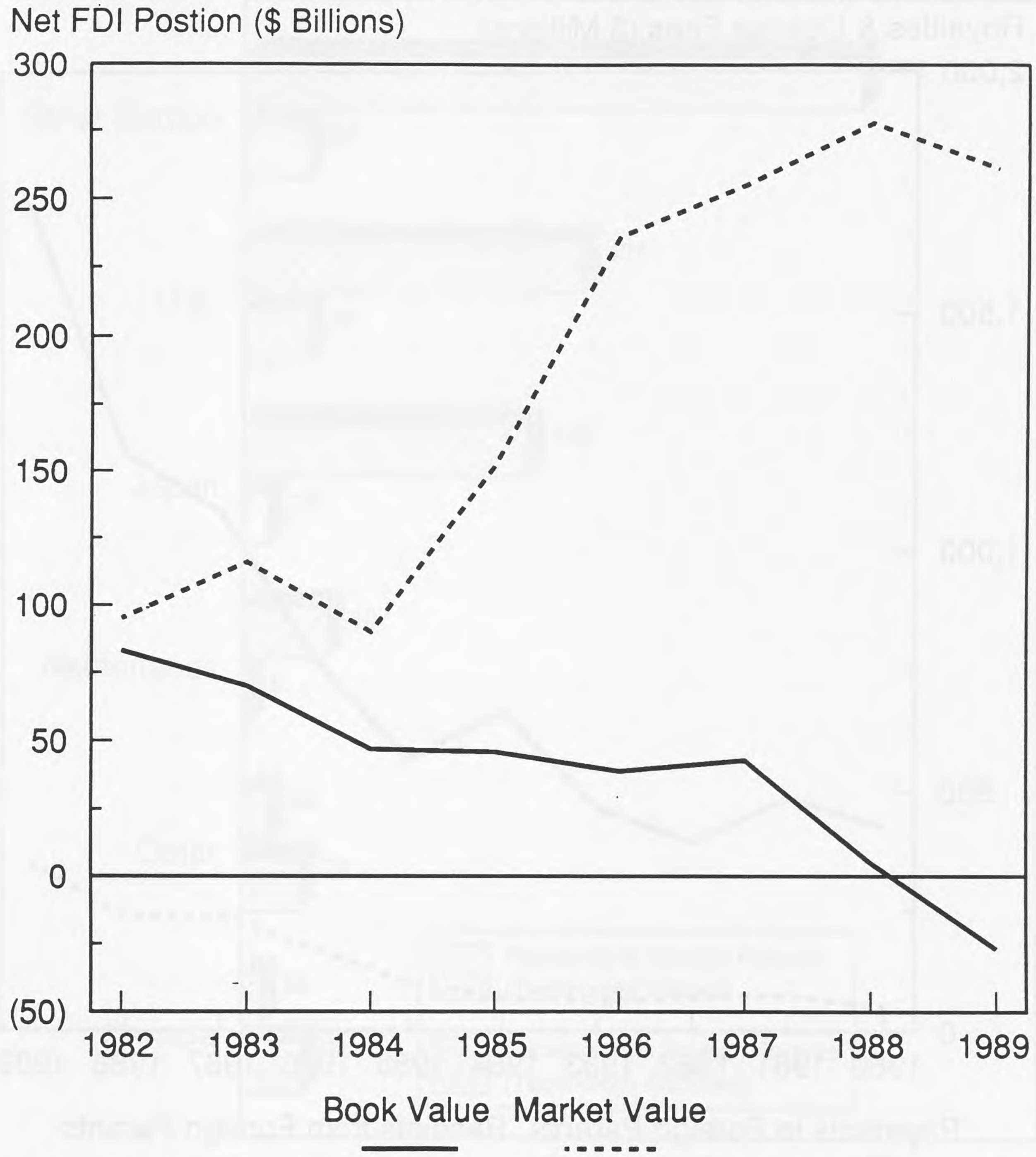
US NEEDS FOREIGN INVESTMENT BECAUSE US SAVINGS RATE SIGNIFICANTLY BELOW MAJOR TRADING PARTNERS

Average Gross Savings Rates 1981-88



Source: OECD

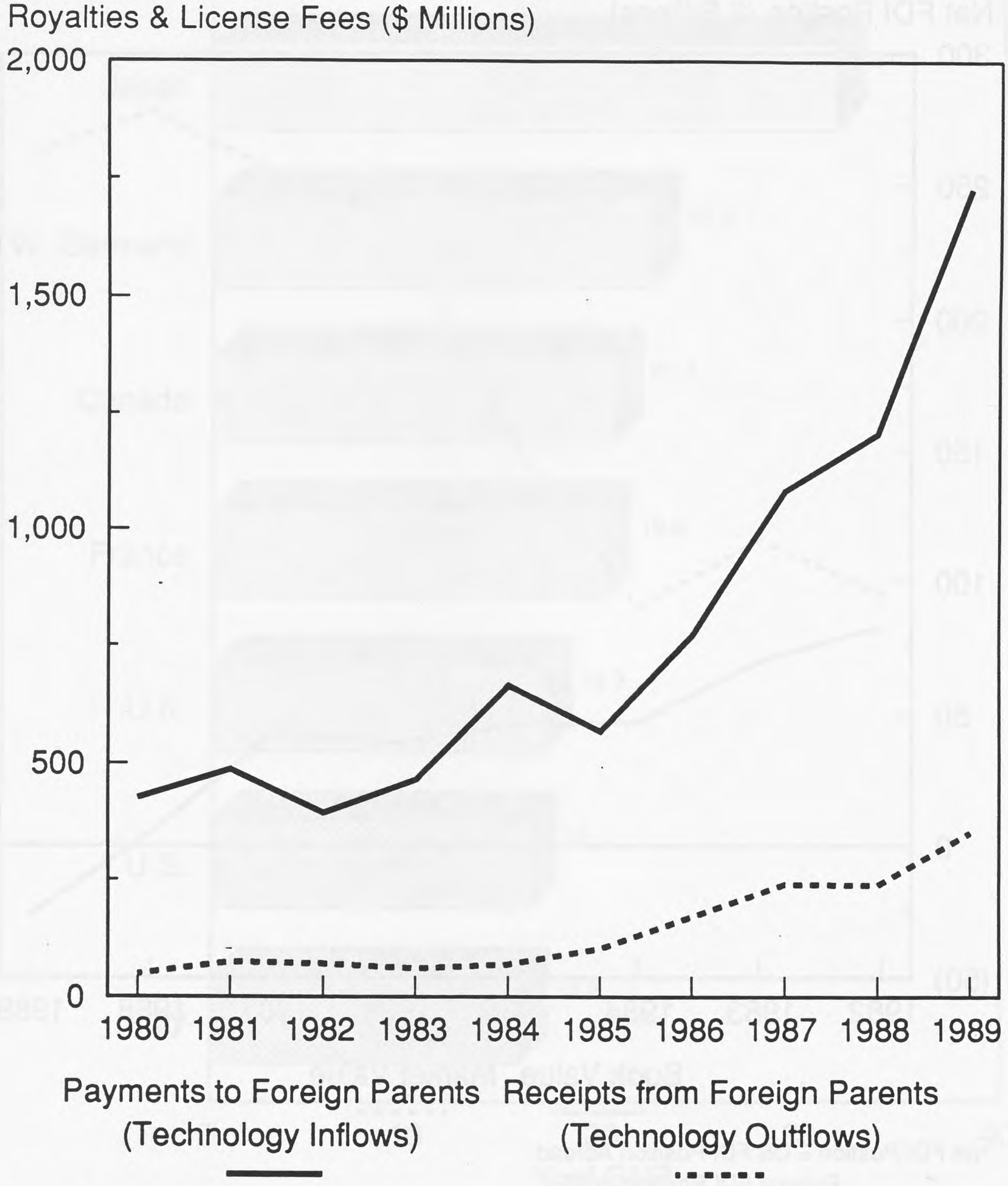
BECAUSE MUCH U.S. FDI ABROAD IS OLDER WHILE MUCH FDI IN US IS NEW, WHEN REVALUED AT MARKET VALUES, U.S. REMAINS LARGE NET CREDITOR



Net FDI Postion = US FDI Position Abroad - Foreign FDI Position in US

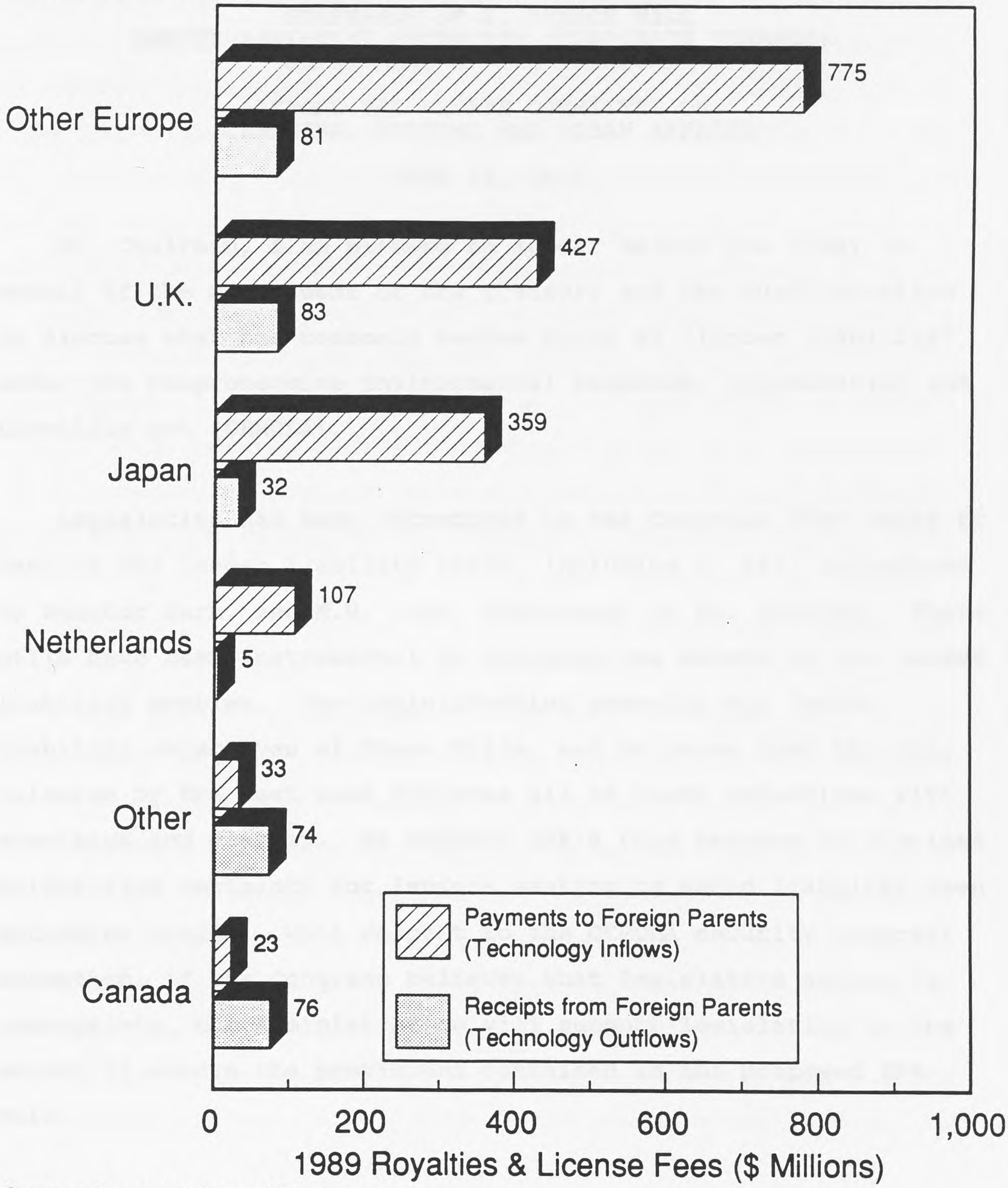
Source: Commerce Department 6/9/91 Press Release

USING PAYMENTS OF ROYALTIES & LICENSE FEES TO MEASURE TECHNOLOGY FLOWS, FDI IN THE US PROVIDES LARGE NET INFLOW OF TECHNOLOGY



Source: Survey of Current Business

USING PAYMENTS OF ROYALTIES & LICENSE FEES TO MEASURE TECHNOLOGY FLOWS, FDI IN THE US PROVIDED NET INFLOW OF TECHNOLOGY FROM MOST COUNTRIES



Source: Survey of Current Business

TREASURY NEWS

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

STATEMENT OF J. FRENCH HILL
DEPUTY ASSISTANT SECRETARY (CORPORATE FINANCE)
DEPARTMENT OF THE TREASURY

BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

JUNE 12, 1991

Mr. Chairman, I am pleased to appear before you today on behalf of the Department of the Treasury and the Administration to discuss what has commonly become known as "lender liability" under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA).

Legislation has been introduced in the Congress that seeks to resolve the lender liability issue, including S. 651, introduced by Senator Garn, and H.R. 1450, introduced by Mr. LaFalce. These bills have been instrumental in focusing the debate on the lender liability problem. The Administration supports the lender liability objectives of these bills, and believes that the rule released by EPA last week achieves all of those objectives with precision and clarity. We support EPA's rule because it provides bright-line certainty for lenders seeking to avoid liability when extending credit. With respect to the CERCLA security interest exemption, if the Congress believes that legislative action is appropriate, the Administration will support legislation to the extent it enacts the provisions contained in the proposed EPA rule.

NB-1322

We are aware that the Committee is concerned that the EPA rule may not effectively bind third-party plaintiffs who may bring suit under CERCLA. This issue is addressed in both S. 651 and H.R. 1450. It is the position of the Administration that the EPA rule, which is a legislative rule, has the force and effect of law and will bind third-party actions.

Both bills also would clarify the security interest exemption with respect to both CERCLA and the Resource Conservation and Recovery Act of 1976 (RCRA). Although the EPA rule only clarifies lender liability in the context of CERCLA, the Administration is aware that there may be a similar issue with respect to liability of lenders under the underground storage tank provisions of RCRA. The Administration believes that the secured creditor provisions of RCRA should be similarly interpreted and applied.

We also are aware that there are a number of other issues of concern to the Committee that could not be addressed by the EPA rulemaking because they involve matters outside the statutory scope of CERCLA. For example, S. 651 contains two provisions intended to make it easier for the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) to dispose of property they acquire when acting as conservators or receivers of failed depository institutions. The first would provide that the initial purchaser of contaminated property from the FDIC or RTC would be immune from strict liability under

CERCLA as an owner or operator. The Administration would support such a provision because it would save taxpayer money by facilitating the disposition of property held by the FDIC and RTC, provided that it also is consistent with our environmental objectives. We believe such a provision would be consistent with our environmental objectives if it conditions initial purchaser immunity on a commitment by the purchaser to clean up the property consistent with the national contingency plan and makes it clear that the purchaser would remain fully liable for any action it takes that threatens or causes the release of hazardous substances.

The second would exempt Federal banking and lending agencies from the CERCLA section 120(h) covenant requirements when they dispose of property acquired in connection with a conservatorship or receivership, through foreclosure on a loan or guarantee, or in civil or criminal law enforcement actions. This issue is not new to the Administration, and has been the subject of an EPA regulation. The Administration firmly believes that all Federal agencies should be fully subject to the covenant requirements with respect to property owned in a proprietary capacity. We also believe that such requirements should not apply to property acquired in the manner described in S. 651 or to property acquired by any agency and held in a temporary custodial capacity for subsequent sale or other disposition.

The EPA rule achieves this result in the context of the security interest exemption because a security holder who satisfies the exemption is not an "owner" for purposes of CERCLA and would therefore not be subject to the requirements of section 120(h). The Administration believes that further clarification of the section 120(h) obligations for Government entities that are innocent landowners under CERCLA can be accomplished administratively, but would not object to appropriate legislative clarification.

Similarly, both S. 651 and H.R. 1450 seek to provide some degree of protection from liability for persons who acquire property in a fiduciary capacity. We believe that such persons are similarly situated to holders of security interests, and that they should be treated accordingly. For example, we do not believe that a trustee in bankruptcy or an executor or administrator of a decedent's estate should be personally subject to strict liability under CERCLA and that any environmental liability of the estate should be limited to the assets of the estate. However, we are concerned that an otherwise culpable person might be able to invoke the guise of a fiduciary to escape liability. For this reason, any legislative provision to protect fiduciaries must be carefully crafted. Finally, consistent with our environmental objectives, the provision must make it clear that a fiduciary is liable for any action it takes that threatens or causes the release of hazardous substances.

Similarly, S. 651 would provide equal treatment of Federal entities and States under CERCLA. Again, to the extent that such provisions are consistent with our environmental objectives, the Administration would support equal treatment of States and Federal entities.

Turning back to lender liability, which is the subject of last week's EPA proposed rule, it is important to emphasize at the outset that the issues involved in "lender liability" affect more than private lenders, such as banks and other financial institutions, although they are certainly the most obviously affected. The same issues are of critical concern to --

- the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) when they become conservators or receivers of troubled or failed depository institutions;
- all Federal agencies that lend funds, guarantee or insure loans, or guarantee mortgage-backed securities, such as the Farmers Home Administration (FmHA), the Small Business Administration (SBA), the Department of Energy, the Department of Veterans Affairs, the Department of Housing and Urban Development, and the Government National Mortgage Association (GNMA);
- all Federal agencies that acquire security interests in the course of carrying out their statutory functions, such as through the seizure and forfeiture of assets of drug traffickers; and
- non-lending Federal agencies such as the Internal Revenue Service, which can acquire property through a lien for delinquent taxes, and the U.S. Customs Service which can acquire liens on vessels by operation of law.

In general, CERCLA imposes strict liability on owners and operators of property for the release or threatened release of hazardous substances. When it enacted CERCLA in 1980, the Congress made special provisions to exempt from this strict liability persons who, without participating in the management of a borrower's business, hold indicia of ownership, such as a deed of trust or mortgage, to protect a security interest. The intention of the exemption is that a lender who holds title to property primarily to protect a security interest (a mortgage is the typical example) is exempt from strict liability, even if the lender is forced to acquire the property by foreclosure. The Administration strongly supports this rational and commercially necessary exemption from liability.

Underlying the lender liability issue is the extent to which CERCLA contemplates that bankers and other lenders are to assume the role in our society of insuring or guaranteeing the environmental purity of borrowers. We find nothing in CERCLA to support such a contention. Neither CERCLA nor EPA's rule imposes any requirement that lenders conduct environmental audits or inspections prior to lending funds, or any requirement that they ensure that their borrowers act consistent with environmental laws or regulations. Instead, the security interest exemption only demands that lenders refrain from participating in the management of a borrower's enterprise when holding indicia of ownership to protect a security interest.

However, as a result of a few recent court decisions, there is now uncertainty regarding the scope of the security interest exemption. Banks and other lenders do not know when, in the course of ordinary dealings with a borrower, they may be deemed to participate in the management of a borrower's business and therefore incur strict liability under CERCLA. This uncertainty places an invisible barrier between lender and borrower and is generally destabilizing to the banking system because it discourages the conduct of normal business relationships, particularly when a borrower is having financial troubles. Similarly, lenders do not know what actions taken to protect a security interest -- such as foreclosure -- will void the exemption.

Because there are instances where lenders have been held strictly liable under CERCLA, we believe there has been an overall chilling effect on both commercial and industrial and real estate lending. Many lenders are simply not making loans to borrowers whose businesses involve hazardous substances or whose properties may have been associated with hazardous substances under a prior ownership. Moreover, many lenders are walking away from their secured collateral and not foreclosing on bad loans for fear of environmental liability, thereby incurring losses that weaken the banking system. Lenders are also refusing to extend additional credit to troubled borrowers, which can result in bankruptcy and layoffs.

If we allow this situation to continue, we believe there are potentially serious consequences for our economy, the Federal deposit insurance funds, and our efforts to clean up the environment.

We believe that lender uncertainty over CERCLA liability is exacerbating the "credit crunch" and may well jeopardize our economic recovery and growth. To the extent Federally insured depository institutions incur strict liability under CERCLA, that liability poses a serious threat to the Federal deposit insurance funds and all taxpayers. The cost of a CERCLA cleanup and attendant liability could erode minimum capital levels and force an institution into Federal conservatorship or receivership at a significant cost to the Federal deposit insurance funds.

To the extent that Federal lending agencies continue to be exposed to strict liability under CERCLA merely because they are carrying out their statutory mandates, those programs will be curtailed as funds intended for loans are diverted to pay CERCLA liability, and as agencies limit program operations for fear of incurring liability.

If Federal law enforcement agencies continue to be exposed to strict liability under CERCLA merely because they seize and forfeit property of persons who violate the law, critical tools will be eliminated from our law enforcement arsenal.

Finally, exposing lenders to the risk of strict CERCLA liability merely because they extend credit simply is not consistent with sound environmental policy. Instead of fostering a climate in which the lending community is a willing partner in our national efforts to clean up the environment by loaning the necessary funds, the uncertainty of lender liability is denying financial resources to those businesses and geographic areas that need them the most.

The Administration is committed to providing private and governmental lenders, other holders of security interests, and the FDIC and RTC with clear and unambiguous certainty concerning their potential liability under CERCLA. Resolving the lender liability issue will benefit lenders, Federal agencies, the economy and the environment.

Since last fall, the Departments of Treasury and Justice, many other Federal agencies, and the President's Council on Competitiveness, have been working with EPA to develop a rule that would resolve the lender liability problem. This has been difficult task in view of the legitimate competing policy interests involved. We are pleased that EPA has been able to develop a rule that provides the certainty needed by lenders, properly protects Federal agencies, and maintains effective protection of the environment.

The rule provides unambiguous guidance to private and Governmental lenders and holders of security interests as to how they may avoid strict liability under CERCLA. However, because clarification of the CERCLA security interest exemption alone was insufficient to protect the FDIC, RTC and other Government-appointed conservators and receivers of failed depository institutions from unwarranted CERCLA liability, the EPA rule also provides that the acquisition of conservatorship and receivership assets constitutes an involuntary transfer under CERCLA. The effect of the rule is to address the three classes of assets of a failed depository institution that can be acquired by Government-appointed conservators and receivers:

- <u>Loan Portfolio</u>. With respect to performing and problem loans where the collateral is in the possession of the borrower, Government-appointed conservator or receiver is a successor-in-interest entitled to fully assert the protections accorded holders in the rule.

- <u>Property Previously Foreclosed</u>. With respect to property foreclosed upon by a depository institution prior to the appointment of a conservator or receiver, if the depository institution is entitled to the security interest exemption, the Government-appointed conservator or receiver is again a successor-in-interest security holder fully protected by the exemption.

  Even if the depository institution may not be entitled to the security interest exemption (<u>e.g.</u>, it impermissibly participated in its management), the EPA rule deems the Government-appointed conservator or receiver to have acquired the property through an involuntary transfer for purposes of the defense to liability available under CERCLA section 101(35).

- <u>Investment and Other Proprietary Property</u>. With respect to such property, the rule deems the Government-appointed conservator or receiver to have acquired the property through an involuntary transfer under section 101(35).

The EPA proposed rule released last week embodies the following principles:

PRIVATE AND GOVERNMENTAL LENDERS AND HOLDERS OF SECURITY INTERESTS

- PRE-LOAN ACTIVITIES. Strict liability under CERCLA cannot result from any action taken prior to the creation of a security interest.

  This principle is critical to lender liability because it permits lenders, without fear of CERCLA liability, to conduct environmental inspections and audits, and to condition a loan upon necessary corrective action by a borrower.

- PARTICIPATION IN MANAGEMENT WHILE BORROWER IN POSSESSION OF COLLATERAL. Strict liability under CERCLA cannot result while the borrower is in possession of the collateral unless the holder of the security interest participates in the management of the borrower's affairs by either --

  - exercising actual decisionmaking control over the borrower's environmental compliance, such that the holder has undertaken responsibility for the borrower's waste disposal or hazardous substance handling practices which results in a release or threatened release, or

  - exercising control at a management level encompassing the borrower's environmental compliance responsibilities comparable to that of a manager of the borrower's enterprise, such that the security holder has assumed or manifested responsibility for the management of the enterprise by establishing, implementing and maintaining the policies and procedures encompassing the day-to-day environmental decisionmaking of the borrower's enterprise.

  This principle (1) encourages the maximum amount of cooperation between lenders and borrowers, (2) ensures that ordinary and customary dealings between lenders and borrowers do not result in strict liability under CERCLA, and (3) clarifies that CERCLA strict liability does not arise if a lender provides financial advice and other services in areas totally unrelated to environmental compliance.

- <u>POST-FORECLOSURE PROTECTION OF THE SECURITY INTEREST</u>.

  A foreclosing security holder is deemed to be acting to protect the security interest and therefore not subject to CERCLA strict liability unless it is shown that the security holder has held the property for any other purposes as evidenced by --

  - a failure to offer the property for sale or to otherwise seek to divest his interest in the property, or

  - a rejection of a bona fide written offer of fair consideration from a qualified purchaser.

  This principle recognizes that lenders are ordinarily not in the business of investing in foreclosed collateral -- they are in the business of making loans. In fact, the law prohibits national banks from holding real property for investment purposes, and provides that they may hold foreclosed property for up to 10 years if that is necessary to recover on a bad loan (see 12 U.S.C. 29). For this reason, the rule provides that a foreclosing lender will be protected from CERCLA liability as long as it continues to protect the security by making a good faith effort to sell or otherwise divest foreclosed collateral for fair consideration.

  This principle also furthers two legitimate policy objectives:

  - It protects the real estate market by ensuring that lenders are not forced to "dump" foreclosed properties in times of weak markets thereby further depressing real estate values.

  - It avoids forcing lenders to wind down an ongoing enterprise -- a shopping center or a factory for example -- to avoid CERCLA liability. Not only may winding down operations reduce the value of the collateral and make it more difficult to sell, but it also eliminates jobs, reduces the tax base of State and local governments, and increases government unemployment compensation costs.

- <u>BURDEN OF PROOF</u>. The burden should be on the plaintiff seeking to impose strict liability on a security holder to prove --

  - that a holder participated in management (as defined above) while the borrower was in possession of the collateral, or

- o that a foreclosing holder has not acted to protect the security interest (as defined above).

GOVERNMENT-APPOINTED CONSERVATORS AND RECEIVERS

- o Government-appointed conservators and receivers (including the FDIC and the RTC) are entitled to assert the security interest exemption with respect to the loan portfolios (including already foreclosed upon properties) of troubled or failed depository institutions.

- o Government-appointed conservators and receivers are deemed to involuntarily acquire the assets of troubled or failed depository institutions and therefore have a defense to CERCLA liability under section 101(35).

- o To the extent liability attaches to property in a Government conservatorship or receivership, liability of the Government-appointed conservator or receiver shall not exceed the market value of the property less the amount of the security interest.

These principles protect the Federal deposit insurance funds from becoming a deep-pocket, either directly or indirectly, for CERCLA liability.

Finally, the Administration also is seriously concerned about another problem unrelated to the question of lender liability, which is addressed partially by S. 651 and not addressed by H.R. 1450. This concerns the potential CERCLA liability attaching to acquisitions of property of Federal agencies that are "involuntary" in nature but not in the context of Government-appointed conservatorship or receivership.

Many Federal agencies, particularly the law enforcement agencies of the Departments of Justice and Treasury that seize and compel forfeiture of property need assurances that such actions will not subject them to CERCLA liability. The same is true with respect to specific property the acquisition of which is required by an Act of Congress, or is incidental to the enforcement of a civil, administrative or criminal fine or penalty. The Administration strongly supports the proposed language in the EPA rule that would provide protection in the context of seizures and forfeitures, and is prepared to extend this principle to other involuntary acquisitions of property by Federal entities where appropriate.

This concludes my formal remarks, and I would be pleased to answer any questions you and the Committee may have.

TREASURY NEWS

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

For Release Upon Delivery
Expected at 2:00 PM
June 12, 1991

STATEMENT OF THE HONORABLE
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
FOR FINANCE
BEFORE THE
SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
JUNE 12, 1991

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before this Subcommittee to discuss the reauthorization of Treasury's rulemaking authority under the Government Securities Act of 1986 ("GSA" or "Act") as reflected in the legislation we have recently transmitted to the Congress entitled, "The Government Securities Act Amendments of 1991."

First, I will summarize Treasury's role in developing and implementing rules for the government securities market and the effectiveness of those rules in meeting the objectives set forth by Congress in enacting the GSA. Then I will discuss the legislation we have proposed that would: (1) extend Treasury's existing rulemaking authority; (2) grant Treasury additional rulemaking powers in the area of sales practices; (3) lift the restriction that currently precludes the National Association of Securities Dealers (NASD) from adopting government securities sales practice rules for its members; (4) grant Treasury discretionary authority to prescribe rules to ensure disclosure of and access to government securities price and volume information; and (5) make technical and conforming changes to the Securities Exchange Act of 1934.

DEVELOPING RULES TO ENSURE FAIR AND EFFICIENT MARKETS

The GSA established, for the first time, a federal system for the regulation of the entire government securities market, including previously unregulated brokers and dealers, in order to protect investors and to ensure the maintenance of a fair, honest, and liquid market. The GSA also assigned Treasury authority for developing and implementing rules pertaining to financial responsibility, protection of customer securities and funds, recordkeeping, reporting and auditing with respect to transactions in government securities conducted by government securities brokers and dealers (i.e., securities firms as well as financial institutions). The Act also called for Treasury to issue regulations relating to the custody of government securities held by depository institutions that are not government securities brokers or dealers. It was the expectation of Congress that Treasury would design rules to prevent fraudulent and manipulative acts and practices, to protect the integrity, liquidity, and efficiency of the government securities market, and to protect the public interest. At the same time, the rules were expected to preclude unfair discrimination between brokers, dealers, and customers, and avoid imposing any unnecessary burden on competition.

Treasury issued the final implementing regulations on July 24, 1987, in compliance with the requirements of the Act. In developing the regulations, Treasury consulted extensively with the Securities and Exchange Commission (SEC), the Board of Governors of the Federal Reserve System (Federal Reserve Board), the other regulatory agencies, and government securities market participants. This consultation and coordination throughout the rulemaking process provided an effective means for the affected entities to raise issues and to express their views concerning various provisions of the regulations.

In order to prevent excessive and duplicative regulation and to minimize compliance burdens, the GSA rules, for the most part, incorporated existing rules of the SEC and bank regulatory agencies. Treasury did, however, adopt a different capital rule for specialized government securities brokers and dealers (which were not registered prior to the GSA) and new rules for hold-in-custody repurchase transactions. As a result, the regulations imposed as few new requirements as possible on those government securities brokers and dealers that were already registered with the SEC as generalist firms or on financial institution broker-dealers that were subject to bank regulatory agency rules. Thus, the GSA regulations had the most significant effect on those entities that, prior to the enactment of the GSA, were not subject to any program of federal registration and regulation.

We believe the final GSA rules reflected a deliberate and responsive approach to regulating the government securities market, with due regard to striking the proper balance between strengthening customer protection (e.g., hold-in-custody repurchase transaction rules and financial responsibility standards) and ensuring the continued liquidity and efficiency of the market. The regulatory agencies, the General Accounting Office , market participants, and industry representatives all agree that Treasury has done a good job of regulating the government securities market.

In part, the GSA was a response to abusive practices by several firms in the repurchase transaction market. These abuses resulted in large customer losses when the firms failed. As a result, one specific area that Congress targeted was the strengthening of customer protection in hold-in-custody repurchase transactions. Due to the several requirements imposed by Treasury's rules -- written repurchase agreements must be in place, certain risks of the transaction must be disclosed to the customer, specific securities must be allocated to and segregated for the customer, and confirmations must be issued -- we believe, as do many market participants, the various regulatory agencies and the GAO, that there now exists a greater degree of customer protection in the repurchase agreement market.

Enforcement of the GSA regulations and supervision of the government securities brokers and dealers by the federal regulatory agencies and self-regulatory organizations has varied. We believe that regular and frequent examinations and timely dissemination of information by the regulatory agencies to the institutions they supervise are essential to ensure that the goals of the GSA are being met. Overall, based on examinations of the government securities brokers and dealers conducted by the regulatory agencies and self-regulatory organizations, the level of compliance with the GSA regulations is satisfactory. Although the agencies have reported violations of the regulations by some institutions, most of the instances of noncompliance were easily correctable and stemmed from misunderstandings of the new rules.

We believe that the actions taken by Treasury, the federal regulatory agencies and the self-regulatory organizations in implementing the GSA regulations have successfully met the objectives established by Congress in enacting the GSA. The rules have been timely and fairly implemented and have improved and strengthened investor safety in the market. At the same time, the rules have not imposed excessive and overly burdensome requirements and have not impaired the liquidity, efficiency and integrity of the government securities market. Most importantly, no customers have lost any funds or securities in those instances where government securities brokers or dealers have failed or discontinued business since the inception of the GSA regulations.

EXTENSION OF TREASURY'S RULEMAKING AUTHORITY

In enacting the GSA, Congress imposed an October 1, 1991, sunset on Treasury's rulemaking authority over the government securities market. Without an extension, Treasury's prospective rulemaking and exemptive authority will cease. We believe that Treasury's continued regulatory presence in the market is required.

In its deliberations on the GSA, Congress recognized the importance of maintaining the liquidity and efficiency of the government securities market. In addition, any regulatory activity must be balanced with its impact on both the market and the cost of Treasury borrowings. As I have just recounted, Treasury's rulemaking has been effective in achieving the purposes of the GSA.

The implementation and administration of the GSA has strengthened investor protection and heightened investor confidence without significant adverse impact on the government securities market and its participants. Much of this result can be attributed to the on-going and effective consultation and coordination among Treasury, the SEC, the Federal Reserve Board, and the various other enforcement and self-regulatory entities. Continued effectiveness in regulating the government securities market requires a continuation of these relationships.

Because the government securities market encompasses the activities of both registered brokers and dealers and financial institutions, a single rulemaker must be empowered to ensure that appropriate government securities regulations are in place for all market participants.

Treasury is in the best position to act as the federal agency overseeing the government securities market because Treasury has a comprehensive understanding of the market and, as issuer, is concerned with maintaining market integrity and efficiency. Market efficiency and integrity benefit the public by minimizing the cost of government borrowing. In addition, Treasury as the single rulemaker can assure that appropriate regulations are in place for all market participants. These factors enhance Treasury's ability to coordinate the views of the various entities and to ensure that the interests of all parties are considered. Treasury's role as rulemaker provides balanced regulatory treatment among the various market participants, and provides the necessary knowledge and expertise to address possible changes in the structure of the dynamic government securities market.

Accordingly, we recommend that Congress extend Treasury's rulemaking authority by enacting the legislation we have proposed that would delete the sunset provision contained in the GSA. The extension of Treasury's authority is supported by the SEC and the Federal Reserve Board -- as recommended in the joint report with Treasury that was submitted to Congress in October 1990 -- and the GAO in its September 1990 report to Congress. In addition, the NASD, the New York Stock Exchange, the Public Securities Association, the American Bankers Association, and all of the bank regulatory agencies support the extension of Treasury's authority.

SALES PRACTICE RULES

Sales practice rules govern a broker-dealer's business relationship with its customers. Such rules are generally intended to ensure, among other things, that broker-dealers conduct fair dealings with customers, that the securities purchased are suitable investments, and that transactions are priced fairly and reasonably. The scope of the GSA and the regulatory authority granted thereunder were limited to those areas of documented abuse and weakness in the government securities market (e.g., unregistered firms, hold-in-custody repurchase transactions), because of the concern that excessive regulation would impair the efficient operation of the market.

Consequently, the GSA did not grant Treasury the authority to prescribe sales practice rules pertaining to transactions in government securities. Additionally, the GSA continued the restriction placed on the NASD that prohibits it from applying its sales practice rules to the government securities transactions conducted by its members. The GSA did, however, authorize the NASD to write rules prohibiting fraudulent, misleading, deceptive or false advertising in connection with the sale of government securities. It should be noted that the registered securities exchanges are permitted to apply their sales practice rules to their members' government securities transactions.

Need for Sales Practice Rules

It is difficult to assess the magnitude and severity of the problem given the lack of specific evidence of widespread sales practice abuses. Indeed, some of the well publicized cases involving customer losses in government securities transactions may not have stemmed solely from abusive sales practices. Nevertheless, the fact is that the government securities market is the only regulated securities market in the United States that does not have broadly applicable sales practice rules. Such rules have become a fixture in all of the securities markets in the United States but, currently, such rules are not imposed for the vast majority of transactions in government securities. The same kinds of abuses that made sales practice rules necessary in the corporate, municipal and penny stock markets may well occur in the government securities market. By applying sales practice rules to the government securities market, investors would benefit from protection similar to those afforded them in other markets. The Treasury clearly wants to prevent unscrupulous brokers and dealers, who may have operated in these other markets until the advent of sales practice rules in those arenas, from gravitating to the government securities market.

The government securities market remains principally a wholesale market in which brokers, dealers, large commercial banks and experienced institutional investors have sufficient knowledge and bargaining power to reduce or eliminate the need for protection afforded by sales practice rules. It is also true that a significant number of smaller and less experienced investors also participate in this market. Our area of concern is not the large, institutional investors, who should be expected to have the knowledge to judge the suitability of particular securities, but the smaller, less sophisticated customers who are attracted to participating in the government market because of their desire for safe and secure investments. Additionally, the government securities market increasingly encompasses instruments that can pose greater risk of adverse price movements than traditional investments in Treasury or agency securities. These instruments include mortgage-backed securities, including collateralized mortgage obligations issued or guaranteed by Government agencies; zero-coupon securities such as STRIPS and agency IOs and POs; and over-the-counter options. Some of these products are quite similar to registered securities that are already subject to sales practice rules or that trade in combination strategies with instruments that are covered by such rules. Even though many of these securities are backed by a U.S. government guarantee and are attractive due to their higher returns, unsophisticated investors may not fully understand their complexity, risks and speculative nature. Further, some of these securities do not have readily available pricing information to enable customers to independently determine their market value.

The SEC has authority under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) to promulgate and enforce rules prohibiting fraudulent, manipulative, and deceptive acts and practices. However, the adoption of sales practice rules for the government market would enable the regulatory agencies to take disciplinary actions without having to prove intent by the broker-dealer to defraud a customer. Currently, sales practice abuses in most of the government market must be so egregious as to rise to the level of fraud before any action can be taken.

<u>Treasury Legislative Proposal for Sales Practice Rules</u>

For these reasons, we urge Congress to adopt Treasury's regulatory proposal for government securities sales practice rules. The proposal would:

1. Grant Treasury the authority to prescribe government securities sales practice rules reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices for all government securities brokers and dealers;

2. Grant Treasury the authority to adopt sales practice rules reasonably designed to promote just and equitable principles of trade for financial institutions that have filed notice as government securities brokers or dealers; and

3. Authorize the NASD to adopt government securities sales practice rules for its members, subject to approval by the

SEC in consultation with Treasury. Any NASD rules must be consistent with Treasury sales practice rules.

Granting Treasury rulemaking authority for sales practices pertaining to transactions in government securities would be consistent with the regulatory structure set out in the GSA. Treasury was selected as the sole rulemaker due to its expertise in the market, its interest in balancing customer protection with the need to preserve the efficiency and liquidity of the market, and its ability to provide balanced regulatory treatment among the various market participants. This regulatory approach would continue to recognize Treasury's knowledge of the market and its responsibility, as the largest issuer, to ensure that any sales practice rules, while strengthening customer protection, would not impair the liquidity or efficiency of the market or increase the cost of financing the public debt.

Regarding any potential concern that granting Treasury rulemaking authority over sales practices would raise a conflict of interest given our role as issuer, this issue was addressed by the Senate Banking Committee during its deliberations on the GSA in 1986. The Committee satisfied itself that there would be no conflict of interest and expressed its confidence that Treasury would "... fully and faithfully pursue the rulemaking authority granted ..." Further, we believe our actions as GSA rulemaker over the past four years should resolve any such concerns. Treasury has demonstrated its commitment to effective regulation of the government securities market by issuing balanced and fair rules that do not unfairly discriminate among market participants and, more importantly, that do not advantage Treasury securities over other government securities.

We believe sales practice rules must apply to all government securities broker-dealers -- both bank and non-bank broker-dealers -- to ensure a level playing field for all market participants. This is consistent with the GSA mandate that any rules should be designed in such a manner that does not permit unfair discrimination between government securities brokers and dealers or customers. Accordingly, vesting rulemaking authority with Treasury would ensure that sales practice rules would provide comparable protection to customers of both bank and non-bank broker-dealers.

We also urge that Congress rescind the current restriction on the NASD's authority regarding sales practice rules. Such action would be consistent with the Congress' prior decision to use the expertise of self-regulatory organizations. The legislative history preceding the Securities Acts Amendments of 1975, in reaffirming the system of self-regulation, cited as an advantage of self-regulation, "the expertise and intimate familiarity with complex securities operations which members of the industry can bring to bear on regulatory problems, and the informality and flexibility of self-regulatory procedures."

Lifting the NASD restriction would put to use its expertise and experience in implementing sales practice rules it has developed for other markets. It would also capitalize on the NASD's knowledge of the business practices of its members, its ability to provide for inter-market comparability, its flexibility in updating its rules to stay abreast of market developments, and its role as a member of the securities industry.

Approach to Sales Practice Rules

Although it is too early to know the precise parameters of any sales practices rules, three areas that may require attention are excessive mark-ups, suitability of recommendations to customers, and unauthorized trading. In developing sales practice rules, we will consider whether different standards are needed based on the complexity and risks of the various securities and whether distinctions need to be made based on the type of customer (i.e., institutional or sophisticated versus retail or individual) involved in the transaction. As has been our practice, we will attempt to model our rules upon existing rules of the SEC, NASD, New York Stock Exchange and Municipal Securities Rulemaking Board (MSRB), where appropriate. Finally, Treasury will consult with the industry, the regulatory agencies and the self-regulatory organizations during the development of the rules.

Strengthening Market Integrity and Investor Confidence

We believe that the extension of sales practice rules to the government securities market will strengthen investor confidence and integrity in the market and will significantly enhance customer protection. Sales practice rules should not result in excessive burdens or significantly increase costs because diversified firms already must comply with sales practice rules for their corporate and municipal securities activities and banks that conduct a business in municipal securities must comply with MSRB sales practice rules. Any rules proposed by Treasury would be designed so that the benefits in terms of customer protection will outweigh any increased regulatory costs or burdens, which we believe would be minimal, in any event.

ACCESS TO GOVERNMENT SECURITIES PRICE AND VOLUME INFORMATION

Public Interest Benefits

Treasury supports expanded disclosure of and access to government securities price and volume information. Expanded information access would serve to enhance customer protection, since customers would be in a better position to determine actual or potential transaction prices for securities, especially for inactively traded issues, and to evaluate the fairness of trades being proposed by a broker or dealer. Moreover, we believe the expanded availability of such information would serve the public interest because it would ensure that a broad spectrum of market participants could obtain current, accurate facts related to market conditions, and thus, the competitiveness, liquidity and efficiency of the government securities market would improve.

Greater access to price and volume information will also foster increased competition between dealers since market quotes will be more widely disseminated. Improvements in the derivative markets are also likely to accrue due to the availability of more timely and accurate information on the underlying securities used for pricing and hedging strategies. Further, access to more accurate price information will enhance the ability of regulatory examiners and independent auditors to carry our their respective responsibilities to ensure that securities transactions and positions are valued appropriately.

Industry Efforts

The need for increased access to government securities price and volume information has been a topic of discussion for a number of years. In its 1987 report, the GAO recommended that market participants be provided increased access to government securities pricing information. At that time, the GAO did not support a federal regulatory structure to achieve expanded access because it believed private sector initiatives, which could obviate the need for such action, should be allowed time to develop price disclosure systems.

In its follow-up report issued in September 1990, the GAO recommended that Congress legislatively mandate that government securities transaction information be made available on a real-time basis to anyone willing to pay the appropriate fees. GAO further recommended that regulatory authority be assigned to Treasury to prescribe regulations as needed to ensure that such transaction information is available. We fully support the recommendation to grant Treasury this rulemaking authority.

We believe the need for federal regulation is appropriate given that there has been no significant increase in the dissemination of government securities price information over the last four years. This is highlighted by the number of unsuccessful attempts by various market participants to develop price disclosure systems. However, two private sector initiatives, that have been in development for several months and are nearing implementation, hold promise for expanded access.

One initiative, an industry-wide joint venture known as GOVPX, Inc., will disseminate real-time price and quotation information on all Treasury bills, notes and bonds on a 24-hour, global basis. This information will be provided to on-line vendors for redistribution to the public. GOVPX is scheduled to be operational on June 16. A second initiative involves Electronic Joint Venture Partners (EJV) which plans to introduce a new computerized trading system where broker-dealers will arrange their purchases and sales electronically. EJV will also deliver real-time market information to the financial services industry.

Federal Regulatory Structure Still Needed

Treasury fully supports the efforts undertaken by private sector initiatives such as GOVPX and EJV in developing systems to disseminate government securities price and volume information. However, we believe that the development of these two systems was significantly influenced by regulatory demands for improved public access and the growing pressure for a federal regulatory presence in this area. We also believe federal rulemaking authority should be granted, as a backstop, to ensure that any private sector information dissemination systems are adequate, fair and reasonable, although it may not be necessary to use this authority.

An example of the potential use of rulemaking authority would be to ensure that information disclosure systems, such as GOVPX, collect and distribute price and volume information on mortgage-backed securities and zero-coupon securities, in addition to Treasury bills, notes and bonds. Another example would be to ensure that such systems provide the best offer for a security rather than the offer accompanying the best bid (as provided by GOVPX) since the best offer affords market participants a more accurate reflection of market prices.

Treasury Legislative Proposal

To provide the public with the benefits of expanded access, we urge Congress to grant Treasury discretionary authority, similar to the existing authority of the SEC with respect to non-exempt securities transaction information, to regulate disclosure of and access to government securities price and volume information. We believe it is in the best interest of the market if private sector initiatives develop systems to disseminate government securities price information. However, given their past record, discretionary rulemaking authority vested at Treasury is necessary in the event these efforts are not successful or do not provide adequate information. The GAO has also recommended that Treasury be the rulemaker for information access.

Given our expertise in the government securities market, Treasury is in the best position to evaluate the reasonableness and sufficiency of information disclosure systems and their effect on competition and safety of the market, and to prescribe rules, if necessary, to ensure that price dissemination arrangements are fair and beneficial to the operation of the government securities market and its participants.

TECHNICAL AND CONFORMING AMENDMENTS

Treasury's proposed legislation also contains several technical and conforming amendments to the Exchange Act which we urge the Congress to adopt. Two amendments revise the definition of the term "appropriate regulatory agency." These changes are intended to make supervisory responsibilities under the GSA consistent with existing bank regulatory agency supervisory responsibilities regarding certain financial institutions that are government securities brokers or dealers. Two conforming amendments respond to changes in nomenclature under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Another amendment involves adding to the Exchange Act a new definition for the term "government securities information processor." The final technical amendment clarifies an information sharing provision in the GSA.

CONCLUSION

Among the reasons Treasury was designated as the rulemaker in 1986 was the need for effective coordination among the interested federal agencies. This coordination is becoming ever more critical in light of the accelerating pace of innovation and growth in the government securities market.

The Treasury has used this unique position to assure that regulations governing the market were written and applied in an even-handed way to both bank and non-bank broker-dealers. The need to rely on Treasury's position, perspective and broad expertise in the market has not diminished. Rather, strengthening Treasury's regulatory role will become increasingly vital as the legal and operational barriers separating the businesses of the different government securities market players become less significant, highlighting the need for balanced treatment for all market participants.

The legislation we have proposed will strengthen Treasury's ability to ensure that any regulations will not impair the safety, integrity, liquidity, and efficiency of the market while also being responsive to the need of strengthening customer protection. Finally, in addition to these factors, Treasury is in the best position to act as the principal agency overseeing the government securities market due to its interest in ensuring that any rules do not inadvertently damage the market, thus increasing the government's cost of borrowing or reducing investor confidence.

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

TEXT AS PREPARED
FOR RELEASE UPON DELIVERY
EXPECTED AT 2 P.M.
JUNE 12, 1991

STATEMENT BY
THE HONORABLE DAVID C. MULFORD
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON
DEFICITS, DEBT MANAGEMENT AND INTERNATIONAL DEBT
FINANCE COMMITTEE
UNITED STATES SENATE

I welcome this opportunity to discuss today two financial issues which are of continuing concern in this Hemisphere: capital flight and debt. The Administration is addressing these problems through both the Strengthened Debt Strategy and the Enterprise for the Americas Initiative (EAI).

The prospects for future economic development in Latin America and the Caribbean will be largely dependent on policies which attract new capital investment. In many instances these policies are now being implemented and represent a significant reversal of past, failed policies of statism and protectionism that have contributed to capital flight and to a dependence on debt financing from abroad. We have been impressed by policies implemented by a number of new Latin leaders, but more must be done. The EAI can make a significant contribution in realizing these objectives.

While Latin America requires capital for growth, competition for international capital has intensified with the opening of Eastern European economies and demands in the Middle East. At the same time, commercial bank lending to developing countries has diminished and budget limitations constrain flows from official bilateral sources. As a result, private capital, including repatriated capital, is increasingly the engine for economic growth for the 1990s.

NB-1324

There are no reliable measurements of capital flight, and economists' estimation procedures produce both variable and dubious results. Some estimates have placed the level of capital flight from Latin America at greater than the level of foreign borrowing, but these estimates probably have minimum credibility. Whatever the magnitude of capital flight in the past, we believe that the pace of outflows may be easing for several countries, and that some are experiencing inflows, but outflows continue to be a major problem for other less developed countries.

CAUSES AND CONSEQUENCES OF CAPITAL FLIGHT

What are the causes of capital outflows? Private capital leaves one country for another to seek a higher return on investment or a safer haven with reduced risks. Important factors therefore include the direction of macro-economic policies and the relative stability of the political climate. High inflation rates erode purchasing power, increase uncertainty and exacerbate risks. Investors anticipating sudden currency devaluations as a result of inflationary policies will move their money abroad to preserve their capital.

Political uncertainty, and the threat of nationalization and populist hostility capital may also discourage both foreign and domestic investors. Drug production, trafficking and money laundering threaten political stability in some countries, and also contribute to instability in domestic financial markets. The Administration is vigorously pursuing policies to combat drug-trafficking in Latin America.

Many countries pursue unfavorable and short-sighted investment policies, which stimulate capital outflow. Investment opportunities can be limited by restrictions or prohibitions on investment in "sensitive" sectors. These often include areas such as telecommunications or transportation, which are reserved for the state or for a state-sanctioned monopoly. Onerous regulatory regimes, together with a reliance on price controls and subsidies, further erode the profitability of investment.

These problems are often compounded by market-distorting credit policies. Interest rate policies, including ceilings on interest paid to depositors, and credit allocation policies, undermine capital markets. Tax avoidance may be another stimulus to capital outflows, reflecting discriminatory tax policies that erode the return to investors. Restrictions on transfering funds out of a country also encourage investors, where possible, to keep and invest their capital abroad.

The negative consequences of massive capital outflows from less developed countries are clear. Capital which is invested abroad is capital that is not available for investment in the developing country. Investment and economic growth will tend to be lower. Moreover, profits on capital held abroad are seldom fully repatriated. Capital outflows also erode the national tax base, due to unreported and unrecorded income which escapes the tax authorities. Foreign exchange receipts may also be under-reported and held abroad.

The political leaders in less developed countries must address the need to reform the investment regimes, to make them more hospitable to investment by both nationals and foreigners. In the past few years we have witnessed a growing awareness of the importance of an attractive investment regime that offers competitive returns and a wide range of investment opportunities.

Such reform is at the heart of both the Strengthened Debt Strategy, known as the Brady Plan, and the EAI.

THE STRENGTHENED DEBT STRATEGY

The major objective of the Brady Plan has been to encourage highly indebted countries to successfully implement market-oriented macroeconomic and structural policy reforms in order to achieve sustained growth and ultimately resolve their debt servicing problems. IMF or World Bank supported adjustment programs are prerequisites for debt reduction under the new strategy.

In advancing this strategy, we have encouraged commercial banks to consider debt and debt service reduction as well as to mobilize additional financial resources in support of debtor reforms. We have also redirected IMF and World Bank resources to back debt and debt service reduction for commercial banks while creditor governments continue to provide needed support.

As we begin our third year under the strengthened debt strategy, we can survey some key successes and progress made to date. In assessing progress within the strategy, we should consider first the magnitude of debt covered through debt reduction agreements and the number of countries involved.

Agreements have now been reached with eight countries, including five in Latin America --Chile, Costa Rica, Mexico, Venezuela, and Uruguay. The eight agreements account for some $125 billion in commercial bank debt, or nearly half of the commercial bank debt of all of the major debtor nations.

The benefits to these debtor nations have been substantial: Mexico's stock of medium and long term commercial bank debt was reduced by 34%, Costa Rica's by 62% and Uruguay's by 40%, in addition to significant annual debt service savings and innovative collateralization have reduced the burden of principal payments. The IMF and World Bank have provided some $5 billion in resources to support debt and debt service reduction by commercial banks.

The strong reform efforts by such countries as Mexico, Chile and Venezuela have been rewarded by their successful reentry into the capital markets and increased cash flows into their economies. All have liberalized their trade and investment regimes. Chile has one of the most open investment regimes in Latin America and has moved to privatize key public enterprises. Venezuela is also beginning a privatization program. Mexico has privatized its airline, copper, and trucking industries in the past 18 months, and has announced some $20-25 billion of future privatizations of government-owned enterprises in the banking, steel, telecommunications, fertilizer, and insurance sectors.

Investor confidence is increased when a country maintains sound relations with its international creditors, including commercial banks and the international financial institutions. Both Mexico and Chile experienced inflows of repatriated funds and foreign capital following reduction of their debt with commercial bank creditors under the Brady Plan. We also believe that Venezuela, which reached agreement with commercial bank creditors in March, 1990, has begun to see a reversal of capital outflows.

EAI - CONTINUING SUPPORT FOR REFORM

To enhance growth and prosperity throughout the hemisphere, last June President Bush announced the Enterprise for the Americas Initiative -- an ambitious agenda for strengthening our ties with Latin America and the Caribbean. The Initiative proposes specific action on three economic issues of greatest importance to the region -- trade, investment, and debt. A key focus is to help countries in the region attract the capital essential for growth and development.

Trade

Our long-term goal is to establish a system of hemispheric free trade. As our first step toward our objective, the President has announced our intention to negotiate a North American Free Trade Agreement. We have recently gained from Congress an extension of fast-track negotiating authority, which will allow us to enter into negotiations with Mexico and Canada to eliminate barriers to trade and investment.

The Administration is also proceeding to conclude EAI Trade and Investment framework agreements with eight countries -- Colombia, Ecuador, Chile, Honduras, Costa Rica, Venezuela, El Salvador and Peru. We are also discussing such agreements with Panama, Nicaragua, the CARICOM group of countries, and a group of countries composed of Argentina, Brazil, Uruguay and Paraguay. Framework agreements constitute a declaration of trade and investment principles and set up Councils to consult on these issues and to work towards liberalization.

Investment

To encourage countries to liberalize their investment regimes and help improve their ability to attract capital, the Initiative proposed creation of a new investment sector loan program in the Inter-American Development Bank (IDB), and the creation of a Multilateral Investment Fund. The IDB has sent diagnostic teams to several countries to negotiate investment sector loans. The first loan, for Chile, will be discussed by the IDB Executive Board on June 19th, and we expect programs for Jamaica and Bolivia to follow this summer.

We are also seeking contributions from other governments to a $1.5 billion Multilateral Investment Fund to be administered by the IDB, which would provide additional support for investment reforms. The US has proposed to contribute $100 million a year, for 5 years. The Japanese have already announced their commitment to provide $100 million a year, for five years, in grant resources to the Fund. Last week, several other governments indicated support for the MIF, and we hope to be able to achieve firm commitments in the near future.

We are confident that investment reforms negotiated with the IDB, together with the creation of a new Multilateral Investment Fund, can make an immense difference in the climate for investment in the region, and to its future growth.

Debt

The debt reduction element of the EAI establishes a coherent approach to bilateral debt reduction which reinforces ongoing economic reforms in Latin American and Caribbean countries. It complements the strengthened debt strategy by addressing the debt problems of countries whose debt portfolio is primarily owed to official creditors rather than to commercial banks.

We propose to reduce existing debts to the USG of countries which are undertaking macroeconomic and structural reforms, are liberalizing their investment regimes, and have negotiated agreements with their commercial banks, as appropriate. We have gained authority from Congress to take such action on PL-480 debt.

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. To provide the full extent of debt reduction proposed under the Initiative, we must gain additional authority from Congress. In particular, we are seeking authority to reduce AID debt -- which represents $5.2 of $7 billion in concessional debt owed by the regional countries to the US -- and to sell, cancel or reduce a portion of Eximbank loans and Commodity Credit Corporation (CCC) assets acquired through its export credit guarantee program for debt-for-equity, debt-for-nature, and debt-for-development swaps.

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 burden 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 official debt for countries committed to necessary economic reforms, we can reinforce the rewards of sound economic policies -- helping them to restore confidence in their economy and attract both domestic and foreign investment.

COUNTRY CASES

I have explained the policy initiatives undertaken by the Administration to encourage economic reform and to address the debt burden in countries in Latin America and the Caribbean. Let me now turn to developments in several countries.

Mexico

Mexican economic policy reforms since the mid-1980s have substantially increased confidence in the Mexican economy, bringing a dramatic reversal in the direction of private capital flows. Trade and investment liberalization, tax reform, and measures to reduce the burden of the public sector have provided a backdrop for economic recovery and for repatriation of flight capital.

We estimate that capital repatriated into Mexico ranged from $1.5-2.0 billion in 1988 and from $2.0-3.5 billion in 1989. All told, since the announcement of the commercial bank deal in June, 1989, Mexico has received an estimated $5.5-6.0 billion in capital repatriation and an additional $5.0-5.5 billion in foreign direct investment. This represents a dramatic turnaround from the early 1980s, when capital flight averaged an estimated $7 billion per annum.

Increased confidence in the Mexican economy is also reflected in Mexico's return to the international capital markets. Mexican firms raised over $5.5 billion in debt and equity financing during 1990, and nearly $3.5 billion so far in 1991.

Mexico's success is due to several factors, in addition to the reforms already mentioned. Investor confidence has improved significantly since the announcement of the commercial bank debt and debt service reduction agreement. This renewed confidence was reflected in a dramatic decline in Mexican interest rates from nearly 50% per annum before the announcement of the commercial bank agreement, to under 20% today. Lower interest costs have been a key element in the fall in Mexico's fiscal deficit, from 13% of GDP in 1988 to 3.5% in 1990. This improved fiscal position has enabled Mexico to reduce inflation from 160% in 1987 to under 30% in 1990, while at the same time achieving GDP growth of 3.9% last year.

Recent measures have further enhanced Mexico's attractiveness to investors. These include a constitutional amendment in June, 1990, that allows privatization of nationalized commercial banks. The announcement of plans to negotiate a Free Trade Agreement with the US was another positive factor, as was the introduction of a well-designed tax amnesty program for repatriation of flight capital. Under this program, Mexican nationals pay a flat 1% tax on all repatriated funds.

Venezuela

Venezuela appears to have reversed capital flight beginning in 1988, when over $1.5 billion in capital was repatriated. Poor economic performance caused capital outflows to resume briefly in 1989, but at modest levels. Falling real GDP (-8.3%) and rising inflation (81%) were the principal causes that year.

In 1989, Venezuela successfully adopted a series of strong adjustment measures which spurred renewed growth and cut inflation. The Government of Venezuela continues to implement an ambitious program of economic reform in a number of sectors and has undertaken trade and fiscal reforms, financial sector reforms, and privatization. These initiatives have been reinforced by the 1990 debt package with commercial bank creditors under the Brady Plan, and together have contributed to attracting capital back into the country. Investor confidence is growing, a fact reflected in the decision of one-third of commercial bank creditors to participate in the new money option in the 1990 debt package.

Chile

Chile has not had difficulty with capital flight since the severe, world-wide recession of 1982 that produced significant economic uncertainty. Chile's successful debt-conversion program has reduced Chile's stock of debt by about $10 billion since 1985, equivalent to about 70% of medium and long-term debt to commercial banks outstanding at end-1985, and has provided a vehicle for investment including repatriated capital. In 1985 the Government put in place a structural adjustment program which has been very successful in fostering both domestic and foreign confidence in the Chilean economy.

A key result of the program is that Chile has one of the more open investment regimes in Latin America. Increased investor confidence in Chile is apparent from Chile's return to voluntary commercial bank lending in 1990 and from the $320 million international bond issue in early 1991. Private foreign investment inflows of direct investment and loan disbursements have increased dramatically from about $400 million in 1986 to $1.6 billion in 1990. In addition, foreign portfolio investment has increased substantially in the past two years. Chile continues to work to improve its investment climate and is very close to reaching an agreement with the Inter-American Development Bank on an investment sector loan.

Argentina

Capital outflows have long been a problem in Argentina. Recognizing that the only way to bring capital back to Argentina is through sound and sustained economic policy, Argentine policy makers have sought to stabilize the economy and rebuild confidence.

In the past 2-3 years, Argentina has undertaken a number of steps to make the country more attractive for investment and to promote economic growth. The trade and investment regimes have been opened, an ambitious privatization program has begun, and the Administration has persisted in its efforts to rein in public spending and cut inflation. In April of this year, the Government of Argentina established a new exchange rate regime and continued a tight monetary policy in order to control inflation and further stabilize the economy.

In 1990, under its privatization program, the Government sold two parastatals, the telephone company ENTEL and the airline Aerolineas Argentinas. Although these transactions were difficult to arrange, Argentina ultimately attracted both foreign and domestic capital: Morgan Guaranty and Citibank participated as agents; the European firms STET, Radio France and Iberia Air participated as buyers. Today, Argentina is pursuing privatizations, through sale or concession, of other state entities including oil fields, steel, electricity, gas, shipping and railroads.

Besides addressing its structural problems, Argentina is also taking specific tax measures to address the problem of capital flight. Legislation proposed last month would tax capital held abroad this year at 2%, but would tax it at 1% if it is repatriated. Capital returning through the end of this month (June 1991) would be exempt from any legal or administrative penalty and from any past tax obligations. This legislation awaits passage by Argentina's Congress. Argentina is seeking an IMF program as a precursor to discussions with commercial bank creditors.

Despite the many positive developments, investors - both foreign and domestic - continue to be cautious with respect to Argentina. Major reflows of capital will depend on a sustained period of economic performance and completion of additional elements of the structural reform process.

Brazil

Brazil appears to have experienced relatively little capital flight in the 1980s, in part due to prevailing high domestic interest rates. Rough estimates place capital flight at about $15 billion cumulatively from 1980 to 1987.

In testimony to the Brazilian Senate's Commission for Economic Affairs in early June 1991, a Central Bank official estimated that, since 1980, Brazil had incurred a cumulative $35 billion in capital flight, equivalent to 10% of GDP. A large part of the recent capital flight, he claimed, was attributable to the Government's move to block deposits in March, 1990.

Capital flight in Brazil since March, 1990 appears to be driven primarily by economic policy miscalculations and the accompanying plunge in investors' confidence. A key event propelling capital flight has been the failure of the massive freeze on domestic deposits in March 1990 to curb the high inflation rate. This event has not only intensified capital flight, but investors appear to have fled depository accounts in the domestic banking system in fear of another confiscation of their deposits. Numerous investors have thus transferred their funds into other assets such as real estate and the domestic stock markets. In fact, there have recently been strong upturns in Brazil's two major stock markets, attributable to inflows from both domestic and global institutional investors. The inflows from international investors have been spurred by new regulations permitting foreign investors to directly buy and sell shares on Brazil's stock exchange.

Substantial repatriation of capital probably will not occur until Brazil has convinced investors that it can successfully implement adjustment and reform policies needed to stabilize the economy and foster non-inflationary growth.

Colombia

In the past few years, increased drug trafficking and violence has promoted capital flight from Colombia. This has been partially offset by repatriation of some of the drug profits. Colombia has recently implemented a number of market-oriented reforms and has liberalized trade and investment regimes. In February, 1990, Colombia launched its "Apertura" policy of gradual trade liberalization. Colombia has also taken steps to improve the investment climate, including launching a privatization program and announcing a policy of granting equal treatment to foreign and domestic investors.

CONCLUSION

Private investment plays an increasingly important role in growth and development. Repatriated capital and increased flows of foreign investment are critical motors of economic growth. For this reason, it is important for developing nations work to improve their macro-economic and investment climates in order to attract investment. We are supporting these efforts by Latin American countries with initiatives which are aimed at supporting reform: the Brady Plan, and the EAI.

As the examples of Mexico, Chile and Venezuela demonstrate, strong reform efforts generate a pay-off in terms of inflows of foreign investment. These examples have confirmed the potential for economies in the region to make the transition from crisis to performance.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE

Contact: Cheryl Crispen
202-566-2041

THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
COMMITTEE FOR THE PRESERVATION OF THE
TREASURY BUILDING
JUNE 11, 1991
CASH ROOM

Thank you, John (Rogers), and welcome to the Cash Room. It is a pleasure to share an evening in this great room with a group of people who appreciate the historic treasures in Washington.

Looking around, I see a number of familiar faces in the audience -- both current employees and people who have worked here over the years. All of us with the experience of walking these halls share a common bond. And I believe we share a genuine respect for the institution and the sense of history, tradition, purpose and future embodied in this building.

As you will see from the slide show, the private effort to restore and preserve the Treasury Department has been extremely successful, and I am pleased that a new generation is joining us here this evening. As the years go by, your appreciation for the institution will undoubtedly increase -- and we thank you for having played a part in preserving this building for future generations.

This is the third Treasury building to stand on this site. The first two were burned down -- once by the British in 1814 and once in 1833 by some ex-Treasury employees who were trying to cover up a crime by burning the evidence. But the arsonists were caught, and the Treasury was rebuilt over a 33-year period ending in 1869.

In that same year, this Cash Room was finished as a grand room -- exuding confidence in the nation's new currency. It was the beginning of a room that is now rich with history.

In fact, President Ulysses S. Grant decided to hold his first inaugural reception in the Treasury Building, using the Cash Room as the main ballroom. Two thousand men were given tickets to that event, and each man could bring two women -- a total of 6,000 guests.

NB-1325

It was a tight squeeze. The band was jammed in the catwalk above us; women were fainting in the crush around the food table; and, at the end of the evening, the faulty coat-check system led to a mad scramble for overcoats -- that's one thing that hasn't changed at inaugurals for over 120 years. But at Grant's party, some guests had to wait until 4 a.m. to get their wraps, and others were so desperate they reached the cloak room by climbing through a transom above the door of an adjacent room.

Today, the Cash Room and the North Lobby have been restored, just as they were for Grant's reception. But this is only one of the many historic gems in the Treasury Building. Through research and hard work, the restoration projects are preserving much of the building's rich heritage. We are restoring antique furniture dating back to the 1860s, matching paint designs, and gilding ornamental fixtures -- all by researching photographs and written descriptions.

The Committee for the Preservation of the Treasury Building is doing a top-flight job of restoring this National Historic Landmark and preserving this important piece of history for future generations. The Committee's efforts have made impressive changes already, and there is much more to be done. This year, our priority restoration projects are the Andrew Johnson and Salmon P. Chase Suites -- both historically significant.

After President Lincoln was assassinated, Mary Todd Lincoln stayed on at the White House for a while. So newly-appointed President Johnson used an office here in the Treasury Building as the Executive Office -- working side-by-side with Treasury Secretary Hugh McCulloch.

It was an historic time for our nation. For two months, President Johnson worked out of an office on the third floor of the Treasury, facing the White House. Here, he signed the Amnesty Proclamation for Confederate Soldiers, and he issued the warrant for the arrest of Jefferson Davis -- offering a $100,000 reward for his capture.

This is American History in the unfolding, and the Treasury Department is proud of its part. We've managed to recapture part of that historic period by restoring the Johnson Suite with period furniture and original paintings. We've even located the teapot President Johnson kept there. The pot is shaped like a locomotive, and the whistle blows when the water boils. And on the side is the name "Jefferson Davis" -- it was confiscated from him after his arrest.

Also, history has been discovered in the Salmon P. Chase Suite -- the third floor corner office that looks down Pennsylvania avenue to the Capitol. In 1973, a painter was about to put another coat of white on the ceiling, but then he looked up and saw a patch of red underneath the chipping paint. After chipping away some more of the old paint, he discovered the reason behind the discoloring: there were two allegorical ceiling paintings that were painted over at the turn of the century.

The ceilings were painted in that office while Secretary Chase worked to finance the Civil War for the Union. In 1862, he implemented President Lincoln's War tax, and he established the nation's first currency -- the Greenback. And to promote the new money, two songs were written: the Salmon Chase March and the Greenback Quick Step.

Secretary Chase also met often in that office with one of America's prominent financiers -- Jay Cooke -- to negotiate private loans to finance the war. Soon -- when its renovation is complete -- a 19th century portrait of Jay Cooke by William Merritt Chase will hang in the Suite as a reminder of Cooke's importance during that critical time.

So you can see, there is something all Americans can learn from historic places like the Treasury Building -- something that can never be learned in a textbook. And throughout our nation's history, the Treasury Department has been linked to some of America's most important events, even in bizarre ways.

When John Wilkes Booth jumped onto the Ford Theater stage after shooting President Lincoln, he caught the spur of his boot on a blue Treasury flag. That mishap caused Booth to break his leg -- eventually slowing down his escape and leading to his capture. One week later, the flag was displayed in the corridor outside President Johnson's office -- in the Treasury building -- as a reminder of the tragedy.

That flag is now exhibited in the museum at Ford's Theater, and a replica -- including the tear -- will soon be displayed outside the Johnson Suite.

It is a small piece of history, but a significant one. Because, as we continue to restore this historic building, we will understand even more about the people and events that have made our nation what it is today.

This restoration is an important project for all of us at Treasury, and we appreciate your interest in helping us preserve for our children and grandchildren this rich heritage. Thank you.

###

TREASURY NEWS

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

STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT, FINANCE, TRADE AND MONETARY POLICY
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
JUNE 12, 1991

Introduction

Madam Chair and Members of the Subcommittee, I am pleased to testify today on the proposed legislation to authorize U.S. participation in the quota increase of the International Monetary Fund (IMF) and the proposed Capital Increase for the International Finance Corporation.

The IMF quota increase, agreed to in May of last year, would raise the basic resources of the IMF by 50 percent from $130 to $195 billion, and the U.S. quota in the Fund by some $12 billion from $26 to 38 billion.

This legislation represents a key foreign economic policy initiative of the Administration. Its passage is critical if the IMF is to help shape the world economy and respond to the challenges of the 1990s.

The IMF is the cornerstone of the world economy. Established in the wake of the Great Depression and the immediate aftermath of World War II, the Fund was charged with the critical mission of promoting the smooth functioning of the international monetary system and restoring international monetary cooperation.

Throughout its history, the IMF has promoted an open and dynamic world economy -- consistent with U.S. principles and foreign economic policy interests -- that has contributed to U.S. job expansion and economic growth. It has helped support countries of vital interest to U.S. national security. The United States has been the leading force behind the Fund over the years, reflecting a strong tradition of bipartisan support for the institution during Democratic and Republican administrations.

NB-1326

The IMF's Role in the Current Global Economic Setting

The world economy now stands at a critical juncture. Throughout the world, centrally-planned, state-run models of economic development and one-party governance are being rejected. In Eastern Europe, Latin America, Africa, and Asia, the focus of economic reforms is on developing free markets and private enterprise. These developments point to the emergence of a new international order of multilateral cooperation and have increased prospects for enhanced international economic stability and prosperity.

In pursuing their paths to political and economic freedom, these countries across-the-board are turning to the IMF for policy guidance and adjustment assistance. They recognize that Fund programs act as an international "seal of approval" and a catalyst for other sources of financing. Both Czechoslovakia and Bulgaria, for example, began their reform efforts by applying for membership in the IMF. The United States has encouraged the Fund to take a leadership role in responding to these challenges and the Fund is doing just that.

The IMF took quick and decisive action in the Gulf crisis, responding to the increased oil import bills faced by developing countries throughout the world and the severe costs of the U.N. sanctions on Iraq. Following the lead of President Bush, who addressed the World Bank and IMF at their Annual Meetings in September 1990, the IMF implemented changes in its policies to ensure it was well-positioned to help adversely-affected countries. A key measure was the introduction of compensatory financing, on a temporary basis, to assist countries in coping with higher oil import costs. The Fund has already committed over $3 billion to countries adjusting to the disruptions brought about by Iraq's invasion of Kuwait. The IMF also provided crucial analytical support to U.S.-led efforts by the Gulf Crisis Financial Coordination Group (GCFCG) to help the front line states (Turkey, Egypt, and Jordan) during the crisis.

In Eastern Europe, the Fund is at the forefront of international efforts to assist countries in restructuring their economies away from central planning and making the transition to free markets and private enterprise. The Fund led the way in Poland and Hungary and is building a strong framework elsewhere for market-oriented adjustment. This year alone, the Fund has already committed $8 billion to the region. These monies are supporting three-year financing arrangements in Poland and Hungary and stand-by arrangements in Czechoslovakia, Bulgaria, and Romania. In addition to program financing, the Fund has disbursed substantial compensatory financing to all five countries to help address increased oil import costs arising from the Gulf crisis and the switch to hard currency trade relations with the Soviet Union.

The Fund's support has unlocked substantial additional financing for Eastern Europe. In Poland, the Fund's program has formed the basis for the recent agreement by official creditors to reduce the country's debt and debt service obligations by 50 percent. Throughout the region, Fund arrangements are a critical element in catalyzing new resources from donor governments through the G-24 process, from private capital markets and through the Paris Club.

The Fund is also continuing to play a pivotal role in the U.S.-led international debt strategy, the "Brady Plan." Eight countries -- Chile, Mexico, the Philippines, Costa Rica, Morocco, Venezuela, Uruguay, and Nigeria -- have reached agreements with commercial banks on packages including debt and debt service reduction. These countries account for nearly half of the total commercial debt held by the major debtors.

Fund adjustment assistance and support for debt and debt service reduction agreements have been particularly important in Latin America, one of the largest export markets of the United States. Sound, free-market policies and the reduction in debt and debt service obligations have dramatically improved growth prospects in many of these countries. In Mexico, for example, inflation and interest rates have dropped sharply, growth rates are up, substantial new foreign investment has flowed into the country, and flight capital is returning. A similar turn-around in economic conditions is occurring in Venezuela. Chile's economic success is confirmed by its return to private credit markets. With Fund support, Costa Rica in 1989 reduced its commercial bank debt by 62 percent. Elsewhere in Central America, Fund programs are supporting adjustment in Honduras and El Salvador.

The Fund is an integral part of international efforts to encourage comprehensive economic reforms and to provide concessional financing to the poorest countries of the world, particularly those of Sub-Saharan Africa. Over 20 African countries currently have Fund programs. Most of the Fund programs are three-year arrangements under IMF concessional facilities and involve extensive collaboration between the Fund, World Bank, and the borrowing country. These programs are addressing the widespread need in Africa for structural reforms that are essential for achieving sustained growth and alleviating poverty.

On the strength of these programs, two countries, Nigeria and Niger, have recently reached debt and debt service reduction agreements with commercial banks. Niger is the first to benefit from International Development Association (IDA) support for such agreements.

Pressures on IMF Liquidity: The Case for a Quota Increase

If the Fund is to meet the challenges of the world economy, it must have adequate resources to fulfill its systemic responsibilities. For this purpose, the IMF regularly reviews the adequacy of its quotas. The current quota review was to be completed in 1988. However, the conclusion of these negotiations was delayed by two years as the United States insisted that there be a strong case for additional resources on the basis of a careful analysis of prospective demands, available resources, and agreement on the future role of the IMF as a monetary institution. Thus, this is the first quota increase in eight years.

The Fund's role in responding to the challenges of the Gulf war and reform efforts in Latin America and Eastern Europe is resulting in substantial current and projected demands on Fund resources. Although aggregate Fund quotas presently total around $130 billion, only about one-half of these quota resources are considered usable (i.e., resources from countries which are not borrowing from the Fund and which have strong financial positions). From this pool, substantial amounts have already been lent. Thus, the Fund currently estimates that it has about $30-35 billion remaining for lending over the five-year period normally covered by the quota review.

Fund resources will be significantly depleted in the period ahead. The Fund currently estimates that disbursements this year will total $16 billion -- more than double last year's lending. Disbursements are expected to remain high in follow-on years. As a result of heavy financing demands and loans, measures of Fund liquidity are expected to drop by almost 40 percent this year and decline further next year. Furthermore, a substantial portion of the loanable resource base could be removed if a major creditor's balance of payments position were to weaken.

For these reasons, the proposed quota increase is timely. The Fund's resource base is being depleted. The quota increase is forward-looking. These resources must serve the Fund over the medium term.

Effectiveness of U.S. Support for the IMF

Support for the IMF is an extremely effective means for advancing U.S. interests.

Use of the U.S. quota by the IMF involves no net budgetary outlays. This is because any transfer of dollars to the Fund is immediately offset by the receipt of an equivalent, interest-bearing and liquid monetary reserve asset. Thus, the transfer of dollars to the Fund is analogous to putting money into a checking account which is interest bearing and can be drawn down at any time. This accounting treatment is used internationally. Over the years, the United States has drawn 24 times on its reserve position for a total amount of $6.5 billion. It last drew on its reserve position in 1978 for some $3 billion.

Indeed, during the 1980s, U.S. participation in the IMF has resulted in a net financial gain of $628 million annually. This gain reflects interest earnings and valuation gains on our reserve position in the IMF, which sharply exceeded the borrowing costs to the Treasury associated with financing transactions with the Fund.

The budget agreement makes specific provision for the unique budgetary treatment of the IMF quota increase. The approximately $12 billion increase in the U.S. quota will not result in any net budgetary outlays. Also, this appropriation is only available for the quota increase; it could not be applied, for example, to other discretionary spending programs.

IMF financing also leverages our scarce resources, which is critical at this time of budget constraint. For every dollar the United States contributes to the Fund, other countries contribute four.

The United States is also well positioned to influence IMF policies. Our voting share in the IMF of some 19 percent gives us veto power over key IMF decisions, such as quota increases and amendments to the Fund's charter, which require an 85 percent special majority vote. In addition, our voting share positions us to build majorities on other major issues, requiring super-majorities of 70 percent for approval. This veto power has often proven essential to ensure that the Fund operated in a manner consistent with overall U.S. interests.

The Strengthened Arrears Strategy

During the quota negotiations, a number of steps were taken to ensure that IMF resources, including U.S. contributions to the quota increase, would be used more effectively.

During the 1980s, arrears to the Fund grew sharply, reaching their current level of $4.5 billion from nine countries, an amount twice the level of the Fund's reserves. Arrears undermine the financial integrity of the IMF and its ability to fulfill its systemic responsibilities. Over time, Fund efforts to address the growth in arrears bolstered Fund reserves but failed to reverse the problem and promote a normalization of relations between the Fund and arrears countries.

Thus, in order to ensure that any increased U.S. quota contributions were wisely and productively spent, a major U.S. priority in the quota negotiations was the adoption of a strengthened arrears strategy. Our basic approach emphasized the need for a comprehensive set of incentives and disincentives designed to reward sound performance and to discourage new arrears. The plan eventually adopted by the Fund closely mirrors the U.S. approach and includes two main elements.

- First, the key to addressing current arrears cases is sound economic performance to restore creditworthiness. Thus, to create an incentive for sound performance, countries which cooperate with the Fund and demonstrate sustained performance under a 2-3 year Fund-monitored arrangement can now earn "rights" to special financing to clear their arrears.

- Second, countries that over time do not fulfill their responsibilities cannot be expected to enjoy the benefits of membership. Thus, if any country does not cooperate in clearing its arrears and continues to fail to fulfill its obligations, the strengthened arrears strategy provides for an amendment to the IMF Articles that would permit the Fund to suspend that country's voting rights and representation privileges.

The rights approach is only available for the 9 remaining arrears cases that were in arrears at the time of the quota agreement. At the successful conclusion of the program, a country would gain access to special financing to help clear its arrears. To receive the financing, however, a country must establish a follow-on program so as to ensure that sound policies continue to be pursued.

Financing for the rights program will come from two main sources:

- For lower-income arrears countries, the Enhanced Structural Adjustment Facility (ESAF) will be used primarily to finance the "rights" programs.

- The two middle-income arrears cases, Peru and Panama, will be eligible for financing from a special account financed from increased charges on IMF loans and reduced remuneration.

In both cases, "rights" financing is to come from special Fund monies separate from the Fund's regular resources. In this way, the Fund will avoid establishing undesirable precedents which could undermine its monetary character.

In this context, since financing for the "rights" program for lower income countries through use of the ESAF increases the potential risk to ESAF creditors, it was agreed that the IMF would sell, if needed, up to 3 million ounces of IMF gold to back up the ESAF's already substantial reserves. This limited amount of gold reflects the gold subscriptions of the countries with arrears.

Progress is being made under the strengthened arrears strategy. The IMF recently approved a three-year "rights" program for Zambia and is working with official creditors and donors to establish a rights program for Peru. These two countries alone account for nearly half of the total arrears owed the IMF. Also, Honduras and Guyana have eliminated their arrears, while Peru, Panama, and Zambia are meeting maturing obligations to the Fund.

Under U.S. law, U.S. consent to any sale of IMF gold for the special benefit of a single member or of a particular segment of the membership must be approved by Congress. Thus, the quota legislation also seeks Congressional approval to allow the Secretary of the Treasury to instruct the U.S. Executive Director of the IMF to vote to approve the IMF's pledge to sell this limited amount of gold.

Also under U.S. law, U.S. agreement to an amendment to the IMF Articles of Agreement requires Congressional approval. Thus, we are seeking legislation that would authorize the U.S. Governor to the Fund to accept the proposed suspension amendment to the IMF Articles. This is a tough remedial measure which encountered resistance from developing countries and was adopted only at U.S. insistence and as a precondition of the suspension amendment, the quota increase cannot go into effect. The goal of the suspension amendment is positive, however: normalization of relations and the deterrence of future arrears.

Impact of IMF Activities on Poverty and the Environment

During the past year, concerns have been raised regarding the IMF's role in environmental protection and alleviating poverty.

The Administration is committed to environmental protection. Towards that end, it has given high priority to promoting Fund actions aimed at protecting the environment, consistent with Fund's basic mandate. We have achieved some important successes:

- At U.S. initiative, the Fund is establishing a group of economists that will serve as liaison with other organizations on environmental research and advise the Fund on addressing environmental concerns. The Fund is currently seeking environmental economists from outside the Fund to work, for a transitional period, with Fund economists.

- With World Bank assistance, the Fund is incorporating measures consistent with environmental protection into Policy Framework Papers (used for concessional programs) and some stand-by and extended arrangements. These can include measures to remove government subsidies on fertilizer, energy, and pesticides.

- IMF Article IV consultations include discussion of environmental concerns.

- The IMF is working with the U.N. to develop national income accounting statistics to reflect use of natural resources.

These achievements have required much hard work on the part of the U.S. Executive Director to the IMF and senior Treasury officials. We faced considerable opposition from developing and developed countries alike in securing these gains. Many countries argue that the impact of Fund macroeconomic policies on the environment is indirect and ambiguous. They are also concerned about overburdening the Fund and detracting from its primary responsibilities as a monetary institution in promoting sustained growth. Developing countries in particular are sensitive to the appearance of the Fund intruding on national sovereignty. Moreover, there is broad recognition that the World Bank is better-suited to addressing environmental concerns in an effective and lasting manner.

The U.S. is the primary force behind increased Fund attention to environmental concerns. By virtue of our leadership position in the institution, we have been able to overcome some of the reservations of others, and we plan to build on the progress that has been made. We look forward to continuing our work with Congress and the environmental community in this important area.

Turning to poverty issues, IMF conditionality is sometimes criticized as imposing austerity on countries and hurting the poorest segments of the population. This view, however, represents a misconception of the IMF's role in the adjustment process.

Countries generally come to the Fund facing severe economic imbalances. Usually, they have lived beyond their means, consuming more than they produce, and are facing a curtailment in foreign financing flows. In these circumstances, they face the prospect of "forced" adjustment -- deep and inefficient cuts in investment, imports, and growth.

In contrast, IMF policy advice and financial support offer countries "breathing room" and the prospect for a more orderly adjustment path. Experience shows that the sound market-oriented reforms the IMF supports are essential to achieve sustained growth, reduce poverty and catalyze additional external resource flows.

There are, to be sure, inevitable costs associated with the adjustment process. The Fund is sensitive, however, to these costs.

Virtually every Fund program includes support for social safety nets, such as the maintenance of expenditures for such basic human needs as health, education, and nutrition. Fund programs also allow for targeted assistance to protect the most vulnerable groups from the effects of such necessary reforms as the removal of subsidies for basic consumer items. Costa Rica, Ghana, Venezuela, Niger, Bangladesh, and Egypt all have Fund programs which incorporate targeted government assistance for the poor.

Furthermore, in recent years, under the debt strategy, the Fund has given increased attention to growth-oriented structural reforms. This has acted in many cases to help the poor. Fund programs increasingly emphasize comprehensive structural reforms in order to free up workers, producers, and farmers to respond to market forces -- not government regulations and bureaucrats. These measures are intended to stimulate supply responses and reduce adjustment programs' reliance on fiscal belt-tightening and monetary restraint.

Also, as noted previously, in the poorest countries of the world, substantial concessional financing is being provided. As part of ESAF programs, the Fund is devoting extensive attention to cushioning the poor from the side-effects of adjustment.

These measures have been adopted with strong U.S. support and encouragement. Moreover, countries undertaking Fund-supported adjustment reforms have themselves recognized that the incorporation of social safety nets substantially enhances popular support for the program. The United States will continue to encourage the IMF to show increased sensitivity to the effects of adjustment on poverty.

Conclusion on IMF Quota Increase

Since its establishment some 45 years ago, the IMF has played a central role in strengthening growth at home and in promoting a sound market-oriented world economy consistent with basic U.S. foreign economic policy interests.

IMF support for a sound and stable world economy is crucial to maintaining conditions in which U.S. jobs and exports can thrive. U.S. economic interests are increasingly tied to international economic developments. In 1990, virtually all of U.S. economic growth was accounted for by the increase in exports. The fastest growing U.S. export markets are in the developing world. Many of our developing country trading partners have received IMF assistance in support of market-opening measures and increased growth.

The foreign policy interests of the United States have been well-served by the Fund. The quick and effective Fund response to the Gulf crisis sent a strong message of continued international support for efforts to gain Iraq's withdrawal from Kuwait. In Eastern Europe and elsewhere, economic reforms are inextricably linked to the movement toward democracy. In Latin America especially, the Fund is supporting sound economic policies and debt and debt service reduction under the Brady Plan. IMF support is essential if countries throughout the world are to achieve peace and prosperity on the basis of democratic and market principles.

The IMF also serves our interests in an extremely effective manner. Use of the U.S. quota in the Fund involves no budgetary outlays and leverages our scare resources. We are the largest member and most influential voice in the Fund, and our large voting power gives us veto power over certain key decisions and positions us to build majorities on other major issues. The strengthened arrears strategy will ensure that increased U.S. resources are used wisely.

The world economy stands at a historic juncture in which U.S. interests will be deeply affected. It is critical that we support the IMF now if we are to continue our strong leadership in this central global institution as it helps shape the world economy of the 1990s. Thus, on behalf of the Administration, I strongly urge you to support passage of the IMF quota legislation.

<u>International Finance Corporation</u>

I am also pleased to testify today on the proposed Capital Increase for the International Finance Corporation (IFC). IFC management and member countries have been negotiating a Capital Increase for over a year. All documents pertaining to the Capital Increase have been circulated, and a joint World Bank/IFC Board is scheduled to discuss the Increase on June 20.

As you know, the IFC is the component of the World Bank Group which most directly serves our key policy goal of promoting private sector development. The IFC was established in 1956 to support private sector led economic growth in its developing member countries by making direct equity and debt investments in private companies, mobilizing funds from other sources, and providing important advisory services to developing country governments and corporations. Unlike the World Bank and IDA, the IFC lends directly to the private sector. The IFC is in strong financial shape, and enjoys an "AAA" credit rating. The U.S. is the largest single shareholder, owning about one quarter of the IFC's capital.

<u>Recent IFC Projects</u>

I would like to mention briefly some current IFC projects, as they help illustrate how the IFC pursues its private sector development mandate.

-- In Czechoslovakia, IFC has been retained by that nation's largest heavy industrial group to provide advice on its privatization strategy.

-- In Poland, IFC has recently established the Polish Business Advisory Service, in cooperation with the European Bank for Reconstruction and Development (EBRD). PBAS will provide technical assistance and support for Polish entrepreneurs and small businesses.

-- The IFC is actively discussing privatization opportunities with Mexico, Argentina, Bolivia, Brazil, Ecuador, and Uruguay. Currently, the IFC is assisting in the privatization of the Chilean telephone company.

-- IFC's strategy in Asia focuses on assisting companies to access international capital markets, as well as developing internal capital markets.

-- In Africa, in addition to individual investment projects, the IFC finances small enterprises directly through its African Enterprise Fund, provides technical assistance through the African Project Development Facility, and is addressing management needs by increasing training activities of the African Management Services Company.

U.S. Goals

The world has changed significantly in recent years, as shown by the momentous events in Eastern Europe and the sweeping reforms now underway in many nations in Latin America. It is now understood in most of the world that real economic, social, and even political progress requires the development of strong local private sectors. Accordingly, we are seeking to strengthen both the IFC and the World Bank so that these institutions will take the lead in assisting this historic transformation.

The U.S. believes that for an IFC Capital Increase to be effective it must be part of an accelerated effort by the entire World Bank Group to support private sector development. We believe that the Bank Group can increase its support for the private sector while maintaining the Bank Group's emphasis on growth and development, poverty alleviation, and the environment.

To accomplish this objective there is a very important practical problem which must be resolved successfully. The IFC needs to implement a stronger and more active policy to promote privatization in countries moving towards market economies. However, this effort will not be successful if the World Bank does not actively support the same objective. A large state enterprise in a developing country or in Eastern Europe which can borrow from the World Bank with the support of a government guarantee will not easily give up that important source of capital by privatizing and cutting itself off from future World Bank loans. How both institutions face and resolve this transitional problem will be an important determinant of the speed and success of privatization.

As Secretary Brady told the Joint World Bank/IMF Development Committee on April 30, 1991, actions in three broad areas are needed as a part of an IFC Capital Increase:

-- First, measures to strengthen IFC's project selection and overall operations.

-- Second, measures to strengthen communications and collaboration between the IFC and the rest of the World Bank Group.

-- Finally, measures to strengthen the private sector focus of the World Bank, so that the IFC is not operating in isolation, but is part of a comprehensive World Bank effort in support of private sector development.

Although the IFC Capital Increase will not be finalized until the Bank and IFC Boards and then IFC Governors approve the Increase, the U.S. has been pursuing a number of major objectives in the negotiations and expects that all our policy objectives will be met.

With respect to the IFC, we believe that the IFC should make privatization a top priority and become a strong advocate for privatization with developing countries. There is clearly a great need for expanded work in this area. We also believe that the IFC should collaborate more closely with the rest of the Bank Group in promoting needed policy reforms in borrowing countries and pay more attention to the Bank's policy reform goals when selecting its own projects. This means that IFC project selection should reinforce economic reforms supported by the World Bank and the IFC should avoid projects in countries where overall macroeconomic policies are clearly unsound. The IFC also should avoid lending into highly protected sectors when there is little prospect for liberalizing trade in those sectors.

In connection with the efforts to improve communication and collaboration between the Bank and the IFC, we believe that there should be a clearer definition of the respective roles of both institutions, especially in such areas as privatization and lending to financial intermediaries. A World Bank Group Private Sector Development (PSD) Committee under the Chairmanship of the Bank's President has been set up to coordinate the implementation of private sector development work within the Bank and between the IFC, MIGA and the Bank. To be successful, this new effort will require the constant close cooperation of key policy, operational, research, and personnel offices within each of the institutions. The Bank and IFC will collaborate in carrying out Private Sector Assessments (PSAs), which will be used to formulate country assistance strategies and will incorporate private sector development priorities. We understand that the Bank is in the process of identifying the first 20 countries for assessments.

We believe that the Bank should increase its own support for private sector development, in addition to what the IFC is doing. This would include developing country policy reforms -- legal, regulatory and institutional -- in support of an efficient private sector, more support for privatizations, and implementation of more projects through private rather than public channels.

We also believe that Bank management and the Executive Board should study the issue of amending the IBRD's charter. The IBRD's charter requires a government guarantee for any Bank loan to a private entity. Although no policy decisions have been made, there could be cases where it would be useful if the IBRD could lend directly to the private sector without government guarantees. Unless the charter is changed, current practice could be a disincentive to privatization. As I mentioned earlier, former state-owned enterprises which have been privatized are no longer eligible for IBRD loans unless the government extends guarantees. Some countries have constitutional prohibitions against such guarantees.

Status of Negotiations

We believe the negotiations for an IFC Capital Increase are moving towards a successful conclusion, with what we hope will be agreement on a Capital Increase and related IFC and World Bank policy reforms. We, along with most other major shareholders generally favor the proposal for an IFC Capital Increase. The IFC Capital Increase and Strengthening the World Bank Group Effort on Private Sector Development will be discussed by the World Bank and IFC Executive Boards on Thursday, June 20. It is our hope that the Boards will agree at that session to send the Capital Increase proposal to member governments for their approval. Approval of a Capital Increase will require an affirmative vote of the IFC's Board of Governors by a three-fourths majority of the total voting power.

The U.S. would be prepared to support a Capital Increase, provided that our major policy reform goals for both the IFC and World Bank are achieved. The U.S. currently holds about 25 percent of IFC capital. It has been our objective to maintain our current share in an agreed Capital Increase. However, the actual amount of the U.S. share will be dependent on the ultimate size of the Increase.

Conclusion on the IFC Capital Increase

We expect the IFC within a coordinated World Bank Group effort to play an especially important role in the 1990s, due to its expertise in privatization, capital markets development, and foreign investment. The IFC will place special emphasis on Eastern Europe (in cooperation with the EBRD), expand its activities in Latin America, and seek to maximize its activities in Sub-Saharan Africa and Asia.

Madam Chair, in the final analysis, the justification for our supporting an IFC Capital Increase bears repeating: that it is essential for the IFC and World Bank to work together to ensure the success of the difficult transition away from state controlled economies to free markets. This will require strong and coordinated support from both the IFC and the World Bank. We look forward to the IFC and the Bank stepping forward to meet this challenge. Thank you.

JUN 17 91 0 0 1 5 5 4

TREASURY NEWS

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

For Release Upon Delivery
Expected at 2:30 p.m.
June 13, 1991

STATEMENT OF MICHAEL J. GRAETZ
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

It is a pleasure to be here this afternoon to address various tax proposals relating to energy conservation, the development of renewable energy source technology, and the Nation's dependence on foreign oil.

As you know, Mr. Chairman, a few months ago the President presented the National Energy Strategy to Congress. This comprehensive report presented the findings of an extensive Administration study of various policy options designed to increase energy security, to increase the availability of electricity and transportation fuels produced from renewable sources, and to improve energy conservation. The National Energy Strategy resulted from 18 months of study, hearings and analysis under the leadership of Secretary of Energy James D. Watkins. The Department of Energy is also here today and will address the broader aspects of the President's National Energy Strategy. My comments will be limited to the Committee's request for the Administration's position on specific tax proposals.

In the course of the development of the National Energy Strategy, literally hundreds of alternative policies were examined -- including many tax proposals similar to those before the Committee today. The Administration evaluated each proposal taking into account the important energy objectives and the need to maintain a healthy economy and to adhere to the 1990 Budget Act. Relatively few tax proposals were included in the National Energy Strategy. In particular, only two options in the Strategy -- a 1-year extension of the renewable energy tax credit and the permanent extension of the research and experimentation tax credit -- call for a statutory change in the tax laws. Two other tax policy options -- a clarification of the current-law treatment of certain utility rebates and an expansion of the allowable nontaxable limitation for transit passes -- are being implemented through administrative action.

The limited number of tax policy aspects of the National Energy Strategy should not be surprising. The Administration believes that the tax laws should continue generally to provide neutral treatment of investments and to maintain the lowest possible tax rates. We have also become concerned about the frequency and scope of changes in the tax law. While the decades of the 1950s, 1960s and 1970s experienced at most two or three major tax bills, there were nine major tax bills in the 1980s and one in the first year of the 1990s. Constant revision of the tax law makes compliance more burdensome and costly for the populace and tax enforcement more difficult for the IRS. These are genuine economic costs. The Administration prefers to rely on market prices, rather than the tax laws, to promote changes in the types of energy supplied by producers or demanded by customers.

The Administration believes that the mix of measures advanced in the National Energy Strategy, together with the Clean Air Act Amendments of 1990 and other significant legislation already passed by the Congress, will promote the objectives sought with minimum interference with energy markets and maximum adherence to our budgetary objectives.

In the remainder of my testimony, I will provide more detailed comments on provisions listed by the Committee in the hearing announcement. For convenience, I have grouped together portions of a number of different bills under their common objectives. I shall discuss each of these groupings, rather than focus sequentially on each of the bills.

I. ENCOURAGE DEVELOPMENT OF RENEWABLE ENERGY SOURCES

Proposals to provide incentives for electricity production from renewable sources generally fall into two categories: extension or modification of current-law investment tax credits for solar and geothermal property, and new tax credits for the production of electricity from renewable sources. The intent of these proposals is to accelerate the development of such renewable energy sources.

Energy Tax Credit

Current law provides a 10-percent tax credit for investment in solar or geothermal energy property. Solar property is equipment that uses solar energy to generate electricity or steam or to provide heating, cooling, or hot water in a structure. Geothermal property consists of equipment, such as a turbine or generator, that converts the internal heat of the earth into electrical or other useful forms of energy. This credit is currently scheduled to expire on December 31, 1991. The Administration has proposed extending the energy tax credit for one additional year.

S. 731 provides a 1-year extension of the energy tax credit, as favored by the Administration. In contrast, S. 141, S. 466, S. 661, S. 741 and S. 743 call for a 5-year extension (to December 31, 1996). S. 1157 would allow the credit to be used against a corporate taxpayer's alternative minimum tax liability.

Administration position. The Administration at this time does not support more than a 1-year extension of the energy credit. While we recognize that a more prolonged period of benefits might provide more certainty and thus a greater incentive, we are not convinced that the incremental speed-up in the development of renewable energy technology that would result from extending the energy credit for four additional years justifies the $200 million in additional revenue losses that such an extension would cost. The Administration also opposes the proposal to create a special exception by allowing the energy tax credit to offset corporate alternative minimum tax liability.

Production Credit

Current law does not contain any production incentives for electricity produced from renewable energy sources. S. 466, S. 661, S. 741, and S. 743 contain proposals for production tax credits. These bills would provide a tax credit of up to 2 cents per kilowatt hour (adjusted for inflation) for the production of electricity generated from a renewable energy source. Renewable energy sources would include new facilities that generate electricity from wind, solar thermal, photovoltaic, and certain geothermal and biomass sources. The credit rate for electricity produced from geothermal sources would be one-half of the regular rate. The proposed legislation would grant the Secretary of the Treasury authority to expand the list of eligible sources. The credit rate for production from a facility placed in service after 1996 would be less than the rate for a facility placed in service between 1991 and 1996, and the program would be entirely phased out for property placed in service after 2001, although credits would be allowed for electricity sold before 2009.

Administration position. The Administration opposes these proposals for a number of reasons. First, because only about 5 percent of the nation's electricity is generated from fuel oil, this proposal will not significantly reduce the level of our oil imports; it is more likely to reduce the future use of coal-fired plants. While this may produce environmental benefits, the cost of the proposed program may be quite high. While we do not have precise estimates of the proposals in these bills, related proposals that we have examined would produce a revenue loss in the range of $500 million to $2.0 billion over the 5-year budget period. Variations in the estimates are associated both with the amount of the credit and the extent that it may be available for projects using existing mature technology. The revenue loss of such proposals per barrel of oil saved would be very high -- in the range of $10 to $30 per barrel. Utilities may use current mature technology and still qualify for the credits.

The accelerated development of renewable energy technology can produce benefits to the nation. However, the National Energy Strategy concludes that growth in renewable energy supplies can be accelerated over the coming decades without resorting to permanent subsidies or legislative mandates. Rather, the National Energy Strategy proposes intensified investment in research and development to reduce the costs and enhance the competitiveness of renewable energy options. Investment in R&D to improve energy technology and reduce costs is a more appropriate role for the Federal Government than using taxes or regulations to subsidize or mandate the use of particular technologies.

II. IMPROVEMENTS IN TRANSPORTATION

Proposals to reduce the use of conventional motor fuels take several forms: (1) tax subsidies to encourage the purchase of vehicles that can operate on alternative fuels, (2) taxes and tax subsidies that encourage the purchase of fuel-efficient vehicles, (3) expansion of tax benefits for employer-provided transit passes and the use of commuter vehicles, or (4) reduction of tax benefits for employer-provided parking.

Increased Use of Alternative Fuels

Under current law, no special tax subsidy is provided for vehicles that use alternative fuels or for delivery systems for alternative fuels. Some proponents of such subsidies contend that consumers will refrain from purchasing motor vehicles that can run on alcohol fuels (such as methanol or ethanol) or other clean-burning fuels because of an inadequate number of service stations from which such fuels can be purchased, and that service station owners are reluctant to install the necessary equipment because of the low demand for such fuels.

S. 1178 would provide tax benefits designed to encourage both the purchase of clean-burning vehicles and the installation of the required infrastructure. In particular, S. 1178 would allow expensing of a limited portion of the purchase price: up to $2,000 for each passenger car or light truck, $5,000 for each medium truck, and $50,000 for each heavy truck or bus. Up to $75,000 of the cost of refueling equipment could also be expensed, although this limitation would be an overall cap per location, rather than a per-pump or annual limitation. In addition, S. 1178 would require the Federal Government to pay state and local governments a portion of their costs of clean-burning vehicles and refueling equipment.

Administration position. The Administration opposes the use of additional tax incentives to encourage the use of alternative fuels. The tax laws currently provide substantial subsidies to alcohol fuels. An income tax credit (or an equivalent excise tax reduction) of 54 cents per gallon of alcohol is allowed to producers and blenders of alcohol fuels. An additional alcohol fuels credit of 10 cents per gallon is available to small producers (those with an annual production capacity of less than 30 million barrels). In addition, the Clean Air Act Amendments of 1990 and various state programs are expected to accelerate significantly the use of alcohol and other clean-burning fuels in areas of low air quality. These provisions, together with the actions suggested in the National Energy Strategy -- including greater federal purchases of alternative fuel vehicles and enhanced R&D of new feedstocks and conversion technologies -- are expected to result in a substantial increase in the use of alternative-fueled vehicles.

Encourage Purchase of Fuel-Efficient Vehicles

The current tax law imposes a so-called "gas guzzler tax" -- an excise tax on the manufacturer or importer of vehicles that have a fuel economy of less than 22.5 miles per gallon. This tax ranges from $1,000 (for a vehicle with fuel economy between 21.5 and 22.5 miles per gallon) to $7,700 (for a vehicle with fuel economy less than 12.5 miles per gallon). S. 201 would increase the fuel economy standard below which the tax applies by one mile per gallon for each model year from 1992 to 2000. In addition, the bill would increase the amount of the tax between 1992 and 2000 and would adjust the tax for inflation. It also would provide a limited investment tax credit for the purchase of fuel-efficient vehicles; the credit would increase by reference to the percentage by which the fuel economy of the vehicle exceeds the average for the model type. S. 741 and S. 743 would retain the gas-guzzler tax and in addition establish a system of taxes and rebates to encourage the purchase of safer and more fuel-efficient vehicles. A tax-exempt rebate would be allowed to a purchaser of any vehicle more fuel efficient than the average for its class, and a tax would be imposed on the purchase of any vehicle less efficient than the average for its class. A similar system would operate with respect to the vehicle's safety rating.

<u>Administration position</u>. The Administration opposes an increase in the gas guzzler tax at this time. This tax was doubled and the motor fuels tax was increased in the Omnibus Budget Reconciliation Act of 1990. It is too soon to know the effects of these increases on fuel efficiency. That same Act also imposed a luxury excise tax on automobiles costing more than $30,000. Sales of many of the less fuel-efficient cars are also subject to this tax. A further increase in the gas-guzzler tax at this time does not seem appropriate. The Administration also opposes the new tax and rebate systems of S. 741 and S. 743. We do not believe any new federal excise tax on the purchase of motor vehicles is appropriate even if that tax is dependent upon the vehicle's relative fuel economy and safety rating and its proceeds are to be rebated to purchasers of more fuel-efficient or safer vehicles.

The impact of such a tax on auto manufacturers will be uneven in the near term, depending principally on the fuel economy and safety characteristics of their existing product mix. Moreover, the application of the proposed tax and rebate system for relative fuel economy to model classes could lead to puzzling results. For example, the purchaser of a car with fuel economy of 35 miles per gallon in a model class with average economy of 40 miles per gallon would be subject to a tax of $357.[1] On the other hand, the purchaser of a car with fuel economy of 30 miles per gallon in a model class with average fuel economy of 25 miles per gallon would obtain a $667 rebate.[2] Thus, the purchaser of the latter car with a fuel economy of 30 miles per gallon would enjoy a $1,024 advantage over the purchaser of the former car with a fuel economy of 35 miles per gallon. Similar results would arise from the proposed application of the tax and rebate system for relative auto safety to model classes.

---

[1]Under S. 741 and S. 743, the tax is calculated as $10 times the difference between the vehicle's annual fuel consumption and the sales-weighted annual fuel consumption for all vehicles in its class, where for this purpose annual fuel consumption is equal to 10,000 divided by the vehicle's miles-per-gallon rating. Thus, for the example noted, the tax is $10 x (10,000/35 - 10,000/40) = $357.

[2]Under S. 741 and S. 743, the rebate is calculated as $10 times the difference between the sales-weighted average fuel consumption for the vehicle's class and the vehicle's fuel consumption. Thus, for the example noted, the rebate is $10 x (10,000/25 - 10,000/30) = $667.

Increase Reliance on Mass Transit

Under current law, the Internal Revenue Code explicitly excludes the value of employer-provided parking at or near the employer's business premises from an employee's gross income as a working condition fringe benefit. Employer reimbursements of an employee's parking expenses are similarly excluded, but only if the payment is a reimbursement of parking expenses actually incurred. Thus, a general transportation allowance paid to an employee whether or not the employee has parking expenses is not excluded under this rule.

The tax code also excludes de minimis fringe benefits of such small value that accounting for them would be unreasonable or administratively impracticable. Pursuant to the legislative history of this rule, regulations allow an employer to provide a tax-free subsidy to employees that commute by public transportation. If the subsidy is provided in the form of discounts on transit passes, tokens, fare cards or similar instruments and does not exceed $15 in any month, the subsidy is excluded from the employee's income; if the value of the subsidy exceeds $15 per month, the benefit no longer qualifies as de minimis and the entire value of the subsidy must be included in the employee's taxable income. Some contend that this disparity in treatment encourages the use of private transportation over the use of mass transit facilities.

In addition to other measures to encourage increased use of carpools and mass transit, the National Energy Strategy indicated that the limitation on the value of tax-exempt transit passes would be increased. The Internal Revenue Service has recently proposed regulations that would increase this limitation to $21 per month, effective July 1, 1991, to reflect the inflation experienced since this exclusion was adopted in 1984. A number of bills have been introduced that would increase the tax-exemption limitation on the value of the transit passes to much higher levels and would allow the tax-exempt level of benefits for all employees even if the employer-provided amount exceeds the threshold. Thus, under S. 129, up to $30 per month of an employee's mass transit commuting expenses would be treated as an excludable fringe benefit; this amount would be raised to $60 per month under S. 26, and $75 per month under S. 741 and S. 743.

From 1979 through 1986, the value of commuting in employer-provided vans, buses, or similar highway vehicles was excluded by statute from an employee's gross income if provided under a nondiscriminatory plan of the employer. Several bills (S. 26, S. 129, S. 741, and S. 743) would provide an exclusion from the employee's gross income of the value of commuting in employer-provided commuting vehicles, which are vehicles that satisfy statutory requirements similar to those in effect during 1979-1986. S. 26 and S. 129 would not limit the amount of such exclusion; S. 741 and S. 743 would limit the exclusion to $75 per month.

Administration position. Although the Administration supports improvement and increased use of mass transit facilities, it opposes these major expansions in the amount of employer-provided commuting costs that may be excluded from income. The proposed expansion in tax benefits would be an inefficient means for encouraging safety or modernization of public transportation facilities.

Other proposals seek to discourage the use of private transportation by limiting or eliminating the current-law exclusion from income of the value of employer-provided parking. Thus, under S. 326, an employer would be denied a deduction for expenses of furnishing parking to an employee unless the employee may elect to receive cash or a transportation subsidy in an amount equal to the value of the parking subsidy. S. 26, S. 129, S. 741, and S. 743 would treat parking as a working condition fringe benefit only for an on-site, employer-operated parking facility used primarily by the taxpayer's employees.

Administration position. The Administration opposes these measures. The exclusion of parking expenses was a part of a comprehensive reexamination of the treatment of fringe benefits during the 1980s, and notwithstanding the potential advantages in the current-law treatment of employer-provided transportation assistance in favor of private passenger car transportation over public transportation, we do not favor reopening this debate. When it previously addressed this question, Congress carefully balanced two conflicting objectives: the need for clear and administrable rules and the need to limit the erosion of the income and social security tax bases due to the increased importance of noncash fringe benefits. Treasury recognizes that the current favorable treatment of employer-provided parking is not fully consistent with the general rules limiting tax-exempt fringe benefits. However, making employer-provided parking taxable would produce serious administrative difficulty, because the valuation of employer-provided parking benefits can be extremely difficult.

S. 741 and S. 743 attempt to avoid the valuation difficulty by requiring that only the value of rented parking facilities, presumably the rent paid, be included in the employee's income. The avoidance of the valuation difficulty, however, produces inequities by excluding from taxation benefits provided by employers able to offer their own parking facilities while taxing employees for similar benefits provided by employers not able to provide parking on their own facilities. S. 326 takes a different approach to the issue by denying employers deductions for certain employer-provided parking, a violation of the general norm that employers should be entitled to deduct all expenses of compensation. In addition, this approach also produces administrative difficulties and inequities, for example, by requiring allocations of depreciation or rent deductions between parking and other building facilities and by having no impact on employers who provide parking in nondeductible or fully depreciated facilities.

Moreover, adequate local public transportation facilities do not exist in all cities. In many areas of the country, taxation of the value of employer-provided parking therefore might have at most a very modest effect on the use of private transportation. The effect may also be modest in cities where public transportation is available if employees strongly value the reduced transit time and greater flexibility possible with private transportation.

III. INCREASE ENERGY CONSERVATION

Two types of tax proposals have been suggested in an effort to encourage energy conservation: the exclusion from income of certain utility rebates and a tax credit for the cost of retrofitting older home furnaces with more fuel-efficient oil burners.

Utility Rebates

A number of utilities offer rebates to customers acquiring certain conservation equipment. Under current law, these rebates may be included in the taxable income of the customer receiving the rebate. The National Energy Strategy calls for the Administration to clarify the nontaxability of rebates provided by utilities in the form of reduced service charges, and the Internal Revenue Service has recently released guidance on this issue in the form of a revenue ruling. This ruling makes it clear that rebates provided by electric utilities to customers as a reduction in the cost of the electricity they provide may be excluded from the income of the customers. However, a cash payment remains fully taxable.

A number of bills (S. 83, S. 326, S. 679, S. 741, S. 743, and S. 922) would provide an exclusion from gross income for subsidies that a utility provides to a customer for the purchase or installation of conservation measures. Each bill also provides that no deduction or credit would be allowed for the expenditure of amounts provided or reimbursed by an excluded subsidy and that the adjusted basis of property would be reduced by the amount of any excluded subsidy for the property.

The bills differ in the scope of the exclusions provided. In general, they apply to subsidies provided by electric or gas utilities for residential or business energy conservation measures. S. 679 and S. 922 are more limited, however; S. 679 applies only to residential energy conservation measures and S. 922 applies only to subsidies provided by electric utilities. On the other hand, S. 83, S. 741, and S. 743, which apply to both energy and water conservation measures are broader than the other bills. Finally, S. 83 and S. 326 apply to payments to qualified cogeneration facilities or qualifying small power production facilities; the other bills except those payments either specifically or by limiting the exclusion to residential energy conservation expenditures.

Administration position. The Administration opposes these proposals. Each proposal deviates from existing tax policy by creating a new category of tax-exempt income, and no doubt would lead to demands by other groups to make other types of income tax-exempt. It would be difficult to police the proposals' prohibitions of double benefits by denying business customers deductions or depreciation for the expenditures financed by the rebate. Moreover, under the recently promulgated revenue ruling, objectives similar to those of these bills can be accomplished through programs that allow discounts on monthly utility bills to customers who participate in conservation programs without departing from general tax principles or opening up the potential for double tax benefits. Finally, the proposed legislative changes would lose significant revenue over the 5-year budget period.

Tax Credit For Retrofitting Home Oil Burners

From 1978 through 1985, the Internal Revenue Code provided a residential energy credit to individuals installing insulation or other energy-saving components in their principal residence. The credit allowed was equal to 15 percent of the first $2,000 of qualifying energy conservation expenditures (a taxpayer's maximum credit per residence was $300) and the credit was nonrefundable.

Several bills (S. 326, S. 741, and S. 743) would provide a nonrefundable credit to individuals for retrofitting residential oil-burning furnaces with flame-retention replacement burners or similar components that use comparable conservation technologies. S. 741 and S. 743 would also allow the credit for expenditures that increase a residence's insulation value (including expenditures that increase the insulation value of a water heater or a window) and expenditures for an automatic thermostat control. The credits would be allowed only for the installation of new equipment with an expected useful life of at least three years.

In general, the credits would be allowed for the full amount of qualifying retrofit expenditures up to a lifetime maximum of $100; joint occupants of a residence would be required to allocate the $100 maximum credit in proportion to their qualifying retrofit expenditures. No credit would be allowed for expenditures made from subsidized (whether in the form of a grant or a low-interest loan) financing provided by a governmental energy conservation program, and expenditures for which a credit is allowed could not be taken into account in determining the basis of the property with respect to which the expenditures are made. The credit would be allowed for expenditures made after December 31, 1990. Under S. 326, the credit would be allowed only for expenditures made before December 31, 1994; S. 741 and S. 743 would also allow a credit for expenditures during 1995.

Administration position. The Administration opposes these proposals because these are inefficient mechanisms for encouraging conservation. Experience with the prior-law residential energy credit, which also provided a modest tax credit for certain residential conservation expenditures, suggests that most taxpayers claiming the credit would have purchased the conservation equipment even in the absence of the credit. These proposals also would complicate the tax forms for all Americans and would be difficult for the IRS to administer.

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

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

PREPARED FOR DELIVERY
EMBARGOED UNTIL 12:30 P.M.
(PARIS)

CONTACT: DESIREE TUCKER-SORINI
42-96-05-89

REMARKS BY
THE U.S. SECRETARY OF THE TREASURY
NICHOLAS F. BRADY
AT THE OECD MINISTERIAL MEETING
PARIS, FRANCE
JUNE 4, 1991

Mr. Chairman, Secretary General Paye, distinguished delegates.

We meet today at a time of unique challenge and opportunity for the world economy.

The new democracies of Eastern Europe are pushing ahead with courageous reforms, and making real progress toward economic revival and self-sustaining growth. In Czechoslovakia, Hungary and Poland, great strides have been made in privatization and market-oriented legal and regulatory reforms, the cornerstones of a successful shift to free enterprise. Far-reaching reforms are also taking hold elsewhere, particularly in Latin America.

Nevertheless, the path has not been an easy one. In many cases the dislocations have been larger than we had hoped and some of the economic benefits more elusive.

The historic transition now underway cannot succeed without the effective support of the OECD community. It is more important than ever that we do what we must to meet the challenges arising from changes we ourselves worked so hard to promote.

The single greatest contribution we can make, both individually and collectively, is to ensure a favorable global economic environment. Solid, sustained growth in the industrial countries is the most effective way to create the market opportunities needed to support economic development and reform in Eastern Europe. After all, that is the opportunity we held open to the emerging democracies. And solid growth is no less important for meeting our own domestic challenges.

Yet we see real grounds for concern on this score. At last year's meeting we expected OECD economic growth in the 3 percent range in 1991. Now it seems more likely to be only about 1-1/2 percent. While the general expectation is that a broad recovery will get underway this year, particularly in the United States, uncertainties nevertheless remain about its strength and timing.

During last year's meeting there was particular concern about the risk of higher inflation. But with prolonged monetary restraint and slower growth, inflation rates are now receding on a broad front. In the United States, for example, consumer prices have risen at an annual rate of only about 2 percent since January. This is a welcome trend, and offers support for the OECD's latest forecast of average G-7 inflation falling to under 4 percent by the end of this year.

The current circumstances therefore argue for a balanced approach, one that recognizes the need for continued vigilance on the inflation front but emphasizes a dynamic forward-looking strategy that gives emerging democracies the hope that, if they stay the course, they will create the solid and durable market based economies they promised to their peoples.

A broad-based approach can respect the different circumstances in our countries. Such a strategy could combine several elements.

First, we must understand that the dynamism and hope we seek, require macroeconomic policies to encourage growth along a steady and sustainable path. In the United States, for example, interest rates have been reduced without contributing to inflation expectations. Against the background of slowing growth, declining inflation, and shifting exchange rate considerations in Europe, some countries have seized the opportunity to reduce interest rates as well.

We also need to ensure that adequate, reasonable priced capital is available to meet the new investment needs emerging around the world. For most of us, this means continued progress in reducing government budget deficits, the major cause of the declining national saving rates we have observed over the past decade.

The United States recognizes its particular responsibilities on this score. The Administration is implementing a broad package of measures that will reduce the federal budget deficit $500 billion over the medium-term. Moreover, we expect the substantial reforms that have been made in the budget process itself will provide savings for years to come.

We need to persevere in opening up markets for trade in goods and services, investment and other capital flows. The quick and successful conclusion of the Uruguay Round deserves top priority. And it is time to reach agreement on the National Treatment Instrument. Over the past forty years, our expanding global trading system has shown itself to be a powerful stimulus to both growth and efficiency in the industrial countries. We need to ensure that the system provides the same opportunities to Eastern Europe and the developing countries.

We also need to look for ways to provide Eastern Europe with the fullest possible access to our markets and to avoid undercutting them in third markets through credit arrangements. The collapse of the Soviet market and the shift to hard-currency pricing makes the need for action especially compelling at this time. If this means rethinking long-standing protection for sheltered sectors, and I believe it does, then now is the time to do it. If it means practical marketing assistance to help them become competitors, and I believe it will, then we should not hesitate.

Finally, we are urging reforming countries to build private markets because we know they provide the foundation for long-term growth. Yet at the same time our own economies are rife with impediments to efficient operation of markets and prices.

Last year I suggested a number of areas where policy improvements could reduce structural impediments in our economies that stifle growth and job creation, distort investment flows and impede trade. Some progress has been made, but there is ample room for additional steps to strengthen our own private markets, and a strong case for moving much more aggressively.

We are all grateful to the OECD for the excellent work it has done in identifying costly structural rigidities in all of our economies. And we are confident that the recent decision to integrate these issues more systematically into the work of the Economic Policy Committee will provide additional impetus. But in the end it is up to us to make the changes, for our own benefit and for the benefit of those whose boldness and determination has been so inspiring.

With its broad membership, responsibilities, and expertise, the OECD has always provided a useful forum for candid discussion of key international economic issues.

This Ministerial offers a golden opportunity to reaffirm our commitment to the success of the great transition now underway, and to assume concrete responsibility for helping it come about.

Now is the time to translate our shared aspirations for the future into a dynamic, hopeful forward-looking strategy for sustained economic growth, development and integration.

####

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

FOR IMMEDIATE RELEASE
PREPARED FOR DELIVERY
JUNE 5, 1991

CONTACT: DESIREE TUCKER-SORINI
42-96-05-89

STATEMENT OF RELATIONS WITH NON-MEMBERS

The OECD and its member countries should be pleased by the growing movement in the world toward our shared belief in democracy and market economies. The past decade has seen these values triumph in the global competition of ideas. They have triumphed, not by force, but by the simple accumulation of the evidence that they provide the most effective organizing principles for meeting human aspirations for personal liberty and material wellbeing.

We in the OECD have contributed to this remarkable transformation by our own success in adopting policies consistent with these objectives. The main credit, however, goes to the individual countries, facing widely different circumstances, which have independently determined to seek a new path to economic and political development.

What is now required of us is that we and our Organization respond effectively to the changes taking place around us. To do this the United States believes that the OECD should continue its flexible approach to links with countries committed to OECD values and prepared to make a meaningful contribution to the OECD's work, in particular countries which are likely to be candidates for membership in the near future. Of course, we need to preserve the essential character of the Organization as a forum for consultation and cooperation among industrial countries and as a locus for liberalization efforts.

We have been joined at this meeting by representatives of Poland, Czechoslovakia and Hungary. Their presence is a dramatic affirmation of the power of the ideas that the OECD embodies. The United States is pleased to join in welcoming these "Partners in Transition". We hope that the Partners in Transition program will make easier these countries' economic transformation and adoption of OECD obligations so that they can become full members of the OECD. In particular, we look for early progress and the involvement of the Partners in OECD work aimed at eliminating barriers to trade and investment.

NB-1329

The Dynamic Asian Economies have used the open international trading system over the past thirty years to make a dramatic advance in economic terms. They, too, now face a transition as their societies and economies mature. An expanded role for market forces will facilitate that transition. Here, we hope the OECD's ongoing dialogue with these economies will help lead them to implement policies consistent with OECD obligations, and to assist the transition of others.

In particular, we welcome indications that Korea may seek to develop closer ties with the OECD and urge that Korea implement policies consistent with the principles of the OECD and its growing role and responsibilities in the World economy.

The recent changes in Mexico are leading to a major economic transition. Consistent with Mexico's effort to reverse half a century of statist, interventionist economic policies, Mexico has expressed an interest in closer links with certain OECD bodies. Its effort to be associated with those activities involving the Organization's trade and investment liberalization principles will help foster Mexico's own efforts. We hope that other Latin American countries will succeed in implementing similarly thorough going economic reform programs.

Now I would like to turn to Ambassador Hills for a brief additional comment.

THE SECRETARY OF THE TREASURY
WASHINGTON

June 7, 1991

The Honorable Dan Quayle
President of the Senate
Washington, D.C. 20510-0010

Dear Mr. President:

I am pleased to transmit the Treasury Department's 1991 report on intermarket coordination, as required by section 8(a) of the Market Reform Act of 1990.

As the report indicates, much has been accomplished through the efforts of the Working Group on Financial Markets, the individual agencies, and private market participants to address the issues most critical to intermarket stability.

The absence of federal oversight of margins on stock index futures remains the most crucial issue affecting systemic stability. Title III of the Senate-approved bill to reauthorize the Commodity Futures Trading Commission (H. R. 707) would assign broad authority for setting margin levels for stock index futures to the Federal Reserve Board to preserve the financial integrity of futures markets and to prevent systemic risk. The Federal Reserve would have the authority to harmonize margins across equity-related markets because it already has ultimate margin authority over stocks and stock options. This provision represents a critical step towards promoting intermarket stability, and I strongly urge that it be supported in the upcoming House-Senate conference.

I look forward to continued progress on intermarket issues.

Sincerely,

Robert R. Glauber
Acting Secretary

Enclosure

THE SECRETARY OF THE TREASURY
WASHINGTON

June 7, 1991

The Honorable Thomas S. Foley
Speaker of the House of
Representatives
U.S. House of Representatives
Washington, D.C. 20515-6501

Dear Mr. Speaker:

I am pleased to transmit the Treasury Department's 1991 report on intermarket coordination, as required by section 8(a) of the Market Reform Act of 1990.

As the report indicates, much has been accomplished through the efforts of the Working Group on Financial Markets, the individual agencies, and private market participants to address the issues most critical to intermarket stability.

The absence of federal oversight of margins on stock index futures remains the most crucial issue affecting systemic stability. Title III of the Senate-approved bill to reauthorize the Commodity Futures Trading Commission (H. R. 707) would assign broad authority for setting margin levels for stock index futures to the Federal Reserve Board to preserve the financial integrity of futures markets and to prevent systemic risk. The Federal Reserve would have the authority to harmonize margins across equity-related markets because it already has ultimate margin authority over stocks and stock options. This provision represents a critical step towards promoting intermarket stability, and I strongly urge that it be supported in the upcoming House-Senate conference.

I look forward to continued progress on intermarket issues.

Sincerely,

Robert R. Glauber
Acting Secretary

Enclosure

1991 Treasury Department Report on Intermarket Coordination

INTRODUCTION

A. The Problem of Major Market Disruptions

Four times in the past four years the stock market has plunged dramatically for no apparent reason: October 19, 1987 -- 22.6 percent, October 26, 1987 -- 8.0 percent, January 8, 1988 -- 6.9 percent, and October 13, 1989 -- 6.9 percent. In October 1987 the Dow Jones Industrial Average (DJIA) lost almost a third of its value -- $1.0 trillion -- in just four days. This included the one-day drop of 508 points on October 19 -- the largest recorded amount since the DJIA began computing index numbers in 1885. The very real prospect of clearinghouse failures in the wake of this crash led to a crisis of confidence that brought the system to the brink of breakdown.

On Friday, October 13, 1989, the DJIA fell 191 points. Almost 90 percent of the drop occurred in the last 90 minutes of trading, supposedly triggered by news of a failed takeover attempt for a single company. The following Monday, October 16, the market lost 63 points in the first 40 minutes of trading, then sharply rebounded to close 88 points up on the day.

In each of these episodes, minor, even untraceable, events appear to have triggered precipitous, violent market declines. Each episode occurred in the last four years, when stock index futures have been actively trading in large volumes. Each episode shared the characteristic of enormous selling pressure from stock index futures markets flowing over to the stock market. And each episode constituted a major market disruption, a period when the markets for stocks and stock index futures disconnect with prices spiralling down.

There now is general agreement that stocks, stock options, and stock index futures are "one market", linked together by electronics. Movements in the price of stock index futures are translated almost immediately to stock prices through index arbitrage, and vice versa. This was the conclusion of the 1987 Task Force on Market Mechanisms (Task Force), chaired by Secretary Brady, and essentially no one has disputed it. The Task Force also concluded that the interaction of trading in stock and stock index futures in the "one market" is a major cause of market disruptions. Unfortunately, the disjointed regulation of stocks and stock derivative instruments has not kept pace with this reality, failing to develop the "one market" tools that are needed to deal with these market disruptions. Until intermarket mechanisms are harmonized to conform to the reality of the "one market", U.S. financial markets will continue to be at risk of disruption and instability.

B. Role of the Treasury Department

For the most part the Treasury Department does not have direct rulemaking or oversight authority with respect to intermarket issues. The Treasury's role with regard to intermarket coordination has been essentially twofold: (1) to closely monitor financial market developments, promote better communication and coordination among agencies, and strive through the Working Group on Financial Markets to correct market weaknesses; and (2) to develop legislation as needed to address these issues. Accordingly, this report focuses on Treasury's roles in coordinating the Working Group and developing legislative policy. Specific agency actions are not discussed in detail, but instead are incorporated by reference from the other agency reports.

In 1989 the Treasury was assigned leadership of the Working Group on Financial Markets with Senator Brady as chairman. The Working Group has created a process for dialogue, coordination, and cooperation that has continued during this Administration. We are generally pleased with the progress the Working Group has made. Indeed, through the constructive actions of market participants, regulators, and self-regulatory organizations, the Working Group has accomplished much of what was advocated by the Task Force. The Working Group initially focused on the significant suggestions of the Task Force and others that could be accomplished immediately to substantially lessen possible systemic dangers to the U.S. financial system if we were again to encounter a severe market decline.

Most importantly, the Working Group has endorsed the Task Force's fundamental premise -- that the markets for stocks, stock options, and stock index futures are linked as one market. Recognition of the "one market" is the foundation upon which intermarket coordination, and interagency cooperation, ultimately depend.

Within the past year, the Working Group process was largely subsumed by the Administration's ambitious legislative program for intermarket issues. Although there were no formal meetings of the Working Group, the Working Group was in close communication at both the principal and staff levels.

C. "The Capital Markets Competition, Stability and Fairness Act of 1990"

In June 1990, the Administration and the Securities and Exchange Commission (SEC), having concluded that regulatory fragmentation was the fundamental problem underlying market instability, proposed S. 2814, "The Capital Markets Competition, Stability and Fairness Act of 1990". Based partly on recommendations developed by the Task Force in its report, this proposal was Treasury's primary legislative initiative relating to those issues.

The bill contained three key provisions designed to address the regulatory structure for stocks and stock index futures. First, it would have transferred authority to regulate stock index futures from the Commodity Futures Trading Commission (CFTC) to the SEC, but in a manner specifically designed to create the least disruption to market participants. Second, it would have provided federal oversight authority over the ability of futures markets to set margins on stock index futures -- not to prevent volatility, but to safeguard the financial system. Third, the bill would have modified the "exclusivity clause" of the Commodity Exchange Act to end costly and anticompetitive legal disputes over what constitutes a "futures contract."

Unfortunately, opponents of these far-reaching changes managed to block consideration of the bill in the last Congress, and the stalemate appeared likely to continue in the 102nd Congress. As a result, S. 2814 was superseded by new Title III of the CFTC reauthorization bill, discussed below.

D. <u>Title III of the Senate-Approved CFTC Reauthorization Bill</u>

As a result of the stalemate over S. 2814, the Administration decided that a separate initiative was needed to break the logjam, especially given the crucial need for harmonized federal oversight of margins to avoid financial market disruptions. Accordingly, in March 1991 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. On April 18, 1991, the Senate adopted the compromise with one amendment as Title III of S. 207 (now H.R. 707).

As discussed more fully in the following section of this report, Title III would grant the Federal Reserve 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 from the Commodity Exchange Act in the public interest, and it would be directed to exempt certain swaps if not contrary to the public interest. Unlike the Administration's original 1990 proposal, 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. Under the Senate-approved bill, certain deposit- and loan-based hybrid instruments would be excluded from the Commodity Exchange Act, rather than the mandatory exemption for certain deposits the

Treasury had proposed and the Senate Agriculture Committee adopted.

While 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. 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 Title III.

I. VIEWS ON THE ADEQUACY OF MARGIN LEVELS AND THE USE OF LEVERAGE BY MARKET PARTICIPANTS

A. The Problem of Unharmonized Margins

Four years have passed since the 1987 market break, and critical intermarket legislation has yet to be enacted, particularly in the crucial area of margins. Meanwhile, as previously discussed, 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.

Both the October 1987 market beak and the October 1989 mini-break demonstrated the need to harmonize margin requirements. Both times the collapse of futures prices led to a steep decline of stock prices -- and in each case futures margins were much lower than stock margins. When a pattern repeats itself, it is likely to be more than just coincidence.

While there is federal oversight of margins on stocks, there is virtually none over margins on stock index futures. The futures exchanges and their clearinghouses set these futures margins themselves. The result is a tremendous disparity in margin levels on stocks and stock index futures, even though they are part of one market where margin levels on one instrument can have a direct impact on the trading and price of the other.

The result has been that futures margins have often dipped to dangerously low levels. Indeed, Chairman Greenspan of the Federal Reserve -- the guardian against excessive risk to the financial system -- has expressed strong concerns about the low level of stock index futures margins prior to the mini-crash in October 1989.

In 1987, the Task Force recommended harmonized margin requirements, and after October 1987 the futures exchanges substantially increased them. As a result, the Working Group concluded that increased margins in 1988 were sufficient for prudential purposes. But by the October 13, 1989 mini-break, the futures markets had reduced margins to levels even lower than before the 1987 collapse, and far lower than margins in the stock market.

This continuing lack of consistency raises fundamental questions. Even though the futures exchanges set margins that may well be adequate to protect their own markets, there are broader issues to be considered.

Futures margins obviously affect futures trading and, because the futures market and stock market are linked as one market, futures margins have a direct and material impact on trading in the stock market. Low futures margins indirectly permit high leveraging in stocks. This leverage creates the potential for extreme volatility, starting in the futures market and washing back to the stock market. The resulting financial exposure cannot be confined to a single market, and can spread quickly to affect the entire financial system.

Because margin requirements affect intermarket risk, there is a public interest involved beyond the private interest of the exchanges. Over 50 years ago the government made a determination to establish minimum margins in the stock market. Now that it has been established that futures trading affects the stock market, futures margins should bear the same public scrutiny. It makes no sense to allow participants in what is one market to control far more stock with a low down payment in the futures market than they could purchase directly in the stock market. It is not good public policy to allow the private exchange of one market to set margins affecting the whole system.

A consequence of low futures margins is that during market downdrafts, when the system is most in need of liquidity, futures exchanges are forced to restrict liquidity through <u>increased</u> margin requirements. This is precisely the opposite of what should occur: during emergencies it is critical to pump liquidity <u>into</u> the system.

Those who try to dismiss the need for federal oversight of margins on stock index futures by claiming that margins are unrelated to volatility simply miss the point. The relevant concern is major market disruptions and how to slow them down when the tidal wave starts to form -- not volatility.

The Federal Reserve Board agrees with the need for federal oversight of margins on stock index futures to limit systemic risks. Indeed no persuasive argument has been advanced against federal oversight -- we must have it 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. Congress ought to address this unjustified anomaly, and we believe Title III of the Senate-approved CFTC reauthorization bill is a timely and appropriate approach to doing so.

B. Title III of the Senate-Approved CFTC Reauthorization Bill

The provision in Title III of the Senate-approved CFTC reauthorization bill assigning broad margin authority over stock index futures to the Federal Reserve represents a critical step toward promoting intermarket stability. 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 Federal Reserve in its judgement 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 Federal Reserve 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.

Congress now has an opportunity to make a significant contribution to the stability and competitiveness of U.S. financial markets. We believe this is a crucial time to move forward with legislation that will lessen the likelihood and consequences of another market break like October 1987.

II. EFFORTS RELATING TO THE COORDINATION OF REGULATORY ACTIVITIES TO ENSURE THE INTEGRITY AND COMPETITIVENESS OF U.S. MARKETS

A. Market Integrity Initiatives

1. Circuit Breakers

Background

One of the primary recommendations of the Task Force report was the adoption of circuit breaker mechanisms, such as price limits and coordinated trading halts, to protect to market system. The Working Group's 1988 Interim Report recommended a one-hour trading halt for equity and equity-related products if the DJIA declines 250 points from the previous day's closing level and a two-hour closing if the DJIA declines 400 points below its previous day's close. The Working Group also recommended that the New York Stock Exchange (NYSE) use reopening procedures, similar to those used on so-called Expiration Fridays, designed to enhance the information made public about market conditions.

Following the Working Group's recommendations, the securities and futures industries adopted several types of circuit breakers, including one- and two-hour trading halts. In addition, the NYSE and Chicago Mercantile Exchange (CME) developed "side car" procedures whereby, if the S&P 500 future traded on the CME falls by a certain amount (currently 12 points), the futures contract price is not permitted to fall further for 30 minutes and program trading orders on the NYSE are automatically routed into a separate file for delayed matching and execution.

In June 1990, the NYSE released the results of a six month study by a broad-based, blue-ribbon advisory committee -- the Panel on Market Volatility and Investor Confidence. The panel recommended new and stronger circuit breakers to halt equity-related trading in all domestic markets when the market is under pressure. Specifically, the panel proposed a one-hour halt when the DJIA moves 100 points from the previous day's close, a 90 minute halt at 200 points, and a two-hour halt at 300 points. The CME and Chicago Board of Trade (CBOT) later proposed to revised their circuit breakers to conform to the NYSE panel's recommendation, but they withdrew their proposals when it became apparent that the NYSE was not moving toward adoption of the panel's recommendation.

In July 1990 the SEC approved an amendment to NYSE rule 80A requiring that index arbitrage sell orders for any component stock of the S&P 500 index be entered only on a plus or zero plus tick and, conversely, that buy orders be entered only on a minus or zero minus tick, when the DJIA moves down 50 points or more from the previous day's close. When the one-year pilot program expires in July 1991, the NYSE intends to seek reapproval from the SEC.

The Market Reform Act of 1990, which the President signed into law on October 16, 1990, clarified and broadened the authority of the SEC to suspend trading and take certain other temporary action during market emergencies. The Act clarifies the SEC's ability to halt trading, market-wide, during a major market disturbance, provided the President does not object to the action. In addition, it provides the SEC with authority to take other temporary emergency action if there is a "major market disturbance".

Finally, the SEC's rule 10a-1, adopted in 1938, prohibits traders from selling stock short when the price is falling. From time to time the SEC has been urged to reconsider the rule, but the Commission is not expected to abolish it in the immediate future.

Discussion

To be effective, circuit breakers must be preestablished, coordinated, and triggered infrequently. By establishing them in advance of the time they are needed, we minimize the panic that can occur from ad hoc circuit breakers. By coordinating them between markets, we avoid the risk that a trading halt in one market might disconnect prices from a related market and thereby exacerbate volatility rather than dampen it. By having them apply only in real emergencies, we ensure that the markets stay open to the maximum extent possible. In short, circuit breakers should be considered catastrophe insurance, not a prepaid medical plan.

Some progress has been made to coordinate circuit breakers in stock and stock index futures markets, and discussions are continuing within the Working Group. Nevertheless, more can be done, and fundamental disagreements continue to exist between markets and their regulators over the appropriate kinds of circuit breakers.

The Working Group has formed a staff subgroup on circuit breakers which is reviewing the timing of release of important government economic data on days when contracts for equities, options, and futures expire -- the so-called triple-and double-witching days. The subgroup also analyzed the regulators' review of the performance of circuit breakers during the October 1989 mini-break, and an ongoing objective is whether circuit breakers need to be simplified and whether triggers should be adjusted and better coordinated.

Circuit breakers appeared to work reasonably well on October 13, 1989, when the DJIA fell 191 points. As in 1987, the futures market led the other markets down, but this time circuit breakers were triggered twice. (The intervening weekend between October 13th and 16th also proved to be a fortuitous form of circuit beaker.) The preestablished circuit breakers seemed to perform as designed: to allow the human mind to catch up with the speed of technology and to give markets some time-out to help them adjust to massive demands concentrated in short periods of time.

The markets' performance on October 13th raised some questions about the need for better coordination, particularly with regard to the 12-point price limit on the Chicago Mercantile Exchange. The Merc's 12-point "shock absorber" is designed to slow down a market decline before trading halts in the stock and futures markets are triggered at roughly 250 Dow points. Unfortunately, when the 12-point shock absorber is triggered in the futures market, selling pressure can be transferred to the stock markets, which are still open.

Day limits on the futures exchanges also provide a mechanism to allow the markets to adjust in the case of an extraordinary market freefall. The futures markets provide instant liquidity, but not infinite liquidity. Day limits institutionalize this fact. We applaud the recent progress that the futures exchanges have made in this area.

Regarding NYSE rule 80A, we have had some concerns about the uncoordinated nature of the buy-minus, sell-plus rule and the possible need to set the triggers at higher levels. Nevertheless, the rule seems to have worked reasonably well so far (it has been triggered at least 27 times). We have no objection to extending it when it expires this July.

With respect to the short selling restrictions under SEC rule 10a-1, we have concerns about the possible evasion of these restrictions due to the absence of an intermarket perspective. The purpose of these restrictions is to prevent "gunning" the market, an attempt to drive down prices through short selling in the hope of panicking small investors. However, a concerted effort in the futures market could undermine the short selling restriction and potentially be used to accelerate a stock market downdraft. Obviously, the rule could not apply directly to sales in the stock index futures market. But with futures and stocks linked through index arbitrage and other mechanisms, the effect of the rule may have been substantially undermined. We believe it is important to harmonize these intermarket rules to prevent manipulators from using one market to evade restrictions in another market.

2. <u>Intermarket Frontrunning Agreements and Financial Surveillance</u>

Vigorous action against problems of intermarket frontrunning and market manipulation is essential. Along with the benefits of new products, technologies, and trading strategies have come increased opportunities for abuse by market professionals and insiders. These abuses have hidden economic costs in addition to their more obvious effect on smaller individual and institutional investors who come to believe that the rules are rigged against them.

It is in the best interest of all investors concerned that the problems of frontrunning and market manipulation be resolved quickly and effectively by the agencies and self-regulatory organizations. Such action is crucial if we are to take seriously the charge that markets are rigged to the disadvantage of small investors.

Some progress has been made. The NYSE and CME have developed a definition of intermarket frontrunning, which involves executing an order in one market based on prior knowledge of an order in another market. In 1988 the CFTC approved the CME's circular, and in 1989 the SEC approved a NYSE rule aimed at banning intermarket in frontrunning.

Coordinated surveillance and information sharing also is helping. In 1981 the self-regulatory organizations formed an Intermarket Surveillance Group (ISG) to facilitate information sharing and coordination of intermarket surveillance activities. One of the ISG's major purposes is to provide a check against intermarket frontrunning.

The Market Reform Act contains a large trader reporting requirement to facilitate SEC surveillance and enforcement, including curbing intermarket front-running and market manipulation. This provision made the SEC's authority in this area more comparable to the CFTC's. As explained in the Task Force report, the 1987 market break illustrated the need for a trading information system incorporating the trade, time of trade, and name of the ultimate customer, in every major market segment. This is critical, the Task Force believed, to assess the nature and cause of a market crisis to determine who bought and sold. This information can be used to diagnose developing problems as well as to uncover potentially damaging abuses.

The pending CFTC reauthorization legislation contains important reforms that will enhance detection and prevention of intermarket trading abuses. Enhanced audit trail procedures, restrictions on dual trading and other abuses, and strengthened enforcement authority and civil and criminal penalties should significantly improve the government's ability to prevent frontrunning and manipulation abuses. We support the thrust of these provisions.

B. Domestic Coordination and Information Sharing

1. Intermarket Coordination and Information Sharing

In addition to regulatory coordination through the Working Group, one of Treasury's primary roles has been to coordinate with other agencies during potential market difficulties. Examples include the recent collapse of Drexel Burnham Lambert, Inc. and the Persian Gulf crisis. In each instance, Treasury officials monitored developments closely, were in frequent communication with other financial agencies, and helped to coordinate governmental action and contingency responses in the event of market turmoil.

2. Government Securities Act of 1986

An important result of the regulations implementing the Government Securities Act of 1986 (GSA) has been the extensive cooperation and coordination that has been fostered among the Treasury, SEC, Federal Reserve Board, other financial institution regulatory agencies, and the self-regulatory organizations (SROs) such as the National Association of Securities Dealers (NASD). While the GSA requires that Treasury consult with the SEC and the Federal Reserve during the regulatory process, Treasury has taken the view that consultation is beneficial during more than just rulemaking periods and should not be limited to the SEC and the Federal Reserve, but should include all appropriate regulatory agencies and market participants when relevant.

In developing proposed regulatory initiatives, in providing clarifications of the regulations, and in responding to requests for interpretation of and exemptions from the GSA rules, Treasury is extremely sensitive to the need for effective coordination with the SEC and other regulatory agencies. In particular, Treasury, through consultation, is able to obtain the benefit of expertise developed by these agencies, which is helpful in developing appropriate responses to inquiries and requests, determining the impact of proposed actions on the government securities market and its participants, and avoiding duplicative or conflicting requirements. This coordination and consultation is not limited to the appropriate regulatory agencies but also includes the SROs such as the NASD. To enhance coordination, Treasury has established a quarterly meeting cycle with staff of the SEC and the NASD to address market developments, to discuss current topics, and to update each other on their respective regulatory initiatives. Additionally, Treasury periodically solicits feedback from the various financial institution regulators, although the volume and variety of issues involving each of them do not lend themselves to a regular quarterly meeting.

Treasury believes it is especially important in the continuing implementation and fine-tuning of the regulations to gather information on the current status of market practices and the types of regulatory violations that have occurred. In order to facilitate this data collection process, the GSA provides express authorization for the sharing of information between the various regulatory agencies and Treasury. This statutory authority is important because each of the regulatory agencies is subject to certain restrictions on the release of information, especially relating to examinations, and this provision eliminates uncertainty regarding the legality of sharing information. The exchanges of information have been useful in identifying needed clarifications of or changes to the regulations, since Treasury does not conduct compliance examinations and is removed from first-hand knowledge of the internal practices of government securities market participants. To aid in the collection of this information, Treasury is continually working with the appropriate regulatory agencies to develop and improve a regular reporting structure for them to provide summary information of regulatory violations and enforcement actions to Treasury.

Because SROs perform the examinations of brokers and dealers subject to the SEC's jurisdiction, they also are an important source of information. The NASD is the SRO for all of the government securities brokers and dealers that registered pursuant to the GSA. Accordingly, Treasury and the SEC have included representatives of the NASD at their quarterly meetings to take advantage of the NASD's knowledge about the state of the government securities market. The NASD has also been instrumental in soliciting the comments and reactions of its membership on new regulatory initiatives and the impact of new market practices. This type of feedback has been useful in identifying areas that warrant attention and the proper focus of any regulatory action. Members of the Treasury and SEC staffs have participated in NASD educational seminars, which have helped all registered government securities brokers and dealers to become equally familiar with the regulations.

The need for coordination is even more significant with respect to the financial institution regulators. Although the rules that each is enforcing are similar, the possibility exists for different levels of understanding of those rules and varied enforcement activity by each agency. To date, these problems have been avoided by the active involvement of all regulators on major issues. Typically, either Treasury or a regulator raises an issue to the attention of the other. Treasury, in turn, submits it for the consideration of the other regulators. After the issue is thoroughly discussed, including the possible outcomes and impacts, Treasury will issue either formal or informal guidance to the agencies as to the appropriate way to view the regulatory requirement.

The frequently informal nature of the consultation and coordination between Treasury and the other agencies, combined with the vast pool of expertise at each institution, has provided market participants with the comfort that all participants will be treated in an equitable manner. The need for equal treatment, to avoid the creation of competitive disadvantages, will become increasingly critical as the legal and operational barriers separating the businesses of the different government securities market players become less significant. Balanced treatment of all market participants provides investors in the government securities market with a wide choice of market professionals with which to conduct business without any trade-offs involving customer protection.

C. <u>International Coordination</u>

The Task Force concluded that our domestic securities and derivative markets are so closely linked as to constitute one market requiring coordinated policies and procedures. Although the world's securities and derivative markets are unified in only some respects, the evidence of their close linkages and interdependence has grown dramatically.

The rapid expansion of global securities markets suggests that we should consider the interrelationship among markets on a global scale. To that end, the Working Group has established a subgroup to identify particular issues where an international and intermarket approach would be useful.

Issues where an international policy coordination might be useful include clearance and settlement operations, coordination in emergencies, enforcement, and capital adequacy standards.

The purpose should not be to impose burdensome new regulations around the world. Instead, we should move towards harmonized regulation that will make markets more competitive and efficient.

Another area where more progress could be made is in establishing electronic links with foreign markets. Progress in new technologies is important to the competitiveness of U.S. markets. We need to clarify the kinds of electronic links we are going to use domestically and make them operational in a more unified manner. The CME's development of Globex is an important step in this direction. In addition, the CFTC reauthorization legislation contains provisions promoting the development of electronic futures trading.

Section IV of this report describes in more detail the Treasury's efforts to promote global coordination.

III. EFFORTS MADE TO FORMULATE COORDINATION MECHANISMS ACROSS MARKETPLACES TO PROTECT THE PAYMENTS AND CLEARANCE AND SETTLEMENT SYSTEMS DURING MARKET EMERGENCIES

A. Coordination of Clearance and Settlement Systems Across Markets

1. Background

The most disturbing consequence of major market disruptions is the risk they pose to the entire financial system, especially through the clearance and settlement process. For example, after the October 1987 break, the clearance and settlement system fell over six hours behind its normal payment times, with over $1.5 billion owed to investment houses. Had these funds been missing for any significantly longer time, it could have unleashed a chain reaction of events spreading losses through the payments system.

The Task Force concluded that the prospect of clearinghouse failures reduced the willingness of lenders to finance market participants, leading to "a crisis of confidence [that] raised the specter of a full-scale financial system breakdown." To reduce the possibility of financial gridlock and the attendant risk to the financial system, the Task Force recommended that clearing for stocks, stock options, and stock index futures be unified through a single mechanism. This was later clarified to mean not necessarily a single centralized clearinghouse, but rather coordinated mechanisms to facilitate safe and efficient clearance and settlement.

The Working Group reviewed existing clearing, payment and settlement systems to identify and set priorities for measures to reduce uncertainty, increase coordination, assure confidence in the integrity of such systems, and facilitate their smooth operation in volatile markets. In the Working Group's Interim Report it proposed an agenda of specific actions in the following areas, among others:

- o <u>Facilitation of timely payments</u>. Several features of existing clearance and settlement systems relevant to payment capacity can be enhanced to facilitate the timely satisfaction of payment obligations, including increased Fedwire availability in highly volatile markets, and coordination of timely information concerning payment obligations and cash flows.

- o <u>Exploration of methods to simplify settlement systems</u>. This would include a cross-margining pilot program for non-customer accounts in options and futures, and consideration of specific initiatives to reduce cash transfers, simplify settlements systems, and unify clearing.

- o <u>Refinement of relevant legal frameworks</u>. It is important to harmonize transfer, delivery and pledge requirements for options and uncertificated securities and to better coordinate bankruptcy protection for securities and commodity brokers.

In an April 1990 report, <u>Clearance and Settlement Reform: The Stock, Options, and Futures Markets are Still at Risk</u>, the General Accounting Office recommended that the Treasury, through the Working Group, make the following improvements in the clearance and settlement process:

(1) Ensure that a routine intermarket information sharing system is developed and used to assess the intermarket risks posed by joint members.

(2) Ensure that studies exploring ways to lessen intermarket cash flow pressures and to simplify intermarket clearing without diminishing safeguards against financial risk are completed and acted on appropriately (as also proposed in the Working Group's <u>Interim Report</u>).

The Secretary, working with other members of the Working Group as well as the exchanges and their clearing organizations, should identify responsibilities, assign tasks, and set time frames for accomplishing these recommendations.

As previously noted, most of the Working Group's efforts during the past year have focused on the legislative agenda. This is also true of the Treasury Department, which has sought legislation unifying regulation of the "one market" to address intermarket concerns. In addition, Treasury helped to develop and strongly supported the Market Reform Act of 1990, which we expect will be of far-reaching importance for coordinated clearance and settlement.

In addition to legislative efforts, considerable progress on clearance and settlement issues, including the two recommendations made by the GAO, has been made through the Working Group. Progress on these issues is discussed in detail in the separate reports of the SEC, the CFTC, and the Federal Reserve. Efforts to improve clearance and settlement are an ongoing responsibility of the Working Group and its constituent agencies. Although much has been accomplished, the job is far from complete.

2. The Market Reform Act of 1990

The Market Reform Act should expedite further improvements in the clearance and settlement process. The Act directs the SEC to facilitate the establishment of linked or coordinated facilities for clearance and settlement of transactions in securities, securities options, futures contracts, and commodity options. The Act does not mandate any particular clearance or settlement system structure, but leaves it to the discretion of the SEC to promulgate rules, having due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and the maintenance of fair competition. The issues raised by clearance and settlement procedures cross regulatory boundaries, and the legislation therefore directs the SEC to consult with the CFTC and the Federal Reserve.

The October 1987 market crash demonstrated that the lack of uniformity and clarity among state laws governing the transfer and pledging of securities also adversely affects liquidity in clearance and settlement systems. The Act establishes a framework through which the SEC could promulgate rules applicable to the transfer and pledging of securities, notwithstanding state laws. The Commission must consult with the Secretary of the Treasury and the Federal Reserve, and it must consider the recommendations of a 15-member advisory committee appointed by the SEC, Federal Reserve, and the Treasury. The Advisory Committee has been formally established, the selection of its members is proceeding, and we anticipate that the Advisory Committee will issue its report to the SEC, Treasury and Federal Reserve within six months of its designation, as required by the Act.

The Market Reform Act also contains provisions intended to provide the SEC with information necessary to assess the overall financial exposure of broker-dealer holding company systems. The Act provides the SEC with specific authority to obtain information regarding certain activities of broker-dealer holding company affiliates that are reasonably likely to have a material impact on the financial and operational condition of broker-dealers under the SEC's jurisdiction. This authority is designed to provide the SEC with "early warning" of potential problems and thus will assist the SEC in its efforts to protect the stability of broker-dealer participants in the marketplace, as well as the investing public.

3. Group of Thirty

Improvement of global clearing and settlement also is being addressed by the Group of Thirty, an independent, non-profit organization representing business and financial organizations of 30 developed countries. In 1989 the Group of Thirty issued a report -- Clearance and Settlement Systems in the World's

Securities Markets -- that made a number of recommendations designed to maximize the efficiency and reduce the cost of clearance and settlement, and thereby reduce risk.

Three of these recommendations are particularly noteworthy: to adopt a universal book entry system, to move toward a T+3 trade settlement, and to adopt a same-day funds convention. Progress is being made, and the Group of Thirty recently released a status report for individual countries as of year-end 1990.

These improvements will help to harmonize the world's securities markets, reduce risks, and lower costs. On balance, we believe they will benefit investors, the securities industry, and the financial system as a whole. We commend the U.S. Working Group of the Group of Thirty for its efforts to evaluate and now implement these recommendations.

The proposals are an example of the private sector responding to a perceived need by taking corrective action itself. We believe this is the best approach. To the extent governmental approvals are needed, we hope regulatory and political obstacles can be minimized.

B. Reducing Cash Flows and Simplifying Settlement Systems

1. Cross-Margining

Cross-margining is another area where more progress needs to be made. Cross-margining reduces the gross amount of payments due, and payments owed, by market participants and clearing-houses, thereby reducing the possibility that a counterparty to the trade may default and relieving some stress to the payments system. In addition, cross-margining reduces differences between pay and collect schedules, and increases the sharing of credit information between clearinghouses.

Several of the reports on the 1987 market break, including that of the Task Force and the Working Group's Interim Report, recommended some form of cross-margining. Since that time, two cross-margining programs have been set up -- between the Options Clearing Corporation/CME and the Options Clearing Corporation/Board of Trade Clearing Corporation.

IV. OTHER ISSUES RELATING TO THE SOUNDNESS, STABILITY AND INTEGRITY OF DOMESTIC AND INTERNATIONAL CAPITAL MARKETS

Following the October 1987 market break, the Organization of Economic Cooperation and Development (OECD) Committee on Financial Markets in May 1988 held a Special Session of Securities Markets Experts, who suggested that the OECD could usefully review systemic risks in securities markets and related activities and questions. This meeting brought together representatives of the world's leading exchanges as well as regulators, central bankers and finance ministry officials. Representatives of the U.S. Securities Industry Association, Investment Company Institute, NYSE, NASD, Chicago Board Options Exchange and the CME attended for the U.S. The Chairman of the Experts' Session was the Director of the Treasury's Office of International Banking and Portfolio Investment, who also serves as Vice Chairman of the Committee on Financial Markets.

The OECD Council of Ministers in its communique of May 19, 1988 indicated:

> "The Organization will intensify its efforts to analyze the nature and functioning of the emerging global financial system and to identify gaps and inadequacies in the coverage and co-ordination of prudential arrangements, especially in the case of securities markets."

At a meeting in November 1988, the Committee on Financial Markets set up an Ad Hoc Group of Experts on Securities Markets under the chairmanship of a Bank of England official to deal with this Ministerial mandate and focus in particular on issues pertaining to systemic risks in securities markets. The Experts Group prepared a draft report on Systemic Risk in Securities Markets. The Committee on Financial Markets vetted and approved the report in October 1990. The OECD Council agreed to the publication of the report in December 1990. During the 1989-1990 period when the Report was being prepared, representatives of the Treasury, SEC and Federal Reserve were involved in the work.

In May 1990, the Committee on Financial Markets published (in Financial Market Trends) a special article, "Recent Trends in the Organization and Regulation of Securities Markets." The substance of the article was based on the Committee's discussions; it dealt with, among other matters, maintaining the stability, safety and soundness of securities markets and the financial system as a whole. The OECD is not an operational body, but it is attempting to serve as a center for international information exchange on these issues.

In September 1990, the Committee on Financial Markets held an Experts Meeting on Banking Structure and Regulation, to review and discuss recent trends in banking activities and regulation and to assess, as far as possible, future developments. Representatives of the Office of the Comptroller of the Currency and Federal Reserve attended. Treasury's Director of International Banking and Portfolio Investment served as the Vice Chairman of the meeting. Topics included the impact on financial firms and markets of financial deregulation and trends toward concentration and formation of financial conglomerates.

Discussion focused on main issues and trends in banking regulation.

Finally, the preparation of the Treasury's National Treatment Study, presented to Congress in December 1990, provided an opportunity to review the treatment of U.S. banks and securities firms in foreign markets. It also included a lengthy description of the regulatory structure covering foreign financial firms in the United States and the manner in which they receive national treatment in the U.S. market. Where foreign regulatory practices overseas discriminate against U.S. firms, these practices were identified.

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 17, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,004 million of 13-week bills to be issued June 20, 1991 and to mature September 19, 1991 were accepted today (CUSIP: 912794XG4).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.59%	5.76%	98.587
High	5.62%	5.80%	98.579
Average	5.61%	5.79%	98.582

Tenders at the high discount rate were allotted 24%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	37,690	37,690
New York	26,538,345	8,179,385
Philadelphia	28,260	28,260
Cleveland	45,900	45,900
Richmond	49,435	49,435
Atlanta	26,955	26,955
Chicago	1,903,390	362,390
St. Louis	54,475	14,475
Minneapolis	11,110	11,110
Kansas City	39,135	39,135
Dallas	26,750	26,750
San Francisco	993,985	548,985
Treasury	634,020	634,020
TOTALS	$30,389,450	$10,004,490
Type		
Competitive	$26,924,310	$6,539,350
Noncompetitive	1,403,860	1,403,860
Subtotal, Public	$28,328,170	$7,943,210
Federal Reserve	1,940,180	1,940,180
Foreign Official Institutions	121,100	121,100
TOTALS	$30,389,450	$10,004,490

NB-1330

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 17, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,020 million of 26-week bills to be issued June 20, 1991 and to mature December 19, 1991 were accepted today (CUSIP: 912794WX8).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.76%	6.03%	97.088
High	5.80%	6.07%	97.068
Average	5.79%	6.06%	97.073

Tenders at the high discount rate were allotted 17%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	32,195	32,195
New York	21,588,665	8,588,465
Philadelphia	18,930	18,930
Cleveland	29,005	29,005
Richmond	64,240	43,490
Atlanta	34,710	34,515
Chicago	2,331,745	400,745
St. Louis	31,505	16,505
Minneapolis	6,845	6,845
Kansas City	39,065	39,065
Dallas	14,475	14,475
San Francisco	746,260	313,260
Treasury	482,035	482,035
TOTALS	$25,419,675	$10,019,530
Type		
Competitive	$21,199,490	$5,799,345
Noncompetitive	1,127,685	1,127,685
Subtotal, Public	$22,327,175	$6,927,030
Federal Reserve	2,300,000	2,300,000
Foreign Official Institutions	792,500	792,500
TOTALS	$25,419,675	$10,019,530

NB-1331

TREASURY NEWS

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

EMBARGOED UNTIL GIVEN
EXPECTED 10:00 A.M.

STATEMENT OF THE HONORABLE
JEROME H. POWELL
ASSISTANT SECRETARY OF THE TREASURY
(DOMESTIC FINANCE)
BEFORE THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

June 18, 1991

Chairman Gonzalez, Congressman Wylie, and Members of the Committee:

It is a pleasure to have the opportunity to comment today on the companion concepts of the "core bank" and the "wholesale bank," two proposals suggested for incorporation into the comprehensive banking legislation your Committee is now considering. If adopted, these proposals would fundamentally alter the traditional business of banking in the United States in ways that are difficult to forecast but that are potentially destabilizing. We are particularly concerned that the core bank structure could create or aggravate future credit crunches and otherwise disrupt routine commercial lending activities.

Nevertheless, we recognize that these proposals, despite their potentially serious problems, are intended to achieve the same result as the Administration's legislative proposal -- safer, more competitive banks. Indeed, some aspects of the proposals are merely more extreme versions of proposals included in the Administration's bill. As discussed in more detail below, there may be elements of the core bank proposal that could be modified in a way that the Administration could support as improvements to the Committee Print.

Let me say at the outset that we have seen a preliminary draft of two alternative core bank amendments. The first would create core banks only, without providing for wholesale banks; the second would establish core banks and wholesale banks as complementary elements of a single banking system. We understand

NB-1332

the text of these drafts is not final, and our observations on these proposals might change depending on later changes.

In my comments today I will review what we see as the aims of these proposals; describe the basic structure of the "core bank" and the "wholesale bank" as we now understand them; and set out the concerns we believe should be given consideration in any further examination of this approach. I should add that our concerns are somewhat different depending on whether the core bank amendment is offered alone -- which raises serious concerns about the availability of credit -- or in combination with the wholesale bank, which raises different concerns about spreading the safety net to new institutions and new activities. It would also allow large banks to avoid paying insurance premiums despite continued access to the federal safety net.

Aims of the Proposals

The basic aims of the core bank and wholesale bank proposals are the same as those of the Administration's proposal for banking reform: to limit the taxpayer's exposure to losses through the overextended federal "safety net," and to bolster the safety, soundness, and competitiveness of the U.S. banking system.

The Administration's banking reform package addresses these objectives in seven different ways. These are (1) a reduction in the overextended scope of deposit insurance, which directly reduces the taxpayer's exposure and directly increases market discipline on bank risk; (2) a strengthened role for capital; (3) direct restrictions on risky bank activities; (4) risk-based deposit insurance; (5) improved supervision of bank risk, especially through a new system of prompt corrective action; (6) nationwide banking and branching, which diversifies geographic risk and reduces unnecessary costs; and (7) new financial activities for organizations with well-capitalized banks, which will improve the overall profitability and competitiveness of the banking franchise.

This integrated package works straightforwardly to achieve its goals, and its consequences are well understood. As you know, legislation reflecting this proposal is now well-advanced in the legislative process and has received careful consideration by the Administration, by regulators, and by a number of Congressional Committees.

The core bank and wholesale bank proposals, however, seek to achieve the same objectives through a much more radical approach. They are intended to reduce risk in the system both by using deposit interest rate controls to significantly limit the amount of insured funds available to banks, and by severely constraining the types of activities in which banks will find it practical to engage. This extreme approach, described in detail below, is considerably more speculative and experimental than the legislation reported out of the Subcommittee on Financial Institutions.

Core Bank/Wholesale Bank Structure

Both of the draft amendments we have reviewed begin by requiring all insured depository institutions to become "core banks," which are described in three simple provisions. First, interest rate regulation: no institution that accepts insured deposits would be permitted to pay a return on any of its deposits, insured or uninsured, greater than 105% of the effective interest rate paid by Treasury securities of comparable maturity. Second, restrictive lending limits: all insured institutions would become subject to greatly reduced limits on the amounts they could lend any one borrower. These limits are calculated on a sliding scale: 15 percent of a bank's first $100,000,000 of tier 1 capital, 4 percent of the next $100,000,000 and 3 percent of any capital over that amount. Third, trading exposure limits: no insured institution could incur an exposure in connection with any trading activity greater than 5% of the institution's tier 1 capital.

These provisions are designed to eliminate excessive risk-taking by banks. By restricting the interest payable on deposits, the proposal would at times reduce the supply of government-insured funds to banks -- an attempt to address the perception that deposit insurance allows too much money to chase too few good lending opportunities. By restricting each loan to such a small amount of capital, the proposal ensures that insured banks will abandon "big-ticket" loans, such as HLTs, real estate finance, and other large-scale commercial lending. By restricting trading exposure, the proposal would require the transfer of most foreign exchange and swap activities out of insured banks.

As a stand-alone amendment, the core bank represents a fundamental change in our financial system. It assumes that all of the activities transferred out of insured core banks -- large commercial and industrial loans, commercial real estate loans, foreign exchange and swaps trading, and other types of intermediation -- will be adequately provided for by financial firms that are completely outside the banking system. This is a very large assumption, especially in view of the fact that all major industrialized countries generally carry out these functions within banks. If the assumption is incorrect, the consequences for credit availability and economic growth could be profound, as set forth in more detail below.

On the other hand, the second amendment would pair the core bank with the wholesale bank, a new creature in our financial markets. This combination amendment creates a somewhat different set of concerns than does the core bank by itself. Specifically, the wholesale bank provision would permit large institutions to avoid paying a substantial amount of insurance premiums despite continued coverage by the federal safety net; it could spread the safety net to new kinds of financial institutions; and in the end, it could defeat the very purpose of the core bank by allowing institutions merely to shift "risky" activities from one part of the safety net to another part.

A wholesale bank, as described in the draft amendment we have reviewed, is essentially a "universal" bank -- based on European models -- which pays <u>no</u> deposit insurance premiums while engaging in securities activities and the "big ticket" bank lending and trading activities prohibited to the core bank. Its status as a wholesale bank is dependent on one condition: that it accept no deposits of less than $100,000 from the general public. A wholesale bank would be free of the core bank interest rate cap, lending limit, and trading exposure restrictions and exempt from much substantive regulation of its nonbanking activities. It would remain, however, a bank: it could be a member of the Federal Reserve System, and would have access to the full safety net support mechanisms and subsidy represented by the Federal Reserve's discount window and access to the payments system. As a result, the federal safety net would be explicitly expanded to cover securities activities for the first time.

It is our understanding that a core bank and a wholesale bank could be affiliated in a single corporate group, though they need not be. Nevertheless, under this alternative the core bank and the wholesale bank would be intended to work together, whether under one roof or not. The core banks would receive all retail, insured deposits and confine themselves to a small-scale lending business, making few or no commercial or real estate loans; the wholesale banks would receive only uninsured deposits of $100,000 or more and conduct all large-scale lending and trading activities.

The proponents of core and wholesale banking have given careful thought to these approaches and their ideas deserve -- and have received -- serious attention from the Treasury and other policy makers. These are, however, untried theories and put into practice they would launch our financial system into uncharted waters. No major nation has organized its banking industry under the core bank/wholesale bank model.

The experience we have had with certain elements of the proposals -- such as deposit rate regulation -- raises serious concern about the effect these provisions would have on the availability of credit, the savings of small investors, the competitiveness of U.S. banks, and the safety and soundness of the banking system generally. The risk of error and the uncertainty of benefit inherent in these proposals argue for caution. The existence of a safer alternative means to the same end -- the integrated approach in the Committee print that addresses bank risk in a number of different ways -- should reinforce this caution.

Our general concern is the result of several specific questions raised by each major element of the proposals, which I will now discuss in more detail. Since we have been presented with two alternative proposals -- one limited to the core bank and the other paired with the wholesale bank -- I will first consider the core bank in isolation and then examine the implications of adding the wholesale bank provisions.

Deposit Interest Regulation

The U.S. has had experience with deposit rate regulation in the past, and that experience was dismal. The core bank's interest cap differs, however, from earlier caps in that it would "float" with the Treasury rate rather than remain a fixed ceiling. While this innovation should eliminate the worst effects of prior attempts at rate regulation, we think the following concerns remain:

- o The principal aim of deposit interest regulation is already dealt with by existing law
- o Even a floating cap must "bind the market" at some point, especially since deposit rates and Treasury rates do not move in tandem
- o Whenever a cap binds, funds will leave the banking system, producing credit crunches
- o Since this is a national cap with no allowance for regional differences, those credit crunches may hit hardest in the regions that need credit most
- o To avoid these effects, rate controls are likely to require management, which means bureaucracy and, ultimately, an "interest rate czar".

o Small banks and small savers, particularly the elderly, are likely to object that the economic costs of the measure weigh disproportionately heavily on them

Let me expand on each of these points.

Rate Regulation is Unnecessary. The "core bank" proposal's reintroduction of interest rate caps appears unnecessary since current law already addresses the major reason for deposit rate regulation: restriction of aggressive, troubled institutions from setting their own rates at an unsound level, thus bidding up deposit rates generally. FIRREA added a new section 29 to the Federal Deposit Insurance Act that prohibits the acceptance, renewal or rollover by any "troubled" -- *i.e.*, undercapitalized -- bank or thrift of deposits bearing a "significantly" higher interest rate than that predominating in its normal market area. The FDIC has adopted regulations stating that 50 basis points will be considered "significant" for this purpose.

This approach of existing law is explicitly embraced in the Committee Print and would be significantly enhanced by restoring the Administration's proposal to remove insurance from brokered deposits. This approach avoids the most significant problems of the "core bank" concept: it recognizes that the appropriate benchmark is the prevailing rate for deposits, not other financial instruments such as Treasuries; it recognizes that prevailing rates will differ from region to region, and thus ties its limit to "normal market areas"; and it recognizes that a measure intended to prevent unsound behavior by a troubled institution should not be transformed into a statutory ceiling applicable to healthy competition among well-capitalized banks.

In short, we believe that the approach adopted in current law and the Committee Print addresses the same interest rate problem that the core bank proposal is intended to address, but in a much more workable manner. Nevertheless, there may be ways to tighten up the current approach which would help accomplish even more of the objectives of the core bank approach. As noted at the outset, this is an area where we would welcome constructive suggestions to accomplish this goal that do not raise the significant problems set forth below.

Floating Rate No Cure. A floating deposit rate cap tied to an appropriate benchmark is far preferable to the fixed-rate caps formerly imposed under the now-infamous Regulation Q. Yet, like all interest rate limits, even a floating cap has only two alternatives: at any given time, it will either be above the rate the market would otherwise require on deposits and similar financial instruments, or it will not. Whenever the cap *is* above the market rate, it will have no effect, but will also serve no purpose. Whenever the cap is *below* the market rate, depositors will -- quite naturally -- seek alternative investments that will pay what the market demands.

Deposit Rates Do Not Always Track Treasuries. It would be tempting to believe that the core bank cap could never fall below the market rate, since a government-guaranteed deposit should be largely equivalent to the short-term Treasury securities to which its rate would be tied. Experience, however, shows that deposit rates are often higher than Treasury rates.

Attached to this testimony are several charts showing relationships between Treasury and CD rates for varying maturities, at varying times, in various parts of the country. The implications of this information are clear. While deposit rates are often below 105 percent of the Treasury rate, Chart A shows that the market interest rate for bank deposits has been significantly above the 105 percent mark for long periods in the past; there is no reason to think that this cannot happen in the future. Indeed, Charts B through E show that current market rates for deposits generally exceed the rate on similar Treasuries for maturities up to one year -- a result that reflects the problem, discussed below, that such rates are most likely to exceed Treasuries during recessions, at the very time when it is most important to avoid constraints on new bank lending.

Disintermediation and Credit Crunch. It thus appears likely that the interest rate caps will indeed "bind the market" from time to time. When they do, deposits will be withdrawn from the core banks, and, in all probability, from the banking system as a whole. One of the foremost proponents of the core bank concept has himself estimated that over 1.5 trillion dollars would move out of core depository institutions after the floating interest cap was imposed.

The lending capacity of the banking system is directly proportional to its available sources of funds. When deposits move elsewhere, banks depending on them must reduce their lending activity. Credit crunches of this classic kind occurred frequently during the period of Regulation Q's effectiveness. We wonder whether enough is yet known about the effect such a massive shift of financial assets would have on banks or on the economy generally to ensure such credit crunches do not repeat themselves.

Moreover, the historical data we have reviewed show that deposit rates are most likely to exceed Treasury yields when Treasury rates are low or declining, as they have been over the past year, and declining Treasury rates are often the sign of a soft economy. Thus, under the core bank proposal, banks might have to cut the rates they pay on deposits, reducing their available resources for credit extensions, just when the economy is weakening and public policy calls for expanded bank credit. We would risk a credit crunch at precisely the time we could least afford it -- during a recession.

Regional Economic Differences. Equally important, we are concerned that a uniform national interest rate cap, even if it floats daily, will ignore important regional economic dislocations that could at times require institutions in particular market areas to pay deposit interest well above the Treasury rate. If the core bank provisions are in effect, funds may well be drained from banks just when they are most needed to provide liquidity for economic recovery.

Distortion of the Market for Financial Services. We know only too well the result when the government tinkers with markets by limiting prices: during periods when core banks would be prevented from offering competitive interest rates on their insured deposit products, they will be forced to develop inefficient and costly methods of nonprice competition for retail deposits. In the days of Regulation Q this took the form of increasingly elaborate gift premiums, inefficiently extensive branch networks and complex legal dodges. Given the strong pressures to evade the cap that would develop, it seems likely that such nonprice competition could once again appear. Even if the notorious free toasters of our recent past are prohibited, it is difficult to police all forms of indirect return. Such policies would reduce the efficiency of resource allocation as banks strove for ways to avoid rate ceilings.

Administrative Burden. As a result of the tendencies identified above, we believe it may be optimistic to suppose that the cap could be self-executing. Given the complicated and interdependent economic factors affected by the interest rate cap, we think it almost inevitable that this proposal will need to be flexible in its application, which would lead to the establishment of a bureaucratic authority -- an "interest rate czar" -- to adjust the restrictions. This czar might need to determine what spread over the Treasury rate was appropriate given particular economic conditions, calculate the level of credit required by the economy in general and perhaps by particular industries, assign interest values to bank services, make the necessary regional adjustments, evaluate competing financial and political interests, and generally supervise this complex program. We think many will hesitate before subjecting such an important market to the bureaucratization and politicization that could result.

Discrimination Against Small Savers. In the past, opponents of interest rate regulation -- particularly representatives of the elderly -- have argued that the economic costs of such regulation are disproportionately borne by the nation's smallest savers. The interest rate cap would apply only to deposits of core banks; sophisticated institutional or individual investors familiar with alternative investments and able to meet the minimum investment standards often required would be able to transfer their funds to receive a market rate. Whenever the cap is below the market rate, then, only the smallest and least financially aware depositors will remain with the bank. Many policy makers and their constituents believe this an unfair penalization of such investors.

Disadvantaging of Smaller Banks. Moreover, precisely because the proposed interest rate caps would apply only to deposits of the core bank, but not to other liabilities, institutions with adequate funding sources outside the deposit market would find themselves able to work around the caps; smaller banks, which rely heavily on retail deposits, would not. In times of economic strain, larger banking organizations would buy their funds free of rate restrictions in the federal funds, Eurodollar or commercial paper markets; smaller banks would find themselves drained of funds. It is upon the community enterprises and local businesses that community banks service that an unnecessary and exaggerated credit crunch is likely to fall most severely.

Limits on Loans to One Borrower

Drastic Reduction. The "core bank" proposal would also drastically reduce the current statutory lending limit for all insured institutions. Under existing law, a national bank may lend up to 15% of its total capital to any one borrower (plus an additional 10%, if secured). Limits applicable to state banks vary, and some are much higher than the national bank restrictions, but most fall within the general range of the federal standard. The draft core bank amendments would replace these loans-to-one-borrower limits with one calculated on a sliding scale: 15 percent of the first $100,000,000 of a bank's Tier 1 capital, 4 percent of the next $100,000,000, and 3 percent of all remaining Tier 1 capital. Thus, for smaller banks -- those with capital under $100,000,000 -- the new 15 percent of Tier 1 limit would represent a reduction of their unsecured lending limit of as much as 50 percent, or a reduction of up to 70 percent including secured loans. For a large national bank contemplating a secured loan, the result is as much as a 94 percent reduction in the applicable lending limit.

Lending Limit Unworkably Small. It may be that existing lending limits, particularly for certain state banks, are too high. Louisiana, for example, permits 50 percent of capital to be lent to a single borrower, and some states have no lending limits whatever. Most banks already have internal policy guidelines on loans-to-one borrower that are far lower than their current governing law would permit. These guidelines, however, are often around 10 percent of total capital, which -- since they are calculated from the entire capital base, and not merely tier 1 -- are as much as six times the proposed "core bank" limit. This suggests that the "core bank" lending limits are unworkably small, even if phased in, and would consequently tend to be disruptive.

This is especially true for smaller banks, servicing primary market areas with one or two particularly large industries. Such banks will, on occasion, lend up to the maximum legal limit to their very best borrowers. Yet while the draft amendment we have seen seems to grant smaller banks greater latitude, it still effectively cuts their limits more than in half, by requiring they be calculated from tier 1 capital.

Commercial and Real Estate Credit Crunch. Commercial and real estate borrowers, rather than individual consumers, are the types of customers most likely to require credit in amounts over the core bank limits. The intended result of the "core bank" loans-to-one-borrower restrictions, then, will be to drive much C&I and real estate lending out of the core bank, effectively prohibiting consumer deposits from funding such activities and thus restricting the credit available to them.

Since we are now considering the alternative in which there would be no wholesale banks, it is not clear what types of financial institutions would have both the capacity and the desire to assume such lending functions. One possibility would be the large foreign banks, thus underscoring the global weakness of the American system. The other possibility is that such large-scale commercial lending -- which is an important engine of our economy -- will simply contract substantially and permanently, leading to unknown and unknowable ripple effects throughout the economy. While there has perhaps been an excess of such lending in the past, especially by federally insured institutions, there may be too little in the future if federally insured institutions are simply prohibited from participating.

Syndication Will Not Necessarily Ease Compliance. While some might argue that banks can always syndicate larger credits so that their remaining liability remains below the applicable loan-to-one-borrower limit, this overestimates the capacity of the loan syndication market. Even after syndicating a portion of a loan, many banks retain liabilities that exceed the "core bank" limit. A bank may also purchase an "over-core" liability from a syndicating institution. Further, market conditions or competitive concerns not infrequently lead banks to act as sole lender for a moderately large loan with the intent of syndicating it in the near future. The core bank lending limits would effectively prohibit that option to an insured institution. In addition, syndication of any kind would be a less available option for smaller institutions.

Trading Exposure Limits

The core bank 5 percent limit on exposure to any trading activity appears intended substantially to restrict the amount of foreign exchange trading and swap business that a core bank can conduct. We feel that such policy decisions should be made directly -- through an explicit consideration of the types of activities to be limited and the concerns such activities have raised -- rather than indirectly through a general exposure limit. When looked at in this light, we think the weight of evidence strongly supports banks' conduct of foreign exchange and swap trading.

<u>The Traditional Business of Banking</u>. Foreign exchange operations are a traditional banking activity, integrally related to bank payment services, financial management, and capital markets transactions. The largest participants in the foreign currency markets historically have been banks, and the great majority of foreign currency trades involve interbank transactions. While swaps are a more recent innovation in the financial markets, the credit risks involved are substantially similar to those of other traditional banking activities, and banks are significant participants in the swaps markets.

<u>Forex and Swaps Businesses Are Profitable</u>. Both foreign exchange and swap operations are profitable, and banks have demonstrated their capacity to manage related risks. The goal of banking reform should be to <u>encourage</u> expansion of profitable, well-managed banking businesses, not eliminate two of the few currently reliable bank profit centers.

<u>Global Competitiveness</u>. U.S. banks would be at a competitive disadvantage if foreign exchange and swap operations were transferred outside the bank. Organizations that wished to continue their conduct of these activities would be required to set up separate affiliates. This will fragment the capital base available to support such activities, a hinderance not applicable to foreign banks and nonbank competitors. Moreover, any attempt to preserve the capital base by keeping as many forex and swap activities in the bank as possible -- moving only those absolutely required by the 5% trading limit -- will impose unnecessary costs in the form of duplicate personnel, support systems, information and communications systems, and compliance programs.

<u>Regulation and Supervision</u>. By keeping foreign exchange and swap operations in the bank, they are subject to much closer supervision from bank regulators than they would be if transferred to affiliates -- or out of banking organizations altogether. Nonbank swap dealers, for example, are subject to virtually no capital standards, regulatory structure, or routine supervision. The Federal Reserve and other bank regulators, by

contrast, have particular expertise in exercising oversight over the types of credit exposures and monetary issues raised by forex and swap trading.

No Demonstrated Danger. While these arguments weigh in favor of continuing to permit banks to conduct forex and swap operations, we are aware of no major problems or concerns that have been identified to justify transfer of such operations outside the banking system.

Wholesale Bank

So far, I have been discussing the conceptual problems raised by a proposal to enact the core bank concept without also providing a companion wholesale banking system. Establishing an alternative form of banking institution to "pick up" the lending and trading activities prohibited to a core bank could soften the "credit crunch" problems of the stand-alone core bank proposal. On the other hand, to the extent that such activities are merely shifted from one part of the safety net to another (deposit insurance to the discount window), the very purpose of the core bank is undermined, while the costs of balkanizing capital in this manner may be considerable. In addition, we believe that the wholesale bank approach raises serious questions of equity and that it runs the risk of greatly weakening the deposit insurance fund.

Adverse Effect on Deposit Insurance Fund. The wholesale bank structure exempts an institution from deposit insurance premiums and from certain limitations on its activities if the bank does not accept deposits of less than $100,000 from the general public. We believe the only banks that will be able to take full advantage of the wholesale bank provisions will be the handful of money center institutions with their principal sources of funding outside the retail deposit market. At a time when the liabilities of the Bank Insurance Fund have expanded dramatically and deposit insurance assessments have tripled in two years, it is surprising -- to say the least -- that it would now be proposed to exempt some of the largest and most significant U.S. banks from deposit insurance assessments entirely.

We would also expect that, in allocating activities between the core and wholesale banks, institutions would tend to leave the worst assets in the core bank (where losses would be covered by insurance) and transfer the best to the wholesale bank. If splitting banks into insured and uninsured entities were to result in weaker core banks drawing on a fund with reduced income, this would put us in a worse position than simply doing nothing.

Of course, as core banks became smaller with the outflow of deposits to wholesale institutions, the aggregate safety net subsidy to the system would arguably be reduced (except that we believe the wholesale bank would still be inside the safety net, as set forth below). We believe, however, that the prompt corrective action provisions of H.R. 1505 -- together with existing provisions of law -- would tend to accomplish that result without the side effects of the core bank and the wholesale bank. Higher capital and the more prompt response of supervisors is a preferable way of reducing the misuse of the safety net.

Wholesale Banks Remain Protected by the Safety Net. The wholesale bank structure, however, is not only surprising from a purely fiscal standpoint. It would appear fundamentally inequitable as well. A wholesale bank would be free of many restrictions on its activities -- most particularly it could conduct securities activities directly, rather than through an affiliate. Yet it would clearly remain a bank, not a mere finance company or investment affiliate. It could remain a member of the Federal Reserve System. It would have access to the Fed's discount window and to Fedwire. Of all the institutions in this country, the large money center wholesale banks could be the ones most likely to present systemic risk problems in the event of failure, triggering efforts to fully protect their uninsured depositors.

Indeed, if depositors would be fully protected in wholesale bank failures as a result of systemic risk concerns, these banks would reap virtually all of the benefits of the federal safety net while paying no deposit insurance assessment and submitting to little regulation of many nonbanking activities.

Wholesale Banks of Limited Practical Use. It might be appealing to think that every banking organization would have its own "wholesale bank" and "core bank" working together in a single corporate group: the core bank would take retail deposits and handle consumer loans, none of which would be likely to exceed the restrictive core bank lending limit; the wholesale bank would pay what the market demanded for large-denomination uninsured deposits and make large scale commercial and real estate loans free of the core bank restrictions. This assumes funding sources that do not exist for most U.S. banks. Even for some of the very largest and best-managed regional institutions, for example, retail deposits remain such a substantial source of their funding that any wholesale bank they established would be relatively weak, while their core bank would be hobbled by the proposed loan-to-one-borrower limitations.

Conclusion

The goals that the core bank/wholesale bank proposal seeks to achieve are laudable: restraint of the federal "safety net"; diversification of bank activities; control of excessive bank risk. They are, in fact, among the goals addressed by the Treasury's earlier study on deposit insurance and by H.R. 1505, the comprehensive banking legislation soon to be considered by this Committee. Moreover, the proponents of the core bank plan deserve credit for helping crystallize the issues surrounding banking reform with an interesting package of ideas. We believe, however, that the core bank's goals are already met by the Treasury proposals embodied in H.R. 1505, and that the core bank structure -- as currently articulated -- may carry with it significant adverse side effects for the banking industry and the economy as a whole.

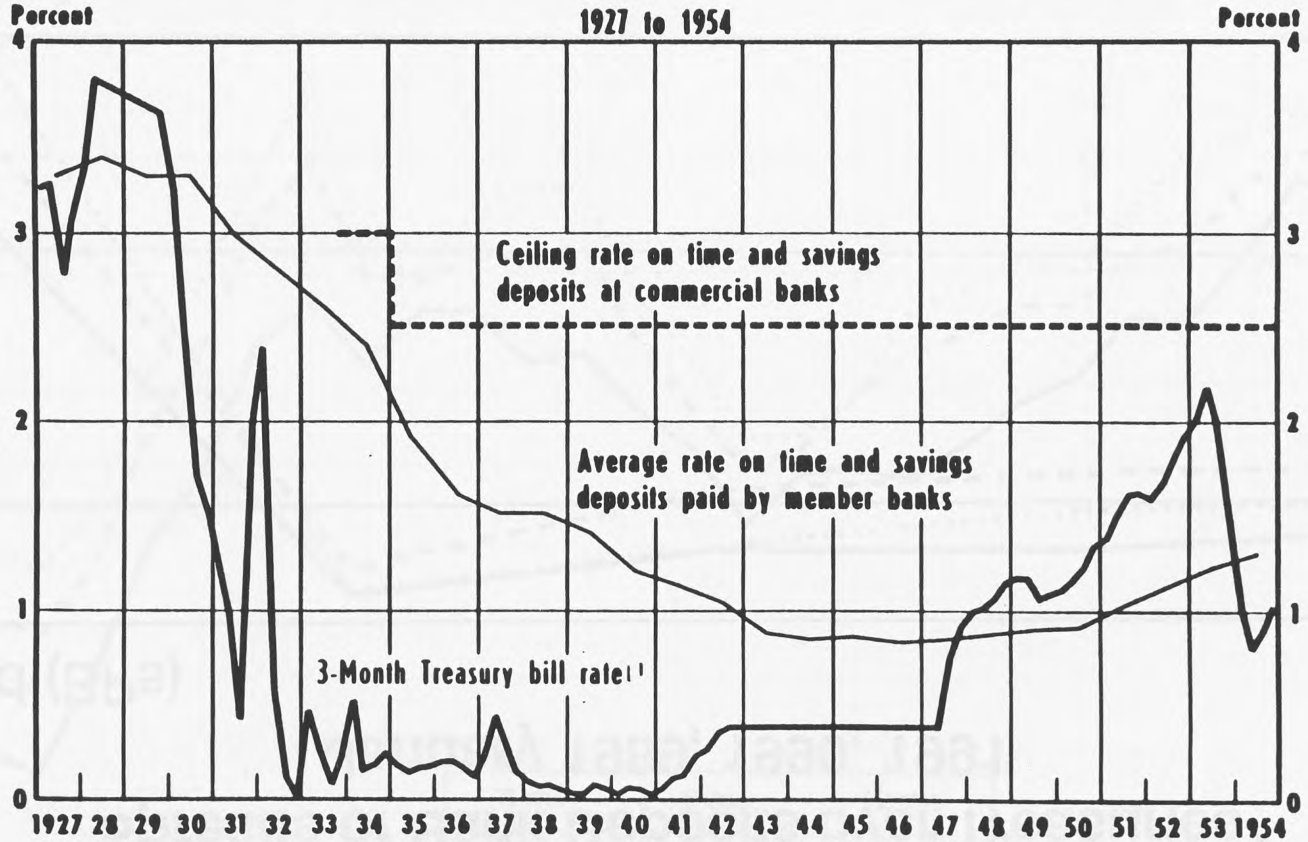
This concludes my prepared statement. I will be happy to answer any questions that you may have.

Chart A

FEDERAL RESERVE BANK OF ST. LOUIS

Interest Rates and the Ceiling Rates on Time and Savings Deposits

1927 to 1954

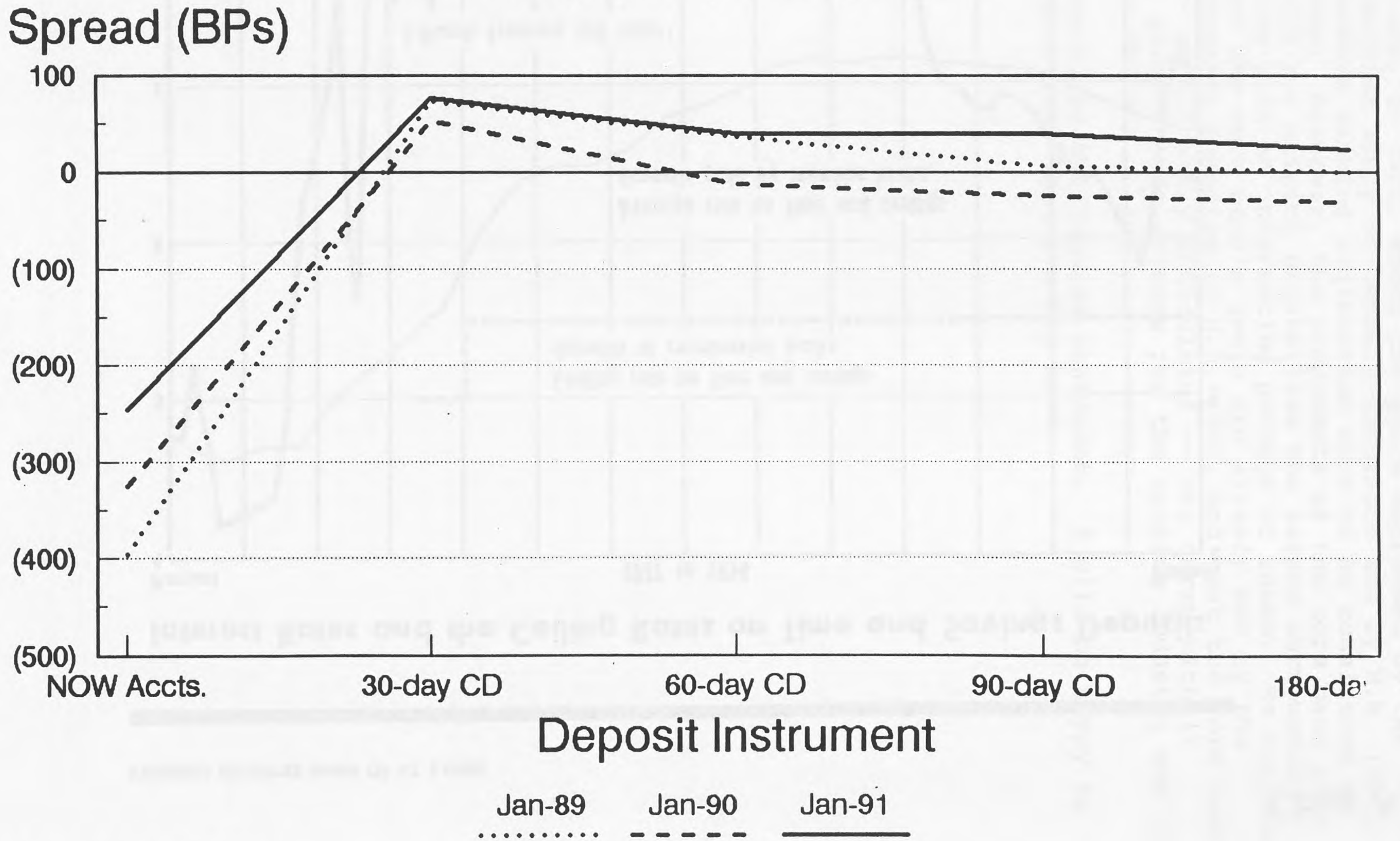


NOTE: All data are quarterly except the average rate paid on time and savings deposits which is an annual series.

[1] Before 1934, the Treasury bill rate includes 3- to 6 month notes and certificates

Chart B

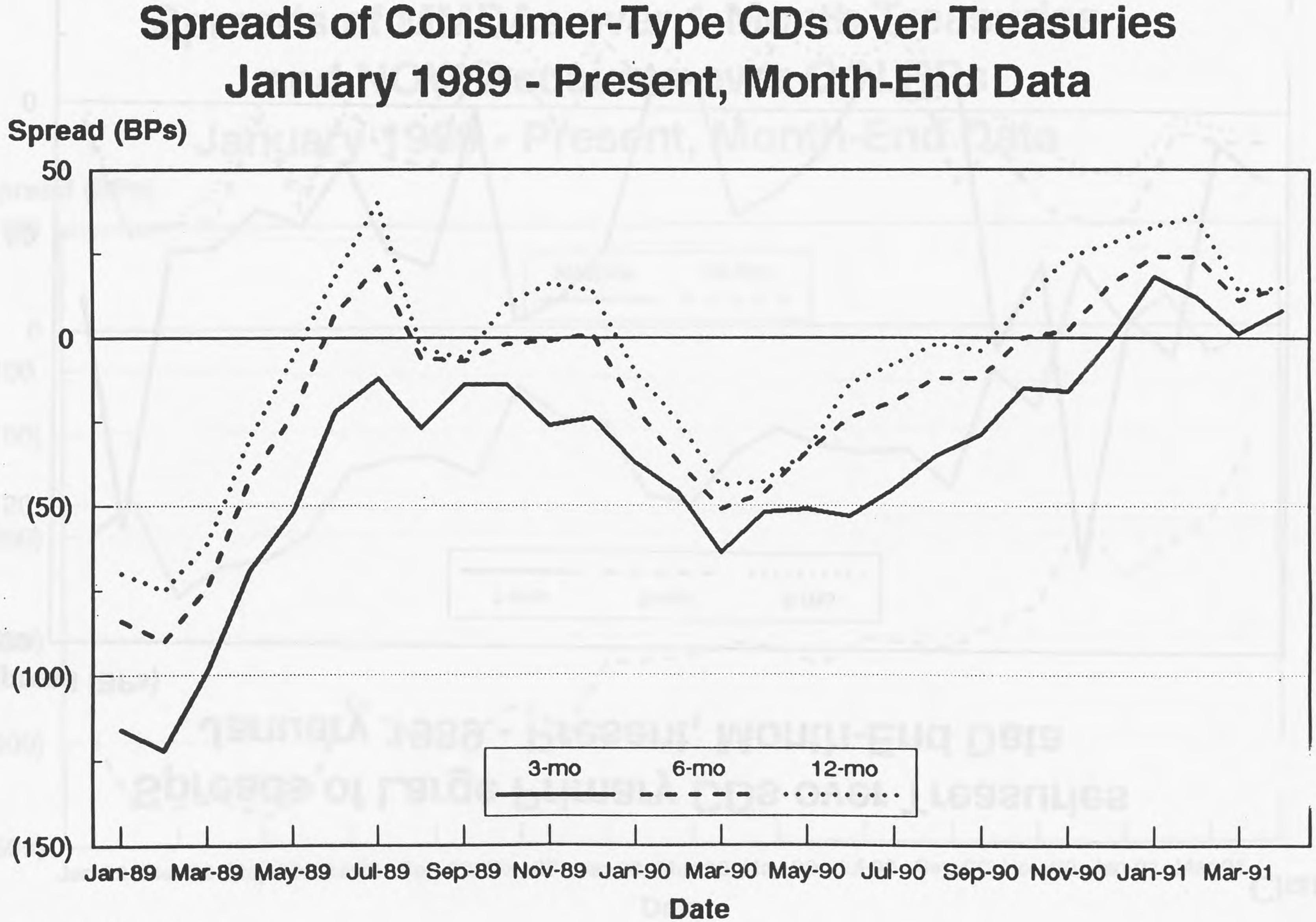
Spreads of Bank Deposits over Treasuries *
January 1989, 1990, 1991



Office of Market Finance

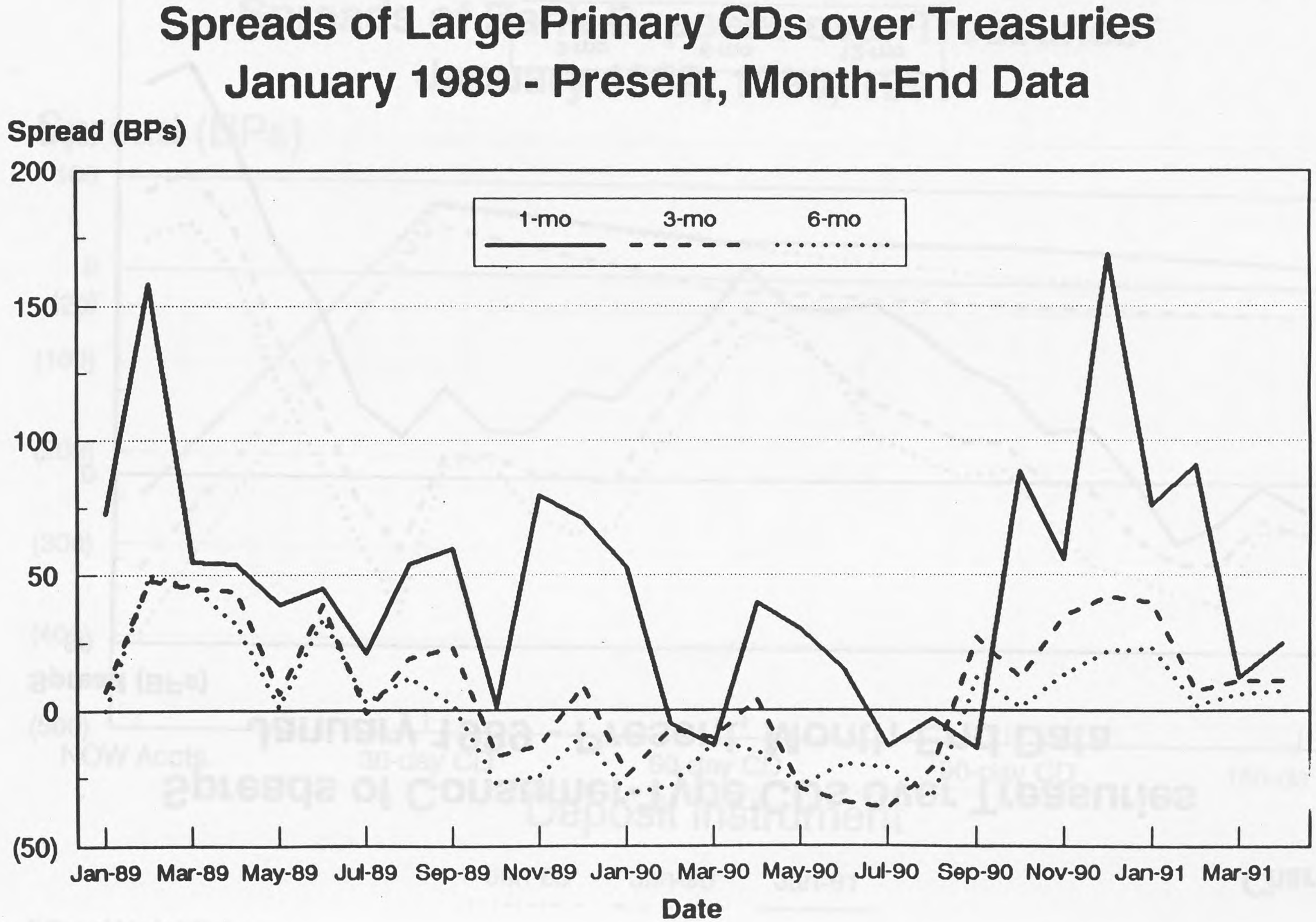
*** NOW account spreads use overnight RP rate as proxy for Treasury rate.**

Chart C



Office of Market Finance

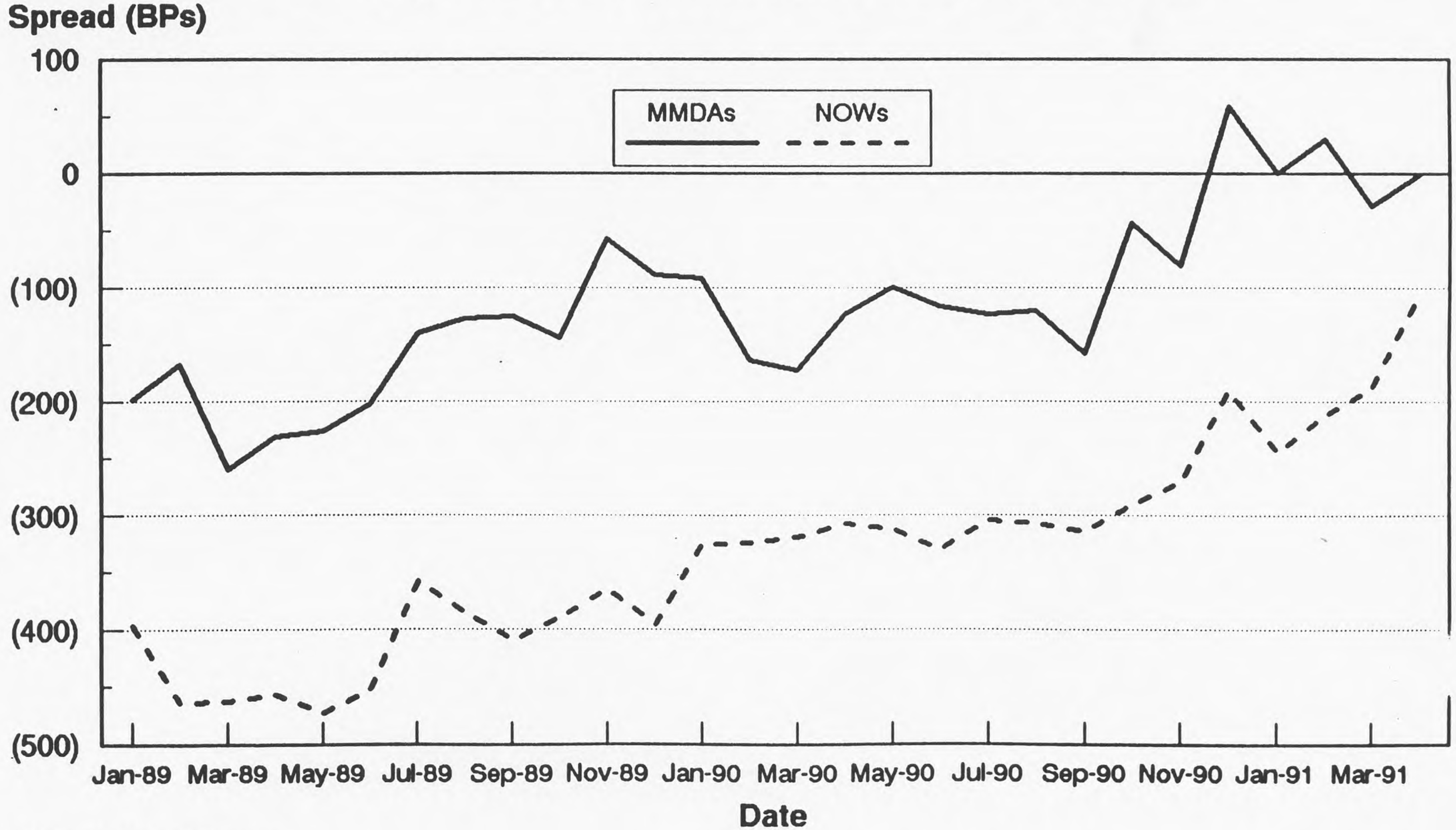
Chart D



Office of Market Finance

Chart E

Spreads of MMDAs over 1-Month Treasuries and NOW Accounts over O/N RPs January 1989 - Present, Month-End Data



Office of Market Finance

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
June 18, 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 $20,400 million, to be issued June 27, 1991. This offering will provide about $2,325 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $18,064 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, June 24, 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 $10,200 million, representing an additional amount of bills dated September 27, 1990, and to mature September 26, 1991 (CUSIP No. 912794 WU 4), currently outstanding in the amount of $18,646 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 10,200 million, to be dated June 27, 1991, and to mature December 26, 1991 (CUSIP No. 912794 XS 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 June 27, 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 $1,492 million as agents for foreign and international monetary authorities, and $3,645 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-1333

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 ON DELIVERY
Expected at 9:30 a.m.
June 19, 1991

STATEMENT OF MICHAEL E. BASHAM
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
FOR FEDERAL FINANCE
BEFORE THE SUBCOMMITTEE ON POSTSECONDARY EDUCATION OF THE
HOUSE COMMITTEE ON EDUCATION AND LABOR

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here today to discuss the results of the Treasury's second study of Government-sponsored enterprises and the Administration's legislation that will provide for more effective financial oversight of these important institutions.

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.

NB-1334

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 has been submitted.

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.

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.

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.

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 policy 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 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, while financially sound GSEs should be subjected to less intensive oversight. 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. One of the deficiencies in the existing regulatory structure for GSEs is that no Federal agency has the responsibility to oversee the financial safety and soundness of the Student Loan Marketing Association (Sallie Mae). While Treasury has some nominal authority over Sallie Mae, the authority is not parallel with that already in place or being proposed for other GSEs.

Treasury Regulatory Authority Should be Expanded

The Administration's proposed legislation would expand Treasury's current oversight responsibilities over Sallie Mae in to make them consistent with the safety and soundness authorities of the other regulators.

Under existing law, 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 with access to all of Sallie Mae's books and records. The Secretary, in turn, is required to report to the President and Congress on the financial condition of Sallie Mae, including a report on any impairment of capital or lack of sufficient capital noted in the audit. The Administration proposes that Treasury's regulatory authority over Sallie Mae be expanded to include the authority to determine capital standards, to require information disclosure, to prescribe standards for books and records, and to take prompt corrective and administrative enforcement actions.

The Administration proposal also establishes a safe harbor for any GSE that receives the highest investment grade credit rating from two nationally recognized statistical rating organizations (NRSROs). If the Secretary determines, after receiving ratings from two NRSROs, that Sallie Mae merits the highest investment grade rating, Sallie Mae would be deemed to meet the proposed minimum risk-based capital requirement for one year following the date of the Secretary's determination. This would result in a significantly reduced regulatory burden for Sallie Mae, which is appropriate for a financially strong GSE.

Sallie Mae received a triple-A rating from S&P, an NRSRO, when it was rated for the purpose of the April 1991 Treasury report on GSEs. Sallie Mae would, in all likelihood, be eligible for this safe harbor, assuming its financial condition had not deteriorated significantly from the time S&P conducted its analysis.

Conclusion

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 form the basis for the GSE legislation the Administration has proposed. 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 RELEASE AT 2:30 P.M.
June 19, 1991

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR NOTES TOTALING $21,750 MILLION

The Treasury will auction $12,500 million of 2-year notes and $9,250 million of 5-year notes to refund $17,291 million of securities maturing June 30, 1991, and to raise about $4,450 million new cash. The $17,291 million of maturing securities are those held by the public, including $1,896 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $21,750 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 $1,814 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-1335

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC OF 2-YEAR AND 5-YEAR NOTES TO BE ISSUED JULY 1, 1991

June 19, 1991

Amount Offered to the Public ...	$12,500 million	$9,250 million
Description of Security:		
Term and type of security	2-year notes	5-year notes
Series and CUSIP designation ...	Series AC-1993 (CUSIP No. 912827 B3 5)	Series Q-1996 (CUSIP No. 912827 B4 3)
Maturity date	June 30, 1993	June 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	December 31 and June 30	December 31 and June 30
Minimum denomination available .	$5,000	$1,000
Terms of Sale:		
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
Payment Terms:		
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
Key Dates:		
Receipt of tenders	Tuesday, June 25, 1991	Wednesday, June 26, 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 ...	Monday, July 1, 1991	Monday, July 1, 1991
b) readily-collectible check ...	Thursday, June 27, 1991	Thursday, June 27, 1991

TREASURY NEWS

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

For Release Upon Delivery
Expected at 10:00 a.m.
June 20, 1991

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

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to discuss with you today the general subject of international competitiveness. I commend the Committee for undertaking this broad overview without a specific legislative agenda. The issues discussed in these hearings will be with us for a long time to come. They will not be resolved by "quick fixes" but rather by steady, stable policy executed consistently to achieve well-defined goals. We should begin now to develop a national consensus on what those goals should be. Such assessments are particularly timely in a world which has embraced freedom and free markets to an extent we could not possibly have imagined even two years ago.

Given the broad scope of this inquiry, I will not attempt to comment on all the issues raised by the Committee's hearing notice or to deal with all the material covered in the Joint Committee's extensive pamphlet. My focus will be on those international comparisons that the Treasury finds particularly instructive in evaluating American competitiveness and the long-term tax policy options that might potentially address the issues raised by competitiveness concerns.

Comparing International Results and Tax Structures

There are inevitably economic costs associated with taxes -- a tax on labor inhibits work effort, a tax on capital inhibits savings and investment -- yet governments must raise revenue to finance their operations.[1] Other industrial countries face problems similar to our own in structuring their tax systems to

[1] Raising revenue can be deferred by borrowing, but only at the cost of diminished government expenditures or increased taxes in the future. Deficits can thus be viewed as a transfer of tax payments from current to future generations.

minimize the adverse impact of such levies on economic activity while raising needed revenue in a manner which is fair and administrable.

The most prominent difference between our tax structure and those of other developed countries is their greater use of consumption taxes, such as value-added taxes (VAT) and gasoline taxes and conversely, our greater use of taxes on income and profits. On average, members of the Organisation for Economic Co-operation and Development (OECD) raised over 28 percent of total tax receipts in 1988 from consumption taxes on goods and services. For the United States, the corresponding figure was less than 15 percent (including Federal, state and local taxes). Of the 23 other OECD members, only Japan relied less heavily on consumption taxes than we did in 1988 (see Table 1), and Japan instituted a broad-based retail sales tax in 1989.

These percentages describe the mix of taxes levied -- but relative levels of taxation are also important.[2] The most recent OECD statistics (see Table 2) show that in 1988 only Turkey of the 24 OECD nations had a lower ratio of taxes to gross domestic product (GDP) than the combined Federal, state, and local burden imposed in the United States (29.8 percent of GDP).

Neither the tax mix nor the tax burden statistics correlate particularly well with statistics on economic growth or investment. For example, Japan has relied even more heavily than the United States on income taxes as a percentage of total taxes (47.3 percent in 1988 as compared to 43.1 percent in the U.S.) and has imposed a greater overall tax burden (31.3 percent of GDP vs. 29.8 percent in the U.S.). Nevertheless, Japan has achieved a higher real growth rate and a higher rate of net investment.

There is, however, a group of international statistics which correlates more strongly with economic performance. Many of those economies that demonstrate high rates of national savings have achieved higher rates of investment than those economies which have not. Japan's national savings rate over the period 1960-89 is almost triple the United States rate; West Germany's rate for the same period is almost double our rate. Both of

---

[2] Some commentators question international comparisons of tax burdens because of differing levels of government services provided. They would distinguish taxes which are directly related to the provision of government services to the economy from taxes levied to fund transfer payments and related expenditures.

these major U.S. competitors have achieved much higher rates of investment than the United States.[3]

Improving National Savings

National savings consist of two components -- private savings and government savings. Both are low in the United States; indeed, the Federal Government by running a large deficit is engaging in wholesale dis-saving. Savings are important because domestic investment -- which directly stimulates employment and productivity -- must be financed from national savings and net foreign borrowing. While high rates of foreign borrowing have cushioned the United States from the negative impact we would otherwise face as a result of our low national savings rate, increased foreign debt means increased foreign claims on our resources in the future.

High deficits damage our nation's competitive strength by lowering national savings. High levels of deficit spending absorb private savings and increase our dependence on foreign lenders. The most important step we can take to promote long-run American competitiveness is to reduce government dis-saving by reducing the deficit. The short-run requirement for implementing that goal is clear. We must fulfill the budget agreement achieved last year. The 1990 budget agreement targets a $492 billion reduction in Federal borrowing over the next five years and makes pay-as-you-go the law of the land.

Since these reforms, the Federal funds rate has fallen from 8 percent in October 1990 to 5.75 percent today; other short-term rates have correspondingly fallen. For American business, lower interest rates mean lower capital costs and increased new investment. Maintaining these achievements requires budget discipline on the part of Congress and the Administration.

While the rate of personal savings (measured as a percentage of disposable personal income) in the United States has increased recently (4.6 percent in both 1988 and 1989, as compared to 2.9 percent in 1987), savings rates are still below historical U.S. levels (6.7 percent) and well below current levels in Japan (15.0 percent) and Germany (12.5 percent). Comparisons of U.S. total national savings rates with those of other countries show similar disparities.

---

[3] A recent econometric study of growth rates in 98 countries over the period 1960 to 1985 found a statistically significant correlation between the growth rate of real per capita GDP and the ratio of real private domestic investment to real GDP. See Barro, Robert J., "Economic Growth in a Cross Section of Countries," Quarterly Journal of Economics CVI, May 1991, pp. 407-443.

The connection between tax incentives and improved private savings is far less direct than the impact of deficit reduction on government savings. The reason is that revenues foregone to finance tax provisions to stimulate private savings act as an offset to the economic benefits produced by the new savings induced.

The Administration continues to believe, however, that a targeted savings incentive in the tax code could improve personal savings. The Family Savings Account program described in the budget[4] would provide such an incentive at an acceptable revenue cost.

Impact of Tax Policy on Competitiveness

Over the long term, there is a stronger correlation between national savings rates and economic performance than between the structure of taxation and economic performance in developed countries. Nonetheless, the tax system may be a powerful allocator of investments and savings and in this way may contribute or detract from the overall competitive strength of the system.

Corporate Taxes Generally

Efforts to provide direct tax comparisons across countries are difficult because the effective tax rate on capital income depends on a number of attributes of a tax system, including the tax rate on capital gains, the individual level of taxation on dividends and interest, and whether the individual and corporate systems are integrated. The "total tax wedge" is a single measure used by economists that summarizes all of these attributes. Table A in the Appendix compares the total tax wedge in the United States and in several other industrialized countries.

Analyzed on a comparative basis, the United States tax system presents a mixed picture. United States tax rates and overall tax burden remain among the lowest in the developed

---

[4] Under the President's budget (which meets the pay-as-you-go requirements) an individual could contribute up to $2,500 per year to a Family Savings Account (spouses could also make contributions to their own accounts). While contributions would not be deductible, funds left in the account and the earnings on such funds could be withdrawn tax-free after seven years. Single taxpayers with adjusted gross income (AGI) of less than $60,000 and couples filing jointly with AGI of less than $120,000 would be eligible. The Office of Tax Analysis estimates that the provision would reduce revenues by $6.5 billion over the budget period.

countries. On the other hand, most developed countries provide some form of relief (often quite generous[5]) to capital gains and virtually all now provide some form of relief from double taxation of corporate profits. Such relief -- often called integration -- is present in the U.S. system only for small business corporations which can elect Subchapter S status or businesses which can be operated in other pass-through forms such as partnerships. The current classical corporate tax system of the United States subjects corporate profits to two levels of tax -- explicitly in the case of profits distributed as a dividend, and implicitly if inexactly through capital gains taxation of stock sales.[6]

These structural characteristics of the U.S. system encourage greater use of debt financing since returns on debt capital in the form of interest are deductible by the corporation and thus bear only a single level of tax. Greater reliance on debt financing may reduce the corporate sector's capacity to ride out economic downturns and increase tendencies to focus on short-term profitability and cash flow.

These problems could be addressed in several ways. The first and simplest would be a reduction in the capital gains rate as the Administration has long favored. Second, the corporate and individual tax systems could be integrated to reduce or eliminate double taxation of corporate profits. Corporate integration would be a major change in our tax system with far-reaching effects. Because the change is so fundamental, the Treasury plans to release a study of several different approaches to achieving integration later this year. Each of these approaches will be specified in sufficient detail to allow a broad base of public comment on the advisability of making such a change.

The third approach, which I will discuss in more detail later, would be to substitute some form of consumption taxation for other forms of taxation.

---

[5] For example, Japan taxes capital gains at the lesser of 1 percent of sale proceeds or 20 percent of gain, thereby providing even greater relief to highly successful investments than to those which achieve only modest success. (See Table 3.)

[6] The maximum capital gains rate of 28 percent is less than the 31 percent maximum rate on dividends, and the ability to defer realization may further reduce the effective rate on capital gains. However, these effects are offset by the fact that inflationary gains are subject to tax. Capital gains may also be attributable to anticipated but unrealized profits.

Research and Experimentation

The Administration believes that a long-term commitment to productivity-enhancing innovation is vital to the future competitive success of the American economy. For this reason, the President's budget contains proposals to make the credit for research and experimentation currently provided in the Code permanent, and to extend for an additional year the current domestic/foreign allocation rules for such expenditures. Since we have so frequently discussed our support for these proposals, I will not elaborate further today other than to observe that programs to encourage research and experimentation should be a central focus of efforts to maintain and improve the long-term competitive capabilities of the American economy.

Foreign Investment by U.S. Firms

The Code provides a basic structure of worldwide taxation of United States residents with relief from double taxation in the form of a foreign tax credit. An unlimited foreign tax credit, however, would result in a U.S. subsidy of foreign taxes when foreign rates exceed the U.S. rate -- hence the credit is limited to the U.S. rate on foreign income.

Lowering the U.S. corporate rate to 34 percent in 1986 was expected to result in more corporations having excess foreign tax credits than prior to the 1986 Act. The limited evidence currently available suggests that such is the case. (In 1984, the proportion of U.S. corporations' income from foreign activities that was in an excess credit position was estimated at 50 percent.) To the extent such companies pay taxes which are not creditable by reason of the limitation of the credit rate to 34 percent, the goal of neutrality between foreign and domestic investment is not achieved. This result occurs, however, because of high foreign taxes. By definition, firms with excess foreign tax credits are paying little or no U.S. tax on that foreign income, provided that foreign income is properly identified.[7]

The fact that many firms have excess foreign tax credits, however, has caused some companies to challenge certain aspects of the Code that they contend affect adversely the ability of U.S. multinationals to compete abroad. In general, these proposals would attack the perceived problem by reducing expenses allocated to foreign source income (thereby increasing foreign income, increasing foreign tax credit utilization, and reducing

[7] The alternative minimum tax may prevent total elimination of U.S. tax on such foreign earnings.

U.S. taxable income and tax).[8] It is clear that these proposals will reduce Federal revenues. By reducing the U.S. tax burden on the affected firms, the proposals will benefit them. However, the net advantage for the United States is less clear since the loss of Federal revenues will increase the deficit unless offset with other revenues.

A more appropriate course may be to simplify the admittedly complex provisions of the Code which govern outbound investment. To the extent such simplification can be achieved without overall revenue loss, it may reduce the cost of tax compliance and thereby aid American companies doing business abroad to compete more effectively.

Inbound Investment

Foreign direct investment in the United States continues to grow and amounted to about $540 billion in 1989 on a market price basis. Our goal with respect to foreign direct investment in the United States has been to provide a level playing field -- neither to encourage nor to discourage such investment through tax policy. We attempt to treat foreign business and investors as we treat domestic business and investors. We believe that this is not merely good policy in the abstract sense -- but judicious practical policy as well. The level of United States direct investment abroad (currently about $800 billion in market prices) is higher than foreign direct investment in the United States. Since foreign governments might retaliate against U.S. tax rules perceived to be unfair to their nationals, we believe that U.S. rules should be fashioned in such a way that we would not be troubled by their reciprocal application by a foreign government.

A level playing field implies, however, that foreign-owned companies doing business in the United States are subjected to the same enforcement of our tax laws as U.S.-owned corporations. In this connection, I am pleased to report that final regulations have been published under section 6038A of the Code. This provision, enacted with the support of the Administration in 1989, is intended to ensure that the Internal Revenue Service can obtain the same data in a transfer pricing case involving foreign-owned businesses operating in the U.S. as it can with respect to U.S.-owned businesses operating abroad. We have assured foreign governments that we will implement these new rules with full consideration for our obligations under our bilateral tax treaties -- and, in particular, where treaty

---

[8] The proposals range from requiring that all state taxes be sourced to domestic source income (even when the state is clearly taxing income treated as foreign source by the Code) to revision of the interest allocation rules adopted in 1986.

information exchange provisions are effective, the Internal Revenue Service will utilize those procedures first.

In addition, we have recently issued proposed regulations to implement section 163(j) of the Code -- the so-called "earnings stripping" rule. While the Administration did not favor enactment of this provision in 1989, we have attempted to execute the will of Congress faithfully in the proposed regulations. The problems inherent in utilizing mostly mechanical rules for excessive interest disallowance remain, and we have not yet proposed a rule for guarantees. We expect that we will receive numerous comments on the rule.

Finally, we are actively engaged in the preparation of new regulations under section 482 regarding intangible property transfers. As part of our international compliance efforts, we have entered into consultations with several of our treaty partners to determine how transfer pricing enforcement can be improved through cooperative international efforts.

Broad-Based Consumption Taxes

As already noted, other countries rely more heavily on consumption taxes as a major source of governmental revenue than the United States does (see Table 1). While value-added taxes are the most prevalent (see Table 4), other countries tend to tax other consumption items such as gasoline, alcohol, and tobacco quite heavily as well (see Table 5). Although the Administration does not believe that a new tax of any kind is needed at this time, we recognize the need for this Committee to investigate whether replacement of a portion of our current system with such taxes would promote economic efficiency and international competitiveness.

Advocates of consumption taxes stress that such taxes do not adversely impact savings during accumulation or investments when made but rather defer the tax burden until the time of consumption. In addition, some have questioned the general assumption that such taxes are regressive.[9] These critics acknowledge that such taxes will show a regressive pattern of incidence in any given year. However, they point out that on a lifetime basis such taxes are more likely to be proportional due to lifetime saving and consumption patterns. Moreover, people benefit from such a tax only to the degree that they invest rather than consume -- if they consume more they will be taxed more.

---

[9] See "Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels," Congressional Budget Office (June 1990), p. 2-4, 30.

While a complete evaluation of a VAT or other consumption taxes is beyond the scope of my testimony today, I would note that the Treasury study prepared such a review of a VAT at the time of the 1984 tax reform study.[10] We continue to agree with most of the basic analysis contained in that report; however, we recognize that the prevalence of consumption taxation abroad may well lead Congress toward serious consideration of such taxes in the decade ahead.

Implementation of consumption taxes will not be simple. Indeed, broad-base consumption taxes often replicate many of the difficult questions of timing and accounting which have bedeviled the income tax since its inception. Nor will the revenues come quickly. While estimates vary, start-up is generally estimated to require 18 to 24 months after enactment.

If properly structured, the GATT permits a VAT to be imposed on imports and rebated for exports. This process does not favor exports or penalize imports. Instead it simply assures that all goods sold in the taxing jurisdiction face an equivalent tax rate. Imposition of a VAT would not have a favorable impact on exports unless it replaced taxes which are not border adjustable and which increase product prices. Even in such circumstances, most analysts doubt that a trade improvement would occur since currency adjustments would likely offset any tax advantage gained.

For the efficiency gains of consumption taxes to be as fully realized as possible, it is vital that they be kept as simple in structure as possible on as broad base as is feasible. In particular, exemptions and zero-rated or differentially rated goods and services should be avoided to the maximum extent feasible. To the extent that relief from the tax for low-income groups is desired, various forms of direct rebating are likely to be more effective. This occurs because all taxpayers regardless of income share in exemptions or rate relief; indeed, to the extent wealthy taxpayers consume more lower-rated goods than low-income taxpayers, the benefit of reduced rates is shifted to the wealthy.

The uniform business tax (UBT) proposed by Congressman Schulze of this Committee would fundamentally change business taxation in the United States by substituting a broad-based, single-rate consumption tax for the existing corporate income tax and the employer's portion of the payroll tax. To ensure the integrity of the social security trust fund, UBT liability could not be less than a business's payroll tax liability had this

---

[10] Tax Reform for Fairness, Simplicity, and Economic Growth, U.S. Treasury Department (November 1984), Vol. 3, Value-Added Tax.

portion of the tax not been replaced. The payroll tax minimum requirement could be expected to be the effective levy in certain start-up businesses and in years of very heavy capital expenditures for some businesses.

Under the UBT, a business (including sole proprietorships, partnerships and S corporations)[11] would determine its taxable receipts by subtracting the cost of goods and services purchased from other businesses from its total receipts from the sale of goods and services in the United States. Amounts paid for machinery and equipment as well as inventory purchases would be deducted from gross receipts (although UBT would be paid by the business selling such items). The effect -- as with other consumption taxes -- is to defer taxation of new capital investment until proceeds are realized from such investment. Adoption of a UBT would raise difficult issues of transition and design. For example, it is not clear how financial services income would be taxed. In addition, differences in treatment of savings by individuals and by entities subject to UBT would have to be addressed because savings by corporations would not face immediate income taxation while direct individual savings would be subject to current taxation.

Consumption taxes can clearly raise substantial revenues. While we have not estimated the revenue yield of a UBT, the 1984 Treasury study did estimate the yield of a broad-based VAT. For 1989, utilizing the tax base described in the 1984 study, we estimate that each 1 percent rate of VAT would raise approximately $25 billion annually. (See Table 6.)

Conclusion

We commend the Committee for undertaking a long-term review of competitiveness issues in this hearing. While the Administration does not favor major tax changes at present, we believe that efforts to compare our current tax structure with feasible alternatives, such as integration of the corporate and individual income tax and increased reliance on consumption taxes are worthwhile. Such analyses provide the foundation for evaluating future proposals to improve the efficiency of our tax system. Given the importance of stability of the tax system for business planning, changes of the magnitude discussed today should be undertaken only after full public debate on their relative merits.

Mr. Chairman, I would be pleased to answer any questions which you and other Members of the Committee may have.

---

[11] However, an exemption would be provided for non-corporate businesses with $50,000 or less in gross receipts.

TABLE 1

Revenues From Various Taxes as a Percentage of Total Tax Collections in 1988

Country	Taxes on Income and Profits	Social Security and Payroll Taxes	Consumption Taxes	Other Taxes
Australia	56.5	5.7	24.0	13.8
Austria	25.7	38.4	30.8	5.1
Belgium	38.9	33.8	23.1	4.2
Canada	46.1	13.2	26.3	14.4
Denmark	58.6	2.5	31.7	7.2
Finland	50.4	8.2	37.3	4.1
France	17.4	45.1	28.6	8.9
Germany	34.2	37.4	24.2	4.2
Greece	17.9	33.6	43.6	4.9
Iceland	N/A	N/A	N/A	N/A
Ireland	38.6	15.4	40.4	5.6
Italy	35.7	33.8	25.7	4.8
Japan	47.3	29.0	10.8	12.9
Luxembourg	41.7	25.4	24.6	8.3
Netherlands	27.9	42.5	23.7	5.9
New Zealand	59.8	2.2	30.8	7.2
Norway	33.5	25.5	35.9	5.1
Portugal	22.2	27.0	47.0	3.8
Spain	29.6	35.7	29.4	5.3
Sweden	43.9	28.5	23.3	4.3
Switzerland	40.8	32.0	17.5	9.7
Turkey	34.2	15.1	31.1	19.6
United Kingdom	37.5	18.5	29.6	14.4
United States	43.1	29.7	14.7	12.5
Unweighted Averages:				
OECD Total	38.3	25.2	28.4	8.1
OECD Europe	34.9	27.7	30.4	7.0
EEC	33.3	29.2	31.0	6.5

Source: OECD, Revenue Statistics of OECD Member Countries, 1965-1989, p. 73. (OECD: Paris), 1990.

N/A = Not Available

TABLE 2

Ratio of Total Taxes to Gross Domestic Product (GDP) in 1988

Country	Total taxes as a Percentage of GDP
Australia	30.8
Austria	41.9
Belgium	45.1
Canada	34.0
Denmark	52.1
Finland	37.9
France	44.4
Germany	37.4
Greece	35.9
Iceland	31.7
Ireland	41.5
Italy	37.1
Japan	31.3
Luxembourg	42.8
Netherlands	48.2
New Zealand	37.9
Norway	46.9
Portugal	34.6
Spain	32.8
Sweden	55.3
Switzerland	32.5
Turkey	22.9
United Kingdom	37.3
United States	29.8

Source: OECD, Revenue Statistics of OECD Member Countries, 1965-1989, p. 71. (OECD: Paris), 1990.

TABLE 3

TAXATION OF LONG-TERM CAPITAL GAINS ON SECURITIES IN G-7 COUNTRIES

G-7 Country	Maximum Individual Tax Rate on Long-Term Capital Gains on Securities*	Special Tax Rules for Capital Gains
United States	28%	None.
Italy	15%	Applied to notional gain between 2-7% on certain indices. Alternative tax of 25% net realized gain, indexed for inflation.
France	16%	Only applies to gains on major transactions (proceeds more than F. 307,600 ($61,748)) or if the seller holds a "substantial interest" (25% or more of the corporate shares).
United Kingdom	40%	Only applies to gains in excess of inflation. The first 5,000 pounds ($9,878) are excluded; the 40% rate applies to any excess.
Canada	22%	Lifetime exemption of C. $100,000 ($86,210). Rate reflects exclusion of 25% of gain.
Germany	0%	Gain on securities held more than 6 months is exempt, unless on the sale of a "substantial participation" (ownership of 25% and sale of at least 1% of the corporation's shares).
Japan	20%	Alternative tax of 1% of the sales price (at taxpayer's option).

Department of the Treasury
Office of Tax Analysis

* National tax only. Subnational taxes are relevant in the United States, Canada, and Japan. In Canada (non-deductible) provincial taxes amount to roughly 50 percent of the Federal tax. In Japan the (non-deductible) local tax adds 6 percentage points to the national tax. The taxation of gains on other assets, e.g. business assets, land, houses, may differ from those shown.

TABLE 4

Value-Added Taxes in Other Countries in 1988

Country	Statutory Rate	VAT as a % of Total Tax Collections	VAT as a% of all Consumption Taxes
Austria	20.0	20.1	65.3
Belgium	19.0	16.2	70.1
Canada	7.0	NA	NA
Denmark	22.0	18.2	57.4
Finland	19.0	23.3**	62.5
France	18.6	19.4	67.8
Germany	14.0	15.6	64.4
Greece	18.0	22.4	51.4
Ireland	18.0	20.7	51.2
Italy	25.0	15.2	59.1
Japan*	3.0	NA	NA
Luxembourg	12.0	14.2	57.7
Netherlands	20.0	16.5	69.6
New Zealand	10.0	9.9	32.1
Norway	20.0	20.1	56.0
Portugal	17.0	20.2	43.0
Spain	12.0	16.4	55.8
Sweden	23.5	13.3	57.1
Turkey	12.0	22.1	71.1
United Kingdom	15.0	16.5	55.7

Source: Alan A. Tait, Value Added Tax: International Practice and Problems (IMF: Washington, D.C.) 1988; and OECD Revenue Statistics of OECD Member Countries 1965-1989 p. 73. (OECD: Paris) 1990.

* Broad-based retail sales tax instituted.

** VAT revenue as a percentage of total revenue in 1987.

TABLE 5

Percentage of Taxes in Retail Price of Alcohol, Gasoline and Cigarettes in OECD Countries

Country	Distilled Spirits	Beer	Wine	Gasoline	Cigarettes
Australia	17	35	15	49.4	51.3
Austria	40	36	31	62.5	71.1
Belgium	56	27	27	64.7	70.0
Canada	82	53	69	40.5	N.A.
Denmark	83	50	48	75.3	87.2
Finland	66	41	66	52.0	N.A.
France	45	18	18	76.9	74.8
Germany	64	20	12	64.0	72.0
Greece	N.A.	N.A.	N.A.	66.4	63.2
Iceland	N.A.	N.A.	N.A.	N.A.	N.A.
Ireland	66	64	51	70.7	73.8
Italy	27	20	8	78.3	72.0
Japan	23	47	22	47.0	N.A.
Luxembourg	44	14	6	56.4	66.9
Netherlands	72	34	25	70.4	71.5
New Zealand	53	30	20	51.0	N.A.
Norway	91	54	59	66.6	N.A.
Portugal	8	14	8	66.0	71.8
Spain	47	15	11	65.2	44.7
Sweden	92	34	69	62.2	N.A.
Switzerland	31	14	5	64.7	N.A.
Turkey	N.A.	N.A.	N.A.	N.A.	N.A.
United Kingdom	51	31	29	67.8	74.3
United States	45	15	12	31.5	34.2

Source: Congressional Budget Office, Federal Taxation of Tobacco, Alcoholic Beverages and Motor Fuels, June 1990 (Tables A16-A18).

Note: N.A. = not available

TABLE 6

Estimate of Value-Added Tax Base in 1989
($ Billions)

Total Personal Consumption Expenditures			$3,450
Less:	Rental value of owner- and tenant-occupied housing (including farms)	462	
	Medical care (including health insurance)	349	
	Insurance and finance (other than health insurance)	136	
	Education	64	
	Religious and welfare	83	
	Foreign travel	0	
	Local transportation	9	
	Other: Food produced and consumed on farms, military-issued clothing, domestic services.	11	
			(1,115)
Plus:	Sales of new housing		204
Broad Value-Added Tax Base			**$2,539**
Less:	Food consumed at home	356	
	Prescription drugs	18	
	Household energy expenditures	139	
Narrow Value-Added Tax Base			**$2,026**

APPENDIX

Tax Wedges

Standard finance theory suggests that a business will continue to invest as long as the expected real after-tax return from the investment exceeds the firm's real after-tax cost of funds. If investment opportunities and the real cost of funds are the same for all countries, then more corporate investment would be expected in countries with the lowest spread between the pre-tax return on investment and the cost of funds. This spread, or corporate "tax wedge", generally depends upon the type of asset acquired, the corporate tax rate, the capital recovery allowances, the rate of inflation, and various other country-specific factors. Table A presents a listing of preliminary OECD calculations of the 1991 corporate tax wedge based on a standardized mix of assets and sources of funding for a manufacturer located in several OECD member countries. The results, which assume the same 5.6 percent inflation rate and 5 percent real after-tax cost of funds in each country, indicate that the corporate tax wedge in Japan is much higher than in the United States.

A more complete picture of how a country's tax system affects savings and investment may be obtained from a comparison of the total tax wedge. The total tax wedge includes effects of both the individual and corporate tax system, and is the spread between the real pre-tax return and the after-tax return ultimately received by investors. Table A also shows the total tax wedge for the same set of OECD member countries. These preliminary calculations allow for the actual rate of inflation in each country, rather than using a fixed rate (5.6 percent) for all countries, as was done for the calculations of corporate tax wedge.

The total tax wedge for Japan is somewhat smaller than that for the United States, although the disparity is very modest. It is possible that, had the mix of assets, sources of finance, and real interest rates actually observed in each country (rather than standardized values) been used, the disparity between the total tax wedge for Japan and the United States would be smaller, or even reverse. Nevertheless, the data of Table A do not suggest that the Japanese tax system is more favorable to investment than the U.S. system. This lower investment rate for the United States may thus be more indicative of the higher cost of funds in the United States or the higher target rates of return sought by the managers of U.S. corporations, perhaps indicating greater investment risk (or greater risk aversion).

Table A

Corporate and Total Personal Income Tax Wedges
for New Investments in Manufacturing in 1991

Country	Corporate Tax Wedge 1/	Total Tax Wedge 2/
United States	0.8	3.0
Canada	1.2	3.8
France	0.4	2.1
Germany	0.6	1.0
Japan	1.4	2.8
United Kingdom	0.9	2.0

Source: OECD, preliminary unpublished estimates.

1/ The difference between the pre-corporate tax rate of return and 5 percent (the real interest rate). Assumes no personal taxes and an inflation rate of 4.5 percent for all countries. The weights for the proportion of investment in each type of asset and the proportion of finance from each source of funds are assumed to be the same for each country: 50 percent for machinery, 27 percent for buildings, 23 percent for inventories; and 35 percent for debt, 10 percent for new equity, and 55 percent for retentions.

2/ The difference between the pre-corporate tax rate of return necessary when real interest rates are 5 percent and the after-personal tax rate of return. Assumes the top marginal rate of personal taxes and the OECD's projection for inflation for each country. The weights for the proportion of investment in each type of asset and finance from each source of funds are described in footnote 1.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
June 20, 1991

Contact: Cheryl Crispen
202-566-2041
Barbara Clay
202-566-5252

TREASURY AMENDS LIST OF IRAQI AGENTS

The Treasury Department today added seven persons to its list identifying front companies and agents of Iraq. The action is part of an ongoing Treasury investigation to uncover and neutralize Iraq's worldwide procurement and financial network.

The amendment to the list of Specially Designated Nationals (SDN) of the Government of Iraq adds the names of seven individuals closely associated with the regime of Iraqi dictator Saddam Hussein. All assets of these seven individuals within U.S. jurisdiction are blocked.

In announcing the action R. Richard Newcomb, Director of Treasury's Office of Foreign Assets Control (OFAC), stated, "These close associates and family members of Saddam Hussein hold key positions within the Iraqi Government and have been rewarded financially for their loyalty to his regime."

The seven names include Ali Hassan Al-Majid, Saddam's paternal first cousin and Iraq's Minister of the Interior; Hussein Kamel Al-Majid, Saddam's son-in-law who heads Iraq's Ministry of Industry and Military Industrialization; Barzan Ibrahim Hassan Al-Takriti, Saddam's half-brother who acts as the Permanent Representative of Iraq to the United Nations in Geneva; Sabawi Ibrahim Al-Takriti, Saddam's half-brother and Director of the Iraqi Intelligence Service; Watban Al-Takriti, Saddam's half-brother who serves as an official in Iraq's Presidential Palace; Udai Saddam Hussein, Saddam's eldest son; and Latif Nusayyif Jasim, a member of the Revolutionary Command Council and former Minister of Culture and Information of the Government of Iraq.

Today's additions to the Iraqi SDN list were accompanied by the removal of two British commercial entities -- PMK/Qudos (Liverpool Polytechnic) and Sollatek -- from the list. These entities had previously been licensed by OFAC to conduct business.

Doing business with an SDN of Iraq 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.

Information on persons who hold Iraqi Government assets, or information on assets which are owned or controlled by persons acting on behalf of the Government of Iraq may be reported to OFAC through the Iraqi assets telephone hotline at 202-566-6045. All calls will be kept confidential.

oOo

TREASURY NEWS

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

FOR IMMEDIATE RELEASE June 21, 1991

Monthly Release of U.S. Reserve Assets

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

As indicated in this table, U.S. reserve assets amounted to $78,263 million at the end of May 1991, down from $78,297 million in April 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					
April	78,297	11,058	10,325	48,108	8,806
May	78,263	11,057	10,515	47,837	8,854

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 reverse 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-1338

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
June 21, 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 $ 12,500 million of 363-day Treasury bills to be dated July 5, 1991 and to mature July 2, 1992 (CUSIP No. 912794 YV 0). This issue will provide about $ 1,950 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $ 10,553 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, June 27, 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 July 5, 1991. In addition to the maturing 52-week bills, there are $ 17,903 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 $ 1,361 million as agents for foreign and international monetary authorities, and $ 7,425 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 $ 265 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-1339

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

SECRETARY OF THE TREASURY NICHOLAS BRADY

Press Conference
Queen Elizabeth II Conference Center, London
June 23, 1991

Secretary Brady:

Thank you, [Assistant Secretary-designate for Public Affairs] Desiree [Tucker-Sorini].

I am sure you have talked to other participants in the meeting, so I will just give you a brief review of my impressions of the most significant parts of it.

First of all, we did review economic conditions in each of our constituent countries and noted with satisfaction that the economies in many of the countries are improving, and that's good news, particularly in the United States where the rate of inflation is now under 3 percent and the early indications of a recovery seem to be more evident.

There was also continued agreement that as we approach the Economic Summit, and the rest of this year, and looking forward into the nineties, that a growth scenario was the best way to meet all of the challenges before us.

We had a useful discussion of the economic conditions in the Soviet Union and with general agreement that the idea that had been suggested by President Bush, the associate status for the Soviet Union, was a good one. I think it was important that these kinds of discussions took place going forward to the summit, and I think that it was extremely useful that we got the kind of agreement that we did have. I will be glad to answer any questions:

Q. [Daily Telegraph in London] [inaudible]...I think I heard you emphasize that the growth scenario was escalating.... Is this what you had intended to say, to emphasize the growth aspect of the world economy?

Q. [repeat question]

A. The question was, if I got it correctly, that I emphasized that the growth scenario was the right way to approach the problems that are before us and the opportunities before us in the nineties as we approach the Economic Summit. The answer to that question is yes, that is what was said, it was agreed to by the participants in the meeting and as we look forward to the nineties as the heads, the heads of state meeting at the summit, look forward to the nineties, a look backwards at the developments of the eighties indicates that the kind of growth scenarios we had during that period of time produced enormously significant changes in the world and that's a good basis for going forward.

Q. Mr. Secretary apart from the offer of associate status from the IMF to the Soviet Union was there agreement on anything else that would be offered to Mr. Gorbachev after the G-7 summit in the nature of aid, the kind of aid, and the level of it to the Soviet Union?

A. Nothing in terms of specifics and obviously part of our job is to present options for the heads of state to consider at the Summit. There was a review of some of the differing plans that have been offered. The fact that we had seen in the United States many of these plans, and that some of them seem to have taken on a life of their own, which all the participants felt was in a sense a confusing development, and that they would all be reviewed and looked at, the number of new ideas coming forward were a great many and they all had to be reviewed and distilled before any kind of a reaction could be given.

Q. Mr. Secretary, did you in the meeting today discuss the recent strengthening of the dollar and can you tell us what was said about that and also what discussion there was of recent moves in interest rates? Have you seen interest rates come down in some countries [inaudible]?

A. Well let me start with the second part of your question. We did discuss the lowering of interest rates in various countries in the world and that was noted with satisfaction. We did discuss the fact that exchange markets in the last several weeks had shown an increase in the level of the dollar but at the same time we also discussed the fact that over a period of three or four years now we have had orderly markets and that these recent movements fit within those orderly markets, but I don't want to amplify too much on that. Paragraph five I believe is the operative paragraph and that tells you what the conclusions really were.

Q. A similar question. What is the United States' view of the strengthening of the dollar which is obviously concerning the Europeans? Are you happy to have a strong dollar or...[inaudible]?

A. Well, as you know we never comment on levels at these meetings and I just refer you back to paragraph five.

Q. [Inaudible] Was the agreement...[inaudible]...and what's the next step to be taken...[inaudible]?

A. Well, we didn't take a vote but I detected nothing but indications for the other participants in the group that the associate status was something that should be put forward, and I would assume that more work will be done between now and the Summit to flesh out exactly what that means. But aside from that I can't tell you anymore.

Q. Going back to the Soviet Union, was it the feeling at the meeting that the Soviet Union could not realistically expect large sums of money in the near future, the tens of billions...[inaudible]...talking about...[inaudible]?

A. Well, I think all of the countries who participated in the G-7 meeting have indicated that that's the case. In other words, large sums of money are not what we are talking about here, but obviously those are things that will have to be discussed between now and the summit. But there's no change in the position that Prime Minister Major and President Bush and Chancellor Kohl and President Mitterand have made on that particular subject.

Q. Was there disagreement among the G-7 over changing the lending system for the EBRD regarding the Soviet Union?

A. I wouldn't say disagreement. The suggestion has been made, as you know, that the lending limits which are now part of the EBRD rules and regulations, there have been suggestions that those be changed. As I think we've made clear already, the United States is not in favor of that, making any changes, and that other countries this morning indicated that they were willing to look at it, but I would suggest you ought to ask them what their feelings are.

Q. I have a consumer question for your constituency back home. Does this meeting today and indeed any cooperation with the other members of the G-7 help save money on interest rates and interest payments every month? Are we moving in that direction?

A. Well, I'm not sure that what we discussed today can be said to help save money on interest rates, but I am pleased to note that in the United States the federal funds rate has fallen from 8 percent to 5-3/4 percent since last October. Long term interest rates are slightly better although not as good as we would hope for but the key thing that's important to regard at this time in my opinion is that the rate of inflation which had been resistant at the 5 to 6 percent level now seems to be under 3 percent and that is very good news. Hopefully, in terms of long term markets, that will have an effect.

Q. Do you anticipate...[inaudible]...Central Bank intervention against the dollar if it remains at the level it is currently?

A. Well, I hate to answer this question the same way every single time but the last finance minister who answered that question got relieved of his duty and I like what I'm doing.

Q. Are you happy or unhappy if the dollar appreciates more?

A. I refer you to the incredibly explicit language in paragraph five on that subject. Thank you very much.

-30-

23 JUNE 1991

STATEMENT OF THE GROUP OF SEVEN

(1) The Finance Ministers and Central Bank Governors of Canada, France, Germany, Italy, Japan, the United States of America and the United Kingdom met on 23 June 1991 in London for an exchange of views on current international economic and financial issues.

(2) The Ministers and Governors reviewed the global economic situation and prospects, including developments in their economies since their meeting in April. They noted with satisfaction the increasing signs for global economic recovery. They agreed that sustained global economic growth with price stability is essential to address the historic challenges and opportunities which are facing the world economy. They further agreed that pursuing such a strategy in a medium term context was the best way of meeting these challenges and accordingly they reaffirmed their support for economic policy coordination.

(3) The Ministers and Governors emphasised the importance of fiscal and monetary policies which provide the basis for lower real interest rates and a sustained global economic recovery with price stability. They recognised that the approach taken would need to reflect the differing situations in each country. They noted the signs of prospective economic recovery and lower inflation in those countries which are in recession; some other countries are experiencing slower growth while in others, particular Germany and Japan, economic activity is continuing to make a positive contribution. The Ministers and Governors also welcomed the reductions in interest rates that have taken place in a number of their countries and elsewhere. They believed that monetary policy should provide the conditions for sustainable growth with price stability in line with the differing circumstances of each country.

(4) The Ministers and Governors stressed the importance of policies aimed at increasing savings. The Ministers and Governors noted the important budgetary measures taken in some of their countries to reduce significantly high budget deficits and improve the conditions for lower interest rates. Continued progress in reducing budget deficits is essential to strengthen national savings. These efforts should be complemented by measures to reduce impediments to private saving, particularly where saving rates are low.

(5) The Ministers and Governors also reviewed recent developments in international financial markets and reaffirmed their commitment to cooperate closely, taking account of the need for orderly markets, if necessary through appropriately concerted action in exchange markets.

(6) The Ministers and Governors noted that sustained expansion in global trade is an important engine of growth, including for countries throughout the world that are restructuring their economies. In this regard, they accorded the highest priority to a swift and successful conclusion to the Uruguay Round. In light

of the particularly difficult circumstances facing Eastern European countries and the Soviet Union, consideration should be given to measures which would enhance the trade prospects of these countries.

(7) The Ministers and Governors welcomed the reform efforts underway in the Eastern European countries. They noted the economic situation in the Soviet Union and the need for sustained economic reform. Success of these countries in their process of transition and fundamental reform is in the interest both of these countries and global economic growth.

(8) The Ministers and Governors also underscored that the adoption of measures in their countries to promote economic efficiency could provide an important spur to global economic recovery and price stability. Such measures could also send a strong and positive signal to reforming countries, implementing their own reforms. They agreed on the need to review regulations and structural policies with a view to improving the functioning of their economies.

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 24, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,206 million of 13-week bills to be issued June 27, 1991 and to mature September 26, 1991 were accepted today (CUSIP: 912794WU4).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.56%	5.73%	98.595
High	5.58%	5.75%	98.590
Average	5.58%	5.75%	98.590

Tenders at the high discount rate were allotted 58%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	32,785	32,785
New York	38,515,650	9,016,985
Philadelphia	24,765	24,765
Cleveland	47,220	47,180
Richmond	145,095	45,095
Atlanta	36,475	32,695
Chicago	1,342,865	56,615
St. Louis	57,135	13,135
Minneapolis	9,910	9,910
Kansas City	43,620	43,620
Dallas	24,390	24,390
San Francisco	364,640	63,640
Treasury	794,745	794,745
TOTALS	$41,439,295	$10,205,560
Type		
Competitive	$38,066,700	$6,832,965
Noncompetitive	1,586,685	1,586,685
Subtotal, Public	$39,653,385	$8,419,650
Federal Reserve	1,645,010	1,645,010
Foreign Official Institutions	140,900	140,900
TOTALS	$41,439,295	$10,205,560

An additional $17,600 thousand of bills will be issued to foreign official institutions for new cash.

NB-1340

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 24, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,222 million of 26-week bills to be issued June 27, 1991 and to mature December 26, 1991 were accepted today (CUSIP: 912794XS8).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.75%	6.02%	97.093
High	5.77%	6.04%	97.083
Average	5.76%	6.03%	97.088

Tenders at the high discount rate were allotted 45%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	26,710	26,710
New York	27,188,560	9,042,420
Philadelphia	17,120	17,120
Cleveland	34,685	34,685
Richmond	87,075	59,575
Atlanta	43,535	36,180
Chicago	1,712,775	239,025
St. Louis	34,005	14,005
Minneapolis	7,395	7,395
Kansas City	40,950	40,950
Dallas	14,570	14,570
San Francisco	485,945	197,195
Treasury	491,890	491,890
TOTALS	$30,185,215	$10,221,720
Type		
Competitive	$25,888,120	$5,924,625
Noncompetitive	1,028,995	1,028,995
Subtotal, Public	$26,917,115	$6,953,620
Federal Reserve	2,000,000	2,000,000
Foreign Official Institutions	1,268,100	1,268,100
TOTALS	$30,185,215	$10,221,720

An additional $214,900 thousand of bills will be issued to foreign official institutions for new cash.

NB-1341

TREASURY NEWS

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

EMBARGOED UNTIL GIVEN
JUNE 25, 1991

STATEMENT OF
STEVEN W. BROADBENT
DEPUTY ASSISTANT SECRETARY
(INFORMATION SYSTEMS)
DEPARTMENT OF THE TREASURY
BEFORE THE COMMITTEE ON GOVERNMENTAL AFFAIRS
OF THE UNITED STATES SENATE
ON THE INTERNAL REVENUE SERVICE'S (IRS)
COMPUTER SYSTEM MODERNIZATION AND PROCUREMENT
JUNE 25, 1991

Mr. Chairman and Members of the Committee:

I am pleased to appear before the Committee to testify on Treasury's role in IRS procurements and on the applicability of existing government-wide procurement laws and regulations to such procurement. I have with me Mr. Thomas P. O'Malley, Director of Treasury's Management Programs Directorate, which contains the procurement policy and program function.

Before discussing the specific issues raised in your letter of March 13, I would like to provide you with some background on Treasury's structure and functions and the ways in which we carry out our management responsibilities in the information technology area.

Treasury is the third largest government department, after Defense and the Department of Veterans Affairs. The functions of the Department and our 13 bureaus range from managing federal finances, collecting taxes and duties, and paying all bills of the government, to investigating and prosecuting counterfeiters, smugglers, narcotics traffickers, and gun violators. Our enforcement mission extends to protecting the President and Vice President and their families, and visiting dignitaries. With over 150,000 employees and 1800 field offices in the U.S. and in many countries abroad, information technology plays a vital role in our support of Treasury's missions.

ROLE OF THE OFFICE OF MANAGEMENT

The Office of Management at Treasury is responsible for: managing the budget and financial matters for the Department; presiding over Department-wide administrative management affairs such as procurement, human resources, security, and information processing activities; and providing administrative support services to the Departmental Offices. Included in these responsibilities is the management of the Office of the Deputy Assistant Secretary for Information Systems and the Office of the Deputy Assistant Secretary for Departmental Finance and Management, which includes the Department's procurement policy and oversight function.

In FY 1992, it is estimated that Treasury will spend over $1.6 billion for the procurement of information technology alone. Given this significant investment, effective management of the procurement process is critical to our ability to implement technology in a timely and cost effective manner. Treasury has a long-established procurement oversight and control program: one that encompasses all stages in the life cycle of information processing resources, from initial planning and development of requirements, to obtaining a Delegation of Procurement Authority (DPA), through solicitation for competitive bids/proposals and contract award, contract administration, and through post-implementation reviews of system effectiveness and management.

ROLE OF THE DEPUTY ASSISTANT SECRETARY FOR INFORMATION SYSTEMS

In my role as Deputy Assistant Secretary for Information Systems, I serve as the Department's Senior Official under the provisions of the Paperwork Reduction Act and have Departmental responsibility for policy, oversight, management and improvement of all categories of Federal Information Processing (FIP) Resources, including the broad range of information resources management functions specified in the Brooks Act. These responsibilities include planning, budgeting, policy and standards development and issuance, and oversight and control of ADP and telecommunications acquisitions and systems management.

My office reviews and approves major acquisitions of information systems resources throughout Treasury. I perform these functions as Treasury's Designated Senior Official (DSO) for IRM and, as such, have responsibility for the conduct of, and accountability for, acquisitions of FIP resources made under a DPA from the General Services Administration (GSA). I have further delegated to the Director of the Office of Information Resources Management (OIRM) signature authority for all matters pertaining to DPA approvals and related actions.

My office also establishes total acquisition cost limits up to which bureaus may approve their own information systems resources acquisitions. For IRS, this threshold is set at one million dollars per competitively procured contract. All acquisitions above this threshold are subject to Treasury and, depending on the dollar amount, GSA review prior to receiving the appropriate DPA to proceed with the solicitation.

Treasury has issued detailed guidelines to our bureaus that adhere to the GSA's Federal Information Resources Management Regulation (FIRMR). For major procurements that require either Departmental or GSA DPAs, the Department becomes extensively involved in reviewing detailed requirements analyses and specifications to ensure that government-wide and Treasury requirements and policies are followed. In those instances involving mission-critical and/or high cost systems, such as the Internal Revenue Service's multi-billion dollar Tax System Modernization project, the Department plays a more active role in monitoring early planning and development activities of the bureaus.

Our bureaus must submit carefully thought-out long range plans for the proposed development or acquisition of major systems through annual information systems plans (ISPs). These plans are the forerunners of the Departmental budget process, and are integral to the analysis leading to the formulation and approval of the budget which is submitted to the Department, OMB, and eventually Congress.

Our information systems oversight activities continue with the Information Resources Management Review program, which was established under the authority of the Paperwork Reduction Act of 1980. It supports improvements in information resources management to better achieve agency missions and compliance with government-wide IRM standards, policies, procedures and regulations. The Department operates on a three year plan/review cycle that encompasses established government-wide and Departmental IRM priorities.

The on-going IRM Review Program tracks bureau and Departmental review plans and results, and allows us to assess whether we are conducting information resources management activities in such a way that program missions and objectives are being met economically and effectively. In accordance with guidance from GSA, Treasury has focused on the reviews of major systems and the validation of system benefits.

The Treasury Department's oversight reviews of information systems development, acquisition, management, and effectiveness are within the scope of the IRM Review Program, with reviews including the Computer Security Act implementation, disaster recovery and contingency planning, information systems planning, paperwork management, and records management included.

ROLE OF THE OFFICE OF PROCUREMENT

The Deputy Assistant Secretary for Departmental Finance and Management, through his Office of Procurement, is responsible for: providing policy and contractual guidance for the

Department's procurement and contracting programs; reviewing and evaluating bureau procurement operations; promoting consolidation of procurement where feasible; overseeing the activities of the Small Business Program Manager and the Departmental Advocate for Competition; and implementing Treasury-wide career management programs for all procurement personnel in accordance with the law (Section 16 (4) of P.L. 98-191, Office of Federal Procurement Policy Act Amendments of 1983).

The Department's Office of Procurement has taken a very active role in developing policies, guidelines, and handbooks that assist our bureaus in understanding their responsibilities in the procurement arena. A number of publications have been issued to Treasury bureaus by the Department on such subjects as competition in contracting, small business procedures, and Contracting Officer and Contracting Officer's Technical Representative responsibilities. In addition, the office has an ongoing oversight system that involves the review and approval of individual high dollar value solicitations (prior to release to industry) and contract actions (prior to award) and a program of on-site reviews of bureau procurement activities. These reviews ensure compliance with procurement laws and regulations and sound business strategies.

PROCUREMENT AUTHORITIES AND CONTRACT ADMINISTRATION/OVERSIGHT

The Department's Office of Information Resources Management (OIRM) and Office of Procurement work closely together throughout the procurement process to ensure bureau compliance with all applicable regulations. A description of the process involved in granting a Delegation of Procurement Authority (DPA) provides an example of how the offices at the Departmental level must coordinate their oversight and management functions in this area.

The process normally starts with a planning session between a bureau technical representative and the cognizant OIRM desk officer to review the procedures and strategy for the projected acquisition of FIP resources. The planning session is followed by the bureau preparing draft statements of mission needs and requirements analyses comparing costs with benefits and assessing alternatives. The desk officer reviews the draft documents to assess conformance with Treasury directives and GSA regulations and guidelines.

The bureau then prepares an Agency Procurement Request (APR) that includes estimated contract costs for the life of the contract and procurement strategy. The APR is submitted to the Department along with the required documentation. The OIRM Desk Officer coordinates the Departmental review through the Office of Procurement and any or all of the following: an Office of Security review of security provisions; an Office of Telecommunications Management review of voice and data communications requirements; an Office of Finance review of budget considerations; and an overall review by OIRM of the FIP resources requirements including a comparison with prior information systems planning documents. If a "Justification for Other than Full and Open Competition" is required, a full review of the requirement is conducted by the Departmental Advocate for Competition.

Depending on the outcome of these reviews, comments are prepared for the bureau, and follow-up working sessions are held to resolve deficiencies, errors, or omissions contained in the APR. The APR is revised and resubmitted, as necessary. Based on the total estimated contract cost and the FIRMR thresholds, it is then determined whether a Departmental DPA will be issued or a GSA DPA is needed.

In the case of a Departmental DPA, the Director, OIRM, after consultation with me, and obtaining the above-mentioned concurrences, approves the APR and delegates the procurement authority to the appropriate Bureau Contracting Officer, subject to any conditions that may be imposed on the DPA. For a GSA DPA, the APR is submitted under signature of the Director, OIRM, to the GSA Authorizations Branch for approval. Normally, GSA requires 20 working days for a reply. During this process, OIRM may have to prepare responses to GSA requests for additional information or to answer questions. Briefings for GSA may also be held.

Once GSA grants the DPA to the Director, OIRM, the Director, OIRM, redelegates the DPA to the appropriate Bureau Contracting Officer, subject to any conditions imposed by GSA or by the Department as a result of the Departmental review. Compliance with these conditions is monitored by the OIRM Desk Officer. Associated solicitation documents are subsequently reviewed to assure that they are in conformance with the issued DPA. As part of its review of solicitation documents, OIRM coordinates comments with the Office of Procurement. OIRM also coordinates GSA briefings during the acquisition cycle.

Prior to contract award, the proposed contract and the complete contract file documentation are reviewed by the Office of Procurement and OIRM to assure the procurement transaction is in full compliance with FAR, FIRMR, and Departmental requirements, including any DPA conditions established by Treasury or GSA.

BROADER OVERSIGHT

As part of Treasury's larger scale oversight responsibilities, the Department has developed an Early Warning System that is used as a tool to apprise senior management of potential financial management issues before they become problems that require substantial corrective actions. The system includes procurement criteria covering Office of Procurement reviews of bureau procurement operations through the program management evaluation visits to bureaus, and findings related to procurement planning.

Treasury constantly strives to improve its procurements to make them more responsive and to better serve the American taxpayer. In fact, Treasury has strengthened its contract administration practices by increasing the attention and resources devoted to properly administering contracts after they are awarded. Many of our bureaus now have separate, specialized, contract administration units that rigorously make sure we obtain what the contract requires. We have also implemented a program of required training for our Contracting Officer's Technical Representatives, and have issued a revised handbook to assist them in successfully discharging their duties. Contracting Officer's Technical Representatives are responsible for monitoring a contractor's performance and are often the key to the success of a contract.

In your March 13th letter of invitation to this hearing, you requested that our testimony specifically address Treasury's role in IRS procurements and the applicability of existing government-wide procurement laws and regulations to such procurements. I will now speak to specific subject matters about which the Committee has inquired.

TREASURY'S ROLE IN THE TAX SYSTEM MODERNIZATION DESIGN MASTER PLAN

The first area is Treasury's role in the creation of IRS' Design Master Plan for Tax System Modernization (TSM), and in its implementation.

I should first mention that the Administration considers TSM to be of such importance to IRS' ability to deliver service and fulfill its revenue collection responsibilities that the program has been designated as a Program for Priority Systems (formerly referred to as a "Presidential Priority System") and, thus, constitutes one of Treasury's priority Management by Objectives. The successful design, development, acquisition, and implementation of TSM is, therefore, of utmost importance to us.

The IRS Design Master Plan has evolved from a basic conceptual document to a blueprint for the actual design. Throughout the design's evolution, the Department has participated with the IRS at all levels in the phases of TSM. Treasury met with IRS executives during various phases of the initial system architecture design and the development of the Design Master Plan. During initial formulation of the Plan, key executives from both the Department and IRS went out on numerous corporate visits to see and discuss first-hand the application of proven technology.

With Treasury support and approval, the IRS sought independent, objective, and unbiased advisory services on its information systems development program. They asked the National Academy of Sciences (NAS) to assess whether the IRS' development program was structured and operating in a manner to guarantee the success of the TSM effort and whether the goals and methodologies employed were realistic and achievable. The NAS was selected because it is an unbiased and highly regarded review organization that brings a high degree of expertise and experience to this effort. An Academy-formed committee of high level executives from the business and academic communities will evaluate research done to date and suggest steps to assure that the IRS sets and meets realistic and achievable program goals. The study will provide confidence that the TSM initiatives can be carried out and will progress toward a modern tax administration system. It will also help minimize risks of disruption of the nation's tax administration system by reason of technological misjudgments or failures.

Treasury works with the IRS and all other bureaus to ensure that the plans, budgets and acquisitions are achievable, cost effective, in the best interest of the taxpayer, and compliant with all applicable standards and regulations. Each year, Treasury issues a planning call for the IRS 5-year Information System Plan (ISP). The Department reviews and analyzes the ISP for budget impact, as well as overall program effectiveness.

Through the budget review, Treasury evaluates major information technology programs of its bureaus to ensure that: 1) the approach will effectively meet user needs; 2) adequate resources are provided to achieve sound technical solutions; 3) estimates of costs and benefits are realistic; 4) schedules are realistic; and 5) the approach is consistent with strategic direction.

Throughout the budget process, Treasury represents the IRS and all bureaus in negotiations and discussions of budget issues. The Department's information systems officials articulate Treasury policy and mission needs to budget officials both within Treasury and at OMB. Bureau technology needs are interpreted for non-technical officials and the Department acts as the bureau's advocate when a bureau budget request leaves Treasury and makes its way to OMB and Congress.

During the Treasury budget review cycle, frequent Departmental hearings are held with project offices to determine the rate of progress according to the schedule outlined in the previous plans, whether project benefits are being achieved, and the adherence of the initiative to Treasury's overall strategy.

Treasury supports the IRS and other bureaus in hearings that are held to deal with issues surfaced by OMB in their analysis of the budget request. Both the Treasury Office of Finance and OIRM work on these OMB issues as they relate to the budget.

Given the multi-billion dollar nature of IRS' TSM program, many procurement initiatives have been selected by GSA for their "Comprehensive Review Program". Under this program GSA participates with the agency in the review of the various phases of the procurement and system implementation. To date, the following major IRS procurements have been selected for the GSA Comprehensive Review Program:

- o Document Processing System,
- o Service Center Support System,
- o Check Enhancement and Expert Systems,
- o Service Center Recognition/Image Processing System,
- o Department of Treasury Telecommunications System, and
- o Disabled Employee Support Acquisition Contract.

In addition, it is anticipated that other procurements exceeding $100 million will be added to GSA's list when they are submitted for delegation authority.

TREASURY OVERSIGHT OF IRS PROCUREMENTS

The second area I will discuss is the role that the Treasury Department has had or will have in managing or otherwise establishing the terms of procurements which will take place under IRS' TSM program.

As Treasury's Senior IRM Official, I advise, review, approve, and guide IRS in the acquisition of all FIP Resources to be utilized in TSM.

Treasury takes a proactive role in developing effective procurement strategies in the use of full and open competition. We establish overall goals for information systems acquisitions, while the IRS must adopt supporting goals that will enable them to fulfill their mission needs in manners that are consistent with Treasury's basic strategies and policies.

The GSA delegation of procurement authority is redelegated by the Department to the appropriate bureau contracting official. Even with such a redelegation, Treasury reviews the solicitation prior to issuance and the proposed contract document and its background file prior to award to ensure that the procurement is in keeping with the delegation granted. In addition, Treasury keeps constantly informed on the status of these procurements through meetings, reports, and day-to-day dealings with bureau staff. Also, Departmental procurement regulations require a legal review of solicitations and contracts over $100,000, to assure compliance with statutory and regulatory requirements.

As TSM is being implemented, Treasury will continually conduct reviews in accordance with its mandate to ensure that the systems are, in fact, achieving the expected results.

In 1990, the Department participated with the IRS in a review of the IRS' contracts and acquisitions function to determine if procurement services were provided in an efficient, effective, and timely manner and if the IRS procurement organization was prepared for successful processing of the various TSM projects. The study resulted in the issuance of 34 recommendations, all of which were accepted by the IRS. Significant recommendations included: 1) placement of the procurement function at the Assistant Commissioner level in the IRS organization to ensure greater independence and visibility; 2) hiring a procurement professional for the Assistant Commissioner position; 3) structuring the function to enable focusing on information systems procurement; and 4) developing a staffing model and a procurement career management program to ensure that there are sufficient numbers of procurement personnel with sufficient professional training to meet the needs of the agency.

ROLES IN TAX SYSTEM MODERNIZATION PROCUREMENTS

The third area for discussion regards the specific roles of Treasury's Assistant Secretary (Management) and Deputy Assistant Secretary for Information Systems (DAS-IS) in IRS' ADP procurements:

As the DAS-IS, I advise and guide IRS in the planning, budgeting and acquisition of FIP Resources to be utilized in Tax System Modernization.

Let me describe to you some specific functions that I perform that have significant impact on major IRS procurements.

I am a standing member of a group of Senior IRS/Departmental Offices Officials who meet once a month to discuss major procurements, critical problems, and any impending key decision points. Obviously, TSM is a significant topic of these discussions.

I have also served a key role in the selection of high level IRM officials that have recently filled positions in IRS.

Specifically:

- I participated as a voting member of the Executive Resources Board that interviewed candidates and recommended the selection of the Chief Information Officer (CIO), namely, Mr. Henry Philcox, for the IRS. This selection represents the establishment of the first CIO position in Treasury, and can serve as a model for other agencies with large procurements.

- I participated, again as a voting member, on the Executive Resources Board that interviewed candidates and recommended the selection of the IRS Assistant Commissioner for Procurement. This position will be instrumental in focusing management attention on the importance of TSM's large contracting efforts.

I also make the key recommendations on IRS's information systems budgetary matters when the Departmental budget is being developed and recommend priority ranking of major initiatives.

As far as the Assistant Secretary for Management's specific involvement in IRS's ADP procurements, the Assistant Secretary primarily interfaces with Commissioner Goldberg on budgetary and policy matters in the management and administrative areas. The Deputy Secretary, Mr. Goldberg, and the Assistant Secretary meet quarterly to evaluate IRS progress in meeting the tasks outlined for the TSM endeavor. Questions concerning procurement activity, issues related to coordination with other interested parties, and progress in meeting deadlines are surfaced by the Office of the Assistant Secretary for Management. These reviews ensure periodic oversight of the TSM program at the most senior policy level in the Department.

The Assistant Secretary receives regular briefings from me on the status of major procurements, and in particular on the status of TSM, since it is an effort of utmost interest and importance to Treasury. While participating in the meetings we have regarding TSM, the Assistant Secretary relies on me to maintain full awareness of the status of the initiative at any given time and fully supports me in the exercise of my Senior IRM Official duties.

The Assistant Secretary also served on the Executive Resources Board that interviewed candidates and recommended the official to fill IRS's first CIO position, and I mention that, Mr. Chairman, because I believe this shows Treasury's commitment to actively participate in the management and oversight of key Departmental initiatives. I should add that the final approving official for the CIO position was Deputy Treasury Secretary John Robson: a fact that is further indicative of the high level of involvement of the Department in key IRS decisions.

TREASURY DEPARTMENT PROCUREMENT POLICY ISSUES

Your letter asked if Treasury seeks to remove TSM or any other Treasury or IRS program from application of existing government-wide procurement laws and regulations, such as GSA authority under the Brooks Act, and GSBCA and GAO procurement protest resolution authority. Your final question also asked if Treasury was engaged in any meetings or discussions with OMB and/or the Office of Federal Procurement Policy (OFPP) to discuss removal of TSM or other Treasury or IRS programs from the current statutory and regulatory procurement framework.

We want to emphasize that the Department is not pursuing the elimination of, or special exemption from, GSA oversight of TSM or any other bureau initiatives. We have held discussions with various Treasury and non-Treasury officials on appropriate actions that the Department might pursue in support of the IRS Tax System Modernization program. Our position is always to look at ways to do things better to benefit the American citizen. In that regard, the Department is working with GSA to facilitate the GSA review of TSM and other initiatives in the following three ways:

- o GSA conducts periodic major IRM reviews of each agency every 3 years. The Department, including the IRS and other bureaus, is preparing for this review, and a successful review may result in GSA raising the DPA threshold for Treasury;
- o Prior to granting a DPA, GSA typically selects high dollar, visible acquisitions for case reviews. The Department is working closely with GSA on these reviews and is hopeful that GSA will soon assign a permanent desk officer or liaison for the Treasury Department;
- o The Department is supporting a FIRMR Council initiative to raise the basic DPA threshold above $2.5 million.

The Internal Revenue Service was granted, through its FY 1991 appropriations bill, a very narrow exemption from the competition requirements of the Competition in Contracting Act. The legislation permits the use of non-competitive procedures to acquire the services of experts for the examination of taxpayers' returns or litigating actions in the Tax Court only. The legislation does not apply to the acquisition of expert services generally and has no application to acquisitions of other services or goods.

Treasury and the IRS had raised with appropriate officials the feasibility of supporting regulatory changes in the Federal Acquisition Regulation and statutory changes which would have exempted small prototype system contracts from certain competition requirements. This action, however, is <u>no longer being explored</u>. In our discussions with OMB, we are instead actively pursuing the competitive process to establish an IRS-sponsored Federally Funded Research and Development Center (FFRDC) for TSM. Congressional support for this has resulted in supportive language and the designation of some funding in the FY 1991 IRS Appropriation. Procedures prescribed in FAR Part 35 and OFPP Policy Letter 84-1 are being followed in the establishment of an FFRDC including full and open competition. The proposed FFRDC will be tasked to conduct research on new and emerging technologies which will include prototypes.

Proposals regarding the General Services Board of Contract Appeals' (GSBCA) rules changes were contained in a memorandum signed by OMB officials on December 27, 1990. These proposals were developed in a joint effort involving OMB, the Internal Revenue Service and Treasury officials, with the knowledge of GSA officials. The proposed amendments are not directed toward Treasury procurements. These are changes which, if adopted by the Board, would strengthen GSBCA procedures, in general, for the federal government and the vendor community as a whole. OMB's intent in distributing these proposed rule changes was to solicit widespread federal agency comment and, thereby, develop a constructive dialogue with GSBCA to hopefully increase the efficiency of this procurement protest resolution mechanism. Out of 19 agency responses, 18 supported the proposed changes, while one recommended that no changes be made. The following statements are representative of the responses:

o "The proposed amendments would help GSBCA resolve protests faster and protect the integrity of the protest resolution process."

o "...the proposed amendments ... will reduce delays in awards of major procurements caused by the filing of unfounded protests."

Based on the overall positive and enthusiastic responses from the agencies to the proposed changes, we feel there is a definite need for a continuing dialogue on the subject. In the spirit of establishing and maintaining a constructive dialogue aimed at increasing the effectiveness of the GSBCA, we have encouraged the Board to consider these proposed changes.

Treasury officials have publicly stated numerous times that we support GSBCA in its efforts to protect the taxpayer's investment in information technology. The Department of the Treasury will be the first to agree that both bidders on Government information technology projects and the Federal Government have interests in the existence of a forum to prevent abuses of the ADP procurement process. And to this end, the GSBCA performs a laudable job. If the procurement is being conducted by the Government in a manner contrary to the interests of the American taxpayer, the aggrieved firm should then make full use of the opportunities presented by the GSBCA. It is not the intent of the proposed rule changes to diminish the opportunity to file a protest for a firm truly aggrieved by the Government, but to further improve the protest process.

Specifically answering your written question on this matter, Mr. Chairman, the scope of any Departmental recommendation for amending the rules of procedure is limited to our participation in drafting the December 27, 1990, OMB memorandum entitled "Proposed Amendments to the GSBCA Rules of Procedure". No other actions are currently underway or planned.

Treasury strongly advocates streamlining the ADP procurement process. Decreasing the length of the procurement cycle to take advantage of the rapid evolution of technology will reduce the costs of the process for both the vendors and taxpayers, while maintaining full and open competition. We earnestly believe that the efforts to refine the ADP procurement process represent the beginning of an important dialogue on improving efficiency in the acquisition of technology, with the ultimate goal to benefit the American taxpayer.

I would like to emphasize to members of the Committee that the subject of ADP procurement process modification is not an issue just of interest and concern to the Department of the Treasury; it is one of significant interest and importance throughout the Government. Calls for procedural changes in the ADP procurement process have gained significant support throughout the Executive Branch and the vendor community. In order to bring about procedural changes that will benefit the American taxpayer, it is important that staff members from your Committee, OMB, GSA, the executive branch agencies, and representatives of the private sector all work together in the development of a more efficient ADP procurement process. I encourage the members of this Committee to involve their staff in the future discussions that will take place on this important issue.

CONCLUSION

Mr. Chairman, I want to end my testimony by reaffirming Treasury's strong commitment to the Competition in Contracting

Act, and to full compliance with existing legal and regulatory measures governing the Federal procurement process. We share your desire for the efficient and economical procurement of goods and services in accordance with full and open competition.

We fully appreciate the importance, indeed the necessity, to obtain quality products at the lowest cost to the American taxpayer. It is the competitive process that results in the best product at the best price. According to agency Competition in Contracting Act reports, 95% of Treasury's procurement dollars in FY 1989 were competed, a percentage that I understand was exceeded only by the Environmental Protection Agency and the Departments of Agriculture and Labor among the larger Federal agencies. In FY 1990, we achieved a 92% competition rate. I think these figures reflect our commitment to conduct our procurement program in accordance with existing policies and regulations. To the extent that existing regulations can be improved and strengthened to the benefit of the American taxpayer, I also state Treasury's commitment to that end.

That concludes my prepared testimony Mr. Chairman. We will be pleased to address questions that you and the Committee may have.

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.

STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
JUNE 25, 1991

Introduction

Mr. Chairman and Members of the Subcommittee, I am pleased to testify today on the proposed legislation to authorize U.S. participation in the quota increase of the International Monetary Fund (IMF).

The IMF quota increase, agreed to in May of last year, would raise the basic resources of the IMF by 50 percent from $130 to $195 billion, and the U.S. quota in the Fund by some $12 billion from $26 to 38 billion.

This legislation represents a key foreign economic policy initiative of the Administration. Its passage is critical if the IMF is to help shape the world economy and respond to the challenges of the 1990s.

The IMF is the cornerstone of the world economy. Established in the wake of the Great Depression and the immediate aftermath of World War II, the Fund was charged with the critical mission of promoting the smooth functioning of the international monetary system and restoring international monetary cooperation.

Throughout its history, the IMF has promoted an open and dynamic world economy -- consistent with U.S. principles and foreign economic policy interests -- that has contributed to U.S. job expansion and economic growth. It has helped support countries of vital interest to U.S. national security. The United States has been the leading force behind the Fund over the years, reflecting a strong tradition of bipartisan support for the institution during Democratic and Republican administrations.

NB-1343

The IMF's Role in the Current Global Economic Setting

The world economy now stands at a critical juncture. Throughout the world, centrally-planned, state-run models of economic development and one-party governance are being rejected. In Eastern Europe, Latin America, Africa, and Asia, the focus of economic reforms is on developing free markets and private enterprise. These developments point to the emergence of a new international order of multilateral cooperation and have increased prospects for enhanced international economic stability and prosperity.

In pursuing their paths to political and economic freedom, these countries across-the-board are turning to the IMF for policy guidance and adjustment assistance. They recognize that Fund programs act as an international "seal of approval" and a catalyst for other sources of financing. Both Czechoslovakia and Bulgaria, for example, began their reform efforts by applying for membership in the IMF. The United States has encouraged the Fund to take a leadership role in responding to these challenges and the Fund is doing just that.

The IMF took quick and decisive action in the Gulf crisis, responding to the increased oil import bills faced by developing countries throughout the world and the severe costs of the U.N. sanctions on Iraq. Following the lead of President Bush, who addressed the World Bank and IMF at their Annual Meetings in September 1990, the IMF implemented changes in its policies to ensure it was well-positioned to help adversely-affected countries. A key measure was the introduction of compensatory financing, on a temporary basis, to assist countries in coping with higher oil import costs. The Fund has already committed over $3 billion to countries adjusting to the disruptions brought about by Iraq's invasion of Kuwait. The IMF also provided crucial analytical support to U.S.-led efforts by the Gulf Crisis Financial Coordination Group (GCFCG) to help the front line states (Turkey, Egypt, and Jordan) during the crisis.

In Eastern Europe, the Fund is at the forefront of international efforts to assist countries in restructuring their economies away from central planning and making the transition to free markets and private enterprise. The Fund led the way in Poland and Hungary and is building a strong framework elsewhere for market-oriented adjustment. This year alone, the Fund has already committed $8 billion to the region. These monies are supporting three-year financing arrangements in Poland and Hungary and stand-by arrangements in Czechoslovakia, Bulgaria, and Romania. In addition to program financing, the Fund has disbursed substantial compensatory financing to all five countries to help address increased oil import costs arising from the Gulf crisis and the switch to hard currency trade relations with the Soviet Union.

The Fund's support has unlocked substantial additional financing for Eastern Europe. In Poland, the Fund's program has formed the basis for the recent agreement by official creditors to reduce the country's debt and debt service obligations by 50 percent. Throughout the region, Fund arrangements are a critical element in catalyzing new resources from donor governments through the G-24 process, from private capital markets and through the Paris Club.

The Fund is also continuing to play a pivotal role in the U.S.-led international debt strategy, the "Brady Plan." Eight countries -- Chile, Mexico, the Philippines, Costa Rica, Morocco, Venezuela, Uruguay, and Nigeria -- have reached agreements with commercial banks on packages including debt and debt service reduction. These countries account for nearly half of the total commercial debt held by the major debtors.

Fund adjustment assistance and support for debt and debt service reduction agreements have been particularly important in Latin America, one of the largest export markets of the United States. Sound, free-market policies and the reduction in debt and debt service obligations have dramatically improved growth prospects in many of these countries. In Mexico, for example, inflation and interest rates have dropped sharply, growth rates are up, substantial new foreign investment has flowed into the country, and flight capital is returning. A similar turn-around in economic conditions is occurring in Venezuela. Chile's economic success is confirmed by its return to private credit markets. With Fund support, Costa Rica in 1989 reduced its commercial bank debt by 62 percent. Elsewhere in Central America, Fund programs are supporting adjustment in Honduras and El Salvador.

The Fund is an integral part of international efforts to encourage comprehensive economic reforms and to provide concessional financing to the poorest countries of the world, particularly those of Sub-Saharan Africa. Over 20 African countries currently have Fund programs. Most of the Fund programs are three-year arrangements under IMF concessional facilities and involve extensive collaboration between the Fund, World Bank, and the borrowing country. These programs are addressing the widespread need in Africa for structural reforms that are essential for achieving sustained growth and alleviating poverty.

On the strength of these programs, two countries, Nigeria and Niger, have recently reached debt and debt service reduction agreements with commercial banks. Niger is the first to benefit from International Development Association (IDA) support for such agreements.

Pressures on IMF Liquidity: The Case for a Quota Increase

If the Fund is to meet the challenges of the world economy, it must have adequate resources to fulfill its systemic responsibilities. For this purpose, the IMF regularly reviews the adequacy of its quotas. The current quota review was to be completed in 1988. However, the conclusion of these negotiations was delayed by two years as the United States insisted that there be a strong case for additional resources on the basis of a careful analysis of prospective demands, available resources, and agreement on the future role of the IMF as a monetary institution. Thus, this is the first quota increase in eight years.

The Fund's role in responding to the challenges of the Gulf war and reform efforts in Latin America and Eastern Europe is resulting in substantial current and projected demands on Fund resources. Although aggregate Fund quotas presently total around $130 billion, only about one-half of these quota resources are considered usable (i.e., resources from countries which are not borrowing from the Fund and which have strong financial positions). From this pool, substantial amounts have already been lent. Thus, the Fund currently estimates that it has about $30-35 billion remaining for lending over the five-year period normally covered by the quota review.

Fund resources will be significantly depleted in the period ahead. The Fund currently estimates that disbursements this year will total $16 billion -- more than double last year's lending. Disbursements are expected to remain high in follow-on years. As a result of heavy financing demands and loans, measures of Fund liquidity are expected to drop by almost 40 percent this year and decline further next year. Furthermore, a substantial portion of the loanable resource base could be removed if a major creditor's balance of payments position were to weaken.

For these reasons, the proposed quota increase is timely. The Fund's resource base is being depleted. The quota increase is forward-looking. These resources must serve the Fund over the medium term.

Effectiveness of U.S. Support for the IMF

Support for the IMF is an extremely effective means for advancing U.S. interests.

Use of the U.S. quota by the IMF involves no net budgetary outlays. This is because any transfer of dollars to the Fund is immediately offset by the receipt of an equivalent, interest-bearing and liquid monetary reserve asset. This accounting treatment is used internationally. Over the years, the United States has drawn 24 times on its reserve position for a total amount of $6.5 billion. It last drew on its reserve position in 1978 for some $3 billion.

Indeed, during the 1980s, U.S. participation in the IMF has resulted in a net financial gain of $628 million annually. This gain reflects interest earnings and valuation gains on our reserve position in the IMF, which sharply exceeded the borrowing costs to the Treasury associated with financing transactions with the Fund.

The budget agreement makes specific provision for the unique budgetary treatment of the IMF quota increase. The approximately $12 billion increase in the U.S. quota will not result in any net budgetary outlays. Also, this appropriation is only available for the quota increase; it could not be applied, for example, to other discretionary spending programs.

IMF financing also leverages our scarce resources, which is critical at this time of budget constraint. For every dollar the United States contributes to the Fund, other countries contribute four.

The United States is also well positioned to influence IMF policies. Our voting share in the IMF of some 19 percent gives us veto power over key IMF decisions, such as quota increases and amendments to the Fund's charter, which require an 85 percent special majority vote. In addition, our voting share positions us to build majorities on other major issues, requiring super-majorities of 70 percent for approval. This veto power has often proven essential to ensure that the Fund operated in a manner consistent with overall U.S. interests.

<u>The Strengthened Arrears Strategy</u>

During the quota negotiations, a number of steps were taken to ensure that IMF resources, including U.S. contributions to the quota increase, would be used more effectively.

During the 1980s, arrears to the Fund grew sharply, reaching their current level of $4.5 billion from nine countries, an amount twice the level of the Fund's reserves. Arrears undermine the financial integrity of the IMF and its ability to fulfill its systemic responsibilities. Over time, Fund efforts to address the growth in arrears bolstered Fund reserves but failed to reverse the problem and promote a normalization of relations between the Fund and arrears countries.

Thus, in order to ensure that any increased U.S. quota contributions were wisely and productively spent, a major U.S. priority in the quota negotiations was the adoption of a strengthened arrears strategy. Our basic approach emphasized the need for a comprehensive set of incentives and disincentives designed to reward sound performance and to discourage new arrears.

The plan eventually adopted by the Fund closely mirrors the U.S. approach and includes two main elements.

- First, the key to addressing current arrears cases is sound economic performance to restore creditworthiness. Thus, to create an incentive for sound performance, countries which cooperate with the Fund and demonstrate sustained performance under a 2-3 year Fund-monitored arrangement can now earn "rights" to special financing to clear their arrears.

- Second, countries that over time do not fulfill their responsibilities cannot be expected to enjoy the benefits of membership. Thus, if any country does not cooperate in clearing its arrears and continues to fail to fulfill its obligations, the strengthened arrears strategy provides for an amendment to the IMF Articles that would permit the Fund to suspend that country's voting rights and representation privileges.

The rights approach is only available for the 9 remaining arrears cases that were in arrears at the time of the quota agreement. At the successful conclusion of the program, a country would gain access to special financing to help clear its arrears. To receive the financing, however, a country must establish a follow-on program so as to ensure that sound policies continue to be pursued.

Financing for the rights program will come from two main sources:

- For lower-income arrears countries, the Enhanced Structural Adjustment Facility (ESAF) will be used primarily to finance the "rights" programs.

- The two middle-income arrears cases, Peru and Panama, will be eligible for financing from a special account financed from increased charges on IMF loans and reduced remuneration.

In both cases, "rights" financing is to come from special Fund monies separate from the Fund's regular resources. In this way, the Fund will avoid establishing undesirable precedents which could undermine its monetary character.

In this context, since financing for the "rights" program for lower income countries through use of the ESAF increases the potential risk to ESAF creditors, it was agreed that the IMF would sell, if needed, up to 3 million ounces of IMF gold to back up the ESAF's already substantial reserves. This limited amount of gold reflects the gold subscriptions of the countries with arrears.

Progress is being made under the strengthened arrears strategy. The IMF recently approved a three-year "rights" program for Zambia and is working with official creditors and donors to establish a rights program for Peru. These two countries alone account for nearly half of the total arrears owed the IMF. Also, Honduras and Guyana have eliminated their arrears, while Peru, Panama, and Zambia are meeting maturing obligations to the Fund.

Under U.S. law, U.S. consent to any sale of IMF gold for the special benefit of a single member or of a particular segment of the membership must be approved by Congress. Thus, the quota legislation also seeks Congressional approval to allow the Secretary of the Treasury to instruct the U.S. Executive Director of the IMF to vote to approve the IMF's pledge to sell this limited amount of gold.

Also under U.S. law, U.S. agreement to an amendment to the IMF Articles of Agreement requires Congressional approval. Thus, we are seeking legislation that would authorize the U.S. Governor to the Fund to accept the proposed suspension amendment to the IMF Articles. This is a tough remedial measure which encountered resistance from developing countries and was adopted only at U.S. insistence and as a precondition of the suspension amendment, the quota increase cannot go into effect. The goal of the suspension amendment is positive, however: normalization of relations and the deterrence of future arrears.

<u>Impact of IMF Activities on Poverty and the Environment</u>

During the past year, concerns have been raised regarding the IMF's role in environmental protection and alleviating poverty.

The Administration is committed to environmental protection. Towards that end, it has given high priority to promoting Fund actions aimed at protecting the environment, consistent with Fund's basic mandate. We have achieved some important successes:

- At U.S. initiative, the Fund is establishing a group of economists that will serve as liaison with other organizations on environmental research and advise the Fund on addressing environmental concerns. The Fund is currently seeking environmental economists from outside the Fund to work, for a transitional period, with Fund economists.

- With World Bank assistance, the Fund is incorporating measures consistent with environmental protection into Policy Framework Papers (used for concessional programs) and some stand-by and extended arrangements. These can include measures to remove government subsidies on fertilizer, energy, and pesticides.

- IMF Article IV consultations include discussion of environmental concerns.

- The IMF is working with the U.N. to develop national income accounting statistics to reflect use of natural resources.

These achievements have required much hard work on the part of the U.S. Executive Director to the IMF and senior Treasury officials. We faced considerable opposition from developing and developed countries alike in securing these gains. Many countries argue that the impact of Fund macroeconomic policies on the environment is indirect and ambiguous. They are also concerned about overburdening the Fund and detracting from its primary responsibilities as a monetary institution in promoting sustained growth. Developing countries in particular are sensitive to the appearance of the Fund intruding on national sovereignty. Moreover, there is broad recognition that the World Bank is better-suited to addressing environmental concerns in an effective and lasting manner.

The U.S. is the primary force behind increased Fund attention to environmental concerns. By virtue of our leadership position in the institution, we have been able to overcome some of the reservations of others, and we plan to build on the progress that has been made. We look forward to continuing our work with Congress and the environmental community in this important area.

Turning to poverty issues, IMF conditionality is sometimes criticized as imposing austerity on countries and hurting the poorest segments of the population. This view, however, represents a misconception of the IMF's role in the adjustment process.

Countries generally come to the Fund facing severe economic imbalances. Usually, they have lived beyond their means, consuming more than they produce, and are facing a curtailment in foreign financing flows. In these circumstances, they face the prospect of "forced" adjustment -- deep and inefficient cuts in investment, imports, and growth.

In contrast, IMF policy advice and financial support offer countries "breathing room" and the prospect for a more orderly adjustment path. Experience shows that the sound market-oriented reforms the IMF supports are essential to achieve sustained growth, reduce poverty and catalyze additional external resource flows.

There are, to be sure, inevitable costs associated with the adjustment process. The Fund is sensitive, however, to these costs.

Virtually every Fund program includes support for social safety nets, such as the maintenance of expenditures for such basic human needs as health, education, and nutrition. Fund programs also allow for targeted assistance to protect the most vulnerable groups from the effects of such necessary reforms as the removal of subsidies for basic consumer items. Costa Rica, Ghana, Venezuela, Niger, Bangladesh, and Egypt all have Fund programs which incorporate targeted government assistance for the poor.

Furthermore, in recent years, under the debt strategy, the Fund has given increased attention to growth-oriented structural reforms. This has acted in many cases to help the poor. Fund programs increasingly emphasize comprehensive structural reforms in order to free up workers, producers, and farmers to respond to market forces -- not government regulations and bureaucrats. These measures are intended to stimulate supply responses and reduce adjustment programs' reliance on fiscal belt-tightening and monetary restraint.

Also, as noted previously, in the poorest countries of the world, substantial concessional financing is being provided. As part of ESAF programs, the Fund is devoting extensive attention to cushioning the poor from the side-effects of adjustment.

These measures have been adopted with strong U.S. support and encouragement. Moreover, countries undertaking Fund-supported adjustment reforms have themselves recognized that the incorporation of social safety nets substantially enhances popular support for the program. The United States will continue to encourage the IMF to show increased sensitivity to the effects of adjustment on poverty.

<u>Conclusion on IMF Quota Increase</u>

Since its establishment some 45 years ago, the IMF has played a central role in strengthening growth at home and in promoting a sound market-oriented world economy consistent with basic U.S. foreign economic policy interests.

IMF support for a sound and stable world economy is crucial to maintaining conditions in which U.S. jobs and exports can thrive. U.S. economic interests are increasingly tied to international economic developments. In 1990, virtually all of U.S. economic growth was accounted for by the increase in exports. Estimates suggest that roughly one out of every four new jobs in the United States is related to merchandise exports. The fastest growing U.S. export markets are in the developing world. Many of our developing country trading partners have received IMF assistance in support of market-opening measures and increased growth. Moreover, IMF support for an open and smoothly functioning international system of payments is essential to fostering growth in trade.

The foreign policy interests of the United States have been well-served by the Fund. The quick and effective Fund response to the Gulf crisis sent a strong message of continued international support for efforts to gain Iraq's withdrawal from Kuwait. In Eastern Europe and elsewhere, economic reforms are inextricably linked to the movement toward democracy. In Latin America especially, the Fund is supporting sound economic policies and debt and debt service reduction under the Brady Plan. IMF support is essential if countries throughout the world are to achieve peace and prosperity on the basis of democratic and market principles.

The IMF also serves our interests in an extremely effective manner. Use of the U.S. quota in the Fund involves no budgetary outlays and leverages our scare resources. We are the largest member and most influential voice in the Fund, and our large voting power gives us veto power over certain key decisions and positions us to build majorities on other major issues. The strengthened arrears strategy will ensure that increased U.S. resources are used wisely.

The world economy stands at a historic juncture in which U.S. interests will be deeply affected. It is critical that we support the IMF now if we are to continue our strong leadership in this central global institution as it helps shape the world economy of the 1990s. Thus, on behalf of the Administration, I strongly urge you to support passage of the IMF quota legislation.

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 25, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 2-YEAR NOTES

Tenders for $12,529 million of 2-year notes, Series AC-1993, to be issued July 1, 1991 and to mature June 30, 1993 were accepted today (CUSIP: 912827B35).

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

	Yield	Price
Low	7.03%	99.945
High	7.06%	99.890
Average	7.06%	99.890

$50,000 was accepted at lower yields.
Tenders at the high yield were allotted 64%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	56,270	55,270
New York	34,298,110	11,444,710
Philadelphia	30,480	30,480
Cleveland	54,540	54,540
Richmond	92,925	67,925
Atlanta	53,530	51,730
Chicago	1,642,020	325,370
St. Louis	78,970	67,250
Minneapolis	25,845	25,845
Kansas City	79,770	79,770
Dallas	21,605	21,605
San Francisco	524,615	64,615
Treasury	239,835	239,835
TOTALS	$37,198,515	$12,528,945

The $12,529 million of accepted tenders includes $1,080 million of noncompetitive tenders and $11,449 million of competitive tenders from the public.

In addition, $1,228 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,514 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1344

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
June 25, 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 $20,800 million, to be issued July 5, 1991. This offering will provide about $ 2,900 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $17,903 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, July 1, 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:

90-day bills (to maturity date) for approximately $ 10,400 million, representing an additional amount of bills dated April 4, 1991 and to mature October 3, 1991 (CUSIP No. 912794 XH 2), currently outstanding in the amount of $7,820 million, the additional and original bills to be freely interchangeable.

181-day bills for approximately $ 10,400 million, to be dated July 5, 1991 and to mature January 2, 1992 (CUSIP No. 912794 XT 6).

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 July 5, 1991. In addition to the maturing 13-week and 26-week bills, there are $ 10,553 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 $ 950 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $ 1,215 million as agents for foreign and international monetary authorities, and $ 7,425 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

EMBARGOED UNTIL GIVEN
EXPECTED AT 10:00 A.M.
JUNE 26, 1991

STATEMENT OF HONORABLE NICHOLAS F. BRADY
Chairman, Oversight Board of the
Resolution Trust Corporation
before the
Senate Committee on Banking, Housing and Urban Affairs
June 26, 1991, 10:00 a.m.
538 Dirksen Senate Office Building
Washington, D.C.

Mr. Chairman, members of the Committee, we are pleased to be making our semiannual appearance before your Committee today. We look forward to bringing you up to date on activities of the Resolution Trust Corporation (RTC) and the Oversight Board as required by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

I appear as Chairman of the Oversight Board of the RTC. Accompanying me are the four other members of the Board: Alan Greenspan, Chairman of the Federal Reserve Board; Philip Jackson, Jr., former member of the Federal Reserve Board and currently adjunct professor at Birmingham Southern College; Jack Kemp, Secretary of the Department of Housing and Urban Development; and Robert Larson, Vice Chairman of the Taubman Company and Chairman of the Taubman Realty Group. Also accompanying us is Peter Monroe, who is President of the Oversight Board.

We are here to discuss progress under provisions of the 1991 Funding Act, RTC asset disposition program, RTC funding needs to complete this unprecedented task, Oversight Board activities since our appearance before your Committee in January, and other matters required by FIRREA.

FUNDING NEEDS

Mr. Chairman, your Committee and the Oversight Board share the objective of getting the savings and loan problem behind us as quickly as possible within the terms of FIRREA and at the least possible cost. Our common goal is to protect the depositors of the nation's failed thrifts: to date some 14 million depositors with

NB-1346

accounts averaging $10,000. In doing so we honor our deposit insurance commitments and keep faith with our citizens.

Let me review what has been done and how far we have to go.

Size of the Task

As we have said before, the ultimate cost of the cleanup is driven by real estate markets, interest rates, and the state of the economy. The number of thrifts that must be closed and the value of the assets seized, and thus the total amount of the loss depends on these larger economic forces. The cost will also reflect our effort to save taxpayer dollars wherever possible.

As Chairman Seidman told the Committee last week, the RTC estimates that it will complete the resolution of 557 thrifts by the end of the fiscal year, and at that time also will have about 185 thrifts in conservatorship or in the Accelerated Resolution Program (ARP). When these 742 institutions are resolved, all those now in Group IV will have been closed, and the lion's share of the job of closing insolvent thrifts will be finished.

What remains to be done?

On June 12 the Office of Thrift Supervision (OTS) announced that Group III, defined as thrifts that are troubled but that are unlikely to require government assistance and that have reasonable prospects of meeting capital requirements, consists of 378 institutions.

It is likely that some of the thrifts in Group III will fail and that the RTC caseload will grow beyond the 742 institutions. We do not believe, however, that sufficient Group III thrifts will be transferred to RTC so as to exceed the upper end of our previously estimated loss range.

Though the exact number of thrifts still to be resolved with Federal assistance cannot be known, we can estimate that virtually all nonviable thrifts will be transferred to the RTC for resolution during the next two years. If this estimate is correct, the orderly downsizing of the industry will then have been completed.

Current law provides that OTS may transfer thrifts to RTC for closing until August 9, 1992, when they would be transferred to the Savings Association Insurance Fund (SAIF). Therefore, as proposed in the President's budget, we request legislation to extend the period in which OTS may transfer thrifts to RTC from August 9, 1992, to September 30, 1993.

This extension should permit the OTS to transfer insolvent thrifts to the RTC in an orderly way to avoid extended waiting periods in conservatorship. Were OTS to transfer nonviable thrifts to RTC in such quantity that they must remain in conservatorship for long periods, the taxpayers' cost would rise because the thrifts would lose franchise value.

The extension should ensure that the cleanup of the backlog of failed savings and loans is completed by September 30, 1993. FIRREA sets up a schedule for contributions to the SAIF, beginning in fiscal year 1992 if Congress and the Administration take further appropriations action. However, if Congress acts on our request, SAIF will not take insolvent institutions until October 1, 1993. The President's budget estimates that at that date, SAIF should have about $1.6 billion in its reserves from premium income. At this time, it is too soon to tell whether and how much of a contribution Treasury will need to make to SAIF.

Loss Funds Needed

Earlier this year, in our January 1991 semiannual appearance, we estimated that the cost of the savings and loan cleanup would be in the range of $90 to $130 billion measured in 1989 present value dollars. We stated that, because of general economic conditions, deterioration in real estate markets and real estate related assets, the most likely cost scenario had probably moved to the higher end of our original range, but that it nevertheless remained within that range.

We still believe this to be true. In other words, we still believe that the higher end of the range estimate of $130 billion in 1989 dollars remains valid. Presenting estimates in constant dollars allows us to compare the estimates better. It is the conventional way for the private sector and the CBO to state the cost of major programs that last for more than one or two years, but it is different from the same amount expressed in current year budget dollars.

Our estimate of $90 to $130 billion in 1989 dollars converts to a range of about $100 to $160 billion in budget dollars. Chairman Seidman gave the same estimate in his testimony last week.

The Oversight Board and the RTC estimate that the additional amount of loss funds necessary to complete the task of closing defunct savings and loans and protecting depositors could be as high as $50 billion in 1989 dollars, or $80 billion in budget dollars. To date, $80 billion has been provided: $50 billion by FIRREA and $30 billion by the RTC Funding Act of 1991. With the additional amount, the total would be brought to $130 billion in 1989 dollars, or $160 billion in budget dollars.

It is our recommendation that Congress provide sufficient funding to complete the job, which we estimate to be $80 billion. This would permit the RTC to complete its work as quickly as possible without costly delay. Funding delays simply add to taxpayer costs because they slow the RTC's resolution activity. Just as we are trying to save taxpayer dollars by improving the cleanup, so we should avoid costly stop and start funding. Chairman Seidman estimated that the amount necessary for RTC to carry out its work in fiscal year 1992 will be $50 to $55 billion.

We know that these decisions are difficult because the public in general does not understand the need for these funds. I'd like to give you some examples of resolutions that have resulted in prompt payments to depositors. Southmost Savings and Loan Association in Brownsville, Texas was closed in October, 1990 and its 9,800 deposit accounts, averaging $9,000, paid off. Alpine Savings in Steamboat Springs, Colorado was closed in June, 1990 and its 5,300 deposit accounts, averaging $6,400, paid. North American Federal Savings and Loan in San Antonio, Texas was closed in May, 1990 and its 11,500 deposit accounts were paid an average of $6,000 each.

I hope these examples underscore the point that the money is going to people - 14 million accounts to date - and that we have no choice but to provide it. We all want to fulfill our Government's commitment to depositors. We do not want the system to be destabilized by TV coverage of lines in front of thrifts, just as we should not permit households and businesses to be impoverished by frozen accounts.

The U.S. Government must provide the money, and we should remind people that it isn't going to crooked or incompetent executives, or to keep bad institutions afloat. The money is used to protect individual Americans who deposited their savings in S&Ls because they believed our government's promise that it would be safe there.

Working Capital Needs

Loss funds, which we have just discussed, are the monies that are needed to fill the "hole" between an institution's deposits and the value of its assets. They will never be recovered.

Working capital, on the other hand, is used to finance the acquisition of the assets of failed thrifts by RTC until they are sold. It is borrowed by the RTC from the Federal Financing Bank (FFB). Working capital borrowings are backed by seized assets. RTC expects to repay its working capital borrowings from the proceeds of the sales of these assets.

By the end of this fiscal year, RTC expects to have $70 billion in working capital borrowings outstanding, an amount well within the "note cap" limitations set by FIRREA. However, during fiscal year 1992, RTC could exceed the $125 billion permitted by the note cap.

Therefore we are approaching the time when additional borrowing authority will be needed. We estimate that working capital needs could peak at $160 billion by mid-1993. At that time the RTC will start the process of repaying working capital borrowings from the FFB. We estimate that outstanding borrowings will decline rapidly to $65 billion in 1995 and will be virtually retired by 1996 when the RTC goes out of business.

Because both loss funds and working capital are needed to fund resolutions, it is imperative that loss fund authorizations be matched with adequate working capital borrowings. Therefore, we request that Congress raise the RTC's borrowing limit to $160 billion. Not to do so might create a situation in which RTC is pressured to dump assets at fire-sale prices simply to stay under the limit. Failure to raise the borrowing limit could just as surely prevent the RTC from resolving thrifts and protecting depositors as delays in funding do.

The working capital concept has caused confusion. For example, some have suggested that asset sales should be used to fund losses. But to do so would violate the principle that asset sales must be used to repay working capital borrowings. Others have suggested that working capital borrowings be used to fund losses directly - but this sort of "backdoor" spending would violate the principle that the RTC should have sufficient assets to repay its FFB borrowings.

The Comptroller General has indicated his concern that RTC may not be able to repay some of its borrowings from asset sales. The RTC has recently completed a review of its assets to determine whether there is sufficient value to pay back borrowings. The GAO and the RTC's Inspector General (IG), at the Oversight Board's request, are both auditing the methodology to verify its accuracy.

In past appearances we have stressed that we cannot predict ultimate costs and borrowing needs with certainty, and we must do so again. As the General Accounting Office (GAO) noted in its 1989 Financial Audit of the RTC, "the actual cost...will depend on the outcome of various uncertainties," including the number of institutions transferred to the RTC, the extent of their operating losses, the quality and salability of their assets, and the conditions of the economy, especially in certain geographic areas.

In January, I told this Committee that the economic downturn, and the Middle East crisis, had worsened the already weak market for real estate assets and made already cautious investors more reluctant to make investment decisions. The climate is still uncertain, and in an uncertain climate, estimates are always subject to change. But we have in the past and have today given you our best estimates of projected loss and working capital needs, and we will continue to do so.

GETTING THE JOB DONE

When President Bush announced his proposed solution to the savings and loan crisis soon after taking office, he established four objectives against which we measure our progress.

First, protect insured depositors: the millions of Americans who acted in trust when they deposited their savings in federally insured accounts. I said earlier that nearly 14 million depositors with accounts averaging $10,000 have been protected; they have had access to their insured funds almost immediately.

Second, restore the safety and soundness of the industry so that another crisis will not occur. In compliance with FIRREA, new capital standards are being phased in. Even with these higher standards, three-quarters of the savings institutions, with more than $600 billion in assets, today meet or exceed current capital requirements.

Third, clean up the S&L overhang so we can get the problem behind us, and do it at the least cost to the taxpayer. When FIRREA created the RTC on August 9, 1989, RTC immediately became responsible for closing 262 insolvent thrifts. By October 1, 1991 it will have closed 557 insolvent thrifts, one about every 33 hours.

Fourth, aggressively pursue and prosecute the crooks and fraudulent operators who helped create the problem. There have been 550 convictions for thrift crimes. About 80 percent of those sentenced have received prison terms.

RTC Funding Act of 1991

The RTC Funding Act that became law on March 23 provided necessary loss funds for this fiscal year and helped advance the objectives of the cleanup.

We are grateful for this Committee's work on this measure. You acted quickly to report the bill and obtain Senate consideration.

The Act also addressed other concerns: RTC management reforms, affordable housing, and minority and women owned business (MWOB) contracting. It included valuable new financial reporting requirements. And it established that RTC personnel would not be personally liable for certain securities transactions undertaken in RTC asset dispositions.

Affordable Housing

The Oversight Board is strongly committed to affordable housing and has made the following improvements in the program.

- o At Oversight Board insistence, $250 million of the RTC's $7 billion seller-financing ceiling has been set aside exclusively for single family affordable housing.

- o $190 million of mortgage revenue bonds has been set aside by state housing finance agencies to be used to assist low- and moderate-income first-time homebuyers to purchase RTC single family homes.

- o SAMDA contractors are offered a special bonus fee to sell affordable single family properties to eligible low- and moderate-income households.

- o The Oversight Board approved a policy allowing the RTC to sell affordable single family properties to eligible low- and moderate-income households at 80 percent of market value. This policy was further expanded in the Funding Act to a "no minimum reserve price" policy. To date, the RTC has scheduled 99 sales events to offer 9,000 properties at no minimum reserve price.

o Recently, the Oversight Board allotted up to $150 million of seller-financing for low downpayment sales of multifamily properties to nonprofit organizations.

The Funding Act provided that, through September 30, single family properties in conservatorship are eligible for the affordable housing program. On April 30, 18,249 properties were eligible for the affordable housing program: 6,429 in conservatorship and 11,820 in receivership. Of these, 12,203 have been listed with clearinghouses. Offers have been accepted on 5,718 properties - 173 in conservatorship and 5,545 in receivership. About 2500 have closed.

Single family homes represent the majority of the sales in terms of the numbers of properties. As of April 30, 5,679 single family properties had been sold.

Multifamily properties are also being sold through the affordable housing program. The availability of seller-financing on these properties is expected to accelerate sales significantly. By the end of May, 471 multifamily properties, representing about 50,000 units, had been listed with clearinghouses. Negotiations on 28 of these properties - with a total of 4500 units - are under way. RTC has accepted offers on 77 properties which have not closed. In addition, 13 properties have closed.

The average sales price for single-family properties sold through the affordable housing program through the end of April is $30,215. The average income of purchasers is $22,718, which is 60 percent of median household income.

Minority Outreach

Participation through outreach by minorities and women in the business generated by the RTC is a goal of FIRREA. Sustained Congressional interest was reflected in the Funding Act's requirement that the Oversight Board and RTC report on actions taken by the RTC to engage additional MWOB contractors in its work. This report was filed on April 30 as part of the Board's Semiannual Report.

Some background may be useful. FIRREA requires that the RTC prescribe regulations for a vigorous outreach program to see that minorities and women are given the opportunity to participate in all aspects of RTC contracting activities. FIRREA also requires that the RTC Strategic Plan provide procedures for the active solicitation of offers from minorities and women, and that it ensure that discrimination on the basis of race, sex, or ethnic group is prohibited in RTC's solicitation and consideration of offers.

RTC has conducted outreach efforts. Its staff has appeared at more than 100 professional and trade conferences to discuss contracting opportunities. In addition, it has held two conferences to explain its programs to minorities and has scheduled several more. But more can be done.

According to the RTC, MWOB's by June 11 had won 4,690 - or 22 percent - of RTC prime contracts, worth $203 million - or 23 percent of the value of all such contracts. Minority and minority-women owned contractors were 6 percent of the total awarded, and non-minority women contractors were 15 percent of the total awarded.

The FDIC/RTC employs 1143 attorneys, of whom 136 or 12 percent, are minority and 459 or 40 percent are non-minority women. The RTC employs 496 attorneys, of whom 68 - or 14 percent - are minority and 156 - or 31 percent - are non-minority women. With respect to the utilization of outside counsel in legal work for receiverships, the RTC awarded $586,547 - or 1.3 percent - to all MWOB law firms in 1990 and $1,364,764 - or 1.9 percent - as of May 1991.

The Oversight Board firmly believes that the outreach requirement of FIRREA must be implemented vigorously and recently has taken steps to enhance RTC's MWOB outreach program on two fronts.

First, the Oversight Board urged the RTC to expand its outreach efforts and to formalize its outreach commitment by adopting comprehensive outreach regulations. The Board emphasized that the RTC have a well-staffed, well-administered, and vigorous outreach program embodied in regulations. RTC is preparing these regulations for public comment.

Second, the Oversight Board urged RTC to make aggressive use of agreements with the Small Business Administration so as to channel RTC business to small and disadvantaged firms. The Board approved a pilot program in April, and in a letter to RTC on June 3 urged RTC to expand the pilot program to include all appropriate areas of RTC contracting.

At the same time the Oversight Board returned to the RTC for further consideration a draft policy proposed to it by the RTC staff. Under this policy additional preferences would be given to minorities and women by according them price and technical competence adjustments. The Oversight Board has asked the RTC for clarification of its proposal.

The Oversight Board President and staff have met with Reverend Jesse Jackson and representatives of the minority business community at the request of Chairman Riegle. One result of those meetings is that the Oversight Board President wrote to the RTC suggesting that RTC should strengthen its administration of the outreach program by hiring a high-level manager with authority to ensure vigorous implementation of the program throughout RTC's operations. He also asked the RTC to build opportunities for small and MWOB firms into all the RTC's programs.

This is an important and little-appreciated concept about which the Oversight Board feels strongly. It means that RTC contracts must be made accessible to a much broader range of bidders by segmenting them by geographic region, by making them smaller, and by breaking them down by type of service. The RTC has begun to implement this approach.

A problem deserving attention is that RTC data show that while there are many MWOB firms on RTC's rolls as qualified contractors, and though all of them receive the RTC's solicitations, a relatively small number respond. When they do respond, they tend to do well in obtaining contracts. This underscores the need for RTC to design its contract solicitations so as to be more accessible to these businesses.

The Oversight Board's goal is to achieve a far more extensive participation of minorities and women in the business generated by the RTC.

Significant Properties

FIRREA contains language authored by Senator Wirth which requires RTC to identify properties with natural, cultural, recreational or scientific significance. In addition, the Coastal Barrier Improvement Act of 1990 imposed waiting periods of up to six months on RTC sales of environmentally sensitive property in coastal areas.

On January 17 of this year, the Oversight Board directed the RTC to expand its program to identify significant properties by taking the following steps:

- o strengthening its internal capacity to identify such properties;

- o procuring the best available expertise from both public and private sectors to assist in identification; and

- o publicizing the availability of significant properties to the widest possible audience of interested persons and agencies.

The Oversight Board further directed the RTC to immediately design a plan to implement these three initiatives; the RTC responded with its plan on February 15.

The Oversight Board has monitored the implementation of the RTC's efforts and their status is described in letters from the RTC's Executive Director on June 10 and 20. I ask that copies of this correspondence be included in the hearing record.

ASSET DISPOSITION

Just as the need to resolve hundreds of insolvent thrifts quickly was the most critical task of the RTC when it was created almost two years ago, asset disposition is its most important job today. I said earlier that because of the pace at which thrifts are being closed we now can estimate that virtually all insolvent thrifts will be closed by September, 1993. But the corollary is that RTC is rapidly accumulating very large amounts of assets.

On April 30, 1991, the RTC held $164 billion in assets. This compares to the year-end assets of the two largest commercial banks, Citicorp and BankAmerica, at $217 billion and $111 billion, respectively.

RTC had passed to acquirers or sold $154.3 billion or 49 percent of its assets by April 30, leaving it with $164 billion at that date.

In its nine-month financial operating plan filed in January, RTC projected book value reductions of $75 billion through the end of the fiscal year - $65 billion after putbacks of assets previously sold to acquirers of closed thrifts. During the

January-April period, book value asset reductions totalled $35 billion. Actual receipts from sales are $33 billion.

The Oversight Board believes there is no more important task before the RTC than organizing the programs necessary to dispose of RTC assets quickly and at best possible prices. I emphasize this because it is our goal to save taxpayer dollars. This is a complex and difficult task, as Senator Dixon's hearings in the Subcommittee on Consumer and Regulatory Affairs last week demonstrated.

The Oversight Board has helped provide the policies to expedite and increase the return from asset sales. It directed the RTC to use securitization to the widest extent possible, and it authorized the use of seller financing. The Oversight Board acted in both cases in order to maximize the taxpayers' recovery against book value.

RTC's asset disposition efforts fall into two broad categories: readily marketable, and hard-to-sell.

Readily Marketable Assets

As of April 30, 1991, the book value of RTC's inventory of readily marketable financial assets totalled $61 billion, consisting of $25 billion in investment grade securities, and $36 billion in performing one- to four- family mortgages. 19

Securities

With regard to securities, the primary disposition strategies are to centralize sales in the Washington, DC headquarters and execute sales in a manner that gets the best possible returns and does not disrupt financial markets. Results to date have been relatively successful as 75 percent of securities held more than 90 days have been sold or collected. With the introduction of RTC's portfolio securities management system, RTC will be better able to pool like securities to achieve price advantages resulting from larger offerings.

One- to Four-Family Mortgages

Numerous initiatives have been implemented to increase the pace of and returns from the disposition of performing one- to four-family mortgages. To date, about 56 percent of these assets held more than 90 days have been sold or collected. Among the most important initiatives was RTC's adoption in April of standardized due diligence procedures, permitting the RTC to stratify its inventory, identify which loans conform to Fannie Mae and Freddie Mac standards, which are eligible for RTC's mortgage-backed securities program, and which should be sold on a whole-loan basis.

RTC has embarked upon an aggressive program of swapping performing, conforming loans with Fannie Mae and Freddie Mac in exchange for highly liquid securities. Through May 31, RTC had swapped more than $1.4 billion in loans.

However, it is estimated that only about 15 percent ($6 billion) of RTC's current inventory of performing one-to four-family mortgages conform to the secondary agencies' criteria for swap. Therefore the balance must be securitized or sold on a whole-loan basis.

The Oversight Board has strongly encouraged the widest possible use of securitization. It offers a much broader market of purchasers than does the outright sale of whole loans and, because of such benefits as reduced risk and more predictable cash flows, results in a higher return on these assets for the taxpayer. Further, securitization will enable the RTC to increase the pace of asset disposition.

Using conservative assumptions, the savings over the next three years from RTC's securitization of single family mortgages alone could exceed $1 billion (not including savings resulting from reduced FFB borrowings). Very significant additional savings could result if other financial assets are securitized.

Immediately following enactment of immunity protection for RTC Board members and employees in connection with their disposition activities, RTC filed a $4 billion shelf registration with the Securities and Exchange Commission to issue its own mortgage-backed securities. The goal of securitizing $1 billion in loans per month has been set and the first issuance of $450 million in securities has been priced and should close within days.

Hard-to-Sell Assets

The most difficult task facing the RTC is the management, marketing and disposition of illiquid assets inherited from insolvent thrifts, principally real estate owned and non-performing loans. The RTC as of April 30 holds other performing loans with a book value of $36 billion, real estate with a book value of about $21 billion, and non-performing loans with a book value of about $25 billion.

To date it does not appear that RTC real estate sales have had an adverse effect on local markets. To the contrary, the extensive soundings of local market conditions taken by all six of the RTC's Regional Advisory Boards in 24 meetings in all sections of the country indicate that in some areas the overhang of RTC properties is depressing real estate markets. This finding simply reinforces the need to dispose of real estate owned.

Other Performing Loans

RTC has used a series of strategies to dispose of other performing loans, including, among others, auctions, bulk sales through the national sales center, and passing loans to thrift acquirers at resolutions. The results of these efforts have been the sale or collection of roughly 35 percent of mortgages other than one- to four- family, and 53 percent of other loans held more than 90 days. Due diligence on many of these loans, such as commercial loans, is time consuming. Also, poor documentation of these instruments hampers RTC disposition efforts.

SAMDA

The RTC's effort to dispose of hard-to-sell assets has been focused on the SAMDA program, that places real estate owned and non-performing assets with the private sector for management and disposition under Standard Asset Management and Disposition Agreements (SAMDAs).

Under a SAMDA, a contractor serves as RTC's agent in the management and sale of RTC assets. The contractor designs a management and disposition program for assets, hires subcontractors to implement the program, and negotiates the sale of assets. The compensation structure gives contractors incentives to sell assets quickly and at the best possible price. A recent revision to the SAMDA standard contract has enhanced these incentives.

As of May 31, 128 SAMDAs with assets of over $24 billion book value have been placed with contractors. An additional $10 billion of assets is currently being bid.

At March 31, SAMDA contractors had sold assets with a book value of $359 million, yielding $218 million in proceeds. Results have been slow to come because 75 percent of the assets now under SAMDA were contracted for within the last six months, and because there is a lag of three to four months after the award of a SAMDA, before the contractor can implement a marketing program for the properties under its management.

The SAMDA program has been criticized because the pools of assets RTC created and bid out for management average $195 million and thus make it very difficult for smaller businesses, including MWOB's, to win SAMDA contracts. At the Oversight Board's urging the RTC has begun to create smaller pools of assets. This should make the SAMDA program more accessible to smaller firms and especially to those owned by minorities and women.

Seller Financing

The Oversight Board adopted last December a policy providing for a $7 billion seller financing program to expedite the pace of sales of illiquid assets and to maximize the value recovered by the RTC from such dispositions. A minimum of $250 million was reserved to assist the sale of affordable single family housing to qualified buyers.

The RTC has a strong cash preference. But the RTC owns assets for which there is no cash market except at distress prices. The RTC reports that there were seven alternative cash offers for the approximately 117 seller financed transactions that have occurred since March, 1991 when the RTC began keeping records of alternative cash offers. In such cases, seller financing gives the RTC a potent means by which to expedite the sale of assets. It gets some cash up front, and avoids the costs, liabilities and physical deterioration that occurs when property is held in inventory.

Nonetheless we recognize that financed transactions ultimately rely on the credit and performance of the buyer. So they are not without risk. Accordingly the Oversight Board included risk-limiting safeguards in its seller financing policies and directed the RTC IG to conduct a front-end risk assessment of the program and to conduct periodic audits.

Portfolio Sales

The RTC, through its sales centers, has been actively engaged in marketing large portfolios of hard-to-sell assets, including apartment buildings, office buildings and shopping centers.

On May 21 the RTC Board adopted a policy to authorize the RTC to negotiate sales of very large portfolios of properties with necessarily very large buyers, given the size of the portfolios.

The Oversight Board considers this an important issue. Given the very large amount of RTC assets, innovative sales methods must be explored. There are elements of the RTC policy that are consistent with existing Board policy, such as cash flow mortgages, if done on a competitive basis. Other elements of the program must be reviewed by the Board. We have just received the information from the RTC that we need to proceed with our consideration of the matter.

The Oversight Board is also considering the effect of this proposal on the SAMDA program. Very substantial effort has been given to making SAMDA work. The Board wants to encourage continued RTC efforts to sell assets. However, we also want to ensure that the portfolio sales policy does not undercut SAMDA just as it is getting started.

I ask your consent that the RTC policy statement, and the Oversight Board's communications with the RTC about it, be included in the record of the hearing.

OTHER BOARD ACTIVITIES

Management Initiatives

Strengthening the RTC's management practices and internal controls have been key objectives of the Oversight Board because they are essential to sound decision-making and ultimately to saving taxpayer dollars.

Improving RTC management practices was mandated by the Congress in the Funding Act. A number of needed improvements identified by the GAO were written into the Act and required to be completed by September 30. These and a number of other management improvements requested by the GAO and the RTC IG are summarized in the Management Initiatives Report contained in Appendix I.

Encouraging the RTC to develop operating plans has been a major objective of the Oversight Board. The first nine-month plan was submitted by the RTC in January. Producing such plans requires setting goals, developing internal plans to achieve the goals, measuring progress against goals, analyzing variances and revising strategies. This process has been given strong stimulus by the Funding Act's requirement that the RTC and Oversight Board submit quarterly projections through the end of each calendar year. This is a healthy discipline that the Board strongly supports.

Operating Plan Management Information System

Beginning in October, 1990, under the leadership of Director Philip Jackson, the Oversight Board has initiated the development with the RTC of an Operating Plan Management Information System.

This is an important undertaking, as the Comptroller General told the Committee in his appearance two weeks ago. When in operation, it will provide the Oversight Board with the consistent, structured information needed to fulfill its role, and form the basis for an executive information system for senior RTC managers. It will help in developing an integrated operating plan process, assessing the reasonableness of operating plan goals and measuring operating results. Its implementation will address the GAO's concern that the RTC have an integrated system that supports decision making in policy as well as operational matters.

This information provides the basis for an ongoing Oversight Board "scorecard" program which visually displays RTC's activities.

Oversight Board Working Group on Audit Reviews

As the Comptroller General indicated, the thrift cleanup requires oversight because it is so big, and costs so many billions of public funds. The Comptroller General's testimony about RTC operational shortcomings raised concerns that have been the subject of ongoing action by the Oversight Board.

Some background may be helpful. Early in 1991 the Oversight Board staff began studying the RTC's internal control systems. This work was given impetus by Comptroller Bowsher's criticisms of the RTC's internal controls provided to the Oversight Board at its April 17 meeting.

Oversight Board staff immediately began to meet with the GAO, with the RTC IG, and with RTC to understand and act on the GAO's concerns. At its next meeting, on May 15, the Oversight Board authorized me as Chairman to write the GAO and the IG to request explicit additional information as the basis for possible further action.

The Oversight Board also created a working group headed by John Robson, Deputy Secretary of the Treasury, and Alfred DelliBovi, Deputy Secretary of HUD to help address concerns raised in the area of internal controls. This working group has three tasks:

- o ensuring that RTC puts adequate systems in place to coordinate activities among RTC's three auditors - the GAO, the RTC's IG, and RTC's own in-house auditors;
- o ensuring that RTC puts an "early warning" system in place so that problems are identified early; and
- o ensuring that RTC has a system to track the implementation of corrective actions, and to verify that expected improvements were achieved.

On June 10, when the Comptroller General responded to my request, I wrote and asked him to meet with the working group. I would like to request, Mr. Chairman, that this correspondence be included in the record of this hearing.

The working group has begun with a series of meetings with representatives of the Comptroller General, the RTC IG, and RTC's recently formed Internal Controls Task Force.

Their first recommendation to me is that RTC be required to comply with the Federal Managers Financial Integrity Act of 1982 (FMFIA). Under the Chief Financial Officers Act of 1990 (CFO), RTC is now required to submit an assurance letter to the President and Congress that RTC's systems of internal controls comply with standards prescribed by the Comptroller General and are consistent with FMFIA.

In addition, while RTC is subject to certain financial audit and management reporting requirements of the CFO Act, I believe RTC would benefit from following all provisions of that act, which include:

- o requirement to designate a CFO who will report to the head of the RTC on all financial matters;
- o institute a modern federal financial management structure and associated systems; and
- o produce consistent financial information.

As the Chairman of the Oversight Board, I fully endorse these working group recommendations. While I will ask the Oversight Board to approve these recommendations thereby requiring RTC to follow the spirit of FMFIA and the CFO Act, I would welcome legislation by this Committee which would officially bring the RTC under FMFIA and all provisions of the CFO Act. In either case, good government dictates that we follow this course.

The Role of the RTC Inspector General

The Oversight Board sees the job of the RTC IG as critical. Timely and comprehensive financial and program audits are absolutely essential to the success of the RTC. The Oversight Board has worked closely with the RTC IG to be sure that his audit plan is focused on areas within RTC that have the greatest relative risk exposure and vulnerability.

We have taken a number of steps to ensure that audits of RTC operations yield substantial change.

When the IG's audit plan was in the initial stages of development, I urged him to use a scientific methodology to identify audit targets. The Oversight Board was pleased that the IG responded to this request and employed a fact-based approach in devising the audit plan.

In our review of the plan we noted several areas including accounting standards, the 1988 Deals, and asset pricing, which in our estimation warranted formal audits. We requested, and the IG did modify his plan accordingly. We also encouraged him to emphasize and speed up audits in the areas of asset management, asset valuation, internal controls, and cash control. As you know, these areas were identified by the GAO as weaknesses in RTC's overall financial management system.

I ask that relevant correspondence with the IG be included in the record of the hearing.

'88 DEALS

FIRREA requires that the Oversight Board establish strategies, policies and goals for restructuring the 1988 Deals. The Board's policy calls on the RTC to renegotiate and prepay the 1988 FSLIC deals to save taxpayer dollars. RTC authorized the expenditure of a total of $925.5 million for the prepayment of FSLIC notes at six investor-owned institutions and Sunbelt. This brings the total amount expended to $6.8 billion, or 31 percent of the $22 billion appropriation for FY91.

Estimated savings resulting from expenditures ranged from a minimum of $70.9 million to a maximum of $133.7 million, or from 7.7 percent to 14.4 percent of cash expended during the month. For the fiscal year to date, savings estimates range from $402.5 million to $738.4 million, equal to 5.9 percent to 10.8 percent of the total $6.8 billion expended. The range of savings reflects the uncertainties about the tax treatment of these deals.

ORGANIZATIONAL ISSUES

FIRREA made the FDIC the exclusive manager of the RTC to perform all responsibilities of RTC under the statute, and made the FDIC Board the Board of Directors for the RTC. At the same time, FIRREA gave the Oversight Board authority over the RTC's strategies, policies, and funding, and gave it responsibility for oversight and evaluation of the RTC. Given the immensity and complexity of the cleanup, and the need for continuing objective oversight, this separation of management and operations from oversight makes sense.

It was prudent to assign the management and operational responsibility to FDIC, because at the time of FIRREA's enactment it was the only organization with the experience and personnel equipped to handle what was then, and throughout the initial phase of the thrift cleanup has been, the RTC's principal task, i.e., seizing and resolving a massive collection of bankrupt institutions. The alternative would have been to create and staff from scratch an organization to handle this problem, a job which inevitably would have delayed the start of the cleanup and added to the costs for taxpayers. Properly, neither Congress nor the Administration was prepared to accept such delay or costs.

We have functioned under this structure for nearly two years. Admittedly, there have been some problems in addressing the giant, unprecedented cleanup task. It would have been unrealistic not to expect them. Indeed, we do not believe that any individual or group of individuals, working under any organizational structure, could perform this huge, difficult task free of problems or errors. And one must also consider the array of other important FIRREA requirements--affordable housing, MWOB contracting and significant properties--that require time and management resources. So, problems have occurred. But in our analysis they have not been problems caused by the structure.

Recently this Committee has heard testimony about some of the problems. For example, the Comptroller General identified the need to develop:

- o a methodology for valuing assets in receivership;
- o systems for tracking RTC's asset inventory and its value;
- o a better system of internal controls; and
- o improved procedures to facilitate transactions with potential buyers of RTC assets.

Some have suggested that these problems are caused by the dual-board structure because that structure, in their view, diffuses responsibility and prevents the RTC management from having clear direction.

We do not agree. Neither does the Comptroller General nor the Chairman of the RTC National Advisory Board, both of whom stated to this Committee that the structure is not the cause of operational problems and that the cleanup does require oversight, such as that provided by the Oversight Board.

However, our mutual objective should not be to debate about problems, but to solve them. And we would like now to turn our attention to that, recognizing that the nature of the cleanup has changed and that solutions must be appropriate.

First, when the RTC was created it had immediately to seize and resolve hundreds of failed thrifts. We wish to commend RTC's management for the fine job they have done under the most challenging circumstances. Bill Seidman, David Cooke, Bill Roelle, Lamar Kelly, and others have built a country-wide organization from the ground up. We should remember that in less than two years the

RTC has been built to an organization of 7,000 people, has taken over more than 600 institutions, and seized assets worth $318 billion. This is a tremendous accomplishment of which they all should be proud.

We should recognize that the nature of the cleanup task has fundamentally changed. The work of the RTC is no longer dominated by the need to seize and resolve hundreds of bankrupt thrifts. Its main task now is to sell to private owners the massive aggregation of assets which the resolution of these thrifts has left in RTC's possession. This is a formidable undertaking--the biggest work-out in history.

Second, we do not believe it is wise or necessary to burden FDIC or its Chairman with the direct responsibility for managing both the RTC and the increasingly difficult problems of the banking industry. The Chairman of the FDIC has more than enough on his plate with FDIC's regular responsibilities.

So we believe the most important action that can be taken to move the thrift cleanup forward effectively is to establish at the head of the RTC a CEO with the credentials and the operating latitude to get this job finished. Chairman Seidman has expressed a similar view and agrees with us that the search for a CEO should get underway immediately. As Chairman Riegle has said, "this is the biggest financial enterprise there is right now," and we ought to "hire the best management" team to run it.

In our view a major and potentially disruptive restructuring is not the first priority. Such a reorganization would require legislation and thus could take months to accomplish. It would create confusion and demoralization in the management ranks of the RTC and thus as the Comptroller General has warned, would impede progress. Time and delay are our enemies. They only mean higher costs.

Immediately upon appointment of the new CEO, the RTC Board should delegate whatever authority may be needed to carry out his or her formidable operating responsibilities. The RTC Board can then focus on broader operating issues.

The CEO should immediately be asked to participate in all meetings of the RTC and Oversight Boards to improve communication and interaction among RTC management, the operational RTC Board, and the Oversight Board. Full membership could be provided under subsequent legislation if necessary.

These actions can be taken immediately, without legislation, which as we know could entail considerable delay. So we need not delay action. The Oversight Board has discussed these matters fully with the FDIC Chairman.

The Oversight Board is aware that there are several proposals to restructure the Oversight and RTC Boards, and that some members of this Committee believe that such restructuring is necessary.

As I have said today and previously, we do not believe restructuring is necessary because the problems are not problems of structure.

Nonetheless, if the Committee is convinced that it is imperative to redraw the organizational chart, we strongly believe that any such plan should meet the following criteria.

First, a new RTC should not be a wholly independent entity. To entrust the expenditure of up to $160 billion taxpayer dollars to an independent agency is not sound public policy. The RTC is not like a private corporation that does not receive public funds. The RTC is a government corporation responsible for spending possibly as much as $160 billion. Certainly our experience with the Federal Asset Disposition Agency suggests that strong oversight is essential to protect the taxpayers' interest.

Second, as the Comptroller General has stated, an oversight function is important and necessary and should be retained. Congress has previously recognized the need for such oversight. It created the Chrysler Loan Guarantee Board in 1980, and that Board had five members, all of them public officials who served part-time. The point has been made that the Chrysler Loan Guarantee is dwarfed by the thrift cleanup, and in dollar terms that is true. The size of the thrift cleanup is even more reason for oversight. But the principle is the same and is valid. It was applied even earlier, in 1970, when Congress created the Emergency Loan Guarantee Board to oversee the government's interest in the Lockheed Loan Guarantee.

Third, the oversight and budget approving entity should not have direct operating responsibility over the RTC. These functions should continue to be separated. A body charged with oversight cannot impartially perform that duty if it is also charged with operations.

Fourth, any restructuring should not disrupt ongoing operations, prolong the cleanup or result in costly delay.

Finally, a restructuring must address the real problems, not just the perceptual ones. We see no useful purpose in just moving the boxes around.

Perhaps a new structure can be fashioned that meets these criteria. Certainly, we will work with the Committee to that end. Chairman Seidman suggested two possible organizational models last week. We are discussing these and other possibilities with him. But we are concerned that a major restructure in mid-stream threatens to disrupt the effort to get this enormous problem off the public agenda.

CONCLUSION

This concludes our statement. It is supplemented by a more detailed response, contained in Appendix II, to several of the specific information requirements set forth in FIRREA for this semiannual appearance.

The great majority of insolvent thrifts will have been seized by the end of the fiscal year. We request additional loss funds, working capital, and an extension of the period in which thrifts may be transferred to the RTC for closing. These authorities will permit the job of protecting depositors and closing insolvent thrifts to be completed in an orderly, efficient way.

The task now before the RTC is to dispose of assets as quickly as it can and with the greatest possible return. This is a Herculean job. Policies and programs put in place months ago are now becoming operational. But much remains to be done, and we look forward to working with you to finish this job.

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 26, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 5-YEAR NOTES

Tenders for $9,301 million of 5-year notes, Series Q-1996, to be issued July 1, 1991 and to mature June 30, 1996 were accepted today (CUSIP: 912827B43).

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	7.95%	99.696
High	7.97%	99.615
Average	7.96%	99.655

$138,000 was accepted at lower yields.
Tenders at the high yield were allotted 37%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	46,244	46,244
New York	23,885,948	8,380,903
Philadelphia	15,783	15,783
Cleveland	48,779	48,779
Richmond	47,531	43,271
Atlanta	30,442	30,427
Chicago	1,342,193	467,803
St. Louis	36,010	32,010
Minneapolis	23,821	23,821
Kansas City	52,275	52,270
Dallas	15,993	15,993
San Francisco	319,081	100,246
Treasury	43,331	43,296
TOTALS	$25,907,431	$9,300,846

The $9,301 million of accepted tenders includes $888 million of noncompetitive tenders and $8,413 million of competitive tenders from the public.

In addition, $100 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $300 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1347

TREASURY NEWS

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

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

STATEMENT OF THE HONORABLE ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY FOR FINANCE
BEFORE THE
COMMITTEE ON THE BUDGET
UNITED STATES HOUSE OF REPRESENTATIVES

June 27, 1991

Chairman Panetta, and members of the Committee, thank you for the opportunity to discuss the budget implications of financial institutions legislation and other issues now or soon expected to be before Congress. As you requested, my testimony discusses the condition of the Bank Insurance Fund (BIF), the Administration's efforts to address the "credit crunch," and the funding requirements of the thrift cleanup. At the end of my testimony, I will be glad to answer your questions about the Administration's proposed deposit insurance and banking reform legislation.

<u>Bank Reform Legislation</u>

I would like to preface my comments on the BIF's funding needs by pointing out that the current problem with BIF is the manifestation of a much larger problem. Outdated legal restrictions prevent our banking organizations from responding to changing financial markets and technology; the scope of deposit insurance has expanded dramatically, increasing taxpayer exposure as market discipline has been weakened; and, a fragmented regulatory system has created duplicative rules and often failed to produce decisive remedial action.

We believe that a comprehensive approach to banking reform is the only way to truly resolve the underlying problems in the banking system -- merely recapitalizing BIF would 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 the following 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.

-- 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.

-- Fourth, we need a better capitalized BIF.

If these four objectives are met, we believe that the deposit insurance funds will once again become little more than an asterisk in the federal budget. This is in contrast to today, when they can cause swings of billions of dollars. With a return to international competitiveness as well as enhanced safety and soundness, our banking system would also return to its crucial role as an important engine for economic growth.

Bank Insurance Fund

Let me now turn to the condition of the Bank Insurance Fund. As the Committee is well aware, BIF reserves are at their lowest level in history as a percentage of insured deposits, and are projected to decline still further over the next two years. Without an infusion of funds, the Federal Deposit Insurance Corporation (FDIC) could find itself with too little cash to pay for losses, resulting in possible exposure for the taxpayer.

Indeed, the FDIC has recently revised its expectations for 1991 and 1992 to the more pessimistic end of its previously released forecast range. While the FDIC estimates that BIF will have sufficient funds to last through the fiscal year, BIF will likely need recapitalization funds in FY92.

The Administration's projections are that the BIF will decline substantially over the next five years, reaching a negative net worth of over $22 billion by the end of 1996. These projections are based on a computer model that applies historical failure and loss rates to banks according to their capital levels.

In addition to the Administration's projections, there are a number of other projections for BIF which reach widely disparate conclusions. This only proves what Chairman Seidman of the FDIC often says -- there can be little certainty in projecting BIF losses, particularly more than two years out. Attached as Exhibit A to my testimony, you will find summarized the results of BIF projections made earlier this year by the Congressional

Budget Office, the FDIC, and the Administration. I would point out that the plan included in our banking legislation is adequate to deal with each of these scenarios. That is also true for the new, higher loss estimates that I understand the FDIC is about to report.

Our plan would fulfill four objectives that we believe a BIF recapitalization should meet. First, the plan would provide sufficient resources for the FDIC to do its job. Second, the plan would be financed by the industry. Third, the plan would be structured to avoid further impairing the health of the banking industry. And fourth, the plan would rely on generally accepted accounting principles.

The plan would give the FDIC authority to borrow up to $25 billion from the Federal Reserve Banks for use as loss funds. These borrowings would bear interest at Treasury rates. The FDIC would be required to increase premiums and dedicate them -- that is, to set them aside -- in amounts sufficient to assure the payment of interest and principal on any such borrowings. In other words, the industry would pay for recapitalizing the funds.

The plan would also modify the FDIC's current borrowing limitation to permit the FDIC to use the Federal Reserve borrowing authority to pay for losses and to have sufficient working capital.

Finally, our proposed legislation would impose an aggregate ceiling on insurance premiums for BIF-insured institutions of 30 basis points. Since the new risk-based premium authority included in our legislation would allow the FDIC to vary premiums depending on the riskiness of the institution, the FDIC would retain the authority to assess individual institutions more than 30 basis points. The ceiling would apply in the aggregate to all BIF-insured institutions.

The Financial Institutions Subcommittee of the House Banking Committee, during its mark-up of the Financial Institutions Safety and Consumer Choice Act of 1991, preserved the key elements of our plan and the House Banking Committee has let the changes stand. That is, BIF would borrow from the government; and banks' deposit insurance premiums would be increased to repay the amount borrowed.

<u>The Administration's Efforts to Address the "Credit Crunch"</u>

Now, I would like to give you some background on the causes of the credit crunch, then discuss steps taken by the Administration and the bank and thrift regulatory agencies to address these causes, and finally to outline continued actions that the Administration and the agencies will be pursuing in the coming weeks.

It is important to note that the credit crunch facing business in the United States has multiple causes. For the last several months, our nation has experienced a declining economy. This has reduced consumer confidence, which has discouraged people from borrowing to buy homes and automobiles and discouraged businesses from committing to capital expenditure plans.

In response, the demand for credit has fallen. Likewise, increasing vacancy rates and falling rents. This has been compounded by several years of over building in certain commercial real estate markets. Commercial banks, as in all downturns, have seen a rise in non-performing assets and the need for greater loan loss reserves -- at the very same time they are working diligently to raise capital to meet international standards.

Recognizing these trends, the Federal Reserve has responded by moving to lower short-term interest rates and reduce the reserves that banks are required to hold on deposit at the Federal Reserve.

However, businesses and banks have perceived a more stringent regulatory approach to bank lending. It must be said that this approach was in substantial measure due to the application of prudent regulation in more severe economic conditions. Praise should be given to the regulators for their vigilance in difficult economic times.

However, as Secretary Brady has pointed out on numerous occasions, the application of prudent regulation also requires balance, common sense and a recognition that certain sectors of the economy are experiencing difficult times and may need some additional flexibility to work through temporary problems. The regulators have made clear that they do not want the availability of credit to sound borrowers to be adversely affected by supervisory policies or banks' misunderstandings about them.

It is for these reasons that Secretary Brady has worked with the federal bank and thrift regulators (the Federal Reserve, the Federal Deposit Insurance Corporation, the Comptroller of the Currency and the Office of Thrift Supervision) to address this regulatory aspect of the credit crunch. A package of proposals and guidelines, which were issued on March 1, 1991, by the regulators, is aimed at clarifying current regulatory practices so that any perceptions -- right or wrong -- of overly harsh, inflexible regulation are avoided.

These proposals are a result of hard work between the regulatory agencies to determine what existing supervisory and examination policies and guidelines should be reassessed and clarified. The proposals address a number of areas of concern raised by both the regulatory community and the private sector during numerous meetings with Secretary Brady and Deputy Secretary Robson and other Treasury officials over the past several months.

These include: guidance on the use by examiners and bankers of appraisals and other valuation issues -- especially in troubled real estate markets; broader disclosure requirements on non-performing loans; a clarification that institutions operating under a capital plan or with loan concentration should continue to work with troubled borrowers and make new, sound loans; clarification on the necessary disclosure of highly leveraged transactions; and, the need for clear and effective communication between regulators, examiners and bankers.

The regulators are carrying out a communications effort to ensure that these guidelines and clarifications are implemented by the more than 7,000 examiners and the thousands of bank officers and directors across the country.

In addition to the March proposals, the Administration continues to seek the application of supervisory policies and guidelines based on common sense and judgment. The regulatory agencies have committed to review other suggestions that could facilitate credit to sound borrowers and to assist in maintaining a balanced regulatory environment.

The Administration has also acted, where appropriate, to remove regulatory impediments to the prudent extension of credit that may exist outside of the bank examination process. On May 29, 1991, the Internal Revenue Service issued proposed regulations that would allow banks and thrift institutions to write off for tax purposes loans which are classified as losses for regulatory purposes. Institutions that elect to follow this procedure will attain greater certainty as to the timing and amount of tax deductions for bad debts.

On June 5, 1991, the Environment Protection Agency released its proposed rule clarifying a lender's liability under the Superfund. This rule will provide certainty for lenders to prudently work with the business community in making responsible and needed loans without fear of spurious environmental litigation. In addition to protecting security interest holders, such as banks and other financial institutions, this proposed rule also protects taxpayers by providing greater certainty that government institutions, such as the RTC and FDIC that obtain property as receivers of failed banks, will not be the "deep pockets" for Superfund.

While there are some indications that the credit crunch has eased somewhat, there are still serious credit availability problems in certain sectors, such as real estate, and in certain hard hit regions, such as New England. You may be assured that the Department of the Treasury will continue to listen to the concerns of bankers, business people and the regulatory agencies in seeking additional measures that facilitate credit for sound borrowers. The regulatory agencies stand ready to work with members of Congress in participating in regional meetings to discuss the application and implementation of the March 1st policy guidelines.

This is a critical stage of the economic recovery, a time when credit to produce goods and new homes as demand increases is fundamental for economic growth. We want sound banks to lend to solid businesses and to work with borrowers facing temporary problems, and we continue to urge the bank and thrift regulators to carry out their responsibilities with balance and good sense.

RTC Funding

Finally, your letter of invitation asked that I address the cost of the savings and loan cleanup. As the Secretary has said many times, the ultimate cost of the cleanup is driven by real estate markets, interest rates, and the state of the economy. The number of thrifts that must be closed and thus the total amount of the loss depends on these larger economic forces. The cost will also reflect our efforts to save taxpayer dollars wherever possible.

Loss Funds

On June 21, 1991, Chairman Seidman said in testimony before the Senate Banking Committee that the RTC estimates it will complete the resolution of 557 thrifts by the end of the fiscal year, and at that time will have used \$75 billion to \$80 billion in loss funds -- all or almost all of the loss funds that have been provided to it by Congress. (The RTC's most recent operating plan, dated June 17, shows that by the end of the fiscal year it will have spent \$79 billion to cover losses in the industry.)

In January of this year, the Oversight Board estimated that the cost of the savings and loan cleanup would be in the range of \$90 to \$130 billion in 1989 dollars. The Secretary stated that, because of general economic conditions and deterioration in real estate markets the most likely cost scenario had probably moved to the higher end of our range, but that it nevertheless remained within that range.

We still believe this to be true. In other words, we still believe that the higher end of the range estimate of \$130 billion in 1989 dollars remains valid. Presenting estimates in constant dollars allows us to compare the estimates better. It is the conventional way for the private sector and the Congressional Budget Office to state the cost of major programs that last for more than one or two years, but it is different from the same amount expressed in budget dollars.

Thus, our estimate of $90 to $130 billion in 1989 dollars converts to a range of $110 to $160 billion in budget dollars. This range estimate was corroborated by Chairman Seidman in his testimony last week.

To date, $80 billion has been authorized: $50 billion by FIRREA and $30 billion by the RTC Funding Act of 1991. The Oversight Board and the RTC estimate that the additional amount of loss funds necessary to complete the task of closing defunct savings and loans and protecting depositors could be as high as $80 billion in budget dollars.

We have recommended that Congress provide the RTC with sufficient funding to complete the job, which we estimate will be up to $80 billion. This would permit the RTC to complete its work as quickly as possible without costly delay. Funding delays, resulting from start and stop funding, simply add to taxpayer costs because they slow the RTC's resolution activity.

However, if Congress wishes to provide only interim funding, Chairman Seidman estimates that the amount necessary for RTC to carry out its work in fiscal year 1992 will be $50 billion to $55 billion.

It should be remembered that the RTC uses the money to protect individual Americans who deposited their savings in S&Ls because they believed our government's promise that it would be safe there.

Working Capital

Loss funds, which we have just discussed, are the monies that are needed to fill the "hole" between an institution's deposits and the value of its assets. These funds will never be recovered.

Working capital, on the other hand, is used to finance the acquisition of the assets of failed thrifts by RTC until they are sold. It is borrowed by the RTC from the Federal Financing Bank (FFB). Working capital borrowings are backed by seized assets. The RTC expects to repay its working capital borrowings from the proceeds of the sales of these assets.

By the end of this fiscal year, RTC expects to have $70 billion in working capital borrowings outstanding, an amount well within the borrowing limitations set by FIRREA. However, during 1992, RTC could exceed the $125 billion permitted by the note cap.

Therefore, we are approaching the time when additional borrowing authority will be needed. We estimate that working capital needs could peak at $160 billion by mid-1993. At that time the RTC will start the process of repaying working capital borrowings from the FFB.

Because both loss funds and working capital fund are required to complete resolutions, it is imperative that loss fund authorizations be matched with adequate working capital borrowings. Therefore, we have requested that Congress raise the RTC's borrowing limit to $160 billion. Not to do so might create a situation in which RTC is pressured to dump assets at fire-sale prices simply to stay under the limit. Failure to raise the borrowing limit could just as surely prevent the RTC from resolving thrifts and protecting depositors as delays in funding do.

In the past, we have stressed that we cannot predict ultimate costs and borrowing needs with certainty. We must do so again. As the General Accounting Office noted in its 1989 Financial Audit of the RTC, "the actual cost...will depend on the outcome of various uncertainties," including the number of institutions transferred to the RTC, the extent of their operating losses, the quality and salability of their assets, and the conditions of the economy, especially in certain geographic areas.

In January 1991, the Secretary told the Senate Banking Committee that the economic downturn had worsened the already weak market for real estate assets and made already cautious investors more reluctant to make investment decisions. The investment climate is still uncertain, and in an uncertain climate, estimates are always subject to change. But we have in the past and have today given you our best estimates of projected loss and working capital needs, and we will continue to do so.

Conclusion

I will, of course, be happy to answer any questions the Committee might have.

EXHIBIT A

COMPARISON OF BIF ESTIMATES

($ in billions)

	1991	1992	1993	1994	1995	1996
Fund Net Worth						
OMB	4.4	(2.2)	(9.1)	(15.5)	(19.3)	(22.2)
CBO	1.4	(2.8)	(2.6)	(1.0)	0.9	4.2
FDIC - base \1	4.1	3.6	n/a	n/a	n/a	n/a
FDIC - pessimistic	0.2	(4.6)	n/a	n/a	n/a	n/a
Assets of Failed Banks						
OMB	62.4	62.4	62.4	56.1	40.6	40.6
CBO \2	96.6	66.9	44.6	37.2	37.2	29.7
FDIC - base	65.0	30.0	n/a	n/a	n/a	n/a
FDIC - pessimistic	90.0	70.0	n/a	n/a	n/a	n/a
Losses on Failed Banks						
OMB	12.0	12.0	12.0	11.5	8.8	8.5
CBO	13.0	9.0	6.0	5.0	5.0	4.0
FDIC - base	10.0	6.5	n/a	n/a	n/a	n/a
FDIC - pessimistic	13.9	10.8	n/a	n/a	n/a	n/a
Net Outlays (excl. FFB interest)						
OMB	15.9	9.2	6.7	5.0	(1.3)	(1.5)
CBO	12.4	3.9	(2.7)	(3.9)	(4.0)	(5.7)
FDIC	n/a	n/a	n/a	n/a	n/a	n/a
Premium Assessments						
OMB	21.25	23	23	23	23	23
CBO	21.25	27	30	30	30	30
FDIC	23	23	23	23	23	23
Deposit Base Growth						
OMB	3.9%	6.6%	7.3%	7.0%	6.7%	6.5%
CBO	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
FDIC	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%

\1 FDIC numbers are for calendar, not fiscal years.

\2 *Estimate based upon data supplied in CBO testimony of January 29, 1991.*

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
June 27, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 52-WEEK BILLS

Tenders for $12,661 million of 52-week bills to be issued July 5, 1991 and to mature July 2, 1992 were accepted today (CUSIP: 912794YV0).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	6.00%	6.39%	93.950
High	6.00%	6.39%	93.950
Average	6.00%	6.39%	93.950

Tenders at the high discount rate were allotted 40%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	22,790	22,790
New York	44,339,515	12,013,215
Philadelphia	14,585	14,585
Cleveland	19,355	19,355
Richmond	34,995	34,995
Atlanta	19,475	16,475
Chicago	1,554,710	29,710
St. Louis	22,155	14,155
Minneapolis	7,950	7,940
Kansas City	30,240	30,240
Dallas	8,985	8,985
San Francisco	526,900	136,900
Treasury	311,405	311,405
TOTALS	$46,913,060	$12,660,750
Type		
Competitive	$43,047,525	$8,795,215
Noncompetitive	734,335	734,335
Subtotal, Public	$43,781,860	$9,529,550
Federal Reserve	2,900,000	2,900,000
Foreign Official Institutions	231,200	231,200
TOTALS	$46,913,060	$12,660,750

NB-1349

TREASURY NEWS

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

For Release Upon Delivery
Expected at 10:00 a.m.
June 27, 1991

STATEMENT OF
THOMAS D. TERRY
BENEFITS TAX COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to present the views of the Department of the Treasury on certain federal tax issues relating to the impact of the conservatorship of the Executive Life Insurance Company on certain tax-qualified retirement plans holding Executive Life insurance products.

Background

First Executive Corporation ("First Executive") is the holding company for two life insurance companies, Executive Life Insurance Company and Executive Life Insurance Company of New York (collectively "Executive Life"). Executive Life Insurance Company is domiciled in California and Executive Life Insurance Company of New York is domiciled in New York.

Executive Life has sold a significant number of products, such as annuity contracts, to tax-qualified retirement plans. These products include annuity contracts purchased by retirement plans to satisfy plan liabilities to participants who have retired or otherwise separated from service under an ongoing plan and to participants in plans that are terminated. Retirement plans have also purchased Executive Life annuity contracts and guaranteed investment contracts ("GICs") as general plan investments. GICs are investment contracts offered by insurance companies under which the insurance company promises to pay a minimum rate of return reflective of the yields currently available on the type and quality of assets acquired by the insurance company.

NB 1350

Executive Life began reporting losses in 1989, reportedly due to defaults on several high-yield bonds held by the company. In early April, 1991, the Departments of Insurance in both California and New York took action to limit the insurance activities of Executive Life. Among other actions, the insurance regulators in California have obtained court orders that limit the payout on retirement annuities issued under qualified retirement plans to 70 percent of the amount otherwise payable. The California court order also precludes any payments out of certain GICs, including those held by qualified plans.

This situation raises a number of federal tax issues that affect retirement plan sponsors and fiduciaries, as well as plan participants and beneficiaries. My testimony will focus on the issues that arise under the Internal Revenue Code. The Department of Labor and the Pension Benefit Guaranty Corporation ("PBGC") are also present today to address the issues raised under the provisions of the Employee Retirement Income Security Act ("ERISA") that are within their jurisdiction.

Overview of tax-qualified plans

A retirement plan that meets the qualification requirements specified in the Internal Revenue Code is entitled to special tax treatment. Most significantly for purposes of today's hearing, employers are entitled to a current deduction (within specified limits) for contributions to the trust established under the plan, the trust is accorded tax-exempt status and participants and beneficiaries are not taxed on plan income or benefits until the benefits are distributed to them. Tax-qualified retirement plans fall into two broad categories, defined benefit plans and defined contribution plans.

Under a defined benefit pension plan, the benefit provided to a participant upon retirement is generally expressed as a definite formula (*e.g.*, a specified percentage of compensation multiplied by years of service). The plan's obligation to pay the benefit is generally funded through assets held in a trust fund established under the plan, or through insurance or annuity contracts issued by a state-licensed life insurance company and owned by the plan. Employer contributions are made to the trust or insurance company to fund the promised benefits. These contributions are subject to the minimum funding standards of the Code and ERISA -- standards that are designed to ensure that sufficient assets will be accumulated to provide the promised benefits when they become due. Thus, if there is a decline in the value of the assets held in the trust, the minimum funding standards may require additional employer contributions. Benefits under defined benefit plans are also guaranteed by the PBGC up to specified limits upon plan termination during the financial distress of the plan sponsor. Thus, under defined benefit plans, the participants generally do not bear the risks of a decline in the value of the assets held by the plan.

There are a variety of defined contribution plans, such as profit-sharing plans (including cash or deferred "401(k)" plans), money purchase plans, target benefit plans, stock bonus plans and employee stock ownership plans ("ESOPs"). Under a defined contribution plan, the employer makes regular contributions to the plan which are allocated to the individual accounts of plan participants. The allocation of the contribution is generally based upon the relative compensation of the participants. Thus, the retirement benefit provided to each individual participant is based solely on contributions made to an account established on his or her behalf, plus investment earnings (or less investment losses) on those contributions. Unlike defined benefit plans, defined contribution plans generally are not subject to the minimum funding standards of ERISA[1] and the benefits under the plan are not guaranteed by the PBGC. Thus, the participant generally bears the risks of a decline in the value of the assets held in his or her account. Many defined contribution plans offer several investment fund options and permit participants to direct the investment of their accounts among the options. The options frequently include a fund devoted to GICs and other time sensitive investment products.

As indicated above, one of the inherent distinctions between defined benefit plans and defined contribution plans is the placement of the investment risk. The risk of loss in the value of assets funding a defined benefit plan promise lies principally with the employer. By contrast, the risk of loss in the value of the assets under a defined contribution plan lies with the individual participant.

<u>Impact of the Executive Life proceedings on qualified plans</u>

The Executive Life conservatorship raises a number of tax issues with respect to qualified plans that have purchased Executive Life products. As discussed below, these issues differ fundamentally depending on whether the plan in question is a defined benefit plan or a defined contribution plan.

Defined benefit plans.

Defined benefit plans may purchase insurance company products for a number of different reasons. For example, annuity contracts may be purchased by an ongoing plan and distributed to a participant to provide for the payment of benefits upon retirement or separation from service. Annuity contracts may

---

[1] Money purchase defined contribution plans are subject to the minimum funding standards. See Code §412(h).

also be purchased to satisfy plan liabilities when a defined benefit plan is terminated. In addition, a plan may purchase annuity contracts or GICs as general investments of the plan.

Where annuity contracts or GICs that are held as general investments under a defined benefit plan decline in value, the employer will generally be required in accordance with the minimum funding requirements of the Code and ERISA to make additional contributions to the plan to make up for the loss. Generally, the funding of a defined benefit plan's investment losses must be amortized over a five-year period and will be deductible over this period in accordance with section 404 of the Code. In some circumstances payments to make up for these losses can be contributed and deducted over a shorter period.

Different issues arise, however, where annuity contracts represent an irrevocable commitment, that is, they have been purchased to satisfy specific plan liabilities, such as when a plan participant retires or separates from service or when the plan is terminated. Where the annuity contracts are not yet in pay status there would appear to be no major tax issues.

The principal tax-related questions are raised for defined benefit plans where irrevocable Executive Life annuity contracts are held by participants who are currently receiving payments under the contracts. In such cases, we understand that pursuant to the pending California court proceedings only 70 percent of each monthly payment is permitted to be paid by Executive Life. A number of concerned employers are exploring ways to ensure that their retirees continue to receive their full pension benefits at least until the Executive Life conservatorship proceedings clarify the value of the Executive Life annuities. Because a number of plan qualification issues may arise if "make-up" payments are made through the qualified plan, we understand that most employers are structuring the make-up either through direct cash payments or payments through a nonqualified plan.

One of the plan qualification issues which arises as a result of make-up payments outside the qualified plan involves section 401(a)(9) of the Code. This section requires that minimum distributions from qualified plans (and from annuity contracts distributed under such plans) be made to participants beginning at age 70½. Since payments made outside a qualified plan cannot be counted to satisfy these requirements, the inability to distribute amounts from the qualified plan due to the court order may result in violations of the qualification requirements and trigger a penalty excise tax of 50 percent of the shortfall on the participant. Similar issues were raised when another insurer, Baldwin-United Corporation, was engaged in a rehabilitation proceeding under applicable state insurance law in the early 1980s. In that case, a statutory amendment was enacted to provide relief for policyholders who were subject to the minimum distribution requirements. See Deficit Reduction Act of 1984, Pub. Law No. 98-369, §553. We have no policy objection to providing similar relief here, providing an appropriate offset is provided for any revenue lost. Congressman Archer has recently introduced such legislation, H.R. 2708, providing similar relief where a portion of a qualified plan benefit is unavailable for distribution due to the fact the insurance company is in receivership. We are currently reviewing H.R. 2708 for technical issues.

Defined contribution plans.

Insurance products purchased by defined contribution plans fall into two primary categories. First, some defined contribution plans may offer annuities as an option for funding benefits to retirees in which case the plan will use the participant's account balance to purchase an irrevocable annuity contract and distribute the contract to the participant. The tax issues relating to benefits paid from these contracts are the same as mentioned above with respect to annuity payments from defined benefit plans.

The second primary category of insurance products purchased by defined contribution plans are GICs which are held for the investment of plan assets. Frequently, a GIC fund will be one of the investment fund options offered under those defined contribution plans that permit participants to direct investment of their accounts among several investment funds. In the context of the Executive Life proceedings, there may have been a decline in the value of a participant's account to the extent the account was invested in a GIC fund, all or a part of which is invested in Executive Life GICs. As discussed above, in the defined contribution plan context, the participant and not the employer is generally at risk for investment losses. From this perspective, the Executive Life situation may have consequences similar to other events causing a decline in the value of investment assets, such as the stock market decline on October 19, 1987, where defined contribution plan assets invested in equities suffered a significant decline in value.

While plan provisions generally do not require employers to make up for investment losses in defined contribution plans, some employers are exploring ways of doing so for a variety of reasons. For example, they may be concerned that their employees viewed the GIC fund investment option as a "guaranteed" fund and believed, albeit erroneously, that the plan or the employer was ultimately the guarantor. Employers may also want to protect their employees against significant losses for employee relations reasons. Finally, employers may believe that unless these payments are made, they may be subject to suit by participants or the Department of Labor charging a breach of fiduciary responsibilities in the acquisition of the Executive Life GICs.

Employers have been exploring various options for offsetting these investment losses. These include purchasing the Executive Life GICs back from the plan for their book value, exchanging Executive Life GICs held under the plan for GICs issued by other insurance companies, or making loans to the plan to permit the plan to continue to make distributions to participants or to permit transfers from the GIC funds to another investment fund under the plan on the same basis as if the GICs were still worth 100 percent of their book value.[2] These transactions raise a number of federal tax issues, including whether they will give rise to "contributions" to the plan by the employer for plan qualification and employer deduction purposes, in which case the limits on plan benefits and contributions and the limits on employer deductions may be exceeded.

As noted, some employers and plan fiduciaries may be concerned that suits will be brought against them for breach of fiduciary liability for investing plan assets in Executive Life GICs. In fact, several such suits have already been brought. Accordingly, some employers and plan fiduciaries are exploring ways of bearing losses caused by investments in Executive Life GICs in an attempt to avoid similar suits. One potential avenue is a payment to the plan in settlement of a potential lawsuit for breach of fiduciary liability. Applying general tax principles, payments made in settlement of lawsuits may be treated for federal income tax purposes as ordinary and necessary business expenses, rather than as contributions to the plan, if the acts that gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business. A payment with respect to a claim generally is sufficient to give rise to an ordinary and necessary business expense as long as it is a bona-fide claim. It is not necessary that litigation be actually instigated, nor that final adjudication of the claims occur. Although a legally-binding document in which claimants waive their rights to sue for breach of fiduciary liability in return for such payments will generally be required to establish the motive for these payments, an admission by the payor that a breach of fiduciary liability occurred would not be necessary in order for the settlement agreement to be valid. The fact that several suits involving plan investments in Executive Life GICs have already been brought by plan participants suggests that some taxpayers may legitimately characterize payments as made in settlement of potential lawsuits. The particular facts and circumstances will determine whether the payments meet these standards.

---

[2] These alternatives may raise prohibited transaction issues under the Code and ERISA. With respect to the buy-back transaction, the Department of Labor, which has the authority to grant prohibited transaction exemptions, has indicated that it will entertain requests for such exemptions on an expedited basis.

If plan participants who have an interest in Executive Life GICs are permitted to make withdrawals on the basis of the full par value of the GICs, and an amount less than par is eventually realized on the GICs by the plan, the burden of the loss will be borne by those participants who do not withdraw and remain invested in the GICs. In order to prevent such shifting of the burden of potential losses from Executive Life GICs, some employers are amending their qualified defined contribution plans to "freeze" the portion of the participant accounts which are invested in the Executive Life GICs. This is usually accomplished by creating a new separate fund in the plan to hold Executive Life GICs and, under the applicable plan valuation procedures, revaluing that GIC fund on an interim basis. Assuming the Executive Life GIC fund is revalued at zero, this procedure is intended to leave "open" all the transactions occurring with the GIC fund and thereby permit a fair distribution of the ultimate GIC loss, if any, among the present, past and future participants in the plan.

Freezing of the portion of a participant's account attributable to Executive Life GICs presents a number of qualification and income tax questions for plan sponsors and plan participants. The Internal Revenue Service has published authoritative guidance on some of these questions. For example, the IRS published a ruling in 1980 holding that a provision in a qualified plan allowing interim valuations of investments held by the trust, *i.e.*, valuations more frequently than annually at the plan trustee's discretion, is permissible provided that the use of interim valuations does not result in discrimination in favor of higher income employees prohibited by section 401(a)(4) of the Code. See Rev. Rul. 80-155, 1980-1 C.B. 84. If the solvency of the issuer of a GIC is in considerable doubt, as evidenced by the pendency of state receivership proceedings, and there is no prohibited discrimination, the Internal Revenue Service will follow the 1980 Revenue Ruling in these circumstances.[3]

---

[3] In invoking the plan's interim valuation procedure a fiduciary must act responsibly to fairly protect the interest of all participants in the plan. Fiduciaries should be aware, however, that some courts have refused to apply plan amendments to permit interim valuations to participants who have separated prior to the amendment date (regardless of its effective date). Compare *Pratt v. Petroleum Production Management, Inc. Employee Savings Plan and Trust,* 920 F.2d 651 (10th Cir. 1990) (amendment after retirement) to *Cator v. Herrgott & Wilson, Inc.*, 609 F.Supp. 12 (N.D. Cal. 1984) (amendment one month before retirement). See also *Brug v. Pension Plan of Carpenters Pension Trust Fund for Northern California,* 669 F.2d 570 (9th Cir.), *cert. denied* 459 U.S. 861 (1982) (eligibility amendment after established disability).

In addition to the plan qualification issues which arise when a GIC fund is frozen, the income tax consequences of distributions from the plan to plan participants and former participants may be complicated because of the freeze. In order for distributees to qualify for the special averaging treatment accorded to lump sum payments from qualified plans under the Code, the entire "balance to the credit" of the participant under the plan must be distributed within one taxable year. Also, in order to roll over the distribution to an IRA or another qualified plan, at least 50 percent of the balance to the credit (or 100 percent in the case of a rollover to a qualified plan) of the participant must be distributed.

If a participant receives a distribution from a qualified plan at a time when his or her account balance includes an interest in a frozen GIC or a frozen GIC fund, the special averaging treatment will not be available unless the portion of the participant's account balance attributable to the frozen GICs can be ignored because only then will the participant be considered to have received the entire balance in the distribution. Similarly, some participants may not even be able to satisfy the 50 percent partial distribution requirement to qualify for IRA rollover treatment unless the frozen GICs are ignored. The Internal Revenue Service has issued revenue rulings which supports ignoring the frozen GICs for these purposes.[4] In the principal ruling, the IRS held that an employee's qualified plan account balance did not include certain court-impounded funds which would otherwise have been credited to the employee's account. See Rev. Rul. 83-57, 1983-1 C.B. 92; see also Rev. Rul. 69-190, 69-1 C.B. 131 (holding similarly that a later distribution of an amount attributable to a revaluation of the value of an annuity did not cause the initial distribution to be disqualified for lump sum distribution treatment).

<u>Conclusion</u>

In offering specific commentary on employee benefit plan qualification and income tax issues which arise when employers volunteer to assist their employees and former employees, our objective is to aid those employers and their advisers by providing general guidance under current law. Further, the Internal Revenue Service is willing to address issues relating to the Executive Life situation on a case by case basis. Because of the varying circumstances that may be controlling in any given case, the determination letter program (for plan qualification issues) and the private letter ruling process (for income tax and deduction issues) generally is the best way for employers to present the specific issues to the Service. I should point out,

---

[4] H.R. 2708, introduced by Congressman Archer, would achieve a similar result by statute.

however, that the Internal Revenue Service generally does not issue rulings on questions that are inherently factual and some of the Executive Life issues may be in that category. In addressing the Executive Life case, however, we must be mindful that many of the same questions might occur with other plan losses. To date, the Internal Revenue Service has received very few requests for private letter rulings on Executive Life issues.

Mr. Chairman, Members of the Subcommittee, that concludes my formal statement. I will be pleased to answer any questions that you may wish to ask.

- 0 -

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

FOR IMMEDIATE RELEASE
June 28, 1991

Contact: Cheryl Crispen
(202) 566-2041

Statement by
Nicholas F. Brady
Secretary of the Treasury

Today, the House Banking Committee voted in favor of the most sweeping bank reform since the 1930s. I applaud Chairman Gonzalez, Ranking Republican Member Wylie, Chairman Annunzio and the members of the House Banking Committee for their leadership in moving this bill expeditiously through Committee. We look forward to final action in the House and I hope the Senate will promptly begin debate on comprehensive banking reform.

The most recent estimate by FDIC Chairman Seidman is that the Bank Insurance Fund (BIF) has sufficient funds to last through the end of 1991, but will need to be recapitalized in 1992. This highlights the need for Congress to enact comprehensive bank reform legislation this year. Comprehensive legislation is needed to assure a safe, competitive banking industry that is ready to face the 21st century.

We must revitalize our outdated banking system. Our goal should be to draw private sector capital back into the system and not risk the chance of calling on the taxpayer.

oOo

NB-1351

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
July 1, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,468 million of 13-week bills to be issued July 5, 1991 and to mature October 3, 1991 were accepted today (CUSIP: 912794XH2).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.57%	5.74%	98.608
High	5.59%	5.76%	98.603
Average	5.59%	5.76%	98.603

$1,000,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 89%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	37,560	37,560
New York	25,961,970	8,963,630
Philadelphia	22,280	22,280
Cleveland	49,755	48,325
Richmond	54,630	54,630
Atlanta	36,025	34,915
Chicago	2,161,535	283,485
St. Louis	16,980	16,980
Minneapolis	9,565	9,565
Kansas City	47,190	47,190
Dallas	29,835	29,835
San Francisco	495,795	85,795
Treasury	833,605	833,605
TOTALS	$29,756,725	$10,467,795
Type		
Competitive	$25,840,150	$6,551,220
Noncompetitive	1,687,290	1,687,290
Subtotal, Public	$27,527,440	$8,238,510
Federal Reserve	2,124,935	2,124,935
Foreign Official Institutions	104,350	104,350
TOTALS	$29,756,725	$10,467,795

An additional $31,150 thousand of bills will be issued to foreign official institutions for new cash.

NB-1352

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
July 1, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,437 million of 26-week bills to be issued July 5, 1991 and to mature January 2, 1992 were accepted today (CUSIP: 912794XT6).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.70%	5.97%	97.134
High	5.72%	5.99%	97.124
Average	5.71%	5.98%	97.129

Tenders at the high discount rate were allotted 13%. The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	34,720	34,720
New York	28,716,400	9,197,945
Philadelphia	17,045	17,045
Cleveland	40,340	40,340
Richmond	39,750	39,750
Atlanta	35,640	35,640
Chicago	1,586,890	109,640
St. Louis	21,275	17,535
Minneapolis	12,825	12,825
Kansas City	49,045	48,175
Dallas	20,610	20,610
San Francisco	851,300	196,800
Treasury	665,925	665,925
TOTALS	$32,091,765	$10,436,950
Type		
Competitive	$27,543,590	$5,888,775
Noncompetitive	1,382,925	1,382,925
Subtotal, Public	$28,926,515	$7,271,700
Federal Reserve	2,400,000	2,400,000
Foreign Official Institutions	765,250	765,250
TOTALS	$32,091,765	$10,436,950

An additional $263,050 thousand of bills will be issued to foreign official institutions for new cash.

NB-1353

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
July 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 $ 20,800 million, to be issued July 11, 1991. This offering will provide about $ 3,050 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 17,753 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, July 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 $ 10,400 million, representing an additional amount of bills dated April 11, 1991, and to mature October 10, 1991 (CUSIP No. 912794 XJ 8), currently outstanding in the amount of $ 7,237 million, the additional and original bills to be freely interchangeable.

182 -day bills for approximately $ 10,400 million, to be dated July 11, 1991, and to mature January 9, 1992 (CUSIP No. 912794 XU 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 July 11, 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 $ 897 million as agents for foreign and international monetary authorities, and $ 4,794 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-1354

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 2:30 P.M.
July 3, 1991

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $9,000 MILLION OF 7-YEAR NOTES

The Department of the Treasury will auction $9,000 million of 7-year notes to refund $4,927 million of 7-year notes maturing July 15, 1991, and to raise about $4,075 million of new cash. The public holds $4,927 million of the maturing 7-year notes, including $16 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $9,000 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks for their own accounts hold $534 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-1355

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

July 3, 1991

<u>Amount Offered:</u>	
To the public	$9,000 million
<u>Description of Security:</u>	
Term and type of security	7-year notes
Series and CUSIP designation	G-1998 (CUSIP No. 912827 B5 0)
Maturity date	July 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	January 15 and July 15
Minimum denomination available ..	$1,000
<u>Terms of Sale:</u>	
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
<u>Payment Terms:</u>	
Payment by non-institutional investors	Full payment to be submitted with tender
Deposit guarantee by designated institutions	Acceptable
<u>Key Dates:</u>	
Receipt of tenders	Wednesday, July 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, July 15, 1991
b) readily-collectible check ..	Thursday, July 11, 1991

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

FOR IMMEDIATE RELEASE
July 3, 1991

Desiree Tucker-Sorini
Appointed Assistant Secretary
For Public Affairs and Public Liaison

Desiree Tucker-Sorini was sworn in today as Assistant Secretary of the Treasury for Public Affairs and Public Liaison. She was confirmed for her position by the United States Senate on June 28, 1991, and appointed to the position by President Bush on July 2, 1991.

As Assistant Secretary for Public Affairs and Public Liaison, Ms. Tucker-Sorini will serve as the lead representative of the Treasury Department in media, business, and intergovernmental affairs.

Since 1989, Ms. Tucker-Sorini has served as the Deputy Assistant Secretary for Public Affairs with the Treasury Department. Prior to joining Treasury, she was the Director of Public Affairs at the International Trade Administration in the Department of Commerce, since 1986. From 1984 to 1986 Ms. Tucker-Sorini served as Press Secretary to Ambassador Clayton Yeutter during his tenure as United States Trade Representative.

Previously, Ms. Tucker-Sorini was the Special Assistant to the Director of Women in Development at the Agency for International Development; Director of Fundraising for Tucker and Associates; and a marketing representative with the Xerox Corporation.

Ms. Tucker-Sorini graduated in 1980 from Colorado State University with a bachelor of arts degree in Communications. She and her husband, Ambassador Ronald Sorini, reside in McLean, Virginia.

NB-1356

PUBLIC DEBT NEWS

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

FOR RELEASE AT 3:OO PM
July 5, 1991

Contact: Peter Hollenbach
(202) 376-4302

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

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

	Dollar Amounts in Thousands
Principal Outstanding (Eligible Securities)	$520,322,781
Held in Unstripped Form	$393,482,066
Held in Stripped Form	$126,840,715
Reconstituted in June	$3,275,440

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-61

TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, JUNE 30, 1991
(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding			Reconstituted This Month[1]
		Total	Portion Held in Unstripped Form	Portion Held in Stripped Form	
11-5/8% Note C-1994	11/15/94	$6,658,554	$5,632,954	$1,025,600	$19,200
11-1/4% Note A-1995	2/15/95	6,933,861	6,509,061	424,800	9,920
11-1/4% Note B-1995	5/15/95	7,127,086	5,984,046	1,143,040	159,520
10-1/2% Note C-1995	8/15/95	7,955,901	7,382,301	573,600	12,400
9-1/2% Note D-1995	11/15/95	7 [illegible]8,550	6,143,750	1,174,800	6,400
8-7/8% Note A-1996	2/15/96	8,575,199	8,351,199	224,000	8,000
7-3/8% Note C-1996	5/15/96	20,085,643	19,871,243	214,400	-0-
7-1/4% Note D-1996	11/15/96	20,258,810	19,967,610	291,200	-0-
8-1/2% Note A-1997	5/15/97	9,921,237	9,840,037	81,200	-0-
8-5/8% Note B-1997	8/15/97	9,362,836	9,330,836	32,000	-0-
8-7/8% Note C-1997	11/15/97	9,808,329	9,798,729	9,600	6,400
8-1/8% Note A-1998	2/15/98	9,159,068	9,149,788	9,280	-0-
9% Note B-1998	5/15/98	9,165,387	9,124,387	41,000	-0-
9-1/4% Note C-1998	8/15/98	11,342,646	11,213,846	128,800	-0-
8-7/8% Note D-1998	11/15/98	9,902,875	9,896,475	6,400	-0-
8-7/8% Note A-1999	2/15/99	9,719,623	9,716,423	3,200	-0-
9-1/8% Note B-1999	5/15/99	10,047,103	9,176,703	870,400	-0-
8% Note C-1999	8/15/99	10,163,644	10,081,619	82,025	-0-
7-7/8% Note D-1999	11/15/99	10,773,960	10,765,960	8,000	-0-
8-1/2% Note A-2000	2/15/00	10,673,033	10,673,033	-0-	-0-
8-7/8% Note B-2000	5/15/00	10,496,230	10,414,630	81,600	-0-
8-3/4% Note C-2000	8/15/00	11,080,646	11,080,646	-0-	-0-
8-1/2% Note D-2000	11/15/00	11,519,682	11,519,682	-0-	-0-
7-3/4% Note A-2001	2/15/01	11,312,802	11,312,802	-0-	-0-
8% Note B-2001	5/15/01	12,398,083	12,398,083	-0-	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	3,788,206	4,513,600	120,000
12% Bond 2005	5/15/05	4,260,758	1,631,708	2,629,050	-0-
10-3/4% Bond 2005	8/15/05	9,269,713	8,316,113	953,600	12,000
9-3/8% Bond 2006	2/15/06	4,755,916	4,755,916	-0-	-0-
11-3/4% Bond 2009-14	11/15/14	6,005,584	1,343,184	4,662,400	132,800
11-1/4% Bond 2015	2/15/15	12,667,799	2,121,079	10,546,720	52,000
10-5/8% Bond 2015	8/15/15	7,149,916	1,616,476	5,533,440	92,480
9-7/8% Bond 2015	11/15/15	6,899,859	2,203,859	4,696,000	20,800
9-1/4% Bond 2016	2/15/16	7,266,854	6,640,454	626,400	-0-
7-1/4% Bond 2016	5/15/16	18,823,551	16,904,351	1,919,200	-0-
7-1/2% Bond 2016	11/15/16	18,864,448	15,119,488	3,744,960	345,040
8-3/4% Bond 2017	5/15/17	18,194,169	6,412,729	11,781,440	181,440
8-7/8% Bond 2017	8/15/17	14,016,858	9,524,058	4,492,800	68,800
9-1/8% Bond 2018	5/15/18	8,708,639	2,446,239	6,262,400	89,600
9% Bond 2018	11/15/18	9,032,870	1,556,870	7,476,000	148,000
8-7/8% Bond 2019	2/15/19	19,250,798	4,951,598	14,299,200	17,600
8-1/8% Bond 2019	8/15/19	20,213,832	10,843,272	9,370,560	310,400
8-1/2% Bond 2020	2/15/20	10,228,868	3,936,868	6,292,000	114,000
8-3/4% Bond 2020	5/15/20	10,158,883	2,863,523	7,295,360	186,880
8-3/4% Bond 2020	8/15/20	21,418,606	9,743,726	11,674,880	1,092,960
7-7/8% Bond 2021	2/15/21	11,113,378	9,542,178	1,571,200	-0-
8-1/8% Bond 2021	5/15/21	11,958,888	11,884,328	74,560	68,800
Total		520,322,781	393,482,066	126,840,715	3,275,440

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

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

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
July 8, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,463 million of 13-week bills to be issued July 11, 1991 and to mature October 10, 1991 were accepted today (CUSIP: 912794XJ8).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.55%	5.72%	98.597
High	5.58%	5.75%	98.590
Average	5.58%	5.75%	98.590

Tenders at the high discount rate were allotted 76%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	33,400	33,400
New York	28,002,115	8,523,920
Philadelphia	41,730	41,730
Cleveland	58,080	58,080
Richmond	51,385	51,385
Atlanta	42,035	39,795
Chicago	1,780,070	492,070
St. Louis	61,975	27,095
Minneapolis	7,825	7,825
Kansas City	47,065	47,065
Dallas	27,810	27,810
San Francisco	677,260	98,760
Treasury	1,014,270	1,014,270
TOTALS	$31,845,020	$10,463,205
Type		
Competitive	$27,615,280	$6,233,465
Noncompetitive	1,824,985	1,824,985
Subtotal, Public	$29,440,265	$8,058,450
Federal Reserve	2,296,830	2,296,830
Foreign Official Institutions	107,925	107,925
TOTALS	$31,845,020	$10,463,205

An additional $43,875 thousand of bills will be issued to foreign official institutions for new cash.

NB-1357

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
July 8, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,459 million of 26-week bills to be issued July 11, 1991 and to mature January 9, 1992 were accepted today (CUSIP: 912794XU3).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.70%	5.97%	97.118
High	5.72%	5.99%	97.108
Average	5.71%	5.98%	97.113

$30,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 5%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	29,470	29,470
New York	33,260,775	9,226,195
Philadelphia	29,480	29,480
Cleveland	38,155	38,155
Richmond	48,465	48,465
Atlanta	31,450	30,450
Chicago	1,351,710	85,460
St. Louis	45,315	21,415
Minneapolis	5,170	5,170
Kansas City	52,255	50,355
Dallas	18,035	18,035
San Francisco	598,095	80,595
Treasury	795,915	795,915
TOTALS	$36,304,290	$10,459,160
Type		
Competitive	$31,698,230	$5,853,100
Noncompetitive	1,494,485	1,494,485
Subtotal, Public	$33,192,715	$7,347,585
Federal Reserve	2,500,000	2,500,000
Foreign Official Institutions	611,575	611,575
TOTALS	$36,304,290	$10,459,160

An additional $228,525 thousand of bills will be issued to foreign official institutions for new cash.

NB-1358

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

FOR IMMEDIATE RELEASE
July 8, 1991

Contact: Cheryl Crispen (202) 566-2041

Mary Catherine Sophos Appointed Assistant Secretary For Legislative Affairs

Mary Catherine Sophos was sworn in today as Assistant Secretary of the Treasury for Legislative Affairs. She was confirmed for her position by the United States Senate on June 26, 1991, and appointed to the position by President Bush on June 28, 1991.

As Assistant Secretary for Legislative Affairs, Ms. Sophos will serve as the primary liaison between the Treasury Department and the United States Congress.

Since 1989, Ms. Sophos has served as the Deputy Assistant Secretary for Legislative Affairs. Prior to joining Treasury, she was the Director of Government Relations with McCamish, Martin, Brown & Loeffler, a Texas based law firm. Prior to that she was the Assistant Minority Counsel and Budget Analyst for the Ways and Means Committee of the U.S. House of Representatives.

Previously, Ms. Sophos was Budget Associate Staff and Legislative Director to Congressman Tom Loeffler; Legislative Assistant to the Director of the Office of Management and Budget; and a Legislative Representative at the National Food Processors Association.

Ms. Sophos received a B.S. in Political Studies (1976) from Pitzer College, The Claremont Colleges, Claremont, California. She resides in Washington D.C.

oOo

NB-1359

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M. July 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 $ 20,800 million, to be issued July 18, 1991 This offering will provide about $ 3,500 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 17,290 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, July 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 $ 10,400 million, representing an additional amount of bills dated April 18, 1991, and to mature October 17, 1991 (CUSIP No. 912794 XK 5), currently outstanding in the amount of $ 7,220 million, the additional and original bills to be freely interchangeable.

182 -day bills (to maturity date) for approximately $ 10,400 million, representing an additional amount of bills dated January 17, 1991 and to mature January 16, 1992 (CUSIP No. 912794 XV 1), currently outstanding in the amount of $ 11,803 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 July 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 $ 682 million as agents for foreign and international monetary authorities, and $4,918 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-1360

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 Upon Delivery
Expected at 10 a.m.
July 10, 1991

STATEMENT OF MICHAEL J. GRAETZ
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

It is a pleasure to be here today to address issues and certain legislative proposals relating to the tax-exempt status of nonprofit hospitals.

My testimony will discuss generally the basic requirements for tax-exempt status of hospitals, including whether new standards of charity care are needed in light of the policy reasons for providing tax exemption to hospitals, and will comment specifically on two bills that would impose new requirements on tax-exempt hospitals: H.R. 1374, introduced by Congressman Donnelly, and H.R. 790, introduced by Congressman Roybal. John E. Burke, Assistant Commissioner of Internal Revenue, will address in his testimony issues that were raised in the hearing announcement and more specifically in correspondence from the Committee regarding the Service's administration of the Federal tax exemption for hospitals. Before discussing the legislative proposals, I shall first review the role of tax-exempt hospitals in providing health care, the benefits to hospitals of tax-exempt status and the legal requirements and economic rationale for their tax exemption.

THE ROLE OF TAX-EXEMPT HOSPITALS IN PROVIDING HEALTH CARE

Categories of Health Expenditures. Health care ranges from routine checkups and treatment of relatively mild illnesses to hospital stays of various durations and intensity of care. Health care expenditures include, for example, expenditures for services of physicians and other health care professionals, drugs, vision products, and other medical supplies, in addition to expenditures on hospital care. Estimates of national health expenditures in 1989, the most recent data available, show that about $233 billion -- 38.5 percent of national health expenditures -- was spent on hospital care. As Table 1 illustrates, about one-half of U.S. hospitals are private, nonprofit tax-exempt institutions, and they account for nearly 65 percent of hospital expenses. About one-third of U.S. hospitals are government owned and about 17 percent operate for profit. Any changes to the requirements for tax exemption of nonprofit hospitals would therefore affect only a portion -- but a significant portion -- of the health care industry.

<u>Sources of Health Care Payments</u>. Most Americans have some form of health insurance. Medicare, which covers most persons over 65, and Medicaid, which provides medical assistance to many low-income persons, are the two largest public insurance programs, accounting for over 60 percent of government expenditures for health care. As Table 2 illustrates, Federal, state and local funds account for more than 40 percent of total health expenditures. About 20 percent of health expenditures are paid out-of-pocket by health-care recipients and 33 percent by private insurance.

<u>Access to Care</u>. Although most Americans have some form of health insurance, over 30 million Americans are uninsured. About 70 percent of the uninsured have incomes above the poverty level. Only 20 percent of the uninsured are adults out of work for a full year (or their children). More than half of uninsured Americans are between the ages of 25 and 64. Uninsured people are not necessarily without access to health care. They pay for about one-half of the care they receive from their own funds. The remainder is provided by public facilities or provided as "uncompensated care" by hospitals and other institutions. The uninsured are more likely to use emergency room care and less likely to use office, clinic, or regular inpatient care than those who have insurance.

<u>Effects of Tax-Exempt Status on Hospitals' Sources of Capital</u>. Under the Federal tax law, as well as under state nonprofit law, a tax-exempt hospital is not permitted to distribute its net earnings to members, shareholders or other private persons. A nonprofit hospital cannot raise funds by selling equity interests. Charitable contributions constitute a very small portion -- approximately 5 percent -- of nonprofit hospitals' net income. Accordingly, tax-exempt hospitals raise most of their capital either through borrowing or through retained earnings, and borrowing must be financed and retired through retained earnings.

BENEFITS OF TAX EXEMPTION

Three significant Federal income tax benefits are granted to hospitals that are tax-exempt under section 501(c)(3):

- The net earnings of tax-exempt hospitals, if any, are exempt from income tax. The value of this exemption obviously depends upon the profitability of the particular hospital. In the aggregate, the value of the income tax exemption for hospitals is estimated to be about $1.5 billion in 1992.

- Charitable contributions to these hospitals are generally deductible by donors. The value of this tax benefit is estimated to be about $0.6 billion in 1992.

- Tax-exempt hospitals are permitted to issue tax-exempt bonds.[1] For tax-exempt hospitals, it is estimated that the value of the exclusion of interest income from bondholders' income will be about $3.3 billion in 1992.

In addition, tax-exempt hospitals may enjoy state and local tax benefits, such as property tax exemption, and are entitled to certain nontax benefits. Similar tax and nontax benefits are generally accorded to hospitals operated by the Federal and state and local governments.

TAX-EXEMPT STATUS OF NONPROFIT HOSPITALS

<u>The Statute and Regulations Require Public Benefit</u>. Section 501(c)(3) of the Internal Revenue Code generally confers tax exemption on any organization "organized and operated exclusively for religious, charitable, scientific, . . . or educational purposes" but only if "no part of [the organization's] net earnings [inure] to the benefit of any private shareholder or individual." The regulations under section 501(c)(3) provide that --

> [t]he term "charitable" is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt

---

[1]Generally, under section 145, a section 501(c)(3) organization is limited to an aggregate outstanding amount of $150 million in tax-exempt bonds, but hospitals are not subject to any dollar limit.

purposes which may fall within the broad outlines of "charity" as developed by judicial decisions.[2]

The regulations also provide that an organization is not organized and operated exclusively for exempt purposes if it serves a private rather than a public interest:

> Thus, . . . it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.[3]

These regulations were adopted in 1959. A short review of the interpretation of the term "charitable" prior to the adoption of the regulations may be useful, however.

Congress enacted the first statute providing tax exemption for charities in 1894. The Supreme Court has determined that, at the time of enactment, the term "charity" meant, among other things, trusts for the benefit of the community, and the Court concluded that Congress conferred tax-exemption on charities "because they provide a benefit to society."[4] In 1938, Congress indicated that the term charity requires public benefit: "the benefits resulting from the promotion of general welfare."[5] The Supreme Court found in the Bob Jones case "unmistakable evidence that, underlying all relevant parts of the Code, is the intent that entitlement to tax exemption depends on meeting certain common-law standards of charity -- namely, that an institution seeking tax-exempt status must serve a public policy and not be contrary to established public policy."

This broad public policy standard, however, was not reflected in early Treasury regulations, and, in 1956, Treasury proposed regulations under section 501(c)(3) that would have limited organizations qualifying as "charitable" to "organizations for the relief of poverty, distress, or other

---

[2]Treas. Reg. § 1.501(c)(3)-1(d)(2).

[3]Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

[4]Bob Jones University v. United States, 461 U.S. 574, 589 (1983).

[5]H.R. Rep. No. 1860, 75th Cong. 3d Sess. 19 (1938).

conditions of similar public concern." Even this proposed regulation, however, provided that "a hospital may require payments for services from those able to pay, and this will not necessarily preclude exemption."

Also in 1956, the Service published Revenue Ruling 56-185,[6] specifically illustrating the requirements for a hospital to qualify for exemption. The ruling provided, among other things, that a hospital "must be operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay." This requirement came to be known as the "financial ability" standard.

Three years later, in 1959, the Service issued final regulations under section 501(c)(3). These regulations redefined "charitable" in its "generally accepted legal sense" as developed in the common law. However, the Service did not specifically issue further published guidelines on the treatment of hospitals as charitable organizations until 1969. In that year, it published Revenue Ruling 69-545,[7] revoking the financial ability standard established by Revenue Ruling 56-185, and acknowledging that the promotion of health is charitable in the generally accepted legal sense of the term. Revenue Ruling 69-545 held that a hospital may qualify for exemption under section 501(c)(3) even though it does not provide free or below-cost care to patients who are unable to pay. Citing the <u>Restatement (Second) of Trusts</u> and the well-known treatise <u>Scott on Trusts</u>, the ruling concluded that the promotion of health is charitable because --

> like the relief of poverty and the advancement of education and religion, [it] is one of the purposes in the general law of charity that is deemed beneficial to the community as a whole even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community, such as indigent members of the community, provided that the class is not so small that its relief is not of benefit to the community.

---

[6] 1956-1 C.B. 202.

[7] 1969-2 C.B. 117.

The standard articulated by Revenue Ruling 69-545 is known as the community benefit standard, and this ruling has been upheld in litigation.[8]

Revenue Ruling 69-545 concluded that a hospital satisfies the community benefit standard by providing health care to all persons in the community able to pay, either directly or by third-party reimbursements, and by operating an emergency room open to all members of the community regardless of their ability to pay. In 1983, the Service ruled that a hospital that does not operate an emergency room may nonetheless satisfy the community benefit standard where a state agency has determined that operation of an emergency room is unnecessary because it would duplicate emergency facilities and services that are adequately provided by another institution in the community, or where the hospital specializes in forms of medical care limited to special conditions unlikely to necessitate emergency care.[9]

<u>The Community Benefit Standard of Current Law Reflects the Economic Rationale for Tax Exemption</u>. The current-law community benefit standard for hospitals, drawn from earlier common law, reflects the basic economic rationale for the public policy underlying tax exemption for nonprofit hospitals. Although the nature of hospitals and their role in the health care system have undergone several fundamental shifts since the adoption of the income tax, nonprofit hospitals' economic activities provide a continuing rationale for their tax exemption under the Code.

<u>Research and Innovation</u>. An economic rationale for tax exemption is that nonprofit hospitals are able to provide services that are not provided or are inadequately provided by for-profit hospitals because the market prices charged by hospitals do not reflect the benefit the hospitals' services

---

[8] <u>Eastern Kentucky Welfare Rights Organizations v. Simon</u>, 506 F.2d 1278 (D.C. Cir. 1974), <u>rev'g Eastern Kentucky Welfare Rights Organization v. Schultz</u>, 370 F. Supp. 325 (D.D.C. 1973), <u>vacated on other grounds</u>, 426 U.S. 26 (1976).

[9] Revenue Ruling 83-157, 1983-2 C.B. 94. Additional factors that would indicate community benefit in cases where a hospital was not required to have an emergency room were that the hospital had a board of directors drawn from the community, an open medical staff policy, treated persons paying their bills with the aid of public programs like Medicare and Medicaid, and applied any surplus to improving facilities, equipment, patient care, and medical training, education and research.

confer on the community as a whole.[10] For example, medical research benefits everyone, not just the patients in the hospital where the research is conducted. Because it is impossible for a hospital to obtain payment from all of the beneficiaries of its research, too little hospital research would be conducted if we relied solely upon private markets to provide such research. As a result, government subsidies in some form are appropriate to achieve a proper level of medical research. Such research is typically conducted in the tax-exempt sector -- at university-affiliated hospitals and at specialized medical institutes.

Medical Teaching. Teaching medical practitioners benefits the community at large and hence may also merit government subsidization. This activity also is typically conducted in the tax-exempt hospital sector.

Care for Low-Income Patients. Nonprofit hospitals may be more willing to care for low-income patients because they have no profit motive. This is a complex matter to evaluate because available data may not be reliable. Hospitals may provide care to low-income patients in a variety of ways, and nonprofit hospitals have not yet developed uniform standards for reporting the amount of such care they provide. As a result, data on the provision of uncompensated care is incomplete, sometimes conflicting, and difficult to interpret. Many hospitals, for example, do not include shortfalls from state Medicaid payments relative to their costs in accounting for "uncompensated care." Some hospitals may, for example, offer free health screening, nutritional services, preventive health clinics, patient counseling, or other services to the poor without billing them -- services that may not appear in any hospital statistics.

Although controversial, the data that are available suggest that nonprofit hospitals provide more services to low-income persons than their for-profit counterparts. For example, a 1981 Office of Civil Rights study found that nonprofit hospitals were somewhat less likely than for-profit hospitals to have fewer than 5 percent uninsured admissions, and somewhat more likely to have disproportionately higher shares of uninsured patients.[11] A study based on data from the 1979-1984 National Hospital Discharge survey found that for-profit hospitals serve

---

[10]In the economics literature, such benefits are labelled "external benefits" or "externalities."

[11]Reported in, "Access to Care and Investor-Owned Providers" in Bradford H. Gray, ed., *For-Profit Enterprise in Health Care*, Institute of Medicine, National Academy Press, 1986.

significantly lower percentages of both uninsured and Medicaid patients than do nonprofit and public hospitals.[12] A 1990 GAO study similarly found that nonprofit hospitals as a group provide more uncompensated care than do for-profit hospitals.[13] Another study, conducted by Lewin and Associates, critiqued several earlier studies that had found little significant difference between nonprofit and for-profit hospitals in their level of charity care and suggested that nonprofit hospitals provide significantly more uncompensated care than for-profit hospitals.[14]

All of these studies found substantial variations among hospitals and that government hospitals provide more uncompensated care than nonprofit hospitals. There are also variations from state to state and among differing communities within states. Some additional evidence also suggests that for-profit hospitals tend to locate in areas with higher income, broader insurance coverage, and fewer Medicaid patients, thereby limiting the number of low-income patients that they are asked to treat. For-profit hospitals also seem to be more likely to discourage admissions of low-income patients and to offer services that are used disproportionately by high-income patients, and apparently are less likely to offer services that might benefit low-income patients, or to offer care at reduced rates.[15]

Community Services. Hospitals may also engage in many other activities that benefit the community. These community services include, for example, health screening and education, temporary housing for patients and their families, immunization, and transportation. The GAO nationwide survey of hospital

---

[12] Frank, R.G., D.S. Salkever and F. Mullann, "Hospital Ownership and the Care of Uninsured and Medicaid Patients: Findings from the National Hospital Discharge Survey 1979-1984," *Health Policy*, 14/1, 1990.

[13] U.S. General Accounting Office, *Nonprofit Hospitals: Better Standards Needed for Tax Exemption*, GAO/HRD-90-84, May 1990.

[14] Lewin, Lawrence S., Timothy J. Eckels, and Dale Roenigk, *"Setting the Record Straight: The Provision of Uncompensated Care By Not-For-Profit Hospitals,"* Lewin and Associates, Inc., April 1988.

[15] Marmor, Theodore M., Mark Schlesinger and Richard W. Smithey, "Nonprofit Organizations and Health Care," in Walter W. Powell, ed., *The Nonprofit Sector: A Research Handbook*. New Haven: Yale University Press, 1987, 231-32.

administrators found that a high proportion of hospitals provide community services. However, nonprofit hospitals were more likely than for-profit hospitals to provide these services and provided them to more people. Nonprofit hospitals were also more likely to target services to low-income individuals.[16]

Quality of Care. Because of the complex nature of the services provided by hospitals, patients generally are not able to evaluate the quality of care they are receiving; they must rely upon the hospital and physicians to monitor the quality of the hospital's services.[17] Hospitals that maximize profits to shareholders may have an incentive to provide lower quality care to patients unable to know whether they have received the best or even appropriate treatment.[18]

* * *

Lack of reliable data, coupled with wide variations in hospitals' accounting practices, locations, the populations they serve and the services they offer, make it impossible to know whether the present combination of tax and other government subsidies is the best practical mechanism for giving nonprofit hospitals the necessary incentives and resources to provide an economically more efficient level of services that benefit the community. On the other hand, standing alone, a nonprofit hospital's loss of tax exemption can be expected to reduce the level of the hospital's activities that benefit its community.

PROPOSED LEGISLATION

H.R. 790. H.R. 790, introduced by Congressman Roybal on February 4, 1991, provides that a hospital will not be exempt from tax under section 501 unless it has an open-door policy toward Medicare and Medicaid patients, serves in a nondiscriminatory manner a reasonable number of such patients and provides in a nondiscriminatory manner specified amounts of qualified charity care and qualified community benefits. The bill would require that the hospital's unreimbursed qualified

---

[16]GAO, pp. 38-43.

[17]In the economics literature, this circumstance is referred to as a case of "asymmetric information."

[18]Marmor, et.al., 230.

charity care costs[19] be at least 50 percent of the value of its tax-exempt status for the year and that its unreimbursed qualified community benefits[20] costs be at least 35 percent of the value of its tax-exempt status for the year.

The bill would value a hospital's tax exemption for a taxable year as a national average percentage of its gross receipts -- the percentage that, when applied to the estimated average gross receipts of tax-exempt hospitals in the United States for the taxable year, will yield an amount equal to the average Federal, state, and local tax revenues that are foregone by reason of hospitals' exempt status. This percentage is to be lowered if necessary to ensure that at least 75 percent of nonprofit hospitals will meet these requirements for exemption.[21]

The bill would revoke a hospital's tax-exempt status only in the most egregious cases; instead, it would impose a 100 percent excise tax on a hospital that has a charity-care or community benefit shortfall in a year (that is, the tax would be equal to the shortfall). This tax would be waived for the first year of a shortfall, but the existence of the shortfall would be published in the Federal Register. The Secretary would have the discretion to increase the tax (up to 1 percent of the hospital's gross receipts). Receipts from this excise tax would be dedicated to providing additional Federal Medicaid matching funds to the state

---

[19]"Qualified charity costs" are the hospital's costs in providing free or discounted health care to those with limited or no ability to pay, bad debts, excess Medicaid costs over reimbursements, and, if the community has too few charity-care patients needing hospital care, the direct or indirect costs of providing health care or services to the medically underserved and disadvantaged in the community.

[20]"Qualified community benefits" are the hospital's "unreimbursed costs in providing those community benefits not customarily provided by hospitals that are not exempt from tax," and the excess of the unreimbursed qualified charity-care costs over 50 percent of the value of tax exemption.

[21]The Secretary is required to adjust this percentage (up or down) where appropriate in the case of a particular hospital, taking into account the hospital's financial and other factors. Within two years of enactment, Treasury must implement, if feasible, a methodology for measuring the Federal, state, and local tax revenues foregone by reason of the tax-exempt status of a hospital, and shall report to Congress any recommendations for modifying these charity care/community benefit standards.

in which the hospital is located, to be used only to pay for hospital charity care.

H.R. 790 would be effective for taxable years beginning after December 31, 1993, except that new reporting requirements would apply to taxable years beginning after December 31, 1991.

H.R. 1374. H.R. 1374, introduced by Congressman Donnelly on March 12, 1991, would impose three requirements on hospitals as a condition of income tax exemption under section 501:

(1) The hospital, in general, would be required to operate an emergency room open to all members of the community. This requirement would be waived in the case of specialty hospitals and in any case where operating an emergency room is duplicative in the community. Hospitals violating the patient-dumping statute under the Medicare program would be conclusively presumed to have violated this requirement.[22]

(2) The hospital would be prohibited from discriminating against Medicaid beneficiaries and would be required to have a Medicaid provider agreement.

(3) The hospital would be required to fulfill at least one of the following five criteria:

(a) It is a sole community hospital;
(b) It is receiving the Medicare or Medicaid disproportionate share adjustment;
(c) Its disproportionate patient percentage (as defined for purposes of the Medicare program) is statistically similar to other hospitals in the community;
(d) It devotes 5 percent of its gross revenues to providing charity care (defined not to include bad debts or contractual allowances); or
(e) It devotes 10 percent of its gross revenues to qualified services to the community (such as health clinics in medically underserved areas).

A hospital that becomes a nonqualified hospital by failing to meet either of the first two requirements would lose its income-tax exemption for a minimum of two years. If it fails only the third requirement, the hospital could preserve its tax

---

[22]Generally, section 1867 of the Social Security Act requires hospitals that have emergency rooms to screen all individuals seeking medical attention (whether or not eligible for Medicare and regardless of ability to pay) to determine whether an emergency medical condition exists and, if so, to stabilize the medical condition before the patient may be transferred.

exemption by electing instead to pay a 10 percent penalty (100 percent in the second year) on the excess of 10 percent of gross revenues over the cost of charity care it actually provides in the year of failure. A hospital would be considered to be a nonqualified hospital even if it elects to pay the excise tax. Becoming nonqualified would not affect the exclusion from income for interest earned on the hospital's outstanding bonds, but a nonqualified hospital would not be permitted to issue additional tax-exempt bonds, nor would a nonqualified hospital be eligible to receive tax-deductible charitable contributions or bequests.

The tax exemption requirements of the bill generally would be effective on the earlier of January 1, 1993, or the date on which the hospital is in compliance with those requirements. The reporting requirements would be effective for taxable years beginning after December 31, 1991.

ADMINISTRATION POSITION

In General. The Administration continues to believe that community benefit is a more appropriate standard for evaluating the tax-exempt status of hospitals than the proposed charity-care standards. A community-benefit standard reflects the long-standing proposition that the promotion of health is a charitable purpose and recognizes the potential for a variety of means for fulfilling that purpose in this nation's diverse communities. By treating private nonprofit and government hospitals the same under Federal tax law, a community-benefit standard encourages pluralistic alternatives to government activity -- the raison d'être for tax exemption.[23]

Under a specific charity-care standard, hospitals will have an incentive to divert their free or reduced cost services to the form of care that best protects their tax-exempt status. Thus, a specific charity-care requirement may bias the health care system toward providing services to low-income persons in the form of hospital care rather than preventive and other less costly forms of medical care. It also might decrease nonprofit hospitals' expenditures for other activities, such as research and teaching, that contribute to the well-being of the community. Neither tax nor health policy would be advanced if nonprofit hospitals were

---

[23]Both H.R. 790 and H.R. 1374 might in some cases result in differential Federal tax treatment of nonprofit and government hospitals. Both bills would impose their charity-care standards and Federal tax sanctions only on nonprofit hospitals. As a result, a nonprofit hospital would be subject to Federal taxation and lose other Federal tax benefits, even though it might provide a higher level of "charity care" than some government-operated hospitals.

simply to substitute one set of activities for another with no net increase in their overall provision of community benefits.

In addition, hospitals may fund any new charity-care requirement by diverting capital that they otherwise would have used to finance expanded or improved plant and equipment. This diversion of capital may simply shift the benefits of tax exemption from future to current patients by reducing the quantity and quality of hospital care available to the community in the future and thereby cause an increase in the burden on the public hospital system in the long run.

The charitable purpose required for tax exemption is served whenever hospitals provide uncompensated care to uninsured or inadequately insured patients, whether or not the recipient is at or below the poverty level. We do not regard it as appropriate in determining whether a hospital merits tax exemption to disregard the provision of below-cost care to a middle-income family that might be financially devastated by a costly illness. Moreover, hospitals should not be disadvantaged simply because they direct services to other populations with medical needs, including the elderly, the homeless, people with AIDs or other diseases, or sufferers from drug, spousal or child abuse.

Because hospitals typically obtain a small portion of their funds from investment income and charitable contributions, increasing charity care would likely be financed, at least in part, by increased charges to insured patients, perhaps including those insured by governmental programs such as Medicare and Medicaid. If increased charitable care were financed by increased charges to insured patients, insurance and out-of-pocket costs to patients will increase commensurately. To the extent these increased charity-care costs are reflected in increased insurance costs to employers, they may respond by decreasing coverage and, even if they maintain existing levels of coverage, the tax expenditure for their health insurance deductions will increase. Since any additional costs of a charity-care requirement may well be borne by Federal, state and local governments, fundamental changes in the requirements for tax exemption, such as those before the Committee today, should be undertaken, if at all, only in the context of a broader reexamination of government policies regarding health care.

H.R. 790. The Administration opposes H.R. 790. We have two principal concerns with this bill. The first is that it would replace the community-benefit standard of existing law with a charity-care standard to evaluate the tax-exempt status of hospitals. For the reasons advanced above, we do not regard such a change as appropriate as a matter of tax policy. Second, the bill requires a hospital to spend an amount on "qualified charity care" measured by a national average value of tax exemption for hospitals, taking into account the Federal, state and local tax revenues foregone by reason of their tax-exempt status. By definition, this would require all hospitals for which the value of exemption is less than the national average to spend an amount greater than their tax benefits on charity care. In an effort to remedy this difficulty the bill requires the Secretary to make case-by-case modifications for individual hospitals if the number derived on a national basis is "inappropriately high or low." This would seem to require an annual evaluation for each tax-exempt hospital to determine whether the national number is appropriate as applied to that hospital. We would also expect challenges to Treasury's determination of the national average value of hospitals' tax exemptions.

H.R. 1374. As described above, H.R. 1374 incorporates elements of both a community-benefit standard and a charity-care standard. We have the following specific comments concerning the bill:

Emergency Room Requirement. The bill requires that a hospital operate an emergency room open to all members of the community except in the case of specialty hospitals and where it is duplicative of emergency facilities in the community. This provision represents a codification of the Service's existing interpretation of the community-benefit standard, and generally, under that standard, a hospital must operate an emergency room to qualify for tax-exempt status. Although the Service has not published guidance concerning the relationship between Medicare's patient-dumping provisions and the emergency room requirement, we believe that compliance with the anti-dumping statute is implicit in the requirement of an emergency room open to all without regard to ability to pay. Accordingly, the Administration does not oppose these provisions of the bill, although we do have some suggestions for clarification. For example, to avoid problems under the statute of limitations, the bill should be clarified to provide that any tax penalty that flows from a violation of the anti-dumping provisions will be imposed in the year the determination by the Department of Health and Human Services occurs, not in the year of the violation.

Nondiscrimination Against Medicaid Patients. We believe that the community-benefit standard of current law prohibits discrimination against Medicaid patients. Therefore, the Administration does not oppose this requirement of H.R. 1374. We are concerned, however, that the requirement that a hospital have a Medicaid provider agreement may not be appropriate in all cases. For example, at least one state, California, contracts for nonemergency Medicaid services with only a limited number of hospitals through a negotiation process. It does not seem appropriate to disadvantage hospitals in states that are unwilling to enter into Medicaid provider agreements.

The bill also seems to require the Internal Revenue Service to determine independently whether a hospital that has entered into a Medicaid provider agreement consistently engages in the systematic practice of refusing services to Medicaid patients. Such a determination seems more appropriately delegated to the Department of Health and Human Services, so that the Service would not be required to duplicate the personnel and expenditures that Department already dedicates to this type of determination.

Expenditures for Community Benefit and Charity Care. In addition to meeting the emergency room and nondiscrimination requirements, the bill requires that hospitals satisfy at least one of five additional alternative tests to maintain their tax-exempt status. The Administration opposes these requirements, although hospitals that meet the emergency room and nondiscrimination requirements plus any of these requirements presumably would qualify for tax exemption under the community-benefit standard of present law. Two of the alternatives -- devotion of 5 percent of gross revenues to charity care or devotion of 10 percent of gross revenues to qualified community services -- would impose an undesirable rigidity in determining which hospitals qualify for tax exemption for the reasons articulated above. In addition, defining what constitutes "charity care" or "qualified services" would be difficult. It is unclear, for example, whether charity care should be measured by the amount of charges foregone by a hospital or by the costs the hospital incurs in providing the care. If charity care were measured on the basis of foregone charges, a hospital with higher charges will appear to be providing more charity care than a hospital with lower charges even if the services it delivers are the same; on the other hand, if charity care were measured by costs, hospitals with greater overhead costs might more easily meet the requirements.

Measurement of the amount of charity care is also complicated by the presence of Medicaid and other state and local programs that provide medical care for low-income persons. Because Medicaid and other programs may reimburse hospitals at lower rates than paying patients, patients covered by these programs may represent some element of charity care even though the hospital receives at least partial payment. Bad debts, which hospitals traditionally have included in their accounting for "uncompensated care," may also present problems of measurement because some are incurred by patients who cannot afford to pay and others are incurred by patients who can afford but do not choose to pay. Many hospitals make no distinction for accounting purposes between the two types of bad debt.

Sanctions. Both H.R. 790 and H.R. 1374 impose new sanctions on hospitals that become nonqualified for tax exemption. For example, under H.R. 1374, a hospital that becomes nonqualified by failing to maintain an open emergency room or a nondiscrimination policy would lose its exemption from Federal income tax for a minimum two-year period. If a hospital satisfies these requirements but fails to satisfy the additional requirements of the bill, as an alternative to losing its exemption, it may pay an amount equal to 10 percent (100 percent in the second year) of the excess of 10 percent of gross revenues over the cost of charity care actually provided by the hospital during the year. Under H.R. 790, a nonqualifying hospital would have to pay an excise tax equal to its charity-care or community-benefit shortfall for the year.

The sole sanction for noncompliance under current law -- loss of tax-exempt status -- may merit reexamination. However, the issue whether the tax law might be improved by imposing sanctions other than loss of tax exemption and the possibility of permitting institutions to correct disqualifying behavior is not limited to hospitals but rather applies to tax-exempt institutions generally. Making revocation of tax exemption the only sanction seems particularly inappropriate when, as under this proposed legislation, a hospital might be disqualified due to small and perhaps inadvertent failures to meet specified requirements.

We do not, however, believe that a temporary loss of tax-exempt status is a viable alternative sanction in any circumstance. Many complex tax issues would arise in connection with the transition from tax-exempt to taxable status, and the transition from taxable back to tax-exempt status. One major issue involves the appropriate treatment of assets held by the hospital at the time of revocation and the treatment of contributions by donors. For example, when Congress denied tax-exemption to Blue Cross and Blue Shield organizations, it provided a transitional rule that marked to market the basis of their assets for purposes of determining gain or loss as of the date they became taxable. If a similar rule were extended to hospitals that temporarily lose tax-exempt status, it would impose substantial administrative and compliance burdens on both the Service and the hospitals.

Any intermediate sanction for tax-exempt organizations should be modeled on the private foundation excise tax provisions and impose a monetary penalty on the organization (or perhaps its responsible officers) in the year it becomes nonqualified. The amount of the excise tax should be imposed only in response to conduct by the organization that is readily determinable on audit. In particular, we are concerned that an excise tax based on the amount of charity care provided by a hospital would prove very difficult to administer.

* * *

Mr. Chairman, this concludes my prepared remarks. I would be pleased to answer any questions the Committee might have.

Table 1

Number of Hospitals, Number of Hospital Beds, and Hospital Expenses by Type of Hospital, 1989

	Hospitals		Beds		Expenses	
	Number	Percent of Total	Number (000)	Percent of Total	Amount ($ billions)	Percent of Total
Total	6,720	100.0	1,226	100.0	214.2	100.0
Nonprofits	3,424	51.0	683	55.7	139.4	65.1
For-Profits	1,145	17.0	136	11.1	20.6	9.6
Government	2,151	32.0	407	33.2	54.2	25.3
Federal	340	5.1	101	8.2	14.4	6.7
State and local	1,811	26.9	306	25.0	39.8	18.6

Department of the Treasury
Office of Tax Analysis

July 3, 1991

Source: American Hospital Association, "AHA Hospital Statistics 1990-1991," Tables 2A and 2B.

Table 2

National Health Expenditures by Source of Funds in 1989

	Amount ($ billion)	Percent of Total
Total	604.1	100.0
Private funds, total	350.9	58.1
Out-of-pocket	124.8	20.7
Private insurance	199.7	33.1
Other	26.3	4.4
Government, total	253.3	41.9
Federal	174.4	28.9
State and local	78.8	13.0
Exhibit		
Medicare	99.8	16.5
Medicaid	59.3	9.8

Department of the Treasury
Office of Tax Analysis

July 1, 1991

Source: Department of Health and Human Services, Health Care Financing Administration, Health Care Financing Review, Winter 1990, Vol. 12, No. 2, Tables 12 and 13.

TREASURY NEWS

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

For Release Upon Delivery
Expected at 1:30 p.m.
July 10, 1991

STATEMENT OF
THOMAS D. TERRY
BENEFITS TAX COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON RETIREMENT INCOME AND EMPLOYMENT
SELECT COMMITTEE ON AGING
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to present the views of the Department of the Treasury on certain issues relating to private pension plan coverage. My testimony will address issues relating to the Administration's proposals for pension simplification, coverage and portability raised in the Subcommittee's letter of invitation to testify.

On April 30, 1991, Secretary of Labor Martin announced Administration proposals to simplify the law governing retirement plans, to expand pension coverage and to increase pension portability. These proposals were developed through the joint efforts of the Department of the Treasury and the Department of Labor.

Last month, Chairman Rostenkowski introduced H.R. 2730, the "Pension Access and Simplification Act of 1991," which includes pension coverage and simplification proposals along the lines of many of the Administration's proposals. Several other pension bills have been introduced in Congress in the last few weeks. The Administration intends to continue to work with Congress in an effort to enact legislation that addresses our common concerns.

Pension portability and related pension coverage issues have long been a public policy concern. Simplifying the taxation of pension distributions, expanding pension coverage and enhancing pension portability will serve to strengthen the role of private pension plans in providing retirement income security for employees.

The Internal Revenue Code provisions relating to retirement plans have become increasingly complex in recent years. This complexity reflects the sophistication and wide variety of plans. Given the complexities of the underlying business arrangements, the tax laws relating to employee benefits in general and the tax qualification requirements for retirement plans in particular will never be "simple." But they can be less complex than they are now. Reducing complexity would benefit employers and employees as well as the tax administrator, and also offers the prospect of improved compliance.

The Administration's proposals include a number of amendments to the Internal Revenue Code which would contribute substantially to our goals of simplifying the pension tax law, expanding pension coverage and enhancing pension portability. These proposals would:

- Simplify and encourage tax-free "rollovers" of pension distributions into IRAs by allowing all plan distributions to be rolled over, except distributions which are made in the form of a life annuity or in installment payments over 10 years or more. The current law restrictions on rollovers of after-tax employee contributions and minimum required distributions would be retained. The favorable income tax treatment for pension distributions which are not rolled over -- the special averaging rules and the deferral of tax on the appreciation on employer securities -- would be repealed.

- Establish a new simplified employee pension program for employers with 100 employees or less. The Small Business Administration estimates that these programs would be available to 98 percent of America's businesses.

- Simplify the administration of 401(k) plans while continuing to require them to provide proportionate benefits to lower paid employees.

- Make 401(k) plans generally available to employees of tax exempt organizations and state and local governments. The Department of Labor estimates that this would extend the availability of 401(k) plans to about 12 million employees -- 3.1 million of whom currently have no pension coverage.

- Simplify the definition of "highly compensated employee" for purposes of the employee benefit provisions of the Code and repeal the complex family aggregation rules.

- o Conform the vesting requirements for multiemployer plans to the existing requirements for single employer plans.

The remainder of my testimony will discuss the specific questions the Subcommittee has asked that I address.

Simplified employee pensions ("SEPs")

Much of the complexity of the pension tax rules is due to the flexibility in plan design available for qualified plans under the Internal Revenue Code. This flexibility is desirable in a voluntary private pension system and should be given substantial weight in evaluating proposals for pension simplification. At the same time, plan sponsors, particularly small business employers, should have a straight forward program available to them so they can avoid the complexity that comes with sophisticated plan designs.

The Administration's proposal would replace the existing salary reduction SEP with a new simplified program. Under the proposal, employers with 100 or fewer employees and no other retirement plan would be relieved from testing for nondiscrimination if they make a base contribution for each eligible employee of 2 percent of pay (up to a maximum base contribution of $2,000). Employees could elect to contribute additional amounts to the plan through salary deferral up to $4,238 (one-half the limit on elective deferrals under 401(k) plans). In addition, the employer could make matching contributions of up to 50 percent of the employees' contributions. We believe that making these simpler plans -- with their promise of reduced administrative and compliance costs for the sponsor -- available and informing employers about their availability will encourage many employers to adopt the simpler plans.

You have asked what the experience has been regarding the adoption and use of SEPs by small employers and whether the adoption and utilization of salary reduction SEPs since this option was enacted in 1986 enables us to predict the expansion of coverage in the private sector. One of the primary advantages of SEPs from the standpoint of the employers who sponsor these programs -- the absence of Internal Revenue Service and Department of Labor reporting requirements -- unfortunately also limits the historical data on SEP utilization. For example, SEPs are not required to file annual reports (Form 5500) with the IRS. Such annual reports have been one of the most important sources of pension statistical data for researchers. Many of the other usual sources for collecting data with respect to pension coverage are also unavailable for SEPs. Last month, the Bureau of Labor Statistics released preliminary data from a survey of small establishments (with less than 100 employees). However, the data are limited to 1990 and do not reveal how the 1986 addition of the salary reduction option affected utilization.

Even if more data were available with respect to current utilization of salary reduction SEPs, they might not reveal the potential for expanded coverage under the Administration's proposal. The current salary reduction SEP may only be adopted by employers with 25 or fewer employees. As indicated above, in addition to simplifying the administration and testing of these plans, the Administration's proposal would permit employers with as many as 100 employees to adopt the program. Accordingly, we expect a greater response than under current law.

<u>Revenue related issues</u>

You have asked questions relating to the revenue losses for both individual retirement accounts ("IRAs") and 401(k) plans. The Treasury estimates that in 1990 there was a revenue loss of $6.6 billion associated with the provisions of current law providing for the deducibility of IRA contributions and the exclusion of IRA earnings from taxation. Although we have estimates of the revenue loss associated with all employer pension plans, we have not made specific estimates of the revenue loss associated with 401(k) plans.

You have also asked for utilization figures by income level for both IRAs and 401(k) plans. Because the Tax Reform Act of 1986 limited the availability of deductible IRAs to individuals without pension plans and individuals with gross income below a specified threshold (e.g., $50,000 for married taxpayers filing joint returns), participation in IRAs has fallen dramatically since 1986. For 1988, the most recent year for which we have tax return data on this point, the IRA participation rate is highest for the $30,000-$50,000 income group and second highest for the over $100,000 income group (based on adjusted gross income).[1] We do not have similar tax return data with respect to 401(k) participation. However, the May 1988 Census Population Survey, Employee Benefit Supplement (1988 CPS-EBS) did include questions and responses on 401(k) plan participation. The results of that survey indicate broad-based coverage of nonhighly compensated employees in businesses that maintain 401(k) plans.

You also inquire about the revenue effects of the Administration's proposal and ask which principal revenue raising provisions contribute to the revenue neutrality of the proposal.

---

[1] Internal Revenue Service, Statistics of Income - 1988, Individual Income Tax Returns.

Some of the specific provisions contained in the Administration's proposal raise revenue, while others lose revenue. In total, the Administration's proposal does not lose revenue. Most of the revenue is raised by the proposals simplifying the distribution rules (*e.g.*, the repeal of 5- and 10-year forward averaging treatment for lump sum distributions and the special tax treatment for net unrealized appreciation on employer securities).

<u>Preretirement distributions of retirement savings</u>

You have asked for the Treasury's view on the appropriateness of using pre-retirement lump sum distributions from IRAs and qualified plans for major purchases and other uses unrelated to retirement savings. The Administration believes that the special tax benefits accorded IRAs and employer-sponsored retirement plans are properly directed toward encouraging retirement savings. Accordingly, we have not supported various proposals that would expand penalty-free premature withdrawals from these tax-favored retirement vehicles for specified nonretirement purposes. The President's FY 1992 Budget proposal which would permit penalty-free IRA withdrawals for certain first-time home purchases is fully consistent with this policy as homeownership constitutes a principal source of retirement savings. Recognizing that individuals need to save for nonretirement reasons as well as retirement reasons, the President's FY 1992 Budget advances a proposal for a new savings vehicle, the Family Savings Account. The Family Savings Account Program would expand savings incentives to income that is saved for other than retirement purposes, while not eroding incentives for retirement savings.

You also asked whether we have statistics regarding the use of pension plan rollovers which were cashed out of the retirement income system over the last year. The most recent information which we have available is survey results from the 1988 CPS-EBS Survey covering the year 1987. In that year, of the individuals receiving lump sum distributions:

-- 20% rolled over all or a portion of the distribution into an IRA or another qualified plan.

-- 37% used all or a portion of the distribution for immediate consumption.

-- 26% put some or all of the distribution into a savings account or other financial instrument.

-- 26% used some or all of the distribution to buy a house, pay off a mortgage or pay off loans or other debts.

These percentages add to more than 100% because some of the individuals receiving distributions used them for more than one of the purposes listed.

Distributions which are neither rolled over nor used for current consumption may still be used for retirement purposes immediately or in the future. Thus, the after-tax proceeds of a distribution from a qualified plan may be used to buy a house or pay off a mortgage. As indicated above, the investment in a home often provides another means of saving for retirement. Also, the after-tax proceeds of a distribution may be held in a savings account or other financial investment and later be used to provide income in retirement.

Treasury has not advocated a prohibition of nonretirement withdrawals to better ensure retirement income security. An outright ban on nonretirement withdrawals from those retirement plans that provide for employee contributions or salary deferrals would likely lead to lower participation and contribution rates. Employees might not contribute to the plans if amounts would in no circumstances be available before retirement, even to meet unforeseen emergencies. Thus, we are concerned that such a ban might result in a decrease in the rate of retirement savings in 401(k) plans and IRAs by individuals.

On the other hand, unlimited free access to retirement savings would almost certainly result in premature consumption of retirement savings for other purposes. The current statutory scheme strikes a balance between an outright ban on withdrawals and unlimited free access by providing a disincentive in the form of an additional 10 percent "penalty" tax on premature withdrawals. You have also asked whether, in the Treasury's view, the present penalties on premature withdrawals are inadequate to enforce private savings in IRAs and 401(k) plans. We regard the present penalties as adequate and we do not have any data that would indicate otherwise. The 1988 EBS-CPS Survey data for the first year the additional tax was in effect suggests that the tax encourages individuals to keep their retirement savings in the retirement income system. We also believe that the Administration's proposal to repeal the special income tax treatment currently available with respect to lump sum distributions from retirement plans, coupled with the proposal to make most non-annuity retirement distributions eligible to be rolled over into an IRA or other qualified plan, will further encourage individuals to keep their retirement savings in the retirement income system.

Mr. Chairman, Members of the Subcommittee, that concludes my formal statement. I will be pleased to answer any questions that you may wish to ask.

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
July 10, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 7-YEAR NOTES

Tenders for $9,003 million of 7-year notes, Series G-1998, to be issued July 15, 1991 and to mature July 15, 1998 were accepted today (CUSIP: 912827B50).

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

	Yield	Price
Low	8.25%	100.000
High	8.26%	99.948
Average	8.26%	99.948

$1,105,000 was accepted at lower yields.
Tenders at the high yield were allotted 91%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	21,121	21,121
New York	19,662,572	8,552,872
Philadelphia	13,767	13,767
Cleveland	25,388	25,388
Richmond	35,448	34,358
Atlanta	23,561	18,381
Chicago	934,062	232,112
St. Louis	18,983	18,983
Minneapolis	12,548	12,003
Kansas City	22,756	22,756
Dallas	9,143	9,143
San Francisco	259,147	32,147
Treasury	9,549	9,549
TOTALS	$21,048,045	$9,002,580

The $9,003 million of accepted tenders includes $553 million of noncompetitive tenders and $8,450 million of competitive tenders from the public.

In addition, $118 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $534 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1363

TREASURY NEWS

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

EMBARGOED UNTIL GIVEN
EXPECTED AT 11:00 A.M.

TESTIMONY OF
THE HONORABLE JEROME H. POWELL
ASSISTANT SECRETARY OF THE TREASURY
FOR DOMESTIC FINANCE
BEFORE THE SUBCOMMITTEE ON
COMMERCE, CONSUMER PROTECTION, AND COMPETITIVENESS
OF THE
HOUSE COMMITTEE ON ENERGY AND COMMERCE

July 11, 1991

Chairwoman Collins, Mr. McMillan, and members of the Subcommittee, thank you for this opportunity to discuss the insurance aspects of the Administration's comprehensive banking reform legislation, H.R. 1505, as well as recent modifications by the House Committee on Banking, Finance and Urban Affairs. We are convinced that modernization of current banking laws is the only permanent solution to the ills now affecting commercial banks, which are draining the bank insurance fund and threatening the taxpayer. Creating a sound structure for profitable affiliations between insurance companies and well-capitalized banks is a key aspect of this reform that will bring substantial benefits to consumers.

Before addressing specific insurance provisions, let me make several broader points about the comprehensive nature of this legislation. The Administration's proposal addresses the fundamental problems of the banking system -- rather than simply funding them. It would do so by decreasing the exposure of the federal safety net, providing prompt corrective action for troubled banks, modernizing and rationalizing the activities conducted by commercial banking organizations, and attracting critically needed new capital to the industry.

We believe this represents a carefully balanced, integrated approach, which is critical to fundamental reform. By contrast, a piecemeal approach is likely to push our most pressing problems into the future and could well defeat the very purpose of the legislation -- to strengthen the banking system. For example, merely recapitalizing the bank insurance fund would only delay the day of reckoning, while piling on endless restrictions in the name of safety and soundness would make banks even less competitive and weaker than they are today. We therefore applaud

NB 1364

the bipartisan decision of the House Banking Committee to preserve core elements of the Administration's comprehensive proposal, although there was some needless scaling back of the insurance provisions that are the subject of today's hearing.

My testimony today discusses (1) the reasons for the Administration's banking and insurance recommendations, (2) the similarities between banking and insurance activities, (3) the empirical evidence supporting the combination of these activities, (4) the "firewalls" required to protect insured institutions and consumers, and (5) the differences between the Administration's proposal and the legislation passed by the House Banking Committee.

Reasons for the Administration's Recommendations

Banks are no longer the protected and steadily profitable businesses they once were. Old laws designed to "protect" banks from competition have become barriers that impede banks from adapting to changed market conditions. The result has been financial fragility and losses and a clear need for change. Antiquated laws must be adapted to permit banks to reclaim the profit opportunities they have lost to changing markets.

Where banking organizations have natural expertise in other lines of business, they should be allowed to provide it for the benefit of consumers. Likewise, where other financial companies have natural synergies with banking, they should be allowed to invest in banks. New sources of capital must be tapped.

The Administration's proposal, H.R. 1505, would allow banks to affiliate with a broad range of financial firms through the formation of financial services holding companies (FSHCs). Commercial companies would in turn be permitted to own these new FSHCs by forming diversified holding companies (DHCs). This proposed structure would create a level playing field that permits banking, financial, and commercial companies to affiliate with each other on fair terms. Moreover, H.R. 1505 includes ample safeguards to prevent an expansion of deposit insurance and the federal safety net to cover new activities (as well as safeguards to protect consumers from abusive practices).

H.R. 1505 would benefit not just banking organizations, but a broad range of financial companies, including insurance companies. It would enable these companies to capture the synergies of providing bundled financial products to retail and corporate consumers, as well as diversifying risk. For example, both banks <u>and</u> insurance companies would have new customer markets to tap and new distribution networks available to sell their products and services. The resulting competition is likely to create direct benefits for consumers, including lower costs and greater convenience.

This blurring of distinctions between banking, financial, and related products is neither a new nor a radical idea, as some have suggested. The marketplace has already moved in this direction, and the laws are merely catching up -- although the United States has clearly fallen behind our major foreign competitors in recognizing the changes that have already taken place. Securities firms currently offer a range of banking and insurance products to consumers; insurance companies provide insured deposits and securities-related products to their customers; and even banks have limited authority to sell securities and insurance products. In addition, commercial companies today own "limited purpose" banks, thrift institutions, industrial banks, and certain savings banks, all of which offer federally insured deposits to their customers.

The Administration's proposal recognizes these changes and puts in place a regulatory structure that permits more comprehensive and more efficient "functional" regulation of financial activities. We believe this structure will improve the regulation of all financial activities conducted in a diversified holding company.

In addition, H.R. 1505 includes unique provisions for banks, especially one that has long been available to its other financial competitors: the ability to tap all aspects of the United States financial markets for new sources of capital. Permitting U.S. commercial companies to own banks -- so long as the companies commit to strong bank capital levels -- will strengthen the banking system and reduce taxpayer exposure. It will also allow U.S. banks to turn to U.S. companies for new sources of capital, instead of overseas investors as some of our major banks have recently been forced to do. Allowing well-capitalized banks to affiliate with insurance companies is simply one aspect of the broader concept of tapping new sources of capital.

Similarities Between Banking and Insurance

Second to securities, insurance is generally considered the financial activity closest to banking. Insurance, like banking, is a financial intermediation process -- taking premiums, rather than deposits, from a large retail base; investing the funds in financial assets and loans; and eventually repaying the proceeds to the policyholder rather than the depositor.

Insurance products are highly complementary to many existing bank products, providing opportunities for additional sources of profit based on greater value added per customer and delivery cost efficiencies. For example, comprehensive and cost effective packages for financial services customers could be built around mortgage loans and mortgage insurance, automobile loans and automobile insurance, small business loans and "key individual" insurance, and corporate credit relationships and corporate life or property/casualty insurance, among others.

Agency activities are especially appropriate for banks. These activities pose little or no risk to the deposit insurance fund. Moreover, with appropriate safeguards, insurance products can be distributed efficiently from existing bank offices that are typically convenient to public access. Finally, local communities are generally known and understood by local bank personnel -- these are individuals well situated to introduce the most needed insurance products.

Summary of the Evidence

The evidence clearly shows that banking and insurance are closely related products that consumers want to buy together and companies want to sell together. For example, savings bank life insurance (SBLI) is a long-established, successful, and safe product offered by savings banks in Connecticut, Massachusetts, and New York. Consumer groups have repeatedly applauded SBLI as one of the best insurance bargains for consumers. While the Administration's legislation would create safeguards for SBLI underwriting, to our knowledge SBLI has created few problems for banks while resulting in a steady stream of diversified income to help bolster bank capital.

In addition to the three savings bank states, seventeen states already have authorized their banks to engage in a broad range of insurance activities, with direct benefits for consumers and substantial profit opportunities for banks. Likewise, state and federal thrifts have long been permitted to provide insurance. <u>To our knowledge, despite these widespread combinations, not one bank or thrift has failed because of insurance activities</u>. Yet national banks cannot take advantage of even the safest of insurance activities because of limits in federal law, creating an obvious competitive disadvantage in those states that permit bank insurance activities.

Even now insurance and banking are being marketed together all over the country. In addition to the institutions mentioned above, major financial companies engage in full service insurance and banking throughout the country through numerous regulatory exemptions, including firms such as American Express, John Hancock, Sears, and USAA. Furthermore, the trend among major industrialized nations outside of the United States is to permit combinations of banking and insurance. Belgium, Germany, Luxembourg, and the United Kingdom currently permit combinations of banking and insurance underwriting and brokerage activities, and more limited combinations are permitted in other countries as well. The impending integration of European financial markets is expected to lead to a convergence of national regulations in such a way that the most flexible system will set the standard that the others will follow. Many of the current restrictions in U.S. law simply do not reflect these realities of the national or international marketplace.

A number of critics have argued that the insurance industry should be protected from bank competition -- even competition on the fairest terms -- because some parts of the insurance industry are weak. The apparent fear is that banks will somehow "skim off the cream" of the best insurance business, leaving the "dregs" to insurance firms unaffiliated with banks. This strikes us as a protectionist, anticompetitive overreaction to the facts. It is hard to believe that the experienced insurance industry will not prove to be a fierce competitor against fair bank competition, just as they have proven to be in states that permit bank insurance activities. Moreover, if the consumer would benefit from increased competition through lower costs and greater convenience, why should federal law bar such competition? Indeed, in the long run we believe both the insurance industry and the banking industry will benefit from open and fair competition, not just the consumer.

The Administration is not alone in its view that more competition from banking organizations will benefit consumers. A 1990 study by the General Accounting Office (GAO) strongly supported bank entry into insurance agency activities. GAO concluded that the selling of insurance by banks would benefit consumers through lower insurance costs while benefitting banks through enhanced profitability. It found little danger of conflicts of interest or coercive tie-ins given the competitive nature of the insurance market, bank internal controls, and regulatory oversight. Finally, GAO concluded that bank safety and soundness would not be placed at risk by agency activities since they are not capital intensive.

The Consumer Federation of America (CFA) reached a similar conclusion in a 1987 study. CFA surveyed over 250 life insurance agents to compare the costs and quality of insurance services provided by banking organizations with those provided by independent insurance agents. The results provided strong support for bank involvement in insurance activities on the basis of costs, convenience, and responsiveness to the concerns of consumers. The CFA estimated that consumers would realize anywhere between a 5 to 10 percent savings from the selling of insurance by banks -- a considerable sum when viewed in terms of the aggregate insurance market. Moreover, the study found that a significant percentage of consumer survey resondents were interested in purchasing insurance products from banks.

Banking and Insurance Under H.R. 1505

It is useful to distinguish between insurance agency activities and insurance underwriting. Agency activities, which encompass the distribution and sale of insurance products, are not capital intensive and generally pose little risk. Underwriting activities, on the other hand, require the assessment and assumption of risk and are capital intensive. Full service insurance firms are those that engage in both agency and underwriting activities.

Because the rules governing bank insurance activities are somewhat complicated, attached to this testimony are three explanatory charts. Chart 1 describes the current bank insurance rules; Chart 2 describes the Administration's proposal; and Chart 3 describes our understanding of the Banking Committee's actions on bank insurance activities. For the Committee's convenience, I will refer to these charts throughout the testimony.

Under H.R. 1505 only well-capitalized banks that form FSHCs would be rewarded with the ability to affiliate with companies engaged in insurance underwriting (See Chart 2). This could be done through the establishment of a separately capitalized affiliate by the FSHC, or it could be done at the level of the diversified holding company (DHC) which itself owned the FSHC. As a result, the failure of the insurance affiliate would not affect the capital of the bank, and likewise, the failure of the bank would not affect the capital of the insurance company.

At the same time, only the bank would have access to deposit insurance, the Federal Reserve's discount window, or the federal payments system; the insurance affiliate, the FSHC, or the DHC would have no such access. In this way the federal safety net is confined strictly to the bank.

The selling of insurance by banks, however, is a different matter. Agency activities of this type are generally recognized as providing significant profit opportunities, carrying little risk, and leaving bank capital unimpaired. Because of this, H.R. 1505 does not disturb the ability of states to authorize their state banks to engage in insurance agency activities, and would permit national banks to engage in these same activities to the extent permitted for state banks. At the same time, however, the ability of national banks to provide insurance in towns of fewer than 5000 would be scaled back; such insurance could only be provided to residents of the state in which the small town is located, and could not be provided on a nationwide basis. Furthermore, because agency sales do not involve safety and soundness questions for insured banks, our legislation would defer to the states on the manner in which banks are permitted to sell the insurance products of either affiliated or unaffiliated companies.

Finally, H.R. 1505 generally eliminates the ability of states to authorize subsidiaries of state banks to underwrite insurance. This prohibition was added only because the bill provides two new ways for banks to affiliate with companies that underwrite insurance (that is, through holding company affiliates in the FSHC or through the DHC). Of course, to the extent that Congress chooses to eliminate or limit these two new alternatives, as the House Banking Committee did, the Administration would support restoring the states' ability to authorize insurance underwriting in subsidiaries of state banks, provided appropriate safeguards were in place.

Firewalls

Those opposed to combinations of banking and insurance often cite two potential problems: (1) risky and anti-competitive funding relationships between banks and their insurance affiliates, and (2) consumer protection issues, including misuse of confidential information and coercive tie-ins. The Administration's bill addresses these concerns directly and appropriately by establishing a set of stringent "firewalls" between the insured bank and its nonbanking affiliates.

Capital. First, and most important, only strongly capitalized banks would be allowed to affiliate with an insurance company. Capital is the single most powerful tool to make banks safer. A large capital cushion reduces the possibility of bank failure, lessens the incentive to take excessive risk, and creates a "buffer" that can absorb any bank losses before the Bank Insurance Fund must. The banks that associate with insurance companies under H.R. 1505 must significantly exceed their capital requirements.

Functional Regulation. Second, the insurance company would be a wholly separate legal entity from the bank. This will simplify functional regulation -- insurance regulators concentrating on the insurance company, banking regulators on the bank, and so forth -- which should itself increase bank safety. Regulators have areas of expertise and should concentrate on these, preventing the risk of missing important developments in a group's business from lack of perspective. Functional regulation is more efficient and more effective than having multiple agencies each regulating essentially the same activity.

Funding Firewalls. Third, the Administration's proposal includes funding firewalls that restrict the ability of a bank to fund a "sister" insurance company.

For example, Section 23A of the Federal Reserve Act limits extensions of credit or other financial support by a bank to an affiliate, and the Administration's proposal expands the transactions and the entities to which Section 23A would apply. (This would include a bank's assumption of an affiliate's liabilities, as well as any other transaction the Federal Reserve determines is similar to the type of financial support already covered by the statute.)

Section 23B of the Federal Reserve Act would continue to require that transactions between a bank and its affiliates be conducted on an arms-length basis, and again, H.R. 1505 would expand the types of covered transactions that would be subject to the arms length requirement.

In addition, the FSHC would be required to provide prior notice to the bank regulator of unusually large transfers of funds between the bank and any affiliate, which would obviously help monitor funding flows between institutions in times of stress.

Stringent dividend restrictions would also apply to undercapitalized banks; this would help prevent the potential "milking" of bank assets by FSHCs.

In addition to these specific firewalls, federal regulators would be granted broad authority to adopt funding firewalls to protect insured depository institutions. These firewalls would be specifically designed to address unfair competition, potential conflicts of interest, and unsafe banking practices. This flexibility will allow regulators to adapt firewalls as necessary to maintain strong protections despite changing market conditions.

Finally, the funding firewalls that apply to DHCs are even more stringent. No credit of any kind may be extended by a bank or its FSHC affiliates to the DHC or any of its subsidiaries. A commercial company will simply be prohibited from using an insured depository as its "piggy bank" for funding needs. Likewise, a bank and its FSHC may not purchase for their own accounts any assets or securities of an affiliated DHC, and they may not issue a guarantee to an affiliated DHC. In addition, all of the other firewalls that would apply to an FSHC affiliate would also apply to a DHC affiliate.

Consumer Disclosure. Consumers will clearly benefit from the convenience and availability of more insurance products from banks. But the Administration's proposal also includes rigorous disclosure requirements to prevent customer confusion between federally insured deposits and other financial products that are not insured. Under H.R. 1505, depository institutions must disclose in writing that any insurance (or securities) products offered are not protected by deposit insurance. In addition, to offer insurance (or securities) products jointly with another firm, the other firm must disclose that it is not insured and is separate from the insured depository institution. Even if an insurance affiliate does not jointly market its products with an affiliated bank, it must make similar disclosures. In all of these situations, the bank as an affiliate must obtain an acknowledgement of receipt of the disclosure from the customer. This is to ensure that customers understand clearly the type of institution they are dealing with and the availability of federal insurance.

In addition to these consumer disclosure provisions, the appropriate federal regulator is authorized to issue regulations limiting disclosures of nonpublic customer information between a depository institution and its affiliates. This new authority will prevent banks from unfairly disclosing such information, especially without customer consent.

Finally, H.R. 1505 for the first time applies statutory anti-tying provisions to holding companies. These provisions are based on the current anti-tying provisions that apply to banks, and they ensure that consumers are not coerced into buying nonbank products of affiliates.

The firewalls I have described are a comprehensive, effective set of restrictions that will prevent the potential abuse of relationships between banks and their insurance affiliates. We have not extended firewalls to include specific limitations on the sharing of management, employees, officers, or directors. Such limitations can restrict and impede operational, managerial, or marketing synergies between a bank and its affiliates without conferring any additional benefits for the federal safety net.

Functional Regulation

As discussed above, the Administration's proposal requires new insurance activities to be located in a separately incorporated and separately capitalized affiliate. The insurance affiliate would not be covered by federal deposit insurance or the federal safety net, and it would not be funded with federally insured deposits. But the insurance affiliate would be "functionally regulated" (in this case by the state insurance commissioner), and would be subject to all laws that currently apply to any other insurance company. In this way, rather than eroding the authority of insurance regulators, the use of the holding company delineates a clear line of authority for the functional regulator with respect to bank-affiliated insurance activities.

H.R. 1505 grants bank regulators the authority to prevent, or reverse, affiliations between insured depository institutions and other financial companies. This authority is predicated on the maintenance of sufficient capital in depository institutions and on other safety and soundness grounds, and is intended to contain the risk exposure of taxpayers that results from federal deposit insurance.

In addition, the bill respects state law limitations on bank insurance activities. While affiliations of banks with insurance companies would be permitted, the bill specifically preserves the ability of states to limit the ability of banks to sell insurance directly. This state authority would extend to the sale by banks of insurance products provided by affiliated companies as well as unaffiliated companies. Consistent with this role for the states, national banks would be authorized to provide insurance in a state to the same extent that state banks were authorized to provide insurance, creating a level playing field for bank insurance sales governed uniformly by state law.

Finally, regarding examinations and access to records, Section 205 of H.R. 1505 specifically provides for the needs of functional regulators. Subsection (c)(1)(E) provides for reciprocal access to reports among functional regulators for financial affiliates and DHCs if the agency or regulator reasonably believes that the activities or financial condition of an affiliate could have a material impact on the company for which the agency or regulator has responsibility. Furthermore, Subsection (c)(2)(D) authorizes the functional regulator of a financial affiliate to examine an affiliated insured depository institution if the regulator reasonably believes that such institution is engaged in a particular transaction or course of conduct that may constitute a material risk to the financial affiliate.

The House Banking Committee's Bill

The bill to be reported by the House Banking Committee -- H.R. 6 -- made a number of changes to the insurance provisions originally submitted by the Administration (<u>See</u> Chart 3). First, banks would not be permitted to affiliate with insurance companies through FSHCs, but only through diversified holding companies. While this would also be allowed under the Administration's bill, we nevertheless believe it appropriate to permit insurance inside the FSHC, since insurance is plainly a <u>financial</u> activity. The essential difference between the two types of affiliations is that there is a prohibition on all credit flows from the bank to the DHC, while certain credit flows from the bank to FSHC are permitted but strictly regulated through stringent funding firewalls. These FSHC firewalls are more than adequate to address potential concerns.

Second, the House Banking Committee eliminated the ability of national banks to sell insurance in their home states to the extent permitted by state law for state banks. We believe this is plainly inequitable, and needlessly diminishes the value of the national bank charter.

Third, the House bill would further restrict the ability of national banks to engage in insurance under the "town of 5000" provision. These sales would be limited to residents of small towns and their local market areas, rather than state residents, which deprives small banks of needed flexibility and profit opportunities --- especially since one of the original purposes of this provision was to provide a diversified source of income to strengthen smaller banks. I should add that the provision included in the Administration's bill, which limits such sales to state residents, is a compromise position that was apparently accepted by both the insurance industry and the banking industry in 1988 in a bill that passed both the House Banking Committee and the Senate.

Fourth, the House Banking Committee bill would limit insurance underwiting by state-chartered banks to the very limited credit-related insurance underwriting activities that are permitted for national banks. This is needlessly restrictive, since the Administration's bill already provided express safeguards to the FDIC to protect the insurance fund from excessive underwriting risk.

Fifth, the House Banking Committee bill would preempt the ability of states to authorize banks to engage in the "export" of insurance activities to other states, even if insurance companies located in that state could engage in such exporting activities. This would perpetuate competitive inequities, and needlessly penalize the ability of banks to provide new insurance products to a broader range of consumers. There is no need to treat bank insurance providers differently from other insurance providers, especially through federal preemption in an area that has traditionally been regulated by the state level.

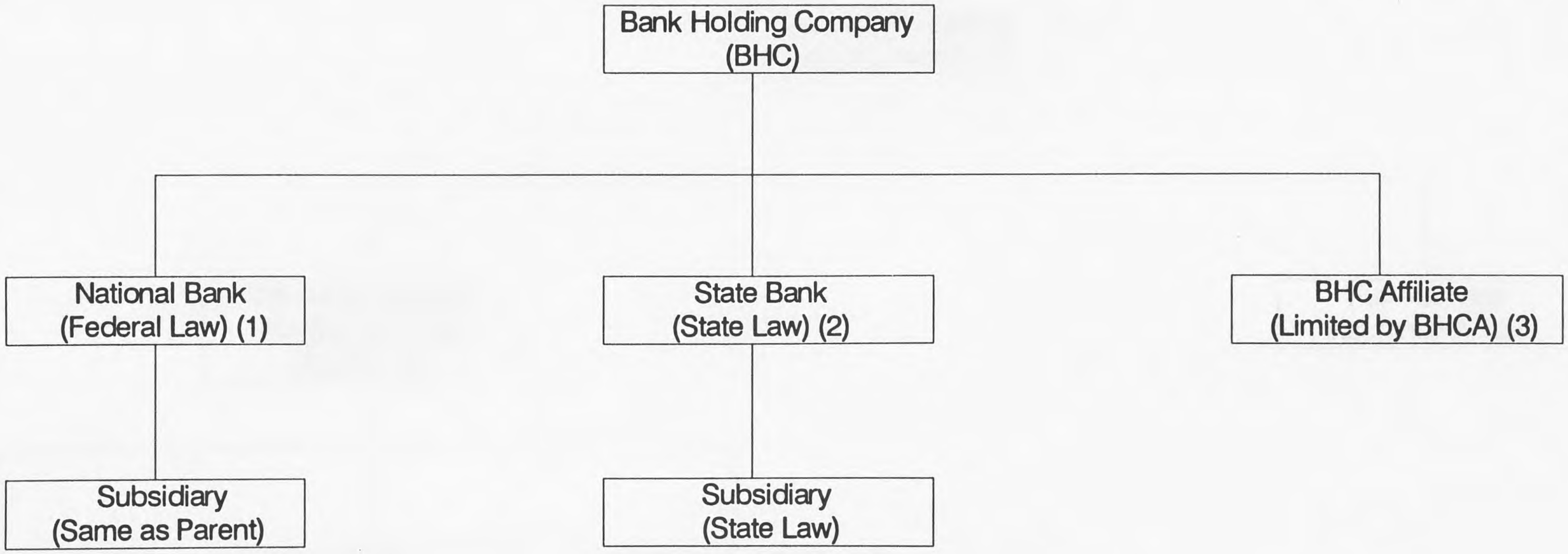
Finally, the House Banking Committee bill made one other change that would create practical problems for affiliations between banks and insurance companies (and any other company, for that matter). This change would require all affiliates of a bank to act as a "source of strength" in the event of problems in the bank. This means that the capital of these affiliates would be put at the mercy of the fortunes of their affiliated bank, which could obviously spread problems from the bank to all parts of an organization. Given the condition of some parts of the insurance industry, it makes little sense to create a system that would spread additional problems to it.

Furthermore, we believe that this policy will be counterproductive in the end. While intended to draw on other sources of capital to prop up troubled banks, the effect will be to deter other companies from ever investing in banks in the first place, because of the virtually limitless liability involved. The best way to draw capital into the banking system is on a voluntary basis, not through a set of mandatory rules.

#####

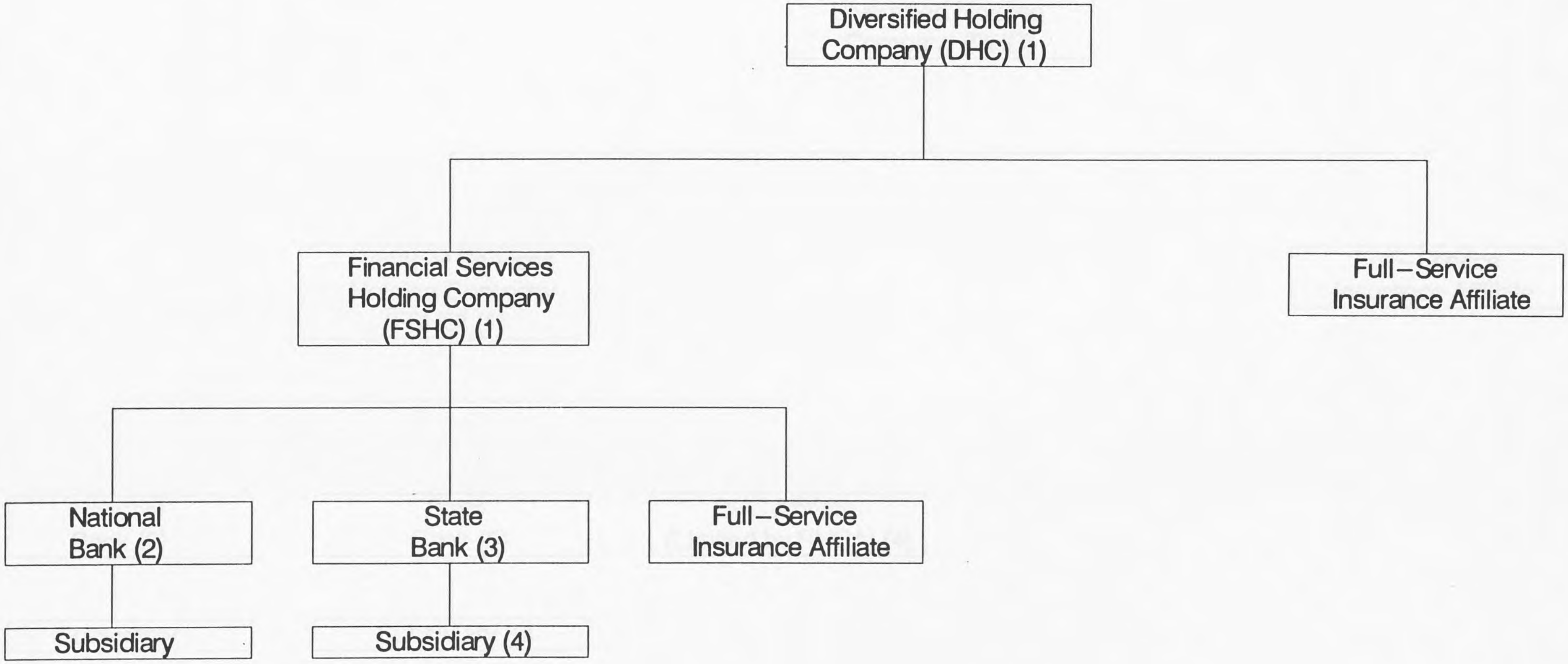
In conclusion, we believe the comprehensive approach to banking reform embodied in H.R. 1505 is critical to placing our banking and financial system on a safe financial footing over the long run. We continue to urge the adoption of comprehensive banking reform legislation as expeditiously as possible.

BANK INSURANCE ACTIVITIES UNDER CURRENT LAW — CHART 1



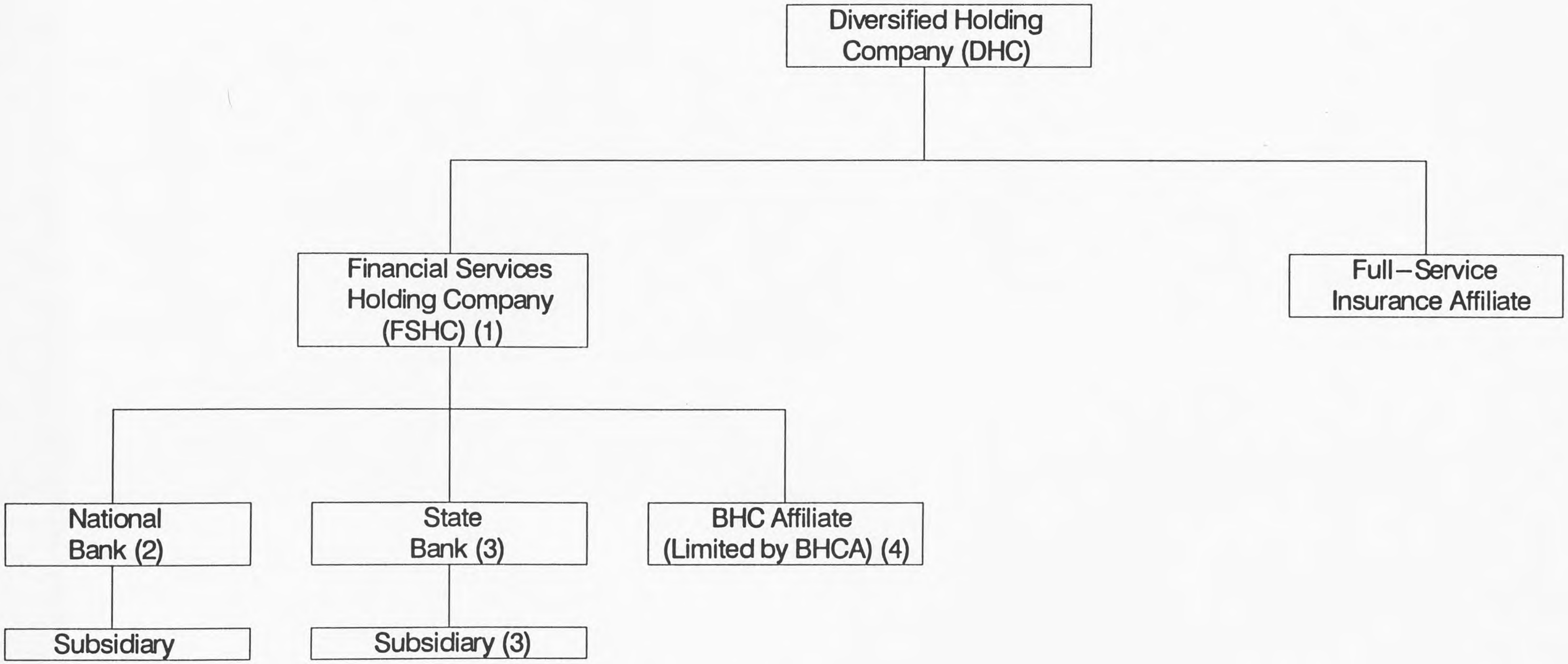
1. National banks have limited insurance powers, including agency powers in "towns of 5,000" and sales and underwriting of credit–related insurance.
2. State law governs the insurance activities of state banks and their subsidiaries. Currently, 17 states permit general insurance brokerage; five of these also permit general insurance underwriting.
3. Insurance activities of BHC affiliates generally are limited to credit–related insurance.

BANK INSURANCE ACTIVITIES UNDER H.R. 1505 CHART 2



1. DHC may engage directly in full–service insurance; FSHC may be mutual insurance company.
2. H.R. 1505 expands the agency activities of national banks to those permitted by states for state banks; "Town of 5,000" sales are restricted to state residents.
3. States determine agency activities; underwriting activities not permitted beyond those permitted national banks unless the state bank (1) satisfies its capital requirement , and (2) receives a determination from the FDIC that these activities do not pose a significant threat to the insurance fund.
4. Agency activities authorized; underwriting prohibited because of availability in other affiliates..

BANK INSURANCE ACTIVITIES UNDER H.R. 6 — CHART 3



1. H.R. 6 removes full service insurance from the FSHC, leaving it in the DHC.
2. H.R. 6 rolls back H.R. 1505's expanded agency powers for national banks; and it restricts "town of 5,000" sales to local market areas.
3. H.R. 6 prohibits interstate insurance activities unless explicitly permitted by host state; underwriting powers limited to those of national banks.
4. Insurance activities of BHC affiliates generally are limited to credit-related insurance.

TREASURY NEWS

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

As prepared for delivery
Embargoed unitl 4:40 P.M.

EXPANDING MULTILATERAL EFFORTS TO STRENGTHEN THE PRIVATE SECTOR

Remarks by
Nicholas Brady
Secretary of the Treasury
before
The Bretton Woods Committee
1991 Annual Meeting
July 10, 1991

It is a pleasure as always to address the Bretton Woods Committee -- a group devoted to the cooperative international effort begun decades ago to forge an open and stable international monetary system.

That historic meeting at Bretton Woods produced an international economic system, centered on the IMF and the World Bank, which has been truly effective in promoting global growth and expanding world trade. It restored international economic cooperation in the aftermath of the Depression and World War II. Today it continues to adapt itself to a vast, complex international economy that could not have been envisioned in that small New Hampshire town in the closing days of 1944.

Yet we hear the accusation that the institutions have outlived their usefulness. That they have failed to respond to changing circumstances and needs. The cynics say that we are on the same old policy treadmill, that we've failed to respond imaginatively to the challenges we now face. In short, the naysayers say we're going nowhere fast.

What are they talking about? In the last two years, breathtaking changes have swept the world. Eastern Europe is rushing headlong toward democracy. Latin America is having a quieter but no less exhilarating revolution, as a whole new generation of leaders spells out their hopes for economic reform. East and West Germany have become one again. And the Soviet Union approaches the upcoming Economic Summit with the goal of integrating itself into the world economy it has so long shunned.

Throughout the world, we see a renewed understanding of how best to provide for each nation's economic well-being. The lessons of the last two years are clear. Freedom works. Free markets work.

NB-1365

These simple principles have moved nations; they have altered the course of history; they have turned the tide of our economic future.

And the international institutions are at the heart of the process. This is what they do best. Every case of successful economic reform in recent years has involved programs supported by these institutions. As we move toward the 21st century, strong Bretton Woods institutions still help nations help themselves.

Let's look at an example of how the process works. Just two and a half years ago, faced with a profound economic crisis, Mexico welcomed its new President Carlos Salinas. He came into office with a strong plan for economic stabilization and reform, and the commitment to make it work. Under his leadership, Mexico made the hard choices.

It opened its doors to trade. It put state industries in the hands of the private sector. It created a climate that encouraged investment.

The Mexicans closed or sold almost two-thirds of their publicly-owned companies. They privatized their airline, their copper industry, and most of their telephone company. Now they are selling their commercial banks and their steel industry to the public. They've deregulated their trucking industry, which has reduced costs by as much as $3 billion since 1989. They've reduced their external debt to commercial banks by over 30 percent.

And what happened? Mexico has flourished. Its foreign exchange reserves increased from $4 billion then to an estimated $15 billion today. Its budget deficit has been reduced from 14.3 percent of GNP in 1987 to 2.3 percent in 1990. Inflation in Mexico is now at one of the lowest levels in all of Latin America. Foreign investment has skyrocketed. And after years of devastating capital flight, Mexicans believe in Mexico, and are now eager to invest in their own thriving economy.

When two roads diverged, Mexico took the one of fundamental economic reform, and that has made all the difference.

At the time, the naysayers asked: where will the money come from to finance Mexico's recovery? They argued that Mexico's reforms would never succeed unless its balance of payments gap was filled up front. That wasn't the way it worked.

Mexico provided the reforms and the private market completed the necessary financing. It was the Bretton Woods institutions who provided the seed money, the expertise, the guidance and support that were so desperately needed for Mexico's success.

To those who argue that there is nothing new, let them explain what happened in Mexico.

The international financial institutions proved in the case of Mexico that they can be the catalysts of economic reform, and can unleash the power of the private sector. The Bretton Woods institutions can move countries toward free markets. But to do so, they must remain at the intersection between the public and private sectors.

To meet the challenges a changing world presents, the World Bank has moved to put in place a strong private sector focus that supports the world's budding free markets. The Board of Directors' recent decision to take the Bank into the nineties by strengthening its commitment to private sector development is good news. We commend Barber Conable for his statement that the Bank's "management is fully determined to ensure effective implementation" of its private sector development action program.

There is no conflict here between private sector development and poverty alleviation. On the contrary, we have promoted private sector development, and encouraged private investment flows and freer trade, precisely because each of these strengthens the Bank's existing efforts. This is the surest way to alleviate poverty in developing countries.

Within the Bank, the International Finance Corporation makes privatization a top priority, and IFC is well positioned to be a forceful advocate of privatization in its dealings with developing countries. In so doing, it funds projects that reinforce economic reforms supported by the Bank. This means funding projects in countries whose economic policies are geared toward free markets, or areas where there is a prospect for liberalized trade.

Of course, the increased emphasis on the private sector is hardly unique to the World Bank. It has also been carefully woven into the newly-born European Bank for Reconstruction and Development. The EBRD was established with a mandate that at least 60 percent of its project funding go to the private sector. This was one of the major reasons for its creation, and it was the critical factor in U.S. support for the Bank's establishment.

At the center of the international economic system is the International Monetary Fund, which has assumed a primary role in promoting the stable economic environment essential for orderly and effective reform. Time and again the IMF has demonstrated a capacity to respond effectively to the changing needs of the world economy. This has been seen most recently in the Fund's swift response to the Gulf crisis, and in Eastern Europe, where there were IMF programs in all of the reforming countries within 17 months after the fall of the Berlin Wall.

However, the Fund must have adequate resources to fulfill this vital role in the 1990s. Passage by Congress of the pending IMF quota increase legislation is essential. Failure to do so will jeopardize the progress we've made since the wall came down.

Clearly, the international financial institutions will be called upon as never before to respond to today's astonishing world developments. This is all to the good, and where their focus ought to be, but the health and soundness of these organizations must not be taken for granted.

To continue to fulfill their mission, the Bretton Woods institutions must remain at their core, strong financial organizations actively supported by their members. This is the secret of their importance, namely that carefully marshalled resources can be leveraged many times over and recycled. This should not be confused with dollar-for-dollar foreign aid.

To guarantee their economic soundness, these institutions must base their lending on sound economic policies. Loans for specific projects must meet the test for economic viability. Policy-based lending must achieve effective economic reform that strengthens the borrower's credit standing. It is only in this way that loans will be repaid, providing resources for others and protecting the credit standing of the institutions. Each country's ability to free itself from dependence on the international institutions will allow the institutions to help other struggling nations.

The major industrial nations have a vital role to play as well. Their message should be one of hope through low-inflationary growth. Sustained growth and price stability, coupled with open markets and lower fiscal and external imbalances, will provide the fertile field in which all nations can grow and prosper.

In the post-communist world, as security concerns diminish, international economic policy has captured the world's attention, and rightfully so. The argument that countries can exist in economic isolation has been proved false. We see around the world an increasing recognition that each country's economic decisions must be made within this new global perspective, if the world economy is to prosper.

What is needed to foster world growth is an approach that is dynamic and forward-looking, yet recognizes the diversity of economic circumstances among nations. This approach incorporates three main elements.

First we must ensure strong sustained economic growth. This does not mean abandoning the cause of price stability. Strong economic performance and low inflation are not mutually exclusive. But sustained economic growth and price stability don't just happen. They must be nurtured through sound macroeconomic policies broadly carried out in concert with other nations.

Economic policies that promote an adequate supply of capital to meet the world's growing requirements constitute another important component of this strategy. Reducing budget deficits throughout the world will help reverse declining savings rates, freeing up sorely needed capital.

Second, dedicated efforts to open markets to trade, investment and other capital flows, as well as a timely and successful resolution of the Uruguay Round, are also key factors in this strategy. We are already making headway on freeing the flow of goods and services as we move toward free trade from Canada to Mexico. And the European Community is moving forward on EC 1992, which will improve the economic efficiency and standard of living of Europe and of their trading partners.

Third, the U.S. and other developed nations can also make a difference by reducing existing impediments to the efficient operation of our own markets. This will not only make us more competitive, but will set an example for developing countries.

In the future we will be judged on how we respond to the aspirations of the new democracies to join the community of nations committed to economic freedom. There are many dimensions to this challenge, and strong, sound international financial institutions remain the key to our success. No legacy we could leave would be more enduring than a thriving world economy that unites all nations.

oOo

TREASURY NEWS

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

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

STATEMENT OF HONORABLE NICHOLAS F. BRADY
Chairman, Oversight Board of the
Resolution Trust Corporation
before the
House Committee on Banking, Finance and Urban Affairs
July 11, 1991, 10:00 a.m.
2128 Rayburn House Office Building
Washington, D.C.

Mr. Chairman, members of the Committee, we are pleased to be making our semiannual appearance before your Committee today. We look forward to bringing you up to date on activities of the Resolution Trust Corporation (RTC) and the Oversight Board as required by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

I appear as Chairman of the Oversight Board of the RTC. Accompanying me are the four other members of the Board: Alan Greenspan, Chairman of the Federal Reserve Board; Philip Jackson, Jr., former member of the Federal Reserve Board and currently Adjunct Professor at Birmingham Southern College; Jack Kemp, Secretary of the Department of Housing and Urban Development; and Robert Larson, Vice Chairman of the Taubman Company and Chairman of the Taubman Realty Group. Also accompanying us is Peter Monroe, who is President of the Oversight Board.

We are here to discuss funding needs to complete this unprecedented task, implementation of provisions of the 1991 RTC Funding Act, RTC's asset disposition activities, Oversight Board activities since our appearance before your Committee in January, and other matters required by FIRREA.

FUNDING NEEDS

Mr. Chairman, your Committee and the Oversight Board share the objective of getting the savings and loan problem behind us as quickly as possible within the terms of FIRREA and at the least possible cost. Our common goal is to protect the depositors of the nation's failed thrifts: to date some 14 million depositor accounts averaging $10,000. In doing so we honor our deposit insurance commitments and keep faith with our citizens.

Let me review what has been done and how far we have to go.

NB-1366

Size of the Task

As we have said before, the ultimate cost of the cleanup is driven by real estate markets, interest rates, and the state of the economy. The number of thrifts that must be closed and the value of the assets seized, and thus the total amount of the loss depends on these larger economic forces. The cost will also reflect our effort to save taxpayer dollars wherever possible.

As Chairman Seidman told the Senate Banking Committee on June 21, the RTC estimates that it will complete the resolution of 557 thrifts by the end of the fiscal year, and at that time also will have about 185 thrifts in conservatorship or in the Accelerated Resolution Program (ARP). When these 742 institutions are resolved, all those now in Group IV will have been closed, and the lion's share of the job of closing insolvent thrifts will be finished.

What remains to be done?

On June 12 the Office of Thrift Supervision (OTS) announced that Group III, defined as thrifts that are troubled but that are unlikely to require government assistance and that have reasonable prospects of meeting capital requirements, consists of 378 institutions.

It is likely that some of the thrifts in Group III will fail and that the RTC caseload will grow beyond the 742 institutions. We do not believe, however, that sufficient Group III thrifts will be transferred to RTC so as to exceed the upper end of our previously estimated loss range.

Though the exact number of thrifts still to be resolved with Federal assistance cannot be known, we can estimate that virtually all nonviable thrifts will be transferred to the RTC for resolution during the next two years. If this estimate is correct, the orderly downsizing of the industry will then have been completed.

However, current law provides that OTS may transfer thrifts to RTC for closing until August 9, 1992, when they would be transferred to the Savings Association Insurance Fund (SAIF). Therefore, as proposed in the President's budget, we request legislation to extend the period in which OTS may transfer thrifts to RTC from August 9, 1992, to September 30, 1993.

This extension should permit the OTS to transfer insolvent thrifts to the RTC in an orderly way to avoid extended waiting periods in conservatorship. Were OTS to transfer nonviable thrifts to RTC in such quantity that they must remain in conservatorship for long periods, the taxpayers' cost would rise because the thrifts would lose franchise value.

The extension should ensure that the cleanup of the backlog of failed savings and loans is completed by September 30, 1993. FIRREA sets up a schedule for contributions to the SAIF, beginning in fiscal year 1992 if Congress and the Administration take further appropriations action. However, if Congress acts on our request, SAIF will not take insolvent institutions until October 1, 1993. The President's budget estimates that at that date, SAIF should have about $1.6 billion in its reserves from premium income. At this time, it is too soon to tell whether and how much of a contribution Treasury will need to make to SAIF.

Loss Funds Needed

Earlier this year, in our January 1991 semiannual appearance, we estimated that the cost of the savings and loan cleanup would be in the range of $90 to $130 billion measured in 1989 present value dollars. We stated that, because of general economic conditions, and deterioration in real estate markets and real estate related assets, the most likely cost scenario had probably moved to the higher end of our original range, but that it nevertheless remained within that range.

We still believe this to be true. In other words, we still believe that the higher end of the range estimate of $130 billion in 1989 dollars remains valid. Presenting estimates in constant dollars allows us to compare the estimates better. It is the conventional way for the private sector and the CBO to state the cost of major programs that last for more than one or two years, but it is different from the same amount expressed in current year budget dollars.

Our estimate of $90 to $130 billion in 1989 dollars converts to a range of about $100 to $160 billion in budget dollars. Chairman Seidman gave the same estimate in his testimony to the Senate Banking Committee.

The Oversight Board and the RTC estimate that the additional amount of loss funds necessary to complete the task of closing defunct savings and loans and protecting depositors could be as high as $80 billion in budget dollars. To date, $80 billion has been provided: $50 billion by FIRREA and $30 billion by the RTC Funding Act of 1991. With the additional amount, the total would be brought to $160 billion in budget dollars, which translates to $130 billion in 1989 dollars.

It is our recommendation that Congress provide sufficient funding to complete the job, which we estimate to be as high as $80 billion. This would permit the RTC to complete its work as quickly as possible without costly delay. Funding delays simply add to taxpayer costs because they slow the RTC's resolution activity. Just as we are trying to save taxpayer dollars by improving the cleanup, so we should avoid costly stop and start funding. Chairman Seidman estimated that the amount necessary for RTC to carry out its work in fiscal year 1992 will be $50 to $55 billion.

We know that these decisions are difficult because the public in general does not understand the need for these funds. I'd like to give you some examples of resolutions that have protected depositors. Broadview Federal Savings Bank in Cleveland, Ohio was closed in May, 1990 and its 108,252 deposit accounts, averaging $8,000 were protected. Home Federal Savings Bank of Worcester in Worcester, Massachusetts was closed in November, 1990 and its 37,900 deposit accounts were protected at an average of $6,148 each. The 8,100 deposit accounts, averaging $9,765, in Founders Federal Savings and Loan Association, a minority-owned institution in Los Angeles, California were protected and successfully transferred in January, 1991, to Founders National Bank, a like minority owned institution. In the case of Founders Federal Savings and Loan, RTC, through its policy of preserving minority-owned institutions, was able both to protect Founders Federal depositors and retain the minority character of the institution by providing a $2 million, nine month loan to Founders National.

I hope these examples underscore the point that the money is going to people - 14 million accounts to date, in 45 of the 50 states. In Texas, more than 1.9 million accounts have been protected, and another 1.2 million accounts are now in conservatorship waiting to be resolved with loss funds voted in March. In Florida, over 800,000 accounts have been protected and another 1 million are in conservatorship. In New York, 900,000 accounts have been protected, with another 500,000 in conservatorship awaiting resolution. Even in Wisconsin there have been two thrift failures requiring protection of 57,425 insured deposit accounts. The important point is not that some states have had a bigger problem than others - it's that depositors in virtually every state have received protection.

We all want to fulfill our Government's commitment to depositors. We do not want the system to be destabilized by TV coverage of lines in front of thrifts, just as we should not permit households and businesses to be impoverished by frozen accounts.

The U.S. Government has no choice but to provide the money, and we should remind people that it isn't going to crooked or incompetent executives, or to keep bad institutions afloat. The money is used to protect individual Americans who deposited their savings in S&Ls because they believed our government's promise that it would be safe there.

Working Capital Needs

Loss funds, which we have just discussed, are the monies that are needed to fill the "hole" between an institution's deposits and the value of its assets. They will never be recovered.

Working capital, on the other hand, is used to finance the acquisition of the assets of failed thrifts by RTC until they are sold. It is borrowed by the RTC from the Federal Financing Bank (FFB). RTC expects to repay its working capital borrowings from the proceeds of the sales of these assets.

As of July 1, RTC's working capital borrowings totalled $54 billion. By the end of this fiscal year, RTC expects to have $70 billion in working capital borrowings outstanding, an amount well within the "note cap" limitation set by FIRREA. However, during fiscal year 1992, RTC could exceed the $125 billion permitted by the note cap. And, by mid-1993, we estimate that working capital needs could peak at $160 billion.

At about that time the RTC will start the process of repaying working capital borrowings from the FFB. We estimate that outstanding borrowings will decline rapidly to $65 billion in 1995 and will be virtually retired by 1996 when the RTC goes out of business.

Because both loss funds and working capital are needed to fund resolutions, it is imperative that loss fund authorizations be matched with adequate working capital borrowings. Therefore, we request that Congress raise the RTC's borrowing limit to $160 billion. This simply means RTC would have an additional $35 billion in borrowing authority over its current authority of $125 billion. Not to do so might create a situation in which RTC is pressured to dump assets at fire-sale prices simply to stay under the limit. Failure to raise the borrowing limit would just as surely prevent the RTC from resolving thrifts and protecting depositors as delays in funding do.

The working capital concept has caused confusion. For example, some have suggested that asset sales should be used to fund losses. But this sort of "backdoor" spending would violate the principle that the RTC should have sufficient assets to repay its FFB borrowings.

In your invitation to testify, Mr. Chairman, you asked that the Board address whether there are sufficient assets to back borrowings. The RTC seeks to assure that FFB borrowings will be fully recovered from sales of assets through an initial mark-to-market valuation of assets at resolution, and quarterly re-estimates of those asset values during receivership.

The RTC has recently completed its first quarterly review of its assets to determine whether there is sufficient value to pay back borrowings and has adjusted asset values accordingly. The RTC's Inspector General (IG) at the Oversight Board's request, and the GAO as part of its 1990 audit, are both examining the RTC's methodology to verify its accuracy.

In summary, Mr. Chairman, we request sufficient loss funds to complete the cleanup, or as high as $80 billion. This amount is within our previous estimate of the cost of this effort. In addition, we request that the current $125 billion cap on RTC borrowing authority be raised to $160 billion, noting again that RTC expects to repay all borrowed funds.

In past appearances we have stressed that we cannot predict ultimate costs and borrowing needs with certainty, and we must do so again. As the General Accounting Office (GAO) noted in its 1989 Financial Audit of the RTC, "the actual cost...will depend on the outcome of various uncertainties," including the number of institutions transferred to the RTC, the extent of their operating losses, the quality and salability of their assets, and the condition of the economy, especially in certain geographic areas.

In January, I told this Committee that the economic downturn, and the Middle East crisis, had worsened the already weak market for real estate assets and made already cautious investors more reluctant to make investment decisions. The climate is still uncertain, and in an uncertain climate, estimates are always subject to change. But we have in the past and have today given you our best estimates of projected loss and working capital needs, and we will continue to do so.

GETTING THE JOB DONE

When President Bush announced his proposed solution to the savings and loan crisis soon after taking office, he established four objectives against which we measure our progress.

First, protect insured depositors: the millions of Americans who acted in trust when they deposited their savings in federally insured accounts. We estimate that by the end of this fiscal year, nearly 20 million depositors with accounts averaging $10,000 will have been protected.

Second, restore the safety and soundness of the industry so that another crisis will not occur. In compliance with FIRREA, new capital standards are being phased in. Even with these higher standards, three-quarters of the savings institutions, with more than $600 billion in assets, today meet or expect to meet current capital requirements.

Third, clean up the S&L overhang so we can get the problem behind us, and do it at the least cost to the taxpayer. When FIRREA created the RTC on August 9, 1989, RTC immediately became responsible for closing 262 insolvent thrifts. By October 1, 1991 it will have closed 557 insolvent thrifts, one about every 33 hours.

Fourth, aggressively pursue and prosecute the crooks and fraudulent operators who helped create the problem. There have been 550 convictions for thrift crimes. About 80 percent of those sentenced have received prison terms.

RTC Funding Act of 1991

The RTC Funding Act that became law on March 23 provided necessary loss funds for this fiscal year and helped advance the objectives of the cleanup.

The Act also addressed other issues of concern to this Committee: RTC management reforms, affordable housing, and minority- and women-owned business (MWOB) contracting. It included valuable new financial reporting requirements. And it established that RTC personnel would not be personally liable for certain securities transactions undertaken in RTC asset dispositions.

Affordable Housing

Although the primary purpose of the RTC is to clean up the savings and loan problem, Congress has assigned it other tasks such as the provision of affordable housing. The RTC and the Oversight Board have made every effort to implement the affordable housing provisions of FIRREA, actively promoting the sale of eligible single family homes to low- and moderate-income families and setting aside 35 percent of all units in multifamily properties for such families. As a result, 7,141 single family homes have been placed under contract and 2,777 of these have closed. Ninety multifamily properties have been placed under contract and 13 have closed.

According to RTC the average sales price for single family properties sold through the affordable housing program through the end of May is $32,297. The average income of purchasers is $22,136, which is less than 60 percent of national median household income.

The Oversight Board is strongly committed to affordable housing and has taken the following initiatives to enhance the program:

o $250 million of the RTC's $7 billion seller-financing ceiling has been set aside exclusively for single family affordable housing.

- o $190 million of mortgage revenue bonds has been set aside by state housing finance agencies to be used to assist low- and moderate-income first-time homebuyers to purchase RTC single family homes.

- o SAMDA contractors are offered a special bonus fee to sell affordable single family properties to eligible low- and moderate-income households.

- o The Oversight Board approved a policy allowing the RTC to sell affordable single family properties to eligible low- and moderate-income households at 80 percent of market value. This policy was further expanded in the Funding Act to a "no minimum reserve price" policy. To date, the RTC has held 90 sales events to offer approximately 8500 properties at no minimum reserve price.

- o Recently, the Oversight Board allotted up to $150 million of seller-financing for low downpayment sales of multifamily properties to nonprofit organizations.

The Funding Act provided that, through September 30, single family properties in conservatorship are eligible for the affordable housing program. On April 30, 18,249 properties were eligible for the affordable housing program: 6,429 in conservatorship and 11,820 in receivership. Of these, 12,203 have been listed with clearinghouses.

By the end of May, 471 multifamily properties, representing about 50,000 units, had been listed with clearinghouses. As I said, sales of 13 properties with 1,023 units have closed. In addition, RTC has accepted offers on 77 properties with 9,974 units. Negotiations are under way on another 28 properties with 4,500 units. The availability of seller-financing on these properties is expected to accelerate sales significantly.

Mr. Chairman, the Oversight Board has provided the policies and financial tools to help make this program work, and RTC has devoted considerable effort to it. In your letter of invitation, you requested extensive data on virtually every property transaction in the affordable housing program - more than 100,000 data elements. These data are being compiled by the RTC and will be made available to the Committee as soon as possible.

It is my understanding that in his presentation later today, Lamar Kelly, Deputy Executive Director of the RTC, will further discuss RTC's affordable housing efforts.

Minority and Women Outreach

Participation through outreach by minorities and women in the business generated by the RTC is a goal of FIRREA. The Torres Amendment to the Funding Act requires that the Oversight Board and RTC report on actions taken by the RTC to engage additional minority- and women-owned business (MWOB) contractors in its work. This report was filed on April 30 as part of the Board's Semiannual Report to Congress.

Some background may be useful. FIRREA requires that the RTC prescribe regulations for an outreach program to see that minorities and women are given the opportunity to participate in all aspects of RTC contracting activities. FIRREA also requires that the RTC Strategic Plan provide procedures for the active solicitation of offers from minorities and women, and that it ensure that discrimination on the basis of race, sex, or ethnic group is prohibited in RTC's solicitation and consideration of offers.

RTC has conducted outreach efforts. Its staff has appeared at more than 100 professional and trade conferences to discuss contracting opportunities. In addition, it has held two conferences to explain its programs to minorities and has scheduled several more. But more can be done.

According to the RTC, MWOB's by June 11 had won 4,690 - or 22 percent - of RTC prime contracts, worth $203 million - or 23 percent of the value of all such contracts. Minority and minority-women owned contractors were 6 percent of the total awarded, and non-minority women contractors were 15 percent of the total awarded.

With respect to the utilization of outside counsel in legal work for receiverships, the RTC awarded $586,547 - or 1.3 percent - to all MWOB law firms in 1990 and $1,364,764 - or 1.9 percent - as of May 1991.

The Oversight Board firmly believes that the outreach requirement of FIRREA must be implemented vigorously and recently has taken steps to enhance RTC's MWOB outreach program on two fronts.

First, the Oversight Board urged the RTC to expand its outreach efforts and to formalize its outreach commitment by adopting comprehensive outreach regulations. The Board emphasized that the RTC have a well-staffed, well-administered, and vigorous outreach program embodied in regulations. RTC is preparing these regulations for public comment.

Second, the Oversight Board urged RTC to make aggressive use of agreements with the Small Business Administration so as to channel RTC business to small and disadvantaged firms. The Board approved a pilot program in April, and in a letter to RTC on June 3 urged RTC to expand the pilot program to include all appropriate areas of RTC contracting.

At the same time the Oversight Board returned to the RTC for further consideration a draft policy proposed to it by the RTC staff. Under this policy additional preferences would be given to minorities and women by according them price and technical competence adjustments. The Oversight Board has asked the RTC for clarification of its proposal.

The Oversight Board's goal is to achieve aggressive outreach to minorities and women so that they will participate in the business generated by the RTC. The Oversight Board has recently taken the following steps toward this goal.

- o The Oversight Board's Regional Advisory Boards have completed a round of meetings in all six regions at which they gathered testimony from representatives of the minority business community at the request of the Board. When formulated, the Advisory Boards' recommendations should be helpful in improving RTC outreach efforts.

- o The Oversight Board President and staff have met with Reverend Jesse Jackson and other representatives of the minority business community at the request of the Chairman of the Senate Banking Committee. As a result of those meetings, the Oversight Board President wrote to the RTC on June 14 and again on June 21, 1991, with a number of suggestions for enhancing RTC's outreach program. The Oversight Board President urged RTC to strengthen the administration of the outreach program by providing for a high-level manager and a comprehensive management network to ensure vigorous implementation of the program throughout RTC's operations.

- o The Oversight Board staff has also supported RTC's efforts to design its programs with an eye to making them accessible to minority- and women-owned firms. This means that RTC contracts must be made accessible to a much broader range of bidders by segmenting them by geographic region, by making them smaller, and by breaking them down by type of service. The RTC has begun to implement this approach.

In summary, Mr. Chairman, I believe that the Board has demonstrated its commitment to the inclusion of minority- and women-owned firms in RTC contracting.

Mr. Chairman, I ask that relevant materials and correspondence be included in the record of this hearing.

Significant Properties

FIRREA requires RTC to identify properties with natural, cultural, recreational or scientific significance. In addition, the Coastal Barrier Improvement Act of 1990 imposed waiting periods of up to six months on RTC sales of environmentally sensitive property in coastal areas.

On January 17 of this year, the Oversight Board directed the RTC to expand its program to identify significant properties by taking the following steps:

- o strengthening its internal capacity to identify such properties;
- o procuring the best available expertise from both public and private sectors to assist in identification; and
- o publicizing the availability of significant properties to the widest possible audience of interested persons and agencies.

The Oversight Board further directed the RTC to immediately design a plan to implement these three initiatives; the RTC responded with its plan on February 15.

The Oversight Board has monitored the implementation of the RTC's efforts and their status is described in letters from the RTC's Executive Director on June 10 and 20. I ask that copies of this correspondence be included in the hearing record.

ASSET DISPOSITION

Just as the need to resolve hundreds of insolvent thrifts quickly was the most critical task of the RTC when it was created almost two years ago, asset disposition is its most important job today. I said earlier that because of the pace at which thrifts are being closed we now can estimate that virtually all insolvent thrifts will be closed by the end of September, 1993. But the corollary is that RTC is rapidly accumulating very large amounts of assets.

On April 30, 1991, the RTC held $164 billion in assets. This compares to the year-end assets of the two largest commercial banks, Citicorp and BankAmerica, at $217 billion and $111 billion, respectively. RTC had passed to acquirers or sold $154.3 billion, or 49 percent, of its assets by April 30.

In its nine-month financial operating plan filed in January, RTC projected book value reductions of $75 billion through the end of the fiscal year - $65 billion after putbacks of assets previously sold to acquirers of closed thrifts. During the January-April period, book value asset reductions totalled $35 billion. Actual receipts from sales and collections are $33 billion.

The Oversight Board believes there is no more important task before the RTC than organizing the programs necessary to dispose of RTC assets quickly and at best possible prices. I emphasize this because it is our goal to save taxpayer dollars.

The Oversight Board has helped provide the policies to expedite and increase the return from asset sales. It directed the RTC to use securitization to the widest extent possible, and it authorized the use of seller financing. The Oversight Board acted in both cases in order to maximize the taxpayers' recovery against book value.

RTC's asset disposition efforts fall into two broad categories: readily marketable, and hard-to-sell.

Readily Marketable Assets

As of April 30, 1991, the book value of RTC's inventory of readily marketable financial assets totalled $61 billion, consisting of $25 billion in investment grade securities, and $36 billion in performing one- to four- family mortgages.

Securities

With regard to securities, the primary disposition strategies are to centralize sales in the Washington, DC headquarters and execute sales in a manner that gets the best possible returns and does not disrupt financial markets. Results to date have been relatively successful, as 75 percent of securities held more than 90 days have been sold or collected. With the introduction of RTC's portfolio securities management system, RTC will be better able to pool like securities to achieve price advantages resulting from larger offerings.

One- to Four-Family Mortgages

Numerous initiatives have been implemented to increase the pace of, and returns from, the disposition of performing one- to four-family mortgages. To date, about 56 percent of these assets held more than 90 days have been sold or collected. Among the most important initiatives was RTC's adoption in April of standardized due diligence procedures, permitting the RTC to stratify its inventory, identify which loans conform to Fannie Mae and Freddie Mac standards, which are eligible for RTC's mortgage-backed securities program, and which should be sold on a whole-loan basis.

RTC has embarked upon an aggressive program of swapping performing, conforming loans with Fannie Mae and Freddie Mac in exchange for highly liquid securities. Through May 31, RTC had swapped more than $1.6 billion in loans.

However, it is estimated that only about 15 percent, or $5.4 billion, of RTC's current inventory of performing one-to four-family mortgages conform to the secondary agencies' criteria for swap. Therefore the balance must be securitized or sold on a whole-loan basis.

The Oversight Board has strongly encouraged the widest possible use of securitization. It offers a much broader market of purchasers than does the outright sale of whole loans and, because of such benefits as reduced risk and more predictable cash flows, results in a higher return on these assets for the taxpayer. Further, securitization will enable the RTC to increase the pace of asset disposition.

Using conservative assumptions, the savings over the next three years from RTC's securitization of single family mortgages alone could exceed $1 billion (not including savings resulting from reduced FFB borrowings). Very significant additional savings could result if other financial assets are securitized.

Immediately following enactment of immunity protection for RTC Board members and employees in connection with their disposition activities, RTC filed a $4 billion shelf registration with the Securities and Exchange Commission to issue its own mortgage-backed securities. The goal of securitizing $1 billion in loans per month has been set and the first issuance of $429 million has been made, with an estimated savings of over $15 million as a result of securitization. Additional securitizations are in the pipeline.

Hard-to-Sell Assets

The most difficult task facing the RTC is the management, marketing and disposition of illiquid assets inherited from insolvent thrifts, principally real estate owned and non-performing loans. The RTC as of April 30 holds other performing mortgages and loans with a book value of $36 billion, real estate with a book value of about $21 billion, and non-performing loans with a book value of about $25 billion.

To date it does not appear that RTC real estate sales have had an adverse effect on local markets. To the contrary, the extensive soundings of local market conditions taken by all six of the RTC's Regional Advisory Boards in 24 meetings in all sections of the country indicate that in some areas the overhang of RTC properties is depressing real estate markets. This finding simply reinforces the need to dispose of real estate owned.

Other Performing Loans

RTC has used a series of strategies to dispose of other performing loans, including, among others, auctions, bulk sales through the national sales center, and passing loans to thrift acquirers at resolutions. The results of these efforts have been the sale or collection of roughly 35 percent of mortgages other than one- to four- family, and 53 percent of other loans held more than 90 days. Due diligence on many of these loans, such as commercial loans, is time consuming. Also, poor documentation of these instruments hampers RTC disposition efforts.

SAMDA

The RTC's effort to dispose of hard-to-sell assets has been focused on the SAMDA program, which places real estate owned and non-performing assets with the private sector for management and disposition under Standard Asset Management and Disposition Agreements (SAMDAs).

Under a SAMDA, a contractor serves as RTC's agent in the management and sale of RTC assets. The contractor designs a management and disposition program for assets, hires subcontractors to implement the program, and negotiates the sale of assets. The compensation structure gives contractors incentives to sell assets quickly and at the best possible price. A recent revision to the SAMDA standard contract has enhanced these incentives.

As of May 31, 128 SAMDAs with assets of over $24 billion book value have been placed with contractors. An additional $10 billion of assets is currently being bid.

At March 31, SAMDA contractors had sold assets with a book value of $359 million, yielding $218 million in proceeds. Results have been slow to come at least partly because 75 percent of the assets now under SAMDA were contracted for within the last six months, and because there is a lag of three to four months after the award of a SAMDA, before the contractor can implement a marketing program for the properties under its management.

The SAMDA program has been criticized because the pools of assets RTC created and bid out for management average of about $190 million and thus make it very difficult for smaller businesses, including MWOB's, to win SAMDA contracts. At the Oversight Board's urging the RTC has begun to create smaller pools of assets. This should make the SAMDA program more accessible to smaller firms and especially to those owned by minorities and women.

Seller Financing

The Oversight Board adopted last December a policy providing for a $7 billion seller financing program to expedite the pace of sales of illiquid assets and to maximize the value recovered by the RTC from such dispositions. A minimum of $250 million was reserved to assist the sale of affordable single family housing to qualified buyers.

The RTC has a strong cash preference. But the RTC owns assets for which there is no cash market except at distress prices. The RTC reports that there were six alternative cash offers for the approximately 117 seller financed transactions that have occurred since March, 1991 when the RTC began keeping records of alternative cash offers. In such cases, seller financing gives the RTC a potent means by which to expedite the sale of assets. It gets some cash up front, and avoids the costs, liabilities and physical deterioration that occurs when property is held in inventory.

Nonetheless we recognize that financed transactions ultimately rely on the credit and performance of the buyer. So they are not without risk. Accordingly the Oversight Board included risk-limiting safeguards in its seller financing policies and directed the RTC IG to conduct a front-end risk assessment of the program and to conduct periodic audits.

Portfolio Sales

The RTC, through its sales centers, has been actively engaged in marketing large portfolios of hard-to-sell assets, including apartment buildings, office buildings and shopping centers.

On May 21 the RTC Board adopted a policy to authorize the RTC to negotiate sales of very large portfolios of properties with necessarily very large buyers, given the size of the portfolios.

The Oversight Board considers this an important issue. Given the very large amount of RTC assets, innovative sales methods must be explored. There are elements of the RTC policy that are consistent with existing Board policy, such as cash flow mortgages, if done on a competitive basis. Following extensive discussions between the Oversight Board staff and the RTC, the Oversight Board will further consider this issue at its meeting on July 25.

The Oversight Board is also considering the effect of this proposal on the SAMDA program. Very substantial effort has been given to making SAMDA work. The Board wants to encourage continued RTC efforts to sell assets. However, we also want to ensure that the portfolio sales policy does not undercut SAMDA just as it is getting started.

I ask your consent that the RTC policy statement, and the Oversight Board's communications with the RTC about it, be included in the record of the hearing.

OTHER BOARD ACTIVITIES

Management Initiatives

Strengthening the RTC's management practices and internal controls have been key objectives of the Oversight Board because they are essential to sound decision-making and ultimately to saving taxpayer dollars.

Specific improvements in RTC's management practices were mandated by the Wylie Amendment to the Funding Act. These and a number of other management improvements requested by the GAO and the RTC IG are summarized in the Management Initiatives Report contained in Appendix I.

Encouraging the RTC to develop operating plans has been a major objective of the Oversight Board. The first nine-month plan was submitted by the RTC in January. Producing such plans requires setting goals, developing internal plans to achieve the goals, measuring progress against goals, analyzing variances and revising strategies. This process has been given strong stimulus by the Funding Act's requirement that the RTC and Oversight Board submit quarterly projections through the end of each calendar year. This is a healthy discipline that the Board strongly supports.

Operating Plan Management Information System

Beginning in October, 1990, under the leadership of Director Philip Jackson, the Oversight Board has initiated the development with the RTC of an Operating Plan Management Information System.

This is an important undertaking, as the Comptroller General testified to the Senate Banking Committee on June 11. When in operation, it will provide the Oversight Board with the consistent, structured information needed to fulfill its role, and form the basis for an executive information system for senior RTC managers. It will help in developing an integrated operating plan process, assessing the reasonableness of operating plan goals and measuring operating results. Its implementation will address the GAO's concern that the RTC have an integrated system that supports decision making in policy as well as operational matters.

This information provides the basis for an ongoing Oversight Board "scorecard" program that visually displays RTC's activities.

Oversight Board Working Group on Audit Reviews

As the Comptroller General indicated, the thrift cleanup requires oversight because it is so big, and costs so many billions of public funds. The Comptroller General's testimony about RTC operational shortcomings raised concerns that have been the subject of ongoing action by the Oversight Board.

Some background may be helpful. Early in 1991 the Oversight Board staff began studying the RTC's internal control systems. This work was given impetus by Comptroller General Bowsher's criticisms of the RTC's internal controls provided to the Oversight Board at its April 17 meeting.

Oversight Board staff immediately began to meet with the GAO, with the RTC IG, and with RTC to understand and act on the GAO's concerns. At its next meeting, on May 15, the Oversight Board authorized me as Chairman to write the GAO and the IG to request explicit additional information as the basis for possible further action.

The Oversight Board also created a working group headed by John Robson, Deputy Secretary of the Treasury, and Alfred DelliBovi, Deputy Secretary of HUD to help address concerns raised in the area of internal controls. This working group has three tasks:

- ensuring that RTC puts adequate systems in place to coordinate activities among RTC's three auditors - the GAO, the RTC's IG, and RTC's own in-house auditors;
- ensuring that RTC puts an "early warning" system in place so that problems are identified early; and
- ensuring that RTC has a system to track the implementation of corrective actions, and to verify that expected improvements were achieved.

On June 10, when the Comptroller General responded to my request, I wrote and asked him to meet with the working group. I would like to request, Mr. Chairman, that this correspondence be included in the record of this hearing.

The working group has begun with a series of meetings with representatives of the Comptroller General, the RTC IG, and RTC's recently formed Internal Controls Task Force.

Their first recommendation to me is that RTC be required to comply with the Federal Managers Financial Integrity Act of 1982 (FMFIA). Under the Chief Financial Officers Act of 1990 (CFO), RTC is now required to submit an assurance letter to the President and Congress that RTC's systems of internal controls comply with standards prescribed by the Comptroller General and are consistent with FMFIA.

In addition, while RTC is subject to certain financial audit and management reporting requirements of the CFO Act, I believe RTC would benefit from following all provisions of that Act.

As the Chairman of the Oversight Board, I fully endorse these working group recommendations. While I will ask the Oversight Board to approve these recommendations thereby requiring RTC to follow the spirit of FMFIA and the CFO Act, I would welcome legislation by this Committee which would officially bring the RTC under FMFIA and all provisions of the CFO Act. In either case, good government dictates that we follow this course.

The Role of the RTC Inspector General

The Oversight Board sees the job of the RTC IG as critical. Timely and comprehensive financial and program audits are absolutely essential to the success of the RTC. The Oversight Board has worked closely with the RTC IG to be sure that his audit plan is focused on areas within RTC that have the greatest relative risk exposure and vulnerability.

We have taken a number of steps to ensure that audits of RTC operations yield substantial change.

When the IG's audit plan was in the initial stages of development, I urged him to use a scientific methodology to identify audit targets. The Oversight Board was pleased that the IG responded to this request and employed a fact-based approach in devising the audit plan.

In our review of the plan we noted several areas - including accounting standards, the 1988 Deals, and asset pricing, - that in our estimation warranted formal audits. We requested that he modify his plan to include these, and he did so. We also encouraged him to emphasize and speed up audits in the areas of asset management, asset valuation, internal controls, and cash control. These areas were identified by the GAO as weaknesses in RTC's overall financial management system.

I ask that relevant correspondence with the IG be included in the record of the hearing.

'88 DEALS

FIRREA requires that the Oversight Board establish strategies, policies and goals for restructuring the 1988 Deals. The Board's policy calls on the RTC to renegotiate and prepay the 1988 FSLIC deals to save taxpayer dollars. In October, 1990, Congress appropriated $22 billion for this purpose. As of May 31, 1991, RTC had spent $7.3 billion, or 33 percent of the $22 billion appropriation for FY91. Seventy-five percent of this amount has been used to prepay high yield FSLIC notes.

Estimates of savings from these prepayments range from $441 million to $821 million, equal to 6.0 percent to 11.2 percent of the total $7.3 billion expended. The range of savings reflects uncertainty about the tax treatment of these deals.

ORGANIZATIONAL ISSUES

Some have questioned whether the current structure of the RTC and Oversight Board permits the cleanup to be completed efficiently. Let me review briefly the current structure.

FIRREA made the FDIC the exclusive manager of the RTC to perform all responsibilities of RTC under the statute, and made the FDIC Board the Board of Directors for the RTC. At the same time, FIRREA gave the Oversight Board authority over the RTC's strategies, policies, and funding, and gave it responsibility for oversight and evaluation of the RTC. Given the immensity and complexity of the cleanup, and the need for continuing objective oversight, this separation of management and operations from oversight makes sense.

It was prudent to assign the management and operational responsibility to FDIC, because at the time of FIRREA's enactment it was the only organization with the experience and personnel equipped to handle what was then, and throughout the initial phase of the thrift cleanup has been, the RTC's principal task, i.e., seizing and resolving a massive collection of bankrupt institutions. The alternative would have been to create and staff from scratch an organization to handle this problem, a job which inevitably would have delayed the start of the cleanup and added to the costs for taxpayers. Properly, neither Congress nor the Administration was prepared to accept such delay or costs.

We have functioned under this structure for nearly two years. Admittedly, there have been some problems in addressing the giant, unprecedented cleanup task. It would have been unrealistic not to expect them.

It has been suggested that these problems are caused by the dual-board structure on the theory that it diffuses responsibility and prevents the RTC management from having clear direction.

We do not agree. Neither does the Chairman of the RTC National Advisory Board who stated that the structure is not the cause of operational problems, nor the Comptroller General who has said that the cleanup does require oversight, such as that provided by the Oversight Board.

We believe the most important action that can be taken to move the thrift cleanup forward effectively is to establish at the head of the RTC a CEO with the credentials and the operating latitude to get this job finished. This recommendation is based on the fact that the nature of the cleanup has fundamentally changed. The RTC has demonstrated its ability to seize and resolve bankrupt thrifts. Now its main task is to dispose of a tremendous accumulation of hard-to-sell assets. Our recommendation is also made in sincere appreciation of the accomplishments of the RTC's current management. Bill Seidman, David Cooke, Bill Roelle, Lamar Kelly, and others have done an outstanding job in building the current RTC from the ground up into a nationwide organization.

We do not believe a major and potentially disruptive restructuring would be productive. Such a reorganization would require legislation and thus could take months to accomplish. It would create confusion and demoralization in the management ranks of the RTC and thus as the Comptroller General has warned, would impede progress. Time and delay are our enemies. They only mean higher costs.

Appointment of a new CEO and actions necessary to give him a full measure of authority can be taken immediately, without legislation, which as we know could entail considerable delay. So we need not delay action. The Oversight Board has discussed these matters fully with the FDIC Chairman. He agrees that the search for a new CEO to run the RTC should begin immediately.

As I have said today and previously, we do not believe restructuring is necessary because the problems are not problems of structure.

Nonetheless, if the Committee is convinced that it is imperative to redraw the organizational chart, we strongly believe that any such plan should meet the following criteria.

First, a new RTC should not be a wholly independent entity. To entrust the expenditure of up to $160 billion taxpayer dollars to an independent agency is not sound public policy. The RTC is not like a private corporation that does not receive public funds. The RTC is a government corporation responsible for spending possibly as much as $160 billion. Certainly our experience with the Federal Asset Disposition Agency suggests that strong oversight is essential to protect the taxpayers' interest.

Second, as the Comptroller General has stated, a separate oversight function is important and necessary and should be retained. Congress has previously recognized the need for such oversight. It created the Chrysler Loan Guarantee Board in 1980, and that Board had five members, all of them public officials who served part-time. The point has been made that the Chrysler Loan Guarantee is dwarfed by the thrift cleanup, and in dollar terms that is true. But the principle is the same and is valid. It was applied even earlier, in 1970, when Congress created the Emergency Loan Guarantee Board to oversee the government's interest in the Lockheed Loan Guarantee. That the thrift cleanup is bigger than either the Chrysler or Lockhead situations is even more reason why oversight is necessary.

Third, the oversight and budget approving entity should not have direct operating responsibility over the RTC. These functions should continue to be separated. A body charged with oversight cannot impartially perform that duty if it is also charged with operations.

Fourth, any restructuring should not disrupt ongoing operations, prolong the cleanup or result in costly delay.

Finally, a restructuring must address the real problems, not just the perceptual ones. We see no useful purpose in just moving the boxes around.

Perhaps a new structure can be fashioned that meets these criteria. Certainly, we will work with the Committee to that end. Chairman Seidman has suggested two possible organizational models. We are discussing these and other possibilities with him. But we are concerned that a major restructure in mid-stream would disrupt the effort to get this enormous problem off the public agenda.

CONCLUSION

This concludes our statement. It is supplemented by a more detailed response, contained in Appendix II, to several of the specific information requirements set forth in FIRREA for this semiannual appearance.

The great majority of insolvent thrifts will have been seized by the end of the fiscal year. We request additional loss funds, working capital, and an extension of the period in which thrifts may be transferred to the RTC for closing. These authorities will permit the job of protecting depositors and closing insolvent thrifts to be completed in an orderly, efficient way.

The task now before the RTC is to dispose of assets as quickly as it can and with the greatest possible return. This is a Herculean job. Policies and programs put in place months ago are now becoming operational. But much remains to be done, and we look forward to working with you to finish this task.

PRESS RELEASE

OVERSIGHT BOARD
Resolution Trust Corporation
1777 F STREET, N.W. WASHINGTON, D.C. 20232

FOR IMMEDIATE RELEASE
July 10, 1991
OB-91-26

CONTACT: ARTHUR SIDDON
(202) 786-9672

BRADY AND SEIDMAN ANNOUNCE SEARCH FOR RTC CEO

Secretary of the Treasury Nicholas F. Brady and Chairman of the Federal Deposit Insurance Corporation L. William Seidman announced today that a nationwide search has begun for a chief executive officer for the Resolution Trust Corporation (RTC).

In recent congressional testimony, both Secretary Brady and Chairman Seidman endorsed the idea of establishing a new CEO position.

The Members of the search committee will be Secretary Brady, Chairman Seidman, Office of Thrift Supervision Director Timothy Ryan and Oversight Board Member Robert C. Larson. Deputy Treasury Secretary John Robson will serve as Director.

The RTC is the organization which conducts the cleanup of failed savings and loan institutions and sells their assets.

The Treasury Secretary serves as Chairman of the Oversight Board which has a policy and oversight role for the RTC. The FDIC Chairman serves as Chairman of the Board of Directors of the RTC, which has the operational responsibilities for the thrift cleanup.

###

TREASURY NEWS

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

For Release Upon Delivery
Expected at 11:00 a.m.
July 11, 1991

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

Mr. Chairman and Members of the Subcommittee:

I am pleased to testify today concerning enterprise zone proposals. One of those proposals, H.R. 23, is the proposal described in the Administration's budget. On June 25, 1991, Secretary of Housing and Urban Development Jack Kemp appeared before this Subcommittee to testify regarding the proposals. As Secretary Kemp made clear, the establishment of Federal tax incentives to aid economically distressed urban and rural areas is a high priority of the Administration.

H.R. 23

The Administration believes that H.R. 23 provides the tax benefits that are most likely to stimulate economic development within Federally designated enterprise zones, while establishing appropriate safeguards to ensure that these tax benefits will not be available to those whose activities do not contribute to economic growth within the designated zones.

Under the proposal, specified tax incentives would be available in areas nominated by State and local governments and designated as Federal enterprise zones by the Secretary of Housing and Urban Development. The proposal authorizes the Secretary of HUD to designate up to 50 zones during a 4-year period beginning in 1991. The designations would be spread over that period. Up to 15 designations could be made by the end of the first year, up to 30 by the end of the second year, up to 45 by the end of the third year, and up to 50 by the end of the fourth year. In making zone designations, the Secretary of HUD would consider the geographic distribution of areas designated as zones, as well as the commitments of support made by nominating State and local governments and the relative economic distress of the nominated areas. In addition, the proposal would require that at least one-third of the areas designated as zones be rural areas. The designation of an area as a zone would be effective for a term of up to 25 years.

Once an area had been designated as an enterprise zone, two Federal tax incentives would be available to encourage zone capital formation, and one Federal tax incentive would be available to stimulate zone employment.

The focus of the capital formation incentives is upon offering investors in enterprise zone businesses lower effective Federal tax rates with respect to their income from zone investment. The first incentive eliminates tax on long-term capital gains realized from the disposition of tangible property used in an enterprise zone business and located within an enterprise zone for at least 2 years. In order for a business to qualify as an "enterprise zone business," the business must meet a number of requirements. Among these are that more than 80 percent of the gross income of the business must be attributable to the active conduct of a trade or business within a zone, substantially all the assets and employees of the business must be located within a zone, and the business must not be controlled by non-zone businesses. These restrictions are designed to target the incentive on the assets of independent activities actually conducted within zones and likely to create significant zone value and employment opportunities. Capital gain excluded from tax by this incentive must accrue while the assets are used in the enterprise zone business.

The second capital formation incentive permits individuals to deduct their contributions to the capital of Subchapter C corporations engaged solely in the conduct of enterprise zone businesses. Recipient corporations must have no more than $5 million of total assets, and must use the capital contributions to acquire tangible assets to be located within the zone and used in enterprise zone businesses. Expensing is restricted to $50,000 annually per investor with a $250,000 lifetime limit per investor, and is not permitted for purposes of the alternative minimum tax. These restrictions are designed to limit the potential for tax shelters and to target the proposal's tax benefits to the entrepreneurial businesses which the Administration believes are most likely to stimulate an economic revitalization of zones. Because the profile of a corporation qualifying for the incentive conforms to that of most small businesses likely to engage in the activities the incentive is designed to encourage, the restrictions are unlikely to impair the effectiveness of the incentive.

The focus of the employment incentive is upon reducing employee costs associated with zone employment. A 5 percent refundable tax credit for the first $10,500 of wages (that is, up to $525 per worker) may be claimed by qualified enterprise zone employees for wages earned by working in a non-governmental enterprise zone business. To qualify for the credit, an employee must perform the services in a zone. The Administration believes that the employee credit will provide an important additional incentive to work in businesses within zones. The credit phases out for an employee earning between $20,000 and $25,000 of total wages, and must be reduced if the employee is subject to the alternative minimum tax.

To protect against excessive subsidies, H.R. 23 authorizes the Treasury Department to issue regulations coordinating Internal Revenue Code provisions that otherwise might result in the Federal Government subsidizing more than 100 percent of the cost of enterprise zone activities. For example, it is possible that certain low-income residential rental projects located within zones would qualify for a low-income housing tax credit with respect to as much as 91 percent of their cost. Because Federal rental subsidies, cost recovery deductions, and other tax benefits may also be available for such an investment, it may be necessary to reduce or eliminate the special enterprise zone tax benefits in order to prevent a combined Federal subsidy totalling more than 100 percent of the cost of the activity.

The Treasury Department estimates that H.R. 23 will reduce Federal revenues by approximately $50 million in 1992, $160 million in 1993, $310 million in 1994, $520 million in 1995, and $750 million in 1996. These figures are consistent with those presented in the President's budget.

H.R. 11

Chairman Rostenkowski, Mr. Archer, Mr. Rangel, and the other sponsors of H.R. 11 are to be commended for recognizing the plight of economically distressed areas and the potential benefit of providing tax incentives to encourage investment and employment in such areas.

H.R. 11 would offer the following array of tax incentives in designated enterprise zones:

(i) A credit for small employers equal to 10 percent of the sum of wages paid for services performed by qualified zone employees plus costs paid for health insurance for qualified zone employees. Employees not residing in a zone could not be qualified zone employees.

(ii) Extension of eligibility for the rehabilitation tax credit to any zone building first placed in service at least 30 years before the date rehabilitation begins.

(iii) Amortization of qualified employer-provided child care facilities in zones over a 60-month period, in lieu of depreciation. To qualify, a facility would have to be used primarily for children of employees working in the zone.

(iv) An increase in the qualified basis of a zone building on which the low-income housing tax credit may be taken to include costs incurred in establishing a qualified child care center in the building. To qualify, a center would have to be used only for children residing in a zone.

(v) A deferral of recognition of capital gain from the sale or exchange of property (tangible or intangible) if the amount realized is invested, within a year, in enterprise zone property or an interest in an enterprise zone corporation or partnership. The deferral would last for up to 9 taxable years after the taxable year in which the sale or exchange occurred. The deferral would be available only to individuals, and a $250,000 lifetime limit would apply.

(vi) Treatment of any loss from the sale or exchange of certain stock or securities of zone corporations (i.e., qualified zone corporate investments) as ordinary rather than capital.

Although H.R. 11 contains more incentives than H.R. 23, the incentives are in fact narrower because only a limited amount of each incentive is available each year in each zone. H.R. 11 requires the tax incentives for each zone to be allocated in advance by a government official who is responsible for ensuring that the annual limits ("volume caps") on each of the zone's tax benefits are not exceeded. The official for each zone would be selected by the governments of the State and locality in which the zone is located.

Other bills

Two other enterprise zone proposals should also be mentioned, H.R. 1445, the Rural Development Investment Zone Act of 1991, sponsored by Mr. Dorgan and Mr. Grandy, and H.R. 1747, the Indian Economic Development Act of 1991, sponsored by Mr. Rhodes. As their titles imply, these bills provide for enterprise zones in rural areas and on Indian reservations, respectively.

H.R. 23 recognizes the special concerns arising in rural areas by requiring that at least one-third of all zones be in rural areas and by providing special qualification rules for rural areas. H.R. 11 relaxes the qualification rules but contains no mandate for any number of rural zones. Both H.R. 11 and H.R. 23 appear to provide sufficient flexibility to permit Indian reservation sites to qualify for enterprise zone designation.

<u>General discussion</u>

The volume cap approach has apparently been adopted in H.R. 11 to ensure that revenue loss resulting from the enterprise zone program will be limited to budgeted amounts. In light of the requirements of the budget agreement, controlling the cost of the program is essential. A volume cap on zone tax incentives should not be necessary, however, if the incentives are tailored sufficiently narrowly that it is possible to estimate and budget for their cost. This is the approach taken by H.R. 23 to controlling costs and is the approach favored by the Administration. We nonetheless share the concern that the provisions of any enterprise zone proposal enacted must be carefully circumscribed to assure both that only incentives which benefit zone development are adopted and that budget limitations are met.

The Administration believes that this approach is preferable to the imposition of volume caps on a broader array of incentives. Volume caps, administered by government agents, increase complexity, paperwork, and opportunities for favoritism. In addition, we believe that the effectiveness of the program can best be evaluated if a small number of well-structured incentives are tested rather than a wide range of incentives which must be limited by reason of their numbers. We believe that H.R. 23 contains the best "short list" of incentives.

We are pleased that both H.R. 11 and H.R. 23 recognize that a reduced tax burden on capital gains should be one of the enterprise zone tax incentives provided. H.R. 23 accomplishes this through exclusion of capital gains arising within zones while H.R. 11 provides a tax-free "rollover" of non-zone capital gains into zones. The Administration believes that the exclusion, targeted to zone gains, will be a more powerful inducement for productive zone activity than the H.R. 11 deferral, which would attract new capital to zones but would not take into account whether zone investments were productive. Because the proposed capital gain exclusion is only available for gain accruing on property used within a zone, the exclusion proposal ensures that the tax incentive will only be available where value is added within a zone.

In addition, the exclusion proposal is limited to capital gains accruing on tangible assets. The Administration believes that this restriction will avoid the difficulties associated with providing incentives for intangible assets, which might be moved into an enterprise zone without stimulating any zone economic development.

Summary

The Administration strongly supports enactment of Federal enterprise zone tax legislation. Due to concerns regarding the Federal budget deficit, as well as potential abuse of the geographically targeted benefits, the appropriate incentives must be carefully structured to achieve economic growth and development in Federal enterprise zones within affordable budget parameters. The Administration believes that H.R. 23 strikes an appropriate balance between effectiveness and cost and should be enacted.

Mr. Chairman, that concludes my formal statement. I am happy to answer any questions that you or the Members of the Subcommittee may wish to ask.

PRESS RELEASE

OVERSIGHT BOARD

Resolution Trust Corporation

1777 F STREET, N.W. WASHINGTON, D.C. 20232

FOR IMMEDIATE RELEASE
July 11, 1991
OB-91-27

CONTACT: Brian P. Harrington
(202)786-9675

OVERSIGHT BOARD REAPPOINTS ADVISORY BOARD MEMBERS

The Oversight Board for the Resolution Trust Corporation (RTC) today announced the reappointment of 10 members of the National and Regional Advisory Boards, which advise the Oversight Board and the RTC on the sale of real estate from the country's failed savings and loans.

Charles Kopp, a Senior Partner and Tax Department Chairman for the law firm of Wolf, Block, Schorr and Solis-Cohen in Philadelphia, Pa., and G. Lindsay Crump, President of the Crump Group in Savannah, Ga., have been reappointed to two-year terms on the Region 1 Regional Advisory Board based in New York, N.Y.

Dick Tourtellotte, President of Tourtellotte Management and Real Estate in Oklahoma City, Okla., has been reappointed to a one-year term as Chairman of the Region 2 Regional Advisory Board based in Oklahoma City, Okla.

Evelyn Carroll, President of FSA Inc. in Minneapolis, Minn., Ritch LeGrand, President of LeGrand and Company in Sioux City, Iowa, and Mirian Saez, Executive Director of the Cambridge Metropolitan Housing Authority in Cambridge, Ohio., have been reappointed to two-year terms on the Region 3 Advisory Board based in Chicago, Ill.

David Dominick, an attorney with the law firm of Cogswell and Eggleston, P.C. in Denver, Colo., and P. Barton Delacy, President of Appraisal Group Inc. in Portland, Ore., have been reappointed to two-year terms on the Region 5 Regional Advisory Board based in Denver, Colo.

- more -

Sydney Fonnesbeck, Director of Training and Communications for the Utah League of Cities in Salt Lake City, Utah, and Gordon Parker, retired President and Chief Operating Officer of First Commercial Corporation in Ark., have been reappointed to two-year terms on the Region 6 Regional Advisory Board based in Los Angeles, Calif.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) required that the Oversight Board establish one national and six regional advisory boards to advise the Oversight Board and Resolution Trust Corporation on the policies and programs for the disposition of real estate from the nation's failed thrifts.

The National and Regional Advisory Boards are each required to meet no less than four times a year. In July, the Boards completed their fourth series of meetings.

###

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:

PRESS RELEASE

AUG 18 92 004594

OVERSIGHT BOARD
Resolution Trust Corporation
1777 F STREET, N.W. WASHINGTON, D.C. 20232

DEPT. OF THE TREASURY

FOR IMMEDIATE RELEASE
July 12, 1991
OB-91-28

Contact: Brian P. Harrington
(202)786-9675

NATIONAL ADVISORY BOARD TO HOLD OPEN MEETING

The members of the National Advisory Board will hold an open meeting on Monday, July 22, in Washington, D.C., to discuss the Resolution Trust Corporation's (RTC) regional real estate sales progress.

The meeting, open to the public and press, will be held from 10:00 a.m. to 3:30 p.m. in the second floor amphitheater at the Office of Thrift Supervision, 1700 G Street, N.W., Washington, D.C.

Reports will be given on the issues discussed at the latest round of regional meetings held in June and July of this year. Including: RTC user friendliness, RTC minority contracting policy, RTC affordable housing disposition, and RTC auction marketing. Nationally recognized industry representatives will testify on each topic.

In addition, Oversight Board President Peter H. Monroe and RTC Executive Director David Cooke will present remarks, and agenda items for the next quarterly series of regional meetings will be determined.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) required that the Oversight Board establish one national and six regional advisory boards to provide advice to the Resolution Trust Corporation and the Oversight Board on the policies and programs for the disposition of real estate from the nation's failed thrifts.

- more -

The National Advisory Board meets quarterly in Washington, D.C. to advise the Oversight Board and the RTC on the status of the real estate sales efforts of the RTC in each region. The National Advisory Board is comprised of the national chairman and the six regional chairmen. The National Advisory Board includes: Philip Searle of Naples, Fla. as chairman; Henry Berliner of Annapolis, Md.; Dick Tourtellotte of Oklahoma City, Okla.; Donald Jacobs of Evanston, Ill.; Bayard Friedman of Fort Worth, Tx.; Edward Lujan of Albuquerque, N.M., and James Simmons of Paradise Valley, Ariz.

###

OVERSIGHT BOARD
RESOLUTION TRUST CORPORATION
Washington, D.C. 20232

THE BUSH ADMINISTRATION'S S&L CLEAN-UP PROGRAM Principles and Results July 8, 1991

Eighteen days after taking office, President Bush presented the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), putting in motion a massive program to clean up the nation's failed savings and loan associations. At that time, the President established four key objectives that have been the foundation of the clean-up effort.

PROTECTING DEPOSITOR SAVINGS

Results: Nearly 14 million depositors' accounts and $139 billion in deposits have been protected by the Resolution Trust Corporation (RTC), created under FIRREA to manage and resolve failed thrifts.

Based on current funding, RTC estimates that, by the end of September 1991, it will have protected a total of nearly 20 million depositors' accounts nationwide.

The average balance of accounts protected is about $10,000, a reality that refutes the misconception that only the wealthy benefit from the clean-up program.

RESTORING THE SAFETY AND SOUNDNESS OF THRIFTS

Results: Two key purposes of FIRREA were: (1) to shut down those thrifts that are not operating safely and soundly, and (2) to institute new risk-based capital standards and a program of tighter, but fair, regulation on the remaining industry.

Since FIRREA's enactment, 623 insolvent thrifts have been seized and 435 of those have been resolved. By the end of September 1991, RTC estimates, it will have resolved 557 failed thrifts (one every 33 hours).

As a result of reforms, 85 percent of private-sector thrifts, with more than $625 billion in assets, today are operating profitably. Additional legislation recommended by the Treasury Department should further improve the safety and soundness of the industry.

CLEANING UP FAILED THRIFTS/LIMITING TAXPAYER COSTS

Results: The goal of FIRREA is not only to close failed S&Ls and sell the remaining assets, but to do it at least cost to **taxpayers**. To meet this dual objective, initiatives have been undertaken by RTC and its Oversight Board, including:

In response to tightened commercial credit availability, the Oversight Board in December 1990 issued a seller **financing** policy to **accelerate asset sales** and increase **returns** to taxpayers.

To **speed sales** at the **best possible prices**, the RTC has placed more than **$24 billion** in assets under private management. Contractors currently are being sought to handle another **$15 billion**.

While it is vital to maximize taxpayer returns, the RTC also must achieve **affordable housing goals**, as required by FIRREA. This program has been stimulated by permitting sales at less-than-market value; tax-exempt mortgage bond financing, and a minimum of **$250 million** in seller financing for qualified buyers of single-family homes and **$150 million** for sale of affordable multi-family properties to non-profit organizations.

Guidelines set by the Oversight Board in January 1991 will allow the RTC to restructure many of the **1988 FSLIC agreements**, saving taxpayers as much as **$2 billion**.

The Oversight Board has directed the widest possible use of the **securitization** of RTC financial assets. On June 27, 1991, RTC closed on its first offering of mortgage pass-through securities, backed by approximately $430 million of mortgages. This transaction represented **$15 million** in savings to taxpayers. A second offering of approximately $580 million will be priced on or about July 16. It is estimated that securitization of single-family mortgages alone could save taxpayers at least **$1 billion**.

Through April 30, 1991, the RTC had sold, liquidated or otherwise collected **$157 billion** of the **$318 billion** in initial assets seized by that date.

SENDING WRONGDOERS TO JAIL AND LEVYING FINES

Results: The RTC's Office of Investigations has referred hundreds of cases to the **Justice Department**.

Since October 1988, there have been **550 convictions** for major thrift crimes. More than **79 percent** of those sentenced have received prison terms, and **$270 million** in restitution has been ordered.

The **FBI** is conducting **718** active investigations of failed financial institutions, **378** involving failed

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
July 15, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,424 million of 13-week bills to be issued July 18, 1991 and to mature October 17, 1991 were accepted today (CUSIP: 912794XK5).

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	5.56%	5.73%	98.595

Tenders at the high discount rate were allotted 20%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	36,270	36,270
New York	37,171,160	8,966,990
Philadelphia	31,840	31,840
Cleveland	69,855	69,855
Richmond	59,310	51,310
Atlanta	29,875	29,875
Chicago	1,751,675	264,165
St. Louis	13,445	13,445
Minneapolis	9,520	9,520
Kansas City	37,120	37,120
Dallas	22,305	22,305
San Francisco	673,520	98,490
Treasury	792,675	792,675
TOTALS	$40,698,570	$10,423,860
Type		
Competitive	$36,587,145	$6,312,435
Noncompetitive	1,795,620	1,795,620
Subtotal, Public	$38,382,765	$8,108,055
Federal Reserve	2,291,120	2,291,120
Foreign Official Institutions	24,685	24,685
TOTALS	$40,698,570	$10,423,860

An additional $33,915 thousand of bills will be issued to foreign official institutions for new cash.

NB-1368

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
July 15, 1991

CONTACT: Office of Financing
202-376-4350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,502 million of 26-week bills to be issued July 18, 1991 and to mature January 16, 1992 were accepted today (CUSIP: 912794XV1).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.68%	5.95%	97.128
High	5.70%	5.97%	97.118
Average	5.70%	5.97%	97.118

Tenders at the high discount rate were allotted 34%. The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	43,630	43,630
New York	31,164,240	9,308,360
Philadelphia	20,265	20,265
Cleveland	55,740	55,740
Richmond	66,150	59,550
Atlanta	51,165	49,645
Chicago	1,763,495	140,755
St. Louis	19,205	19,205
Minneapolis	14,180	14,180
Kansas City	45,935	43,705
Dallas	19,840	19,840
San Francisco	573,425	105,425
Treasury	621,400	621,400
TOTALS	$34,458,670	$10,501,700
Type		
Competitive	$29,802,230	$5,845,260
Noncompetitive	1,437,425	1,437,425
Subtotal, Public	$31,239,655	$7,282,685
Federal Reserve	2,750,000	2,750,000
Foreign Official Institutions	469,015	469,015
TOTALS	$34,458,670	$10,501,700

An additional $546,185 thousand of bills will be issued to foreign official institutions for new cash.

NB-1369

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

FOR IMMEDIATE RELEASE

July 15, 1991

FEDERAL FINANCING BANK ACTIVITY

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

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $182.6 billion on May 31, 1991, posting a decrease of $0.1 billion from the level on April 30, 1991. This net change was the result of decreases in holdings of agency debt of $121 million, of agency assets of $2.8 million, and of agency-guaranteed loans of $2.4 million. FFB made 16 disbursements during May.

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

NB-1370

FEDERAL FINANCING BANK

MAY 1991 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
Note #550	5/2	$ 3,000,000.00	6/28/91	5.837%	
+Note #551	5/6	6,210,000.00	8/5/91	5.770%	
+Note #552	5/24	10,000,000.00	8/23/91	5.695%	
TENNESSEE VALLEY AUTHORITY					
Short-term Bond #96	5/6	219,000,000.00	5/22/91	5.753%	
Short-term Bond #97	5/15	150,000,000.00	5/22/91	5.760%	
Short-term Bond #98	5/15	339,000,000.00	5/31/91	5.760%	
Short-term Bond #99	5/22	348,000,000.00	6/6/91	5.739%	
Short-term Bond #100	5/31	377,000,000.00	6/10/91	5.743%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Morocco 13	5/8	4,443,933.27	5/31/96	7.729%	
Morocco 13	5/24	1,101,882.32	5/31/96	7.839%	
GENERAL SERVICES ADMINISTRATION					
U.S. Trust Company of New York					
+Advance #12	5/15	23,538,374.31	11/15/91	6.007%	
Advance #13	5/21	2,535,573.05	11/15/91	5.992%	

+rollover

FEDERAL FINANCING BANK

MAY 1991 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION					
Central Iowa Power #295	5/3	$ 643,000.00	1/2/18	8.160%	8.078% qtr.
*United Power Assoc. #212A	5/13	365,000.00	12/31/19	8.351%	8.266% qtr.
Oglethorpe Power #335	5/31	28,272,000.00	1/2/24	8.290%	8.206% qtr.
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-91-07	5/31	2,439,941.15	6/28/91	5.743%	

*maturity extension

FEDERAL FINANCING BANK
(in millions)

Program	May 31, 1991	April 30, 1991	Net Change 5/1/91-5/31/91	FY '91 Net Change 10/1/90-5/31/91
Agency Debt:				
Export-Import Bank	$ 11,180.5	$ 11,180.5	$ -0-	$ -159.3
NCUA-Central Liquidity Fund	52.9	55.8	-2.9	-3.7
Resolution Trust Corporation	57,908.0	57,908.0	-0-	16,426.3
Tennessee Valley Authority	13,400.0	13,221.0	179.0	-982.00
U.S. Postal Service	6,400.6	6,697.8	-297.2	-297.2-
sub-total*	88,942.0	89,063.1	-121.1	14,984.2
Agency Assets:				
Farmers Home Administration	52,669.0	52,669.0	-0-	620.0
DHHS-Health Maintenance Org.	66.9	69.6	-2.7	-2.7
DHHS-Medical Facilities	82.7	82.7	-0-	-0-
Rural Electrification Admin.-CBO	4,463.9	4,463.9	-0-	56.7
Small Business Administration	7.0	7.2	-0.1	-1.4
sub-total*	57,289.5	57,292.4	-2.8	672.6
Government-Guaranteed Loans:				
DOD-Foreign Military Sales	4,699.5	4,721.9	-22.3	-5,056.1
DEd.-Student Loan Marketing Assn.	4,850.0	4,850.0	-0-	-30.0
DHUD-Community Dev. Block Grant	219.1	222.0	-2.9	-24.9
DHUD-Public Housing Notes +	1,903.4	1,903.4	-0-	-47.4
General Services Administration +	491.5	489.0	2.5	124.2
DOI-Guam Power Authority	29.1	29.1	-0-	-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	18,878.5	18,849.6	28.9	-163.8
SBA-Small Business Investment Cos.	296.9	303.0	-6.1	-85.6
SBA-State/Local Development Cos.	712.4	717.0	-4.5	-29.1
TVA-Seven States Energy Corp.	2,389.2	2,386.8	2.4	33.2
DOT-Section 511	22.0	22.4	-0.4	-1.4
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	36,350.4	36,352.8	-2.4	-6,393.3
grand total*	$ 182,581.9	$ 182,708.2	$ -126.3	$ 9,263.5

*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 Release Upon Delivery
Expected at 10:00 a.m.
July 16, 1991

STATEMENT OF
ROBERT R. WOOTTON
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
FINANCE COMMITTEE
UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to present the views of the Treasury Department on S. 1393, which seeks to regulate so-called partnership "rollup" transactions through the imposition of a 50% federal excise tax on transactions that do not provide specified dissenters' rights to limited partners.

We oppose S. 1393. We believe that the federal tax laws should not be used to attempt to regulate the terms of securities transactions on the merits.

The Internal Revenue Service personnel who would be asked to enforce the new excise tax would not have experience with the securities-law concepts that the statute would embody. In particular, the application of the tax would depend on whether, in connection with a partnership rollup, the limited partners have a reasonable opportunity to dissent and dissenters' rights. Making this determination would involve the examination and resolution of issues that are well outside our normal areas of experience.

If S. 1393 were enacted, we might well look to applicable federal or state laws for rules governing the form, content and timing of disclosure and proxy solicitation, the methodology of valuation and appraisal, and other matters implicated by S. 1393. This would require Internal Revenue Service agents to learn and interpret federal securities and state securities and corporation laws, in order to enforce the federal tax law. Alternatively, we could through Treasury regulations adopt a set of uniform rules governing these matters. However, this approach would lead to inconsistencies with applicable federal and state laws and, in the case of state laws, might raise questions of pre-emption.

On audit, issues regarding compliance with S. 1393 would typically arise in combination with other federal tax issues, and agents could not be expected to pursue rollup violations single-mindedly if other meritorious audit issues were present. As a practical matter, agents seldom have the experience, knowledge or time to raise all possible issues. Issues that require applying non-tax law may be less likely to be raised than those closer to the agent's usual experience. Further, in proposing adjustments or penalties, agents give first priority to revenue collection. An agent might reasonably decline to assert liability for the rollup excise tax in cases in which the liability is unclear and potential collections appear small. The agent might also compromise the excise tax in exchange for concessions on other issues.

These considerations might make the new excise tax a less effective deterrent against the targeted rollup transactions. Yet deterrence would be the only justification for the tax. Tax laws do not create private remedies. Accordingly, if the new excise tax did not deter a transaction, the only possible beneficiary would be the federal fisc. The intended beneficiaries, the dissenting limited partners, would be simply out of luck. In contrast, state dissenters' rights laws, such as those recently added to the limited partnership statutes of New York and California, do create private rights of action. Careful consideration should be given as to whether the enactment of S. 1393 would inhibit the further development of appropriate responses by state legislatures and federal or state securities regulators.

Partnership Rollup Transactions.

"Rollup" is a term popularized in the financial press that is generally used to describe the merger or consolidation of two or more limited partnerships into a single surviving entity. Often, the old partnerships have failed to achieve their original investment objectives and have performed poorly. The rollup may have been proposed as a way to salvage some portion of the limited partners' investments.

Partnership rollup transactions have generated controversy and a good deal of Congressional interest. A series of hearings has identified numerous concerns that may arise in a rollup transaction, including lack of clear, concise and understandable disclosure of the consequences of the rollup to limited partners; enhancement of the general partner's compensation, voting rights and ownership interest; changes relating to the partnership's borrowing policies, business plan, investment objectives and intended term of existence; and absence of legal or equitable alternatives to the rollup for dissenting limited partners. See Securities Act Release No. 33-6900 (June 17, 1991), at pp. 3-5.

The Securities and Exchange Commission (SEC) has taken several actions to improve the disclosure of information to limited partners, which it will describe in testimony today. The National Association of Securities Dealers has also recently proposed to amend its rules to prohibit its members from receiving higher compensation for "yes" votes than for "no" votes from limited partners in connection with rollup transactions.

Currently, the laws of at least three states (New York, California and Maryland) and the District of Columbia grant compensation rights to limited partners who dissent from partnership merger or consolidation transactions. The New York statute became effective on April 1, 1991; the California statute on January 1, 1991. See Testimony of Richard C. Breeden, Chairman of the Securities and Exchange Commission, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (April 23, 1991), at p. 23 n. 10.

Technical Comments on S. 1393.

Scope. The new excise tax would apply if (1) as a result of any transaction, a limited partner who was entitled to a proportionate share of all net proceeds of all sales or refinancings of the partnership's assets is no longer entitled to such a proportionate share, (2) in connection with the transaction, there is a securities offering that must be registered with the SEC or a comparable state or local governmental agency or there is a request for a proxy or other vote, and (3) specified dissenters' rights are not provided.

The excise tax would be equal to 50% of the gain or other income realized by reason of the covered payments. The tax would apply whether or not the gain or other income is recognized.

Proportionate share. The excise tax would apply to any transaction that changes a limited partner's right to a proportionate share of net proceeds from sales and refinancings. It would apply even if the transaction does not involve the combination of two or more limited partnerships into a single entity. The bill makes no provision for special allocations, preferred returns and the like. The excise tax would accordingly apply (unless dissenters' rights were provided) to a registered offering of a new class of limited partnership interests, if the new limited partners received, for instance, a right to a preferred return. While it is doubtful this scope of coverage is intended, the existing language of the bill would reach a number of common (and legitimate) partnership transactions that could not reasonably be viewed as "rollups."

Dissenters' rights. The excise tax would not apply if the limited partners have a reasonable opportunity to dissent from the transaction and, if they dissent, the right to require redemption of their limited partnership interests for net asset value (in cash, marketable securities or negotiable promissory notes) or to receive securities with substantially the same value, rights, powers and privileges. For this purpose, the value of a limited partnership interest cannot be less than its share of the amount represented as the value of the partnership's assets in any filing with the SEC or other governmental authority. It is not entirely clear that the bill as drafted requires a comparison of the value of the partnership interest with its share of represented partnership asset values (although this is surely the intention). The provision also appears flawed in not focusing on net asset values.

Payments subject to excise tax. The excise tax would be imposed on any payment received for services rendered in connection with the transaction or to the entity resulting from the transaction. The excise tax would also be imposed on any payment received in exchange for an interest in, or contract right with, any limited partnership that is a party to the transaction or on account of holding an interest in the entity resulting from the transaction.

In the case of payments for services, the excise tax would apply only to the extent that the payment exceeds the amount that would have been paid had the transaction not occurred. This may be a difficult standard to apply to fees based on revenues, profits, assets under management or similar performance-based measures. In addition, the exception would not seem to apply in cases where each partnership participating in a rollup transaction has a different general partner, but the resulting entity has a single general partner being paid no more than what would have been paid in the aggregate to the several general partners. In such cases, it seems that this exception should be available.

The excise tax would apply to payments received by any person who is a general partner, manager or investment advisor of a limited partnership that is a party to the transaction. It would also be imposed on payments received by any person who performs services as a broker, dealer, underwriter, promoter, investment banker or appraiser in connection with the transaction. Thus, the excise tax would apply not only to those who structure and sponsor the rollup transaction, but also to others such as brokers and appraisers who have no control over the terms of the transaction and may indeed have no reason to know that it is a transaction to which the excise tax is applicable. It does not seem that the effectiveness of the excise tax is greatly enhanced by covering this latter group.

The excise tax would apply to payments to the persons described above whenever they are made, even years after the rollup transaction has been completed, and even if they have no connection to the transaction. It appears, for example, that the excise tax would apply to any future fees paid to an individual who performed an appraisal in connection with the rollup, even though the fees are paid for services unrelated to the rollup and the individual is chosen for the subsequent work through open bidding and not because of his connection with the prior rollup transaction.

* * *

In conclusion, we believe it is inappropriate to use the federal tax laws to regulate the merits of securities transactions, such as partnership rollups. We believe that any regulation of partnership rollups should be left to those with greater expertise in securities regulation.

Mr. Chairman, that concludes my prepared remarks. I will be pleased to answer questions at this time.

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
July 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 $ 20,800 million, to be issued July 25, 1991. This offering will provide about $ 2,800 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $18,006 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, July 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 $10,400 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 $17,771 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 10,400 million, to be dated July 25, 1991 and to mature January 23, 1992 (CUSIP No. 912794 XW 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 July 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 $ 620 million as agents for foreign and international monetary authorities, and $ 5,021 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

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

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

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of 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 ON DELIVERY
Expected at 9:30 A.M.
July 18, 1991

STATEMENT OF THE HONORABLE
JEROME H. POWELL
ASSISTANT SECRETARY OF THE TREASURY
(DOMESTIC FINANCE)
BEFORE THE SUBCOMMITTEE ON GOVERNMENT
INFORMATION AND REGULATION OF THE
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here today to discuss the results of the Treasury's study of Government-sponsored enterprises and the Administration's legislation that will provide for more effective financial oversight of these important institutions.

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.

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 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. Legislation reflecting the approach identified in the April 1991 report has been submitted.

NB-1373

The immense size and concentration of GSE activities serve to underscore the need for effective oversight 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 the April 1991 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.

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.

Based on the Standard & Poor's 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.

Given the need for effective financial oversight of GSEs, Treasury has developed four principles of effective safety and soundness regulation. These are:

I. Financial safety and soundness regulation of GSEs must be given primacy over other public policy goals.

Regulation of GSEs involves multiple public policy 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.

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. We believe that building upon the Treasury's existing regulatory oversight of Sallie Mae, rather than creating a new bureau at the Department of Education to regulate Sallie Mae, is the best way to ensure effective financial safety and soundness regulation of Sallie Mae. This is consistent with the approach that we have followed with respect to other existing regulators of GSEs.

Single Regulator

We are aware that the General Accounting Office has suggested the option of combining oversight of all the GSEs under a single regulator. There are certainly sound arguments in favor of such an approach, and creating one regulator for all of the GSEs could, if structured correctly, result in effective oversight of these entities. However, the advantage of the Administration's proposal is that Congress does not have to create yet another new bureaucracy. The Administration's bill utilizes the specialized expertise of the existing regulatory structure and makes it more effective, which would more than offset any savings or efficiencies from a single regulator.

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 form the basis for the GSE legislation the Administration has proposed. 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 RELEASE UPON DELIVERY
Expected at 10:00 AM
July 17, 1991

STATEMENT OF
GERALD MURPHY
FISCAL ASSISTANT SECRETARY
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON GOVERNMENT OPERATIONS
GOVERNMENT INFORMATION, JUSTICE, AND AGRICULTURE SUBCOMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I welcome this opportunity to provide Treasury Department views with respect to United States Postal Service proposals to borrow, invest and bank in the commercial market.

The Postal Reorganization Act of 1970 established the Postal Service as "an independent establishment of the executive branch" (39 U.S.C. 201), but continued links designed to assure coordination of the actions of the Postal Service with the rest of Government. The Act also continued checks and balances of fiscal responsibility necessary in a Federal institution. In accordance with 39 U.S.C. 2006, Treasury has continued a close relationship with the Postal Service, providing borrowing, investment, and banking services. The Postal Service is considering recommendations for change in these relationships, based on a report prepared by a private contractor. Treasury did not participate in the contractor study, but we have had an opportunity to read the contractor's report. I would like to comment on each of the three relationship areas in turn.

BORROWING

The Postal Service is authorized to borrow up to a total of $15 billion (39 U.S.C. 2005 (a)(2)(C)), with fiscal year limits of $2 billion for capital improvements and $1 billion for operating expenses (39 U.S.C. 2005 (a)(1)). Under 39 U.S.C. 2006 (a), the Postal Service must consult with Treasury prior to issuing any obligations and Treasury has first right of refusal. Since the creation of the Federal Financing Bank (FFB) in 1973, Treasury has directed Postal Service to borrow from the FFB. (The Postal Service had one public debt issue, $250 million in 1972, which matures in 1997.)

NB-1374

The contractor report recommends that the Postal Service seek the flexibility to borrow in the market. The contractor estimates a range of savings from zero to $2 million a year, assuming that the Postal Service would have the option to borrow either from the FFB or in the market. We believe that even this modest savings estimate is overstated and that the FFB is the only appropriate borrowing source.

While borrowing in the market would appear to offer some market discipline for the Postal Service, Treasury believes that market participants would still look to the statutory line of credit and other ties the Postal Service would retain with the U. S. Government and assume that an implied Federal guarantee of such borrowings exists. This would reflect the way market participants view the Government-sponsored enterprises, which are not Federal agencies but which also benefit from their relationships with the Government; the market trades their debt as if there were an explicit Government guarantee, even though there is none by law. Thus, the expected benefits of market discipline would not be achieved. The only way to fully achieve such a goal, through severing all financial and other relationships between the Postal Service and the Government, is not realistic and is not being sought by either the Postal Service or the Administration.

However, Treasury is prepared to address certain specific requests to make Postal Service borrowings more flexible and market responsive. For example, even though the statute requires 15 days notice prior to any such borrowing, we may be able to operate with a shorter period.

INVESTMENT

Under 39 U.S.C. 2003(c), the Postal Service may request that the Secretary of the Treasury invest the portion of the Postal Service Fund that the Postal Service determines to be in excess of current needs in Government-issued or Government-guaranteed securities and, with approval by the Secretary, in non-Government securities.

The Postal Service makes daily investments in market-priced, nonmarketable Treasury securities maturing in one day to up to four years through the Treasury Financial Management Service. The rate of return for these nonmarketable securities is based on the average of market price quotations from five major dealers for similar maturity marketable securities. In this way, Treasury attempts to simulate current market conditions for those agencies authorized to invest -- without disrupting the market with numerous agency purchase and redemption transactions. The pricing information is compiled by the Federal Reserve Bank of New York. One-day certificates, which are used for short-term cash management purposes, are priced at the overnight repurchase agreement rate, also calculated by the New York Fed. The Postal Service is not charged transaction fees or fees for account administration services.

The contractor report suggests that the Postal Service can improve its rate of return by investing directly in the market and by broadening the range of investment options to include such more speculative investments as corporate securities and foreign exchange swaps. With respect to investing directly in the market, it should be noted that, based on a 1977 U. S. Attorney General opinion, "the Postal Service may only invest in Government Obligations through the Secretary of the Treasury. Since no other mode of making such investments is described...no other mode is permitted." (Letter from Attorney General Levi to Treasury Secretary Simon, January 5, 1977.)

With respect to broadening investment options, no Government-related entity should be able to borrow from the Treasury or the FFB and invest in the market so as to secure arbitrage profits, either through speculating on the yield curve or with lower quality investments. Excess borrowings from the FFB are not intended to fund an aggressive money management operation, which would expose the investing agency to a risk of loss. We do not believe this to be the intention of the Postal Service; nevertheless, opportunities for such speculation would exist if the range of investment options were broadened as proposed.

Furthermore, investment of Postal Service funds in the market in non-Federal securities would increase Treasury borrowing from the public and would be scored for budget purposes as an outlay, thereby increasing the total Federal deficit. Assuming an amount in the $1 to $4 billion range, the effect would not be insignificant.

With respect to investment methods, Treasury provides investment services for approximately 150 Federal funds and has established a number of guidelines to facilitate investment at a reasonable cost. For instance, Treasury provides the Postal Service with price quotes each day for five securities, and requires that securities other than one-day certificates must be held for at least five days. Treasury provides this investment service for Postal Service and other agencies without charge. Investing the Postal Service Fund in nonmarketable Treasury securities avoids the possibility of large dollar Postal Service transactions moving the market, causing unexpected changes in price and yield.

We do not believe these operational guidelines have a major impact on Postal Service investment results. However, it may be possible to accommodate some of the Postal Service's needs, e.g., the five-day holding period could be reduced. We understand that the Postal Service will also be looking at some of its own internal restrictions so as to better match investment maturities with long-term liabilities.

BANKING SERVICE

Under 39 U.S.C. 2003, the Postal Service Fund was established as a revolving fund in the Treasury and, unless otherwise approved by the Treasury, all Postal Service revenues must be deposited into the Fund, and all disbursements must be made from the Fund. Currently, the Postal Service initiates approximately 38 million check and Automated Clearing House payments a year from several disbursing centers. About 60% of these payments are salary payments to employees. Based on its own recent study, the Postal Service reports a cost per check of eight cents for salary and 17 cents for vendor payments. Added to that is a two cents per check cost that Treasury incurs (without reimbursement) for accounting, reconciliation, and check claims.

The contractor report suggests that transferring banking support for disbursements from Treasury to commercial banks would earn between $12 and $25 million in check float. The contractor assumed that the Postal Service Fund could gain three to five days float on checks if written on a commercial bank rather than on Treasury. (For the most part, Federal agencies do not benefit from float on Treasury checks. The major exceptions are certain large trust funds that receive check float on their regularly scheduled benefit payments.) While it is not clear to us that the use of commercial banks for this purpose would be cost beneficial, Treasury would be happy to participate in a joint study to explore payment options with the Postal Service. The study should also consider the Postal Service policy regarding the use of electronic payment methods. Use of Direct Deposit and Vendor Express, two state-of-the-art and well-tested Treasury programs, would reduce the unit cost to five cents per payment while eliminating check float.

CONCLUSION

In summary, Treasury believes that the Postal Service with its benefits as a Federal establishment and its statutory links to the credit of the United States should continue to borrow and invest through the Treasury as do other Executive branch entities. Nevertheless, Treasury recognizes that a more business-like approach to Postal Service financial activities is in keeping with its own efforts to increase productivity. Therefore, Treasury will work with the Postal Service to improve those aspects of financial management where change can be successfully accommodated without breaching the current Treasury/FFB structure of operations.

That concludes my statement, Mr. Chairman. I would be happy to answer any questions you or the Committee may have.

o 0 o

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
July 17, 1991

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR NOTES TOTALING $21,750 MILLION

The Treasury will auction $12,500 million of 2-year notes and $9,250 million of 5-year notes to refund $9,046 million of securities maturing July 31, 1991, and to raise about $12,700 million new cash. The $9,046 million of maturing securities are those held by the public, including $720 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $21,750 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 $787 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-1375

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 5-YEAR NOTES TO BE ISSUED JULY 31, 1991

July 17, 1991

<u>Amount Offered to the Public</u> ...	$12,500 million	$9,250 million
<u>Description of Security</u>:		
Term and type of security	2-year notes	5-year notes
Series and CUSIP designation ...	Series AD-1993 (CUSIP No. 912827 B6 8)	Series R-1996 (CUSIP No. 912827 B7 6)
Maturity date	July 31, 1993	July 31, 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	January 31 and July 31	January 31 and July 31
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	Tuesday, July 23, 1991	Wednesday, July 24, 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 ...	Wednesday, July 31, 1991	Wednesday, July 31, 1991
b) readily-collectible check ...	Monday, July 29, 1991	Monday, July 29, 1991

London Economic Summit 1991

ECONOMIC DECLARATION

BUILDING WORLD PARTNERSHIP

1. We, the Heads of State and Government of the seven major industrial democracies and the representatives of the European Community, met in London for our seventeenth annual Summit.

2. The spread of freedom and democracy which we celebrated at Houston has gathered pace over the last year. Together the international community has overcome a major threat to world peace in the Gulf. But new challenges and new opportunities confront us.

3. We seek to build world partnership, based on common values, and to strengthen the international order. Our aim is to underpin democracy, human rights, the rule of law and sound economic management, which together provide the key to prosperity. To achieve this aim, we will promote a truly multilateral system, which is secure and adaptable and in which responsibility is shared widely and equitably. Central to our aim is the need for a stronger, more effective UN system, and for greater attention to the proliferation and transfer of weapons.

Economic policy

4. Over the last year, some of our economies have maintained good growth, while most have slowed down and some gone into recession. But a global recession has been avoided. The uncertainty created by the Gulf crisis is behind us. We welcome the fact that there are now increasing signs of economic recovery. Progress has been made too in reducing the largest trade and current account imbalances.

5. Our shared objectives are a sustained recovery and price stability. To this end, we are determined to maintain, including through our economic policy coordination process, the medium-term strategy endorsed by earlier Summits. This strategy has contained inflationary expectations and created the conditions for sustainable growth and new jobs.

6. We therefore commit ourselves to implement fiscal and monetary policies, which, while reflecting the different situations in our countries, provide the basis for lower real interest rates. In this connection, continued progress in reducing budget deficits is essential. This, together with the efforts being made to reduce impediments to private saving, will help generate the increase in global savings needed to meet demands for investment. We also welcome the close cooperation on exchange markets and the work to improve the functioning of the international monetary system.

7. We will also, with the help of the Organisation for Economic Co-operation and Development (OECD) and other institutions, pursue reforms to improve economic efficiency and thus the potential for growth. These include:-

a) greater competition in our economies, including regulatory reform. This can enhance consumer choice, reduce prices and ease burdens on business.

b) greater transparency, elimination or enhanced discipline in subsidies that have distorting effects, since such subsidies lead to inefficient allocation of resources and inflate public expenditure.

c) improved education and training, to enhance the skills and improve the opportunities of those both in and out of employment, as well as policies contributing to greater flexibility in the employment system.

d) a more efficient public sector, for example through higher standards of management and including possibilities for privatisation and contracting out.

e) the wide and rapid diffusion of advances in science and technology.

f) essential investment, both private and public, in infrastructure.

8. We will encourage work nationally and internationally to develop cost-effective economic instruments for protecting the environment, such as taxes, charges and tradeable permits.

International trade

9. No issue has more far-reaching implications for the future prospects of the world economy than the successful conclusion of the Uruguay Round. It will stimulate non-inflationary growth by bolstering confidence, reversing protectionism and increasing trade flows. It will be essential to encourage the integration of developing countries and Central and East European nations into the multilateral trading system. All these benefits will be lost if we cannot conclude the Round.

10. We therefore commit ourselves to an ambitious, global and balanced package of results from the Round, with the widest possible participation by both developed and developing countries. The aim of all contracting parties should be to complete the Round before the end of 1991. We shall each remain personally involved in this process, ready to intervene with one another if differences can only be resolved at the highest level.

11. To achieve our objectives, sustained progress will be needed in the negotiations at Geneva in all areas over the rest of this year. The principal requirement is to move forward urgently in the following areas taken together:-

a) market access, where it is necessary, in particular, to cut tariff peaks for some products while moving to zero tariffs for others, as part of a substantial reduction of tariffs and parallel action against non-tariff barriers.

b) agriculture, where a framework must be decided upon to provide for specific binding commitments in domestic support, market access and export competition, so that substantial progressive reductions of support and protection may be agreed in each area, taking into account non-trade concerns.

c) services, where accord on a general agreement on trade in services should be reinforced by substantial and binding initial commitments to reduce or remove existing restrictions on services trade and not to impose new ones.

(d) intellectual property, where clear and enforceable rules and obligations to protect all property rights are necessary to encourage investment and the spread of technology.

12. Progress on these issues will encourage final agreement in areas already close to conclusion, such as textiles, tropical products, safeguards and dispute settlement. Agreement to an improved dispute settlement mechanism should lead to a commitment to operate only under the multilateral rules. Taken all together, these and the other elements of the negotiations, including GATT rule-making, should amount to the substantial, wide-ranging package which we seek.

13. We will seek to ensure that regional integration is compatible with the multilateral trading system.

14. As we noted at Houston, a successful outcome of the Uruguay Round will also call for the institutional reinforcement of the multilateral trading system. The concept of an international trade organisation should be addressed in

this context.

15. Open markets help to create the resources needed to protect the environment. We therefore commend the OECD's pioneering work in ensuring that trade and environment policies are mutually supporting. We look to the General Agreement on Tariffs and Trade (GATT) to define how trade measures can properly be used for environmental purposes.

16. We are convinced that OECD members must overcome in the near future and, in any case, by the end of the year, remaining obstacles to an agreement on reducing the distortions that result from the use of subsidised export credits and of tied aid credits. We welcome the initiative of the OECD in studying export credit premium systems and structures and look forward to an early report.

Energy

17. As the Gulf crisis showed, the supply and price of oil remain vulnerable to political shocks, which disturb the world economy. But these shocks have been contained by the effective operation of the market, by the welcome increase in supplies by certain oil-exporting countries and by the actions co-ordinated by the International Energy Agency (IEA), particularly the use of stocks. We are committed to strengthen the IEA's emergency preparedness and its supporting measures. Since the crisis has led to improved relations between producers and consumers, contacts among all market participants could be further developed to promote communication, transparency and the efficient working of market forces.

18. We will work to secure stable worldwide energy supplies, to remove barriers to energy trade and investment, to encourage high environmental and safety standards and to promote international cooperation on research and development in all these areas. We will also seek to improve energy efficiency and to price energy from all sources so as to reflect costs fully, including environmental costs.

19. In this context, nuclear power generation contributes to diversifying energy sources and reducing greenhouse gas emissions. In developing nuclear power as an economic energy source, it is essential to achieve and maintain the highest available standards of safety, including in waste management, and to encourage co-operation to this end throughout the world. The safety situation in Central and Eastern Europe and the Soviet Union deserves particular attention. This is an urgent problem and we call upon the international community to develop an effective means of coordinating its response.

20. The commercial development of renewable energy sources and their integration with general energy systems should also be encouraged, because of the advantages these sources offer for environmental protection and energy security.

21. We all intend to take a full part in the initiative of the European Community for the establishment of a European Energy Charter on the basis of equal rights and obligations of signatory countries. The aim is to promote free and undistorted energy trade, to enhance security of supply, to protect the environment and to assist economic reform in Central and East European countries and the Soviet Union, especially by creating an open, non-discriminatory regime for commercial energy investment.

Central and Eastern Europe

22. We salute the courage and determination of the countries of Central and Eastern Europe in building democracy and moving to market economies, despite formidable obstacles. We welcome the spread of political and economic reform throughout the region. These changes are of great historical importance. Bulgaria and Romania are now following the pioneering advances of Poland, Hungary and Czechoslovakia. Albania is emerging from its long isolation.

23. Recognising that successful reform depends principally on the continuing efforts of the countries concerned, we renew our own firm commitment to support their reform efforts, to forge closer ties with them and to encourage their integration into the international economic system. Regional initiatives reinforce our ability to co-operate.

24. All the Central and East European countries except Albania are now members of the International Monetary Fund (IMF) and the World Bank. We welcome the steps being taken by those countries that are implementing IMF-supported programmes of macro-economic stabilisation. It is crucial that these programmes are complemented by structural reforms, such as privatising and restructuring state-owned enterprises, increasing competition and strengthening property rights. We welcome the establishment of the European Bank for Reconstruction and Development (EBRD), which has a mandate to foster the transition to open, market-oriented economies and to promote private initiative in Central and East European countries committed to democracy.

25. A favourable environment for private investment, both foreign and domestic, is crucial for sustained growth and for avoiding dependence on external assistance from governments. In this respect, technical assistance from our private sectors and governments, the European Community and international institutions should concentrate on helping this essential market-based transformation. In this context, we emphasise the importance of integrating environmental considerations into the economic restructuring process in Central and Eastern Europe.

26. Expanding markets for their exports are vital for the Central and East European countries. We welcome the

substantial increases already made in exports to market economies and we undertake to improve further their access to our markets for their products and services, including in areas such as steel, textiles and agricultural produce. In this context, we welcome the progress made in negotiating Association Agreements between the European Community and Poland, Hungary and Czechoslovakia, as well as the Presidential Trade Enhancement Initiative announced by the United States, all of which will be in accordance with GATT principles. We will support the work of the OECD to identify restrictions to East/West trade and to facilitate their removal.

27. The Group of Twenty-four (G24) process, inaugurated by the Arch Summit and chaired by the European Commission, has mobilised $31 billion in bilateral support for these countries, including balance of payments finance to underpin IMF-supported programmes. Such programmes are in place for Poland, Hungary and Czechoslovakia. We welcome the contributions already made for Bulgaria and Romania. We are intensifying the G24 coordination process and we reaffirm our shared willingness to play our fair part in the global assistance effort.

The Soviet Union

28. We support the moves towards political and economic transformation in the Soviet Union and are ready to assist the integration of the Soviet Union into the world economy.

29. Reform to develop the market economy is essential to create incentives for change and enable the Soviet people to mobilise their own substantial natural and human resources. A clear and agreed framework within which the centre and the republics exercise their respective responsibilities is fundamental for the success of political and economic reform.

30. We have invited President Gorbachev to meet us for a discussion of reform policies and their implementation, as well as ways in which we can encourage this process.

31. We commend the IMF, World Bank, OECD and EBRD for their study of the Soviet economy produced, in close consultation with the European Commission, in response to the request we made at Houston. This study sets out many of the elements necessary for successful economic reform, which include fiscal and monetary discipline and creating the framework of a market economy.

32. We are sensitive to the overall political context in which reforms are being conducted, including the "New Thinking" in Soviet foreign policy around the world. We are sensitive also to the importance of shifting resources from military to civilian use.

33. We are concerned about the deterioration of the Soviet economy, which creates severe hardship not only within the

Soviet Union but also for the countries of Central and Eastern Europe.

The Middle East

34. Many countries have suffered economically as a result of the Gulf crisis. We welcome the success of the Gulf Crisis Financial Co-ordination Group in mobilising nearly $16 billion of assistance for those countries suffering the most direct economic impact of the Gulf crisis and urge all donors to complete disbursements rapidly. Extensive assistance is being provided by Summit participants for the Mediterranean and the Middle East, as well as by the IMF and World Bank.

35. We believe that enhanced economic co-operation in this area, on the basis of the principles of non-discrimination and open trade, could help repair the damage and reinforce political stability. We welcome the plans of major oil exporting countries for providing financial assistance to others in the region and their decision to establish a Gulf Development Fund. We support closer links between the international financial institutions and Arab and other donors. We believe this would encourage necessary economic reforms, promote efficient use of financial flows, foster private sector investment, stimulate trade liberalisation and facilitate joint projects e.g. in water management, which would draw on our technical skills and expertise.

Developing Countries and Debt

36. Developing countries are playing an increasingly constructive role in the international economic system, including the Uruguay Round. Many have introduced radical policy reforms and are adopting the following principles:

(a) respect for human rights and for the law, which encourages individuals to contribute to development;

(b) democratic pluralism and open systems of administration, accountable to the public;

(c) sound, market-based economic policies to sustain development and bring people out of poverty;

We commend these countries and urge others to follow their example. Good governance not only promotes development at home, but helps to attract external finance and investment from all sources.

37. Our steadfast commitment to helping developing countries, in conjunction with a durable non-inflationary recovery of our economies and the opening of our markets, will be the most effective way we have of enhancing prosperity in the developing world.

38. Many of these countries, especially the poorest, need our financial and technical assistance to buttress their own development endeavours. Additional aid efforts are required, to enhance both the quantity and the quality of our support for priority development issues. These include alleviating poverty, improving health, education and training and enhancing the environmental quality of our aid. We endorse the increasing attention being given to population issues in devising strategies for sustainable progress.

39. Africa deserves our special attention. Progress by African governments towards sound economic policies, democracy and accountability is improving their prospects for growth. This is being helped by our continued support, focused on stimulating development of the private sector, encouraging regional integration, providing concessional flows and reducing debt burdens. The Special Programme of Assistance for Africa, co-ordinated by the World Bank and providing support for economic reform in over 20 African countries, is proving its worth. We will provide humanitarian assistance to those parts of Africa facing severe famine and encourage the reform of United Nations structures in order to make this assistance more effective. We will also work to help the countries concerned remove the underlying causes of famine and other emergencies, whether these are natural or provoked by civil strife.

40. In the Asia-Pacific region, many economies, including members of the Association of South-East Asian Nations (ASEAN) and the Asia-Pacific Economic Co-operation (APEC), continue to achieve dynamic growth. We welcome the efforts by those economies of the region which are assuming new international responsibilities. Other Asian countries, which are strengthening their reform efforts, continue to need external assistance.

41. In Latin America we are encouraged by the progress being made in carrying out genuine economic reforms and by developments in regional integration. We welcome the continuing discussions on the Multilateral Investment Fund, under the Enterprise for the Americas Initiative which, together with other efforts, is helping to create the right climate for direct investment, freer trade and a reversal of capital flight.

42. We recognise with satisfaction the progress being made under the strengthened debt strategy. Some countries have already benefited from the combination of strong adjustment with commercial bank debt reduction or equivalent measures. We encourage other countries with heavy debts to banks to negotiate similar packages.

43. We note:

(a) the agreement reached by the Paris Club on debt reduction or equivalent measures for Poland and Egypt, which should be treated as exceptional cases;

(b) the Paris Club's continued examination of the special situation of some lower middle-income countries on a case by case basis.

44. The poorest, most indebted countries need very special terms. We agree on the need for additional debt relief measures, on a case by case basis, for these countries, going well beyond the relief already granted under Toronto terms. We therefore call on the Paris Club to continue its discussions on how these measures can best be implemented promptly.

45. We recognise the need for appropriate new financial flows to developing countries. We believe the appropriate way to avoid unsustainable levels of debt is for developing countries to adopt strengthened policies to attract direct investment and the return of flight capital.

46. We note the key role of the IMF, whose resources should be strengthened by the early implementation of the quota increase under the Ninth General Review and the associated Third Amendment to the Articles of Agreement.

Environment

47. The international community will face formidable environmental challenges in the coming decade. Managing the environment continues to be a priority issue for us. Our economic policies should ensure that the use of this planet's resources is sustainable and safeguards the interests of both present and future generations. Growing market economies can best mobilise the means for protecting the environment, while democratic systems ensure proper accountability.

48. Environmental considerations should be integrated into the full range of government policies, in a way which reflects their economic costs. We support the valuable work in this field being undertaken by the OECD. This includes the systematic review of member countries' environmental performance and the development of environmental indicators for use in decision-making.

49. Internationally, we must develop a co-operative approach for tackling environmental issues. Industrial countries should set an example and thus encourage developing countries and Central and East European nations to play their part. Co-operation is also required on regional problems. In this context, we welcome the consensus reached on the Environmental Protocol of the Antarctic Treaty, aimed at reinforcing the environmental preservation of this continent. We note the good progress of the Sahara and Sahel Observatory as well as the Budapest Environmental Centre.

50. The UN Conference on Environment and Development (UNCED)

in June 1992 will be a landmark event. It will mark the climax of many international environmental negotiations. We commit ourselves to work for a successful Conference and to give the necessary political impetus to its preparation.

51. We aim to achieve the following by the time of UNCED:-

a) an effective framework convention on climate change, containing appropriate commitments and addressing all sources and sinks for greenhouse gases. We will seek to expedite work on implementing protocols to reinforce the convention. All participants should be committed to design and implement concrete strategies to limit net emissions of greenhouse gases, with measures to facilitate adaptation. Significant actions by industrial countries will encourage the participation of developing and East European countries, which is essential to the negotiations.

b) agreement on principles for the management, conservation and sustainable development of all types of forest, leading to a framework convention. This should be in a form both acceptable to the developing countries where tropical forests grow and consistent with the objective of a global forest convention or agreement which we set at Houston.

52. We will seek to promote, in the context of UNCED:

a) mobilisation of financial resources to help developing countries tackle environmental problems. We support the use of existing mechanisms for this purpose, in particular the Global Environment Facility (GEF). The GEF could become the comprehensive funding mechanism to help developing countries meet their obligations under the new environmental conventions.

b) encouragement of an improved flow of beneficial technology to developing countries, making use of commercial mechanisms.

c) a comprehensive approach to the oceans, including regional seas. The environmental and economic importance of oceans and seas means that they must be protected and sustainably managed.

d) further development of international law of the environment, drawing inter alia on the results of the Siena Forum.

e) the reinforcement of international institutions concerned with the environment, including the United Nations Environment Programme (UNEP), for the decade ahead.

53. We support the negotiation, under the auspices of UNEP, of an acceptable framework convention on biodiversity, if possible to be concluded next year. It should concentrate on protecting ecosystems, particularly in species-rich areas, without impeding positive developments in biotechnology.

54. We remain concerned about the destruction of tropical forests. We welcome the progress made in developing the pilot programme for the conservation of the Brazilian tropical forest, which has been prepared by the Government of Brazil in consultation with the World Bank and the European Commission, in response to the offer of co-operation extended following the Houston Summit. We call for further urgent work under the auspices of the World Bank, in co-operation with the European Commission, in the framework of appropriate policies and with careful attention to economic, technical and social issues. We will financially support the implementation of the preliminary stage of the pilot programme utilising all potential sources, including the private sector, non-governmental organisations, the multilateral development banks, and the Global Environmental Facility. When details of the programme have been resolved, we will consider supplementing these resources with bilateral assistance, so that progress can be made on the ground. We believe that good progress with this project will have a beneficial impact on the treatment of forests at UNCED. We also welcome the spread of debt for nature exchanges, with an emphasis on forests.

55. The burning oil wells and polluted seas in the Gulf have shown that we need greater international capacity to prevent and respond to environmental disasters. All international and regional agreements for this purpose, including those of the International Maritime Organisation (IMO), should be fully implemented. We welcome the decision by UNEP to establish an experimental centre for urgent environmental assistance. In the light of the recent storm damage in Bangladesh, we encourage the work on flood alleviation under the auspices of the World Bank, which we called for at the Arch Summit.

56. Living marine resources threatened by over-fishing and other harmful practices should be protected by the implementation of measures in accordance with international law. We urge control of marine pollution and compliance with the regimes established by regional fisheries organisations through effective monitoring and enforcement measures.

57. We call for greater efforts in co-operation in environmental science and technology, in particular:-

a) scientific research into the global climate, including satellite monitoring and ocean observation. All countries, including developing countries, should be involved in this research effort. We welcome the development of information services for users of earth observation data since the Houston Summit.

b) the development and diffusion of energy and environment technologies, including proposals for innovative technology programmes.

Drugs

58. We note with satisfaction progress made in this field since our Houston meeting, notably the entry into force of the 1988 United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychiatric Substances. We welcome the formation of the United Nations International Drugs Control Programme (UNDCP).

59. We will increase our efforts to reduce the demand for drugs as a part of overall anti-drug action programmes. We maintain our efforts to combat the scourge of cocaine and will match these by increased attention to heroin, still the principal hard drug in Europe and Asia. Enhanced co-operation is needed both to reduce production of heroin in Asia and to check its flow into Europe. Political changes in Central and Eastern Europe and the opening of frontiers there have increased the threat of drug misuse and facilitated illicit trafficking, but have also given greater scope for concerted Europe-wide action against drugs.

60. We applaud the efforts of the "Dublin Group" of European, North American and Asian governments to focus attention and resources on the problems of narcotics production and trafficking.

61. We commend the achievements of the task-forces initiated by previous Summits and supported by an increasing number of countries:-

a) We urge all countries to take part in the international fight against money laundering and to cooperate with the activities of the Financial Action Task Force (FATF). We strongly support the agreement on a mutual evaluation process of each participating country's progress in implementing the FATF recommendations on money laundering. We endorse the recommendation of the FATF that it should operate on a continuing basis with a secretariat supplied by the OECD.

b) We welcome the report of the Chemical Action Task Force (CATF) and endorse the measures it recommends for countering chemical diversion, building on the 1988 UN Convention against drug trafficking. We look forward to the special meeting in Asia, concentrating on heroin, and the CATF meeting due in March 1992, which should consider the institutional future of this work.

62. We are concerned to improve the capacity of law

enforcement agencies to target illicit drug movements without hindering the legitimate circulation of persons and goods. We invite the Customs Cooperation Council to strengthen its cooperation with associations of international traders and carriers for this purpose and to produce a report before our next Summit.

Migration

63. Migration has made and can make a valuable contribution to economic and social development, under appropriate conditions, although there is a growing concern about worldwide migratory pressures, which are due to a variety of political, social and economic factors. We welcome the increased attention being given these issues by the OECD and may wish to return to them at a future Summit.

Next meeting

64. We have accepted an invitation from Chancellor Kohl to hold our next Summit in Munich, Germany in July 1992.

17 July 1991

TREASURY NEWS

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

FOR RELEASE ON DELIVERY
Expected at 10:00AM
July 18, 1991

STATEMENT OF
THE HONORABLE ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY FOR FINANCE
BEFORE THE
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here today to present the Administration's position on H.R. 29000, the "Government Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991" (H.R. 2900). As you know, the Administration has also submitted legislation that addresses the need for enhanced Federal supervision and increased capital of Government-sponsored Enterprises (GSEs).

I commend this subcommittee and the full House Banking Committee for its attention to this issue which is important to taxpayers. The last decade has provided harsh lessons on the need for effective control of risk-taking by financial institutions that benefit from an explicit or implicit Federal Government guarantee. The difficulties brought on by the insolvency of a large part of the thrift industry, the 1987 bailout of the Farm Credit System, and the recent difficulties of the Bank Insurance Fund have all focused the attention of Congress and the Administration on other areas of taxpayer exposure to financial risk. GSEs, because of their size and the marketplace perception of an implicit Federal guarantee, are financial institutions whose safety and soundness must be of prime concern to public policymakers. The long-term financial viability of the three largest GSEs, Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System, is a special responsibility of this subcommittee. The outstanding obligations of these housing GSEs represent approximately 90 percent of the total outstanding financial obligations of all of the GSEs.

As we reported to the full House Banking Committee earlier this year, based on the analysis conducted for Treasury by the Standard & Poor's Corporation, we have concluded that none of the housing GSEs poses an imminent financial threat to the taxpayer. Unfortunately, the lack of an immediate GSE problem has caused some to suggest "if it ain't broken, don't fix it." We, however, believe that complacency would be inappropriate. The financially devastating failure of many federally insured thrift institutions in the 1980s was preceded by many years of profitability of these institutions. Similarly, the weakness of many insured banks comes as an unpleasant surprise after years of apparent profits. The luxury of waiting until a financial crisis is painfully evident has now clearly been seen as costly and difficult for the American taxpayer. This subcommittee recognizes that the most prudent policy goal is to establish an effective regulatory framework that will significantly reduce the possibility of another financially painful government rescue.

All of the various GSE studies conducted over the last two years point to the need for more effective supervision of GSEs and a strong cushion of shareholder capital to avoid unforeseen risk to the taxpayer. These considerations provided the basis for the Administration's legislative proposal and should, as well, for this subcommittee's legislation.

The Administration has several concerns about H.R. 2900. These concerns include the lack of primacy for safety and soundness regulation, weaker prompt corrective action and general enforcement powers, the inclusion of an affordable housing program and, most importantly, the proposed capital standards. Because appropriate capital standards are at the heart of responsible GSE legislation, I will use the remainder of my statement to discuss our specific concerns about the proposed capital standards.

<u>Capital Standards</u>

The ability of the regulator to establish and enforce appropriate capital standards for Fannie Mae and Freddie Mac is the single most important regulatory tool needed to ensure their financial safety and soundness. The capital standards proposed in H.R. 2900 are a serious concern for two principal reasons. First, the proposed capital levels are significantly weaker than those in the Administration's bill. Second, the regulator does not have statutory discretion in determining appropriate capital standards.

The minimum capital standard, or leverage ratio, in H.R. 2900 is lower than that in the Administration's proposal, even though, as of June 30, 1991, Fannie Mae already clears the Administration's hurdle by $100 million, and Freddie Mac, short by $241 million, is expected to meet this requirement from retained earnings within one year.

However, the most glaring weakness is the risk-based capital standard that represents the highest level of capital deemed appropriate for Fannie Mae and Freddie Mac. The risk-based capital level in H.R 2900 is actually lower, by $23 million according to Freddie Mac's own analysis, than the minimum capital level in the Administration proposal. (See attached table.)

H.R. 2900 also eliminates most of the Director's discretion in establishing adequate capital standards, by "hardwiring" in statute the critical assumptions to be used in the stress test. This causes two problems. First, it limits the Director to using stress test methodology, which is very sensitive to changes in parameters, rather than a range of tests based on different methodologies and other market-sensitive indicators. For example, Freddie Mac's own analysis indicates that a change of only 5 percentage points in two critical assumptions, the loss rates upon default and fixed-rate loan prepayment rates, can result in a swing in equity capital requirements of $1.2 billion, or almost one half of its current equity.

Second, the Director would also have no flexibility in choosing parameters, because the worst-case scenario would be already dictated in statute. The Director could not then alter the scenario until after a more stressful housing environment has been experienced and identified, which may well be too late. If this bill had become law in 1980, the worst-case scenario used would have been 1973, but this would have been replaced two years later by events, the 1981-1984 Texas experience that quickly became the newest worst-case scenario.

What needs to be done in this case is what we and the House Banking Committee have done in banking regulation -- give the regulator flexibility, both with regard to methodology and the choice of scenario and resulting parameters. The Director must have flexibility to adopt new methods of analysis which reflect evolving markets and financial instruments and require that Fannie Mae and Freddie Mac be able to survive in a variety of severe, but still plausible, economic environments.

Why would there be opposition to the regulatory flexibility in the Administration's bill and which has traditionally been given to financial regulators? Fannie Mae and Freddie Mac say that the regulator will set the capital standards too high, thereby denying homebuyers mortgages at reasonable costs. We disagree, and I believe the facts support our case. First, demands for such higher capital should rightfully come from the shareholders not the homeowners. The shareholders of Fannie Mae, for example, have benefitted from a corporate return on equity exceeding 25 percent on average for the last four years (1987-1990), which has translated into a return for its shareholders in excess of 80 percent per year for the last three years to date (representing higher stock prices and dividends). It would surely be possible to retain or raise significant funds to increase capital without causing shareholders to suffer significant distress. In fact, Fannie Mae and Freddie Mac's own internal estimates of their earnings and capital levels over the next three years indicate they will have no difficulty in meeting, through retained earnings, the Administration's critical capital level, minimum leverage ratio, and any reasonable risk-based capital level. Further, based on their track record and earnings performance, these two GSEs could easily raise additional capital through equity offerings. GAO corroborates this general view when it writes in its most recent GSE study, "We believe it is possible for Fannie Mae and Freddie Mac to meet increased capital requirements without any resulting increase in mortgage rates." These are powerful arguments against dilution of the Administration's proposed capital standards. We do not have to choose between the taxpayer and the homeowner; we can do both -- protect the taxpayer while offering the homeowner mortgage money at fair rates.

If the GSEs have undue concern that the Director will be too zealous in carrying out the prescribed duties by setting the risk-based capital standard too high, each GSE can avail itself of the safe harbor that the Administration built into its proposal. This safe harbor would allow the GSE to be deemed to meet the minimum risk-based capital standard.

<u>Conclusion</u>

In conclusion, let us learn at least one lesson from spending $200 billion on the savings and loan debacle -- that meaningful capital standards, when the taxpayer could be at risk, must be maintained. GSE capital standards must be sufficient to make those enterprises safe to avoid potential risk to the taxpayer. Anything less would be a failure in our responsibility to the taxpayer. The Administration will not support the imposition of capital standards which appear to have teeth but in fact do not provide sufficient protection.

Mr. Chairman, the housing agencies are the largest and most visible of the GSEs. The legislation drafted to deal with these agencies will set the standards for the other GSEs. Because these GSEs have established such credible records in the investor marketplace, we have the opportunity to demand that they build strong enough balance sheets to protect taxpayers and at the same time deliver their services at rates which make mortgages available at reasonable cost to homeowners. We do not have to choose between protecting the taxpayer and protecting the homeowner, and we should not.

That concludes my statement. I would be happy to answer any questions the subcommittee might have.

0o0

Freddie Mac's Internal Estimation of House Bill's Risk–based Capital Requirements
Includes Total Requirement for Credit, Interest Rate, and M&O risks (Year–end 1990)

Major Assumptions	A	B	C	Base Case	D	E	F
Loss rates upon default*:	25%	30%	30%	30%	30%	35%	35%
Prepayment rates on fixed rates:	30%	25%	30%	30%	35%	30%	35%
Prepayments on ARMs:	20%	20%	15%	20%	25%	20%	20%

Additional Assumptions

National losses equal worst 3–yr regional experience (set in statute)

All losses occur over 8–yr. period (set in statute)

50% reduction in interest rates (set in statute)

20% additional capital for M&O risk (set in statute)

No new business

Dividends equal to 20% of income

Mortgage insurance disappears in years 7 and 8

Output of Freddie Mac's Model ($ mil.)	A	B	C	Base Case	D	E	F
Primary capital surplus/deficit	358	301	(182)	(279)	(1069)	(916)	(1496)
Equity (core) capital surplus/deficit	(262)	(319)	(802)	(899)	(1689)	(1536)	(2116)

Memo:

	Base Case	
House Bill's Statutory GAAP Leverage Ratio		
Equity capital surplus/deficit ($ mil.) (1.5% of on–balance sheet assets, 0.5% of UPB of MBS)	(54)	(19) 2nd Qtr. 1991
Administration's Statutory GAAP Leverage Ratio		
Equity capital surplus/deficit ($ mil.) (2.50% of on–balance sheet assets, 0.45% of face value of MBS)	(302)	(241) 2nd Qtr. 1991

Note: Year–end 1990 primary capital totaled $2,756 million: $2,136 million in equity and $620 million in reserves.
2nd Qtr. 1991 primary capital totaled $3,005 million: $2,333 million in equity and $672 million in reserves.

* This parameter will be fixed in the statute; however, the regulator may have some flexibility in setting this number due to a lack of complete cost data for mortgages originated in the early 1980s.

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
July 19, 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 $12,500 million of 364-day Treasury bills to be dated August 1, 1991 and to mature July 30, 1992 (CUSIP No. 912794 YW 8). This issue will provide about $1,800 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $10,691 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, July 25, 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 August 1, 1991. In addition to the maturing 52-week bills, there are $18,085 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 $1,847 million as agents for foreign and international monetary authorities, and $7,297 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 $150 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-1377

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